DRIL-QUIP INC
Form 10-Q
November 09, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2012

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, or a non-accelerated filer. See the 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 November 2 , 2012, the number of shares outstanding of the registrant s common stock, par value $0.01 per share, was 40,435,393.

PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	September 30, 2012	December 31, 2011
	(In thousands)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 263,421	$ 298,576
Trade receivables, net	240,839	180,095
Inventories, net	350,053	277,802
Deferred income taxes	24,229	23,868
Prepaids and other current assets	13,366	18,961
Total current assets	891,908	799,302
Property, plant and equipment, net	293,074	274,599
Other assets	11,221	11,957
Total assets	$ 1,196,203	$ 1,085,858
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 36,299	$ 35,580
Accrued income taxes	4,516	5,447
Customer prepayments	75,026	76,610
Accrued compensation	14,058	12,584
Other accrued liabilities	25,322	20,779
Total current liabilities	155,221	151,000
Long-term debt, net of current maturities		
Deferred income taxes	9,522	9,614
Total liabilities	164,743	160,614
Commitments and contingencies (Note 8)		
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, 40,431,518 and 40,175,426 shares issued and outstanding at September 30, 2012 and December 31, 2011	404	402
Additional paid-in capital	177,050	162,505
Retained earnings	869,037	780,780
Accumulated other comprehensive income (loss)	(15,031)	(18,443)
Total stockholders equity	1,031,460	925,244
Total liabilities and stockholders equity	$ 1,196,203	$ 1,085,858

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 September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
		(In thousands, except per share data)		
Revenues:				
Products	$ 159,465	$ 134,238	$ 455,846	$ 368,901
Services	31,395	20,797	88,708	60,795
Total revenues	190,860	155,035	544,554	429,696
Cost and expenses:				
Cost of sales:				
Products	103,614	80,713	287,567	216,219
Services	18,207	15,774	49,629	42,381
Total cost of sales	121,821	96,487	337,196	258,600
Selling, general and administrative	20,764	18,274	58,614	52,572
Engineering and product development	9,552	8,498	28,640	25,725
	152,137	123,259	424,450	336,897
Operating income	38,723	31,776	120,104	92,799
Interest income	148	84	329	269
Interest expense	(7)	(15)	(21)	(37)
Income before income taxes	38,864	31,845	120,412	93,031
Income tax provision	9,207	8,582	32,155	25,888
Net income	$ 29,657	$ 23,263	$ 88,257	$ 67,143
Earnings per common share:				
Basic	$ 0.73	$ 0.58	$ 2.19	$ 1.68
Diluted	$ 0.73	$ 0.58	$ 2.18	$ 1.67
Weighted average common shares outstanding:				
Basic	40,423	40,059	40,292	40,055
Diluted	40,589	40,296	40,492	40,311

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 September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
	(In thousands)			
Net income	$ 29,657	$ 23,263	$ 88,257	$ 67,143
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	7,105	(17,666)	3,412	(7,714)
Total comprehensive income	$ 36,762	$ 5,597	$ 91,669	$ 59,429

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

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Nine months ended September 30,	
	2012	**2011**
	(In thousands)	
Operating activities		
Net income	$ 88,257	$ 67,143
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	19,410	16,973
Stock-based compensation expense	3,922	3,438
Gain (loss) on sale of equipment	240	(636)
Deferred income taxes	(459)	(837)
Changes in operating assets and liabilities:		
Trade receivables, net	(59,487)	(28,054)
Inventories, net	(70,211)	(29,498)
Prepaids and other assets	5,409	1,460
Excess tax benefits of stock option exercises	(1,219)	(297)
Accounts payable and accrued expenses	4,222	21,553
Net cash provided by (used in) operating activities	(9,916)	51,245
Investing activities		
Purchase of property, plant and equipment	(40,606)	(45,114)
Proceeds from sale of equipment	1,303	2,258
Net cash used in investing activities	(39,303)	(42,856)
Financing activities		
Principal payments on debt	(34)	(257)
Proceeds from exercise of stock options	10,040	404
Excess tax benefits of stock option exercises	1,219	297
Net cash provided by financing activities	11,225	444
Effect of exchange rate changes on cash activities	2,839	889
Increase (decrease) in cash and cash equivalents	(35,155)	9,722
Cash and cash equivalents at beginning of period	298,576	245,850
Cash and cash equivalents at end of period	$ 263,421	$ 255,572

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 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, 2011, 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, 2012 and the results of operations and comprehensive income for the three and nine-month periods ended September 30, 2012 and 2011, and cash flows for the nine-month periods ended September 30, 2012 and 2011. 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 nine-month period ended September 30, 2012 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, 2011.

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, 2011.

Revenue Recognition

Product Revenue

The Company earns product revenues from two sources:

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

Revenues recognized under the percentage-of-completion method

The Company uses the percentage-of-completion method on long-term project contracts 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 this 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 do not always correlate directly to the revenue recognized. Based upon the terms of the specific contract, billings may be in excess of the revenue recognized, in which case the amounts are included in customer prepayments as a liability on the 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, 2012 and December 31, 2011, receivables included $68.1 million and $30.5 million of unbilled receivables, respectively. During the quarter ended September 30, 2012, there were 17 projects representing approximately 21.0% of the Company s total revenue and approximately 25.2% of its product revenues that were accounted for using percentage-of-completion accounting, compared to 11 projects during the third quarter of 2011 representing 12.8% of the Company s total revenues and 14.8% of its product revenues. For the nine months ended September 30, 2012, there were 19 projects representing 19.1% of the Company s total revenues and 22.3% of its product revenues, compared to 16 projects representing 18.8% of the Company s total revenues and 22.4% of its product revenues for the nine months ended September 30, 2011, 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 stock 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 September 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 September 30,		**Nine months ended September 30,**	
	2012	**2011**	**2012**	**2011**
	(In thousands)			
Number of common shares outstanding at end of period basic	40,432	40,060	40,432	40,060
Effect of using weighted average common shares outstanding	(9)	(1)	(140)	(5)
Weighted average basic common shares outstanding basic	40,423	40,059	40,292	40,055
Dilutive effect of common stock options	166	237	200	256
Weighted average diluted common shares outstanding diluted	40,589	40,296	40,492	40,311

3. New Accounting Standards

In December 2011, the FASB issued Accounting Standards Update (ASU) 2011-11, Balance Sheet Disclosures about Offsetting Assets and Liabilities. This ASU was issued to alleviate some of the differences in presentation between U.S. generally accepted accounting principles (GAAP) and International Financial

Reporting Standards (IFRS) as to presentations showing gross versus netted amounts. Entities are required to disclose both gross and net information about instruments and transactions that are eligible for offset in the statements of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. This ASU is effective for annual reporting periods beginning on or after January 1, 2013 and interim periods within those annual periods. The adoption of this accounting standard update will not have a material impact on the Company s condensed consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, Comprehensive Income. This ASU amended the guidance on the presentation of comprehensive income in financial statements to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items that are recorded in other comprehensive income. The new accounting guidance requires entities to report components of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. The provisions of this new guidance were effective for the Company on January 1, 2012. The Company adopted ASU 2011-05 effective with the period ended March 31, 2012. In December 2011, the FASB issued ASU 2011-12, Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items out of Accumulated Other Comprehensive Income. It was determined that the reclassification would be difficult for preparers and may add unnecessary complexity to financial statements.

4. Stock Options and Stock Awards

During the three and nine months ended September 30, 2012, the Company recognized approximately $1.3 million and $3.9 million, respectively, of stock-based compensation expense compared to $1.0 million and $3.4 million, respectively, for the three and nine months ended September 30, 2011. Stock-based compensation expense is included in the selling, general and administrative expense line of the Condensed Consolidated Statements of Income. No stock-based compensation expense was capitalized during the three and nine months ended September 30, 2012 or 2011. There were no stock options or stock awards granted in the third quarter of 2012 or 2011. Refer to Note 13 of the Company s Annual Report on Form 10-K for the year ended December 31, 2011 for additional information regarding stock-based compensation plans.

5. Inventories

Inventories consist of the following:

	September 30, 2012	December 31, 2011
	(In thousands)	
Raw materials and supplies	$ 75,536	$ 48,240
Work in progress	81,522	75,690
Finished goods	221,018	180,100
	378,076	304,030
Less: allowance for obsolete and excess inventory	(28,023)	(26,228)
Total	$ 350,053	$ 277,802

6. Geographic Areas

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
	(In thousands)			
Revenues:				
Western Hemisphere				
Products	$ 74,598	$ 69,670	$ 215,180	$ 198,547
Services	16,191	9,788	48,415	25,443
Intercompany	17,739	18,662	55,512	45,772
Total	$ 108,528	$ 98,120	$ 319,107	$ 269,762
Eastern Hemisphere				
Products	$ 50,488	$ 43,515	$ 151,010	$ 120,424
Services	9,341	6,843	27,727	23,020
Intercompany	264	331	3,933	788
Total	$ 60,093	$ 50,689	$ 182,670	$ 144,232
Asia-Pacific				
Products	$ 34,379	$ 21,053	$ 89,656	$ 49,930
Services	5,863	4,166	12,566	12,332
Intercompany	417	974	760	982
Total	$ 40,659	$ 26,193	$ 102,982	$ 63,244
Summary				
Products	$ 159,465	$ 134,238	$ 455,846	$ 368,901
Services	31,395	20,797	88,708	60,795
Intercompany	18,420	19,967	60,205	47,542
Eliminations	(18,420)	(19,967)	(60,205)	(47,542)
Total	$ 190,860	$ 155,035	$ 544,554	$ 429,696
Income (loss) before income taxes:				
Western Hemisphere	$ 14,789	$ 19,611	$ 54,509	$ 53,166
Eastern Hemisphere	9,848	10,703	34,158	27,199
Asia-Pacific	12,667	2,936	24,446	13,326
Eliminations	1,560	(1,405)	7,299	(660)
Total	$ 38,864	$ 31,845	$ 120,412	$ 93,031

	September 30, 2012	December 31, 2011
	(In thousands)	
Total Long-Lived Assets:		
Western Hemisphere	$ 212,604	$ 196,380
Eastern Hemisphere	35,744	34,927
Asia-Pacific	58,849	58,058
Eliminations	(2,902)	(2,809)
Total	$ 304,295	$ 286,556

Total Assets:		
Western Hemisphere	$ 702,720	$ 666,915
Eastern Hemisphere	279,311	229,043
Asia-Pacific	254,029	209,143
Eliminations	(39,857)	(19,243)
Total	$ 1,196,203	$ 1,085,858

7. Share Repurchase Plan

On June 18, 2012, the Company s Board of Directors approved a share repurchase plan of up to $100 million of the Company s common stock. As of September 30, 2012, no shares had been repurchased. The repurchase plan has no expiration date and all shares purchased are expected to be cancelled.

8. 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 is a party to an ongoing contract with an affiliate of BP to supply wellhead systems in connection with BP s U.S. Gulf of Mexico operations, and the Company s wellhead and certain of its other equipment were in use on the *Deepwater Horizon* at the time of the incident. A moratorium was placed on offshore deepwater drilling on May 28, 2010 in the U.S. Gulf of Mexico and was lifted on October 12, 2010. Since the first quarter of 2011, after delays attributed to new regulations that increased the complexity of the drilling permit process, the issuance of deepwater permits resumed and deepwater drilling activity in the U.S. Gulf of Mexico has steadily increased since that time.

The Company was named, along with other unaffiliated defendants, in both class action and other lawsuits arising from of the *Deepwater Horizon* incident. The actions filed against the Company were consolidated, along with hundreds of other lawsuits not directly naming the Company, 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). The lawsuits generally allege, among other things, violation of state and federal environmental and other laws and regulations, negligence, gross negligence, strict liability, personal injury and/or property damages and generally seek awards of unspecified economic, compensatory and punitive damages and/or declaratory relief.

On January 20, 2012, the judge presiding over the MDL Proceeding, another related proceeding filed by affiliates of Transocean Ltd under the Limitation of Liability Act, and the U.S. government s action under the Oil Pollution Act, 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.

Additional lawsuits may be filed and additional investigations may be launched in the future. An adverse outcome with respect to any of these lawsuits or investigations, or any lawsuits or investigations that may arise in the future, could have a material adverse effect on the Company s results of operations. The Company intends to continue to vigorously defend any litigation, fine and/or penalty relating to the *Deepwater Horizon* incident. Accordingly, the Company does not believe this litigation will have a material impact and no liability has been accrued in conjunction with these matters.

At the time of the *Deepwater Horizon* incident, the Company had a general liability insurance program with an aggregate coverage limit of $100 million for claims with respect to property damage, injury or death and pollution. The coverage was increased to $200 million in October 2010. The insurance policies may not cover all potential claims and expenses relating to the *Deepwater Horizon* incident. In addition, the Company s policies may not cover fines, penalties or costs and expenses related to government-mandated clean up of pollution. The Company has received a reservation of rights letter from its insurers. The incident may also lead to further tightening of the availability of insurance coverage. If liability limits are increased or the insurance market becomes more restricted, the risks and costs of conducting offshore exploration and development activities may increase, which could materially impact the Company s results of operations.

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) that can 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 preceeding paragraph. The Company has objected to this assessment as it would represent double taxation on the importation of the same goods and that the Company is entitled to the credits under applicable Brazilian law. The Company believes that these credits are valid and that success in the matter is probable. Based upon this analysis and because the Company is not able to reasonably estimate a loss or range of losses based upon an adverse judgment, 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. As of September 30, 2012, the Company had $1.4 million of ATP receivables and $4.3 million in customer prepayments from ATP.

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 consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2011.

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 on an as-requested basis during installation of its products, as well as rework and reconditioning services for customer-owned Dril-Quip products and rental of running tools for use in connection with the installation and retrieval of the Company s products.

Deepwater Horizon Incident

On April 22, 2010, a deepwater U.S. Gulf of Mexico drilling rig known as the *Deepwater Horizon,* operated by BP, sank after an explosion and fire that began on April 20, 2010. The Department of Interior issued an order imposing a moratorium on deepwater drilling in the U.S. Gulf of Mexico that was lifted on October 12, 2010. As a result of the *Deepwater Horizon* incident, the Company s revenues and earnings may be affected by, among other things, new or revised governmental laws or regulations relating to offshore oil and gas exploration and production activities, both in the U.S. Gulf of Mexico and in other areas in which the Company s customers operate, and the effect of such laws or regulations on the level of demand for the Company s products and services. For additional information related to the impact of the *Deepwater Horizon* incident as well as information related to litigation and additional governmental investigations and regulations arising out of the incident, see Commitments and Contingencies, Note 8, of the Notes to Condensed Consolidated Financial Statements and Part II, Item 1, Legal Proceedings. As a result of recent scrutiny of the offshore drilling industry triggered by the *Deepwater Horizon* incident, the technical specifications for the Company s existing and future products may change resulting in additional testing of its products to ensure their compliance with such specifications. If the Company s products are unable to satisfy the requirements of the additional testing, 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 or decide not to purchase 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 crude oil (West Texas Intermediate Cushing) and natural gas (Henry Hub) closing prices are listed below for the periods covered by this report:

	Three months ended September 30,		Nine months ended September 30,	
	2012	**2011**	**2012**	**2011**
Crude Oil ($/Bbl)	$ 92.17	$ 89.53	$ 96.11	$ 95.18
Natural gas ($/Mcf)	2.97	4.25	2.61	4.35

For the quarter ended September 30, 2012, West Texas Intermediate crude oil closing prices ranged between $83.72 per barrel and $98.94 per barrel with an average quarterly price of $92.17. During the quarter ended September 30, 2011, West Texas Intermediate crude oil prices ranged between $78.93 per barrel and $99.61 per barrel with an average quarterly price of $89.53. During the nine months ended September 30, 2012, West Texas Intermediate crude oil prices ranged between $77.72 per barrel and $109.39 per barrel with an average price of $96.11 per barrel, as compared to a range of $78.93 per barrel to $113.39 per barrel with an average price of $95.18 per barrel for the same period in 2011. West Texas Intermediate crude oil prices ended the third quarter of 2012 at $92.18 per barrel and Henry Hub natural gas prices at September 30, 2012 were $3.18 per Mcf.

According to the October 2012 release of the Short-Term Energy Outlook published by the EIA, West Texas Intermediate crude oil prices are projected to average $95.55 per barrel for the full year 2012 and $92.63 per barrel in 2013. The EIA projected Henry Hub natural gas prices to average $2.79 per Mcf for 2012 and $3.45 per Mcf in 2013. In its October 2012 Oil Market Report, the International Energy Agency (IEA) stated that global demand is estimated to be 89.7 million barrels per day for 2012, increasing to 90.5 million barrels per day in 2013.

Rig Count

Detailed below is the average contracted rig count for the Company s geographic regions for the three and nine months ended September 30, 2012 and 2011. 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.

	Three months ended September 30,		Nine months ended September 30,	
	2012	**2011**	**2012**	**2011**
Western Hemisphere	214	189	208	181
Eastern Hemisphere	172	162	170	154
Asia-Pacific	271	255	266	245
	657	606	644	580

Source: ODS Petrodata RigBase September 30, 2012 and 2011

The above 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 September 30, 2012, there were 68 rigs under contract in the U.S. Gulf of Mexico (30 jack-up rigs and 38 floating rigs). Of the total contracted, 60 were actively drilling (29 jack-up rigs and 31 floating rigs). As of September 30, 2011, there were 54 rigs under contract in the U.S. Gulf of Mexico (29 jack-up rigs and 25 floating rigs), 49 of which were actively drilling (29 jack-up rigs and 20 floating rigs).

The Company believes that the number of rigs (semi-submersibles, drillships and jack-up rigs) under construction impacts its revenue 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 September 2012 and 2011, there were 186 and 146 rigs, respectively, under construction. The expected delivery dates for the rigs under construction at September 30, 2012 are as follows:

2012	17
2013	70
2014	48
2015	16
After 2015 or unspecified delivery date	35
	186

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. For a description of certain actions taken by the U.S. government related to the *Deepwater Horizon* incident, see Commitments and Contingencies in Note 8 of the Notes to Condensed Consolidated Financial Statements.

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 and economic events have contributed to oil and natural gas price volatility and are likely to continue to do so in the future. West Texas Intermediate crude oil closing prices reached a high of $98.94 per barrel during the third quarter of 2012, but decreased to $86.65 by October 23, 2012. 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 September 30, 2012 was approximately $747 million compared to approximately $697 million at June 30, 2012, $716 million at December 31, 2011, and $730 million at September 30, 2011. In August 2012, the Company s Brazilian subsidiary, Dril-Quip do Brasil LTDA, was awarded a four-year contract by Petrobras, Brazil s national oil company. At current exchange rates, the contract is 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. The Company s September 30, 2012 backlog does not include any purchase order amounts relating to the new Petrobras contract. Subsequent to September 30, 2012 and as of November 7, 2012, purchase orders totaling approximately $60 million have been received under this contract. This amount, plus any subsequent orders received prior to December 31, 2012, will be included in the Company s year-end backlog. 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 the installation of the Company s products, reconditioning services and rental of running tools for installation and retrieval of the Company s products. For the nine months ended September 30, 2012 and 2011, the Company derived 84% and 86% of its revenues from the sale of its products and 16% and 14% 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 services during installation and rental of running tools. The Company has substantial international operations, with approximately 78% and 69% of its revenues derived from foreign sales for the three months ended September 30, 2012 and 2011, respectively, and 74% and 70% for the nine months ended September 30, 2012 and 2011, respectively. Substantially all of the Company s domestic revenue relates to operations in the U.S. Gulf of Mexico. Domestic revenue approximated 22% and 31%, respectively, of the Company s total revenues for the three months ended September 30, 2012 and 2011 and 26% and 30% for the nine months ended September 30, 2012 and 2011, respectively.

Product contracts are negotiated and sold separately from service contracts. In addition, service contracts are not 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 worldwide 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 nine months ended September 30, 2012, 19 projects representing approximately 19.1% of the Company s total revenue and approximately 22.3% of its product revenues were accounted for using percentage-of-completion accounting, compared to 16 projects representing approximately 18.8% of the Company s total revenue and 22.4% of its product revenue for the first nine months of 2011. 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 September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
		(In millions)		
Revenues:				
Products				
Subsea equipment	$ 27.3	$ 29.2	$ 90.9	$ 67.2
Surface equipment	0.1		0.3	0.2
Offshore rig equipment	3.6	11.8	17.1	44.8
Total products	31.0	41.0	108.3	112.2
Services	11.9	6.9	35.7	17.6
Total Gulf of Mexico revenues	$ 42.9	$ 47.9	$ 144.0	$ 129.8

As a result of the U.S. Gulf of Mexico drilling moratorium and subsequent delays in the issuance of permits, many of the Company s customers in the U.S. Gulf of Mexico still have unused inventory of the Company s subsea wellhead equipment. However, the number of floating rigs actively drilling in the U.S. Gulf of Mexico has steadily increased and is currently greater than pre-moratorium levels, which should increase the Company s opportunities for greater subsea equipment revenues in the future. 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 nine months ended September 30, 2012 compared to the nine months ended September 30, 2011 resulted primarily from a reduction of revenues from projects accounted for under the percentage-of-completion method. The Company s U.S. Gulf of Mexico service revenues, which decreased in each quarter of 2010 as a percentage of worldwide revenues as a result of the U.S. Gulf of Mexico drilling moratorium, have increased since the beginning of 2011. For the quarter ending March 31, 2011, U.S. Gulf of Mexico service revenues were 3.2% of total worldwide revenue and have increased to 6.2% of total worldwide revenue for the quarter ended September 30, 2012. The Company will continue to monitor any remaining effects of the U.S. drilling moratorium and the subsequent permitting delays on its ongoing business operations.

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 consolidated 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 production 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,	
	2012	2011	2012	2011
Revenues:				
Products	83.6%	86.6%	83.7%	85.9%
Services	16.4	13.4	16.3	14.1
Total revenues:	100.0	100.0	100.0	100.0
Cost of sales:				
Products	54.3	52.1	52.8	50.3
Services	9.5	10.1	9.1	9.9
Total cost of sales:	63.8	62.2	61.9	60.2
Selling, general and administrative expenses	11.0	11.9	10.8	12.3
Engineering and product development expenses	5.0	5.5	5.3	6.0
Operating income	20.2	20.4	22.0	21.5
Interest income	0.1	0.1	0.1	0.1
Interest expense				
Income before income taxes	20.3	20.5	22.1	21.6
Income tax provision	4.8	5.5	5.9	6.0
Net income	15.5%	15.0%	16.2%	15.6%

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,	
	2012	2011	2012	2011
		(In millions)		
Revenues:				
Products				
Subsea equipment	$ 138.7	$ 116.3	$ 385.9	$ 302.1
Surface equipment	9.2	6.3	30.3	16.4
Offshore rig equipment	11.6	11.6	39.7	50.4
Total products	159.5	134.2	455.9	368.9
Services	31.4	20.8	88.7	60.8
Total revenues	$ 190.9	$ 155.0	$ 544.6	$ 429.7

Three Months Ended September 30, 2012 Compared to Three Months Ended September 30, 2011

Revenues. Revenues increased by $35.9 million, or approximately 23.2%, to $190.9 million in the three months ended September 30, 2012 from $155.0 million in the three months ended September 30, 2011. Product revenues increased by approximately $25.3 million for the three months ended September 30, 2012 compared to the same period in 2011 as a result of increased revenues of $22.4 million in subsea equipment and $2.9 million in surface equipment. Offshore rig equipment remained constant at $11.6 million. Product revenues increased in the Western Hemisphere by $4.9 million, in the Eastern Hemisphere by $7.0 million and in Asia-Pacific by $13.4 million. In any given time period, the revenues recognized between the various product lines will vary depending upon the completion status of the projects accounted for under the percentage-of-completion accounting method,

market conditions and customer demand. Service revenues increased by approximately $10.6 million from higher service revenues in the Western Hemisphere of $6.4 million, the Eastern Hemisphere of $2.5 million and Asia-Pacific of $1.7 million. The majority of the increases in service revenues related to an increase in technical advisory services, partially offset by a decrease in reconditioning services.

Cost of Sales. Cost of sales increased by $25.3 million, or approximately 26.2%, to $121.8 million for the three months ended September 30, 2012 from $96.5 million for the same period in 2011. As a percentage of revenues, cost of sales were approximately 63.8% and 62.2% for the three-month period ended September 30, 2012 and 2011, respectively. The increase in cost of sales as a percentage of revenues resulted primarily from changes in the product mix and increases in unabsorbed manufacturing overhead expenses.

Selling, General and Administrative Expenses. For the three months ended September 30, 2012, selling, general and administrative expenses increased by approximately $2.5 million, or 13.7%, to $20.8 million from $18.3 million for the same period in 2011. The increase in selling, general and administrative expenses was primarily due to the effect of foreign currency transactions and increased personnel and related expenses. The Company experienced approximately $2.4 million in foreign currency transaction losses in the third quarter of 2012 as compared to $961,000 in foreign currency transaction losses in the third quarter of 2011. Stock option and awards expense was approximately $300,000 higher for the three months ended September 30, 2012 as compared to the same period in 2011 which was substantially offset by a decrease in legal expenses. Selling, general and administrative expenses as a percentage of revenues decreased to 11.0% in 2012 from 11.9% in 2011.

Engineering and Product Development Expenses. For the three months ended September 30, 2012, engineering and product development expenses increased by approximately $1.1 million, or 12.9%, to $9.6 million from $8.5 million in the same period of 2011. Engineering and product development staffs have been increased to meet the demands of the higher backlog related to long-term projects. Engineering and product development expenses as a percentage of revenues decreased to 5.0% in 2012 from 5.5% in 2011.

Interest Income. Interest income for the three months ended September 30, 2012 was approximately $148,000 as compared to $84,000 for the three-month period ended September 30, 2011. The Company continues to keep the majority of its short-term investments in funds which invest in U.S. Treasury obligations.

Interest expense. Interest expense for the three months ended September 30, 2012 was $7,000 compared to $15,000 for the same period in 2011.

Income tax provision. Income tax expense for the three months ended September 30, 2012 was $9.2 million on income before taxes of $38.9 million, resulting in an effective income tax rate of approximately 24%. Income tax expense for the three months ended September 30, 2011 was $8.6 million on income before taxes of $31.8 million, resulting in an effective tax rate of approximately 27%. The change 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 $29.7 million for the three months ended September 30, 2012 and $23.3 million for the same period in 2011, for the reasons set forth above.

Nine Months Ended September 30, 2012 Compared to Nine Months Ended September 30, 2011.

Revenues. Revenues increased by $114.9 million, or approximately 26.7%, to $544.6 million in the nine months ended September 30, 2012 from $429.7 million in the nine months ended September 30, 2011. Product revenues increased by approximately $87.0 million for the nine months ended September 30, 2012 compared to the same period in 2011 as a result of increased revenues of $83.8 million in subsea equipment, $13.9 million in surface equipment, partially offset by a decrease of $10.7 million in offshore rig equipment. Product revenues increased in the Western Hemisphere by $16.7 million, the Eastern Hemisphere by $30.6 million and $39.7 million in Asia-Pacific. Service revenues increased by approximately $27.9 million, from increased service revenues in the Western Hemisphere of $23.0 million, the Eastern Hemisphere of $4.7 million and $200,000 in Asia-Pacific. The majority of the increase in service revenues related to an increase in technical advisory services and the rental of running tools.

Cost of Sales. Cost of sales increased by $78.6 million, or approximately 30.4%, to $337.2 million for the nine months ended September 30, 2012 from $258.6 million for the same period in 2011. As a percentage of revenues, cost of sales were approximately 61.9% and 60.2% for the nine-month periods ending September 30, 2012 and 2011, respectively. The increase in cost of sales as a percentage of revenues resulted primarily from changes in the product mix.

Selling, General and Administrative Expenses. For the nine months ended September 30, 2012, selling, general and administrative expenses increased by approximately $6.0 million, or11.4%, to $58.6 million from $52.6 million for the same period in 2011. The increase in selling, general and administrative expenses was primarily due to the effect of foreign currency transactions and increased personnel and related expenses. The Company experienced approximately $4.3 million in foreign currency transaction losses in the first nine months of 2012 compared to $2.9 million in foreign currency transaction losses in the first nine months of 2011. Stock option and awards expense was approximately $500,000 greater for the nine months ended September 30, 2012 as compared to the same period in 2011. Selling, general and administrative expenses as a percentage of revenues decreased to 10.8% in 2012 from 12.3% in 2011.

Engineering and Product Development Expenses. For the nine months ended September 30, 2012, engineering and product development expenses increased by $2.9 million, or approximately 11.3%, to $28.6 million from $25.7 million in the same period of 2011. Engineering and product development expenses as a percentage of revenues totaled 5.3% in 2012 and 6.0% in 2011. Engineering and product development staffs have increased due to the higher backlog related to long-term projects.

Interest Income. Interest income for the nine months ended September 30, 2012 was $329,000 as compared to $269,000 for the nine months ended September 30, 2011. The Company continues to keep the majority of its short-term investments in funds which invest in U.S. Treasury obligations.

Interest Expense. Interest expense for the nine months ended September 30, 2012 was $21,000 compared to $37,000 for the same period in 2011.

Income tax provision. Income tax expense for the nine months ended September 30, 2012 was $32.2 million on income before taxes of $120.4 million, resulting in an effective income tax rate of approximately 27%. Income tax expense for the nine months ended September 30, 2011 was $25.9 million on income before taxes of $93.0 million, resulting in an effective income tax rate of approximately 28%.

Net Income. Net income was approximately $88.3 million for the nine months ended September 30, 2012 and $67.1 million for the same period in 2011, for the reasons set forth above.

Liquidity and Capital Resources

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

	Nine months ended September 30,	
	2012	2011
	(In thousands)	
Operating activities	$ (9,916)	$ 51,245
Investing activities	(39,303)	(42,856)
Financing activities	11,225	444
	(37,994)	8,833
Effect of exchange rate changes on cash activities	2,839	889
Increase (decrease) in cash and cash equivalents	$ (35,155)	$ 9,722

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. Recently, the Company s principal sources of funds have been cash flows from operations.

During the nine months ended September 30, 2012, the Company used $9.9 million of cash from operations as compared to generating $51.2 million for the same period in 2011. Cash totaling approximately $121.3 was used during the first nine months of 2012 due to increases in operating assets and liabilities, compared to $34.8 million that was used during the same period in 2011. The increase in operating assets and liabilities during the first nine months of 2012 primarily reflected an increase in trade receivables of $59.5 million, due primarily to a $36.4 million increase in unbilled revenues. Inventory increased by approximately $70.2 million due to higher balances in raw materials and finished goods to accommodate the higher backlog requirements. Trade accounts payable and accrued expenses were higher by approximately $4.2 million.

Capital expenditures by the Company were $40.6 million and $45.1 million in the first nine months of 2012 and 2011, respectively. Capital expenditures in 2012 and 2011 included expanding manufacturing facilities in the Asia-Pacific, Eastern and Western Hemispheres and increased expenditures on machinery and equipment and running tools due to expanded operations. The capital expenditures for the first nine months of 2012 were primarily $7.3 million for facilities, $21.3 million for machinery and equipment, $9.5 million for running tools and other expenditures of $2.5 million.

As of September 30, 2012, 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.

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 September 30, 2012, no shares had been repurchased.

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, 2011 for a discussion of our critical accounting policies. During the nine months ended September 30, 2012, 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, 2011.

Foreign Exchange Rate Risk

Through its subsidiaries, the Company conducts a portion of its business in currencies other than the United States dollar, principally the British pound sterling and to a lesser extent, the Brazilian real. The Company experienced a foreign currency pre-tax loss of approximately $2.4 million and $4.3 million during the three and nine months ended September 30, 2012, respectively, compared to a $961,000 and a $2.9 million pre-tax loss for the three and nine month periods ended September 30, 2011, 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 September 30, 2012 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 47 of the Company s Annual Report on Form 10-K for the year ended December 31, 2011.

There has been no change in the Company s internal controls over financial reporting that occurred during the quarter ended September 30, 2012 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 new lawsuits may be filed against the Company in the future.

For a further description of the Company s legal proceedings, see Commitments and Contingencies, Note 8 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, 2011.

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 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, 2011 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;

terrorists 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.

The following exhibits are filed herewith:

e Company (incorporated herein by reference to Exhibit 3.2 to the Company s Registration Statement on Form S-1 (Registration No. 333-33447)).

nior 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).

npany (incorporated herein by reference to Exhibit 3.1 to the Company s report on Form 8-K filed January 17, 2012).

Stock (incorporated herein by reference to Exhibit 4.2 to the Company s Registration Statement on Form S-1 (Registration No. 333-33447).

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 Repo

gust 20, 2012 between Petroleo Brasileiro S.A. and Dril-Quip, do Brasil LTDA (English translation).

t (incorporated herein by reference to Exhibit 10.1 to the Company s report on Form 8-K filed on October 19, 2012).

Blake T. DeBerry.

Jerry M. Brooks.

Berry.

oks.

* Incorporated herein by reference as indicated.

+ Management contract or compensatory plan or arrangement.

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: November 8, 2012