

FORM 10-Q
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

(Mark one)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTER ENDED SEPTEMBER 30, 2004 OR

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

Commission file number 1-12317

NATIONAL-OILWELL, INC.

(Exact name of registrant as specified in its charter)

Delaware

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

76-0475875

*(I.R.S. Employer
Identification No.)*

**10000 Richmond Avenue
Houston, Texas
77042-4200**

(Address of principal executive offices)

(713) 346-7500

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES NO

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No

As of November 2, 2004, 85,950,480 common shares were outstanding.

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Item 1. Financial Statements

NATIONAL-OILWELL, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

| | September 30, 2004 | December 31, 2003 |
|---|-----------------------|----------------------|
| | (Unaudited) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 73,365 | \$ 74,217 |
| Receivables, net | 459,377 | 460,910 |
| Inventories, net | 591,279 | 546,690 |
| Costs in excess of billings | 156,410 | 107,625 |
| Deferred income taxes | 14,860 | 15,410 |
| Prepaid and other current assets | 20,204 | 41,548 |
| Total current assets | 1,315,495 | 1,246,400 |
| Property, plant and equipment, net | 242,629 | 252,365 |
| Deferred income taxes | 74,914 | 52,391 |
| Goodwill | 618,326 | 587,341 |
| Intangibles, net | 77,142 | 79,281 |
| Property held for sale | 1,337 | 8,693 |
| Other assets | 18,065 | 16,265 |
| | <u>\$ 2,347,908</u> | <u>\$ 2,242,736</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Current portion of long-term debt | 175,000 | 14,910 |
| Accounts payable | 237,213 | 228,576 |
| Customer prepayments | 27,407 | 26,424 |
| Accrued compensation | 23,082 | 25,382 |
| Billings in excess of costs | 50,396 | 49,259 |
| Accrued income taxes | 36,125 | 24,673 |
| Other accrued liabilities | 101,656 | 82,991 |
| Total current liabilities | 650,879 | 452,215 |
| Long-term debt | 350,000 | 593,980 |
| Deferred income taxes | 109,036 | 52,368 |
| Other liabilities | 39,856 | 37,996 |
| Total liabilities | 1,149,771 | 1,136,559 |
| Commitments and contingencies | | |
| Minority interest | 16,906 | 15,748 |
| Stockholders' equity: | | |
| Common stock — par value \$.01; 85,902,659 and 85,124,979 shares issued and outstanding at September 30, 2004 and December 31, 2003 | 859 | 851 |
| Additional paid-in capital | 690,677 | 674,965 |
| Accumulated other comprehensive loss | (29,472) | (44,374) |
| Retained earnings | 519,167 | 458,987 |
| | <u>1,181,231</u> | <u>1,090,429</u> |
| | <u>\$ 2,347,908</u> | <u>\$ 2,242,736</u> |

The accompanying notes are an integral part of these statements.

NATIONAL-OILWELL, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(In thousands, except per share data)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|----------------------------------|--------------------|---------------------------------|--------------------|
| | 2004 | 2003 (Restated) | 2004 | 2003 (Restated) |
| Revenues | \$ 618,892 | \$ 498,600 | \$ 1,648,652 | \$ 1,474,574 |
| Cost of revenues | 486,929 | 379,757 | 1,295,551 | 1,130,896 |
| Gross profit | 131,963 | 118,843 | 353,101 | 343,678 |
| Selling, general, and administrative | 82,835 | 76,468 | 239,938 | 222,697 |
| Operating income | 49,128 | 42,375 | 113,163 | 120,981 |
| Interest and financial costs | (9,829) | (9,497) | (28,698) | (29,059) |
| Interest income | 1,113 | 762 | 2,445 | 2,388 |
| Other income (expense), net | (1,219) | (697) | (1,501) | (4,246) |
| Income before income taxes and minority interest | 39,193 | 32,943 | 85,409 | 90,064 |
| Provision for income taxes | 10,668 | 10,237 | 24,071 | 28,712 |
| Income before minority interest | 28,525 | 22,706 | 61,338 | 61,352 |
| Minority interest in income of consolidated subsidiaries | (696) | (1,002) | (1,158) | (4,040) |
| Net income | \$ 27,829 | \$ 21,704 | \$ 60,180 | \$ 57,312 |
| Net income per share: | | | | |
| Basic | \$ 0.32 | \$ 0.26 | \$ 0.70 | \$ 0.68 |
| Diluted | \$ 0.32 | \$ 0.25 | \$ 0.70 | \$ 0.68 |
| Weighted average shares outstanding: | | | | |
| Basic | 85,885 | 84,982 | 85,692 | 84,375 |
| Diluted | 86,712 | 85,198 | 86,345 | 84,888 |

The accompanying notes are an integral part of these statements.

NATIONAL-OILWELL, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(In thousands)

| | Nine Months Ended September 30, | |
|---|---------------------------------|--------------------|
| | 2004 | 2003 (Restated) |
| Cash flow from operating activities: | | |
| Net income | \$ 60,180 | \$ 57,312 |
| Adjustments to reconcile net income to net cash used by operating activities: | | |
| Depreciation and amortization | 32,795 | 28,417 |
| Provision for losses on receivables | 4,843 | 3,822 |
| Provision for deferred income taxes | 1,473 | 5,125 |
| Gain on sale of assets | (6,270) | (3,781) |
| Foreign currency transaction loss | 1,727 | 4,534 |
| Interest rate contract | (60) | (90) |
| Tax benefit from exercise of nonqualified stock options | 3,070 | 3,639 |
| Changes in assets and liabilities, net of acquisitions: | | |
| Receivables | (3,310) | (2,673) |
| Inventories | (44,589) | (40,703) |
| Costs in excess of billings | (48,785) | (43,299) |
| Prepaid and other current assets | 21,894 | (15,011) |
| Accounts payable | 16,237 | 53,758 |
| Billings in excess of cost | 1,137 | (22,560) |
| Other assets/liabilities, net | 39,360 | (21,550) |
| Net cash provided by operating activities | <u>79,702</u> | <u>6,940</u> |
| Cash flow from investing activities: | | |
| Purchases of property, plant and equipment | (23,476) | (21,960) |
| Proceeds from sale of assets | 16,375 | 6,473 |
| Businesses acquired, net of cash | — | (52,914) |
| Net cash used by investing activities | <u>(7,101)</u> | <u>(68,401)</u> |
| Cash flow from financing activities: | | |
| Borrowings against lines of credit | 409,283 | 302,631 |
| Payments against lines of credit | (494,128) | (296,501) |
| Proceeds from stock options exercised | 14,084 | 8,929 |
| Net cash provided (used) by financing activities | <u>(70,761)</u> | <u>15,059</u> |
| Effect of exchange rate gain (loss) on cash | (2,692) | 2,359 |
| Decrease in cash and equivalents | (852) | (44,043) |
| Cash and cash equivalents, beginning of period | 74,217 | 118,338 |
| Cash and cash equivalents, end of period | <u>\$ 73,365</u> | <u>\$ 74,295</u> |
| Supplemental disclosures of cash flow information: | | |
| Cash payments during the period for: | | |
| Interest | \$ 27,743 | \$ 28,958 |
| Income taxes | \$ 16,919 | \$ 24,084 |

The accompanying notes are an integral part of these statements.

National-Oilwell, Inc.
Notes to Consolidated Financial Statements (Unaudited)

1. Basis of Presentation

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect reported and contingent amounts of 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.

The accompanying unaudited consolidated financial statements present information in accordance with accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-Q and applicable rules of Regulation S-X. They do not include all information or footnotes required by accounting principles generally accepted in the United States for complete financial statements and should be read in conjunction with our 2003 Annual Report on Form 10K. The financial statements for the three months and nine months ended September 30, 2003 have been restated as disclosed in Note 12 to our consolidated financial statements included in our 2003 Annual Report on Form 10K.

In our opinion, the consolidated financial statements include all adjustments, all of which are of a normal, recurring nature, necessary for a fair presentation of the results for the interim periods. The results of operations for the three months and nine months ended September 30, 2004 are not necessarily indicative of the results to be expected for the full year.

On August 12, 2004, National Oilwell and Varco International, Inc. signed a definitive merger agreement. The merger agreement was unanimously approved by each company's board of directors, and provides for the issuance of .8363 shares of National Oilwell common stock for each outstanding Varco share, resulting in the combined company having approximately 170 million shares outstanding on a fully diluted basis. The transaction is subject to stockholder approval of both companies and customary regulatory approval. On October 13, the companies received a request for additional information under the notification requirements of the Hart-Scott-Rodino Antitrust Improvements Act from the Antitrust Division of the U.S. Department of Justice regarding the merger. The companies are gathering information to comply with the request, and currently expect to respond by late November or early December. Upon favorable resolution of the matters raised and any other regulatory approvals, the companies will proceed with stockholder votes and closing of the transaction.

2. Stock-Based Compensation

We apply Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees", and related interpretations in accounting for our stock option plans. Accordingly, no compensation expense has been recognized for stock option grants as all options granted had an exercise price equal to the market value of the underlying common stock on the date of grant. Had compensation expense for the stock option grants been determined on the fair value at the grant dates consistent with the method of Statement of Financial Accounting Standards Board (SFAS) No. 123, "Accounting for Stock-Based Compensation", our net income and income per share would have been adjusted to the pro forma amounts indicated below (amounts in thousands, except per share amounts):

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| | Quarter Ended September 30, | | Nine Months Ended September 30, | |
|---|-----------------------------|--------------------|---------------------------------|--------------------|
| | 2004 | 2003 (Restated) | 2004 | 2003 (Restated) |
| Net income, as reported | \$ 27,829 | \$ 21,704 | \$ 60,180 | \$ 57,312 |
| Deduct: | | | | |
| Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (1,834) | (2,088) | (5,364) | (6,465) |
| Pro forma net income | \$ 25,995 | \$ 19,616 | \$ 54,816 | \$ 50,847 |
| Net income per common share: | | | | |
| Basic, as reported | \$ 0.32 | \$ 0.26 | \$ 0.70 | \$ 0.68 |
| Basic, pro forma | 0.30 | 0.23 | 0.64 | 0.60 |
| Diluted, as reported | \$ 0.32 | \$ 0.25 | \$ 0.70 | \$ 0.68 |
| Diluted, pro forma | 0.30 | 0.23 | 0.63 | 0.60 |

For purposes of determining compensation expense using the provisions of SFAS No. 123, the fair value of option grants was determined using the Black-Scholes option-valuation model. The weighted average fair value per share of stock options granted in the first nine months of 2004 and 2003 was \$13.19 and \$9.20, respectively. The key input variables used in valuing the options granted in 2004 and 2003 were: risk-free interest rate of 2.7% in 2004 and 2.6% in 2003; dividend yield of zero in each year; stock price volatility of 51% in 2004 and 48% in 2003, and expected option lives of five years for each year presented.

3. Inventories

Inventories consist of (in thousands):

| | September 30, 2004 | December 31, 2003 |
|---------------------------------------|-----------------------|----------------------|
| Raw materials and supplies | \$ 56,843 | \$ 45,354 |
| Work in process | 62,364 | 107,747 |
| Finished goods and purchased products | 472,072 | 393,589 |
| Total | \$ 591,279 | \$ 546,690 |

4. Comprehensive Income

The components of comprehensive income are as follows (in thousands):

| | Quarter Ended September 30, | | Nine Months Ended September 30, | |
|----------------------------------|-----------------------------|--------------------|---------------------------------|--------------------|
| | 2004 | 2003 (Restated) | 2004 | 2003 (Restated) |
| Net income | \$ 27,829 | \$ 21,704 | \$ 60,180 | \$ 57,312 |
| Currency translation adjustments | 17,552 | 577 | 15,438 | 977 |
| Interest rate contract | (20) | (30) | (60) | (90) |
| Comprehensive income | \$ 45,361 | \$ 22,251 | \$ 75,558 | \$ 58,199 |

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5. Business Segments

Segment information follows (in thousands):

| | Quarter Ended September 30, | | Nine Months Ended September 30, | |
|--|-----------------------------|--------------|---------------------------------|------------|
| | 2004 | 2003 | 2004 | 2003 |
| | | (Restated) | | (Restated) |
| Revenues from unaffiliated customers | | | | |
| Products and Technology | \$ 389,517 | \$ 292,322 | \$ 987,747 | \$ 895,798 |
| Distribution Services | 229,375 | 206,278 | 660,905 | 578,776 |
| | 618,892 | 498,600 | 1,648,652 | 1,474,574 |
| Intersegment revenues | | | | |
| Products and Technology | 28,888 | 26,385 | 83,406 | 69,849 |
| Distribution Services | 3,929 | 669 | 8,876 | 1,764 |
| | 32,817 | 27,054 | 92,282 | 71,613 |
| Operating income | | | | |
| Products and Technology | 44,990 | 41,562 | 103,411 | 120,157 |
| Distribution Services | 8,463 | 4,119 | 20,627 | 10,207 |
| Total profit for reportable segments | 53,453 | 45,681 | 124,038 | 130,364 |
| Unallocated corporate costs | (4,325) | (3,306) | (10,875) | (9,383) |
| Operating income | 49,128 | 42,375 | 113,163 | 120,981 |
| Net interest expense | (8,716) | (8,735) | (26,253) | (26,671) |
| Other income (expense) | (1,219) | (697) | (1,501) | (4,246) |
| Income before income taxes and minority interest | \$ 39,193 | \$ 32,943 | \$ 85,409 | \$ 90,064 |
| Total assets | | | | |
| Products and Technology | \$ 1,859,838 | \$ 1,748,495 | | |
| Distribution Services | 381,628 | 323,861 | | |

6. Debt

Debt consists of (in thousands):

| | September 30, 2004 | December 31, 2003 |
|----------------------|-----------------------|----------------------|
| Credit facilities | \$ 25,000 | \$ 108,890 |
| 6.875% senior notes | 150,000 | 150,000 |
| 6.50% senior notes | 150,000 | 150,000 |
| 5.65% senior notes | 200,000 | 200,000 |
| | 525,000 | 608,890 |
| Less current portion | 175,000 | 14,910 |
| | \$ 350,000 | \$ 593,980 |

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Our \$150 million of 6.875% unsecured senior notes are due July 1, 2005. In addition, our unsecured \$175 million North American revolving credit facility expires July 31, 2005. In early 2005, we intend to re-negotiate our unsecured credit facilities to replace these obligations.

In November 2002, we sold \$200 million of 5.65% unsecured senior notes due November 15, 2012. Interest is payable on May 15 and November 15 of each year. In March 2001, we sold \$150 million of 6.50% unsecured senior notes due March 15, 2011, with interest payable on March 15 and September 15 of each year. In June 1998, we sold \$150 million of 6.875% unsecured senior notes due July 1, 2005, with interest payments due on January 1 and July 1.

At September 30, 2004, we had two committed credit facilities, a North American and a Norwegian facility, totaling \$268 million. Both facilities are available for general corporate purposes and acquisitions, including letters of credit and performance bonds.

Our North American facility is an unsecured \$175 million revolving credit facility that expires July 31, 2005. At September 30, 2004, borrowings against this facility totaled \$25 million and there were \$64 million in outstanding letters of credit. Interest (2.25% @ September 30, 2004) is based upon prime or Libor plus 0.5% subject to a ratings based grid.

Our Norwegian facility, which expires in 2006, has revolving credit facilities totaling \$93 million, with \$37 million available for letter of credit purposes. At September 30, 2004, there were \$19 million in outstanding letters of credit and no borrowings against this facility. Interest is based upon a pre-agreed percentage point spread from either the prime interest rate, NIBOR or EURIBOR.

We also have additional uncommitted credit facilities totaling \$138 million that are used primarily for letters of credit, bid bonds and performance bonds. At September 30, 2004, there were \$43 million in outstanding letters of credit and performance bonds and no borrowings against these facilities.

The senior notes contain reporting covenants and the credit facilities contain financial covenants and ratios regarding maximum debt to capital and minimum interest coverage. We were in compliance with all covenants governing these facilities at September 30, 2004.

7. Employee Benefit Plans

Total net benefit expense associated with the Company's defined benefit pension and postretirement benefit plans consisted of the following (in thousands):

| Pension Benefits | Quarter Ended September 30, | | Nine Months Ended September 30, | |
|--------------------------------|-----------------------------|----------|---------------------------------|-----------|
| | 2004 | 2003 | 2004 | 2003 |
| Service cost | \$ 754 | \$ 748 | \$ 2,262 | \$ 2,244 |
| Interest cost | 1,917 | 1,868 | 5,751 | 5,604 |
| Expected return on plan assets | (1,985) | (1,871) | (5,955) | 1,871 |
| Net amortization and deferral | 326 | 353 | 978 | 1,059 |
| Total net benefit expense | \$ 1,012 | \$ 1,098 | \$ 3,036 | \$ 10,778 |
| Postretirement Benefits | | | | |
| Service cost | \$ 8 | \$ 10 | \$ 24 | \$ 30 |
| Interest cost | 127 | 124 | 381 | 372 |
| Net amortization and deferral | 53 | 53 | 159 | 159 |
| Total net benefit expense | \$ 188 | \$ 187 | \$ 564 | \$ 561 |

8. Recently Issued Accounting Standards

In May 2004, the Financial Accounting Standards Board (“FASB”) issued FASB Staff Position No. 106-2 (“FSP 106-2”), “*Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*” (the “Act”), which supersedes FSP 106-1 of the same name, which was issued in January 2004 and permitted a sponsor of a post-retirement health care plan that provides a prescription drug benefit to make a one-time election to defer accounting for the effects of the Act until more authoritative guidance on the accounting for the federal subsidy was issued. FSP 106-2 provides guidance on how to account for future subsidies available beginning in 2006 to employers who provided prescription drug benefits that are “actuarially equivalent” to those that will be provided under Medicare Part D. Sponsors that provide actuarially equivalent benefits must account for the subsidy as a reduction in the accumulated postretirement benefit obligation and any reduction of the sponsor’s share of future costs should be reflected in service cost in the period of implementation. We do not believe adoption of FSP No. 106-2 will have a material effect on our financial condition or results of operations.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Introduction

On August 12, 2004, National Oilwell and Varco International, Inc. signed a definitive merger agreement. The merger agreement was unanimously approved by each company's board of directors, and provides for the issuance of .8363 shares of National Oilwell common stock for each outstanding Varco share, resulting in the combined company having approximately 170 million shares outstanding on a fully diluted basis. The transaction is subject to stockholder approval of both companies and customary regulatory approval. On October 13, the companies received a request for additional information under the notification requirements of the Hart-Scott-Rodino Antitrust Improvements Act from the Antitrust Division of the U.S. Department of Justice regarding the merger. The companies are gathering information to comply with the request, and currently expect to respond by late November or early December. Upon favorable resolution of the matters raised and any other regulatory approvals, the companies will proceed with stockholder votes and closing of the transaction.

We design, manufacture and sell drilling systems, drilling equipment and downhole products as well as distribute maintenance, repair and operating products to the oil and gas industry. Our revenues and operating results are directly related to the level of worldwide oil and gas drilling and production activities and the profitability and cash flow of oil and gas companies and drilling contractors, which in turn are affected by current and anticipated prices of oil and gas. Oil and gas prices have been and are likely to continue to be volatile causing our industry to be cyclical.

We conduct our operations through the following segments:

Products and Technology

Our Products and Technology segment designs and manufactures complete land drilling and workover rigs, and drilling related systems for offshore rigs. Technology has increased the desirability of one vendor assuming responsibility for the entire suite of components used in the drilling process, as mechanical and hydraulic components are replaced by or augmented with integrated computerized systems. In addition to traditional components such as drawworks, mud pumps, top drives, derricks, cranes, jacking and mooring systems, and other structural components, we provide automated pipehandling, control and electrical power systems. We have also developed new technology for drawworks and mud pumps applicable to the highly demanding offshore markets. We have made strategic acquisitions during the past several years in an effort to expand our product offering and our global manufacturing capabilities, including new operations in Norway, the United Kingdom and China. Product and Technology revenues are directly dependent on the levels of worldwide drilling activity.

Distribution Services

Our Distribution Services segment provides maintenance, repair and operating supplies and spare parts from our network of distribution service centers to drill site and production locations throughout North America and to offshore contractors worldwide. Products are purchased from numerous manufacturers and vendors, including our Products and Technology segment. We have expanded this business to locations outside North America, including Europe, the Middle East, Southeast Asia, and South America. We have made significant investments in systems, staffing and inventory in the international market and, using our information technology platforms and processes, we can provide complete procurement, inventory management, and logistics services to our customers. Approximately half of Distribution Services revenues are tied to worldwide drilling activity, and the balance relates to the production of oil and gas reserves.

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Operating results by segment are as follows (in thousands):

| | Quarter Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------------------|-----------------------------|--------------------------|---------------------------------|---------------------------|
| | 2004 | 2003 | 2004 | 2003 |
| Revenues: | | | | |
| Revenues from backlog | \$ 198,920 | \$ 146,850 | \$ 482,832 | \$ 471,534 |
| Noncapital equipment | 219,485 | 171,857 | 588,321 | 494,113 |
| Products and Technology | 418,405 | 318,707 | 1,071,153 | 965,647 |
| Distribution Services | 233,304 | 206,947 | 669,781 | 580,540 |
| Eliminations | (32,817) | (27,054) | (92,282) | (71,613) |
| Total | \$ 618,892 | \$ 498,600 | \$ 1,648,652 | \$ 1,474,574 |
| Operating Income | | | | |
| Products and Technology | \$ 44,990 | \$ 41,562 ⁽¹⁾ | \$ 103,411 | \$ 120,157 ⁽¹⁾ |
| Distribution Services | 8,463 | 4,119 ⁽¹⁾ | 20,627 | 10,207 ⁽¹⁾ |
| Corporate | (4,325) | (3,306) | (10,875) | (9,383) |
| Total | \$ 49,128 | \$ 42,375 ⁽¹⁾ | \$ 113,163 | \$ 120,981 ⁽¹⁾ |
| Capital equipment backlog: | | | | |
| Beginning of quarter | \$ 441,288 | \$ 366,381 | \$ 338,900 | \$ 363,600 |
| Add: Orders, net | 333,100 | 120,595 | 719,400 | 448,060 |
| Less: Revenues | 198,920 | 146,850 | 482,832 | 471,534 |
| End of quarter | \$ 575,468 | \$ 340,126 | \$ 575,468 | \$ 340,126 |

(1) Restated -See Note 1 to consolidated financial statements.

*Products and Technology*Q3 2004 versus Q3 2003

Revenues for the Products and Technology segment increased approximately \$100 million, or 31%, during the third quarter of 2004 as compared to the same quarter in 2003. The market for capital equipment has grown, as evidenced in our backlog growth, with capital equipment revenues accounting for approximately half of this increase. The remaining revenue increase of approximately \$48 million is primarily driven by the higher North American rig count experienced this quarter as compared to the third quarter of 2003. The number of rotary rigs operating worldwide is a key driver of our parts, service and rental tools businesses.

Operating income increased by \$3 million in the third quarter of 2004 compared to the same quarter in 2003. Margin increases due to the higher volume were offset in part by higher steel prices, overall product mix and increased warehouse/shipping and commission expenses. Higher depreciation and intangible asset amortization also contributed to the reduced operating income. We are actively addressing margin issues and expect to achieve higher operating margins over the next few quarters.

Backlog of the Products and Technology capital products was \$575 million at September 30, 2004, reflecting an increase of \$134 million from the June 30, 2004 level. Backlog at September 30, 2003 was \$340 million. Product in current backlog will be delivered by the end of 2005.

1st Nine Month of 2004 versus 1st Nine Months of 2003

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Products and Technology segment revenues increased \$106 million in the first nine months of 2004 as compared to the same period in 2003. Due to the recent strong surge in international capital equipment orders, capital equipment revenues have increased \$11 million on a year-to-date basis. Given the current backlog, we anticipate this higher level of activity to continue in the near term. For the first nine months of 2004, an increase in the average number of rigs operating worldwide has driven our increased sales of drilling spare parts, expendable pump parts and downhole tools and rentals.

Operating income decreased \$17 million in the first nine months of 2004 compared to the same period in 2003 primarily due to a 3% reduction in gross margins and higher property taxes, insurance coverage costs and depreciation and amortization costs totaling \$6 million. Unusually high costs on several capital equipment orders in prior quarters resulted in the lower overall margins. We believe our efforts to improve margins are achieving positive results and we should see improving margins in the next few quarters.

Distribution Services

Q3 2004 versus Q3 2003

Distribution Services revenues increased \$26 million, or approximately 13%, during the third quarter of 2004 over the comparable 2003 period. North American revenues accounted for almost \$23 million of this increase due to the higher number of active rigs running in the U.S. and Canada. From a product perspective, maintenance, repair and operating supplies ("MRO") revenues increased approximately \$21 million and the sale of parts manufactured by the Products and Technology segment increased approximately \$5 million.

Operating income of \$8.5 million in the third quarter of 2004 doubled the prior year results due primarily to the increased revenue and a margin % improvement resulting from recent price increases on certain products. Increases in expenses to run our field operations totaled approximately \$2 million while selling and administrative expenses were virtually flat.

1st Nine Month of 2004 versus 1st Nine Months of 2003

Revenues for the Distribution Services segment increased \$89 million in the first nine months of 2004 when compared to the prior year. All areas have experienced significant growth as Canada revenues increased 27%, U.S. operations increased 11% and international revenues were up 13%. Revenues from the sale of parts manufactured by the Products & Technology segment increased \$14 million (18%) while the maintenance, repair and operating supplies revenues reflected a 14% improvement from the first nine months of 2003. Tubular revenues were higher by approximately \$5 million.

Operating income in the first nine months of 2004 of \$21 million doubled the comparable period in 2003. Gross margin improvement resulting from the revenue volume increase and price increases on certain products was offset by higher administrative expenses to support the global market expansion, and higher taxes, insurance and depreciation.

Corporate

Corporate charges represent the unallocated portion of centralized and executive management costs. These costs have increased this year primarily due to efforts to comply with the Sarbanes-Oxley Act of 2002 and tax planning consulting fees. For the quarter ending September 30, 2004, spending approximated \$4 million and we anticipate it to continue near this level in the near term.

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Interest Expense

Interest expense during the three months ending September 30, 2004 of \$8.4 million was \$0.2 million lower than the comparable period in 2003. A lower debt level of almost \$39 million contributed to this lower amount as our average borrowing cost of 5.71% was slightly higher than the prior year. For the nine months ended September 30, 2004, interest expense was \$1 million less than the same period in 2003 due to both a lower average debt level and a lower average borrowing rate.

Income Taxes

The effective tax rate for the nine months ended September 30, 2004 was 28% compared to 32% for the same period in 2003, reflecting a higher percentage of earnings in foreign jurisdictions with lower tax rates, recovery of certain prior period taxes and the benefit associated with export sales. These benefits were recently repealed by Congress and will be phased out over a three year period. A newly enacted tax benefit for manufacturing profits will phase in over the same period to replace the export tax benefit. We anticipate our tax rate for 2004 to be 29% and expect the rate in 2005 to be lower due to the realignment of certain foreign operations.

Liquidity and Capital Resources

At September 30, 2004 we had working capital of \$665 million, a decrease of \$130 million from December 31, 2003. This reduction is primarily due to our reclassification of \$175 million from long-term to short-term debt. Our \$150 million of 6.875% unsecured senior notes are due July 1, 2005. In addition, our unsecured \$175 million North American revolving credit facility expires July 31, 2005. In early 2005, we intend to re-negotiate our unsecured credit facilities to replace these obligations. We believe our borrowing costs will be lower upon replacement of these facilities. Inventory has increased \$45 million, primarily due to our belief that the current strong business indicators of this industry will be sustained in the short-term as well as our desire to take advantage of an active market place. Increases in accounts payable and other accrued liabilities have partially offset the inventory increase. Costs in excess of billings has increased \$49 million this year, reflecting the growing number of large capital projects that we have underway. Cash and accounts receivable have remained essentially flat during the first nine months ended September 30, 2004.

Total capital expenditures were \$23 million during the first nine months of 2004 compared to \$22 million in the same period of the prior year. The majority of these capital expenditures represent additions to the downhole rental tool fleet and enhancements to information management systems. We expect our capital expenditures in 2004 to total approximately \$30 million. We believe we have sufficient existing manufacturing capacity to meet currently anticipated demand for our products and services.

In November 2002, we sold \$200 million of 5.65% unsecured senior notes due November 15, 2012. Interest is payable on May 15 and November 15 of each year. In March 2001, we sold \$150 million of 6.50% unsecured senior notes due March 15, 2011, with interest payable on March 15 and September 15 of each year. In June 1998, we sold \$150 million of 6.875% unsecured senior notes due July 1, 2005, with interest payments due on January 1 and July 1.

At September 30, 2004, we had two committed credit facilities, a North American and a Norwegian facility, totaling \$268 million. Both facilities are available for general corporate purposes and acquisitions, including letters of credit and performance bonds.

Our North American facility is an unsecured \$175 million revolving credit facility that expires July 31, 2005. At September 30, 2004, borrowings against this facility totaled \$25 million and there were \$64 million in outstanding letters of credit. Interest (2.25% @ September 30, 2004) is based upon prime or Libor plus 0.5% subject to a ratings based grid.

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Our Norwegian facility, which expires in 2006, has revolving credit facilities totaling \$93 million, with \$37 million available for letter of credit purposes. At September 30, 2004, there were \$19 million in outstanding letters of credit and no borrowings against this facility. Interest is based upon a pre-agreed percentage point spread from either the prime interest rate, NIBOR or EURIBOR.

We also have additional uncommitted credit facilities totaling \$138 million that are used primarily for letters of credit, bid bonds and performance bonds. At September 30, 2004, there were \$43 million in outstanding letters of credit and performance bonds and no borrowings against these facilities.

The senior notes contain reporting covenants and the credit facilities contain financial covenants and ratios regarding maximum debt to capital and minimum interest coverage. We were in compliance with all covenants governing these facilities at September 30, 2004.

We believe cash generated from operations and amounts available under the credit facilities and from other sources of debt will be sufficient to fund operations, working capital needs, capital expenditure requirements and financing obligations. We also believe any significant increase in capital expenditures caused by any need to increase manufacturing capacity can be funded from operations or through debt financing.

During the nine months ended September 30, 2004, we did not enter into any transactions, arrangements, or relationships with unconsolidated entities or other persons which would materially affect liquidity, or the availability of or requirements for capital resources, from the amounts disclosed in our Form 10-K for the year ending December 31, 2003.

We intend to pursue additional acquisition candidates, but the timing, size or success of any acquisition effort and the related potential capital commitments cannot be predicted. We expect to fund future cash acquisitions primarily with cash flow from operations and borrowings, including the unborrowed portion of the credit facility or new debt issuances, but may also issue additional equity either directly or in connection with acquisitions. There can be no assurance that additional financing for acquisitions will be available at terms acceptable to us.

Inflation has not had a significant impact on our operating results or financial condition in recent years.

Critical Accounting Policies and Estimates

The preparation of our financial statements requires us to make certain estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Our estimation process generally relates to potential bad debts, obsolete and slow moving inventory, revenue recognition on long term contracts, pension plan accounting, value of goodwill and intangible assets, and deferred income tax accounting. Our estimates are based on historical experience and on our future expectations that we believe to be reasonable under the circumstances. The combination of these factors result in the amounts shown as carrying values of assets and liabilities in the financial statements and accompanying notes. Actual results could differ from our current estimates and those differences may be material.

These estimates may change as new events occur, as more experience is acquired, as additional information is obtained and as our operating environment changes. There have been no material changes or developments in our evaluation of the accounting estimates and the underlying assumptions or methodologies that we believe to be material to the Critical Accounting Policies and Estimates as disclosed in our Form 10-K for the year ending December 31, 2003.

Recently Issued Accounting Standards

In May 2004, the Financial Accounting Standards Board (“FASB”) issued FASB Staff Position No. 106-2 (“FSP 106-2”), “*Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*” (the “Act”), which supersedes FSP 106-1 of the same name, which was issued in January 2004 and permitted a sponsor of a post-retirement health care plan that provides a prescription drug benefit to make a one-time election to defer accounting for the effects of the Act until more authoritative guidance on the accounting for the federal subsidy was issued. FSP 106-2 provides guidance on how to account for future subsidies available beginning in 2006 to employers who provided prescription drug benefits that are “actuarially equivalent” to those that will be provided under Medicare Part D. Sponsors that provide actuarially equivalent benefits must account for the subsidy as a reduction in the accumulated postretirement benefit obligation and any reduction of the sponsor’s share of future costs should be reflected in service cost in the period of implementation. We do not believe adoption of FSP No. 106-2 will have a material effect on our financial condition or results of operations.

Forward-Looking Statements

Some of the information in this document contains, or has incorporated by reference, forward-looking statements. Statements that are not historical facts, including statements about our beliefs and expectations, are forward-looking statements. Forward-looking statements typically are identified by use of terms such as “may,” “will,” “expect,” “anticipate,” “estimate,” and similar words, although some forward-looking statements are expressed differently. You should be aware that our actual results could differ materially from results anticipated in the forward-looking statements due to a number of factors, including but not limited to changes in oil and gas prices, customer demand for our products and worldwide economic activity. You should also consider carefully the statements under “Risk Factors,” as disclosed in our Form 10-K for the year ending December 31, 2003, which address additional factors that could cause our actual results to differ from those set forth in the forward-looking statements. Given these uncertainties, current or prospective investors are cautioned not to place undue reliance on any such forward-looking statements. We undertake no obligation to update any such factors or forward-looking statements to reflect future events or developments.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to changes in foreign currency exchange rates and interest rates. Additional information concerning each of these matters follows:

Foreign Currency Exchange Rates

We have operations in foreign countries, including Canada, Norway and the United Kingdom, as well as operations in Latin America, China and other European countries. The net assets and liabilities of these operations are exposed to changes in foreign currency exchange rates, although such fluctuations generally do not affect income since their functional currency is the local currency. These operations also have net assets and liabilities not denominated in the local currency, which exposes us to changes in foreign currency exchange rates that do impact income. We recorded foreign exchange losses in our income statement of approximately \$1.7 million in the first nine months of 2004, compared to \$4.5 million in foreign exchange losses in the same period of the prior year. We do not believe that a hypothetical 10% movement in these foreign currencies would have a material impact on our earnings.

Some of our revenues in foreign countries are denominated in US dollars, and therefore, changes in foreign currency exchange rates impact our earnings to the extent that costs associated with those US dollar revenues are denominated in the local currency. In order to mitigate that risk, we may utilize foreign currency forward contracts

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to better match the currency of our revenues and associated costs. We do not use foreign currency forward contracts for trading or speculative purposes. The counterparties to these contracts are major financial institutions, which minimizes counterparty credit risk.

Interest Rate Risk

Our long term borrowings consist of \$150 million in 6.875% senior notes, \$150 million in 6.5% senior notes and \$200 million in 5.65% senior notes. We also have borrowings under our other facilities totaling \$25 million at September 30, 2004 (weighted average interest rate of 2.25% at September 30, 2004). A portion of the borrowings are denominated in multiple currencies which could expose us to market risk with exchange rate movements. These instruments carry interest at a pre-agreed upon percentage point spread from either the prime interest rate, LIBOR, NIBOR or EURIBOR. Under our credit facilities, we may, at our option, fix the interest rate for certain borrowings based on a spread over LIBOR, NIBOR or EURIBOR for 30 days to 6 months. Based upon our September 30, 2004 borrowings under our variable rate facilities of \$24 million, an immediate change of one percent in the interest rate would cause a change in annual interest expense of approximately \$0.3 million. Our objective in maintaining a portion of our debt in variable rate borrowings is the flexibility obtained regarding early repayment without penalties and lower overall cost as compared with fixed-rate borrowings.

Item 4. Controls and Procedures

Within 90 days before filing this report, we carried out an evaluation, under the supervision and with the participation of the company's management, including the company's President and Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the company's disclosure controls and procedures. Based upon that evaluation, the company's President and Chief Executive Officer along with the company's Chief Financial Officer concluded that the company's disclosure controls and procedures are effective in timely alerting them to material information relating to the company (including its consolidated subsidiaries) required to be included in the company's periodic Securities and Exchange Commission filings.

There have been no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of our evaluation.

PART II — OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

31.1 Certification pursuant to Rule 13a-14a and Rule 15d-14(a) of the Securities and Exchange Act, as amended

31.2 Certification pursuant to Rule 13a-14a and Rule 15d-14(a) of the Securities and Exchange Act, as amended

32.1 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

A report on Form 8 — K was filed on July 30, 2004 regarding the issuance of a press release containing earnings information for the three months ended June 30, 2004.

A report on Form 8 — K was filed on August 12, 2004 announcing a merger of equals transaction with Varco International, Inc. pursuant to the terms of an Agreement and Plan of Merger dated as of August 11, 2004.

A report on Form 8 — K was filed on September 13, 2004 announcing that on September 10, 2004 we filed a Premerger Notification and Report Form with the Antitrust Division of the U.S. Department of Justice and the U.S. Federal Trade Commission relating to our proposed merger with Varco International, Inc.

A report on Form 8 — K was filed on September 17, 2004 announcing that we had entered into a material definitive agreement with Varco International, Inc. On September 13, 2004 the board of directors of National-Oilwell, Inc. and Varco each approved an amendment and restatement of the Merger Agreement previously announced. Varco will merge with and into National-Oilwell, Inc.

A report on Form 8 — K was filed on October 13, 2004 regarding the issuance of a press release announcing that, in conjunction with the proposed merger with Varco International, Inc., we had received a request for additional information from the U.S. Department of Justice.

A report on Form 8 — K was filed on October 29, 2004 regarding the issuance of a press release announcing earnings information for the quarter ended September 30, 2004.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 8, 2004

/s/ Steven W. Krablin

Steven W. Krablin
Principal Financial and Accounting Officer
and Duly Authorized Signatory

INDEX TO EXHIBITS

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CERTIFICATION

I, Merrill A. Miller, Jr., certify that:

1. I have reviewed this quarterly report on Form 10-Q of National-Oilwell, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) [INTENTIONALLY OMITTED PURSUANT TO SEC RELEASE NO. 33-8238];
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2004

By: */s/ Merrill A. Miller, Jr.*

Merrill A. Miller, Jr.
Chairman, President and
Chief Executive Officer

CERTIFICATION

I, Steven W. Krablin, certify that:

1. I have reviewed this quarterly report on Form 10-Q of National-Oilwell, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) [INTENTIONALLY OMITTED PURSUANT TO SEC RELEASE NO. 33-8238];
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2004

By: */s/ Steven W. Krablin*

Steven W. Krablin
Chief Financial Officer

CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of National-Oilwell, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, Merrill A. Miller, Jr., Chairman, President and Chief Executive Officer of the Company, hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (i) The Report fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934; and
- (ii) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

The certification is given to the knowledge of the undersigned.

By: /s/ Merrill A. Miller, Jr.

Name: Merrill A. Miller, Jr.

Title: Chairman, President and Chief Executive Officer

Date: November 8, 2004

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to National-Oilwell, Inc. and will be retained by National-Oilwell, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of National-Oilwell, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, Steven W. Krablin, the Chief Financial Officer of the Company, hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (i) The Report fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934; and
- (ii) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

The certification is given to the knowledge of the undersigned.

By: /s/ Steven W. Krablin

Name: Steven W. Krablin
Title: Chief Financial Officer
Date: November 8, 2004

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to National-Oilwell, Inc. and will be retained by National-Oilwell, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.