DRIL-QUIP INC
Form 10-Q
October 25, 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 September 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 October 24, 2018, the number of shares outstanding of the registrant's common stock, par value $0.01 per share, was 35,777,241.

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PART I—FINANCIAL INFORMATION
Item 1. Financial Statements
DRIL-QUIP, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	September 30, 2018	December 31, 2017
	(In thousands, except for par value and shares)	
ASSETS		
Current assets:		
Cash and cash equivalents	$424,053	$493,180
Trade receivables, net	190,437	191,629
Inventories, net	242,123	291,087
Prepaids and other current assets	40,837	32,653
Total current assets	897,450	1,008,549
Property, plant and equipment, net	292,667	284,247
Deferred income taxes	5,512	5,364
Goodwill	47,120	47,624
Intangible assets	35,535	38,408
Other assets	14,475	15,613
Total assets	$1,292,759	$1,399,805
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$21,155	$33,480
Accrued income taxes	4,583	24,714
Customer prepayments	7,489	4,767
Accrued compensation	11,478	11,412
Other accrued liabilities	23,557	25,538
Total current liabilities	68,262	99,911
Deferred income taxes	3,211	3,432
Income tax payable	28,029	—
Other long-term liabilities	2,001	2,001
Total liabilities	101,503	105,344
Commitments and contingencies (Note 14)		
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, 36,152,694 and 38,132,693 shares issued and outstanding at September 30, 2018 and December 31, 2017	394	372
Additional paid-in capital	31,002	20,083
Treasury shares (at cost)	(71,107)	—
Retained earnings	1,371,368	1,400,296
Accumulated other comprehensive losses	(140,401)	(126,290)
Total stockholders' equity	1,191,256	1,294,461
Total liabilities and stockholders' equity	$1,292,759	$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 (LOSS)
(UNAUDITED)

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
	(In thousands, except per share data)			
Revenues:				
Products	$63,246	$75,885	$199,010	$269,570
Services	30,011	24,461	88,281	77,928
Total revenues	93,257	100,346	287,291	347,498
Cost and expenses:				
Cost of sales:				
Products	47,859	48,761	151,290	190,214
Services	17,771	14,289	51,534	42,825
Total cost of sales	65,630	63,050	202,824	233,039
Selling, general and administrative	31,566	27,985	83,359	85,060
Engineering and product development	10,159	10,379	30,133	32,537
Impairment and other charges	—	60,968	—	60,968
Gain on sale of assets	(14)	9	(5,113)	(79)
Total costs and expenses	107,341	162,391	311,203	411,525
Operating loss	(14,084)	(62,045)	(23,912)	(64,027)
Interest income	1,893	957	5,965	2,963
Interest expense	(195)	(12)	(545)	(44)
Loss before income taxes	(12,386)	(61,100)	(18,492)	(61,108)
Income tax provision (benefit)	(2,028)	(31,840)	2,291	(31,959)
Net loss	$(10,358)	$(29,260)	$(20,783)	$(29,149)
Loss per common share:				
Basic	$(0.28)	$(0.78)	$(0.56)	$(0.78)
Diluted	$(0.28)	$(0.78)	$(0.56)	$(0.78)
Weighted average common shares outstanding:				
Basic	37,119	37,528	37,349	37,527
Diluted	37,119	37,528	37,349	37,527

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 September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
	(In thousands)			
Net loss	$(10,358)	$(29,260)	$(20,783)	$(29,149)
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	(5,566)	13,187	(14,111)	27,786
Total comprehensive loss	$(15,924)	$(16,073)	$(34,894)	$(1,363)

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)

	Nine months ended September 30,	
	2018	2017
	(In thousands)	
Operating activities		
Net loss	$(20,783)	$(29,149)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	25,966	32,231
Stock-based compensation expense	9,950	10,477
Impairment and other charges	—	60,968
Gain on sale of assets	(5,113)	(79)
Deferred income taxes	(914)	(31,529)
Changes in operating assets and liabilities:		
Trade receivables, net	298	21,271
Inventories, net	32,610	32,596
Prepaids and other assets	(9,675)	17,308
Accounts payable and accrued expenses	(41)	(39,359)
Other, net	309	—
Net cash provided by operating activities	32,607	74,735
Investing activities		
Purchase of property, plant and equipment	(26,683)	(19,563)
Proceeds from sale of equipment	11,244	1,160
Acquisition of business, net of cash acquired	—	(21,289)
Net cash used in investing activities	(15,439)	(39,692)
Financing activities		
Repurchase of common shares	(80,937)	—
ABL Credit Facility issuance costs	(815)	—
Proceeds from exercise of stock options	1,106	455
Net cash provided by (used in) financing activities	(80,646)	455
Effect of exchange rate changes on cash activities	(5,649)	14,050
Increase (decrease) in cash and cash equivalents	(69,127)	49,548
Cash and cash equivalents at beginning of period	493,180	423,497
Cash and cash equivalents at end of period	$424,053	$473,045

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 September 30, 2018 and the results of operations and comprehensive income for the three and nine months ended September 30, 2018 and 2017 and cash flows for the nine-month periods ended September 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 nine-month period ended September 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.

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Use of Estimates

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

Revenue Recognition

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

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within one year. At September 30, 2018 and December 31, 2017, receivables included $47.3 million and $41.0 million of unbilled receivables, respectively. For the three months ended September 30, 2018, there were eight projects representing approximately 15.7% of the Company's total revenues and approximately 23.1% of its product revenues that were accounted for using the over time method, compared to seven projects for the three months ended September 30, 2017, which represented approximately 15.0% of the Company's total revenues and approximately 20.0% of its product revenues. For the nine months ended September 30, 2018, there were 14 projects representing approximately 14.0% of the Company’s total revenues and approximately 20.3% of its product revenues that were accounted for using over time accounting, compared to eight projects for the nine months ended September 30, 2017, which represented approximately 15.0% of the Company’s total revenues and approximately 19.0% 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 generally 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.

Restructuring and Other Charges

In the third quarter of 2018, we initiated a global strategic analysis to better align our operations with current market conditions. As a result of this plan, during the three and nine months ended September 30, 2018, we incurred restructuring and other charges of approximately $3.7 million primarily related to employee termination benefits and consulting fees, which are included in "Selling, general and administrative" in our accompanying condensed

consolidated statement of income (loss).

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Treasury Shares

On July 26, 2016, the Board of Directors authorized a share repurchase plan under which the Company can repurchase up to $100 million of its common stock. The repurchase plan has no set expiration date and any repurchased shares are expected to be cancelled. For the three-month period ended September 30, 2018, the Company purchased 1,395,521 shares under the share repurchase plan at an average price of approximately $50.95 per share totaling approximately $71.1 million, which is reflected in "Treasury shares (at cost)", in our accompanying condensed consolidated balance sheet. In May 2018, the Company purchased 219,102 shares under the share repurchase plan at an average price of approximately $44.87 per share totaling approximately $9.8 million and retired such shares, which is reflected within our retained earnings for the period ended September 30, 2018.

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:

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
	(In thousands)			
Weighted average common shares outstanding - basic	37,119	37,528	37,349	37,527
Dilutive effect of common stock options and awards	—	—	—	—
Weighted average common shares outstanding - diluted	37,119	37,528	37,349	37,527

For the three and nine months ended September 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 September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
	(In thousands)			
Director stock awards	11	15	9	13
Stock options	181	328	196	333
Performance share units	126	212	90	207
Restricted stock awards	172	315	125	293

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.

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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 ultimate effect on our condensed consolidated financial statements will be based on an evaluation of the contract-specific facts and circumstances. With respect to leases in which we are the lessee, we expect to recognize a lease liability and a corresponding right of use asset. We plan to utilize the FASB package of three practical expedients under ASC 842-10-65-1(f). We are currently evaluating what other effect, if any, ASC 842 will have on our condensed consolidated financial statements and related disclosures.

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 $0.1 million and $2.4 million in our results from operations for the three and nine months ended September 30, 2018, respectively, and did not have a material impact on the Company's consolidated financial position, results of 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 September 30, 2018				
	Western Hemisphere	Eastern Hemisphere	Asia-Pacific	Intercompany	Total
	(In thousands)				
Product Revenues	$43,825	$ 17,834	$ 1,587	$ —	$63,246
Service Revenues	10,169	4,364	3,008	—	17,541
Total	$53,994	$ 22,198	$ 4,595	$ —	$80,787

	Nine months ended September 30, 2018				
	Western Hemisphere	Eastern Hemisphere	Asia-Pacific	Intercompany	Total
	(In thousands)				
Product Revenues	$130,259	$ 52,238	$ 16,513	$ —	$199,010
Service Revenues	29,173	15,485	8,345	—	53,003

Total	$159,432	$ 67,723	$ 24,858	$ —	$252,013

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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	44,110
Transfers to Accounts Receivable	10,180
Contract Assets at September 30, 2018	$75,755

Contract Liabilities (amounts shown in thousands)	
Contract Liabilities at December 31, 2017	$4,767
Additions	25,039
Revenue Recognized	23,018
Contract Liabilities at September 30, 2018	$6,788

Receivables, which are included in trade receivables, net, were $98.3 million and $136.5 million for the nine months ended September 30, 2018 and December 31, 2017, respectively. The amount of revenues from performance obligations satisfied (or partially satisfied) in previous periods was $3.9 million and $15.7 million for the three and nine months ended September 30, 2018, respectively. The contract liabilities primarily relate to advance payments from customers and are included in "Customer prepayments" in our accompanying condensed 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 condensed 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 September 30, 2018.

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 $33.8 million as of September 30, 2018. The Company expects to recognize revenue on approximately 85% and 15% 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 nine months ended September 30, 2018, the Company recognized approximately $2.4 million and $10.0 million, respectively, of stock-based compensation expense, which is included in "Selling, general and administrative" in our accompanying condensed consolidated statements of income (loss) and "Additional paid-in capital" in our accompanying condensed consolidated balance sheets, compared to $3.7 million and $10.5 million recognized for the three and nine months ended September 30, 2017, respectively. No stock-based compensation expense was capitalized during the three and nine months ended September 30, 2018 or 2017.

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6. Inventories, net

Inventories consist of the following:

	September 30, 2018	December 31, 2017
	(In thousands)	
Raw materials and supplies	$59,505	$70,188
Work in progress	53,546	65,382
Finished goods	206,543	239,083
	319,594	374,653
Less: allowance for obsolete and excess inventory	(77,471)	(83,566)
Total inventory	$242,123	$291,087

7. Goodwill

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

	Carrying Value December 31, 2017	Foreign Currency Translation	Carrying Value September 30, 2018
	(In thousands)		
Western Hemisphere	$39,158	$ (93)	$ 39,065
Eastern Hemisphere	8,466	(411)	8,055
Asia-Pacific	—	—	—
Total	$47,624	$ (504)	$ 47,120

The Company performs its annual impairment tests of goodwill as of October 1 or when there is an indication an impairment may have occurred. As of September 30, 2018, there were no indications an impairment may have occurred.

The fair values used in the goodwill impairment assessment were determined using the net present value of the expected future cash flows for the reporting unit. During the Company’s goodwill impairment analysis, the Company determines the fair value of the reporting unit, as a whole, using a discounted cash flow analysis, which requires significant assumptions and estimates about future operations. The assumptions about future cash flows and growth rates are based on our current budget for the remainder of the current year, 2019 and for future periods, as well as our strategic plans and management’s beliefs about future exploration and development in the industry.

Changes in management's forecast commodity price assumptions may cause us to reassess our goodwill for impairment and could result in non-cash impairment charges in the future.

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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:

		September 30, 2018			
	Estimated Useful Lives	Gross Book Value	Accumulated Amortization	Foreign Currency Translation	Net Book Value
		(In thousands)			
Trademarks	indefinite	$8,275	$ —	$ (73)	$8,202
Patents	15 - 30 years	5,950	(1,309)	(32)	4,609
Customer relationships	5 - 15 years	25,889	(3,101)	(136)	22,652
Non-compete agreements	3 years	171	(99)	—	72
		$40,285	$ (4,509)	$ (241)	$35,535

		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 nine months ended September 30, 2018 was $0.6 million and $1.7 million, respectively, compared to the three and nine months ended September 30, 2017 of $0.6 million and $1.8 million, respectively.

9. Gain on Sale of Assets

During the second quarter of 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" in our accompanying condensed consolidated statements of income (loss). There were no significant sales of assets during the three months ended September 30, 2018.

10. Impairments and Other Charges

We carry a variety of long-lived assets on our balance sheet, including property, plant and equipment, goodwill and other intangibles. We conduct impairment tests on long-lived assets if events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. We review the recoverability of the carrying value of our assets based upon estimated future cash flows while taking into consideration assumptions and estimates, including the future use of the asset, remaining useful life of the asset and service potential of the asset. Additionally, inventories are valued at the lower of cost or market.

In connection with our preparation and review of financial statements for the quarter ended September 30, 2017, after considering current Brent Crude consensus forecasts and expected rig counts for the foreseeable future, we determined that the carrying amount of certain of our long-lived assets in the Western Hemisphere exceeded their respective fair values due to projected declines in asset utilization and that the cost of some of our worldwide inventory exceeded its market value. As a result, we recorded corresponding impairments and other charges.

Primarily as a result of the factors described above, we recorded charges of approximately $33.6 million related to inventory and $27.4 million related to fixed assets during the three and nine months ended September 30, 2017. There were no impairments during the three and nine months ended September 30, 2018.

11. 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 (as defined therein) or (ii) the Adjusted LIBOR (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 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 September 30, 2018.

As of September 30, 2018, the availability under the ABL Credit Facility was $56.0 million, after taking into account the outstanding letters of credit of approximately $0.3 million issued under the facility.

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12. Geographic Areas

	Three months ended September 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	$34,101	$43,344	$12,918	$9,246	$1,587	$7,940	$—	$—	$48,606	$60,530
Percentage of Completion	9,724	—	4,916	7,954	—	7,401	—	—	14,640	15,355
Total Products	43,825	43,344	17,834	17,200	1,587	15,341	—	—	63,246	75,885
Services										—
Technical Advisory	7,305	6,732	3,612	3,931	2,889	1,701	—	—	13,806	12,364
Reconditioning	2,864	2,008	752	844	119	19	—	—	3,735	2,871
Total Services (excluding rental tools)	10,169	8,740	4,364	4,775	3,008	1,720	—	—	17,541	15,235
Leasing	5,899	5,666	3,115	2,782	3,456	778	—	—	12,470	9,226
Total Services (including rental tools)	16,068	14,406	7,479	7,557	6,464	2,498	—	—	30,011	24,461
Intercompany	2,564	12,569	1,302	267	573	416	—	—	4,439	13,252
Eliminations	—	—	—	—	—	—	(4,439)	(13,252)	(4,439)	(13,252)
Total Revenues	$62,457	$70,319	$26,615	$25,024	$8,624	$18,255	$(4,439)	$(13,252)	$93,257	$100,346
Depreciation and amortization	$5,607	$6,827	$1,057	$1,073	$1,390	$1,015	$670	$603	$8,724	$9,518
Income (loss) before income taxes	$13,902	$(40,472)	$8,133	$(2,882)	$(301)	$(4,525)	$(34,120)	$(13,221)	$(12,386)	$(61,100)

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	Nine months ended September 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	$110,074	$162,656	$35,556	$29,919	$13,031	$26,298	$—	$—	$158,661	$218,873
Percentage of Completion	20,185	275	16,682	23,648	3,482	26,774	—	—	40,349	50,697
Total Products	130,259	162,931	52,238	53,567	16,513	53,072	—	—	199,010	269,570
Services										
Technical Advisory	20,835	21,709	12,785	11,135	7,021	5,340	—	—	40,641	38,184
Reconditioning	8,338	5,985	2,700	1,392	1,324	204	—	—	12,362	7,581
Total Services (excluding rental tools)	29,173	27,694	15,485	12,527	8,345	5,544	—	—	53,003	45,765
Leasing	18,162	21,604	10,837	8,158	6,279	2,401	—	—	35,278	32,163
Total Services (including rental tools)	47,335	49,298	26,322	20,685	14,624	7,945	—	—	88,281	77,928
Intercompany	9,685	22,700	1,835	554	1,300	533	—	—	12,820	23,787
Eliminations	—	—	—	—	—	—	(12,820)	(23,787)	(12,820)	(23,787)
Total	$187,279	$234,929	$80,395	$74,806	$32,437	$61,550	$(12,820)	$(23,787)	$287,291	$347,498
Depreciation and amortization	$17,091	$24,153	$3,402	$3,228	$3,521	$3,046	$1,952	$1,804	$25,966	$32,231
Income (loss) before income taxes	$12,999	$(28,558)	$13,792	$3,401	$(45)	$3,115	$(45,238)	$(39,066)	$(18,492)	$(61,108)

	Western Hemisphere		Eastern Hemisphere		Asia-Pacific		DQ Corporate		Total	
	September 30, 2018	December 31, 2017	September 30, 2018	December 31, 2017	September 30, 2018	December 31, 2017	September 30, 2018	December 31, 2017	September 30, 2018	December 31, 2017
	(In thousands)									
Long-Lived Assets	$466,703	$482,636	$256,779	$264,828	$66,466	$58,606	$(394,640)	$(414,814)	$395,309	$391,256
Total Assets	$800,936	$877,779	$777,868	$752,967	$161,662	$185,229	$(447,707)	$(416,170)	$1,292,759	$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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13. Income Tax

The effective tax rates for the three and nine months ended September 30, 2018 were 16.4% and (12.4)%, respectively, compared to 52.0% and 52.2% for the same periods in 2017. The Company established valuation allowances on deferred tax assets for losses and tax credits generated in each period, which, when applied to losses for the three and nine months ended September 30, 2018, resulted in lower effective tax rates than the U.S. statutory rate. The negative tax rate for the nine months ended September 30, 2018 is the result of net tax expense recorded against a pre-tax loss for the period. The change in effective tax rate from 2017 to 2018 was also impacted by the decrease in the U.S. federal corporate tax rate from 35% in 2017 to 21% in 2018.

On December 22, 2017, the President of the United States signed into law P.L. 115-97, informally known as the Tax Cuts and Jobs Act of 2017 ("Tax Reform"). Tax Reform amends the Internal Revenue Code to reduce tax rates and modify policies, credits and deductions for individuals and businesses. For businesses, Tax Reform reduced the corporate federal tax rate from a maximum of 35% to 21% and transitions from a worldwide tax system to a modified territorial tax system. Tax Reform also adds many new provisions including changes to bonus depreciation, the deduction for executive compensation and interest expense, a tax on global intangible low-taxed income, the base erosion anti-abusive tax and a deduction for foreign-derived intangible income. Given the amount and complexity of the changes to tax law, we continue to finalize our accounting for the income tax effects stemming from Tax Reform. At December 31, 2017, certain provisional amounts were taken as estimates to account for the impact of Tax Reform. The actual impact of Tax Reform may differ from the estimates used due to, among other things, further refinement of our calculations, changes in interpretations and assumptions we have made, guidance that may be issued and actions we may take as a result of the tax legislation. Any adjustments to these provisional estimates will be reported as a component of income tax expense in the reporting period in which any such adjustments are identified, which will be no later than the fourth quarter of 2018. For the three and nine months ended September 30, 2018, the Company reclassified $28.0 million from current income taxes payable to non-current income taxes payable due to tax return elections, recent guidance and regulations occurring in the quarter.

14. 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.

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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.

15. Subsequent Events

On October 18, 2018, we announced that Dril-Quip (Europe) Limited, our wholly owned subsidiary, has entered into a Front End Engineering and Design (FEED) Contract and Frame Agreement with Premier Oil Exploration and Production Limited (Premier) to provide the subsea production systems for the Sea Lion Phase 1 Development located offshore the Falkland Islands. The Frame Agreement replaces the previously announced letter of intent. The current estimated value of the equipment portion of the scope of work is $207 million, which includes plans for up to 30 subsea production systems, including wellheads, horizontal trees, tubing hangers, control systems, associated production and injection manifolds and subsea umbilicals. Under the Frame Agreement, it is envisaged that Dril-Quip will provide vendor financing for up to 30% of the equipment portion of the contract. Formal contract award will be subject to agreement of a definitive contract and Premier taking a final investment decision.

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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 September 30,		Nine months ended September 30,	
Brent Crude Oil Price per Barrel	2018	2017	2018	2017
Low	$68.38	$46.47	$61.94	$43.98
High	82.72	59.77	82.72	59.77
Average	75.07	52.10	72.17	51.75
Closing	$82.72	$57.02	$82.72	$57.02

According to the October 2018 release of the Short-Term Energy Outlook published by the EIA, Brent Crude oil prices are projected to average approximately $74.0 per barrel in 2018 and $75.0 per barrel in 2019. In its October 2018 Oil Market Report, the International Energy Agency projected the 2018 global oil demand will grow to 79.0 million barrels per day, a 1.3 million barrels per day increase over 2017.

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Offshore Rig Count

Detailed below is the average contracted offshore rig count (rigs currently drilling as well as rigs committed, but not yet drilling) for the Company's geographic regions for the nine months ended September 30, 2018 and 2017. The rig count data includes floating rigs (semi-submersibles and drillships) and jack-up rigs. The Company has included only these types of rigs as they are the primary assets used to deploy the Company's products.

	Nine months ended September 30,			
	2018		2017	
	Floating Rigs	Jack-up Rigs	Floating Rigs	Jack-up Rigs
Western Hemisphere	58	38	63	42
Eastern Hemisphere	58	63	56	58
Asia-Pacific	33	226	31	217
Total	149	327	150	317

Source: IHS—Petrodata RigBase – September 30, 2018 and 2017

According to IHS-Petrodata RigBase, as of September 30, 2018, there were 466 contracted rigs for the Company's geographic regions (145 floating rigs and 321 jack-up rigs), which represents a marginal increase from the rig count of 464 rigs (148 floating rigs and 316 jack-up rigs) as of September 30, 2017.

The Company believes that the number of rigs (semi-submersibles, drillships and jack-up rigs) under construction impacts its backlog and resulting revenues because in certain cases, its customers order some of the Company's products during the construction of such rigs. As a result, an increase in rig construction activity tends to favorably impact the Company's backlog while a decrease in rig construction activity tends to negatively impact the Company's backlog. According to IHS-Petrodata RigBase, as of September 30, 2018 and 2017, there were 126 and 143 rigs, respectively, under construction, which represents an approximate 12% decrease in rigs under construction. The expected delivery dates for the rigs under construction at September 30, 2018 are as follows:

	Floating Rigs	Jack-Up Rigs	Total
2018	7	16	23
2019	16	42	58
2020	12	22	34
2021	7	4	11
After 2021 or unspecified delivery date	—	—	—
Total	42	84	126

However, given the slow recovery of oil and gas prices and oversupply of offshore drilling rigs, the Company believes it is possible that delivery of some rigs under construction could be postponed or cancelled, limiting the opportunity for supply of the Company's products.

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.

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In March 2018, the President of the United States issued a proclamation imposing a 25 percent global tariff on imports of certain steel products, effective March 23, 2018. The President subsequently proposed an additional 25 percent tariff on approximately $50 billion worth of imports from China, and the government of China responded with a proposal of an additional 25 percent tariff on U.S. goods with a value of $50 billion. The initial U.S. tariffs were implemented on July 6, 2018 covering $34 billion worth of Chinese goods, with another $16 billion of goods facing tariffs beginning on August 23, 2018. In September 2018, the President directed the U.S. Trade Representative to place additional tariffs on approximately $200 billion worth of additional imports from China. These tariffs, which took effect on September 24, 2018, initially have been set at a level of 10 percent until the end of the year, at which point the tariffs will rise to 25 percent. These tariffs, or any additional tariffs or trade restrictions initiated by or against the United States, could cause our cost of raw materials to increase or affect the markets for our products. However, given the uncertainty regarding the scope and duration of these trade actions by the United States and other countries, their ultimate impact on our business and operations remains uncertain.

Business Environment

Oil and gas prices and the level of drilling and production activity have been characterized by significant volatility in recent years. Worldwide military, political, economic and other events have contributed to oil and natural gas price volatility and are likely to continue to do so in the future. Sustained low crude oil and natural gas prices have resulted in a trend of customers seeking to renegotiate contract terms with the Company, including reductions in the prices of its products and services, extensions of delivery terms and, in some instances, contract cancellations or revisions. In some cases, a customer may already hold an inventory of the Company's equipment, which may delay the placement of new orders. In addition, some of the Company’s customers could experience liquidity or solvency issues or could otherwise be unable or unwilling to perform under a contract, which could ultimately lead a customer to enter bankruptcy or otherwise encourage a customer to seek to repudiate, cancel or renegotiate a contract. An extended period of reduced crude oil and natural gas prices may accelerate these trends. If the Company experiences significant contract terminations, suspensions or scope adjustments to its contracts, then its financial condition, results of operations and cash flows may be adversely impacted.

The Company expects continued pressure in both crude oil and natural gas prices, as well as in the level of drilling and production related activities. Even during periods of increasing prices for oil and natural gas, companies exploring for oil and gas may cancel or curtail programs, seek to renegotiate contract terms, including the price of products and services, or reduce their levels of capital expenditures for exploration and production for a variety of reasons. Continued low hydrocarbon prices have had and are expected to continue to 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, slow recovery in the commodity prices or an extended downturn in the global economy or future restrictions on, or declines in, oil and gas exploration and production could have a negative impact on the Company and its backlog.

The Company’s product backlog at September 30, 2018 was approximately $249.0 million, compared to approximately $260.9 million at June 30, 2018, $266.7 million at March 31, 2018 and $207.3 million at December 31, 2017.

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The following table represents the change in backlog for the three months ended September 30, 2018, June 30, 2018, March 31, 2018 and December 31, 2017:

	Three months ended			
	September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017
	(In thousands)			
Beginning Backlog	$260,894	$266,675	$207,305	$ 216,495
Bookings:				
Product (1)	56,117	64,818	130,283	74,513
Service	30,012	30,142	28,128	26,409
Cancellation/Revision adjustments	(3,374)	(3,920)	(253)	(1,260)
Translation adjustments	(1,416)	(1,960)	385	(879)
Total Bookings	81,339	89,080	158,543	98,783
Revenues:				
Product	63,246	64,719	71,045	81,564
Service	30,011	30,142	28,128	26,409
Total Revenue	93,257	94,861	99,173	107,973
Ending Backlog (1)	$248,976	$260,894	$266,675	$ 207,305

(1) The backlog data shown above includes all bookings as of September 30, 2018, including contract awards and signed purchase orders for which the contracts would not be considered enforceable or qualify for the practical expedient under ASC 606. As of September 30, 2018, approximately $84 million related to contract awards is included in our backlog. As a result, this table above will not agree to the disclosed performance obligations of $33.8 million within "Revenue Recognition (Adoption of ASC 606)", Note 4 to the Notes to Condensed Consolidated Financial Statements.

During the first quarter of 2018, Dril-Quip Asia-Pacific Pte Ltd. was awarded a contract to supply top-tensioned riser (TTR) systems and related services for the development of the Ca Rong Do Project (CRD Project) located offshore Vietnam operated by Repsol with the participation of Mubadala, PVEP and PetroVietnam. The CRD Project is included within the backlog balance presented in the table above; however, due to ongoing territorial discussions between China and Vietnam, the CRD Project may experience continued delays or cancellation.

In August 2012, the Company's Brazilian subsidiary, Dril-Quip do Brasil LTDA, was awarded a four-year contract by Petroleo Brasileiro S.A. (Petrobras), Brazil's national oil company, which was amended in 2016 to extend the term of the contract through July 2020. As of September 30, 2018, the Company's backlog included $5.6 million of purchase orders under this Petrobras contract. The Company has not yet recognized revenue of approximately $1.5 million as of September 30, 2018 for certain items of equipment that were completed but not yet accepted for delivery by Petrobras. If Petrobras does not ultimately accept these items for delivery or if they refuse to accept these or similar items completed in the future, the Company's results of operations may be adversely affected. As part of the amendment to extend the term of the contract, Petrobras agreed to issue purchase orders totaling a minimum of approximately $24.5 million (based on current exchange rates) before 2019. As of September 30, 2018, approximately $5.6 million of the purchase orders have been issued (based on current exchange rates). The Company cannot provide assurance that Petrobras will order all of the equipment under the contract.

As of September 30, 2017, the total number of the Company's employees was 2,067, of which 1,099 were located in the United States. The total number of the Company's employees as of December 31, 2017 was 2,019, of which 1,095 were located in the United States. As a result of natural attrition and reductions in workforce, the total number of employees as of September 30, 2018 was 1,849, of which 820 were located in the United States.

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

Interruption of the Company’s international operations could have a material adverse effect on its overall operations.

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The June 23, 2016 referendum by British voters to exit the European Union (Brexit) adversely impacted global markets, including currencies, and resulted in a decline in the value of the British pound sterling, as compared to the U.S. dollar and other currencies. Volatility in exchange rates could be expected to continue in the short term as the United Kingdom (U.K.) negotiates its exit from the European Union. A weaker British pound sterling compared to the U.S. dollar during a reporting period would cause local currency results of the Company's U.K. operations to be translated into fewer U.S. dollars. Continued adverse consequences such as deterioration in economic conditions and volatility in currency exchange rates could have a negative impact on the Company's financial position and results of operations. See “Our international operations expose us to instability and changes in economic and political conditions and other risks inherent to international business, which could have a material adverse effect on our results of operations, financial position or cash flows" under "Item 1A. Risk Factors" in Part I of the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

In the third quarter of 2018, we initiated a global strategic analysis to better align our operations with current market conditions. As a result of our ongoing analysis, we expect related cost savings to begin in early 2019.

Revenues. Dril-Quip’s revenues are generated from two sources: products and services. Product revenues are derived from the sale of drilling and production equipment. Service revenues are earned when the Company provides technical advisory assistance and rental tools during installation and retrieval of the Company’s products. Additionally, the Company earns service revenues when rework and reconditioning services are provided. For the three months ended September 30, 2018 and 2017, the Company derived 67.8% and 75.6%, respectively, of its revenues from the sale of its products and 32.2% and 24.4%, respectively, of its revenues from services. For the nine months ended September 30, 2018 and 2017, the Company derived 69.3% and 77.6%, respectively, of its revenues from the sales of its products and 30.7% and 22.4%, respectively, of its revenues from services. Service revenues generally correlate to revenues from product sales because increased product sales typically generate increased demand for technical advisory assistance services and rental of running tools during installation. The Company has substantial international operations, with approximately 57.0% and 56.0% of its revenues derived from foreign sales for the nine months ended September 30, 2018 and 2017, respectively. The majority of the Company’s domestic revenue relates to operations in the U.S. Gulf of Mexico. Domestic revenue approximated 43.0%