DRIL-QUIP INC
Form 10-Q
October 25, 2018

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 September 30, 2018

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 every Interactive Data File required to be submitted 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 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	¨	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 October 24, 2018, the number of shares outstanding of the registrant's common stock, par value $0.01 per share, was 35,777,241.

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

	September 30, 2018	December 31, 2017
	(In thousands, except for par value and shares)	
ASSETS		
Current assets:		
Cash and cash equivalents	$424,053	$493,180
Trade receivables, net	190,437	191,629
Inventories, net	242,123	291,087
Prepaids and other current assets	40,837	32,653
Total current assets	897,450	1,008,549
Property, plant and equipment, net	292,667	284,247
Deferred income taxes	5,512	5,364
Goodwill	47,120	47,624
Intangible assets	35,535	38,408
Other assets	14,475	15,613
Total assets	$1,292,759	$1,399,805
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current liabilities:		
Accounts payable	$21,155	$33,480
Accrued income taxes	4,583	24,714
Customer prepayments	7,489	4,767
Accrued compensation	11,478	11,412
Other accrued liabilities	23,557	25,538
Total current liabilities	68,262	99,911
Deferred income taxes	3,211	3,432
Income tax payable	28,029	—
Other long-term liabilities	2,001	2,001
Total liabilities	101,503	105,344
Commitments and contingencies (Note 14)		
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, 36,152,694 and 38,132,693 shares issued and outstanding at September 30, 2018 and December 31, 2017	394	372
Additional paid-in capital	31,002	20,083
Treasury shares (at cost)	(71,107)	—
Retained earnings	1,371,368	1,400,296
Accumulated other comprehensive losses	(140,401)	(126,290)
Total stockholders' equity	1,191,256	1,294,461
Total liabilities and stockholders' equity	$1,292,759	$1,399,805

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

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

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
	(In thousands, except per share data)			
Revenues:				
Products	$63,246	$75,885	$199,010	$269,570
Services	30,011	24,461	88,281	77,928
Total revenues	93,257	100,346	287,291	347,498
Cost and expenses:				
Cost of sales:				
Products	47,859	48,761	151,290	190,214
Services	17,771	14,289	51,534	42,825
Total cost of sales	65,630	63,050	202,824	233,039
Selling, general and administrative	31,566	27,985	83,359	85,060
Engineering and product development	10,159	10,379	30,133	32,537
Impairment and other charges	—	60,968	—	60,968
Gain on sale of assets	(14)	9	(5,113)	(79)
Total costs and expenses	107,341	162,391	311,203	411,525
Operating loss	(14,084)	(62,045)	(23,912)	(64,027)
Interest income	1,893	957	5,965	2,963
Interest expense	(195)	(12)	(545)	(44)
Loss before income taxes	(12,386)	(61,100)	(18,492)	(61,108)
Income tax provision (benefit)	(2,028)	(31,840)	2,291	(31,959)
Net loss	$(10,358)	$(29,260)	$(20,783)	$(29,149)
Loss per common share:				
Basic	$(0.28)	$(0.78)	$(0.56)	$(0.78)
Diluted	$(0.28)	$(0.78)	$(0.56)	$(0.78)
Weighted average common shares outstanding:				
Basic	37,119	37,528	37,349	37,527
Diluted	37,119	37,528	37,349	37,527

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

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

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
	(In thousands)			
Net loss	$(10,358)	$(29,260)	$(20,783)	$(29,149)
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	(5,566)	13,187	(14,111)	27,786
Total comprehensive loss	$(15,924)	$(16,073)	$(34,894)	$(1,363)

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

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

	Nine months ended September 30,	
	2018	2017
	(In thousands)	
Operating activities		
Net loss	$(20,783)	$(29,149)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	25,966	32,231
Stock-based compensation expense	9,950	10,477
Impairment and other charges	—	60,968
Gain on sale of assets	(5,113)	(79)
Deferred income taxes	(914)	(31,529)
Changes in operating assets and liabilities:		
Trade receivables, net	298	21,271
Inventories, net	32,610	32,596
Prepaids and other assets	(9,675)	17,308
Accounts payable and accrued expenses	(41)	(39,359)
Other, net	309	—
Net cash provided by operating activities	32,607	74,735
Investing activities		
Purchase of property, plant and equipment	(26,683)	(19,563)
Proceeds from sale of equipment	11,244	1,160
Acquisition of business, net of cash acquired	—	(21,289)
Net cash used in investing activities	(15,439)	(39,692)
Financing activities		
Repurchase of common shares	(80,937)	—
ABL Credit Facility issuance costs	(815)	—
Proceeds from exercise of stock options	1,106	455
Net cash provided by (used in) financing activities	(80,646)	455
Effect of exchange rate changes on cash activities	(5,649)	14,050
Increase (decrease) in cash and cash equivalents	(69,127)	49,548
Cash and cash equivalents at beginning of period	493,180	423,497
Cash and cash equivalents at end of period	$424,053	$473,045

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

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DRIL-QUIP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. Organization and Principles of Consolidation

Dril-Quip, Inc., a Delaware corporation (the “Company” or “Dril-Quip”), designs, manufactures, sells and services highly engineered 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 regional headquarter locations as well as in Macae, Brazil. 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; and Dril-Quip do Brazil LTDA, located in Macae, Brazil. Other operating subsidiaries include TIW Corporation (TIW), located in Houston, Texas; DQ Holdings Pty. Ltd., located in Perth, Australia; Dril-Quip (Ghana) Ltd., located in Takoradi, Ghana; PT DQ Oilfield Services Indonesia, located in Jakarta, Indonesia; Dril-Quip (Nigeria) Ltd., located in Port Harcourt, Nigeria; Dril-Quip Egypt for Petroleum Services S.A.E., located in Alexandria, Egypt; Dril-Quip Oilfield Services (Tianjin) Co. Ltd., located in Tianjin, China, with branches in Shezhen and Beijing, China; and Dril-Quip Qatar LLC, located in Doha, Qatar; TIW de Mexico S.A. de C.V., located in Villahermosa, Mexico; TIW de Venezuela S.A., located in Anaco, Venezuela and with a registered branch located in Shushufindi, Ecuador; TIW (UK) Limited, located in Aberdeen, Scotland; TIW Hungary LLC, located in Szolnok, Hungary; and TIW International, LLC., with a registered branch located in Singapore.

On January 6, 2017, the Company acquired The Technologies Alliance Inc. d/b/a OilPatch Technologies (OPT) for approximately $20.0 million, which was integrated into the Company’s existing Western Hemisphere operations.

The condensed consolidated financial statements included herein are unaudited. The balance sheet at December 31, 2017 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 September 30, 2018 and the results of operations and comprehensive income for the three and nine months ended September 30, 2018 and 2017 and cash flows for the nine-month periods ended September 30, 2018 and 2017. 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 nine-month period ended September 30, 2018 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, 2017.

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.

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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

The Company generates revenues through the sale of products, the sale of services and the leasing of installation tools. The Company normally negotiates contracts for products, including those accounted for under the over time method, rental tools and services separately. Modifications to the scope and price of sales contracts may occur in the form of variations and change orders. 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 instead choose to use a third party or its own personnel.

Product and Service Revenues

Product and service revenues are recognized as the Company satisfies the performance obligation by transferring control of the promised good or service to the customer. Revenues are measured based on consideration specified in a contract with a customer and exclude sales incentives and amounts collected on behalf of third parties. In addition, some customers may impose contractually negotiated penalties for late delivery that are excluded from the transaction price.

Management has elected to utilize certain practical expedients allowed under Accounting Standards Codification 606, Revenue from Contracts with Customers (ASC 606). Taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer are excluded from the measurement of the transaction price. Shipping and handling activities that are performed after a customer obtains control of the good are accounted for as activities to fulfill the promise to transfer the good and thus are excluded from the transaction price.

Product revenues

The Company recognizes product revenues from two methods:

- product revenues are recognized over time as control is transferred to the customer; and
- product revenues from the sale of products that do not qualify for the over time method are recognized as point in time.

Revenues recognized under the over time method

The Company uses the over time 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;
- product requirements cannot be filled directly from the Company's standard inventory; and
- The Company has an enforceable right to payment for any work completed to date and the enforceable payment includes a reasonable profit margin.

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 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 over time 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

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within one year. At September 30, 2018 and December 31, 2017, receivables included $47.3 million and $41.0 million of unbilled receivables, respectively. For the three months ended September 30, 2018, there were eight projects representing approximately 15.7% of the Company's total revenues and approximately 23.1% of its product revenues that were accounted for using the over time method, compared to seven projects for the three months ended September 30, 2017, which represented approximately 15.0% of the Company's total revenues and approximately 20.0% of its product revenues. For the nine months ended September 30, 2018, there were 14 projects representing approximately 14.0% of the Company’s total revenues and approximately 20.3% of its product revenues that were accounted for using over time accounting, compared to eight projects for the nine months ended September 30, 2017, which represented approximately 15.0% of the Company’s total revenues and approximately 19.0% of its product revenues.

Revenues recognized under the point in time method

Revenues from the sale of standard inventory products, not accounted for under the over time method, are recorded at the point in time that the customer obtains control of the promised asset and the Company satisfies its performance obligation. This point in time recognition aligns with the time of shipment, which is when the Company typically has a present right to payment, title transfers to the customer, the customer or its carrier has physical possession and the customer has significant risks and rewards of ownership. The Company may provide product storage to some customers. Revenues for these products are recognized at the point in time that control of the product transfers to the customer, the reason for storage is requested by the customer, the product is separately identified, the product is ready for physical transfer to the customer and the Company does not have the ability to use or direct the use of the product. This point in time typically occurs when the products are moved to storage. We receive payment after control of the products has transferred to the customer.

Service revenues

The Company recognizes service revenues from two sources:

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

The Company generally does not install products for its customers, but it does provide technical advisory assistance. The Company normally negotiates contracts for products, including those accounted for under the over time 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. The contracts for these services are typically considered day-to-day.

Rework and reconditioning service revenues are recorded using the over time method based on the remaining steps that need to be completed as the refurbishment process is performed. The measurement of progress considers, among other things, the time necessary for completion of each step in the reconditioning plan, the materials to be purchased, labor and ordering procedures. We receive payment after the services have been performed by billing customers periodically (typically monthly).

Lease revenues

The Company earns lease revenues from the rental of running tools. Rental revenues are recognized within service revenues on a dayrate basis over the lease term.

Practical Expedients

We do not disclose the value of unsatisfied performance obligations for contracts with an original expected length of one year or less.

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.

Restructuring and Other Charges

In the third quarter of 2018, we initiated a global strategic analysis to better align our operations with current market conditions. As a result of this plan, during the three and nine months ended September 30, 2018, we incurred restructuring and other charges of approximately $3.7 million primarily related to employee termination benefits and consulting fees, which are included in "Selling, general and administrative" in our accompanying condensed consolidated statement of income (loss).

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Treasury Shares

On July 26, 2016, the Board of Directors authorized a share repurchase plan under which the Company can repurchase up to $100 million of its common stock. The repurchase plan has no set expiration date and any repurchased shares are expected to be cancelled. For the three-month period ended September 30, 2018, the Company purchased 1,395,521 shares under the share repurchase plan at an average price of approximately $50.95 per share totaling approximately $71.1 million, which is reflected in "Treasury shares (at cost)", in our accompanying condensed consolidated balance sheet. In May 2018, the Company purchased 219,102 shares under the share repurchase plan at an average price of approximately $44.87 per share totaling approximately $9.8 million and retired such shares, which is reflected within our retained earnings for the period ended September 30, 2018.

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: