

DRIL-QUIP INC  
Form 10-Q  
October 29, 2015

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

**FORM 10-Q**

**(MARK ONE)**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2015**

**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**  
**(State or other jurisdiction of**  
**incorporation or organization)**

**74-2162088**  
**(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  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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer

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

As of October 23, 2015, the number of shares outstanding of the registrant's common stock, par value \$0.01 per share, was 38,355,812.

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**PART I FINANCIAL INFORMATION**
**Item 1. FINANCIAL STATEMENTS****DRIL-QUIP, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(UNAUDITED)**

	<b>September 30, 2015</b>	<b>December 31, 2014</b>
	<b>(In thousands)</b>	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 396,969	\$ 298,705
Trade receivables, net	298,442	373,993
Inventories, net	365,674	392,559
Deferred income taxes	29,452	23,569
Prepays and other current assets	43,290	38,314
Total current assets	1,133,827	1,127,140
Property, plant and equipment, net	292,608	309,525
Other assets	11,685	12,586
Total assets	\$ 1,438,120	\$ 1,449,251
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 44,688	\$ 53,837
Accrued income taxes	9,628	16,903
Customer prepayments	26,916	71,177
Accrued compensation	16,327	21,527
Other accrued liabilities	20,491	35,198
Total current liabilities	118,050	198,642
Deferred income taxes	4,275	5,417
Total liabilities	122,325	204,059
Commitments and contingencies (Note 7)		
Stockholders equity:		
Preferred stock, 10,000,000 shares authorized at \$0.01 par value (none issued)		
Common stock:		
100,000,000 shares authorized at \$0.01 par value, 38,353,789 and 38,932,508 shares issued and outstanding at September 30, 2015 and December 31, 2014		
	382	388
Additional paid-in capital		16,480

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Retained earnings	1,409,409	1,278,528
Accumulated other comprehensive losses	(93,996)	(50,204)
Total stockholders' equity	1,315,795	1,245,192
Total liabilities and stockholders' equity	\$ 1,438,120	\$ 1,449,251

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

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

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
	<b>(In thousands, except per share data)</b>			
<b>Revenues:</b>				
Products	\$ 157,790	\$ 198,827	\$ 521,413	\$ 560,742
Services	43,612	42,923	121,267	115,396
<b>Total revenues</b>	<b>201,402</b>	<b>241,750</b>	<b>642,680</b>	<b>676,138</b>
<b>Cost and expenses:</b>				
<b>Cost of sales:</b>				
Products	88,923	113,642	293,279	309,181
Services	19,209	21,608	57,655	61,849
<b>Total cost of sales</b>	<b>108,132</b>	<b>135,250</b>	<b>350,934</b>	<b>371,030</b>
Selling, general and administrative	17,280	20,845	67,871	70,300
Engineering and product development	11,735	12,663	35,348	34,295
<b>Total costs and expenses</b>	<b>137,147</b>	<b>168,758</b>	<b>454,153</b>	<b>475,625</b>
<b>Operating income</b>	<b>64,255</b>	<b>72,992</b>	<b>188,527</b>	<b>200,513</b>
Interest income	345	206	559	555
Interest expense	(4)	(3)	(10)	(15)
<b>Income before income taxes</b>	<b>64,596</b>	<b>73,195</b>	<b>189,076</b>	<b>201,053</b>
Income tax provision	13,819	17,512	45,422	51,428
<b>Net income</b>	<b>\$ 50,777</b>	<b>\$ 55,683</b>	<b>\$ 143,654</b>	<b>\$ 149,625</b>
<b>Earnings per common share:</b>				
Basic	\$ 1.32	\$ 1.41	\$ 3.72	\$ 3.72
Diluted	\$ 1.32	\$ 1.40	\$ 3.70	\$ 3.70
<b>Weighted average common shares outstanding:</b>				
Basic	38,347	39,630	38,601	40,208
Diluted	38,548	39,880	38,789	40,444

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



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

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
	<b>(In thousands)</b>			
Net income	\$ 50,777	\$ 55,683	\$ 143,654	\$ 149,625
Other comprehensive loss, net of tax:				
Foreign currency translation adjustments	(33,099)	(28,432)	(43,792)	(12,004)
Total comprehensive income	\$ 17,678	\$ 27,251	\$ 99,862	\$ 137,621

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

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

	<b>Nine months ended September 30, 2015          2014 (In thousands)</b>	
<b>Operating activities</b>		
Net income	\$ 143,654	\$ 149,625
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	22,777	22,774
Stock-based compensation expense	9,794	8,640
Loss (gain) on sale of equipment	73	(199)
Deferred income taxes	(7,420)	1,879
Changes in operating assets and liabilities:		
Trade receivables, net	60,329	(55,169)
Inventories, net	8,993	(44,047)
Prepays and other assets	(8,747)	(2,722)
Excess tax benefits of stock options and awards	(57)	(309)
Accounts payable and accrued expenses	(70,658)	22,112
Net cash provided by operating activities	158,738	102,584
<b>Investing activities</b>		
Purchase of property, plant and equipment	(16,746)	(31,164)
Proceeds from sale of equipment	183	543
Net cash used in investing activities	(16,563)	(30,621)
<b>Financing activities</b>		
Repurchase of common stock	(40,911)	(140,261)
Proceeds from exercise of stock options	1,952	1,864
Excess tax benefits of stock options and awards	57	309
Net cash used in financing activities	(38,902)	(138,088)
Effect of exchange rate changes on cash activities	(5,009)	(3,267)
Increase (decrease) in cash and cash equivalents	98,264	(69,392)
Cash and cash equivalents at beginning of period	298,705	384,356
Cash and cash equivalents at end of period	\$ 396,969	\$ 314,964

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



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**DRIL-QUIP, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

**1. Organization and Principles of Consolidation**

Dril-Quip, Inc., a Delaware corporation (the Company or Dril-Quip), designs, manufactures, sells and services highly engineered 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 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 Macae, Brazil.

The condensed consolidated financial statements included herein are unaudited. The balance sheet at December 31, 2014, has been derived from the audited consolidated financial statements at that date. In the opinion of management, the unaudited condensed consolidated interim financial statements include all normal recurring adjustments necessary for a fair presentation of the financial position as of September 30, 2015 and the results of operations and comprehensive income for the three- and nine-month periods ended September 30, 2015 and 2014 and the cash flows for the nine-month periods ended September 30, 2015 and 2014. Certain information and footnote disclosures normally included in annual audited consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. Management believes the unaudited interim related disclosures in these condensed consolidated financial statements are adequate. The results of operations, comprehensive income and cash flows for the nine-month period ended September 30, 2015 are not necessarily indicative of the results to be expected for the full year. The condensed consolidated financial statements included herein should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014.

**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.

*Revisions*

The Company has corrected its Condensed Consolidated Statements of Cash Flows for the nine-month period ended September 30, 2014, to reflect a \$6.7 million reclassification adjustment from changes in prepaids and other assets to changes in accounts payable and accrued expenses related to the 2014 beginning balances. There was no impact on the net cash provided by operating activities or any other reported cash flow amounts as a result of the reclassifications. The Company has evaluated the impact of this revision and determined that it was not material.

*Use of Estimates*

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

*Revenue Recognition*

*Product 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. At September 30, 2015 and December 31, 2014, receivables included \$87.2 million and \$68.0 million of unbilled receivables, respectively. For the quarter ended September 30, 2015, there were 9 projects representing approximately 17% of the Company's total revenue and approximately 22% of its product revenues that were accounted for using percentage-of-completion accounting, compared to 14 projects during the third quarter of 2014, which represented approximately 15% of the Company's total revenues and approximately 18% of its product revenues. For the nine months ended September 30, 2015, there were 14 projects representing approximately 16% of the Company's total revenues and approximately 20% of its product revenues, compared to 17 projects representing approximately 10% of the Company's total revenues and

approximately 13% of its product revenues for the nine months ended September 30, 2014, 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 does provide technical advisory assistance. At the time of delivery of the product, the customer is not obligated to buy or rent the Company's running tools and the Company is not obligated to perform any subsequent services relating to installation. Technical advisory assistance service revenue is recorded at the time the service is rendered. Service revenues associated with the rental of running and installation tools are recorded as earned. Rework and reconditioning service revenues are recorded when the refurbishment process is complete.

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

#### *Fair Value of Financial Instruments*

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

#### *Earnings Per Share*

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

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

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
	<b>(In thousands)</b>			
Weighted average common shares outstanding - basic	38,347	39,630	38,601	40,208
Dilutive effect of common stock options and awards	201	250	188	236
Weighted average common shares outstanding - diluted	38,548	39,880	38,789	40,444

### **3. New Accounting Standards**

In July 2015, the FASB issued ASU 2015-11 Simplifying the Measurement of Inventory (Topic 330). This standard states that inventory within the scope of this update should be measured at the lower of cost and net realizable value. Net realizable value is defined as the estimated selling price in the normal course of business, less reasonably predictable costs of completion, disposal, and transportation. The standard is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. The Company is evaluating the impact of the new guidance on its consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09 Revenue from Contracts with Customers (Topic 606). The amendment applies a new five-step revenue recognition model to be used in recognizing revenues associated with customer contracts. The amendment requires disclosure sufficient to enable readers of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers, including qualitative and quantitative disclosures, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill the contract. The standard's effective date was originally for fiscal years beginning after December 15, 2016, including interim periods within the reporting period. On April 1, 2015, the FASB voted to defer the effective date by one year to December 15, 2017 and interim periods within annual reporting periods beginning

after December 15, 2017. The Company is currently evaluating the new guidance to determine the impact on its consolidated financial statements.

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

During the three months ended September 30, 2015 and 2014, the Company recognized approximately \$3.3 million and \$3.0 million, respectively, of stock-based compensation expense, which is included in the selling, general and administrative expense line on the Condensed Consolidated Statements of Income. For the nine months ended September 30, 2015 and 2014, stock-based compensation expense totaled \$9.8 million and \$8.6 million, respectively. No stock-based compensation expense was capitalized during the three and nine months ended September 30, 2015 or 2014.

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**5. Inventories**

Inventories consist of the following:

	<b>September 30, 2015</b>	<b>December 31, 2014</b>
	<b>(In thousands)</b>	
Raw materials	\$ 102,029	\$ 107,357
Work in progress	105,124	112,514
Finished goods	195,016	207,295
	402,169	427,166
Less: allowance for obsolete and excess inventory	(36,495)	(34,607)
Total inventory	\$ 365,674	\$ 392,559

## 6. Geographic Areas

	Three months ended September 30, 2015		2014		Nine months ended September 30, 2015		2014	
	(In thousands)							
<i>Revenues:</i>								
Western Hemisphere								
Products	\$ 75,681	\$ 101,833	\$ 250,056	\$ 312,175				
Services	23,285	20,397	67,092	55,678				
Intercompany	17,002	19,501	41,757	38,856				
Total	\$ 115,968	\$ 141,731	\$ 358,905	\$ 406,709				
Eastern Hemisphere								
Products	\$ 44,955	\$ 53,894	\$ 185,194	\$ 151,631				
Services	15,128	17,587	40,387	45,578				
Intercompany	549	7,018	5,372	10,517				
Total	\$ 60,632	\$ 78,499	\$ 230,953	\$ 207,726				
Asia-Pacific								
Products	\$ 37,154	\$ 43,100	\$ 86,163	\$ 96,936				
Services	5,199	4,939	13,788	14,140				
Intercompany	2,492	394	4,881	2,724				
Total	\$ 44,845	\$ 48,433	\$ 104,832	\$ 113,800				
Summary								
Products	\$ 157,790	\$ 198,827	\$ 521,413	\$ 560,742				
Services	43,612	42,923	121,267	115,396				
Intercompany	20,043	26,913	52,010	52,097				
Eliminations	(20,043)	(26,913)	(52,010)	(52,097)				
Total	\$ 201,402	\$ 241,750	\$ 642,680	\$ 676,138				
<i>Income before income taxes:</i>								
Western Hemisphere	\$ 23,536	\$ 34,496	\$ 83,500	\$ 106,666				
Eastern Hemisphere	24,386	25,620	69,969	56,794				
Asia-Pacific	16,471	13,646	28,960	34,954				
Eliminations	203	(567)	6,647	2,639				
Total	\$ 64,596	\$ 73,195	\$ 189,076	\$ 201,053				

**September 30, 2015**      **December 31, 2014**



**(In thousands)**

<i>Total Long-Lived Assets:</i>		
Western Hemisphere	\$ 208,406	\$ 221,597
Eastern Hemisphere	42,946	45,517
Asia-Pacific	55,867	57,923
Eliminations	(2,926)	(2,926)
Total	\$ 304,293	\$ 322,111
<i>Total Assets:</i>		
Western Hemisphere	\$ 707,263	\$ 731,448
Eastern Hemisphere	392,007	375,781
Asia-Pacific	356,149	354,329
Eliminations	(17,299)	(12,307)
Total	\$ 1,438,120	\$ 1,449,251

## 7. Commitments and Contingencies

### *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 long-term prepaid tax) to be used to offset future state taxes on sales to customers in the State of Rio de Janeiro, subject to certification by the tax authorities. During the second quarter of 2015, the tax authorities certified approximately \$8.3 million of those credits paid in 2010 and granted an additional \$2.3 million in inflation-related credits. The additional amount of credits granted by the tax authorities increased long-term prepaid taxes and decreased selling, general and administrative expenses by \$2.3 million.

In December 2010 and January 2011, the Company's Brazilian subsidiary was served with two 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 above. The Company has objected to these assessments on the grounds that they would represent double taxation on the importation of the same goods and that the Company is entitled to the credits under applicable Brazilian law. With regard to the December 2010 assessment, the Company's Brazilian subsidiary filed an appeal with the relevant State of Rio de Janeiro judicial court to annul the tax assessment following a ruling against the Company by the tax administration's highest council. In connection with that appeal, the Company was required to deposit with the court approximately \$3.1 million as the full amount of the assessment with penalties and interest. The Company intends to file a similar appeal in the judicial system with regard to the January 2011 assessment as a result of a recent ruling against the Company by the tax administration's highest council. The Company believes that these credits are valid and that success in the judicial court process 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.

### *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, the Company's products 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 liabilities or obligations 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 results of operations, 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 and notes therein 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, 2014.

### 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 assistance services 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 activity have historically been characterized by significant volatility.

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

	Three months ended September 30,		Nine months ended September 30,	
	2015	2014	2015	2014
Closing Crude Oil (\$/Bbl)	\$ 47.29	\$ 94.67	\$ 47.29	\$ 94.67
Average Crude oil (\$/Bbl)	\$ 50.44	\$ 101.90	\$ 55.31	\$ 106.56
Closing Natural gas (\$/Mcf)	\$ 2.55	\$ 4.27	\$ 2.55	\$ 4.27
Average Natural gas (\$/Mcf)	\$ 2.84	\$ 4.09	\$ 2.89	\$ 4.72

For the quarter ended September 30, 2015, Brent Crude oil closing prices ranged between \$41.59 per barrel and \$61.73 per barrel with an average quarterly price of \$50.44 per barrel, as compared to a range of \$94.53 per barrel and \$110.84 per barrel with an average quarterly price of \$101.90 per barrel for the same period in 2014. For the nine months ended September 30, 2015, Brent Crude oil prices ranged between \$41.59 per barrel and \$66.33 per barrel with an average price of \$55.31 per barrel, as compared to a range of \$94.53 per barrel to \$115.19 per barrel with an average price of \$106.56 per barrel for the same period in 2014. Brent Crude oil prices ended the third quarter of 2015 at \$47.29 per barrel and closed at \$47.51 per barrel on October 19, 2015. Average crude oil prices for the nine-month periods ended September 30, 2014 and 2015 have dropped approximately 48.1%. The Henry Hub natural gas prices

ranged from \$2.55 per Mcf to \$3.02 per Mcf for the quarter ended September 30, 2015, as compared to a low of \$3.89 per Mcf and a high of \$4.61 per Mcf for the quarter ended September 30, 2014. For the nine months ended September 30, 2015, Henry Hub prices ranged between \$2.55 per Mcf and \$3.42 per Mcf with a closing price of \$2.55 per Mcf, compared to a range of \$3.89 per Mcf to \$8.40 per Mcf for the same period in 2014. On October 19, 2015, the Henry Hub natural gas price was \$2.51 per Mcf.

According to the October 2015 release of the Short-Term Energy Outlook published by the EIA, Brent Crude oil prices are expected to average approximately \$53.96 per barrel for 2015 and \$58.50 per barrel in 2016. In its October 2015 Oil Market Report, the International Energy Agency projected world demand for oil will be approximately 95.4 million barrels per day in 2015 and 95.7 million barrels per day in 2016. In October 2015, the EIA projected Henry Hub natural gas prices will average \$2.89 per Mcf in 2015 and \$3.14 per Mcf in 2016.

*Rig Count*

Detailed below is the average contracted rig count (rigs currently drilling as well as rigs committed, but not yet drilling) for the Company's geographic regions for the nine months ended September 30, 2015 and 2014. 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 assets used to deploy the Company's products.

	Nine months ended September 30,			
	2015		2014	
	Floating Rigs	Jack-up Rigs	Floating Rigs	Jack-up Rigs
Western Hemisphere	118	69	125	98
Eastern Hemisphere	87	87	100	96
Asia-Pacific	41	252	54	259
Total	246	408	279	453

Source: IHS Petrodata RigBase September 30, 2015

According to IHS-Petrodata RigBase, as of September 30, 2015, there were 606 rigs under contract for the Company's geographic regions (223 floating rigs and 383 jack-up rigs) which represents a 15.5% decrease from the rig count of 717 rigs (274 floating rigs and 443 jack-up rigs) as of December 31, 2014. There was a 16.6% decrease year over year from September 2014 to September 2015. As of September 30, 2014, there were 727 rigs under contract (279 floating rigs and 448 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 IHS-Petrodata RigBase, at the end of September 2015 and 2014, there were 204 and 237 rigs, respectively, under construction. The expected delivery dates for the rigs under construction at September 30, 2015 are as follows:

	Floating Rigs	Jack-Up Rigs	Total
2015	6	43	49
2016	29	49	78
2017	17	30	47
2018	11	4	15
After 2018 or unspecified delivery date	12	3	15
	75	129	204

*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. Lower crude oil and natural gas prices have resulted in a trend of customers seeking to renegotiate contract terms with the Company, including reductions in the prices of its products and services, extensions of delivery terms and, in some instances, contract cancellations or revisions. In addition, some of the Company's customers could experience liquidity or solvency issues or could otherwise be unable or unwilling to perform under a contract, which could ultimately lead a customer to enter bankruptcy or otherwise encourage a customer to seek to repudiate, cancel or renegotiate a contract. An extended period of reduced crude oil and natural gas prices may accelerate these trends. If the Company experiences significant contract terminations, suspensions or scope adjustments to its contracts, financial condition, results of operations and cash flows may be adversely impacted.

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. 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 continued decline in commodity prices or an extended 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 September 30, 2015 was \$824 million compared to \$974 million at June 30, 2015, approximately \$1.2 billion at December 31, 2014, and approximately \$1.25 billion at September 30, 2014. The Company's backlog balance during the first nine months of 2015 has been negatively impacted by purchase order cancellations and revisions totaling approximately \$42 million and, due primarily to the strengthening of the U.S. dollar versus the Brazilian real, translation adjustments of approximately \$36 million.

In August 2012, the Company's Brazilian subsidiary, Dril-Quip do Brasil LTDA, was awarded a four-year contract by Petroleo Brasileiro S.A. (Petrobras), Brazil's national oil company. The contract was valued at \$650 million, net of Brazilian taxes, at exchange rates in effect at that time (approximately \$334 million based on the September 30, 2015 exchange rate of 3.97 Brazilian real to 1.00 U.S. dollar) if all the equipment under the contract was ordered. Amounts are included in the Company's backlog as purchase orders under the contract are received. Revenues of approximately \$97 million have been recognized on this contract through September 30, 2015. As of September 30, 2015, the Company's backlog included \$51 million (at September 30, 2015 exchange rate of 3.97 Brazilian real to 1.00 U.S. dollar) of purchase orders under the Petrobras contract. The Company has not yet recognized revenue of approximately \$11 million as of September 30, 2015 for certain items of equipment that were completed but not yet accepted for delivery by Petrobras. If Petrobras does not ultimately accept these items for delivery or if they refuse to accept these or similar items completed in the future, the Company's results of operations may be adversely affected. The Company is in ongoing discussions with Petrobras regarding this contract and does not expect that Petrobras will order all of the equipment under the contract during its current four-year term.

As a result of declining oil prices and the Company's decreasing backlog, the Company expects its total number of employees worldwide to decrease from 2,720 as of December 31, 2014 to approximately 2,250 as of December 31, 2015 due to employee attrition and workforce reductions.

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.

*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 the three months ended September 30, 2015 and 2014, the Company derived 78% and 82%, respectively, of its revenues from the sale of its products and 22% and 18%, respectively, of its revenues from services. For the nine months ended September 30, 2015 and 2014, the Company derived 81% and 83%, respectively, of its revenues from the sale of its products and 19% and 17% of its revenues from services, respectively. Service revenues generally correlate to revenues from product sales because increased product sales typically generate increased demand for technical advisory assistance services during installation and rental of running tools. The Company has substantial international operations, with approximately 63% and 69% of its revenues derived from foreign sales for the three months ended September 30, 2015 and 2014, respectively, and 64% and 63%, for the nine months ended September 30, 2015 and 2014, respectively. Substantially all of the Company's domestic revenue relates to operations in the U.S. Gulf of Mexico. Domestic revenue approximated 37% and 31% respectively, of the Company's total revenues for the three months ended September 30, 2015 and 2014 and 36% and 37% for the nine months ended September 30, 2015 and 2014, respectively.

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 global oil prices, 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 nine months ended September 30, 2015, 14 projects representing approximately 16% of the Company's total revenue and approximately 20% of its product revenues were accounted for using percentage-of-completion accounting, compared to 17 projects representing approximately 10% of the Company's total revenue and 13% of its product revenue for the first nine months of 2014. For the quarter ended September 30, 2015, there were 9 projects representing approximately 17% of the Company's total revenues and approximately 22% of its product revenues compared to 14 projects during the third quarter of 2014, which represented approximately 15% of the Company's total revenues and approximately 18% of its product revenues. 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.

*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, business development expenses, 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 September 30,		Nine months ended September 30,	
	2015	2014	2015	2014
<b>Revenues:</b>				
Products	78.3%	82.2%	81.1%	82.9%
Services	21.7	17.8	18.9	17.1
<b>Total revenues:</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<b>Cost of sales:</b>				
Products	44.2	47.0	45.6	45.7
Services	9.5	8.9	9.0	9.2
<b>Total cost of sales:</b>	<b>53.7</b>	<b>55.9</b>	<b>54.6</b>	<b>54.9</b>
Selling, general and administrative expenses	8.6	8.8	10.5	10.4
Engineering and product development expenses	5.8	5.2	5.5	5.1
<b>Operating income</b>	<b>31.9</b>	<b>30.1</b>	<b>29.4</b>	<b>29.6</b>
Interest income	0.2	0.1	0.1	0.1
<b>Income before income taxes</b>	<b>32.1</b>	<b>30.2</b>	<b>29.5</b>	<b>29.7</b>
Income tax provision	6.9	7.2	7.1	7.6
<b>Net income</b>	<b>25.2%</b>	<b>23.0%</b>	<b>22.4%</b>	<b>22.1%</b>

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

	Three months ended September 30,		Nine months ended September 30,	
	2015	2014	2015	2014
	(In millions)			
<b>Revenues:</b>				
<b>Products</b>				
Subsea equipment	\$ 139.1	\$ 166.4	\$ 467.7	\$ 494.5
Surface equipment	6.7	12.4	18.0	25.1
Offshore rig equipment	12.0	20.0	35.7	41.1
<b>Total products</b>	<b>157.8</b>	<b>198.8</b>	<b>521.4</b>	<b>560.7</b>
Services	43.6	42.9	121.3	115.4
<b>Total revenues</b>	<b>\$ 201.4</b>	<b>\$ 241.7</b>	<b>\$ 642.7</b>	<b>\$ 676.1</b>

*Three Months Ended September 30, 2015 Compared to Three Months Ended September 30, 2014*

*Revenues.* Revenues decreased by \$40.3 million, or approximately 16.7%, to \$201.4 million in the three months ended September 30, 2015 from \$241.7 million in the three months ended September 30, 2014. Product revenues decreased by approximately \$41.0 million for the three months ended September 30, 2015 compared to the same period in 2014 as a result of decreased revenues of \$27.3 million in subsea equipment, \$5.7 million in surface equipment and \$8.0 million in offshore rig equipment. Product revenues decreased in the Western Hemisphere by \$26.2 million, in the Eastern Hemisphere by \$8.9 million and \$5.9 million in Asia-Pacific. 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. Service revenues increased by approximately \$0.7 million as a result of increases of \$2.9 million in the Western Hemisphere and \$0.3 million in Asia-Pacific, partially offset by a decrease of \$2.5 million in the Eastern Hemisphere.

*Cost of Sales.* Cost of sales decreased by \$27.2 million, or approximately 20.1%, to \$108.1 million for the three months ended September 30, 2015 from \$135.3 million for the same period in 2014. This decrease was primarily due to reduced revenues. As a percentage of revenues, cost of sales were approximately 53.7% and 55.9% for the three-month periods ended September 30, 2015 and 2014, respectively. This change is as a result of a decrease in unabsorbed manufacturing overhead, a reduction in cost of sales as a percentage of service revenues to 44.1% from 50.3% and an increase in service revenues as a percentage of total revenues to 21.7% from 17.8% for the for the three-month periods ended September 30, 2015 and 2014, respectively.

*Selling, General and Administrative Expenses.* For the three months ended September 30, 2015, selling, general and administrative expenses decreased by approximately \$3.5 million, or 16.8%, to \$17.3 million from \$20.8 million for the same period in 2014. The decrease was mostly attributable to \$6.5 million in foreign currency transaction gains for the three months ended September 30, 2015, compared to \$4.0 million in foreign currency transaction gains in the third quarter of 2014. The majority of the gain was due to the strengthening of the United States dollar compared to the British pound sterling. Also, personnel and related expenses decreased by \$1.0 million due to reductions in headcount. Stock-based compensation expense was approximately \$300,000 higher for the three months ended September 30, 2015 as compared to the same period in 2014. Selling, general and administrative expenses as a percentage of revenues decreased to 8.6% in 2015 from 8.8% in 2014.

*Engineering and Product Development Expenses.* For the three months ended September 30, 2015, engineering and product development expenses decreased by approximately \$1.0 million, or 7.9%, to \$11.7 million from \$12.7 million in the same period of 2014. Engineering and product development expenses have decreased largely due to a reduction in research and development expenditures. Engineering and product development expenses as a percentage of revenues increased to 5.8% in 2015 from 5.2% in 2014 due primarily to reduced revenues.

*Income tax provision.* Income tax expense for the three months ended September 30, 2015 was \$13.8 million on income before taxes of \$64.6 million, resulting in an effective income tax rate of approximately 21.4%. Income tax expense for the three months ended September 30, 2014 was \$17.5 million on income before taxes of \$73.2 million, resulting in an effective tax rate of approximately 23.9%. The decrease in the effective income tax rate percentage primarily reflects the changes in taxable income among the Company's three geographic areas which have different income tax rates and an increase in foreign tax credits in the U.S.

*Net Income.* Net income was approximately \$50.8 million for the three months ended September 30, 2015 and \$55.7 million for the same period in 2014, for the reasons set forth above.

*Nine Months Ended September 30, 2015 Compared to Nine Months Ended September 30, 2014.*

*Revenues.* Revenues decreased by \$33.4 million, or approximately 4.9%, to \$642.7 million in the nine months ended September 30, 2015 from \$676.1 million in the nine months ended September 30, 2014. Product revenues decreased by approximately \$39.3 million for the nine months ended September 30, 2015 compared to the same period in 2014 as a result of decreased revenues of \$26.8 million in subsea equipment, \$7.1 million in surface equipment and \$5.4 million in offshore rig equipment. The majority of the subsea equipment and offshore rig equipment decreases occurred in the Western Hemisphere as activity decreased in the U.S. Gulf of Mexico. Product revenues decreased in the Western Hemisphere by \$62.1 million and in Asia-Pacific by \$10.8 million, partially offset by an increase of \$33.6 in the Eastern Hemisphere. 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. Service revenues increased by approximately \$5.9 million from increased service revenues in the Western Hemisphere of \$11.4 million, partially offset by a decrease in the Eastern Hemisphere of \$5.2 million, and \$0.3 million in Asia-Pacific. The majority of the increase in service revenues related to an increase in rental tool revenues.

*Cost of Sales.* Cost of sales decreased by \$20.1 million, or approximately 5.4%, to \$350.9 million for the nine months ended September 30, 2015 from \$371.0 million for the same period in 2014. As a percentage of revenues, cost of sales were approximately 54.6% and 54.9% for the nine-months ended September 30, 2015 and 2014, respectively. The decrease in cost of sales as a percentage of revenues was minimal.

*Selling, General and Administrative Expenses.* For the nine months ended September 30, 2015, selling, general and administrative expenses decreased by approximately \$2.4 million, or 3.4%, to \$67.9 million from \$70.3 million for the same period in 2014. The Company experienced approximately \$1.1 million in foreign currency transaction gains in the first nine months of 2015 and 2014. Stock-based compensation expense for the first nine months of 2015 was \$9.8 million compared to \$8.6 million for the same period in 2014. Personnel and related expenses decreased \$2.6 million due to reductions in headcount. Also, the State of Rio de Janeiro judicial court awarded the Company \$2.3 million in inflation-related credits in the second quarter of 2015. Selling, general and administrative expenses as a percentage of revenues had a slight increase to 10.5% in the first nine months of 2015 as compared to 10.4% for the same period in 2014.

*Engineering and Product Development Expenses.* For the nine months ended September 30, 2015, engineering and product development expenses increased by \$1.0 million, or approximately 2.9%, to \$35.3 million from \$34.3 million in the same period in 2014. Cost reductions in engineering and product development in the quarter ended September 30, 2015 of approximately \$1.0 million in comparison to the quarter ended September 30, 2014, partially reversed the \$2.0 million increase for the six months ended June 30, 2015 in comparison with the six months ended June 30, 2014. Engineering and product development expenses as a percentage of revenues totaled 5.5% in 2015 and 5.1% in 2014.

*Income tax provision.* Income tax expense for the nine months ended September 30, 2015 was \$45.4 million on income before taxes of \$189.1 million, resulting in an effective income tax rate of approximately 24.0%. Income tax expense for the nine months ended September 30, 2014 was \$51.4 million on income before taxes of \$201.1 million, resulting in an effective income tax rate of approximately 25.6%. The decrease in the effective income tax rate percentage primarily reflects the changes in taxable income among the Company's three geographic areas which have different income tax rates.

*Net Income.* Net income was approximately \$143.7 million for the nine months ended September 30, 2015 and \$149.6 million for the same period in 2014, for the reasons set forth above.

### Liquidity and Capital Resources

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

	<b>Nine months ended September 30, 2015                  2014 (In thousands)</b>	
Operating activities	\$ 158,738	\$ 102,584
Investing activities	(16,563)	(30,621)
Financing activities	(38,902)	(138,088)
	103,273	(66,125)
Effect of exchange rate changes on cash activities	(5,009)	(3,267)
Increase (decrease) in cash and cash equivalents	\$ 98,264	\$ (69,392)

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.

Net cash provided from operating activities increased by \$56.2 million for the first nine months of 2015 compared to the same period in 2014, primarily due to an increase in cash from operating assets and liabilities of \$70.0 million.

The decrease in cash from operating assets and liabilities for the first nine months of 2015 of \$10.1 million primarily reflected a \$70.7 million decrease in accounts payable and accrued expenses, partially offset by a decrease in trade receivables of \$60.3 million. Trade receivables decreased in 2015 largely due to significant collections attributable to milestone billings on our percentage-of-completion projects in the first quarter of 2015 partially offset by an increase in unbilled receivables. Inventory decreased by approximately \$9.0 million due to lower balances in finished goods. Accounts payable and accrued expenses decreased due to a decrease in customer prepayments of \$44.3 million from recognition of revenues under the percentage-of-completion method and payments of accrued federal and local taxes.



The decrease in cash from operating assets and liabilities for the first nine months of 2014 of \$80.1 million primarily reflected an increase in trade receivables of \$55.2 million and an increase in inventory of \$44.0 million, partially offset by a \$22.1 million increase in accounts payable and accrued expenses. Trade receivables increased in 2014 largely due to increased billings directly attributable to significant milestone billings on our percentage-of-completion projects and an increase in revenues in the third quarter of 2014. Unbilled revenues increased \$9.9 million since the end of 2013. Inventory increased due to higher balances in raw materials, work in progress and finished goods to accommodate the higher backlog requirements related to long-term projects. Accounts payable and accrued expenses increased due to purchases of raw materials and an increase in customer prepayments of \$12.8 million from billings in excess of revenues.

Capital expenditures by the Company were \$16.7 million and \$31.2 million in the first nine months of 2015 and 2014, respectively. Capital expenditures in 2015 and 2014 included increased expenditures on machinery and equipment and running tools. The capital expenditures for the first nine months of 2015 were \$0.3 million for facilities, \$8.7 million for machinery and equipment, \$6.4 million for running tools and other expenditures of \$1.3 million. The capital expenditures for the first nine months of 2014 were \$2.5 million for facilities, \$20.3 million for machinery and equipment, \$5.3 million for running tools and other expenditures of \$3.1 million.

The exercise of stock options generated cash to the Company of \$2.0 million in the first nine months of 2015 compared to \$1.9 million in the same period of 2014.

On February 26, 2015, the Company announced that its Board of Directors authorized a stock repurchase plan under which the Company is authorized to repurchase up to \$100 million of its common stock. Under the plan, the Company repurchased and cancelled 351,800 shares at a total cost of \$21.0 million during the third quarter of 2015. The repurchase program has no expiration date and any repurchased shares are expected to be cancelled.

As of September 30, 2015, 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, continued significant 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.

### **Other Matters**

From time to time, the Company enters into discussions or negotiations to acquire other businesses or enter into joint ventures. The timing, size or success of any such efforts and the associated potential capital commitments are unpredictable and dependent on market conditions and opportunities existing at the time. The Company may seek to fund all or part of any such efforts with proceeds from debt or equity issuances. Debt or equity financing may not, however, be available at that time due to a variety of events, including, among others, maintenance of the Company's credit ratings, industry conditions, general economic conditions and market conditions.

### **Critical Accounting Policies**

Refer to our Annual Report on Form 10-K for the year ended December 31, 2014 for a discussion of our critical accounting policies. During the nine months ended September 30, 2015, 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. There have been no material changes in market risks for the Company from December 31, 2014.

**Foreign Exchange Rate Risk**

The Company has operations in various countries around the world and conducts business in a number of different currencies. Our significant foreign subsidiaries may also have monetary assets and liabilities not denominated in their functional currency. These monetary assets and liabilities are exposed to changes in currency exchange rates which may result in non-cash gains and losses primarily due to fluctuations between the U.S. dollar and each subsidiary's functional currency.

The Company experienced a foreign currency pre-tax gain of approximately \$6.5 million during the three months ended September 30, 2015 and a \$1.1 million pre-tax gain during the nine months ended September 30, 2015, compared to an approximate \$4.0 million pre-tax gain and a \$1.1 million pre-tax gain during the three and nine months ended September 30, 2014, respectively. These gains in 2015 were primarily due to exchange rate fluctuations between the U.S. dollar and the British pound sterling.

The Company does not engage in any material hedging transactions, forward contracts or currency trading which could mitigate the effects and risks inherent in such transactions. Additionally, there is no assurance that the Company will be able to protect itself against currency fluctuations in the future.

**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 September 30, 2015 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.

There has been no change in the Company's internal controls over financial reporting that occurred during the quarter ended September 30, 2015 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.**

For a 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, 2014.

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

In February 2015, the Company announced that its Board of Directors authorized a stock repurchase plan under which the Company is authorized to repurchase up to \$100 million of its common stock. The following table summarizes the repurchase and cancellation of common stock during the three months ended September 30, 2015.

*Issuer Purchase of Equity Securities*

Total Number of Shares Purchased	Average Price paid Per Share	Total Number of Shares Purchased as Part of a	Maximum Dollar Value (in millions) of
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				<b>Publicly Announced Plan or Program</b>	<b>Shares that May Yet Be Purchased Under the Program</b>
July 1	31, 2015		\$		\$ 80.1
August 1	31, 2015	351,800	59.60	351,800	59.1
September 1	30, 2015				59.1
Total		351,800	\$ 59.60	351,800	\$ 59.1

## 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 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 need for and 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;

changes in customers' future product and service requirements that may not be cost effective or within the Company's capabilities; 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, 2014 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);

project terminations, suspensions or scope adjustments to contracts reflected in the Company's backlog;

the Company's reliance on product development;

technological developments;

the Company's reliance on third-party technologies;

acquisition and merger activities involving the Company or its competitors;

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

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 laws 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:

- \*3.1 Restated Certificate of Incorporation of the Company (incorporated herein by reference to Exhibit 3.1 to the Company's report on Form 8-K filed on May 20, 2014).
- \*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 3.2 to the Company's report on Form 8-K filed on May 20, 2014).
- \*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).
- \*10.1 Form of Indemnification Agreement (incorporated herein by reference to Exhibit 10.1 to the Company's report on Form 8-K filed on August 12, 2015).
- 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: October 28, 2015