

DRIL-QUIP INC  
Form 10-K  
February 26, 2010  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

(MARK ONE)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2009

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the transition period from            to            .

Commission file number: 001-13439

**Dril-Quip, Inc.**

(Exact name of registrant as specified in its charter)

Edgar Filing: DRIL-QUIP INC - Form 10-K

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)  
**13550 Hempstead Highway**  
**Houston, Texas**  
(Address of principal executive offices)  
**Registrant's telephone number, including area code: (713) 939-7711**

**74-2162088**  
(IRS Employer  
Identification No.)  
**77040**  
(Zip code)

**Securities registered pursuant to Section 12(b) of the Act:**

<b>Title of Each Class</b>	<b>Name of Each Exchange On Which Registered</b>
Common Stock, \$.01 par value per share	New York Stock Exchange
Rights to Purchase Series A Junior Participating	New York Stock Exchange

Preferred Stock

**Securities registered pursuant to Section 12(g) of the Act: None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined by Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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  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  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

## Edgar Filing: DRIL-QUIP INC - Form 10-K

Large accelerated filer       Accelerated filer       Non-Accelerated filer       Smaller reporting company   
(Do not check if a smaller reporting company)  
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).    Yes     No

At June 30, 2009, the aggregate market value of the registrant's Common Stock held by non-affiliates of the registrant was approximately \$1,109,000,000 based on the closing price of such stock on such date of \$38.10.

At February 23, 2010, the number of shares outstanding of registrant's Common Stock was 39,754,190.

### **DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's Proxy Statement for its 2010 Annual Meeting of Stockholders to be filed pursuant to Regulation 14A are incorporated by reference in Part III of this Form 10-K.

**Table of Contents****TABLE OF CONTENTS****PART I**

Item 1.	<u>Business</u>	2
Item 1A.	<u>Risk Factors</u>	11
Item 1B.	<u>Unresolved Staff Comments</u>	17
Item 2.	<u>Properties</u>	17
Item 3.	<u>Legal Proceedings</u>	18
Item 4.	<u>Submission of Matters to a Vote of Security Holders</u>	19
Item S-K 401(b).	<u>Executive Officers of the Registrant</u>	19

**PART II**

Item 5.	<u>Market for Registrant's Common Stock, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	20
Item 6.	<u>Selected Financial Data</u>	21
Item 7.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	22
Item 7A.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	34
Item 8.	<u>Financial Statements and Supplementary Data</u>	34
Item 9.	<u>Changes in and Disagreements With Accountants on Accounting and Financial Disclosure</u>	57
Item 9A.	<u>Controls and Procedures</u>	57
Item 9B.	<u>Other Information</u>	57

**PART III**

Item 10.	<u>Directors, Executive Officers and Corporate Governance</u>	58
Item 11.	<u>Executive Compensation</u>	58
Item 12.	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	58
Item 13.	<u>Certain Relationships and Related Transactions, and Director Independence</u>	58
Item 14.	<u>Principal Accountant Fees and Services</u>	58

**PART IV**

Item 15.	<u>Exhibits and Financial Statement Schedules</u>	59
	<u>Signatures</u>	61

**Table of Contents**

**FORWARD-LOOKING STATEMENTS**

This Annual Report on Form 10-K 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 the control of Dril-Quip, Inc. (the Company or Dril-Quip). 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. Although the Company believes that the expectations reflected in such forward-looking statements are reasonable, no assurances 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 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 this report and the following:

## Edgar Filing: DRIL-QUIP INC - Form 10-K

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;

uncertainties regarding 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;

**Table of Contents**

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, including future environmental regulations;

competitive products and pricing pressures;

fluctuations in foreign currency;

the Company's reliance on significant customers;

creditworthiness of the Company's customers;

fixed-price contracts;

the worldwide financial crisis;

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.

**PART I**

**Item 1. Business**  
**General**

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

## Edgar Filing: DRIL-QUIP INC - Form 10-K

principal products consist of subsea and surface wellheads, subsea and surface production trees, subsea control systems and manifolds, mudline hanger systems, specialty connectors and associated pipe, drilling and production riser systems, liner hangers, wellhead connectors and diverters. Dril-Quip's products are used by major integrated, large independent and foreign national oil and gas companies in offshore areas throughout the world. Dril-Quip also provides technical advisory assistance on an as-requested basis during installation of its products, as well as rework and reconditioning services for customer-owned Dril-Quip products. In addition, Dril-Quip's customers may rent or purchase running tools from the Company for use in the installation and retrieval of its products.

Dril-Quip has developed its broad line of subsea equipment, surface equipment and offshore rig equipment primarily through its internal product research and development efforts. The Company believes that it has achieved significant market share and brand name recognition with respect to its established products due to the technological capabilities, reliability, cost effectiveness and operational timesaving features of these 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



---

**Table of Contents**

Macaé, Brazil. The Company maintains additional facilities for fabrication and/or reconditioning in Norway, Denmark, China and Australia. 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 (DQE), located in Aberdeen with branches in Denmark, Norway and Holland; Dril-Quip Asia Pacific PTE Ltd. (DQAP), located in Singapore; Dril-Quip do Brasil LTDA (DQB), located in Macaé, Brazil; and Dril-Quip Holdings Pty Ltd. (DQH), located in Perth, Australia. Dril-Quip (Nigeria) Ltd. is located in Port Harcourt, Nigeria and Dril-Quip Egypt for Petroleum Services S.A.E. is located in Alexandria, Egypt. Both are wholly owned subsidiaries of DQE. Dril-Quip Oilfield Services (Tianjin) Co. Ltd. (DQT) is located in Tianjin, China. DQT is a wholly owned subsidiary of DQAP. For additional discussion of our geographic segments, please see Note 11 of Notes to Consolidated Financial Statements.

Dril-Quip markets its products through its offices and sales representatives located in the major international energy markets throughout the world. In 2009, the Company generated approximately 66% of its revenues from foreign sales compared to 69% in both 2008 and 2007.

The Company was co-founded in 1981 by Larry E. Reimert, Gary D. Smith, J. Mike Walker and an investor who is no longer affiliated with the Company. On September 23, 2009, Mr. Smith unexpectedly passed away. Together, Messrs. Reimert and Walker have over 70 years of experience in the oilfield equipment industry, essentially all of which has been with the Company and its major competitors. In addition, most of the Company's key department managers have been with the Company over 10 years.

The Company makes available free of charge on its website its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after it electronically files such reports with, or furnishes them to, the Securities and Exchange Commission (SEC). The Company's website address is [www.dril-quip.com](http://www.dril-quip.com). Except to the extent explicitly stated herein, documents and information on the Company's website are not incorporated by reference herein. Any materials we file with the SEC may be read and copied at the SEC's Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. Information concerning the Public Reference Room may be obtained by calling 1-800-SEC-0330. In addition, the SEC maintains a website ([www.sec.gov](http://www.sec.gov)) that contains reports we file with the SEC.

Additionally, the Company makes available free of charge on its internet website ([www.dril-quip.com/govern.htm](http://www.dril-quip.com/govern.htm)):

its Code of Business Conduct and Ethical Practices,

its Corporate Governance Guidelines,

its Nominating, Governance, and Compensation Committee Charter, and

its Audit Committee Charter.

Any stockholder, who so requests, may obtain a printed copy of any of these documents from the Company. Changes in or waivers to our Code of Business Conduct and Ethical Practices involving directors and executive officers of the Company will be posted on our website.

The information on the Company's website or any other website is not incorporated by reference into this Form 10-K.

**Overview and Industry Outlook**

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. The level of capital expenditures has generally been dependent upon the prevailing view of future oil and gas prices, which are influenced by numerous factors affecting the supply and demand for oil and gas, including worldwide economic activity, interest rates and the cost of capital, environmental regulation, tax policies, and the ability of

---

## **Table of Contents**

OPEC and other producing nations to set and maintain production levels and prices. Capital expenditures are also dependent on the cost of exploring for and producing oil and gas, the sale and expiration dates of offshore leases, the discovery rate of new oil and gas reserves in offshore areas and technological advances. Oil and gas prices and the level of offshore drilling and production activity have historically been characterized by significant volatility. In general, increases in oil and gas prices, rig counts and new rig construction result in an increase in demand for the Company's products and services.

Increasing oil and gas prices from 2005 through mid-2008 resulted in oil operators increasing capital spending for both exploration and development programs. As various geopolitical issues have limited the ability of oil and gas companies to invest in certain geographic areas, such as Russia and the Middle East, an increasing amount of this capital spending was in the deepwater areas. However, in mid-2008, oil and gas prices began to decline. This decline resulted in reduced capital spending by some oil and gas companies and may result in additional reductions in capital spending. The economic volatility continued in the first half of 2009 and began to stabilize somewhat in the latter half of the year. This volatility significantly impacted land drilling activity and, to a lesser degree, offshore drilling activity, particularly deep-offshore waters, where Dril-Quip products are more frequently utilized. The Company expects that the need for specialized products will continue and to date, the Company has not seen a material dropoff in demand for its products during this volatile market period. See Item 1A. Risk Factors A material or extended decline in expenditures by the oil and gas industry could significantly reduce our revenue and income.

## **Products and Services**

### *Products*

Dril-Quip designs, manufactures, fabricates, inspects, assembles, tests and markets subsea equipment, surface equipment and offshore rig equipment. The Company derived approximately 84% of its revenues from the sale of its products in 2007, 2008 and 2009. The Company's products are used to explore for oil and gas on offshore drilling rigs, such as floating rigs and jack-ups, and for drilling and production of oil and gas wells on offshore platforms, TLPs, Spars and moored vessels such as FPSOs. TLPs are floating production platforms that are connected to the ocean floor via vertical mooring tethers (called tension legs). A Spar is a floating cylindrical structure approximately six or seven times longer than its diameter and is anchored in place (like a Spar buoy). FPSOs are floating production, storage and offloading monohull moored vessels.

**Subsea Equipment.** Subsea equipment is used in the drilling and production of offshore oil and gas wells around the world. Included in the subsea equipment product line are subsea wellheads, mudline hanger systems, specialty connectors and associated pipe, subsea production trees, liner hangers, subsea control systems and subsea manifolds.

*Subsea wellheads* are pressure-containing forged and machined metal housings in which casing hangers are landed and sealed subsea to suspend casing (downhole pipe). As drilling depth increases, successively smaller diameter casing strings are installed, each suspended by an independent casing hanger. Subsea wellheads are utilized when drilling from floating drilling rigs, either semi-submersible or drillship types, and TLPs and Spars. The Company's SS-15 Big Bore Subsea Wellhead System is designed to accommodate additional casing strings installed through a conventional marine riser and a subsea blowout preventer.

*Mudline hanger systems* are used in jack-up drilling operations to support the weight of the various casing strings at the ocean floor while drilling a well. They also provide a method to disconnect the casing strings in an orderly manner at the ocean floor after the well has been drilled, and subsequently reconnect to enable production of the well by either tying it back vertically to a subsequently installed platform or by installing a subsea tree.

Large diameter weld-on *specialty connectors* (threaded or stab type) are used in offshore wells drilled from floating drilling rigs, jack-ups, fixed platforms, TLPs and Spars. Specialty connectors join lengths of conductor or large diameter (16-inch or greater) casing. Specialty connectors provide a more rapid connection than other

## **Table of Contents**

methods of connecting lengths of pipe. Connectors may be sold individually or as an assembly after being welded to sections of Company or customer supplied pipe. Dril-Quip's weld-on specialty connectors are designed to prevent cross threading and provide a quick, convenient method of joining casing joints with structural integrity compatible with casing strength.

A *subsea production tree* is an assembly composed of valves, a wellhead connector, control equipment and various other components installed on a subsea wellhead or a mudline hanger system and used to control the flow of oil and gas from a producing well. Subsea trees may be either stand alone satellite type or template mounted cluster arrangements. Both types typically produce via flowlines to a central control point located on a platform, TLP, Spar or FPSO. The use of subsea production trees has become an increasingly important method for producing wells located in hard-to-reach deepwater areas or economically marginal fields located in shallower waters. The Company is an established manufacturer of more complicated dual-bore production trees, which are used in severe service applications. In addition, Dril-Quip manufactures a patented single bore (SingleBore) subsea completion system which features a hydraulic mechanism instead of a wireline-installed mechanism that allows the operator to plug the tubing hanger annulus remotely from the surface via a hydraulic control line and subsequently unplug it when the well is put on production. This mechanism eliminates the need for an expensive multibore installation and workover riser, thereby saving both cost and installation time. Dril-Quip's guidelineless subsea production tree is used in ultra-deepwater applications. This tree features remote multiple flowline and control connections, utilizing remotely operated intervention tools. The Company's subsea production trees are generally custom designed and manufactured to customer specifications.

A *liner hanger* is used to hang-off and seal casing into a previously installed casing string in the well bore, and can provide a means of tying back the liner for production to surface. Dril-Quip has developed a state-of-the-art liner hanger system and has installed its liner hangers in a number of difficult well applications, resulting in improved industry recognition and market opportunities.

A *subsea control system* provides control of subsea trees, manifolds and other ocean floor process equipment. Dril-Quip has developed a variety of subsea control systems, including fiber optic based multiplex control systems that provide real time access to tree functions and tree equipment status. The control system can be packaged for shallow water or deepwater applications. Dril-Quip also manufactures control systems used in the installation, retrieval and workover of production equipment.

A *subsea manifold* is a structure located on the ocean floor consisting of valves, chokes, flowline connections and a control module used to collect and control the flow of oil and gas from subsea wells for delivery to a terminal.

**Surface Equipment.** Surface equipment is principally used for flow control on offshore production platforms, TLPs and Spars. Included in the Company's surface equipment product line are platform wellheads and platform production trees. Dril-Quip's development of platform wellheads and platform production trees was facilitated by adaptation of its existing subsea wellhead and tree technology to surface wellheads and trees.

*Platform wellheads* are pressure-containing forged and machined metal housings in which casing hangers are landed and sealed at the platform deck to suspend casings. The Company emphasizes the use of metal-to-metal sealing wellhead systems with operational time-saving features which can be used in high pressure, high temperature and corrosive drilling and production applications.

After installation of a wellhead, a *platform production tree*, consisting of gate valves, a wellhead connector, controls, tree cap and associated equipment, is installed on the wellhead to control and regulate oil or gas production. Platform production trees are similar to subsea production trees but utilize less complex equipment and more manual, rather than hydraulically activated, valves and connectors. Platform wellheads and platform production trees and associated equipment are designed and manufactured in accordance with customer specifications.

**Offshore Rig Equipment.** Offshore rig equipment includes drilling and completion riser systems, wellhead connectors and diverters. The *drilling riser system* consists of (i) lengths of riser pipe and associated riser

---

## **Table of Contents**

connectors that secure one to another; (ii) the telescopic joint, which connects the entire drilling riser system to the diverter at the rig and provides a means to compensate for vertical motion of the rig relative to the ocean floor; and (iii) the wellhead connector, which provides a means for remote connection and disconnection of the drilling riser system to and from the blowout preventer stack. *Completion risers* provide a vertical conduit from the subsea wellhead to a TLP, Spar or FPSO. The *wellhead connector* also provides remote connection/disconnection of the blowout preventer stack, production tree or production riser to/from the wellhead. *Diverter*s are used to provide protection from shallow gas blowouts and to divert gases off of the rig during the drilling operation.

Wellhead connectors and drilling and production riser systems are also used on both TLPs and Spars, which are being installed more frequently in deepwater applications. The principal markets for offshore rig equipment are new rigs, rig upgrades, TLPs and Spars. Diverter, drilling and production risers and wellhead connectors are generally designed and manufactured to customer specifications.

Certain products of the Company are used in potentially hazardous drilling, completion and production applications that can cause personal injury, product liability and environmental claims. See Item 1A. Risk Factors Our business involves numerous operating hazards that may not be covered by insurance. The occurrence of an event not fully covered by insurance could have a material adverse effect on the financial conditions and results of operations.

### *Services*

Services provided by Dril-Quip include technical advisory services, reconditioning of its products which are customer-owned, and rental of running tools for installation and retrieval of its products. These services are provided from the Company's worldwide locations and represented approximately 16% of revenues in each of 2007, 2008 and 2009.

*Technical Advisory.* Dril-Quip does not install products for its customers, but provides technical advisory assistance to the customer, if requested, in the installation of its products. The customer is not obligated to utilize these services and may use its own personnel or a third party to perform these services. Technical advisory services performed by the Company are negotiated and sold separately from the Company's products. These services are not a prerequisite to the sale of the Company's products as its products are fully functional on a stand alone basis. The Company's technicians provide assistance in the onsite installation of the Company's products and are available on a 24-hour call out from the Company's facilities located in Houston, Texas; Aberdeen, Scotland; Stavanger, Norway; Esbjerg, Denmark; Singapore; Perth, Australia; Macae, Brazil; Alexandria, Egypt; and Tianjin, China.

*Reconditioning.* The Company provides reconditioning of its products at its facilities in Houston, Texas; Aberdeen, Scotland; Stavanger, Norway; Singapore; and Macae, Brazil. The Company does not service, repair or recondition its competitors' products.

*Rental.* The Company rents running and installation tools for use in installing its products. These tools are used to install and retrieve the Company's products which are purchased by customers. Rental or purchase of running tools is not a condition of the sale of the Company's products and are contracted for separately from product sales and other services offered by the Company. Running tools are available from Dril-Quip's locations in Houston, Texas; Aberdeen, Scotland; Stavanger, Norway; Esbjerg, Denmark; Beverwijk, Holland; Singapore; Perth, Australia; Tianjin, China; Alexandria, Egypt; and Macae, Brazil.

### **Manufacturing**

Dril-Quip has major manufacturing facilities in Houston, Texas; Aberdeen, Scotland; Singapore; and Macae, Brazil. Each location conducts a broad variety of processes, including machining, fabrication, inspection, assembly and testing. The Houston facility provides forged and heat treated products to all the major manufacturing facilities.

## **Table of Contents**

The Company's Houston, Aberdeen and Singapore manufacturing plants are ISO 9001:2008 certified and licensed to applicable API product specifications. The Company's Macae manufacturing plant is ISO 9001:2008 certified. See Properties Major Manufacturing Facilities. Dril-Quip maintains its high standards of product quality through the use of quality assurance specialists who work with product manufacturing personnel throughout the manufacturing process by inspecting and documenting equipment as it is processed through the Company's manufacturing facilities. The Company has the capability to manufacture various products from each of its product lines at its major manufacturing facilities and believes that this localized manufacturing capability is essential in order to compete with the Company's major competitors.

The Company's manufacturing process is vertically integrated, producing a majority of its forging requirements and essentially all of its heat treatment, machining, fabrication, inspection, assembly and testing in house. The Company's primary raw material is cast steel ingots, from which it produces steel shaped forgings at its forging and heat treatment facility. The Company routinely purchases steel ingots from multiple suppliers on a purchase order basis and does not have any long-term supply contracts. The Company's Houston facility provides forgings and heat treatment for its Aberdeen, Singapore and Macae facilities. The Company's major competitors depend on outside sources for all or a substantial portion of their forging and heat treatment requirements. The Company has made significant capital investments in developing its vertically integrated manufacturing capability. Prolonged periods of low demand in the market for offshore drilling and production equipment could have a greater effect on the Company than on certain of its competitors that have not made such large capital investments in their facilities.

Dril-Quip's manufacturing facilities utilize state-of-the-art computer numerically controlled ( CNC ) machine tools and equipment, which contribute to the Company's product quality and timely delivery. The Company has also developed a cost effective, in-house machine tool rebuild capability which produces like new machine upgrades with customized features to enhance the economic manufacture of its specialized products. The Company purchases quality used machine tools as they become available and stores them at its facilities to be rebuilt and upgraded as the need arises. Rebuilding used machine tools allows for greater customization suitable for manufacturing Dril-Quip proprietary product lines. This provides the added advantage of requiring only in-house expertise for repairs and maintenance of these machines. A significant portion of the Company's manufacturing capacity growth has been through the rebuild/upgrade of quality used machine tools, including the replacement of outdated control systems with state-of-the-art CNC controls.

## **Customers**

The Company's principal customers are major integrated, large independent and foreign national oil and gas companies. Offshore drilling contractors and engineering and construction companies also represent a minor customer base. The Company's customers are generally oil and gas companies that are well-known participants in offshore exploration and production.

The Company is not dependent on any one customer or group of customers. In 2007 and 2008, the Company's top 15 customers represented approximately 51% and 45%, respectively, of total revenues, with no customer accounting for more than 10% of the Company's total revenues. In 2009, the Company's top 15 customers represented approximately 60% of total revenues, and one customer accounted for approximately 10% of the Company's total revenues. The number and variety of the Company's products required in a given year by any one customer depends upon the amount of that customer's capital expenditure budget devoted to offshore exploration and production and on the results of competitive bids for major projects. Consequently, a customer that accounts for a significant portion of revenues in one fiscal year may represent an immaterial portion of revenues in subsequent years. While the Company is not dependent on any one customer or group of customers, the loss of one or more of its significant customers could, at least on a short-term basis, have an adverse effect on the Company's results of operations.

---

## **Table of Contents**

### **Backlog**

Backlog consists of firm customer orders for which a purchase order or signed contract has been received, satisfactory credit or financing arrangements exist and delivery is scheduled. The Company's revenues for a specific period have not been directly related to its backlog as stated at a particular point in time. The Company's backlog was approximately \$429 million and \$603 million at December 31, 2007 and 2008, respectively, compared to \$563 million at December 31, 2009, an increase of approximately \$174 million, or 41%, from 2007 to 2008 and a decrease of approximately \$40 million, or 7%, from 2008 to 2009. The Company expects to fill approximately 65% of the December 31, 2009 backlog by December 31, 2010. The remaining backlog at December 31, 2009 consists of longer-term projects which are being designed and manufactured to customer specifications requiring longer lead times. Our reported backlog at December 31, 2008 and 2009 excludes \$27 million related to the MPF contract discussed in Item 3. Legal Proceedings.

The Company can give no assurance that backlog will remain at current levels. Sales of the Company's products are affected by prices for oil and natural gas, which fluctuate significantly. Additional future declines in oil and natural gas prices could reduce new customer orders, possibly causing a decline in the Company's future backlog. All of the Company's projects currently included in its backlog are subject to change and/or termination at the option of the customer. In the 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. In the past, terminations and cancellations have not been significant to the Company's overall operating results.

### **Marketing and Sales**

Dril-Quip markets its products and services throughout the world directly through its sales personnel in two domestic and fifteen international locations. In addition, in certain foreign markets where the Company does not maintain offices, it utilizes independent sales representatives to enhance its marketing and sales efforts. Some of the locations in which Dril-Quip has sales representatives are India, Mexico, Brazil, Indonesia, Malaysia, China, Turkey, Egypt, Libya, Nigeria, Qatar, Saudi Arabia and United Arab Emirates. Although they do not have authority to contractually bind the Company, these representatives market the Company's products in their respective territories in return for sales commissions. The Company also advertises its products and services in trade and technical publications targeted to its customer base. The Company also participates in industry conferences and trade shows to enhance industry awareness of its products.

The Company's customers generally order products on a purchase order basis. Orders, other than those considered to be long-term projects, are typically filled within three to six months after receipt of a purchase order, depending on the type of product and whether it is sold out of inventory or requires some customization. Contracts for certain of the Company's larger, more complex products, such as subsea production trees, drilling risers and equipment for TLPs and Spars can take a year or more to complete.

The primary factors influencing a customer's decision to purchase the Company's products are the quality, reliability and reputation of the product, price and technologically superior features. Timely delivery of equipment is also very important to customer operations and the Company maintains an experienced sales coordination staff to help assure such delivery. For large drilling and production system orders, project management teams coordinate customer needs with engineering, manufacturing and service organizations, as well as with subcontractors and vendors.

A portion of the Company's business consists of designing, manufacturing and selling equipment, as well as offering technical advisory assistance during installation of the equipment, for major projects pursuant to competitive bids. The number of such projects in any year fluctuates. The Company's profitability on such projects is critically dependent on making accurate and cost effective bids and performing efficiently in accordance with bid specifications. Various factors can adversely affect the Company's performance on individual projects, with potential material adverse effects on project profitability.

## **Table of Contents**

### **Product Development and Engineering**

The technological demands of the oil and gas industry continue to increase as offshore exploration and drilling expand into more hostile environments. Conditions encountered in these environments include well pressures of up to 15,000 psi (pounds per square inch), mixed flows of oil and gas under high pressure that may also be highly corrosive and water depths in excess of 10,000 feet. Since its founding, Dril-Quip has actively engaged in continuing product development to generate new products and improve existing products. When developing new products, the Company typically seeks to design the most technologically advanced version for a particular application to establish its reputation and qualification in that product. Thereafter, the Company leverages its expertise in the more technologically advanced product to produce less costly and complex versions of the product for less demanding applications. The Company also focuses its activities on reducing the overall cost to the customer, which includes not only the initial capital cost but also operating and installation costs associated with its products.

The Company has continually introduced new products and product enhancements since its founding in 1981. In the 1990s, the Company introduced a series of new products, including diverters, wellhead connectors, SingleBore subsea trees, improved severe service dual bore subsea trees, subsea and platform valves, platform wellheads, platform trees, subsea tree workover riser systems, drilling risers and TLP and Spar production riser systems. Since the year 2000, Dril-Quip has introduced multiple new products including liner hangers, subsea control systems and subsea manifolds.

Dril-Quip's product development work is conducted at its facilities in Houston, Texas and Aberdeen, Scotland. In addition to the work of its product development staff, the Company's application engineering staff provides engineering services to customers in connection with the design and sales of its products. The Company's ability to develop new products and maintain technological advantages is important to its future success. There can be no assurance that the Company will be able to develop new products, successfully differentiate itself from its competitors or adapt to evolving markets and technologies.

The Company believes that the success of its business depends more on the technical competence, creativity and marketing abilities of its employees than on any individual patent, trademark or copyright. Nevertheless, as part of its ongoing product development and manufacturing activities, Dril-Quip's policy has been to seek patents when appropriate on inventions concerning new products and product improvements. All patent rights for products developed by employees are assigned to the Company and almost all of the Company's products have components that are covered by patents.

Dril-Quip has numerous U.S. registered trademarks, including Dril-Quip®, Quik-Thread®, Quick-Stab®, Multi-Thread®, MS-15®, SS-15®, SS-10® and SU-90®. The Company has registered its trademarks in the countries where such registration is deemed material.

Although in the aggregate the Company's patents and trademarks are of considerable importance to the manufacturing and marketing of many of its products, the Company does not consider any single patent or trademark or group of patents or trademarks to be material to its business as a whole, except the Dril-Quip® trademark. The Company also relies on trade secret protection for its confidential and proprietary information. The Company routinely enters into confidentiality agreements with its employees and suppliers. There can be no assurance, however, that others will not independently obtain similar information or otherwise gain access to the Company's trade secrets.

### **Competition**

Dril-Quip faces significant competition from other manufacturers and suppliers of exploration and production equipment. Several of its primary competitors are diversified multinational companies with substantially larger operating staffs and greater capital resources than those of the Company and which, in many instances, have been engaged in the manufacturing business for a much longer period of time than the Company.

---

## **Table of Contents**

The Company competes principally with GE Oil and Gas (formerly Vetco Gray), and the petroleum production equipment segments of Cameron International Corporation, FMC Technologies, Inc. and Aker Solutions.

Because of their relative size and diversity of products, several of the Company's competitors have the ability to provide turnkey services for offshore drilling and production applications, which enables them to use their own products to the exclusion of Dril-Quip's products. See Item 1A. Risk Factors We may be unable to successfully compete with other manufacturers of drilling and production equipment. The Company also competes to a lesser extent with a number of other companies in various products. The principal competitive factors in the petroleum drilling and production equipment markets are quality, reliability and reputation of the product, price, technology, service and timely delivery.

### **Employees**

The total number of the Company's employees as of December 31, 2009 was 2,130. Of these, 1,288 were located in the United States. Substantially all of the Company's employees are not covered by collective bargaining agreements, and the Company considers its employee relations to be good.

The Company's operations depend in part on its ability to attract quality employees. While the Company believes that its wage and salary rates are competitive and that its relationship with its labor force is good, a significant increase in the wages and salaries paid by competing employers could result in a reduction of the Company's labor force, increases in the wage and salary rates paid by the Company or both. If either of these events were to occur, in the near-term, the profits realized by the Company from work in progress would be reduced and, in the long-term, the production capacity and profitability of the Company could be diminished and the growth potential of the Company could be impaired. See Item 1A. Risk Factors Loss of our key management or other personnel could adversely impact our business.

### **Governmental Regulations**

Many aspects of the Company's operations are affected by political developments and are subject to both domestic and foreign governmental regulations, including those relating to oilfield operations, worker safety and the protection of the environment. In addition, the Company depends on the demand for its services from the oil and gas industry and, therefore, is affected by changing taxes, price controls and other laws and regulations relating to the oil and gas industry in general, including those specifically directed to offshore operations. The adoption of laws and regulations curtailing exploration and development drilling for oil and gas for economic or other policy reasons could adversely affect the Company's operations by limiting demand for the Company's products. See Item 1A. Risk Factors Our operations and our customers' operations are subject to a variety of governmental laws and regulations that may increase our costs, limit the demand for our products and services or restrict our operations.

In recent years, increased concern has been raised over the protection of the environment. Legislation to regulate emissions of greenhouse gases has been introduced in Congress, and there has been a wide-ranging policy debate, both nationally and internationally, regarding the impact of these gases and possible means for their regulation. In addition, efforts have been made and continue to be made in the international community toward the adoption of international treaties or protocols that would address global climate change issues, such as the United Nations Climate Change Conference in Copenhagen in 2009. Also, the EPA has undertaken new efforts to collect information regarding greenhouse gas emissions and their effects. Recently, the EPA declared that certain greenhouse gases represent a danger to human health and proposed to expand its regulations relating to those emissions. Moreover, offshore drilling in certain areas has been opposed by environmental groups and, in certain areas, has been restricted. To the extent that new laws or other governmental actions prohibit or restrict offshore drilling or impose additional environmental protection requirements that result in increased costs to the oil and gas industry in general and the offshore drilling industry in particular, the business of the Company could be adversely affected. The Company cannot determine to what extent its future operations and earnings may be



## **Table of Contents**

affected by new legislation, new regulations or changes in existing regulations. See Item 1A. Risk Factors Our business and our customers businesses are subject to environmental laws and regulations that may increase our costs, limit the demand for our products and services or restrict our operations.

Based on the Company's experience to date, the Company does not currently anticipate any material adverse effect on its business or consolidated financial position as a result of future compliance with existing environmental laws and regulations controlling the discharge of materials into the environment. However, future events, such as changes in existing laws and regulations or their interpretation, more vigorous enforcement policies of regulatory agencies, or stricter or different interpretations of existing laws and regulations, may require additional expenditures by the Company, which may be material.

### **Item 1A. Risk Factors**

In this Item 1A, the terms we, our, us, and Dril-Quip used herein refer to Dril-Quip, Inc. and its subsidiaries unless otherwise indicated or as the context so requires.

#### **Our principal stockholders have the ability to significantly influence our management and affairs and matters on which shareholders may vote.**

Our principal stockholders, Larry E. Reimert and J. Mike Walker and certain entities they control, beneficially own approximately 15% of our common stock and are able to exert significant control over us. The collective ownership of Messrs. Reimert and Walker may have the effect of delaying or preventing a change of control. In addition, our principal stockholders are generally not prohibited from selling their interest in us to a third party.

#### **A material or extended decline in expenditures by the oil and gas industry could significantly reduce our revenue and income.**

Our business depends upon 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. The level of capital expenditures is generally dependent on the prevailing view of future oil and gas prices, which are influenced by numerous factors affecting the supply and demand for oil and gas, including:

worldwide economic activity;

the level of exploration and production activity;

interest rates and the cost of capital;

environmental regulation;

federal, state and foreign policies regarding exploration and development of oil and gas;

the ability of the Organization of Petroleum Exporting Countries (OPEC) to set and maintain production levels and pricing;

the cost of exploring and producing oil and gas;

## Edgar Filing: DRIL-QUIP INC - Form 10-K

the cost of developing alternative energy sources;

the sale and expiration dates of offshore leases in the United States and overseas;

the discovery rate of new oil and gas reserves in offshore areas;

technological advances; and

weather conditions.

Oil and gas prices and the level of offshore drilling and production activity have been characterized by significant volatility in recent years. Worldwide military, political and economic events have contributed to oil

---

**Table of Contents**

and natural gas price volatility and are likely to continue to do so in the future. Oil prices declined from record levels in July 2008 of over \$140 per barrel to \$45 per barrel in December 2008 and natural gas prices declined from over \$13 per thousand cubic feet to below \$6 per thousand cubic feet over the same period. Oil prices in the first six months of 2009 ranged from approximately \$34 per barrel to slightly over \$70 per barrel by the end of June 2009. In the latter half of 2009, oil prices ranged from approximately \$60 per barrel to \$80 per barrel. We expect continued volatility in both crude oil and natural gas prices as well as in the level of drilling and production related activities. Even during periods of high prices for oil and natural gas, companies exploring for oil and gas may cancel or curtail programs, or reduce their levels of capital expenditures for exploration and production for a variety of reasons. In addition, future significant or prolonged declines in hydrocarbon prices may have a material adverse effect on our results of operations.

**The unsettled conditions in the global financial system may have impacts on our business and financial condition that we currently cannot predict.**

The credit crisis and unsettled conditions in the global financial system may have an impact on our business and our financial condition. Uncertainty and turmoil in the credit markets may negatively impact the ability of our customers to finance purchases of our products and services and could result in a decrease in, or cancellation of, orders included in our backlog or adversely affect the collectability of our receivables. If the availability of credit to our customers is reduced, they may reduce their drilling and production expenditures, thereby decreasing demand for our products and services, which could have a negative impact on our financial condition. Additionally, unsettled conditions could have an impact on our suppliers, causing them to be unable to meet their obligations to us. Although we do not currently anticipate a need to access the credit markets in the short term, a prolonged constriction on future lending by banks or investors could result in higher interest rates on future debt obligations or could restrict our ability to obtain sufficient financing to meet our long-term operational and capital needs.

**Our international operations expose us to instability and changes in economic and political conditions and other risks inherent to international business, which could have a material adverse effect on our operations or financial condition.**

We have substantial international operations, with approximately 69%, 69% and 66% of our revenues derived from foreign sales in each of 2007, 2008 and 2009, respectively. We operate our business and market our products and services in all of the significant oil and gas producing areas in the world and are, therefore, subject to the risks customarily attendant to international operations and investments in foreign countries. Risks associated with our international operations include:

volatility in general economic, social and political conditions;

terrorist acts, war and civil disturbances;

expropriation or nationalization of assets;

renegotiation or nullification of existing contracts;

foreign taxation, including changes in law or interpretation of existing law;

assaults on property or personnel;

restrictive action by local governments;

foreign and domestic monetary policies;

limitations on repatriation of earnings;

travel limitations or operational problems caused by public health threats; and

changes in currency exchange rates.

Any of these risks could have an adverse effect on our ability to manufacture products abroad or the demand for our products and services in some locations. To date, we have not experienced any significant problems in

---

**Table of Contents**

foreign countries arising from local government actions or political instability, but there is no assurance that such problems will not arise in the future. Interruption of our international operations could have a material adverse effect on our overall operations.

**We are subject to taxation in many jurisdictions and there are inherent uncertainties in the final determination of our tax liabilities.**

As a result of our international operations, we are subject to taxation in many jurisdictions. Therefore, the final determination of our tax liabilities involves the interpretation of the statutes and requirements of taxing authorities worldwide. Foreign income tax returns of foreign subsidiaries and related entities are routinely examined by foreign tax authorities. These tax examinations may result in assessments of additional taxes or penalties or both. Please see Item 3. Legal Proceedings for a description of our current dispute regarding a tax assessment in Brazil.

**Our excess cash is invested in various financial instruments which may subject us to potential losses.**

We invest excess cash in various financial instruments including interest bearing accounts, money market mutual funds and funds which invest in U.S. Treasury obligations and repurchase agreements backed by U.S. Treasury obligations. However, changes in the financial markets, including interest rates, as well as the performance of the issuers, can affect the market value of our short-term investments.

**We may suffer losses as a result of foreign currency fluctuations and limitations on the ability to repatriate income or capital to the U.S.**

We conduct a portion of our business in currencies other than the United States dollar, and our operations are subject to fluctuations in foreign currency exchange rates. We cannot assure you that we will be able to protect the Company against such fluctuations in the future. Historically, we have not conducted business in countries that limit repatriation of earnings. However, as we expand our international operations, we may begin operating in countries that have such limitations. Further, we cannot assure you that the countries in which we currently operate will not adopt policies limiting repatriation of earnings in the future.

**Our business involves numerous operating hazards that may not be covered by insurance. The occurrence of an event not fully covered by insurance could have a material adverse effect on our financial conditions and results of operations.**

Our products are used in potentially hazardous drilling, completion and production applications that can cause personal injury, product liability and environmental claims. A catastrophic occurrence at a location where our equipment and/or services are used may expose us to substantial liability for personal injury, wrongful death, product liability or commercial claims. To the extent available, we maintain insurance coverage that we believe is customary in the industry. Such insurance does not, however, provide coverage for all liabilities, and we cannot assure you that our insurance coverage will be adequate to cover claims that may arise or that we will be able to maintain adequate insurance at rates we consider reasonable. The occurrence of an event not fully covered by insurance could have a material adverse effect on our results of operations, financial position and cash flows.

**We may lose money on fixed-price contracts.**

A portion of our business consists of the designing, manufacturing and selling of our equipment for major projects pursuant to competitive bids, and is performed on a fixed-price basis. Under these contracts, we are typically responsible for all cost overruns, other than the amount of any cost overruns resulting from requested changes in order specifications. Our actual costs and any gross profit realized on these fixed-price contracts will often vary from the estimated amounts on which these contracts were originally based. This may occur for various reasons, including:

errors in estimates or bidding;

---

**Table of Contents**

changes in availability and cost of labor and materials; and

variations in productivity from our original estimates.

These variations and the risks inherent in our projects may result in reduced profitability or losses on projects. Depending on the size of a project, variations from estimated contract performance could have a material adverse impact on our operating results.

**Our business could be adversely affected if we do not develop new products and secure and retain patents related to our products.**

Technology is an important component of our business and growth strategy, and our success as a company depends to a significant extent on the development and implementation of new product designs and improvements. Whether we can continue to develop systems and services and related technologies to meet evolving industry requirements and, if so, at prices acceptable to our customers will be significant factors in determining our ability to compete in the industry in which we operate. Many of our competitors are large multinational companies that may have significantly greater financial resources than we have, and they may be able to devote greater resources to research and development of new systems, services and technologies than we are able to do.

Our ability to compete effectively will also depend on our ability to continue to obtain patents on our proprietary technology and products. Although we do not consider any single patent to be material to our business as a whole, the inability to protect our future innovations through patents could have a material adverse effect.

**We may be required to recognize a charge against current earnings because of percentage-of-completion accounting.**

Revenues and profits on long-term project contracts are recognized on a percentage-of-completion basis. We calculate the percent complete and apply the percentage to determine revenues earned and the appropriate portion of total estimated costs. Accordingly, purchase order 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. To the extent that these adjustments result in a reduction or elimination of previously reported profits, we would have to recognize a charge against current earnings, which could be significant depending on the size of the project or the adjustment.

**Loss of our key management or other personnel could adversely impact our business.**

We depend on the services of our executive management team, Larry E. Reimert and J. Mike Walker. The loss of either of these officers could have a material adverse effect on our operations and financial condition. In addition, competition for skilled machinists, fabricators and technical personnel among companies that rely heavily on engineering and technology is intense, and the loss of qualified employees or an inability to attract, retain and motivate additional highly skilled employees required for the operation and expansion of our business could hinder our ability to conduct research activities successfully and develop and produce marketable products and services. A significant increase in the wages paid by competing employers could result in a reduction of our skilled labor force, increases in the wage rates paid by us or both. If either of these events were to occur, in the near-term, the profits realized by us from work in progress would be reduced and, in the long-term, our production capacity and profitability could be diminished and our growth potential could be impaired.

**Our operations and our customers' operations are subject to a variety of governmental laws and regulations that may increase our costs, limit the demand for our products and services or restrict our operations.**

Our business and our customers' businesses may be significantly affected by:

federal, state and local and foreign laws and other regulations relating to the oilfield operations, worker safety and the protection of the environment;

---

**Table of Contents**

changes in these laws and regulations; and

the level of enforcement of these laws and regulations.

In addition, we depend on the demand for our products and services from the oil and gas industry. This demand is affected by changing taxes, price controls and other laws and regulations relating to the oil and gas industry in general, including those specifically directed to offshore operations. For example, the adoption of laws and regulations curtailing exploration and development drilling for oil and gas for economic or other policy reasons could adversely affect our operations by limiting demand for our products. We cannot determine the extent to which our future operations and earnings may be affected by new legislation, new regulations or changes in existing regulations.

Because of our foreign operations and sales, we are also subject to changes in foreign laws and regulations that may encourage or require hiring of local contractors or require foreign contractors to employ citizens of, or purchase supplies from, a particular jurisdiction. If we fail to comply with any applicable law or regulation, our business, results of operations or financial condition may be adversely affected.

**Our businesses and our customers' businesses are subject to environmental laws and regulations that may increase our costs, limit the demand for our products and services or restrict our operations.**

Our operations and the operations of our customers are also subject to federal, state, local and foreign laws and regulations relating to the protection of the environment. These environmental laws and regulations affect the products and services we design, market and sell, as well as the facilities where we manufacture our products. In addition, environmental laws and regulations could limit our customers' exploration and production activities. We are required to invest financial and managerial resources to comply with environmental laws and regulations and anticipate that we will continue to be required to do so in the future. These laws and regulations change frequently, which makes it impossible for us to predict their cost or impact on our future operations. Legislation to regulate emissions of greenhouse gases has been introduced in Congress, and there has been a wide-ranging policy debate, both nationally and internationally, regarding the impact of these gases and possible means for their regulation. In addition, efforts have been made and continue to be made in the international community toward the adoption of international treaties or protocols that would address global climate change issues, such as the United Nations Climate Change Conference in Copenhagen in 2009. Also, the EPA has undertaken new efforts to collect information regarding greenhouse gas emissions and their effects. Recently, the EPA declared that certain greenhouse gases represent a danger to human health and proposed to expand its regulations relating to those emissions. It is too early to determine whether, or in what form, further regulatory action regarding greenhouse gas emissions will be adopted or what specific impacts a new regulatory action might have on us or our customers. Generally, the anticipated regulatory actions do not appear to affect us in any material respect that is different, or to any materially greater or lesser extent, than other companies that are our competitors. However, our business and prospects could be adversely affected to the extent laws are enacted or modified or other governmental action is taken that prohibits or restricts our customers' exploration and production activities or imposes environmental protection requirements that result in increased costs to us or our customers.

These laws may provide for strict liability for damages to natural resources or threats to public health and safety, rendering a party liable for environmental damage without regard to negligence or fault on the part of such party. Sanctions for noncompliance may include revocation of permits, corrective action orders, administrative or civil penalties, and criminal prosecution. Some environmental laws and regulations provide for joint and several strict liability for remediation of spills and releases of hazardous substances. In addition, we may be subject to claims alleging personal injury or property damage as a result of alleged exposure to hazardous substances, as well as damage to natural resources. These laws and regulations also may expose us to liability for the conduct of or conditions caused by others, or for our acts that were in compliance with all applicable laws and regulations at the time such acts were performed. Any of these laws and regulations could result in claims, fines or expenditures that could be material to results of operations, financial position and cash flows.

## **Table of Contents**

### **We may be unable to successfully compete with other manufacturers of drilling and production equipment.**

Several of our primary competitors are diversified multinational companies with substantially larger operating staffs and greater capital resources than ours and which have been engaged in the manufacturing business for a much longer time than us. If these competitors substantially increase the resources they devote to developing and marketing competitive products and services, we may not be able to compete effectively. Similarly, consolidation among our competitors could enhance their product and service offerings and financial resources, further intensifying competition.

### **The loss of a significant customer could have an adverse impact on our financial results.**

Our principal customers are major integrated oil and gas companies, large independent oil and gas companies and foreign national oil and gas companies. Offshore drilling contractors and engineering and construction companies also represent a portion of our customer base. In 2008, our top 15 customers represented approximately 45% of total revenues, with no customer accounting for more than 10% of our total revenues. In 2009, our top 15 customers represented approximately 60% of total revenues, and one customer accounted for approximately 10% of our total revenues. While we are not dependent on any one customer or group of customers, the loss of one or more of our significant customers could, at least on a short-term basis, have an adverse effect on our results of operations, financial position and cash flows.

### **Our customers' industries are undergoing continuing consolidation that may impact our results of operations.**

The oil and gas industry is rapidly consolidating and, as a result, some of our largest customers have consolidated and are using their size and purchasing power to seek economies of scale and pricing concessions. This consolidation may result in reduced capital spending by some of our customers or the acquisition of one or more of our primary customers, which may lead to decreased demand for our products and services. We cannot assure you that we will be able to maintain our level of sales to a customer that has consolidated or replace that revenue with increased business activity with other customers. As a result, the acquisition of one or more of our primary customers may have a significant negative impact on our results of operations or our financial condition. We are unable to predict what effect consolidations in the industry may have on price, capital spending by our customers, our selling strategies, our competitive position, our ability to retain customers or our ability to negotiate favorable agreements with our customers.

### **Increases in the cost of raw materials and energy used in our manufacturing processes could negatively impact our profitability.**

Any increases in commodity prices for items such as nickel, molybdenum and heavy metal scrap that are used to make the steel alloys required for our products would result in an increase in our raw material costs. Similarly, any increase in energy costs would increase our product costs. If we are not successful in raising our prices on products to compensate for any increased raw material or energy costs, our margins will be negatively impacted.

### **We depend on third party suppliers for timely deliveries of raw materials, and our results of operations could be adversely affected if we are unable to obtain adequate supplies in a timely manner.**

Our manufacturing operations depend upon obtaining adequate supplies of raw materials from third parties. The ability of these third parties to deliver raw materials may be affected by events beyond our control. Any interruption in the supply of raw materials needed to manufacture our products could adversely affect our business, results of operations and reputation with our customers.



## **Table of Contents**

### **Our shares that are eligible for future sale may have an adverse effect on the price of our common stock.**

Future sales of substantial amounts of our common stock, or a perception that such sales could occur, could adversely affect the market price of our common stock and could impair our ability to raise capital through the sale of our equity securities. This risk is compounded by the fact that a substantial portion of our common stock is owned by Messrs. Reimert and Walker and an entity Mr. Reimert controls. Messrs. Reimert and Walker and an entity Mr. Reimert controls have piggyback and demand registration rights that provide for the registration of the resale of shares at our expense which will allow those shares to be sold in the public market generally without restriction.

### **The market price of our common stock is volatile.**

The trading price of our common stock and the price at which we may sell common stock in the future are subject to large fluctuations in response to any of the following:

limited trading volume in our common stock;

quarterly variations in operating results;

general financial market conditions;

the prices of natural gas and oil;

announcements by us and our competitors;

our liquidity;

changes in government regulations;

our ability to raise additional funds;

our involvement in litigation; and

other events.

### **We do not anticipate paying dividends on our common stock in the near future.**

We have not paid any dividends in the past and do not intend to pay cash dividends on our common stock in the foreseeable future. Our Board of Directors reviews this policy on a regular basis in light of our earnings, financial condition and market opportunities. We currently intend to retain any earnings for the future operation and development of our business.

### **Item 1B. *Unresolved Staff Comments***

None.

**Item 2. Properties**  
**Major Manufacturing Facilities**

<b>Location</b>	<b>Building Size (Approximate Square Feet)</b>	<b>Land (Approximate Acreage)</b>	<b>Owned or Leased</b>
Houston, Texas			
Hempstead Highway	175,000	15.0	Owned
	21,000		Leased
N. Eldridge Parkway	1,519,000	218.0	Owned
Aberdeen, Scotland	165,300	16.8	Owned
	3,200		Leased
Singapore	56,000		Owned
	10,500	16.7	Leased
Macaé, Brazil	100,900	10.6	Owned

**Table of Contents**

Dril-Quip has manufacturing facilities in Houston, Aberdeen, Singapore and Macae. The Houston facility at Eldridge produces in-house a majority of the Company's forging and heat treatment requirements.

**Sales, Service and Reconditioning Facilities**

Location(1)	Building Size (Approximate Square Feet)	Land (Approximate Acreage)	Activity
New Orleans, Louisiana	2,300		Sales/Service
Great Yarmouth, England	1,300	0.4	Service
Beverwijk, Holland	5,200	0.4	Sales
Perth, Australia	1,400		Sales/Service
Darwin, Australia	62,400		Service/Warehouse/Reconditioning
Stavanger, Norway	42,000	6.1	Sales/Service/Reconditioning/Warehouse/Fabrication
Esbjerg, Denmark	19,400	1.2	Sales/Service/Reconditioning/Warehouse
Port Harcourt, Nigeria	8,300	0.5	Sales/Service/Reconditioning/Warehouse
Tianjin, China	12,200		Service/Reconditioning/Warehouse
Paris, France	300		Sales
Cairo, Egypt	6,400		Sales/Warehouse
Alexandria, Egypt	5,200	0.6	Service/Reconditioning/Warehouse
Ghana, West Africa	1,800		Service/Reconditioning/Warehouse

(1) All facilities are leased except Stavanger, Norway, which is owned.

The Company also performs sales, service and reconditioning activities at its facilities in Houston, Aberdeen, Singapore and Macae.

**Item 3. Legal Proceedings**

In 2006, the Company entered into a contract in the amount of approximately \$47 million with MPF Corp. Ltd. (MPF) under which the Company was to construct risers and related equipment to be installed on an offshore drill ship being constructed for MPF. MPF and its affiliates filed a Chapter 11 bankruptcy case in September 2008 in the United States Bankruptcy Court for the Southern District of Texas, Houston Division (Case No. 08-36084). Under the Bankruptcy Code, at some point MPF must either assume this contract or reject it. Since MPF is not required to make a decision on the handling of the contract immediately, the Company cannot be sure as to when its rights under the contract will be clarified. Currently, the Company has possession of all the raw materials purchased to date and work-in-progress under the contract. At the time of the bankruptcy filing, the Company had recognized approximately \$20 million in revenues under the contract and had received payments of approximately \$16 million. No further revenue has been recognized since the second quarter of 2008. The Company believes the remaining \$4 million of unpaid receivables will be realized through the workings of the contract or through its interest in the partially constructed inventory. While the Company has made filings in the bankruptcy proceedings that it believes are appropriate to protect its rights, there can be no assurance that the Company will be able to receive the expected benefits of the contract with MPF. While the Company does not expect the outcome of this matter to have a material adverse effect on the Company's operations, financial position or cash flows, the Company may be required to write down or forfeit some portion of the revenues recognized to date if it becomes probable that the Company will not receive such funds or realize the value of the inventory in its possession.

In August 2007, our Brazilian subsidiary was served with assessments collectively valued at approximately BRL23.3 million (approximately U.S. \$12.6 million as of February 2010) from the State of Rio de Janeiro, Brazil, to collect a state tax on the importation of goods. The Company believes that its subsidiary is not liable

**Table of Contents**

for the taxes and is vigorously contesting the assessments in the Brazilian administrative and judicial systems. At this time, the ultimate disposition of this matter cannot be determined and therefore, it is not possible to reasonably 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. The Company does not expect the liability, if any, resulting from these assessments to have a material adverse effect on its operations, financial position or cash flows. While pending, the amount of interest, penalties and monetary restatement fees on the tax assessments continues to accrue and totaled as of February 2010 approximately BRL35.4 million (approximately U.S. \$19.1 million).

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 action, in the opinion of management, the ultimate liability with respect thereto will not have a material adverse effect on the Company's operations, financial position or cash flows.

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

No matters were submitted to a vote of security holders of the Company during the quarter ended December 31, 2009.

**Item S-K 401(b). Executive Officers of the Registrant**

Pursuant to Instruction 3 to Item 401(b) of Regulation S-K and General Instruction G(3) to Form 10-K, the following information is included in Part I of this Form 10-K:

The following table sets forth the names, ages (as of February 25, 2010) and positions of the Company's executive officers:

<b>Name</b>	<b>Age</b>	<b>Position</b>
Larry E. Reimert	62	Co-Chairman of the Board and Co-Chief Executive Officer
J. Mike Walker	66	Co-Chairman of the Board and Co-Chief Executive Officer
Jerry M. Brooks	58	Chief Financial Officer and Corporate Secretary

*Larry E. Reimert* is Co-Chairman of the Board and Co-Chief Executive Officer with principal responsibility for engineering, product development, finance, sales and training. He has been the Director Engineering, Product Development and Finance, as well as a member of the Board of Directors, since the Company's inception in 1981. On September 24, 2009, he assumed additional responsibilities for the areas of sales and training. Prior to 1981, he worked for Vetco Offshore, Inc. in various capacities, including Vice President of Technical Operations, Vice President of Engineering and Manager of Engineering. Mr. Reimert holds a BSME degree from the University of Houston and an MBA degree from Pepperdine University.

*J. Mike Walker* is Co-Chairman of the Board and Co-Chief Executive Officer with principal responsibility for manufacturing, purchasing, facilities, service and administration. He has been the Director Manufacturing, Purchasing and Facilities, as well as a member of the Board of Directors, since the Company's inception in 1981. On September 24, 2009, he assumed additional responsibilities for the areas of service and administration. Prior to 1981, he served as the Director of Engineering, Manager of Engineering and Manager of Research and Development with Vetco Offshore, Inc. Mr. Walker holds a BSME degree from Texas A&M University, an MSME degree from the University of Texas at Austin and a Ph.D. in mechanical engineering from Texas A&M University.

**Table of Contents**

*Jerry M. Brooks* has been Vice-President Finance and Chief Financial Officer since February 2007. From March 1999 until February 2007, Mr. Brooks was Chief Financial Officer. Prior to March 1999, he served as Chief Accounting Officer since joining the Company in 1992. On September 24, 2009, he assumed the additional responsibilities of Corporate Secretary. From 1980 to 1991, he held various positions with Chiles Offshore Corporation, most recently as Chief Financial Officer, Secretary and Treasurer. Mr. Brooks holds a BBA in Accounting and a MBA from the University of Texas at Austin.

**PART II****Item 5. Market for Registrant's Common Stock, Related Stockholder Matters and Issuer Purchases of Equity Securities**

The Company's Common Stock is publicly traded on the New York Stock Exchange under the symbol DRQ. The following table sets forth the quarterly high and low sales prices of the Common Stock as reported on the New York Stock Exchange for the indicated quarters of fiscal 2008 and 2009.

Quarter Ended	Sales Price (\$)			
	2008		2009	
	High	Low	High	Low
March 31	60.22	42.14	33.22	18.13
June 30	65.36	46.01	46.40	29.31
September 30	63.59	40.08	50.52	33.95
December 31	43.32	14.15	59.00	47.07

There were approximately 34 stockholders of record of the Company's Common Stock as of February 10, 2010. This number does not include the number of security holders for whom shares are held in a nominee or street name.

The Company has not paid any dividends in the past. The Company currently intends to retain any earnings for the future operation and development of its business and does not currently anticipate paying any dividends in the foreseeable future. The Board of Directors will review this policy on a regular basis in light of the Company's earnings, financial condition and market opportunities.

Information concerning securities authorized for issuance under equity compensation plans is included in Note 12 of Notes to Consolidated Financial Statements.

*Repurchases of Equity Securities*

In May 2008, the Company announced that its Board of Directors had authorized a share repurchase program under which the Company could repurchase up to \$100 million of its common stock. At the end of the third quarter of 2008, the Company had repurchased 1,799,928 shares at an average price of \$55.58 per share (including commissions) for a total of approximately \$100 million. All repurchased shares were retired in 2008.

There were no repurchases of the Company's equity securities during 2009.

**Table of Contents****Item 6. Selected Financial Data**

The information set forth below should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and Notes thereto included elsewhere in this report on Form 10-K.

	Year ended December 31,				
	2005	2006	2007	2008	2009
	(In thousands, except per share amounts)				
<b>Statement of Operations Data:</b>					
Revenues:					
Products	\$ 291,299	\$ 372,540	\$ 417,970	\$ 453,315	\$ 456,022
Services	49,530	70,202	77,587	89,456	84,182
<b>Total revenues</b>	<b>340,829</b>	<b>442,742</b>	<b>495,557</b>	<b>542,771</b>	<b>540,204</b>
Cost and expenses:					
Cost of sales:					
Products	\$ 197,779	\$ 217,847	\$ 237,728	\$ 260,626	\$ 260,780
Services	32,070	38,841	47,553	51,673	49,513
<b>Total cost of sales</b>	<b>229,849</b>	<b>256,688</b>	<b>285,281</b>	<b>312,299</b>	<b>310,293</b>
Selling, general and administrative expenses	40,916	44,085	49,313	62,390	55,474
Engineering and product development expenses	20,867	19,559	22,578	26,369	27,173
Special item(1)					5,224
<b>Operating income</b>	<b>49,197</b>	<b>122,410</b>	<b>138,385</b>	<b>141,713</b>	<b>142,040</b>
Interest income	258	3,632	8,275	3,453	507
Interest expense	(2,045)	(669)	(370)	(182)	(156)
<b>Income before income taxes</b>	<b>47,410</b>	<b>125,373</b>	<b>146,290</b>	<b>144,984</b>	<b>142,391</b>
Income tax provision	14,843	38,482	38,349	39,399	37,250
<b>Net income</b>	<b>\$ 32,567</b>	<b>\$ 86,891</b>	<b>\$ 107,941</b>	<b>\$ 105,585</b>	<b>\$ 105,141</b>
Earnings per common share:					
Basic	\$ 0.92	\$ 2.21	\$ 2.67	\$ 2.65	\$ 2.68
Diluted	\$ 0.90	\$ 2.15	\$ 2.63	\$ 2.62	\$ 2.66
Weighted average common shares outstanding:					
Basic	35,276	39,340	40,447	39,918	39,164
Diluted	36,206	40,342	41,007	40,292	39,538
<b>Statement of Cash Flows Data:</b>					
Net cash provided by (used in) operating activities	\$ (16,889)	\$ 93,482	\$ 82,663	\$ 40,677	\$ 136,412
Net cash used in investing activities	(19,206)	(23,290)	(24,854)	(49,527)	(44,325)
Net cash provided by (used in) financing activities	62,961	36,851	10,160	(100,075)	13,436
<b>Other Data:</b>					
Depreciation and amortization	\$ 13,426	\$ 15,087	\$ 15,653	\$ 16,854	\$ 17,997
Capital expenditures	20,557	24,133	25,208	50,134	44,749
	2005	2006	December 31, 2007	2008	2009
	(In thousands)				
<b>Balance Sheet Data:</b>					
Working capital	\$ 220,892	\$ 347,250	\$ 454,192	\$ 400,535	\$ 512,731
Total assets	428,262	594,935	699,822	680,609	817,246
Total debt	3,847	3,720	2,911	1,532	1,039
Total stockholders' equity	329,462	467,497	592,495	559,450	705,085

(1) See discussion on page 26 under *Special Item*.

## Table of Contents

The Company adopted Financial Accounting Standards Board ( FASB ) Accounting Standards Codification<sup>TM</sup>( ASC ) Topic 718 effective January 1, 2006. During the years ended December 31, 2007, 2008 and 2009, stock-based compensation expense on a pre-tax basis totaled \$2.3 million, \$3.2 million and \$4.0 million, respectively. Stock option expense in 2009 excludes \$1.3 million for the accelerated vesting of stock options due to the death of a Co-Chairman. The amount was reclassified to Special item in the Consolidated Statements of Income. No stock-based compensation expense was capitalized during these years. Additionally, all share and per share data has been adjusted for all periods presented for the two-for-one stock split effective October 5, 2006.

### **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following is management's discussion and analysis of certain significant factors that have affected certain aspects of the Company's financial position, results of operations and cash flows during the periods included in the accompanying consolidated financial statements. This discussion should be read in conjunction with the Company's consolidated financial statements and notes thereto presented elsewhere in this Report.

#### **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 technical advisory services on an as-requested basis during installation of its products, as well as rework and reconditioning services for customer-owned Dril-Quip products and rental of 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. See Item 1A. Risk Factors A material or extended decline in expenditures by the oil and gas industry could significantly reduce our revenue and income.

According to the Energy Information Administration ( EIA ) of the U.S. Department of Energy, average crude oil (West Texas Intermediate Cushing) and natural gas (Henry Hub) closing prices are listed below for periods covered by this report:

	Average prices during year ended December 31,		
	2007	2008	2009
Oil (\$/Bbl)	\$ 72.32	\$ 99.57	\$ 62.18
Natural gas (\$/per Mcf)	7.18	9.13	4.07

In mid July 2008, crude oil prices spiked to \$145.16 per barrel and ended the year in 2008 at \$44.60 per barrel. Additionally, by the end of December 2008, gas prices had declined to \$5.48 per Mcf. These declines in hydrocarbon prices have adversely affected the willingness of some oil and gas companies to make capital expenditures on exploration, drilling and production operations offshore, which could have an adverse impact on the Company's financial condition and results of operations. During 2009, the average West Texas Intermediate crude oil price was \$62.18 per barrel with a high during 2009 of \$81.37 per barrel and a low of \$33.98 per barrel. Crude oil ended at \$79.36 per barrel at December 31, 2009.



**Table of Contents**

According to the January 12, 2010 release of the Short-Term Energy Outlook published by the EIA, West Texas Intermediate crude oil prices are projected to average \$79.83 per barrel in 2010 and \$83.50 in 2011. These projections are based upon the assumption that the U.S. real gross domestic product (GDP) grows by 2% in 2010 and 2.7% in 2011 and world oil-consumption-weighted real GDP grows by 2.5% and 3.7% in 2010 and 2011, respectively.

In its January 12, 2010 report, the EIA expects Henry Hub natural gas prices to average \$5.36 per Mcf in 2010 and \$6.12 per Mcf in 2011. Henry Hub natural gas were priced at \$5.57 per Mcf at the end of December 2009.

According to the EIA Short-Term Energy Outlook report dated January 12, 2010, the EIA expects crude oil production, which decreased by almost 2.2 million barrels per day on average in 2009, will increase by an average of approximately 0.5 million barrels per day per year through 2011 as global oil demand recovers. In its January 15, 2010 Oil Market Report, the International Energy Agency projected global oil demand to be 86.3 million barrels per day in 2010 compared to 84.9 million barrels per day in 2009.

Detailed below is the average contracted rig count for our geographic regions for the years ended December 31, 2007, 2008 and 2009. The rig count data includes floating rigs (semi-submersibles and drill ships) and jack-ups. The Company has included only these types of rigs as they are the primary end users of the Company's products.

	Year ended December 31,		
	2007	2008	2009
Western Hemisphere	181	185	165
Eastern Hemisphere	161	162	150
Asia-Pacific	218	238	233

Source: ODS Petrodata RigBase December 31, 2007, 2008 and 2009

The table represents rigs under contract and includes rigs currently drilling as well as rigs committed, but not yet drilling.

The Company believes that the number of rigs (semi-submersibles, jack-ups and drill ships) under construction impacts its revenues because in certain cases, its customers order some of our products during the construction of such rigs. As a result, an increase in rig construction activity tends to favorably impact the Company's backlog while a decrease in rig construction activity tends to negatively impact its backlog. According to ODS-Petrodata, at the end of 2007, 2008 and 2009, there were 156, 172 and 130 rigs, respectively, under construction and the expected delivery dates for the rigs under construction on December 31, 2009 are as follows:

2010	64
2011	44
2012	22
	130

Due to the significant increase in the oil and gas activity over the past several years, the Company has expanded facilities in all of its major manufacturing locations in Houston, Texas; Aberdeen, Scotland; Singapore; and Macae, Brazil. With limited manufacturing capacity, the Company has had to prioritize its responses to customer's bid requests. In making the decision, the Company takes into consideration such factors as manufacturing time, current projects in progress, delivery requirements, projected gross margins, available personnel and availability of material. Based upon these decisions, it is possible for the Company to have variations between quarters and years based upon product mix.

---

**Table of Contents**

Oil and gas prices and the level of offshore drilling and production activity have been characterized by significant volatility in recent years. Worldwide military, political and economic events have contributed to oil and natural gas price volatility and are likely to continue to do so in the future. Although hydrocarbon prices improved from 2005 until mid-2008 and the level of offshore exploration, drilling and production activity increased during that period, in mid-2008 oil and gas prices began to decline. The economic volatility continued in the first half of 2009 and began to stabilize somewhat in the latter half of the year. The Company expects continued volatility in both crude oil and natural gas prices as well as in the level of drilling and production related activities. The volatility in prices appears to have impacted the land drilling activity more so than offshore drilling, particularly in deeper offshore waters, where Dril-Quip's products are more often utilized. Even during periods of high prices for oil and natural gas, companies exploring for oil and gas may cancel or curtail programs, or reduce their levels of capital expenditures for exploration and production for a variety of reasons. In addition, a significant and prolonged decline in hydrocarbon prices would likely have a material adverse effect on the Company's results of operations.

The Company operates its business and markets its products and services in most of the significant oil and gas producing areas in the world and is, therefore, subject to the risks customarily attendant to international operations and investments in foreign countries. These risks include nationalization, expropriation, war, acts of terrorism and civil disturbance, restrictive action by local governments, limitation on repatriation of earnings, change in foreign tax laws and change in currency exchange rates, any of which could have an adverse effect on either the Company's ability to manufacture its products in its facilities abroad or the demand in certain regions for the Company's products or both. To date, the Company has not experienced any significant problems in foreign countries arising from local government actions or political instability, but there is no assurance that such problems will not arise in the future. Interruption of the Company's international operations could have a material adverse effect on its overall operations. See Item 1A. Risk Factors Our international operations expose us to instability and changes in economic and political conditions and other risks inherent to international business, which could have a material adverse effect on our operations or financial condition.

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 technical advisory service for installation of the Company's products, reconditioning services and rental of running tools for installation and retrieval of the Company's products. In 2009, the Company derived 84% of its revenues from the sale of its products and 16% of its revenues from services. Service revenues generally correlate to revenues from product sales because increased product sales normally generate increased revenues from technical advisory services during installation and rental of running tools. The Company has substantial international operations, with approximately 69%, 69% and 66% of its revenues derived from foreign sales in 2007, 2008 and 2009, respectively.

Generally, the Company attempts to raise its prices as its costs increase. However, the actual pricing of the Company's products and services is impacted by a number of factors, including competitive pricing pressure, the level of utilized capacity in the oil service sector, maintenance of market share, the introduction of new products and general market conditions.

The Company accounts for larger and more complex projects that have relatively longer manufacturing time frames on a percentage-of-completion basis. During 2007 and 2008, 16 and 23 projects, respectively representing approximately 19% and 25% of the Company's total revenues and 22% and 30% of the Company's product revenues were accounted for using the percentage-of-completion accounting. During 2009, 17 projects representing approximately 13% of the Company's total revenues and 16% of the Company's product 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 based upon a calculation of the percentage complete which is used to determine the revenue earned and the appropriate portion of total estimated cost of sales. 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,

**Table of Contents**

are recognized when they become known. Amounts received from customers in excess of revenues recognized are classified as a current liability. See Item 1A. Risk Factors We may be required to recognize a charge against current earnings because of percentage-of-completion accounting.

**Results of Operations**

The following table sets forth, for the periods indicated, certain consolidated statements of income data expressed as a percentage of revenues:

	Year Ended December 31,		
	2007	2008	2009
Revenues:			
Products	84.3%	83.5%	84.4%
Services	15.7	16.5	15.6
Total revenues	100.0	100.0	100.0
Cost of sales:			
Products:	48.0	48.0	48.3
Services	9.6	9.5	9.1
Total cost of sales	57.6	57.5	57.4
Selling, general and administrative expenses	9.9	11.5	10.3
Engineering and product development expenses	4.6	4.9	5.0
Special item(1)			1.0
Operating income	27.9	26.1	26.3
Interest income	1.7	0.6	0.1
Interest expense	(0.1)		
Income before income taxes	29.5	26.7	26.4
Income tax provision	7.7	7.3	6.9
Net income	21.8%	19.4%	19.5%

(1) See discussion on page 26 under *Special Item*.

The following table sets forth, for the periods indicated, a breakdown of our products and service revenues:

	2007	2008	2009
	(In millions)		
Revenues:			
Products			
Subsea equipment	\$ 316.7	\$ 318.2	\$ 357.3
Surface equipment	38.1	30.6	31.2
Offshore rig equipment	63.2	104.5	67.5
Total products	418.0	453.3	456.0
Services	77.6	89.5	84.2
Total revenues	\$ 495.6	\$ 542.8	\$ 540.2

## Edgar Filing: DRIL-QUIP INC - Form 10-K

*Year ended December 31, 2009 Compared to Year Ended December 31, 2008*

*Revenues.* Revenues decreased by \$2.6 million, or approximately 0.5%, to \$540.2 million in 2009 from \$542.8 million in 2008, primarily due to a decrease in service revenues of \$5.3 million in 2009 compared to 2008. Product revenues increased by approximately \$2.7 million for the year ended December 31, 2009 compared to the same period in 2008 as a result of increased revenues of \$39.1 million in subsea equipment and

**Table of Contents**

\$600,000 in surface equipment, partially offset by a \$37.0 million decrease in offshore rig equipment. The decrease in offshore rig equipment was primarily due to the decrease in the number of long-term projects. During 2008, there were 23 projects, compared to 17 projects during 2009. The majority of the projects in 2008 and 2009 related to offshore rig equipment. Product revenues increased in the Eastern Hemisphere by \$12.0 million, partially offset by decreases in the Western Hemisphere of \$4.7 million and \$4.6 million in Asia-Pacific. Service revenues decreased by approximately \$5.3 million resulting from decreased service revenues in the Western Hemisphere of \$6.0 million and \$0.6 million in Asia-Pacific, partially offset by a \$1.3 million increase in the Eastern Hemisphere. The majority of the decreases in service revenues related to decreases in the rental of running and installation tools and reconditioning services.

*Cost of Sales.* Cost of sales decreased by \$2.0 million, or approximately 0.6%, to \$310.3 million for 2009 from \$312.3 million for the same period in 2008. As a percentage of revenues, cost of sales were approximately 57.5% in 2008 and 57.4% in 2009. Cost of sales as a percentage of revenue remained relatively consistent between 2008 and 2009.

*Selling, General and Administrative Expenses.* For 2009, selling, general and administrative expenses decreased by approximately \$6.9 million, or 11.1%, to \$55.5 million from \$62.4 million in 2008. The decrease in selling, general and administrative expenses was primarily due to the effect of foreign currency transaction gains, partially offset by increased stock option expenses. The Company experienced approximately \$2.1 million in pre-tax foreign currency transaction losses during 2008 versus approximately \$4.6 million in pre-tax foreign currency transaction gains during 2009. The gain in 2009 is primarily due to the weakening of the U.S. dollar compared to the British pound sterling, the Australian dollar and the Brazilian real. The loss in 2008 is primarily due to the increasing strength of the U.S. dollar in the later part of 2008 as compared to the Brazilian real. Stock option expense for 2008 totaled \$3.2 million compared to \$4.0 million in 2009. The stock option expense for 2009 excludes \$1.3 million for the accelerated vesting of Mr. Smith's remaining options upon his death as discussed in *Special Item* below. Selling, general and administrative expenses as a percentage of revenues were 11.5% in 2008 and 10.3% in 2009.

*Engineering and Product Development Expenses.* For 2009, engineering and product development expenses increased by approximately \$800,000, or 3.0%, to approximately \$27.2 million from \$26.4 million in 2008. Engineering and product development expenses as a percentage of revenues increased from 4.9% in 2008 to 5.0% in 2009.

*Special Item.* In September 2009, Gary D. Smith, one of the Company's Co-Chief Executive Officers, unexpectedly passed away. Under the terms of Mr. Smith's employment contract, the Company was obligated to pay Mr. Smith's base salary, including accrued vacation, and his annual bonus through the remaining employment period (October 27, 2012). In addition, stock options owned by Mr. Smith that were outstanding at the date of his death were immediately vested under the terms of the contract. Accordingly, the Company recognized a pre-tax expense of \$5.2 million during the third quarter of 2009. The contractual obligation, including related payroll taxes, totaled \$4.3 million, of which \$434,000 had been previously accrued. The acceleration of the vesting increased non-cash expenses by \$1.3 million.

*Interest Income.* Interest income for 2009 was approximately \$507,000 as compared to \$3.5 million in 2008. This decrease was due to reduced interest earned on short-term investments from lower interest rates and reduced balances in short-term investments. Due to the global financial crisis, the Company has transferred the majority of its short-term investments to funds which invest in U.S. Treasury obligations, which normally earn lower interest rates than money market funds.

*Interest expense.* Interest expense for 2009 was approximately \$156,000 compared to \$182,000 in 2008.

*Income tax provision.* Income tax expense for 2009 was \$37.2 million on income before taxes of \$142.4 million, resulting in an effective income tax rate of approximately 26.2%. Income tax expense in 2008 was \$39.4 million on income before taxes of \$145.0 million, resulting in an effective tax rate of approximately 27.2%. The decrease in the effective income tax rate reflects the difference in income before income taxes among the Company's three geographic areas, which have different income tax rates.

---

**Table of Contents**

*Net Income.* Net income was approximately \$105.1 million in 2009 and \$105.6 million in 2008, for the reasons set forth above.

*Year ended December 31, 2008 Compared to Year Ended December 31, 2007*

*Revenues.* Revenues increased by \$47.2 million, or approximately 9.5%, to \$542.8 million in 2008 from \$495.6 million in 2007. Product revenues increased by approximately \$35.3 million for the year ended December 31, 2008 compared to the same period in 2007 as a result of increased revenues of \$41.3 million in offshore rig equipment and \$1.5 million in subsea equipment partially offset by a \$7.5 million decrease in surface equipment. The increase in offshore rig equipment was primarily due to the increase in the number of long-term projects. During 2007 there were 16 projects, compared to 23 projects during 2008 and the majority of these projects related to offshore rig equipment. Of the Company's total product revenues, product revenues increased in the Western Hemisphere, Eastern Hemisphere and Asia-Pacific by \$26.5 million, \$6.0 million and \$2.8 million, respectively. Service revenues increased by approximately \$11.9 million from increased service revenues in the Western Hemisphere of \$4.8 million, Eastern Hemisphere of \$2.0 million and Asia-Pacific of \$5.1 million. The majority of the increases in service revenues related to an increase in technical advisory assistance and reconditioning services.

*Cost of Sales.* Cost of sales increased by \$27.0 million, or approximately 9.5%, to \$312.3 million for 2008 from \$285.3 million for the same period in 2007. As a percentage of revenues, cost of sales were approximately 57.6% in 2007 and 57.5% in 2008. Cost of sales as a percentage of revenue remained relatively consistent between 2007 and 2008. The increase in cost of sales in 2008 as compared to 2007 is basically consistent with the increase in revenue.

*Selling, General and Administrative Expenses.* For 2008, selling, general and administrative expenses increased by approximately \$13.1 million, or 26.6%, to \$62.4 million from \$49.3 million in 2007. The increase in selling, general and administrative expenses was due to increased labor and overhead expenses resulting from increased staffing levels in the areas of sales and administration, increases in legal and professional fees, stock option expenses and the effect of foreign currency transaction gains and losses. The Company experienced approximately \$3.0 million in pre-tax foreign currency transaction gains during 2007 versus approximately \$2.1 million in pre-tax foreign currency transaction losses during 2008. The loss in 2008 is primarily due to the increasing strength of the U.S. dollar in the later part of 2008 as compared to the Brazilian real. Selling, general and administrative expenses as a percentage of revenues were 9.9% in 2007 and 11.5% in 2008.

*Engineering and Product Development Expenses.* For 2008, engineering and product development expenses increased by \$3.8 million, or approximately 16.8%, to approximately \$26.4 million from \$22.6 million in 2007. This increase was due primarily to an increase in personnel and associated operating expenses. Engineering and product development expenses as a percentage of revenues increased from 4.6% in 2007 to 4.9% in 2008.

*Interest Income.* Interest income for 2008 was \$3.5 million as compared to \$8.3 million in 2007. This decrease was due to a reduction in interest earned on short-term investments caused by lower interest rates and reduced balances in short-term investments. Due to the global financial crisis, the Company has transferred the majority of its short-term investments to funds which invest in U.S. Treasury obligations, which normally earn lower interest rates than money market funds. Short-term investment balances declined primarily as a result of expenditures of \$100 million related to the Company's share repurchase program.

*Interest expense.* Interest expense for 2008 was \$182,000 compared to \$370,000 in 2007.

*Income tax provision.* Income tax expense for 2008 was \$39.4 million on income before taxes of \$145.0 million, resulting in an effective income tax rate of approximately 27.2%. Income tax expense in 2007 was \$38.3 million on income before taxes of \$146.3 million, resulting in an effective tax rate of approximately 26.2%. In the fourth quarter of 2007 the Company benefited from a foreign development tax incentive which resulted in a reduction in income taxes of approximately \$4.7 million.

**Table of Contents**

*Net Income.* Net income was approximately \$105.6 million in 2008 and \$107.9 million in 2007, for the reasons set forth above.

**Liquidity and Capital Resources**

Cash flows provided by (used in) operations by type of activity were as follows:

	2007	Year ended December 31, 2008 (In thousands)	2009
Operating activities	\$ 82,663	\$ 40,677	\$ 136,412
Investing activities	(24,854)	(49,527)	(44,325)
Financing activities	10,160	(100,075)	13,436
	67,969	(108,925)	105,523
Effect of exchange rate changes on cash activities	(1,666)	3,145	(3,683)
Increase (decrease) in cash and cash equivalents	\$ 66,303	\$ (105,780)	\$ 101,840

Statements of cash flows for entities with international operations that are local currency functional exclude the effects of the changes in foreign currency exchange rates that occur during any given year, as these are noncash changes. As a result, changes reflected in certain accounts on the Consolidated Statements of Cash Flows, may not reflect the changes in corresponding accounts on the Consolidated Balance Sheets.

The primary liquidity needs of the Company are (i) to fund capital expenditures to improve and expand facilities and manufacture additional running tools and (ii) to fund working capital. Recently, the Company's principal sources of funds have been cash flows from operations.

During 2009, the Company generated \$136.4 million of cash from operations as compared to \$40.7 million for the same period in 2008. The primary reasons for the increase were the changes in operating assets and liabilities during 2009 as compared to the same period in 2008. Cash totaling approximately \$16.0 million was provided during 2009 from decreases in operating assets and liabilities, compared to a \$84.5 million utilization of cash during the same period in 2008 to increase operating assets and liabilities. The decrease in operating assets and liabilities during 2009 primarily reflected a decrease of \$51.5 million in trade receivables, resulting primarily from a decrease in unbilled receivables of \$20.0 million. Inventory increased by approximately \$19.3 million, mostly in finished goods, to meet the needs of our existing backlog. The excess tax benefit on stock options exercised totaled \$7.8 million and is offset by the same amount in financing activities. In 2009, there were approximately 636,000 stock options exercised compared to approximately 29,000 stock options exercised in 2008. Trade account payables and accrued expenses decreased by \$4.7 million.

Capital expenditures by the Company were \$25.2 million, \$50.1 million and \$44.7 million in 2007, 2008 and 2009, respectively. Capital expenditures in 2008 and 2009 included expanding manufacturing facilities in Southeast Asia and the Western Hemisphere and increased expenditures on machinery and equipment and running tools due to expanded operations. The capital expenditures for 2009 were primarily \$11.3 million for machinery and equipment, \$11.7 million for facilities, \$16.7 million running tools and other expenditures of \$5.0 million. Principal payments on long-term debt were approximately \$900,000, \$800,000 and \$700,000 in 2007, 2008 and 2009, respectively.

In October 2009, Dril-Quip Asia Pacific Pte Ltd, a wholly owned subsidiary of Dril-Quip, Inc. entered into an agreement for the construction of a new manufacturing facility in Singapore valued at SGD46.5 million (\$33.2 million on December 31, 2009).

**Table of Contents**

In May 2008 the Company announced that its Board of Directors had authorized a share repurchase program under which the Company could repurchase up to \$100 million of its common stock. At the end of the third quarter of 2008, the Company had repurchased 1,799,928 shares at an average price of \$55.58 per share (including commissions) for a total of approximately \$100 million. All repurchased shares were retired and the share repurchase program as authorized by the Board of Directors was completed as of December 31, 2008.

The following table presents long-term contractual obligations of the Company and the related payments, excluding the effects of interest, due in total and by year as of December 31, 2009:

Contractual Obligations	Payments due by year						Total
	2010	2011	2012	2013	2014	After 2014	
	(In thousands)						
Long-term debt and capital leases	\$ 723	\$ 274	\$ 37	\$ 5	\$	\$	\$ 1,039
Operating lease obligations (1)	1,808	17,800	3,222	244	158	2,356	25,588
Estimated interest payments (2)	19	9	7	1			36
Total	\$ 2,550	\$ 18,083	\$ 3,266	\$ 250	\$ 158	\$ 2,356	\$ 26,663

(1) Includes certain minimum lease obligations for investments in machinery, leasehold improvements and buildings.

(2) Interest rates for leases were calculated using the interest portion of the lease payment. Interest payments for variable rate debt were calculated using the interest rate and exchange rate in effect at December 31, 2009.

The Company's credit facility with Guaranty Bank, FSB which provided an unsecured revolving line of credit of up to \$10 million, terminated in accordance with its terms on September 1, 2009. The Company is in the process of reviewing alternatives, including securing a new line of credit.

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. \$6.5 million as of December 31, 2009). Borrowing under this facility bears interest at the Bank of Scotland base rate, which was 0.50% at December 31, 2009, 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 December 31, 2008 and 2009 was approximately U.S. \$1.4 million and U.S. \$865,000, respectively. The facility is secured by land and buildings in Aberdeen, Scotland and contains no restrictive financial covenants.

In addition to the above, the Company has issued purchase orders in the ordinary course of business for the purchase of goods and services. These purchase orders are enforceable and legally binding. However, none of the Company's purchase obligations call for deliveries of goods or services for time periods in excess of one year.

The Company believes that cash generated from operations plus cash on hand will be sufficient to fund operations, working capital needs and anticipated capital expenditure requirements in 2010. 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.

**Backlog**

Backlog consists of firm customer orders for which a purchase order or signed contract has been received, satisfactory credit or financing arrangements exist and delivery is scheduled. The Company's revenues for a specific period have not been directly related to its backlog as stated at a particular point in time. The Company's backlog was approximately \$429 million and \$603 million at December 31, 2007 and 2008, respectively, compared to \$563 million at December 31, 2009, an increase of approximately \$174 million, or 41%, from 2007 to 2008 and a decrease of approximately \$40 million, or 7%, from 2008 to 2009. The lead time on many of the



---

## **Table of Contents**

projects extends for a year or more and several large projects that were reflected in the Company's backlog as of December 31, 2008 were completed in 2009. The Company expects to fill approximately 65% of the December 31, 2009 backlog by December 31, 2010. The remaining backlog at December 31, 2009 consists of longer-term projects which are being designed and manufactured to customer specifications requiring longer lead times. The backlog amount at December 31, 2008 and 2009 excludes \$27 million related to the MPF contract as discussed in Item 3. Legal Proceedings.

The Company can give no assurance that backlog will remain at current levels. Sales of the Company's products are affected by prices for oil and natural gas, which fluctuated significantly between 2005 and 2009. Additional future declines in oil and natural gas prices could reduce new customer orders, possibly causing a decline in the Company's future backlog. All of the Company's projects currently included in its backlog are subject to change and/or termination at the option of the customer. In the 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. In the past, terminations and cancellations have been immaterial to the Company's overall operating results.

### **Geographic Segments**

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 Macae, Brazil.

Revenues for each of these segments are dependent upon the ultimate sale of products and services to the Company's customers. For information on revenues by geographic segment, see Note 11 of Notes to Consolidated Financial Statements. Revenues of the Western Hemisphere are also influenced by its sale of products to the Eastern Hemisphere and Asia-Pacific segments. Accordingly, the operating incomes of each area are closely tied to third-party sales, and the operating income of the Western Hemisphere is also dependent upon its level of intercompany sales.

### **Currency Risk**

Through its subsidiaries, the Company conducts a portion of business in currencies other than the United States dollar, principally the British pound sterling ( GBP ) in the Eastern Hemisphere and the Brazilian real ( BRL ) in Brazil. The Company generally attempts to minimize its currency exchange risk by seeking international contracts payable in local currency in amounts equal to the Company's estimated operating costs payable in local currency and in U.S. dollars for the balance of the contract. Because of this strategy, the Company has not experienced significant transaction gains or losses associated with changes in currency exchange rates and does not anticipate such exposure to be material in the future. In 2007, 2008 and 2009, the Company had, net of income taxes, transaction gains of \$2.2 million, transaction losses of \$1.5 million and transaction gains of \$3.4 million, respectively. The gain in 2007 was principally due to the weakening of the U.S. dollar to the Brazilian real on the intercompany payables between Brazil and the United States. The BRL rose as compared to the U.S. dollar from the average of 0.47 in January 2007 to an average rate of 0.56 in December 2007. The loss in 2008 was primarily due to strengthening of the U.S. dollar compared to the Brazilian real on the intercompany payables between Brazil and the United States. The BRL fell as compared to the U.S. dollar from an average of 0.59 for the first nine months of 2008 to an average rate of 0.44 for the fourth quarter of 2008. The gain in 2009 was primarily due to the weakening of the U.S. dollar compared to the British pound sterling and the Brazilian real. At December 31, 2008, the pound sterling was 1.46 compared to 1.62 at December 31, 2009. The Brazilian real was 0.43 December 31, 2008 and 0.57 at December 31, 2009.

There is no assurance that the Company will be able to protect itself against such fluctuations in the future. Historically, the Company has not conducted business in countries that limit repatriation of earnings. However,

## **Table of Contents**

as the Company expands its international operations, it may begin operating in countries that have such limitations. Further, there can be no assurance that the countries in which the Company currently operates will not adopt policies limiting repatriation of earnings in the future. The Company also has significant investments in countries other than the United States, principally its manufacturing operations in Aberdeen, Scotland and, to a lesser extent, Singapore, Brazil and Norway. The functional currency of these foreign operations is the local currency except for Singapore, where the U.S. dollar is used. Financial statement assets and liabilities are translated at the end of the period exchange rates. Resulting translation adjustments are reflected as a separate component of stockholders' equity and have no current effect on earnings or cash flow.

### **Critical Accounting Policies**

The Company's discussion and analysis of its financial condition and results of operations are based on the Company's consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States of America under guidance from the ASC. The preparation of the consolidated financial statements requires the Company to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. There can be no assurance that actual results will not differ from those estimates. The Company believes the following accounting policies affect its more significant judgments and estimates used in preparation of its consolidated financial statements.

#### *Revenue Recognition.*

##### *Product Revenue*

The Company earns product revenues from two sources:

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 pursuant to ASC Topic 605-35, which provides guidance on accounting for the performance of contracts. Long-term project contracts have the following characteristics:

The contracts call for products which are designed to customer specifications;

The structural designs are unique and require significant engineering and manufacturing efforts generally requiring more than one year in duration;

The contracts contain specific terms as to milestones, progress billings and delivery dates; and

Product requirements cannot be filled directly from the Company's standard inventory.

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

## Edgar Filing: DRIL-QUIP INC - Form 10-K

Under the percentage-of-completion method, billings do not always correlate directly to the revenue recognized. Based upon the terms of the specific contract, billings may be in excess of the revenue recognized, in

---

**Table of Contents**

which case the amounts are included in customer prepayments as a liability on the 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 December 31, 2008 and 2009, trade receivables included \$44.8 million and \$24.8 million of unbilled receivables, respectively. During 2009, 17 projects representing approximately 13% and 16% of the Company's total revenue and product revenue, respectively, were accounted for using percentage-of-completion accounting, compared to 23 projects during 2008 representing approximately 25% of the Company's total revenues and 30% of product revenue, respectively.

*Revenues not recognized under the percentage-of-completion method*

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

*Service revenue*

The Company earns service revenues from three sources:

technical advisory assistance;

rental of running tools; and

rework and reconditioning of customer owned Dril-Quip products.

The recognition of service revenue is the same for all products, including those accounted for under the percentage-of-completion method. The Company does not install products for our customers, but it provides 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 related 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 services. The customer may use a third party or their own personnel.

*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. Company manufactured inventory is valued principally using standard costs, which are calculated based upon direct costs incurred and overhead allocations. Inventory purchased from third party vendors is principally valued at the weighted average cost. 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 \$20.8 million and \$24.2 million have been established as of December 31, 2008 and 2009, respectively. If market conditions are less favorable than those projected by management, additional inventory reserves may be required.

*Contingent liabilities.* The Company establishes reserves for estimated loss contingencies when the Company believes a loss is probable and the amount of the loss can be reasonably estimated. Revisions to contingent liabilities are reflected in income in the period in which different facts or information become known or circumstances change that affect the Company's previous assumptions with respect to the likelihood or amount of loss. Reserves for contingent liabilities are based upon the Company's assumptions and estimates regarding the probable outcome of the matter. Should the outcome differ from the Company's assumptions and estimates, revisions to the estimated reserves for contingent liabilities would be required.

---

## **Table of Contents**

### **Off-Balance Sheet Arrangements**

The Company has no derivative instruments and no off-balance sheet hedging or financing arrangements or contracts or operations that rely upon credit or similar ratings.

### **New Accounting Standards**

In October 2009, the FASB issued Accounting Standards Update ( ASU ) 2009-13, Multiple-Deliverable Revenue Arrangements ( ASU 2009-13 ). The new standard changes the requirements for establishing separate units of accounting in a multiple element arrangement and requires the allocation of arrangement consideration to each deliverable based on the relative selling price. The selling price for each deliverable is based on vendor-specific objective evidence ( VSOE ) if available, third-party evidence if VSOE is not available, or estimated selling price if neither VSOE or third-party evidence is available. ASU 2009-13 is effective for revenue arrangements entered into in fiscal years beginning on or after June 15, 2010. The Company does not expect that the provisions of the new guidance will have a material effect on its consolidated financial statements.

In September 2009, the Company adopted ASC Topic 105. This standard establishes the ASC as the single source of the authoritative U. S. generally accepted accounting principles (U.S. GAAP) recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the SEC under authority of federal securities laws are also sources of the authoritative U.S. GAAP for SEC registrants. The ASC supersedes all existing non-SEC accounting and reporting standards. Following the ASC, the FASB will not issue new standards in the form of statements, FASB staff positions or Emerging Issues Task Force. Instead, it will issue ASU s that serve to update the ASC, provide background information about the guidance and provide the basis for conclusions on changes to the ASC.

In June 2009, the Company adopted ASC Topic 825 regarding disclosures about the fair value of financial instruments for interim periods of publicly traded companies as well as in the annual financial statements. The standard also requires publicly traded companies to include disclosures about the fair value of its financial instruments whenever it issues summarized financial information for interim reporting periods. The adoption of this standard had no material effect on the Company s consolidated financial statements.

In May 2009, the Company adopted ASC Topic 855 regarding subsequent events. This standard establishes general standards of accounting for and disclosure of events or transactions that occur after the balance sheet date but before financial statements are issued or are available to be issued. This standard sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosure that an entity should make about events or transactions that occurred after the balance sheet date. The standard requires entities to disclose the date through which subsequent events have been evaluated as well as whether that date is the date the financial statements were issued or the date the financial statements were available to be issued. See Note 16 of the Notes to Consolidated Financial Statements.

In January 2009, the Company adopted ASC Topic 805 regarding business combinations. The standard establishes principles and requirements for the recognition and measurement of assets, liabilities and goodwill including the requirement that most transaction costs and restructuring costs be expensed. In addition, the standard requires disclosures to enable users to evaluate the nature and financial effects of the business combination that occurs either during the reporting period or after the reporting period but before the financial statements are issued or are available to be issued. The adoption of this standard had no material effect on the Company s consolidated financial statements.

In January 2009, the Company adopted ASC Topic 810 regarding noncontrolling interest in consolidated financial statements. The standard established accounting and reporting standards for noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. The adoption of this standard had no material effect on the Company s consolidated financial statements.

**Table of Contents**

In January 2008, the Company adopted ASC Topic 820-10. In February 2008, ASC 820-10-55 was issued. The standard provides a one year deferral of the effective date of ASC 820-10 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed in the financial statements at fair value at least annually. ASC 820-10 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. ASC 820-10 applies under other accounting pronouncements that require or permit fair value measurements and does not require any new fair value measurements. The Company does not have any assets or liabilities that would be recognized or disclosed on a fair value basis as of December 31, 2008 or December 31, 2009.

**Item 7A. 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 mitigate the market risks inherent in 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 has not experienced significant transaction gains or losses associated with changes in currency exchange rates and does not anticipate such exposure to be material in the future. However, there is no assurance that the Company will be able to protect itself against currency fluctuations in the future. See Management's Discussion and Analysis of Financial Condition and Results of Operations Currency Risk in Item 7 of this report.

The Company uses a sensitivity analysis model to measure the impact on revenue and net income of a 10% adverse movement of foreign currency exchange rates against the U.S. dollar over the previous year. Based upon this model, a 10% decrease would result in a decrease in revenues of approximately \$23 million and a decrease in net income of approximately \$8 million over the year ended December 31, 2009. There can be no assurance that the exchange rate decrease projected above will materialize as fluctuations in exchange rates are beyond the Company's control.

**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 a loan that requires the Company to pay interest at a floating rate. This floating-rate obligation exposes the Company to the risk of increased interest expense in the event of increases in the short-term interest rates. Based upon the December 31, 2009 balance of approximately \$865,000 related to this floating rate obligations, each 1.0% rise in interest rates would result in additional annual interest expense to the Company of approximately \$8,700, or \$2,175 per quarter.

**Item 8. Financial Statements and Supplementary Data**

	<b>Page</b>
<u>Management's Annual Report on Internal Control over Financial Reporting</u>	35
<u>Reports of Independent Registered Public Accounting Firm</u>	36
<u>Consolidated Statements of Income for the Three Years in the Period Ended December 31, 2009</u>	38
<u>Consolidated Balance Sheets as of December 31, 2008 and 2009</u>	39
<u>Consolidated Statements of Cash Flows for the Three Years in the Period Ended December 31, 2009</u>	40
<u>Consolidated Statements of Stockholders' Equity for the Three Years in the Period Ended December 31, 2009</u>	41
<u>Notes to Consolidated Financial Statements</u>	42

---

**Table of Contents**

**Management's Annual Report on Internal Control over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) or 15d-15(f) promulgated under the Securities Exchange Act of 1934 as a process designed by, or under the supervision of, the Company's principal executive and principal financial officers and effected by the Company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America and includes those policies and procedures that:

pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company;

provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Management has designed its internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with accounting principles generally accepted in the United States of America. Management's assessment included review and testing of both the design effectiveness and operating effectiveness of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Under the supervision and with the participation of our management, including our principal executive officers and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in *Internal Control - Integrated Framework*, our management has concluded that our internal control over financial reporting was effective as of December 31, 2009.

BDO Seidman, LLP, the independent registered public accounting firm, which audited the consolidated financial statements included in the Annual Report on Form 10-K, has also issued an attestation on our internal control over financial reporting, and their report is set forth on page 36.

---

**Table of Contents**

**Report of Independent Registered Public Accounting Firm**

Board of Directors and Shareholders

Dril-Quip, Inc.

Houston, Texas

We have audited Dril-Quip, Inc.'s internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Dril-Quip, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Item 9A. Management's Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Dril-Quip, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Dril-Quip, Inc. as of December 31, 2009 and 2008, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2009 and our report dated February 25, 2010 expressed an unqualified opinion thereon.

/s/ BDO Seidman, LLP

Houston, Texas

February 25, 2010



**Table of Contents**

**Report of Independent Registered Public Accounting Firm**

Board of Directors and Stockholders

Dril-Quip, Inc.

Houston, Texas

We have audited the accompanying consolidated balance sheets of Dril-Quip, Inc. as of December 31, 2009 and 2008 and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2009. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Dril-Quip, Inc. at December 31, 2009 and 2008, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2009, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Dril-Quip, Inc.'s internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated February 25, 2010, expressed an unqualified opinion thereon.

/s/ BDO Seidman, LLP

Houston, Texas

February 25, 2010

**Table of Contents****DRIL-QUIP, INC.****CONSOLIDATED STATEMENTS OF INCOME**

	Year Ended December 31,		
	2007	2008	2009
	(In thousands, except per share data)		
Revenues:			
Products	\$ 417,970	\$ 453,315	\$ 456,022
Services	77,587	89,456	84,182
Total revenues	495,557	542,771	540,204
Cost and expenses:			
Cost of sales:			
Products	237,728	260,626	260,780
Services	47,553	51,673	49,513
Total cost of sales	285,281	312,299	310,293
Selling, general and administrative	49,313	62,390	55,474
Engineering and product development	22,578	26,369	27,173
Special item			5,224
	357,172	401,058	398,164
Operating income	138,385	141,713	142,040
Interest income	8,275	3,453	507
Interest expense	(370)	(182)	(156)
Income before income taxes	146,290	144,984	142,391
Income tax provision	38,349	39,399	37,250
Net income	\$ 107,941	\$ 105,585	\$ 105,141
Earnings per common share:			
Basic	\$ 2.67	\$ 2.65	\$ 2.68
Diluted	\$ 2.63	\$ 2.62	\$ 2.66
Weighted average common shares outstanding:			
Basic	40,447	39,918	39,164
Diluted	41,007	40,292	39,538

The accompanying notes are an integral part of these statements.

**Table of Contents****DRIL-QUIP, INC.****CONSOLIDATED BALANCE SHEETS**

	December 31, 2008      2009 (In thousands)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 95,952	\$ 197,792
Trade receivables, net	172,072	130,816
Inventories, net	222,203	251,357
Deferred income taxes	15,834	24,542
Prepays and other current assets	8,213	12,849
Total current assets	514,274	617,356
Property, plant and equipment, net	160,810	194,703
Other assets	5,525	5,187
Total assets	\$ 680,609	\$ 817,246
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 31,715	\$ 24,828
Current maturities of long-term debt	636	723
Accrued income taxes	7,153	8,514
Customer prepayments	51,153	47,214
Accrued compensation	9,702	10,751
Other accrued liabilities	13,380	12,595
Total current liabilities	113,739	104,625
Long-term debt	896	316
Deferred income taxes	6,524	7,220
Total liabilities	121,159	112,161
 Commitments and contingencies (Note 9)		
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, 39,022,597 and 39,658,524 issued and outstanding at December 31, 2008 and 2009, respectively		
	390	396
Additional paid-in capital	109,784	129,528
Retained earnings	478,146	583,287
Foreign currency translation adjustment	(28,870)	(8,126)
Total stockholders' equity	559,450	705,085
Total liabilities and stockholders' equity	\$ 680,609	\$ 817,246

The accompanying notes are an integral part of these statements.



**Table of Contents****DRIL-QUIP, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Year Ended December 31,		
	2007	2008	2009
	(In thousands)		
<b>Operating activities</b>			
Net income	\$ 107,941	\$ 105,585	\$ 105,141
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	15,653	16,854	17,997
Stock-based compensation expense	2,286	3,181	3,975
Gain on sale of equipment	(253)	(102)	(132)
Deferred income taxes	(666)	(383)	(7,869)
Special item non-cash			1,272
Changes in operating assets and liabilities:			
Trade receivables, net	4,990	(46,853)	51,461
Inventories, net	(18,172)	(62,139)	(19,280)
Prepays and other assets	(7,428)	(141)	(3,580)
Excess tax benefits of stock option exercises	(6,271)	(399)	(7,833)
Trade accounts payable and accrued expenses	(15,417)	25,074	(4,740)
<b>Net cash provided by operating activities</b>	<b>82,663</b>	<b>40,677</b>	<b>136,412</b>
<b>Investing activities</b>			
Purchase of property, plant, and equipment	(25,208)	(50,134)	(44,749)
Proceeds from sale of equipment	354	607	424
<b>Net cash used in investing activities</b>	<b>(24,854)</b>	<b>(49,527)</b>	<b>(44,325)</b>
<b>Financing activities</b>			
Repurchase of common stock		(100,038)	
Principal payments on long-term debt	(875)	(812)	(695)
Proceeds from exercise of stock options	4,764	376	6,298
Excess tax benefits of stock option exercises	6,271	399	7,833
<b>Net cash provided by (used in) financing activities</b>	<b>10,160</b>	<b>(100,075)</b>	<b>13,436</b>
Effect of exchange rate changes on cash activities	(1,666)	3,145	(3,683)
<b>Increase (decrease) in cash and cash equivalents</b>	<b>66,303</b>	<b>(105,780)</b>	<b>101,840</b>
Cash and cash equivalents at beginning of year	135,429	201,732	95,952
<b>Cash and cash equivalents at end of year</b>	<b>\$ 201,732</b>	<b>\$ 95,952</b>	<b>\$ 197,792</b>

The accompanying notes are an integral part of these statements.

**Table of Contents****DRIL-QUIP, INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

	<b>Common Stock</b>	<b>Additional Paid-In Capital</b>	<b>Retained Earnings (In thousands)</b>	<b>Foreign Currency Translation Adjustment</b>	<b>Total</b>
Balance at December 31, 2006	\$ 404	\$ 192,086	\$ 264,620	\$ 10,387	\$ 467,497
Translation adjustment				3,304	3,304
Net income			107,941		107,941
Comprehensive income					111,245
Options exercised (436,057 shares)	4	4,760			4,764
Stock-based compensation		2,286			2,286
Excess tax benefits - stock options		6,703			6,703
Balance at December 31, 2007	408	205,835	372,561	13,691	592,495
Translation adjustment				(42,561)	(42,561)
Net income			105,585		105,585
Comprehensive income					63,024
Options exercised (28,812 shares)		376			376
Stock-based compensation		3,181			3,181
Treasury stock (1,799,928 shares)	(18)	(100,020)			(100,038)
Excess tax benefits - stock options		412			412
Balance at December 31, 2008	390	109,784	478,146	(28,870)	559,450
Translation adjustment				20,744	20,744
Net income			105,141		105,141
Comprehensive income					125,885
Options exercised (635,927 shares)	6	6,292			6,298
Stock-based compensation		3,975			3,975
Special item - stock-based compensation		1,272			1,272
Excess tax benefits - stock options		8,205			8,205
Balance at December 31, 2009	\$ 396	\$ 129,528	\$ 583,287	\$ (8,126)	\$ 705,085

The accompanying notes are an integral part of these statements.

---

**Table of Contents**

**DRIL-QUIP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Organization**

Dril-Quip, Inc., a Delaware corporation (the Company or Dril-Quip), designs, manufactures, sells and services highly engineered offshore drilling and production equipment that is well suited for use in deepwater, harsh environment and severe service applications. The Company's principal products consist of subsea and surface wellheads, subsea and surface production trees, subsea control systems and manifolds, mudline hanger systems, specialty connectors and associated pipe, drilling and production riser systems, liner hangers, wellhead connectors and diverters. Dril-Quip's products are used by major integrated, large independent and foreign national oil and gas companies in offshore areas throughout the world. Dril-Quip also provides technical advisory assistance on an as-requested basis during installation of its products, as well as rework and reconditioning services for customer-owned Dril-Quip products. In addition, Dril-Quip's customers may rent or purchase running tools from the Company for use in the installation and retrieval of 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 as well as Macae, Brazil. The Company's major subsidiaries are Dril-Quip (Europe) Limited (DQE), located in Aberdeen with branches in Denmark, Norway and Holland; Dril-Quip Asia Pacific PTE Ltd. (DQAP), located in Singapore; Dril-Quip do Brasil LTDA (DQB), located in Macae, Brazil; and Dril-Quip Holdings Pty Ltd. (DQH), located in Perth, Australia. Dril-Quip (Nigeria) Ltd. is located in Port Harcourt, Nigeria, and Dril-Quip Egypt for Petroleum Services S.A.E. is located in Alexandria, Egypt. Both are wholly owned subsidiaries of DQE. Dril-Quip Oilfield Services (Tianjin) Co. Ltd. (DQT) is located in Tianjin, China. DQT is a wholly owned subsidiary of DQAP.

**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 under guidance from the Financial Accounting Standards Board Accounting Standards Codification (ASC) 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.

*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 interest bearing accounts, money market mutual funds and funds which invest in U.S. Treasury obligations and repurchase agreements backed by U.S. Treasury obligations. The Company's investment objectives continue to be the preservation of capital and the maintenance of liquidity.

**Table of Contents***Trade Receivables*

The Company maintains an allowance for doubtful accounts on trade receivables equal to amounts estimated to be uncollectible. This estimate is based upon historical collection experience combined with a specific review of each customer's outstanding trade receivable balance. Management believes that the allowance for doubtful accounts is adequate; however, actual write-offs may exceed the recorded allowance. The following is a summary of activity relating to the allowance for doubtful accounts for the years ended December 31, 2007, 2008 and 2009:

	<b>In thousands</b>
Balance at December 31, 2006	\$ 2,672
Charges to costs and expenses	978
Recoveries/write-offs	(1,338)
Balance at December 31, 2007	2,312
Charges to costs and expenses	1,937
Recoveries/write-offs	(742)
Balance at December 31, 2008	3,507
Charges to costs and expenses	1,333
Recoveries/write-offs	(2,173)
Balance at December 31, 2009	\$ 2,667

*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. Inventory purchased from third party vendors is principally valued at the weighted average cost. 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 \$20.8 million and \$24.2 million were recorded as of December 31, 2008 and 2009, 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.

*Impairment of Long-Lived Assets*

Long-lived assets including property, plant and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If the carrying amount of an asset exceeds the estimated undiscounted future cash flows expected to be generated by the asset, an impairment charge is recognized by reflecting the asset at its fair value. No impairment of long-lived assets existed at December 31, 2008 or 2009.

*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



## **Table of Contents**

enacted tax rates for the expected future tax consequences of temporary differences between the carrying amounts and the tax basis of assets and liabilities. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

### *Revenue Recognition*

#### *Product Revenue*

The Company earns product revenues from two sources:

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 pursuant to ASC Topic 605-35, which provides guidance on accounting for the performance of contracts. Long-term project contracts 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 requirement cannot be filled directly from the Company's standard inventory.

For each project, the Company prepares a detailed analysis of estimated costs, profit margin, completion date and risk factors which include availability of material, production efficiencies and other factors that may impact the project. On a quarterly basis, management reviews the progress of each project, which may result in revisions of previous estimates, including revenue recognition. The Company calculates the percent complete and applies the percentage to determine the revenues earned and the appropriate portion of total estimated costs. Losses, if any, are recorded in full in the period they first become evident. 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 do not always 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 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. As of December 31, 2008 and 2009, receivables included \$44.8 million and \$24.8 million of unbilled receivables, respectively. For the year ended December 31, 2009, there were 17 projects representing approximately 13% of the Company's total revenues and approximately 16% of its product revenues that were accounted for using percentage-of-completion accounting as compared to 23 projects during 2008 which represented 25% of the Company's total revenue and 30% 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.



## **Table of Contents**

### *Service revenue*

The Company earns service revenues from three sources:

technical advisory assistance;

rental of running tools; and

rework and reconditioning of customer owned Dril-Quip products.

The recognition of service revenue is the same for all products, including those accounted for under the percentage-of-completion method. The Company does not install products for our customers, but it provides 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 related 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 services. The customer may use a third party or their own personnel.

### *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. These adjustments amounted to an increase of \$3.3 million in 2007, a decrease of \$42.6 million in 2008 and an increase of \$20.7 million in 2009. The translation adjustment decrease in 2008 resulted primarily from the strengthening of the U.S. dollar compared to the British pound sterling and the Brazilian real during the latter half of 2008. The translation adjustment increase in 2009 resulted primarily from the weakening of the U.S. dollar compared to the British pound sterling and the Brazilian real.

Foreign currency exchange transactions are recorded using the exchange rate at the date of the settlement. Exchange gains (losses) were approximately \$2.2 million in 2007, (\$1.5 million) in 2008, and \$3.4 million in 2009, net of income taxes. These amounts are included in selling, general and administrative costs in the Consolidated Statements of Income.

### *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 that approximate market rates.

### *Concentration of Credit Risk*

Financial instruments which subject the Company to concentrations of credit risk primarily include 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.

---

## **Table of Contents**

In addition, the Company invests excess cash in interest bearing accounts, money market mutual funds and funds which invest in obligations of the U.S. Treasury and repurchase agreements backed by U.S. Treasury obligations. Changes in the financial markets and interest rates could affect the interest earned on short-term investments.

### *Comprehensive Income*

ASC Topic 220 establishes the rules for the reporting and display of comprehensive income and its components. The standard 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.

### *Interest Capitalization*

The Company capitalizes interest on significant construction projects for which interest costs are being incurred. These projects principally consist of construction or expansion of the Company's facilities. No interest was capitalized in 2007, 2008 or 2009.

### *Earnings Per Share*

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

### *New Accounting Standards*

In October 2009, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) 2009-13, Multiple-Deliverable Revenue Arrangements ( ASU 2009-13 ). The new standard changes the requirements for establishing separate units of accounting in a multiple element arrangement and requires the allocation of arrangement consideration to each deliverable based on the relative selling price. The selling price for each deliverable is based on vendor-specific objective evidence ( VSOE ) if available, third-party evidence if VSOE is not available, or estimated selling price if neither VSOE or third-party evidence is available. ASU 2009-13 is effective for revenue arrangements entered into in fiscal years beginning on or after June 15, 2010. The Company does not expect that the provisions of the new guidance will have a material effect on its consolidated financial statements.

In September 2009, the Company adopted ASC Topic 105. This standard establishes the FASB Accounting Standards Codification ( ASC ) as the single source of the authoritative U.S. generally accepted accounting principles (U.S. GAAP) recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the SEC under authority of federal securities laws are also sources of the authoritative U.S. GAAP for SEC registrants. The ASC supersedes all existing non-SEC accounting and reporting standards. Following the ASC, the FASB will not issue new standards in the form of statements, FASB staff positions or Emerging Issues Task Force. Instead, it will issue ASUs that serve to update the ASC, provide background information about the guidance and provide the basis for conclusions on changes to the ASC.

In June 2009, the Company adopted ASC Topic 825 regarding disclosures about the fair value of financial instruments for interim periods of publicly traded companies as well as in the annual financial statements. The standard also requires publicly traded companies to include disclosures about the fair value of its financial instruments whenever it issues summarized financial information for interim reporting periods. The adoption of this standard had no material effect on the Company's consolidated financial statements.

In May 2009, the Company adopted ASC Topic 855 regarding subsequent events. This standard establishes general standards of accounting for and disclosures of events or transactions that occur after the balance sheet

**Table of Contents**

date but before financial statements are issued or are available to be issued. This standard sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosure that an entity should make about events or transactions that occurred after the balance sheet date. The standard requires entities to disclose the date through which subsequent events have been evaluated as well as whether that date is the date the financial statements were issued or the date the financial statements were available to be issued. See Note 16 of the Notes to Consolidated Financial Statements for the Company's disclosure on this topic.

In January 2009, the Company adopted ASC Topic 805 regarding business combinations. The standard establishes principles and requirements for the recognition and measurement of assets, liabilities and goodwill including the requirement that most transaction costs and restructuring costs be expensed. In addition, the standard requires disclosures to enable users to evaluate the nature and financial effects of the business combination that occurs either during the reporting period or after the reporting period but before the financial statements are issued or are available to be issued. The adoption of this standard had no material effect on the Company's consolidated financial statements.

In January 2009, the Company adopted ASC Topic 810 regarding noncontrolling interest in consolidated financial statements. The standard established accounting and reporting standards for noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. The adoption of this standard had no material effect on the Company's consolidated financial statements.

In January 2008, the Company adopted ASC Topic 820-10. In February 2008, ASC 820-10-55 was issued. The standard provides a one year deferral of the effective date of ASC 820-10 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed in the financial statements at fair value at least annually. ASC 820-10 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. ASC 820-10 applies under other accounting pronouncements that require or permit fair value measurements and does not require any new fair value measurements. The Company does not have any assets or liabilities that would be recognized or disclosed on a fair value basis as of December 31, 2008 or December 31, 2009.

**3. Inventories**

Inventories consist of the following:

	<b>December 31,</b>	
	<b>2008</b>	<b>2009</b>
	<b>(In thousands)</b>	
Raw materials and supplies	\$ 55,470	\$ 50,853
Work in progress	71,926	74,956
Finished goods	115,636	149,749
	243,032	275,558
Less: allowance for obsolete and excess inventory	(20,829)	(24,201)
	\$ 222,203	\$ 251,357

**Table of Contents**

Summary of allowance for obsolete and excess inventory:

	<b>In thousands</b>
Balance at December 31, 2006	\$ 16,873
Charges to costs and expenses	2,648
Write-offs of inventory	(294)
Balance at December 31, 2007	19,227
Charges to costs and expenses	2,378
Write-offs of inventory	(776)
Balance at December 31, 2008	20,829
Charges to costs and expenses	3,942
Write-offs of inventory	(570)
Balance at December 31, 2009	\$ 24,201

**4. Property, Plant and Equipment**

Property, plant and equipment consists of:

	<b>Estimated Useful Lives</b>	<b>December 31, 2008      2009</b>	
		<b>(In thousands)</b>	
Land and improvements	10-25 years	\$ 19,371	\$ 20,839
Buildings	15-40 years	87,616	103,713
Machinery, equipment and other	3-10 years	186,128	224,956
		293,115	349,508
Less accumulated depreciation		(132,305)	(154,805)
		\$ 160,810	\$ 194,703

**5. Long-Term Debt**

Long-term debt consists of the following:

	<b>December 31, 2008      2009</b>	
	<b>(In thousands)</b>	
Bank financing	\$ 1,362	\$ 865
Equipment financing agreements	170	174
	1,532	1,039
Less current portion	(636)	(723)
	\$ 896	\$ 316

## Edgar Filing: DRIL-QUIP INC - Form 10-K

The Company's credit facility with Guaranty Bank, FSB which provided an unsecured revolving line of credit of up to \$10 million, terminated in accordance with its terms on September 1, 2009. The Company is in the process of reviewing alternatives, including securing a new line of credit.

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. \$6.5 million at December 31, 2009). Borrowing under this facility bears interest at the Bank of Scotland base rate, which was 0.50% at December 31, 2009, plus 1%, and is repayable in 120 equal monthly installments, plus interest. Substantially all of this facility

**Table of Contents**

was used to finance capital expenditures in Norway. The outstanding balance of this facility at December 31, 2008 and 2009 was approximately U.S. \$1.4 million and U.S. \$865,000, respectively. The facility is secured by land and buildings in Aberdeen, Scotland and contains no restrictive financial covenants.

Interest paid on long-term debt for the years ended December 31, 2007, 2008 and 2009 was \$253,000, \$132,000 and \$21,700 respectively. Scheduled maturities of long-term debt are as follows: 2010 \$723,000; 2011 \$274,000; 2012 \$36,000; 2013 \$6,000; and none thereafter.

**6. Income Taxes**

In accordance with ASC 740-10, the Company is required to 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 standard provides guidance on recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. Based on the Company's evaluation, the Company has concluded that there are no significant uncertain tax positions requiring recognition in the Company's financial statements. The evaluation was performed for the tax years which remain subject to examination by major tax jurisdictions as of December 31, 2009, which are the years ended December 31, 2004 through December 31, 2009. The Company has occasionally been assessed interest or penalties by major tax jurisdictions and these assessments historically have been minimal and immaterial to the Company's financial results. In accordance with the Company's accounting policy, both before and after adoption of ASC Topic 740-10, interest expense assessed by tax jurisdictions is included with interest expense and assessed penalties are included in selling, general and administrative expenses.

Income before income taxes consisted of the following:

	Year ended December 31,		
	2007	2008	2009
	(In thousands)		
Domestic	\$ 79,397	\$ 72,515	\$ 52,203
Foreign	66,893	72,469	90,188
<b>Total</b>	<b>\$ 146,290</b>	<b>\$ 144,984</b>	<b>\$ 142,391</b>

The income tax provision (benefit) consists of the following:

	Year ended December 31,		
	2007	2008	2009
	(In thousands)		
<b>Current:</b>			
Federal	\$ 25,371	\$ 24,428	\$ 23,998
Foreign	13,747	14,844	21,264
<b>Total current</b>	<b>39,118</b>	<b>39,272</b>	<b>45,262</b>
<b>Deferred:</b>			
Federal	222	(929)	(7,188)
Foreign	(991)	1,056	(824)
<b>Total deferred</b>	<b>(769)</b>	<b>127</b>	<b>(8,012)</b>
	<b>\$ 38,349</b>	<b>\$ 39,399</b>	<b>\$ 37,250</b>



**Table of Contents**

The difference between the effective income tax rate reflected in the provision for income taxes and the U.S. federal statutory rate was as follows:

	Year ended December 31,		
	2007	2008	2009
Federal income tax statutory rate	35.0%	35.0%	35.0%
Foreign income tax rate differential	(4.0)	(4.5)	(5.7)
Foreign development tax incentive	(3.3)	(2.0)	(2.1)
Manufacturing benefit	(0.9)	(1.1)	(0.7)
Other	(0.6)	(0.2)	(0.3)
Effective income tax rate	26.2%	27.2%	26.2%

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Based upon existing market conditions and the Company's earnings prospects, it is anticipated that all deferred tax assets will be realized in future years. Significant components of the Company's deferred tax assets and liabilities are as follows:

	December 31,	
	2008	2009
	(In thousands)	
Deferred tax assets:		
Deferred profit on intercompany sales	\$ 4,109	\$ 6,439
Inventory	2,504	5,489
Inventory reserve	4,790	5,210
Allowance for doubtful accounts	551	656
Reserve for accrued liabilities	378	1,420
Stock options	2,104	3,431
Other	1,398	1,897
Total deferred tax assets	15,834	24,542
Deferred tax liability:		
Property, plant and equipment	(6,524)	(7,220)
Net deferred tax asset	\$ 9,310	\$ 17,322

Undistributed earnings of the Company's foreign subsidiaries are considered to be indefinitely reinvested and, accordingly, no provision for U.S. federal income taxes has been provided thereon. Upon distribution of those earnings in the form of dividends or otherwise, the Company may be subject to both U.S. income taxes (subject to an adjustment for foreign tax credits) and withholding taxes payable to the various foreign countries. Determination of the amount of unrecognized deferred U.S. income tax liability is not practicable.

The American Jobs Creation Act of 2004 provides for a tax deduction for qualified production activities. Under the guidance of ASC Topic 740, Income Tax and the Tax Deduction on Qualified Production Activities Provided by American Jobs Creation Act of 2004, the deduction will be treated as a special deduction and not as a reduction in the tax rate. As such, the special deduction has no effect on deferred tax assets and liabilities existing on the date of enactment. The Company's production activities qualify for the tax deduction and the Company's 2009 income tax provision includes an estimated deduction of approximately \$3.0 million.

The Company paid \$41.9 million, \$40.5 million and \$37.8 million in income taxes in 2007, 2008 and 2009, respectively.

**Table of Contents****7. Other Accrued Liabilities**

Other accrued liabilities consist of the following:

	December 31,	
	2008	2009
	(In thousands)	
Payroll taxes	\$ 2,733	\$ 2,443
Property, sales and other taxes	2,321	130
Commissions payable	1,459	2,179
Accrued project costs	1,510	2,614
Accrued vendor costs	2,692	1,965
Other	2,665	3,264
<b>Total</b>	<b>\$ 13,380</b>	<b>\$ 12,595</b>

**8. Employee Benefit Plans**

The Company has a defined-contribution 401(k) plan covering domestic employees and a defined-contribution pension plan covering certain foreign employees. The Company generally makes contributions to the plans equal to each participant's eligible contributions for the plan year up to a specified percentage of the participant's annual compensation. The Company's contribution expense was \$2.7 million, \$3.0 million and \$3.1 million in 2007, 2008 and 2009, respectively.

**9. Commitments and Contingencies**

The Company leases certain office, shop and warehouse facilities, automobiles, and equipment. The Company expenses all lease payments when incurred. Total lease expense incurred was \$2.7 million, \$2.6 million and \$3.1 million in 2007, 2008 and 2009, respectively. Future annual minimum lease commitments, including required leasehold improvements, at December 31, 2009 are as follows: 2010 \$2.5 million; 2011 \$18.1 million; 2012 \$3.3 million; 2013 \$0.2 million; 2014 \$0.2 million; and thereafter \$2.4 million.

In 2006, the Company entered into a contract in the amount of approximately \$47 million with MPF Corp. Ltd. (MPF) under which the Company was to construct risers and related equipment to be installed on an offshore drill ship being constructed for MPF. MPF and its affiliates filed a Chapter 11 bankruptcy case in September 2008 in the United States Bankruptcy Court for the Southern District of Texas, Houston Division (Case No. 08-36084). Under the Bankruptcy Code, at some point MPF must either assume this contract or reject it. Since MPF is not required to make a decision on the handling of the contract immediately, the Company cannot be sure as to when its rights under the contract will be clarified. Currently, the Company has possession of all the raw materials purchased to date and work-in-progress under the contract. At the time of the bankruptcy filing, the Company had recognized approximately \$20 million in revenues under the contract and had received payments of approximately \$16 million. No further revenue has been recognized since the second quarter of 2008. The Company believes the remaining \$4 million of unpaid receivables will be realized through the workings of the contract or through its interest in the partially constructed inventory. While the Company has made filings in the bankruptcy proceedings that it believes are appropriate to protect its rights, there can be no assurance that the Company will be able to receive the expected benefits of the contract with MPF. While the Company does not expect the outcome of this matter to have a material adverse effect on the Company's operations, financial position or cash flows, the Company may be required to write down or forfeit some portion of the revenues recognized to date if it becomes probable that the Company will not receive such funds or realize the value of the inventory in its possession.

In August 2007, the Company's Brazilian subsidiary was served with assessments collectively valued at approximately BRL23.3 million (approximately U.S. \$12.6 million as of February 2010) from the State of

## **Table of Contents**

Rio de Janeiro, Brazil, to collect a state tax on the importation of goods. The Company believes that its subsidiary is not liable for the taxes and is vigorously contesting the assessments in the Brazilian administrative and judicial systems. At this time, the ultimate disposition of this matter cannot be determined and therefore, it is not possible to reasonably 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. The Company does not expect the liability, if any, resulting from these assessments to have a material adverse effect on its operations, financial position or cash flows. While pending, the amount of interest, penalties and monetary restatement fees on the tax assessments continues to accrue and totaled as of February 2010 approximately BRL35.4 million (approximately U.S. \$19.1 million).

In November 2007, the Company entered into a lease agreement in Singapore for approximately 11 acres of vacant land. The lease term is 30 years and the Company elected to make a lump sum payment for the entire lease. In addition, under the terms of the lease, the Company is obligated to make certain minimum investments in machinery, leasehold improvements and buildings by November 2012.

In October 2009, the Company entered into an agreement for the construction of a manufacturing facility in Singapore. The agreement is valued at SGD46.5 million (approximately \$33.2 million USD on December 31, 2009). The expected construction term is 16 months and is followed by a maintenance term of 12 months.

The Company operates its business and markets its products and services in most of the significant oil and gas producing areas in the world and is, therefore, subject to the risk customarily attendant to international operations and dependency on the condition of the oil and gas industry. Additionally, products of the Company are used in potentially hazardous drilling, completion, and production applications that can cause personal injury, product liability, and environmental claims. Although exposure to such risk has not resulted in any significant problems in the past, there can be no assurance that future developments will not adversely impact the Company.

The Company is also 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 action, in the opinion of management, the ultimate liability with respect thereto will not have a material adverse affect on the Company's operations, financial position or cash flows.

## **10. Stockholders' Equity**

The Rights Agreement between the Company and ChaseMellon Shareholder Services, L.L.C. dated as of October 17, 1997 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 Agreement and the rights issued thereunder expired by their terms, at which time no shares of the Series A Preferred Stock were issued or outstanding.

Under a Stockholder Rights Plan adopted by the Board of Directors on November 24, 2008, each share of common stock includes one right to purchase from the Company a unit consisting of one one-hundredth of a share (a Fractional Share) of Series A Junior Participating Preferred Stock at a specific purchase price per Fractional Share, subject to adjustment in certain event. The rights will cause substantial dilution to any person or group that attempts to acquire the Company without the approval of the Company's Board of Directors.

**Table of Contents****11. Geographic Segments**

	Year ended December 31,		
	2007	2008	2009
	(In thousands)		
<i>Revenues</i>			
Western Hemisphere			
Products	\$ 198,346	\$ 224,816	\$ 220,171
Services	38,301	43,065	37,014
Intercompany	57,281	64,418	67,546
Total	\$ 293,928	\$ 332,299	\$ 324,731
Eastern Hemisphere			
Products	\$ 148,223	\$ 154,226	\$ 166,181
Services	32,699	34,732	36,053
Intercompany	6,364	1,858	1,765
Total	\$ 187,286	\$ 190,816	\$ 203,999
Asia-Pacific			
Products	\$ 71,401	\$ 74,273	\$ 69,670
Services	6,587	11,659	11,115
Intercompany	6,524	7,714	3,397
Total	\$ 84,512	\$ 93,646	\$ 84,182
Summary			
Products	\$ 417,970	\$ 453,315	\$ 456,022
Services	77,587	89,456	84,182
Intercompany	70,169	73,990	72,708
Eliminations	(70,169)	(73,990)	(72,708)
Total	\$ 495,557	\$ 542,771	\$ 540,204
	2007	December 31, 2008	2009
	(In thousands)		
<i>Income (loss) before income taxes</i>			
Western Hemisphere	\$ 77,183	\$ 69,319	\$ 63,839
Eastern Hemisphere	31,538	35,509	45,939
Asia-Pacific	28,093	33,592	35,061
Eliminations	9,476	6,564	(2,448)
Total	\$ 146,290	\$ 144,984	\$ 142,391
<i>Total Long-Lived Assets</i>			
Western Hemisphere	\$ 122,978	\$ 147,460	\$ 158,210
Eastern Hemisphere	29,169	22,892	27,214
Asia-Pacific	15,496	16,402	18,029
Eliminations	(20,419)	(20,419)	(3,563)
Total	\$ 147,224	\$ 166,335	\$ 199,890

Edgar Filing: DRIL-QUIP INC - Form 10-K

<i>Total Assets</i>			
Western Hemisphere	\$ 522,732	\$ 465,797	\$ 518,475
Eastern Hemisphere	161,626	125,497	158,112
Asia-Pacific	74,297	120,943	147,644
Eliminations	(58,833)	(31,628)	(6,985)
Total	\$ 699,822	\$ 680,609	\$ 817,246

**Table of Contents**

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 Macae, Brazil.

Eliminations of operating profits are related to intercompany inventory transfers that are deferred until shipment is made to third party customers.

In 2007 and 2008, no single customer accounted for more than 10% of the Company's revenues. In 2009, one customer accounted for approximately 10% of the Company's total revenues.

**12. Employee Stock Option Plan and Awards**

On September 19, 1997, the Company adopted the Dril-Quip, Inc. 1997 Incentive Plan (as amended, the 1997 Plan) and the Company reserved 3,400,000 shares of Common Stock for use in connection with the 1997 Plan. During 2001, the Company reserved an additional 1,400,000 shares for use in connection with the 1997 Plan. Some options remain outstanding under the 1997 Plan; however, no additional grants will be awarded under this plan. 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 used in connection with the 2004 Plan. Persons eligible for awards under the 1997 Plan and 2004 Plan are employees holding positions of responsibility with the Company or any of its subsidiaries. Options granted under the 1997 Plan and the 2004 Plan have a term of ten years and become exercisable in cumulative annual increments of one-fourth of the total number of shares of Common Stock subject thereto, beginning on the first anniversary of the date of the grant.

The fair value of stock options granted is estimated on the grant date using the Black-Scholes option pricing model. The expected life was based on the Company's historical trends and volatility was based on the expected life of the options. The risk-free interest rate is based on U.S. Treasury yield curve at the grant date. The Company does not pay dividends and therefore, there is no dividend yield.

On October 26, 2007, October 28, 2008 and October 28, 2009, the Company granted options to purchase 256,284, 408,123 and 243,470 shares respectively, of Common Stock pursuant to the 2004 Plan to certain officers and employees. The following table presents the assumptions used in the option pricing model.

	2007	2008	2009
Expected life (years)	6.0	6.3	6.2
Volatility	45.8%	46.2%	48.8%
Risk-free interest rate	4.04%	2.75%	2.37%
Dividend yield	0.0%	0.0%	0.0%
Fair value of each option	\$ 26.76	\$ 10.23	\$ 24.22

Option activity for the year ended December 31, 2009 was as follows:

	Number of Options	Weighted Average Price	Aggregate intrinsic value (in millions)	Weighted Average Remaining Contractual Life (in years)
Outstanding at December 31, 2008	1,610,210	\$ 23.59		
Granted	243,470	48.77		
Exercised	(635,927)	9.90		
Forfeited	(15,313)	36.41		
Outstanding at December 31, 2009	1,202,440	\$ 35.74	\$ 24.9	7.99
Exercisable at December 31, 2009	555,539	\$ 32.66	\$ 13.2	6.98



**Table of Contents**

The total intrinsic value of stock options exercised in 2007, 2008 and 2009 was \$19.9 million, \$1.3 million and \$24.9 million, respectively. The income tax benefit realized from stock options exercised was \$8.7 million for the year ended December 31, 2009.

Stock-based compensation is recognized as selling, general and administrative expense in the accompanying Consolidated Statements of Income. During the years ended December 31, 2007, 2008 and 2009, stock-based compensation expense totaled \$2.3 million, \$3.2 million and \$4.0 million, respectively. Stock option expense for 2009 excludes \$1.3 million for the accelerated vesting of Mr. Smith's remaining options upon his death as discussed in Note 15 to the consolidated financial statements. This expense is included in Special Item on the Consolidated Statements of Income. No stock-based compensation expense was capitalized during 2007, 2008 or 2009.

Options granted to employees vest over four years and the Company recognizes compensation expense on a straight-line basis over the vesting period of the options. At December 31, 2009, there was \$11.4 million of total unrecognized compensation expense related to nonvested stock options. This expense is expected to be recognized over a weighted average of 1.9 years.

The following table summarizes information for equity compensation plans in effect as of December 31, 2009:

Plan category	Number of securities to be issued upon exercise of outstanding options (a)	Weighted-average exercise price of outstanding options (b)	Number of securities remaining available for future issuance under equity compensation plan (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by stockholders	1,202,440	\$ 35.74	1,523,982
Equity compensation plans not approved by stockholders	0	not applicable	0
<b>Total</b>	<b>1,202,440</b>	<b>\$ 35.74</b>	<b>1,523,982</b>

**13. Earnings Per Share**

The following is a reconciliation of the basic and diluted earnings per share computation as required by ASC Topic 260.

	Year Ended December 31, 2007      2008      2009 (In thousands, except per share amounts)		
Net income	\$ 107,941	\$ 105,585	\$ 105,141
Weighted average common shares outstanding	40,447	39,918	39,164
Effect of dilutive securities - stock options	560	374	374
Total shares and dilutive securities	41,007	40,292	39,538
Basic earnings per common share	\$ 2.67	\$ 2.65	\$ 2.68
Diluted earnings per common share	\$ 2.63	\$ 2.62	\$ 2.66
Weighted average number of stock options with an exercise price greater than average market price for the period	306	576	294





**Table of Contents****14. Common Stock**

In May 2008, the Company announced that its Board of Directors had authorized a share repurchase program under which the Company could repurchase up to \$100 million of its Common Stock. At the end of the third quarter of 2008, the Company had repurchased 1,799,928 shares at an average price of \$55.58 per share (including commissions) for a total of approximately \$100 million. All repurchased shares were retired by September 30, 2008.

**15. Special Item**

In September 2009, Gary D. Smith, one of the Company's Co-Chief Executive Officers, unexpectedly passed away. Under the terms of Mr. Smith's employment contract, the Company was obligated to pay Mr. Smith's base salary, including accrued vacation, and his annual bonus through the remaining employment period (October 27, 2012). In addition, stock options owned by Mr. Smith that were outstanding at the date of his death were immediately vested under the terms of the contract. Accordingly, the Company recognized a pre-tax expense of \$5.2 million during the third quarter of 2009. The contractual obligation, including related payroll taxes, totaled \$4.3 million, of which \$434,000 had been previously accrued. The acceleration of the vesting increased pre-tax non-cash expenses by \$1.3 million.

**16. Subsequent Events**

The Company has evaluated subsequent events through February 25, 2010, the date of the issuance of these consolidated financial statements.

**17. Quarterly Results of Operations (Unaudited):**

	Quarter Ended			
	March 31	June 30	Sept. 30	Dec. 31
	(In thousands, except per share data) (Unaudited)			
<b>2008</b>				
Revenues	\$ 132,413	\$ 142,544	\$ 132,271	\$ 135,543
Cost of sales	77,819	83,726	74,230	76,524
Gross profit	54,594	58,818	58,041	59,019
Operating income	34,712	37,760	35,818	33,423
Net income	25,391	27,703	27,446	25,045
Earnings per share:				
Basic(1)	\$ 0.62	\$ 0.69	\$ 0.70	\$ 0.64
Diluted(1)	0.62	0.68	0.69	0.64
<b>2009</b>				
Revenues	\$ 127,522	\$ 133,186	\$ 138,157	\$ 141,339
Cost of sales	72,017	77,407	78,260	82,609
Gross profit	55,505	55,779	59,897	58,730
Operating income	34,660	36,311	34,434	36,635
Net income	24,671	26,707	25,084	28,679
Earnings per share:				
Basic(1)	\$ 0.63	\$ 0.68	\$ 0.64	\$ 0.73
Diluted(1)	0.63	0.68	0.63	0.72

- (1) The sum of the quarterly per share amounts may not equal the annual amount reported, as per share amounts are computed independently for each quarter and for the full year.

**Table of Contents**

**Item 9. *Changes in and Disagreements With Accountants on Accounting and Financial Disclosure***

None.

**Item 9A. *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 December 31, 2009 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 Report on Internal Control over Financial Reporting appears on page 35 of this annual report on Form 10-K.

There has been no change in the Company's internal controls over financial reporting that occurred during the three months ended December 31, 2009 that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

**Item 9B. *Other Information***

None.

**Table of Contents**

**PART III**

**Item 10. *Directors, Executive Officers and Corporate Governance***

The information required by this item is set forth under the captions Election of Directors, Corporate Governance Matters and Section 16(a) Beneficial Ownership Reporting Compliance in the Company's definitive Proxy Statement (the 2010 Proxy Statement) for its annual meeting of stockholders to be held on May 12, 2010, which sections are incorporated herein by reference.

Pursuant to Item 401(b) of Regulation S-K, the information required by this item with respect to executive officers of the Company is set forth in Part I of this report.

**Item 11. *Executive Compensation***

The information required by this item is set forth in the sections entitled Director Compensation, Executive Compensation and Corporate Governance Matters in the 2010 Proxy Statement, which sections are incorporated herein by reference.

**Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

The information required by this item is set forth in the sections entitled Security Ownership of Certain Beneficial Owners and Management and Executive Compensation Equity Compensation Plan Information in the 2010 Proxy Statement, which sections are incorporated herein by reference.

**Item 13. *Certain Relationships and Related Transactions, and Director Independence***

The information required by this item is set forth in the section entitled Corporate Governance Matters in the 2010 Proxy Statement, which section is incorporated herein by reference.

**Item 14. *Principal Accountant Fees and Services***

The information required by this item is set forth in the sections entitled Approval of Appointment of Independent Public Accounting Firm Fees and Audit Committee Pre-Approval Policy for Audit and Non-Audit Services in the 2010 Proxy Statement, which sections are incorporated herein by reference.

**Table of Contents**

**PART IV**

**Item 15. Exhibits and Financial Statement Schedules**

(a)(1) Financial Statements

All financial statements of the registrant are set forth under Item 8 of this Annual Report on Form 10-K.

(a)(2) Financial Statement Schedules

All schedules and other statements are omitted because of the absence of conditions under which they are required or because the required information is presented in the financial statements or notes thereto.

(a)(3) Exhibits

Dril-Quip will furnish any exhibit to a stockholder upon payment by the stockholder of the Company's reasonable expenses to furnish the exhibit.

**Exhibit No. Description**

*3.1	Restated Certificate of Incorporation 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)).
*3.2	Certificate of Designations of Series A Junior Participating Preferred Stock of the Company (Incorporated herein by reference to Exhibit 3.1 to the Company's report on Form 8-K dated November 25, 2008).
*3.3	Amended and restated Bylaws of the Company (Incorporated herein by reference to Exhibit 3.1 to the Company's report on Form 8-K dated December 21, 2007.)
*4.1	Form of certificate representing Common Stock (Incorporated herein by reference to Exhibit 4.2 the Company's Registration Statement on Form S-1 (Registration No. 333-33447)).
*4.2	Registration Rights Agreement among the Company and certain stockholders (Incorporated herein by reference to Exhibit 4.2 to the Company's Registration Statement Form S-1 (Registration No. 333-33447)).
*4.3	Rights Agreement dated as of November 24, 2008 between Dril-Quip, Inc. and Mellon Investor Services LLC, as Rights Agent (Incorporated herein by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K filed on November 25, 2008).
*10.1	Credit Agreement between Dril-Quip (Europe) Limited and Bank of Scotland dated November 18, 1999 (Incorporated by reference to Exhibit 10.2 to the Company's Report on Form 10-Q for the Quarter ended March 30, 2000 (SEC File No. 001-13439)).
*+10.2	Form of Employment Agreement between the Company and each of Messrs. Reimert and Walker (Incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on December 17, 2009).
*10.3	2004 Incentive Plan of Dril-Quip, Inc. (Incorporated herein by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on December 19, 2008).
**+10.4	Summary of Executive Officer and Non-employee Director Compensation.
**10.5	Agreement between Dril-Quip Asia Pacific PTE Ltd and Lum Chang Building Contractors PTE Ltd. dated October 16, 2009.
**21.1	Subsidiaries of the Registrant.
**23.1	Consent of BDO Seidman, LLP.
**31.1	Rule 13a-14(a)/15d-14(a) Certification of Larry E. Reimert.
**31.2	Rule 13a-14(a)/15d-14(a) Certification of J. Mike Walker.

\*\*31.3 Rule 13a-14(a)/15d-14(a) Certification of Jerry M. Brooks.

**Table of Contents**

**Exhibit No. Description**

- \*\*32.1 Section 1350 Certification of Larry E. Reimert.
- \*\*32.2 Section 1350 Certification of J. Mike Walker.
- \*\*32.3 Section 1350 Certification of Jerry M. Brooks.

\* Incorporated herein by reference as indicated.

+ Management contract or compensatory plan or arrangement required to be filed as an exhibit to this Form 10-K.

\*\* Filed with this Report

**Table of Contents****SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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 on February 25, 2010.

**DRIL-QUIP, INC.**

By: */s/* LARRY E. REIMERT  
**Larry E. Reimert**  
**Co-Chief Executive Officer and**

**Co-Chairman of the Board of Directors**

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Name	Capacity	Date
<i>/s/</i> J. MIKE WALKER <b>J. MIKE WALKER</b>	Co-Chief Executive Officer, Co-Chairman of the Board and Director (Co-Principal Executive Officer)	February 25, 2010
<i>/s/</i> LARRY E. REIMERT <b>LARRY E. REIMERT</b>	Co-Chief Executive Officer, Co-Chairman of the Board and Director (Co-Principal Executive Officer)	February 25, 2010
<i>/s/</i> JERRY M. BROOKS <b>JERRY M. BROOKS</b>	Chief Financial Officer (Principal Financial and Accounting Officer)	February 25, 2010
<i>/s/</i> JOHN V. LOVOI <b>JOHN V. LOVOI</b>	Director	February 25, 2010
<i>/s/</i> L.H. DICK ROBERTSON <b>L.H. DICK ROBERTSON</b>	Director	February 25, 2010
<i>/s/</i> A.P. SHUKIS <b>A.P. SHUKIS</b>	Director	February 25, 2010