DRIL-QUIP INC
Form 10-Q
August 02, 2013

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**(MARK ONE)**

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

**FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2013**

**OR**

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

**Commission file number 001-13439**

# DRIL-QUIP, INC.

**(Exact name of registrant as specified in its charter)**

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

**6401 N. ELDRIDGE PARKWAY**

**HOUSTON, TEXAS**

**77041**

**(Address of principal executive offices)**

**(Zip Code)**

**(713) 939-7711**

**(Registrant s telephone number, including area code)**

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

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

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

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

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

As of July 29, 2013, the number of shares outstanding of the registrant s common stock, par value $.01 per share, was 40,669,539.

**PART I FINANCIAL INFORMATION**

**Item 1. FINANCIAL STATEMENTS**

**DRIL-QUIP, INC.**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

**(UNAUDITED)**

| | June 30, 2013 | December 31, 2012 |
|---|---|---|
| | (In thousands) | |
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 325,541 | $ 257,191 |
| Trade receivables, net | 241,022 | 263,213 |
| Inventories, net | 376,594 | 362,181 |
| Deferred income taxes | 25,315 | 23,838 |
| Prepaids and other current assets | 18,739 | 17,965 |
| Total current assets | 987,211 | 924,388 |
| Property, plant and equipment, net | 299,092 | 295,982 |
| Other assets | 10,176 | 11,077 |
| Total assets | $ 1,296,479 | $ 1,231,447 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 44,949 | $ 28,302 |
| Accrued income taxes | 10,694 | 5,604 |
| Customer prepayments | 53,362 | 86,313 |
| Accrued compensation | 16,717 | 14,620 |
| Other accrued liabilities | 22,508 | 20,250 |
| Total current liabilities | 148,230 | 155,089 |
| Deferred income taxes | 9,756 | 9,926 |
| Total liabilities | 157,986 | 165,015 |
| Commitments and contingencies (Note 7) | | |
| Stockholders equity: | | |
| Preferred stock, 10,000,000 shares authorized at $0.01 par value (none issued) | | |
| Common stock: | | |
| 50,000,000 shares authorized at $0.01 par value, 40,661,286 and 40,475,061 shares issued and outstanding at June 30, 2013 and December 31, 2012 | 407 | 405 |
| Additional paid-in capital | 193,293 | 179,868 |
| Retained earnings | 982,757 | 899,989 |
| Accumulated other comprehensive losses | (37,964) | (13,830) |
| Total stockholders equity | 1,138,493 | 1,066,432 |
| Total liabilities and stockholders equity | $ 1,296,479 | $ 1,231,447 |

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

**DRIL-QUIP, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

**(UNAUDITED)**

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| | (In thousands, except per share data) | | | |
| Revenues: | | | | |
| Products | $ 188,859 | $ 146,675 | $ 349,344 | $ 296,381 |
| Services | 33,172 | 29,895 | 65,842 | 57,313 |
| Total revenues | 222,031 | 176,570 | 415,186 | 353,694 |
| Cost and expenses: | | | | |
| Cost of sales: | | | | |
| Products | 113,312 | 91,830 | 209,985 | 183,953 |
| Services | 19,891 | 16,495 | 39,546 | 31,422 |
| Total cost of sales | 133,203 | 108,325 | 249,531 | 215,375 |
| Selling, general and administrative | 23,273 | 17,418 | 38,902 | 37,850 |
| Engineering and product development | 9,340 | 9,478 | 18,361 | 19,088 |
| Total costs and expenses | 165,816 | 135,221 | 306,794 | 272,313 |
| Operating income | 56,215 | 41,349 | 108,392 | 81,381 |
| Interest income | 167 | 78 | 283 | 181 |
| Interest expense | (6) | (9) | (20) | (14) |
| Income before income taxes | 56,376 | 41,418 | 108,655 | 81,548 |
| Income tax provision | 13,449 | 11,615 | 25,886 | 22,948 |
| Net income | $ 42,927 | $ 29,803 | $ 82,769 | $ 58,600 |
| Earnings per common share: | | | | |
| Basic | $ 1.06 | $ 0.74 | $ 2.04 | $ 1.46 |
| Diluted | $ 1.05 | $ 0.74 | $ 2.03 | $ 1.45 |
| Weighted average common shares outstanding: | | | | |
| Basic | 40,636 | 40,268 | 40,583 | 40,226 |
| Diluted | 40,821 | 40,453 | 40,767 | 40,432 |

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

**DRIL-QUIP, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**(UNAUDITED)**

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| | (In thousands) | | | |
| Net income | $ 42,927 | $ 29,803 | $ 82,769 | $ 58,600 |
| Other comprehensive loss, net of tax: | | | | |
| Foreign currency translation adjustments | (9,511) | (12,318) | (24,134) | (3,693) |
| Total comprehensive income | $ 33,416 | $ 17,485 | $ 58,635 | $ 54,907 |

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

**DRIL-QUIP, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(UNAUDITED)**

| | Six months ended June 30, 2013 | Six months ended June 30, 2012 |
|---|---|---|
| | (In thousands) | |
| **Operating activities** | | |
| Net income | $ 82,769 | $ 58,600 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 14,353 | 12,431 |
| Stock-based compensation expense | 4,136 | 2,611 |
| (Gain) loss on sale of equipment | (22) | 34 |
| Deferred income taxes | (1,751) | (336) |
| Changes in operating assets and liabilities: | | |
| Trade receivables, net | 15,203 | (40,756) |
| Inventories, net | (24,658) | (63,150) |
| Prepaids and other assets | (921) | (1,117) |
| Excess tax benefits of stock option exercises | (1,682) | (1,009) |
| Trade accounts payable and accrued expenses | (1,326) | 197 |
| Net cash provided by (used in) operating activities | 86,101 | (32,495) |
| **Investing activities** | | |
| Purchase of property, plant and equipment | (23,101) | (27,737) |
| Proceeds from sale of equipment | 299 | 1,090 |
| Net cash used in investing activities | (22,802) | (26,647) |
| **Financing activities** | | |
| Proceeds from exercise of stock options | 7,749 | 7,204 |
| Excess tax benefits of stock option exercises | 1,682 | 1,009 |
| Net cash provided by financing activities | 9,431 | 8,213 |
| Effect of exchange rate changes on cash activities | (4,380) | 496 |
| Increase (decrease) in cash and cash equivalents | 68,350 | (50,433) |
| Cash and cash equivalents at beginning of period | 257,191 | 298,576 |
| Cash and cash equivalents at end of period | $ 325,541 | $ 248,143 |

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

**DRIL-QUIP, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

## 1. Organization and Principles of Consolidation

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

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

The condensed consolidated financial statements included herein are unaudited. The consolidated balance sheet at December 31, 2012, has been derived from the audited consolidated financial statements at that date. In the opinion of management, the unaudited condensed consolidated interim financial statements include all normal recurring adjustments necessary for a fair presentation of the financial position as of June 30, 2013 and the results of operations and comprehensive income for the three- and six-month periods ended June 30, 2013 and 2012 and the cash flows for the six-month periods ended June 30, 2013 and 2012. Although management believes the unaudited interim related disclosures in these condensed consolidated financial statements are adequate to make the information presented not misleading, certain information and footnote disclosures normally included in annual audited consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. The results of operations, comprehensive income and the cash flows for the six-month period ended June 30, 2013 are not necessarily indicative of the results to be expected for the full year. The condensed consolidated financial statements included herein should be read in conjunction with the consolidated audited financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2012.

## 2. Significant Accounting Policies

*Principles of Consolidation*

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

*Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Some of the Company s more significant estimates are those affected by critical accounting policies for revenue recognition, inventories and contingent liabilities as discussed more fully in the Company s Annual Report on Form 10-K for the year ended December 31, 2012.

*Revenue Recognition*

*Product Revenue*

The Company earns product revenues from two methods:

product revenues recognized under the percentage-of-completion method; and

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

*Revenues recognized under the percentage-of-completion method*

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

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

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

Under the percentage-of-completion method, billings may not correlate directly to the revenue recognized. Based upon the terms of the specific contract, billings may be in excess of the revenue recognized, in which case the amounts are included in customer prepayments as a liability on the Condensed Consolidated Balance Sheets. Likewise, revenue recognized may exceed customer billings in which case the amounts are reported in trade receivables. Unbilled revenues are expected to be billed and collected within one year. As of June 30, 2013 and December 31, 2012, receivables included $37.8 million and $62.1 million of unbilled receivables, respectively. For the quarter ended June 30, 2013, there were 11 projects representing approximately 6% of the Company s total revenue and approximately 7% of its product revenues that were accounted for using percentage-of-completion accounting, compared to13 projects during the second quarter of 2012, which represented approximately 18% of the Company s total revenues and approximately 22% of its product revenues. For the six months ended June 30, 2013, there were 15 projects representing approximately 12% of the Company s total revenues and 14% of its product revenues, compared to 17 projects which represented approximately 18% of the Company s total revenues and 21% of its product revenues for the six months ended June 30, 2012, all of which were accounted for using percentage-of-completion accounting.

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

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

*Service revenue*

The Company earns service revenues from three sources:

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

The Company does not install products for its customers, but it 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

relating to installation. Technical advisory assistance service revenue is recorded at the time the service is rendered. Service revenues associated with the rental of running and installation tools are recorded as earned. Rework and reconditioning service revenues are recorded when the refurbishment process is complete.

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

*Fair Value of Financial Instruments*

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

*Earnings Per Share*

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

In each relevant period, the net income used in the basic and dilutive earnings per share calculations is the same. The following table reconciles the number of common shares outstanding at June 30 of each year to the weighted average number of common shares outstanding and the weighted average diluted number of common shares outstanding for the purpose of calculating basic and diluted earnings per share:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| | (In thousands) | | | |
| Number of common shares outstanding at end of period basic | 40,661 | 40,376 | 40,661 | 40,376 |
| Effect of using weighted average common shares outstanding | (25) | (108) | (78) | (150) |
| Weighted average basic common shares outstanding basic | 40,636 | 40,268 | 40,583 | 40,226 |
| Dilutive effect of common stock options and awards | 185 | 185 | 184 | 206 |
| Weighted average diluted common shares outstanding diluted | 40,821 | 40,453 | 40,767 | 40,432 |

**3. New Accounting Standards**

In February 2013, the FASB issued ASU 2013-02 Comprehensive Income (Topic 220) Reporting Amounts Reclassified Out of Accumulated Other Comprehensive Income. The amendment requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. An entity is required to present, either on the face of the statements where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income. The statement is effective for reporting periods beginning after December 15, 2012. The Company adopted this statement for the reporting period ended March 31, 2013. The Company s balance in accumulated other comprehensive gains (losses) is comprised solely of cumulative translation adjustments and no amounts were reclassified to the income statement during the quarter ended June 30, 2013.

**4. Stock-Based Compensation and Stock Awards**

During the three months ended June 30, 2013 and 2012, the Company recognized approximately $2.0 million and $1.2 million, respectively, of stock-based compensation expense. For the six-months ended June 30, 2013 and 2012, stock-based compensation expense totaled $4.1 million and $2.6 million, respectively. Stock-based compensation expense is included in the selling, general and administrative expense line of the Condensed Consolidated Statements of Income. In May 2012, the Company awarded a total of 4,800 shares of restricted stock to its non-employee directors, one-third of which (1,599 shares) vested in May 2013. No stock-based compensation expense was capitalized during the three or six months ended June 30, 2013 or 2012. There were no stock options or awards granted in the second quarter of 2013. Refer to Note 13 of the Company s Annual Report on Form 10-K for the year ended December 31, 2012 for additional information regarding stock-based compensation plans.

**5. Inventories**

Inventories consist of the following:

| | June 30, 2013 | December 31, 2012 |
|---|---|---|
| | (In thousands) | |
| Raw materials | $ 85,797 | $ 86,007 |
| Work in progress | 109,980 | 97,379 |
| Finished goods | 212,356 | 209,221 |
| | 408,133 | 392,607 |
| Less: allowance for obsolete and excess inventory | (31,539) | (30,426) |
| Total inventory | $ 376,594 | $ 362,181 |

**6. Geographic Areas**

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| | (In thousands) | | | |
| *Revenues*: | | | | |
| Western Hemisphere | | | | |
| Products | $ 95,871 | $ 72,890 | $ 195,600 | $ 140,582 |
| Services | 18,567 | 16,464 | 34,196 | 32,224 |
| Intercompany | 10,891 | 20,315 | 23,278 | 37,773 |
| Total | $ 125,329 | $ 109,669 | $ 253,074 | $ 210,579 |
| Eastern Hemisphere | | | | |
| Products | $ 60,647 | $ 41,870 | $ 98,480 | $ 100,522 |
| Services | 10,400 | 9,864 | 22,567 | 18,386 |
| Intercompany | 596 | (257) | 751 | 3,669 |
| Total | $ 71,643 | $ 51,477 | $ 121,798 | $ 122,577 |
| Asia-Pacific | | | | |
| Products | $ 32,341 | $ 31,915 | $ 55,264 | $ 55,277 |
| Services | 4,205 | 3,567 | 9,079 | 6,703 |
| Intercompany | 4,146 | 318 | 4,277 | 343 |
| Total | $ 40,692 | $ 35,800 | $ 68,620 | $ 62,323 |
| Summary | | | | |
| Products | $ 188,859 | $ 146,675 | $ 349,344 | $ 296,381 |
| Services | 33,172 | 29,895 | 65,842 | 57,313 |
| Intercompany | 15,633 | 20,376 | 28,306 | 41,785 |
| Eliminations | (15,633) | (20,376) | (28,306) | (41,785) |
| Total | $ 222,031 | $ 176,570 | $ 415,186 | $ 353,694 |
| *Income before income taxes:* | | | | |

| | | | | |
|---|---|---|---|---|
| Western Hemisphere | $ 19,199 | $ 20,399 | $ 44,145 | $ 39,720 |
| Eastern Hemisphere | 21,116 | 11,156 | 38,124 | 24,310 |
| Asia-Pacific | 13,133 | 7,334 | 22,824 | 11,779 |
| Eliminations | 2,928 | 2,529 | 3,562 | 5,739 |
| Total | $ 56,376 | $ 41,418 | $ 108,655 | $ 81,548 |

| | June 30, 2013 | December 31, 2012 |
|---|---|---|
| | (In thousands) | |
| *Total Long-Lived Assets:* | | |
| Western Hemisphere | $ 214,469 | $ 215,340 |
| Eastern Hemisphere | 39,232 | 36,194 |
| Asia-Pacific | 58,495 | 58,484 |
| Eliminations | (2,928) | (2,959) |
| Total | $ 309,268 | $ 307,059 |
| *Total Assets:* | | |
| Western Hemisphere | $ 753,668 | $ 727,242 |
| Eastern Hemisphere | 286,904 | 275,868 |
| Asia-Pacific | 277,543 | 261,319 |
| Eliminations | (21,636) | (32,982) |
| Total | $ 1,296,479 | $ 1,231,447 |

**7. Commitments and Contingencies**

*Deepwater Horizon Incident*

On April 22, 2010, a deepwater U.S. Gulf of Mexico drilling rig known as the *Deepwater Horizon,* operated by BP Exploration & Production, Inc. ( BP ), sank after an explosion and fire that began on April 20, 2010. The Company s wellhead and certain of its other equipment were in use on the *Deepwater Horizon* at the time of the incident. The Company was named in both class action and other lawsuits arising from the *Deepwater Horizon* incident that were consolidated in the multi-district proceeding *In Re: Oil Spill by the Oil Rig Deepwater Horizon in the Gulf of Mexico, on April 20, 2010* ( MDL Proceeding ). On January 20, 2012, the judge presiding over the MDL Proceeding issued an order that granted the Company s Motion for Summary Judgment and dismissed all claims asserted against the Company in those proceedings with prejudice. On April 9, 2012, the judge issued an order granting a final judgment in favor of the Company with respect to the court s prior order that granted the Company s Motion for Summary Judgment.

One of the lawsuits against the Company consolidated in the MDL Proceeding was a personal injury lawsuit initially filed in a Texas state court for which the plaintiff has filed a motion to remand the lawsuit back to the Texas state court. If that lawsuit is remanded to the Texas state court, the Company intends to vigorously defend that lawsuit and does not believe it will have a material impact. Accordingly, no liability has been accrued in conjunction with this matter.

*Brazilian Tax Issue*

From 2002 to 2007, the Company s Brazilian subsidiary imported goods through the State of Espirito Santo in Brazil and subsequently transferred them to its facility in the State of Rio de Janeiro. During that period, the Company s Brazilian subsidiary paid taxes to the State of Espirito Santo on its imports. Upon the final sale of these goods, the Company s Brazilian subsidiary collected taxes from customers and remitted them to the State of Rio de Janeiro net of the taxes paid on importation of those goods to the State of Espirito Santo in accordance with the Company s understanding of Brazilian tax laws.

In August 2007, the State of Rio de Janeiro served the Company s Brazilian subsidiary with assessments to collect a state tax on the importation of goods through the State of Espirito Santo from 2002 to 2007 claiming that these taxes were due and payable to it under applicable law. The Company settled these assessments with payments to the State of Rio de Janeiro of $12.2 million in March 2010 and $3.9 million in December 2010. Approximately $7.8 million of these settlement payments were attributable to penalties, interest and amounts that had expired under the statute of limitations so that amount was recorded as an expense. The remainder of the settlement payments generated credits (recorded as a prepaid tax) and will be used to offset future state taxes on sales to customers in the State of Rio de Janeiro once certified by the tax authorities under a process that is currently ongoing.

In December 2010 and January 2011, the Company s Brazilian subsidiary was served with additional assessments totaling approximately $13.0 million from the State of Rio de Janeiro to cancel the credits associated with the tax payments to the State of Espirito Santo ( Santo Credits ) on the importation of goods from July 2005 to October 2007. The Santo Credits are not related to the credits described in the immediately preceding paragraph. The Company has objected to this assessment as it would represent double taxation on the importation of the same goods and the Company is entitled to the credits under applicable Brazilian law. The Company believes that these credits are valid and success in the matter is probable. Based upon this analysis, the Company has not accrued any liability in conjunction with this matter.

Since 2007, the Company s Brazilian subsidiary has paid taxes on the importation of goods directly to the State of Rio de Janeiro and the Company does not expect any similar issues to exist for periods subsequent to 2007.

*ATP Bankruptcy*

The Company has entered into several contracts with ATP Oil & Gas Corporation ( ATP ). In August 2012, ATP filed for bankruptcy in the U.S Bankruptcy Court in the Southern District of Texas. At December 31, 2012, the Company had $1.4 million of receivables owed by ATP or its subsidiaries. During the second quarter of 2013, the Company recognized a pre-tax loss of $0.7 million on receivables owed to it by ATP and concurrently recognized previously deferred revenues of $3.7 million for work performed that was prepaid by ATP. At June 30, 2013, the Company had remaining receivables of approximately $400,000 owed by ATP or its subsidiaries.

*General*

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 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 ongoing and 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 effect on the Company s operations, comprehensive income, financial position or cash flows.

**Item 2.** ***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 aspects of the Company s financial position, results of operations, comprehensive income and cash flows during the periods included in the accompanying unaudited condensed consolidated financial statements. This discussion should be read in conjunction with the unaudited condensed consolidated financial statements presented elsewhere herein as well as the discussion under Risk Factors, Management s Discussion and Analysis of Financial Condition and Results of Operations and the financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2012.

**Overview**

Dril-Quip designs, manufactures, sells and services highly engineered offshore drilling and production equipment that is well suited for use in deepwater, harsh environments 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 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 customers may rent or purchase running tools from the Company for use in the installation and retrieval of the Company s products.

*Oil and Gas Prices*

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.

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

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Crude oil ($/Bbl) | $ 102.56 | $ 107.75 | $ 107.34 | $ 113.32 |
| Natural gas ($/Mcf) | 4.14 | 2.37 | 3.88 | 2.44 |

During the second quarter of 2013, Brent Crude oil closing prices ranged between $96.84 per barrel and $109.66 per barrel with an average quarterly price of $102.56 per barrel, as compared to a range of $88.69 and $124.44 per barrel with the average quarterly price of $107.75 per barrel for the same period in 2012. For the six months ended June 30, 2013 and 2012, Brent Crude oil closing prices averaged $107.34 per barrel and $113.32 per barrel, respectively, and ranged between $96.84 per barrel and $118.90 per barrel for the 2013 period, as compared to a range of $88.69 per barrel to $128.14 per barrel for the same period in 2012. Brent Crude oil prices ended the second quarter of 2013 at $102.49 per barrel and closed at $108.82 per barrel on July 22, 2013. The Henry Hub natural gas price at June 28, 2013 was $3.68 per Mcf and on July 22, 2013, the closing price was $3.83 per Mcf.

According to the July 2013 release of the Short-Term Energy Outlook published by the EIA, Brent Crude oil prices are projected to average approximately $101.83 per barrel in the second half of 2013 and $99.75 per barrel in 2014. In its July 2013 Oil Market Report, the International Energy Agency projects that world demand for oil will rise by approximately 930,000 barrels per day in 2013, and will rise an additional 1.2 million barrels per day in 2014. In July 2013, the EIA projected Henry Hub natural gas prices will average $3.89 per Mcf in the second half of 2013 and $4.02 per Mcf in 2014.

*Rig Count*

Detailed below is the average contracted rig count for the Company s geographic regions for the six months ended June 30, 2013 and 2012. The rig count data includes floating rigs (semi-submersibles and drillships) and jack-up rigs. The Company has included only these types of rigs as they are the primary end users of the Company s products.

| | Six months ended June 30, | | | |
|---|---|---|---|---|
| | 2013 | | 2012 | |
| | **Floating Rigs** | **Jack-up Rigs** | **Floating Rigs** | **Jack-up Rigs** |
| Western Hemisphere | 131 | 87 | 123 | 82 |
| Eastern Hemisphere | 92 | 89 | 88 | 82 |
| Asia - Pacific | 48 | 239 | 49 | 215 |
| TOTAL | 271 | 415 | 260 | 379 |

*Source: ODS - Petrodata RigBase June 30, 2013 and 2012*

The table represents rigs under contract and includes rigs currently drilling as well as rigs committed, but not yet drilling. According to ODS-Petrodata RigBase, as of June 30, 2013, there were 71 rigs under contract in the U.S. Gulf of Mexico (37 floating rigs and 34 jack-up rigs). All of the contracted rigs were actively drilling. As of June 30, 2012, there were 66 rigs under contract in the U.S. Gulf of Mexico, (35 floating rigs and 31 jack-up rigs) of which 60 were actively drilling (31 floating rigs and 29 jack-up rigs).

The Company believes that the number of rigs (semi-submersibles, drillships and jack-up rigs) under construction impacts its revenues because in certain cases, its customers order some of the Company s 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 the Company s backlog. According to ODS-Petrodata, at the end of June 2013 and 2012, there were 213 and 180 rigs, respectively, under construction. The expected delivery dates for the rigs under construction on June 30, 2013 are as follows:

| | Floating Rigs | Jack-Up Rigs | Total |
|---|---|---|---|
| 2013 | 18 | 35 | 53 |
| 2014 | 26 | 29 | 55 |
| 2015 | 20 | 42 | 62 |
| 2016 | 16 | 6 | 22 |
| After 2016 or unspecified delivery date | 19 | 2 | 21 |
| | 99 | 114 | 213 |

*Regulation*

The demand for the Company s products and services is also affected by laws and regulations relating to the oil and gas industry in general, including those specifically directed to offshore operations. The adoption of new laws and regulations, or changes to existing laws or regulations that curtail 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 its products.

*Business Environment*

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, economic and other events have contributed to oil and natural gas price volatility and are likely to continue to do so in the future. Oil and gas prices fell from previously high historic levels beginning in mid-2008 and continued into 2009, and began to stabilize somewhat in the latter half of 2009. Brent Crude oil prices in 2010 ranged from $67.18 per barrel to $93.63 per barrel. In 2011, Brent Crude oil prices peaked at $126.64 per barrel and ended the year at $108.09 per barrel. In 2012, Brent Crude oil prices ranged between $88.69 per barrel and $128.14 per barrel with an average price of $111.63 per barrel and ended the year at $110.80 per barrel. For the first six months of

2013, Brent Crude oil prices have ranged between $96.84 per barrel and $118.90 per barrel. 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 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 believes that its backlog should help mitigate the impact of negative market conditions; however, a prolonged decline in commodity prices, an extended continuation of the downturn in the global economy or future restrictions or declines in offshore oil and gas exploration and production could have a negative impact on the Company and/or its backlog. The Company s backlog at June 30, 2013 was approximately $1,137 million compared to approximately $697 million at June 30, 2012, $881 million at December 31, 2012, and $1,022 million at March 31, 2013. In August 2012, the Company s Brazilian subsidiary, Dril-Quip do Brasil LTDA, was awarded a four-year contract by Petroleo Brasiliero S.A. ( Petrobras ), Brazil s national oil company. At exchange rates in effect at the signing date, the contract was valued at $650 million, net of Brazilian taxes, if all the equipment under contract is ordered. Amounts will be included in the Company s backlog as purchase orders under the contract are received. At December 31, 2012, backlog included $105 million of purchase orders under the new Petrobras contract and an additional $15 million was added during the second quarter of 2013. No shipments have been made on this contract during the first six months of 2013. The Company can give no assurance that backlog will remain at current levels. All of the Company s projects currently included in its backlog are subject to change and/or termination at the option of the customer. If the Company s existing or future products are unable to satisfy the requirements for any testing required by its customers or additional testing triggered by the *Deepwater Horizon* incident, or if the costs of the modifications to such products necessary to satisfy the testing are not acceptable to the Company s customers, the customers may terminate their contracts with the Company.

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.

*Revenues*. Dril-Quip s revenues are generated from two sources: products and services. Product revenues are derived from the sale of offshore drilling and production equipment. Service revenues are earned when the Company provides technical advisory assistance for installation of the Company s products, reconditioning services and rental of running tools for installation and retrieval of the Company s products. For each of the six months ended June 30, 2013 and 2012, 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 typically generate increased demand for technical advisory services during installation and rental of running tools. The Company has substantial international operations, with approximately 67% and 75% of its revenues derived from foreign sales for the three months ended June 30, 2013 and 2012, respectively, and 70% and 71% for the six months ended June 30, 2013 and 2012, respectively. Substantially all of the Company s domestic revenue relates to operations in the U. S. Gulf of Mexico. Domestic revenue approximated 33% and 25%, respectively, of the Company s total revenues for the three months ended June 30, 2013 and 2012 and 30% and 29%, respectively, for the six months ended June 30, 2013 and 2012.

Product contracts are negotiated and sold separately from service contracts. In addition, service contracts are not typically included in the product contracts or related sales orders and are not offered to the customer as a condition of the sale of the Company s products. The demand for products and services is generally based on world-wide economic conditions in the offshore oil and gas industry, and is not based on a specific relationship between the two types of contracts. Substantially all of the Company s sales are made on a purchase order basis. Purchase orders are subject to change and/or termination at the option of the customer. In case of a change or termination, the customer is required to pay the Company for work performed and other costs necessarily incurred as a result of the change or termination.

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. For the six months ended June 30, 2013, 15 projects representing approximately 12% of the Company s total revenue and approximately 14% of its product revenue were accounted for using percentage-of-completion accounting, compared to 17 projects representing approximately 18% of the Company s total revenue and approximately 21% of its product revenue for the first six months of 2012. 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, are recorded in full in the period they become known. Amounts received from customers in excess of revenues recognized are classified as a current liability.

The following table sets forth, for the periods indicated, a breakdown of the Company s U.S. Gulf of Mexico products and services revenues:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| | (In millions) | | | |
| Revenues: | | | | |
| Products | | | | |
| Subsea equipment | $ 58.9 | $ 26.0 | $ 97.3 | $ 63.6 |
| Surface equipment | 0.1 | 0.1 | 0.1 | 0.2 |
| Offshore rig equipment | 0.4 | 5.9 | 0.9 | 13.5 |
| Total products | 59.4 | 32.0 | 98.3 | 77.3 |
| Services | 13.9 | 12.1 | 25.0 | 23.8 |
| Total U.S. Gulf of Mexico revenues | $ 73.3 | $ 44.1 | $ 123.3 | $ 101.1 |

During the second quarter of 2013, several subsea equipment orders were completed and shipped, contributing to the large increase in subsea equipment revenue for the three and six months ended June 30, 2013 as compared to the same periods in 2012. As the oil and gas industry continues to recover, the number of floating rigs (the rig type where Dril-Quip equipment is normally utilized) actively drilling in the U.S. Gulf of Mexico continues to increase. At June 30, 2013, there were 37 floating rigs actively drilling and an average of 36 for the first six months of 2013 compared to a yearly average of 29 in 2012 and a yearly average of 18 for 2011. The Company believes that the effects of the U.S. Gulf of Mexico drilling moratorium and related permitting delays have had little or no impact on revenues related to offshore rig equipment. The change in offshore rig equipment revenues in the first half of 2013 compared to the first half of 2012 resulted primarily from a reduction of revenues from projects accounted for under the percentage-of-completion method. For the three and six months ended June 30, 2013 the Company s U.S. Gulf of Mexico service revenues as a percentage of worldwide revenue was 6.3% and 6.0%, respectively compared to 6.9% and 6.7% for the same period in 2012.

*Cost of Sales.* The principal elements of cost of sales are labor, raw materials and manufacturing overhead. Cost of sales as a percentage of revenues is influenced by the product mix sold in any particular period, costs from projects accounted for under the percentage-of-completion method and market conditions. The Company s costs related to its foreign operations do not significantly differ from its domestic costs.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses include the costs associated with sales and marketing, general corporate overhead, compensation expense, stock-based compensation expense, legal expenses, foreign currency transaction gains and losses and other related administrative functions.

*Engineering and Product Development Expenses.* Engineering and product development expenses consist of new product development and testing, as well as application engineering related to customized products.

*Income Tax Provision.* The Company s effective income tax rate has historically been lower than the statutory rate primarily due to foreign income tax rate differentials, research and development credits and deductions related to domestic manufacturing activities.

**Results of Operations**

The following table sets forth, for the periods indicated, certain statement of operations data expressed as a percentage of revenues:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Revenues: | | | | |
| Products | 85.1% | 83.1% | 84.1% | 83.8% |
| Services | 14.9 | 16.9 | 15.9 | 16.2 |
| Total revenues | 100.0 | 100.0 | 100.0 | 100.0 |
| Cost of sales: | | | | |
| Products | 51.0 | 52.0 | 50.6 | 52.0 |
| Services | 9.0 | 9.3 | 9.5 | 8.9 |
| Total cost of sales | 60.0 | 61.3 | 60.1 | 60.9 |
| Selling, general and administrative expenses | 10.5 | 9.8 | 9.4 | 10.7 |
| Engineering and product development expenses | 4.2 | 5.4 | 4.4 | 5.4 |
| Operating income | 25.3 | 23.5 | 26.1 | 23.0 |
| Interest income | 0.1 | | 0.1 | 0.1 |
| Interest expense | | | | |
| Income before income taxes | 25.4 | 23.5 | 26.2 | 23.1 |
| Income tax provision | 6.1 | 6.6 | 6.2 | 6.5 |
| Net income | 19.3% | 16.9% | 20.0% | 16.6% |

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

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| | (In millions) | | | |
| Revenues: | | | | |
| Products | | | | |
| Subsea equipment | $ 174.2 | $ 120.1 | $ 313.3 | $ 247.2 |
| Surface equipment | 8.5 | 10.1 | 15.1 | 21.1 |
| Offshore rig equipment | 6.1 | 16.5 | 20.9 | 28.1 |
| Total products | 188.8 | 146.7 | 349.3 | 296.4 |
| Services | 33.2 | 29.9 | 65.9 | 57.3 |
| Total revenues | $ 222.0 | $ 176.6 | $ 415.2 | $ 353.7 |

*Three Months Ended June 30, 2013 Compared to Three Months Ended June 30, 2012.*

*Revenues.* Revenues increased by $45.4 million, or approximately 25.7%, to $222.0 million in the three months ended June 30, 2013 from $176.6 million in the three months ended June 30, 2012. Product revenues increased by approximately $42.1 million for the three months ended June 30, 2013 compared to the same period in 2012 as a result of increased revenues of $54.1 million in subsea equipment, offset by a slight decrease of $1.6 million in surface equipment and a decrease of $10.4 million in offshore rig equipment. The increase in subsea equipment is primarily due to increased activity in the Gulf of Mexico. The change in offshore rig equipment revenues in the second quarter of 2013 compared to the second quarter of 2012 resulted primarily from a decrease of revenues from projects accounted for under the

percentage-of-completion method. In any given time period, the revenues recognized between the various product lines and geographic areas will vary depending upon the timing of shipments to customers, completion status of the projects accounted for under the percentage-of-completion accounting method, market conditions and customer demand at that time. Product revenues increased in the Western Hemisphere by approximately $23.0 million, Eastern Hemisphere by approximately $18.7 million and in Asia-Pacific by $400,000. Service revenues increased by approximately $3.3 million as a result of increases of $2.1 million in the Western Hemisphere, $500,000 in the Eastern Hemisphere and $700,000 in Asia-Pacific. The majority of the increases in service revenues related to an increase in technical advisory assistance revenues.

*Cost of Sales.* Cost of sales increased by $24.9 million, or approximately 23.0%, to $133.2 million for the three months ended June 30, 2013 from $108.3 million for the same period in 2012. Contributing to the increased cost of sales was the 25.7% increase in sales revenue and a slight increase in unabsorbed manufacturing overhead. As a percentage of revenues, cost of sales were approximately 60.0% and 61.3% for the three-month period ended June 30, 2013 and 2012, respectively. The decrease in cost of sales as a percentage of revenues resulted primarily from changes in product mix.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses increased by $5.9 million, or approximately 33.9%, to $23.3 million for the three months ended June 30, 2013 from $17.4 million for the same period in 2012. The increase is partially attributable to additional personnel and related expenses of $2.8 million. This increase was compounded by a $940,000 foreign currency transaction loss for the three months ended June 30, 2013 compared to a $450,000 gain for the three months ended June 30, 2012. Stock-based compensation expense for the second quarter of 2013 was $2.0 million compared to $1.2 million for the quarter ended June 30, 2012. Selling, general and administrative expenses as a percentage of revenues increased to 10.5% in 2013 from 9.8% in 2012.

*Engineering and Product Development Expenses.* For the three months ended June 30, 2013, engineering and product development expenses were basically flat compared to the same period of 2012. Engineering and product development expenses as a percentage of revenues decreased to 4.2% in 2013 from 5.4% in 2012 due to increased revenues.

*Income tax provision*. Income tax expense for the three months ended June 30, 2013 was $13.4 million on income before taxes of $56.4 million, resulting in an effective tax rate of approximately 24%. Income tax expense for the three months ended June 30, 2012 was $11.6 million on income before taxes of $41.4 million, resulting in an effective tax rate of approximately 28%. 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.

*Net Income.* Net income was approximately $42.9 million for the three months ended June 30, 2013 and $29.8 million for the same period in 2012 for the reasons set forth above.

*Six Months Ended June 30, 2013 Compared to Six Months Ended June 30, 2012.*

*Revenues.* Revenues increased by $61.5 million, or approximately 17.4%, to $415.2 million in the six months ended June 30, 2013 from $353.7 million in the six months ended June 30, 2012. Product revenues increased by approximately $52.9 million for the six months ended June 30, 2013 compared to the same period in 2012 as a result of increased revenues of $66.1 million in subsea equipment, offset by a $6.0 million decrease in surface equipment and $7.2 million decrease in offshore rig equipment. The majority of the subsea equipment increases occurred in the Western Hemisphere as activity increased in the U.S. Gulf of Mexico. Product revenues increased in the Western Hemisphere by $55.0 million, partially offset by decreases in the Eastern Hemisphere of $2.1 million. Asia-Pacific product revenues were basically flat. In any given time period, the revenues recognized between the various product lines and geographic areas will vary depending upon the timing of shipments to customers, completion status of the projects accounted for under the percentage-of-completion accounting method, market conditions and customer demand at that time. Service revenues increased by approximately $8.6 million due to increased service revenues in the Western Hemisphere of $2.0 million, in the Eastern Hemisphere of $4.2 million, and $2.4 million in Asia-Pacific. The majority of the increase in service revenues related to an increase in technical advisory assistance revenues.

*Cost of Sales.* Cost of sales increased by $34.1 million, or approximately 15.8%, to $249.5 million for the six months ended June 30, 2013 from $215.4 million for the same period in 2012. The increase was partially due to the approximate 17.4% increase in sales as well as a change in product mix. As a percentage of revenues, cost of sales were approximately 60.1% and 60.9% for the six months ended June 30, 2013 and 2012, respectively.

*Selling, General and Administrative Expenses.* For the six months ended June 30, 2013, selling, general and administrative expenses increased by approximately $1.1 million, or 2.9%, to $38.9 million from $37.8 million for the same period in 2012. Approximately $4.3 million was primarily related to increases in personnel and related expenses. The Company experienced approximately $4.7 million in foreign currency transaction gains in the first six months of 2013 compared to approximately $1.9 million in foreign currency transaction losses for the same period in 2012. Stock-based compensation expense for the first six months of 2013 was $4.1 million compared to $2.6 million for the same period in 2012. Selling, general and administrative expenses as a percentage of revenues decreased to 9.4% in 2013 from 10.7% in 2012.

*Engineering and Product Development Expenses.* For the six months ended June 30, 2013, engineering and product development expenses decreased by $700,000, or approximately 3.7%, to $18.4 million from $19.1 million for the same period in 2012. Engineering and product development expenses as a percentage of revenues was 4.4% in 2013 and 5.4% in 2012 due to increased revenues.

*Income tax provision*. Income tax expense for the six months ended June 30, 2012 was $25.9 million on income before taxes of $108.7 million, resulting in an effective tax rate of approximately 24%. Income tax expense for the six months ended June 30, 2012 was $22.9 million on income before taxes of $81.5 million, resulting in an effective tax rate of approximately 28%. The decrease in

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the effective income tax rate reflects the $1.2 million Research and Development tax credit from the American Taxpayer Relief Act of 2012 recognized on the 2012 U.S. income tax return, but not recorded until 2013 for financial statement purposes in accordance with GAAP, and the difference in income among the Company s three geographic areas, which have different income tax rates.

*Net Income.* Net income was approximately $82.8 million for the six months ended June 30, 2013 and $58.6 million for the same period in 2012 for the reasons set forth above.

**Liquidity and Capital Resources**

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

| | Six months ended June 30, | |
|---|---|---|
| | **2013** | **2012** |
| | (In thousands) | |
| Operating activities | $ 86,101 | $ (32,495) |
| Investing activities | (22,802) | (26,647) |
| Financing activities | 9,431 | 8,213 |
| | 72,730 | (50,929) |
| Effect of exchange rate changes on cash activities | (4,380) | 496 |
| Increase (decrease) in cash and cash equivalents | $ 68,350 | $ (50,433) |

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 period, as these are non-cash changes. As a result, changes reflected in certain accounts on the Condensed Consolidated Statements of Cash Flows may not reflect the changes in corresponding accounts on the Condensed 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. The Company s principal sources of funds have been cash flows from operations.

During the six months ended June 30, 2013, the Company generated $86.1 million of cash from operating activities as compared to using $32.5 million during the six months ended June 30, 2012. Cash totaling approximately $13.4 million was used during the six-month period ended June 30, 2013 due to net increases in operating assets and liabilities, compared to $105.8 million that was used during the same period in 2012. The changes in operating assets and liabilities during 2013 primarily reflected a decrease in trade receivables of $15.2 million offset by an increase of $24.7 million in inventory. Trade receivables decreased approximately $24.3 million due to a decrease in unbilled revenues related to long-term projects (as discussed in Note 2 to the Notes to Condensed Consolidated Financial Statements) and a net increase of $9.1 million in trade receivables attributable to growth of revenues in 2013 (as discussed previously). Inventory increased to accommodate increases in backlog (as discussed previously).

Capital expenditures by the Company were $23.1 million and $27.7 million in the first six months of 2013 and 2012, respectively. Capital expenditures in 2013 and 2012 included expanding manufacturing facilities in the Asia-Pacific, Eastern and Western Hemispheres and increased expenditures on machinery and equipment and running tools. The capital expenditures for the first six months of 2013 were primarily $4.7 million for facilities, $11.2 million for machinery and equipment, $4.6 million for running tools and other expenditures of $2.6 million.

On June 19, 2012, the Company announced that its Board of Directors authorized a stock repurchase plan under which the Company can repurchase up to $100 million of its common stock. The repurchase program has no expiration date. As of June 30, 2013, no shares had been repurchased.

As of June 30, 2013, the Company has no commercial lending arrangement or lines of credit. 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 for the next twelve months. However, any significant future declines in hydrocarbon prices, catastrophic events or significant changes in regulations affecting the Company or its customers could have a material adverse effect on the Company s liquidity. Should market conditions result in unexpected cash requirements, the Company believes that borrowing from commercial lending institutions would be available and adequate to meet such requirements.

**Off-Balance Sheet Arrangements**

The Company has no derivative instruments and no off-balance sheet hedging or financing arrangements, contracts or operations.

**Critical Accounting Policies**

Refer to our Annual Report on Form 10-K for the year ended December 31, 2012 for a discussion of our critical accounting policies. During the six months ended June 30, 2013, there were no material changes in our judgments and assumptions associated with the development of our critical accounting policies.

**Item 3.** ***Quantitative and Qualitative Disclosures About Market Risk***

The Company is currently exposed to certain market risks related to interest rate changes on its short-term investments 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. There have been no material changes in market risks for the Company from December 31, 2012.

**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 the Brazilian real. The Company experienced a foreign currency pre-tax loss of approximately $940,000 during the three months ended June 30, 2013 and a $4.7 million pre-tax gain during the six months ended June 30, 2013, compared to approximately $450,000 in pre-tax gains and a $1.9 million pre-tax loss during the three and six months ended June 30, 2012, respectively. Historically, the Company s foreign currency gains and losses have not been significant. However, when significant disparities between the British pound sterling and the U.S. dollar or the Brazilian real and the U.S. dollar occur, there can be no assurance that the Company will be able to protect itself against such currency fluctuations.

**Item 4.** ***Controls and Procedures***

In accordance with Exchange Act Rules 13a-15 and 15d-15, the Company carried out an evaluation, under the supervision and with the participation of management, including the Company s Chief Executive Officer 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 Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures were effective as of June 30, 2013 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 Chief Executive Officer 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 44 of the Company s Annual Report on Form 10-K for the year ended December 31, 2012.

There has been no change in the Company s internal controls over financial reporting that occurred during the quarter ended June 30, 2013 that has materially affected, or is reasonably likely to materially affect, the Company s internal controls over financial reporting.

## PART II OTHER INFORMATION

**Item 1.** ***Legal Proceedings.***
In December 2010 and January 2011, the Company s Brazilian subsidiary was served with assessments from the disallowance of netting certain import and export taxes. The Company is vigorously contesting these assessments.

In addition, the Company is involved in lawsuits filed as a result of the April 2010 *Deepwater Horizon* incident in the U.S. Gulf of Mexico. The judge presiding over the multi-district litigation proceedings for the *Deepwater Horizon* incident dismissed all claims consolidated against the Company in those proceedings in January 2012 and issued a final judgment ordering the same in April 2012, but there is a pending motion before the judge to remand one of the lawsuits back to a Texas state court.

For a further description of the Company s legal proceedings, see Commitments and Contingencies, Note 7 to the Notes to Condensed Consolidated Financial Statements.

**Item 1A.** ***Risk Factors.***
There have been no material changes from the risk factors disclosed in the Company s Annual Report on Form 10-K for the year ended December 31, 2012.

**Item 2.** ***Unregistered Sales of Equity Securities and Use of Proceeds.***
None.

## FORWARD LOOKING STATEMENTS

This Quarterly Report on Form 10-Q includes certain statements that may be deemed to be forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act ), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act ). Statements contained in all parts of this document that are not historical facts are forward-looking statements that involve risks and uncertainties that are beyond 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 assurance can be given that these expectations will prove to be correct. These forward-looking statements include the following types of information and statements as they relate to the Company:

- future operating results and cash flow;
- scheduled, budgeted and other future capital expenditures;
- working capital requirements;
- the availability of expected sources of liquidity;
- the introduction into the market of the Company s future products;

- the market for the Company s existing and future products;
- the Company s ability to develop new applications for its technologies;
- the exploration, development and production activities of the Company s customers;
- compliance with present and future environmental regulations and costs associated with environmentally related penalties, capital expenditures, remedial actions and proceedings;
- effects of pending legal 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 Part I of the Company s Annual Report on Form 10-K for the year ended December 31, 2012 and the following:

- the volatility of oil and natural gas prices;
- the cyclical nature of the oil and gas industry;

uncertainties associated with the United States and worldwide economies;

uncertainties regarding political tensions in the Middle East, Africa and elsewhere;

current and potential governmental regulatory actions in the United States and regulatory actions and political unrest in other countries;

uncertainties regarding future oil and gas exploration and production activities in the U.S. Gulf of Mexico and elsewhere, including new regulations, customs requirements and product testing requirements;

operating interruptions (including explosions, fires, weather-related incidents, mechanical failure, unscheduled downtime, labor difficulties, transportation interruptions, spills and releases and other environmental risks);

the Company s reliance on product development;

technological developments;

the Company s reliance on third-party technologies;

the Company s dependence on key employees and skilled machinists, fabricators and technical personnel;

the Company s reliance on sources of raw materials;

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;

changes in general economic, market or business conditions;

- access to capital markets;
- negative outcome of litigation, threatened litigation or government proceedings;
- terrorist threats or acts, war and civil disturbances; and
- the interpretation of foreign tax law with respect to our foreign subsidiaries.

Many of such factors are beyond the Company s ability to control or predict. Any of the factors, or a combination of these factors, could materially affect the Company s future results of operations and the ultimate accuracy of the forward-looking statements. Management cautions against putting undue reliance on forward-looking statements or projecting any future results based on such statements or present or prior earnings levels. Every forward-looking statement speaks only as of the date of the particular statement, and the Company undertakes no obligation to publicly update or revise any forward-looking statement.

**Item 6.**
(a) Exhibits

The following exhibits are filed herewith:

| 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 filed January 17, 2012). |
| *4.1 | Form of certificate representing Common Stock (incorporated herein by reference to Exhibit 4.2 to the Company s Registration Statement on Form S-1 (Registration No. 333-33447)). |
| *4.2 | 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). |
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification of Blake T. DeBerry. |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification of Jerry M. Brooks. |
| 32.1 | Section 1350 Certification of Blake T. DeBerry. |
| 32.2 | Section 1350 Certification of Jerry M. Brooks. |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Schema Document |
| 101.CAL | XBRL Calculation Document |
| 101.DEF | XBRL Definition Linkbase Document. |
| 101.LAB | XBRL Label Linkbase Document |
| 101.PRE | XBRL Presentation Linkbase Document |

* Incorporated herein by reference as indicated.

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**DRIL-QUIP, INC.**

By: /s/ JERRY M. BROOKS

**Jerry M. Brooks,**
**Vice-President Finance and**

**Chief Financial Officer**

**(Principal Accounting Officer and**

**Duly Authorized Signatory)**

Date: August 1, 2013