DRIL-QUIP INC
Form 10-Q
July 26, 2018

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

FORM 10-Q

(MARK ONE)
ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended June 30, 2018
or
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission file number 001-13439

DRIL-QUIP, INC.
(Exact name of registrant as specified in its charter)

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

6401 N. ELDRIDGE PARKWAY
HOUSTON, TEXAS
77041
(Address of principal executive offices) (Zip Code)
(713) 939-7711
(Registrant’s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No ¨
Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of regulations S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes ý No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer”, “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	ý	Accelerated filer	¨
Non-accelerated filer	¨	Smaller reporting company	¨
		Emerging growth company	¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨
Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes ¨ No ý
As of July 23, 2018, the number of shares outstanding of the registrant’s common stock, par value $0.01 per share, was 37,546,504.

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PART I—FINANCIAL INFORMATION

Item 1. Financial Statements

DRIL-QUIP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	June 30, 2018	December 31, 2017
	(In thousands, except for par value and shares)	
ASSETS		
Current assets:		
Cash and cash equivalents	$493,422	$493,180
Trade receivables, net	184,463	191,629
Inventories, net	264,096	291,087
Prepaids and other current assets	34,441	32,653
Total current assets	976,422	1,008,549
Property, plant and equipment, net	283,040	284,247
Deferred income taxes	3,991	5,364
Goodwill	47,042	47,624
Intangible assets	36,140	38,408
Other assets	15,056	15,613
Total assets	$1,361,691	$1,399,805
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$20,967	$33,480
Accrued income taxes	24,976	24,714
Customer prepayments	4,144	4,767
Accrued compensation	13,462	11,412
Other accrued liabilities	16,920	25,538
Total current liabilities	80,469	99,911
Deferred income taxes	3,055	3,432
Other long-term liabilities	2,720	2,001
Total liabilities	86,244	105,344
Commitments and contingencies (Note 12)		
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, 37,531,965 and 38,132,693 issued and outstanding at June 30, 2018 and December 31, 2017	394	372
Additional paid-in capital	28,149	20,083
Retained earnings	1,381,739	1,400,296
Accumulated other comprehensive losses	(134,835)	(126,290)
Total stockholders' equity	1,275,447	1,294,461
Total liabilities and stockholders' equity	$1,361,691	$1,399,805

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

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

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
	(In thousands, except per share data)			
Revenues:				
Products	$64,719	$102,092	$135,764	$193,684
Services	30,142	25,830	58,270	53,466
Total revenues	94,861	127,922	194,034	247,150
Cost and expenses:				
Cost of sales:				
Products	51,822	74,991	103,431	141,453
Services	17,621	12,558	33,762	28,536
Total cost of sales	69,443	87,549	137,193	169,989
Selling, general and administrative	23,739	31,267	51,794	57,075
Engineering and product development	10,526	10,308	19,974	22,158
Gain on sale of assets	(5,099)	(88)	(5,099)	(88)
Total costs and expenses	98,609	129,036	203,862	249,134
Operating loss	(3,748)	(1,114)	(9,828)	(1,984)
Interest income	2,275	1,070	4,075	2,007
Interest expense	(151)	(18)	(350)	(33)
Income (loss) before income taxes	(1,624)	(62)	(6,103)	(10)
Income tax provision (benefit)	1,418	(77)	4,318	(120)
Net income (loss)	$(3,042)	$15	$(10,421)	$110
Earnings (loss) per common share:				
Basic	$(0.08)	$—	$(0.28)	$—
Diluted	$(0.08)	$—	$(0.28)	$—
Weighted average common shares outstanding:				
Basic	37,615	37,528	37,672	37,526
Diluted	37,615	37,718	37,672	37,706

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

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

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
	(In thousands)			
Net income (loss)	$(3,042)	$15	$(10,421)	$110
Other comprehensive loss, net of tax:				
Foreign currency translation adjustments	(21,666)	6,740	(8,545)	14,599
Total comprehensive income (loss)	$(24,708)	$6,755	$(18,966)	$14,709

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

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

	Six months ended June 30, 2018	2017
	(In thousands)	
Operating activities		
Net income (loss)	$ (10,421)	$ 110
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	17,242	22,713
Stock-based compensation expense	7,585	6,783
Gain on sale of equipment	(5,099)	(88)
Deferred income taxes	578	(1,486)
Changes in operating assets and liabilities:		
Trade receivables, net	7,007	(4,823)
Inventories	22,731	29,246
Prepaids and other assets	(3,117)	4,471
Accounts payable and accrued expenses	(13,374)	(18,226)
Other, net	334	—
Net cash provided by operating activities	23,466	38,700
Investing activities		
Purchase of property, plant and equipment	(19,605)	(12,936)
Proceeds from sale of equipment	10,517	610
Acquisition of business, net of cash acquired	—	(21,289)
Net cash used in investing activities	(9,088)	(33,615)
Financing activities		
Repurchase of common stock	(9,830)	—
ABL Credit Facility issuance costs	(815)	—
Proceeds from exercise of stock options	642	403
Net cash provided by (used in) financing	(10,003)	403

activities				
Effect of exchange rate changes on cash activities	(4,133	)	8,002	
Increase in cash and cash equivalents	242		13,490	
Cash and cash equivalents at beginning of period	493,180		423,497	
Cash and cash equivalents at end of period	$	493,422	$	436,987

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

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

1. Organization and Principles of Consolidation

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

The Company’s operations are organized into three geographic segments— Western Hemisphere (including North and South America; headquartered in Houston, Texas), Eastern Hemisphere (including Europe and Africa; headquartered in Aberdeen, Scotland) and Asia-Pacific (including the Pacific Rim, Southeast Asia, Australia, India and the Middle East; headquartered in Singapore). Each of these segments sells similar products and services, and the Company has major manufacturing facilities in all three of its regional headquarter locations as well as in Macae, Brazil. The Company’s major subsidiaries are Dril-Quip (Europe) Limited, located in Aberdeen with branches in Denmark, Norway and Holland; Dril-Quip Asia-Pacific PTE Ltd., located in Singapore; and Dril-Quip do Brazil LTDA, located in Macae, Brazil. Other operating subsidiaries include TIW Corporation (TIW), located in Houston, Texas; DQ Holdings Pty. Ltd., located in Perth, Australia; Dril-Quip (Ghana) Ltd., located in Takoradi, Ghana; PT DQ Oilfield Services Indonesia, located in Jakarta, Indonesia; Dril-Quip (Nigeria) Ltd., located in Port Harcourt, Nigeria; Dril-Quip Egypt for Petroleum Services S.A.E., located in Alexandria, Egypt; Dril-Quip Oilfield Services (Tianjin) Co. Ltd., located in Tianjin, China, with branches in Shezhen and Beijing, China; and Dril-Quip Qatar LLC, located in Doha, Qatar; TIW de Mexico S.A. de C.V., located in Villahermosa, Mexico; TIW de Venezuela S.A., located in Anaco, Venezuela and with a registered branch located in Shushufindi, Ecuador; TIW (UK) Limited, located in Aberdeen, Scotland; TIW Hungary LLC, located in Szolnok, Hungary; and TIW International, LLC., with a registered branch located in Singapore.

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

The condensed consolidated financial statements included herein are unaudited. The balance sheet at December 31, 2017 has been derived from the audited consolidated financial statements at that date. In the opinion of management, the unaudited condensed consolidated interim financial statements include all normal recurring adjustments necessary for a fair statement of the financial position as of June 30, 2018 and the results of operations and comprehensive income for the three and six months ended June 30, 2018 and 2017 and cash flows for the six-month periods ended June 30, 2018 and 2017. Certain information and footnote disclosures normally included in annual audited consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. Management believes the unaudited interim related disclosures in these condensed consolidated financial statements are adequate. The results of operations, comprehensive income and cash flows for the six-month period ended June 30, 2018 are not necessarily indicative of the results to be expected for the full year. The condensed consolidated financial statements included herein should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

2. Significant Accounting Policies

Principles of Consolidation

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

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

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expenses during the reporting period. Actual results could differ from those estimates. Some of the Company's more significant estimates are those affected by critical accounting policies for revenue recognition, inventories and contingent liabilities.

Revenue Recognition

The Company generates revenues through the sale of products, the sale of services and the leasing of installation tools. The Company normally negotiates contracts for products, including those accounted for under the over time method, rental tools and services separately. Modifications to the scope and price of sales contracts may occur in the form of variations and change orders. For all product sales, it is the customer's decision as to the timing of the product installation as well as whether Dril-Quip running tools will be purchased or rented. Furthermore, the customer is under no obligation to utilize the Company's technical advisory assistance services. The customer may instead choose to use a third party or its own personnel.

Product and Service Revenues

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

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

Product revenues

The Company recognizes product revenues from two methods:

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

Revenues recognized under the over time method

The Company uses the over time method on long-term project contracts that have the following characteristics:

- the contracts call for products which are designed to customer specifications;
- the structural designs are unique and require significant engineering and manufacturing efforts generally requiring more than one year in duration;
- the contracts contain specific terms as to milestones, progress billings and delivery dates;
- product requirements cannot be filled directly from the Company's standard inventory; and
- The Company has an enforceable right to payment for any work completed to date and the enforceable payment includes a reasonable profit margin.

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

Under the over time method, billings may not correlate directly to the revenue recognized. Based upon the terms of the specific contract, billings may be in excess of the revenue recognized, in which case the amounts are included in customer prepayments as a liability on the Condensed Consolidated Balance Sheets. Likewise, revenue recognized may exceed customer billings in which case the amounts are reported in trade receivables. Unbilled revenues are expected to be billed and collected within one year. At June 30, 2018 and December 31, 2017, receivables included

$44.7 million and $41.0 million of unbilled receivables, respectively. For the three months ended June 30, 2018, there were nine projects representing approximately 13% of the Company's total revenues and approximately 19% of its product revenues that were accounted for using the over time method, compared to six projects for the three months ended June 30, 2017, which represented approximately 16% of the Company's total revenues and approximately 20% of its product revenues. For the six months ended June 30, 2018, there were

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ten projects representing approximately 13% of the Company's total revenues and approximately18% of its product revenues that were accounted for using over time accounting, compared to seven projects for the six months ended June 30, 2017, which represented approximately 14% of the Company's total revenues and approximately 18% of its product revenues.

Revenues recognized under the point in time method

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

Service revenues

The Company recognizes service revenues from two sources:

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

The Company does not install products for its customers, but it does provide technical advisory assistance.

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

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

Lease revenues

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

Practical Expedients

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

Fair Value of Financial Instruments

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

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:

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	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
	(In thousands)			
Weighted average common shares outstanding - basic	37,615	37,528	37,672	37,526
Dilutive effect of common stock options and awards	—	190	—	180
Weighted average common shares outstanding - diluted	37,615	37,718	37,672	37,706

For the three and six months ended June 30, 2018, the Company has excluded the following common stock options and awards because their impact on the loss per share is anti-dilutive (in thousands on a weighted average basis):

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
	(In thousands)			
Director stock awards	6	—	4	—
Stock options	10	—	11	—
Performance share units	97	—	87	—
Restricted stock awards	105	1	89	—

3. New Accounting Standards

In January 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2017-04, “Intangibles - Goodwill and Other (Topic 350).” The standard simplifies the subsequent measurement of goodwill by removing the second step of the two-step impairment test. The amendment requires an entity to perform its annual or interim goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. The amendment should be applied on a prospective basis. The standard is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company has adopted this standard as of October 1, 2017.

In January 2017, the FASB issued ASU 2017-01, “Business Combinations: Clarifying the Definition of a Business (Topic 805).” This update clarifies the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. For public business entities, the amendments in this update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company has adopted this standard as of December 31, 2017.

In February 2016, the FASB issued ASU 2016-02 “Leases (Topic 842).” The new standard requires lessees to recognize lease assets (right of use) and lease obligations (lease liability) for leases previously classified as operating leases under generally accepted accounting principles on the balance sheet for leases with terms in excess of 12 months. The standard is effective for annual periods beginning after December 15, 2018, including interim periods within those fiscal years. The Company has engaged a third-party expert to assist in the analysis of its lease arrangements to ensure the appropriate steps are taken in its assessment of the standard. The Company has completed the selection of a lease monitoring and reporting system and has begun to perform testing of the contracts.

Adoption of ASC Topic 606, “Revenue from Contracts with Customers”

In May 2014, the FASB issued ASU 2014-09 “Revenue from Contracts with Customers (Topic 606).” On January 1, 2018, we adopted the new accounting standard ASC 606, Revenue from Contracts with Customers and all the related amendments (the "new revenue standard”) for contracts that are not completed at the date of initial application using the modified retrospective method.

We recognized the cumulative effect of the initial application of the new revenue standard as an increase to the opening balance of retained earnings at January 1, 2018 for $1.8 million. Therefore, the comparative information for prior periods has not been restated and continues to be reported under the accounting standards in effect for those periods.

A majority of the Company's revenues are not subject to the new revenue standard. The adoption of ASC 606 resulted in an increase of approximately $0.5 million and $2.3 million in our results from operations for the three and six months ended June 30, 2018, respectively, and did not have a material impact on the Company's consolidated financial position, results of

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operations, equity or cash flows. A majority of our product revenues continues to be recognized when products are shipped from our facilities.

4. Revenue Recognition (Adoption of ASC 606)

Revenues from contracts with customers consisted of the following:

	Three months ended June 30, 2018				
	Western Hemisphere	Eastern Hemisphere	Asia-Pacific	Intercompany	Total
	(In thousands)				
Product Revenues	$43,999	$ 14,539	$ 6,181	$ —	$64,719
Service Revenues	9,917	5,148	2,931	—	17,996
Total	$53,916	$ 19,687	$ 9,112	$ —	$82,715

	Six months ended June 30, 2018				
	Western Hemisphere	Eastern Hemisphere	Asia-Pacific	Intercompany	Total
	(In thousands)				
Product Revenues	$86,434	$ 34,404	$ 14,926	$ —	$135,764
Service Revenues	19,000	11,122	5,336	—	35,458
Total	$105,434	$ 45,526	$ 20,262	$ —	$171,222

Contract Balances

Balances related to contracts with customers consisted of the following:

Contract Assets (amounts shown in thousands)	
Contract Assets at December 31, 2017	$41,825
Additions	94,912
Transfers to Accounts Receivable	65,713
Contract Assets at June 30, 2018	$71,024

Contract Liabilities (amounts shown in thousands)	
Contract Liabilities at December 31, 2017	$4,767
Additions	20,457
Revenue Recognized	20,502
Contract Liabilities at June 30, 2018	$4,722

Receivables, which are included in trade receivables, net, were $95.0 million and $136.5 million for the six months ended June 30, 2018 and December 31, 2017, respectively. The amount of revenues from performance obligations satisfied (or partially satisfied) in previous periods was $4.7 million and $11.8 million for the three and six months ended June 30, 2018, respectively . The contract liabilities primarily relate to advance payments from customers and are included within "Customer prepayments" in our accompanying consolidated balance sheets. The contract assets primarily relate to unbilled amounts typically resulting from sales under contracts when the over time method of revenue recognition is utilized and revenue recognized exceeds the amount billed to the customer and is included in "Trade receivables, net" in our accompanying consolidated balance sheets. Contract assets are transferred to the receivables when the rights become unconditional.

Obligations for returns and refunds were considered immaterial as of June 30, 2018.

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Remaining Performance Obligations

The aggregate amount of the transaction price allocated to remaining performance obligations from our reconditioning services and over time product lines was $25.4 million as of June 30, 2018. The Company expects to recognize revenue on approximately 87% and 13% of the remaining performance obligations over the next 12 and 24 months, respectively, with the remainder recognized thereafter.

The Company applies the practical expedient available under the new revenue standard and does not disclose information about remaining performance obligations that have original expected durations of one year or less.

5. Stock-Based Compensation and Stock Awards

During the three and six months ended June 30, 2018, the Company recognized approximately $3.6 million and $7.6 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, compared to $3.6 million and $6.8 million recognized for the three and six months ended June 30, 2017, respectively. No stock-based compensation expense was capitalized during the three and six months ended June 30, 2018 or 2017.

6. Inventories, net

Inventories consist of the following:

	June 30, 2018	December 31, 2017
	(In thousands)	
Raw materials and supplies	$61,404	$70,188
Work in progress	56,196	65,382
Finished goods	226,624	239,083
	344,224	374,653
Less: allowance for obsolete and excess inventory	(80,128)	(83,566)
Total inventory	$264,096	$291,087

7. Goodwill

The changes in the carrying amount of goodwill by reporting unit during the six months ended June 30, 2018 were as follows:

	Carrying Value December 31, 2017	Foreign Currency Translation	Carrying Value June 30, 2018
	(In thousands)		
Western Hemisphere	$39,158	$ (278)	$38,880
Eastern Hemisphere	8,466	(304)	8,162
Asia-Pacific	—	—	—
Total	$47,624	$ (582)	$47,042

The Company performs its annual impairment tests of goodwill as of October 1 or when there is an indication an impairment may have occurred.

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8. Intangible Assets

Intangible assets, substantially all of which were acquired in the acquisition of TIW and OPT, consist of the following:

	June 30, 2018				
	Estimated Useful Lives	Gross Book Value	Accumulated Amortization	Foreign Currency Translation	Net Book Value
		(In thousands)			
Trademarks	indefinite	$8,197	$ —	$ (64)	$8,133
Patents	15 - 30 years	5,950	(1,174)	(22)	4,754
Customer relationships	5 - 15 years	25,924	(2,720)	(36)	23,168
Non-compete agreements	3 years	171	(86)	—	85
		$40,242	$ (3,980)	$ (122)	$36,140

	December 31, 2017				
	Estimated Useful Lives	Gross Book Value	Accumulated Amortization	Foreign Currency Translation	Net Book Value
		(In thousands)			
Trademarks	indefinite	$8,416	$ —	$ 56	$8,472
Patents	15 - 30 years	5,946	(968)	80	5,058
Customer relationships	5 - 15 years	26,503	(1,675)	(64)	24,764
Non-compete agreements	3 years	171	(57)	—	114
		$41,036	$ (2,700)	$ 72	$38,408

Amortization expense for each of the three and six months ended June 30, 2018 was $0.5 million and $1.2 million, respectively, compared to the three and six months ended June 30, 2017 of $0.5 million and $1.2 million, respectively.

9. Gain on Sale of Assets

During the three months ended June 30, 2018, we sold certain property, plant and equipment for a net gain of approximately $5.1 million as part of our reorganization and consolidation of operations at our headquarters location in Houston, Texas. A gain on property, plant and equipment or intangible assets is calculated as the difference between the cost of the asset disposed of, net of depreciation, and the sales proceeds received. The net gain is reflected in "Gain on sale of assets" line on the Condensed Consolidated Statements of Income.

10. Asset Backed Loan (ABL) Credit Facility

On February 23, 2018, the Company, as borrower, and the Company's subsidiaries TIW and Honing, Inc., as guarantors, entered into a five-year senior secured revolving credit facility (the "ABL Credit Facility") with JPMorgan Chase Bank, N.A., as administrative agent, and other financial institutions as lenders with total commitments of $100.0 million, including up to $10.0 million available for letters of credit. The maximum amount that the Company may borrow under the ABL Credit Facility is subject to the borrowing base, which is based on a percentage of eligible accounts receivable and eligible inventory, subject to reserves and other adjustments.

All obligations under the ABL Credit Facility are fully and unconditionally guaranteed jointly and severally by the Company, TIW, Honing, Inc., and future significant domestic subsidiaries, subject to customary exceptions.

Borrowings under the ABL Credit Facility are secured by liens on substantially all of the Company's personal property, and bear interest at the Company's option at either (i) the CB Floating Rate (as defined therein), calculated as the rate of interest publicly announced by JPMorgan Chase Bank, N.A., as its "prime rate," subject to each increase or decrease in such prime rate effective as of the date such change occurs, with such CB Floating Rate not being less than Adjusted One Month LIBOR Rate (as defined therein) or (ii) the Adjusted LIBO Rate (as defined therein), plus, in each case, an applicable margin. The applicable margin ranges from 1.00% to 1.50% per annum for CBFR loans and 2.00% to 2.50% per annum for Eurodollar loans and, in each case, is based on

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the Company's leverage ratio. The unused portion of the ABL Credit Facility is subject to a commitment fee that varies from 0.250% to 0.375% per annum, according to average unused commitments under the ABL Credit Facility. Interest on Eurodollar loans is payable at the end of the selected interest period, but no less frequently than quarterly. Interest on CB Floating Rate loans is payable monthly in arrears.

The ABL Credit Facility contains various covenants and restrictive provisions that limit the Company's ability to, among other things, (1) enter into asset sales; (2) incur additional indebtedness; (3) make investments or loans and create liens; (4) pay certain dividends or make other distributions and (5) engage in transactions with affiliates. The ABL Credit Facility also requires the Company to maintain a fixed charge coverage ratio of 1.0 to 1.0, based on the ratio of EBITDA (as defined therein) to Fixed Charges (as defined therein) during certain periods, including when availability under the ABL Credit Facility is under certain levels. If the Company fails to perform its obligations under the agreement that results in an event of default, the commitments under the ABL Credit Facility could be terminated and any outstanding borrowings under the ABL Credit Facility may be declared immediately due and payable. The ABL Credit Facility also contains cross default provisions that apply to the Company's other indebtedness. The Company is in compliance with the related covenants as of June 30, 2018.

As of June 30, 2018, the availability under the ABL Credit Facility was $63.0 million, after taking into account the outstanding letters of credit of approximately $1.5 million issued under the facility.

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11. Geographic Areas

	Three months ended June 30,									
	Western Hemisphere		Eastern Hemisphere		Asia-Pacific		DQ Corporate		Total	
	2018	2017	2018	2017	2018	2017	2018	2017	2018	2017
	(In thousands)									
Revenues										
Products										
Standard Products	$40,022	$54,299	$7,571	$13,633	$4,938	$13,412	$—	$—	$52,531	$81,344
Percentage of Completion	3,977	—	6,968	8,808	1,243	11,940	—	—	12,188	20,748
Total Products	43,999	54,299	14,539	22,441	6,181	25,352	—	—	64,719	102,092
Services										—
Technical Advisory	7,286	7,658	4,072	4,270	2,768	1,662	—	—	14,126	13,590
Reconditioning	2,631	2,058	1,076	207	163	140	—	—	3,870	2,405
Total Services (excluding rental tools)	9,917	9,716	5,148	4,477	2,931	1,802	—	—	17,996	15,995
Leasing	6,734	6,713	3,516	2,376	1,896	746	—	—	12,146	9,835
Total Services (including rental tools)	16,651	16,429	8,664	6,853	4,827	2,548	—	—	30,142	25,830
Intercompany	4,048	4,227	347	256	563	51	—	—	4,958	4,534
Eliminations	—	—	—	—	—	—	(4,958)	(4,534)	(4,958)	(4,534)
Total Revenues	$64,698	$74,955	$23,550	$29,550	$11,571	$27,951	$(4,958)	$(4,534)	$94,861	$127,922
Depreciation and amortization	$5,993	$10,190	$1,134	$1,075	$1,155	$1,014	$719	$602	$9,001	$12,881
Income (loss) before income taxes	$6,362	$4,442	$8,133	$2,792	$(301)	$5,796	$(15,818)	$(13,092)	$(1,624)	$(62)

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	Six months ended June 30,									
	Western Hemisphere		Eastern Hemisphere		Asia-Pacific		DQ Corporate		Total	
	2018	2017	2018	2017	2018	2017	2018	2017	2018	2017
	(In thousands)									
Revenues										
Products										
Standard Products	$77,117	$119,312	$22,638	$20,673	$11,444	$18,358	$—	$—	$111,199	$158,343
Percentage of Completion	9,317	275	11,766	15,694	3,482	19,372	—	—	24,565	35,341
Total Products	86,434	119,587	34,404	36,367	14,926	37,730	—	—	135,764	193,684
Services										
Technical Advisory	13,527	14,978	9,174	7,203	4,132	3,639	—	—	26,833	25,820
Reconditioning	5,473	3,977	1,948	548	1,204	184	—	—	8,625	4,709
Total Services (excluding rental tools)	19,000	18,955	11,122	7,751	5,336	3,823	—	—	35,458	30,529
Leasing	12,267	15,936	7,722	5,377	2,823	1,624	—	—	22,812	22,937
Total Services (including rental tools)	31,267	34,891	18,844	13,128	8,159	5,447	—	—	58,270	53,466
Intercompany	7,121	10,130	532	287	728	117	—	—	8,381	10,534
Eliminations	—	—	—	—	—	—	(8,381)	(10,534)	(8,381)	(10,534)
Total	$124,822	$164,608	$53,780	$49,782	$23,813	$43,294	$(8,381)	$(10,534)	$194,034	$247,150
Depreciation and amortization	$11,484	$17,327	$2,346	$2,155	$2,130	$2,031	$1,282	$1,200	$17,242	$22,713
Income (loss) before income taxes	$7,086	$11,914	$13,792	$6,283	$(45)	$7,640	$(26,936)	$(25,847)	$(6,103)	$(10)

	Western Hemisphere		Eastern Hemisphere		Asia-Pacific		DQ Corporate		Total	
	June 30, 2018	December 31, 2017	June 30, 2018	December 31, 2017	June 30, 2018	December 31, 2017	June 30, 2018	December 31, 2017	June 30, 2018	December 31, 2017
	(In thousands)									
Long-Lived Assets	$470,169	$482,636	$273,489	$264,828	$67,489	$58,606	$(425,878)	$(414,814)	$385,269	$391,256
Total Assets	$835,296	$877,779	$766,741	$752,967	$188,777	$185,229	$(429,123)	$(416,170)	$1,361,691	$1,399,805

The Company’s operations are organized into three geographic segments - Western Hemisphere (including North and South America; headquartered in Houston, Texas), Eastern Hemisphere (including Europe and Africa; headquartered in Aberdeen, Scotland) and Asia-Pacific (including the Pacific Rim, Southeast Asia, Australia, India and the Middle East; headquartered in Singapore). Each of these segments sells similar products and services and the Company has major manufacturing facilities in all three of its regional headquarter locations as well as in Macae, Brazil. Eliminations of operating profits are related to intercompany inventory transfers that are deferred until shipment is made to third party customers.

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12. 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 December 2010 and January 2011, the Company's Brazilian subsidiary was served with two 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 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. The Company's Brazilian subsidiary filed appeals with a State of Rio de Janeiro judicial court to annul both of these tax assessments following rulings against the Company by the tax administration's highest council. In connection with those appeals, the Company deposited with the court a total amount of approximately $8.8 million in December 2014 and December 2016 as the full amount of the assessments with penalties and interest. 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, products of the Company are used in potentially hazardous drilling, completion, and production applications that can cause personal injury, property damage 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 results of operations, financial position or cash flows.

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13. Subsequent Events

On July 13, 2018, we announced that Dril-Quip (Europe) Limited, our wholly owned subsidiary, has entered into a letter of intent with Premier Oil Exploration and Production Limited (Premier) to provide subsea production systems for the Sea Lion Phase 1 Development located offshore the Falkland Islands.

The scope of work includes plans for 23 subsea production systems, including wellheads, trees, control systems, associated production and injection manifolds, subsea umbilicals and related services. It is intended that Dril-Quip will commence pre-sanction engineering work in August 2018. Formal contract award will be subject to agreement of a definitive contract and Premier taking a final investment decision. Dril-Quip would also provide vendor financing for a portion of the contract.

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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 Company's unaudited condensed consolidated financial statements and notes thereto 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, 2017.

Overview

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

Oil and Gas Prices

The market for 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. Oil and gas prices and the level of 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, Brent Crude oil prices per barrel are listed below for the periods covered by this report:

	Three months ended June 30,		Six months ended June 30,	
Brent Crude Oil Price per Barrel	2018	2017		