Hydril Company Nasdaq: HYDL

Analysis by Sheryl Sostarich
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Eye on Operations

When you notice that oil prices are going up and rig counts are going up, it's time to invest in oilfield services and equipment companies like Hydril. Hydril is a mid-cap company based on annual sales and a component of the Standard & Poor's Small Cap 600 Index. Hydril was founded in 1933 and taken public in September 2000.

Hydril operates two distinct product divisions: Premium Connections and Pressure Control Systems. Sixty-five percent of total revenue is generated from sales of premium connection products while thirty-five percent of revenue comes from premium control products.

Premium connections are pipes that are threaded on the ends so they can be joined together. The term premium means that the product is produced in a precision manufacturing process. Premium connections are used in drilling environments where conditions of extreme pressure, temperature, corrosion and mechanical stress continually test a product's durability. Hydril's premium connection products are proprietary designs, protected by 27 U.S. patents.

Hydril's pressure control products are safety devices that control and contain fluid and gas pressure during drilling, completion and maintenance of wells. The key component of a pressure control system is a blowout preventer. A blowout preventer is a high-pressure safety valve designed to prevent the uncontrolled release of fluids and gases from the well. In 2005, Hydril landed contracts to supply blowout preventer stacks and control systems for five deepwater rigs and nine jack-ups.

The company provides an aftermarket of replacement parts and employs a team of engineers who repair pressure control equipment onsite. The aftermarket portion of the company's Pressure Control segment is heavily influenced by the level of offshore drilling and also by the level of U.S. land drilling. In the first quarter of 2006, the worldwide offshore rig count averaged 352, up 2% from the prior quarter and the U.S. rig count averaged 1,519, up 3% from the prior quarter.

A Superior Recovery Technology

Hydril believes its products are well suited to SAGD drilling. Because of Steam Assisted Gravity Drainage (SAGD) technology, an estimated 600 billion barrels of oil are now accessible in the Athabasca oilsands of Canada. SAGD is a simple technology in concept but complex in application. It is a process whereby two horizontal wells are drilled into the oil sands. Steam is injected into the upper well where heat melts the bituminous rock. The molten liquid then drains by gravity to the lower well where it is pumped to the surface. The process is the invention of Roger Butler, a humble professor in Petroleum Engineering who says, "If he hadn't thought of it, somebody else would have."

Who is the Competition?

Hydril sells to roughly 1,100 customers worldwide. Petroleos de Venezuela is its largest customer at 13% of revenues. Petroleos Mexicanos (Pemex) is its second largest customer at 11% of revenues. Hydril competes with Tenaris, Vallourec & Mannessmann and Sumitomo Metals in the premium connections markets. Any steel mill can etch threaded connections in the pipes it produces so Hydril has to be sensitive to the prices it charges for its products. Hydril competes with Cooper Cameron and National Oilwell Varco for sales of pressure control products.

Financial Snapshot

First quarter revenue of $114 million was sequentially flat due to a product shift mix in premium connections from lower margin pipe to higher margin connections. Operating income rose by 7% to $32.9 million. Net income was $22.7 million or 94 cents per diluted share, up 6% from 88 cents in the fourth quarter. Gross margin for the first quarter rose to 44%, up 3 percentage points from the fourth quarter 2005 due to the product mix shift and improved plant efficiencies.

SG&A expense rose 8% to $17 million, which included $500,000 in stock option expense mandated by FAS 123R. Hydril spent $5 million during the quarter to purchase equipment for its pressure control plant in Mexico, to make capacity additions at its pressure control plant in Houston and to expand its premium connection manufacturing facility in Vera Cruz, Mexico.

Hydril ended the quarter with $206 million in cash and cash equivalents and no debt. The Board of Directors has authorized the repurchase of up to $100 million of common stock. The stock has had a 16% correction from its highs of April 2006 and I expect the Company to report some repurchase activity in the second quarter of 2006.

The Outlook

International market orders were strong particularly in the Eastern Hemisphere. Slightly less than half of the underlying premium connection revenues came from the U.S. market, where the majority of the company's products are used in drilling for natural gas. The company has not noticed any slack demand for its products due to fluctuating natural gas prices. The U.S. deepwater rig count averaged 182 in the fourth quarter of 2005 compared to 204 in the first quarter of 2006. Drilling activity in the Gulf of Mexico is expected to gradually increase following the interruptions caused by Hurricane Katrina. The company is seeking ways to increase its international market penetration through partnerships with Russia and China.

Construction is on schedule on the new pressure control plant in Vera Cruz, Mexico and production is expected to begin in mid-year. When fully utilized, the plant will increase pressure control manufacturing capacity by 15% and free-up capacity at the Houston facility for a larger volume of high-tech deepwater equipment.

The Company's backlog increased 48% during the quarter to $233 million, which includes eight new purchase orders for deepwater blowout preventer systems. Deepwater capital equipment orders currently make up about 70% of the backlog. Approximately 30% of the backlog will be recognized in revenue in 2006, 50% in 2007, and 20% in 2008.

Analyst Estimates

The average rating of the ten analysts who follow the Company is a buy. The five-year projected growth rate of 30% by Standard & Poor's was far too aggressive in my opinion. Yahoo and Reuters growth projections of 23% were more in line but still a bit lofty.

If you look at the SSG for Hydril, you will note a steep upward slope. In 2005, the rig equipment market experienced strong growth driven by an upturn in drilling rig utilization. The last offshore rig construction up-cycle, which peaked in 1998, ended in 1999. Management talks in generalities about its business prospects but does not give specific guidance.

Judgments On the SSG

I used Manifest's Fundamental Forecast report of 5/26/06 and the SSG Preferred Procedure to calculate a more conservative growth projection of 22.3%. I used a sales growth rate of 13.8%, net profit margin of 27.1%, and shares outstanding of 23.7 million to calculate earnings per share of $8.99.

The five-year average high and low P/Es are 29.4 and 16.8 were again too aggressive in my opinion. I chose to strike the highest high P/E and the highest low P/E [of the last five years] and use the resulting average high and low P/Es of 25 and 13. The relative value is 118%.

The Bottom Line

At 25/50/25 zoning and a current price of $75.91, Hydril has an upside potential of 4.5 to 1 with a buy below price of $88. The projected annual return (PAR) is 17.6% and the total return is 24%.

I'm asking you to consider investing in a cyclical industry, one that can reward investors with generous profits or severe losses. The club member who follows Hydril will need to be dedicated to the task. I recommend that we buy the stock to diversify and potentially improve the total return on our club portfolio.

For further reading:

2005 Annual Report and 10K.
Credit Suisse Stock Analyst Report April 25, 2006
Standard & Poor's Stock Report
1st Quarter 2006 Earnings Call Transcript
Simmons, Matthew R. Twilight in the Desert: The Coming Saudi Oil Shock and the World Economy New Jersey: John Wiley & Sons, 2005.

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Stock Selection Guide ®

The most widely used aid to good investment judgment

Company	HYDRIL CO	Date	07/07/06
Prepared by	Ssostar	Data taken from	NAIC Data
Where traded	NASDAQ	Major product/service	Oil & Gas E

CAPITALIZATION --- Outstanding Amounts | Reference

		% Insiders	% Institution
Preferred ($M)	0.0		
Common (M Shares)	23.7	0.0	0.0

Debt ($M)	0.0	% to Tot.Cap.	0.0	% Potential Dil.	None

1 VISUAL ANALYSIS of Sales, Earnings and Price

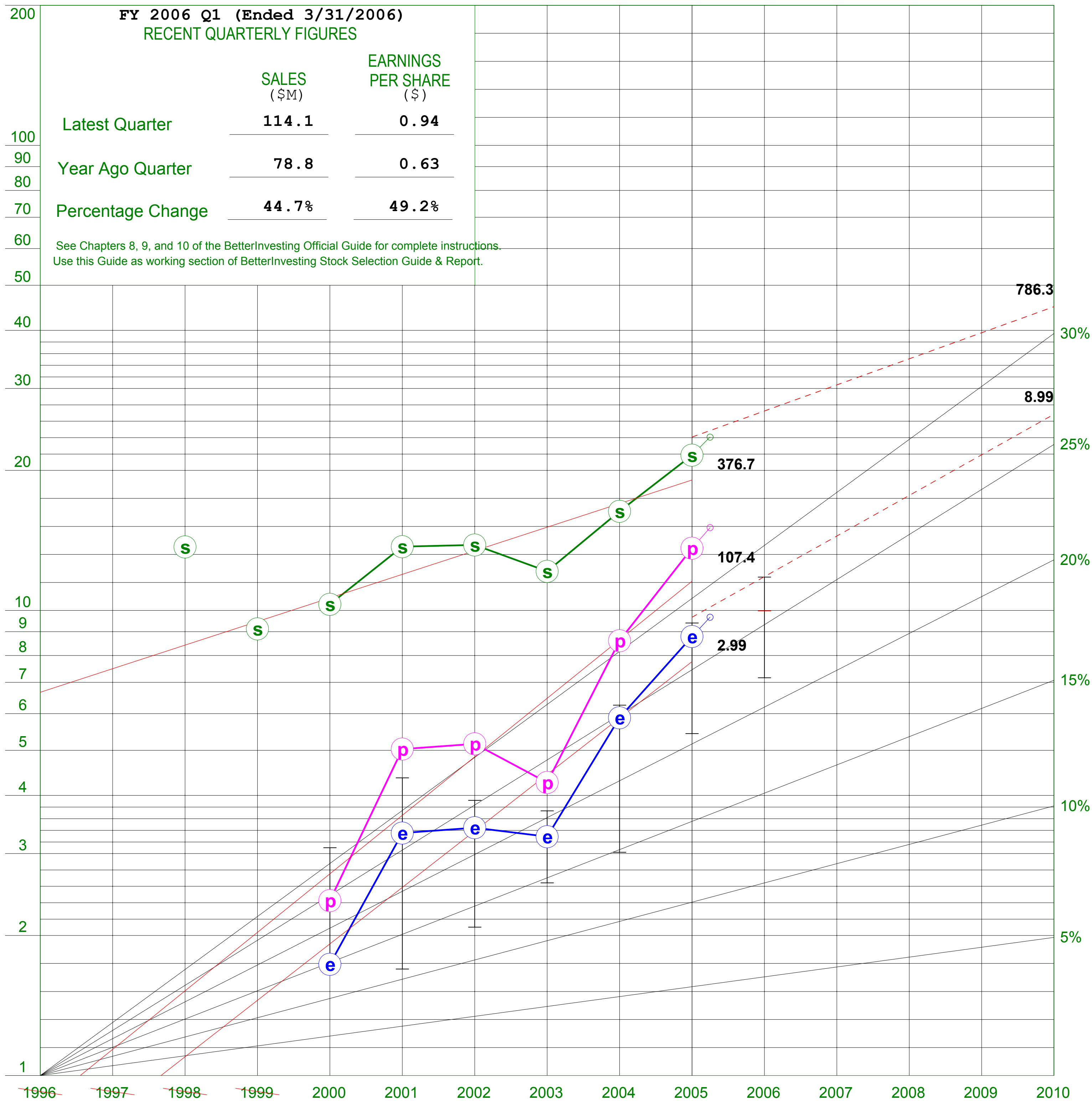
HYDL

FY 2006 Q1 (Ended 3/31/2006)

RECENT QUARTERLY FIGURES

	SALES ($M)	EARNINGS PER SHARE ($)
Latest Quarter	114.1	0.94
Year Ago Quarter	78.8	0.63
Percentage Change	44.7%	49.2%

See Chapters 8, 9, and 10 of the BetterInvesting Official Guide for complete instructions.
Use this Guide as working section of BetterInvesting Stock Selection Guide & Report.



(1) Historical Sales Growth	12.4 %	(3) Historical Earnings Per Share Growth	32.2 %
(2) Estimated Future Sales Growth	13.8 %	(4) Estimated Future Earnings Per Share Growth	22.3 %

2 EVALUATING MANAGEMENT

Company HYDRIL CO (HYDL) 07/07/06

		1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	LAST 5 YEAR AVG.	TREND UP	TREND DOWN
A	% Pre-tax Profit on Sales (Net Before Taxes ÷ Sales)			-9.2	-6.9	10.4	16.6	16.9	15.9	23.8	28.5	20.3	UP	
B	% Earned on Equity (E/S ÷ Book Value)			-17.4	-9.4	9.9	15.7	14.0	11.7	16.9	19.6	15.6	UP	

3 PRICE-EARNINGS HISTORY as an indicator of the future

This shows how stock prices have fluctuated with earnings and dividends. It is a building block for translating earnings into future stock prices.

PRESENT PRICE 75.910 HIGH THIS YEAR 89.710 LOW THIS YEAR 54.530

	Year	A PRICE HIGH	B PRICE LOW	C Earnings Per Share	D Price Earnings Ratio HIGH A ÷ C	E Price Earnings Ratio LOW B ÷ C	F Dividend Per Share	G % Payout F ÷ C X 100	H % High Yield F ÷ B X 100
1	2001	33.2	12.9	1.13	29.4	11.4	0.000	0.0	0.0
2	2002	29.7	15.9	1.16	25.6	13.7	0.000	0.0	0.0
3	2003	28.2	19.8	1.11	25.4	17.8	0.000	0.0	0.0
4	2004	47.6	23.0	2.00	23.8	11.5	0.000	0.0	0.0
5	2005	71.5	41.4	2.99	23.9	13.8	0.000	0.0	0.0
6	TOTAL		113.0		128.1	68.2		0.0	
7	AVERAGE		22.6		25.6	13.6		0.0	
8	AVERAGE PRICE EARNINGS RATIO		19.6	9	CURRENT PRICE EARNINGS RATIO		23.1		

Proj. P/E [18.87] Based on Next 4 qtr. EPS [4.02] Current P/E Based on Last 4 qtr. EPS [3.29]
PEG=85

4 EVALUATING RISK and REWARD over the next 5 years

Assuming one recession and one business boom every 5 years, calculations are made of how high and how low the stock might sell. The upside-downside ratio is the key to evaluating risk and reward.

A HIGH PRICE -- NEXT 5 YEARS

Avg. High P/E ~~25.6~~ 25.0 (3D7 as adj.) X Estimate High Earnings/Share 8.99 = Forecast High Price $ 224.7 (4A1)

B LOW PRICE -- NEXT 5 YEARS

(a) Avg. Low P/E ~~13.6~~ 13.0 (3E7 as adj.) X Estimated Low Earnings/Share ~~2.99~~ 3.29 = $ 42.8

(b) Avg. Low Price of Last 5 Years = 22.6 (3B7)

(c) Recent Severe Market Low Price = 23.0

(d) Price Dividend Will Support Present Divd. / High Yield (H) = 0.000 / 0.000 = 0.0

Selected Estimate Low Price = $ 42.8 (4B1)

C ZONING

224.7 (4A1) High Forecast Price Minus 42.8 (4B1) Low Forecast Price Equals 181.9 (C) Range. 1/3 of Range = 45.5 (4CD)

(4C2) Lower 1/3 = (4B1) 42.8 to 88.3 (Buy) Note: Ranges changed to 25%/50%/25%

(4C3) Middle 1/3 = 88.3 to 179.2 (Maybe)

(4C4) Upper 1/3 = 179.2 to 224.7 (4A1) (Sell)

Present Market Price of 75.910 is in the Buy (4C5) Range

D UP-SIDE DOWN-SIDE RATIO (Potential Gain vs. Risk of Loss)

High Price (4A1) 224.7 Minus Present Price 75.910 / Present Price 75.910 Minus Low Price (4B1) 42.8 = 148.8 / 33.1 = 4.5 (4D) To 1

E PRICE TARGET (Note: This shows the potential market price appreciation over the next five years in simple interest terms.)

High Price (4A1) 224.7 / Present Market Price 75.910 = (2.960) X 100 = (296.0) - 100 = 196.0 (4E) % Appreciation

Relative Value: 117.9% Proj. Relative Value: 96.3%

5 5-YEAR POTENTIAL

This combines price appreciation with dividend yield to get an estimate of total return. It provides a standard for comparing income and growth stocks.

Note: Results are expressed as a simple rate; use the table below to convert to a compound rate.

A Present Full Year's Dividend $ 0.000 / Present Price of Stock $ 75.910 = 0.000 X 100 = 0.0 (5A) Present Yield or % Returned on Purchase Price

B AVERAGE YIELD OVER NEXT 5 YEARS

Avg. Earnings Per Share Next 5 Years 6.01 X Avg. % Payout (3G7) 0.0 = 0.0 / Present Price $ 75.910 = 0.0 (5B) %

C ESTIMATED AVERAGE ANNUAL RETURN OVER NEXT FIVE YEARS

5 Year Appreciation Potential (4E) 196.0 / 5 = 39.2 %

Average Yield (5B) 0.0 %

Average Total Annual Return Over the Next 5 Years (5C) 39.2 %

	P.A.R.	Tot. Ret.
Average Yield	0.0%	0.0%
Annual Appreciation	17.6%	24.2%
% Compd Ann Rate of Ret	17.6%	24.2%