

Allis Chalmers Energy Inc.  
Form 10-Q  
November 04, 2008

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

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2008  
OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_  
*Commission file number 1-02199*  
**ALLIS-CHALMERS ENERGY INC.**  
(Exact name of registrant as specified in its charter)**

**DELAWARE**

**39-0126090**

(State or other jurisdiction of  
incorporation or organization)

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

**5075 WESTHEIMER, SUITE 890, HOUSTON,  
TEXAS**

**77056**

(Address of principal executive offices)

(Zip Code)

**(713) 369-0550**

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 a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. At October 28, 2008 there were 35,513,739 shares of common stock, par value \$0.01 per share, outstanding.

**ALLIS-CHALMERS ENERGY INC.**  
**FORM 10-Q**  
**For the Quarterly Period Ended September 30, 2008**  
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**ALLIS-CHALMERS ENERGY INC.**  
**CONSOLIDATED CONDENSED BALANCE SHEETS**  
(in thousands, except for share and per share amounts)

|  | <b>September<br/>30,<br/>2008</b><br>(unaudited) | <b>December<br/>31,<br/>2007</b> |
|--|--|----------------------------------|
| <b>Assets</b>  |  |                                  |
| Cash and cash equivalents  | \$ 6,810   | \$ 43,693                        |
| Trade receivables, net   | 159,231  | 130,094                          |
| Inventories  | 35,816   | 32,209                           |
| Prepaid expenses and other   | 15,516   | 11,898                           |
| <b>Total current assets</b>  | <b>217,373</b>                                   | <b>217,894</b>                   |
| Property and equipment, net  | 694,040  | 626,668                          |
| Goodwill   | 137,548  | 138,398                          |
| Other intangible assets, net   | 30,670   | 35,180                           |
| Debt issuance costs, net   | 12,774   | 14,228                           |
| Note receivable  | 40,000   |                                  |
| Other assets   | 41,472   | 21,217                           |
| <b>Total assets</b>  | <b>\$ 1,173,877</b>                              | <b>\$ 1,053,585</b>              |
| <b>Liabilities and Stockholders Equity</b>   |  |                                  |
| Current maturities of long-term debt   | \$ 8,819   | \$ 6,434                         |
| Trade accounts payable   | 54,054   | 37,464                           |
| Accrued salaries, benefits and payroll taxes                                       | 20,063   | 15,283                           |
| Accrued interest   | 6,974  | 17,817                           |
| Accrued expenses   | 32,519   | 20,545                           |
| <b>Total current liabilities</b>   | <b>122,429</b>                                   | <b>97,543</b>                    |
| Long-term debt, net of current maturities  | 560,960  | 508,300                          |
| Deferred income taxes  | 35,680   | 30,090                           |
| Other long-term liabilities  | 2,641  | 3,323                            |
| <b>Total liabilities</b>   | <b>721,710</b>                                   | <b>639,256</b>                   |
| Commitments and contingencies  |  |                                  |
| Stockholders Equity  |  |                                  |
| Preferred stock, \$0.01 par value (25,000,000 shares authorized, no shares issued) |  |                                  |

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|  |              |              |
|--|--------------|--------------|
| Common stock, \$0.01 par value (100,000,000 shares authorized; 35,513,739 issued and outstanding at September 30, 2008 and 35,116,035 issued and outstanding at December 31, 2007) | 355          | 351          |
| Capital in excess of par value   | 333,009      | 326,095      |
| Retained earnings  | 118,803      | 87,883       |
| Total stockholders' equity   | 452,167      | 414,329      |
| Total liabilities and stockholders' equity   | \$ 1,173,877 | \$ 1,053,585 |

The accompanying Notes are an integral part of the Consolidated Condensed Financial Statements.

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**ALLIS-CHALMERS ENERGY INC.**  
**CONSOLIDATED CONDENSED INCOME STATEMENTS**

(in thousands, except per share amounts)

(unaudited)

|                                      | <b>For the Three Months<br/>Ended<br/>September 30,</b> |             | <b>For the Nine Months<br/>Ended<br/>September 30,</b> |             |
|--------------------------------------|---|-------------|--|-------------|
|                                      | <b>2008</b>   | <b>2007</b> | <b>2008</b>  | <b>2007</b> |
| Revenues                             | \$ 178,265  | \$ 147,881  | \$ 494,582   | \$ 427,143  |
| Cost of revenues                     |   |             |  |             |
| Direct costs                         | 117,609   | 89,120      | 321,841  | 249,943     |
| Depreciation                         | 15,601  | 13,168      | 45,328   | 37,232      |
| Gross margin                         | 45,055  | 45,593      | 127,413  | 139,968     |
| General and administrative           | 15,161  | 13,456      | 44,082   | 41,729      |
| Gain on asset dispositions           | (166)   |             | (166)  | (8,868)     |
| Amortization                         | 1,027   | 989         | 3,214  | 3,015       |
| Income from operations               | 29,033  | 31,148      | 80,283   | 104,092     |
| Other income (expense):              |   |             |  |             |
| Interest expense                     | (12,166)  | (11,805)    | (36,243)   | (37,671)    |
| Interest income                      | 1,457   | 851         | 4,147  | 2,718       |
| Other                                | 115   | 32          | 591  | 308         |
| Total other income (expense)         | (10,594)  | (10,922)    | (31,505)   | (34,645)    |
| Income before income taxes           | 18,439  | 20,226      | 48,778   | 69,447      |
| Provision for income taxes           | (6,127)   | (7,239)     | (17,858)   | (24,791)    |
| Net income                           | \$ 12,312   | \$ 12,987   | \$ 30,920  | \$ 44,656   |
| Net income per common share:         |   |             |  |             |
| Basic                                | \$ 0.35   | \$ 0.37     | \$ 0.88  | \$ 1.32     |
| Diluted                              | \$ 0.35   | \$ 0.37     | \$ 0.87  | \$ 1.29     |
| Weighted average shares outstanding: |   |             |  |             |
| Basic                                | 35,156  | 34,784      | 35,004   | 33,934      |
| Diluted                              | 35,551  | 35,286      | 35,455   | 34,512      |

The accompanying Notes are an integral part of the Consolidated Condensed Financial Statements.

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**ALLIS-CHALMERS ENERGY INC.**  
**CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS**  
(in thousands)  
(unaudited)

|   | <b>For the Nine Months Ended<br/>September 30,</b> |              |
|---|--|--------------|
|   | <b>2008</b>  | <b>2007</b>  |
| <b>Cash Flows from Operating Activities:</b>                                      |  |              |
| Net income  | \$ 30,920  | \$ 44,656    |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |              |
| Depreciation and amortization   | 48,542   | 40,247       |
| Amortization and write-off of deferred financing fees                             | 1,563  | 2,686        |
| Stock-based compensation  | 6,212  | 2,132        |
| Allowance for bad debts   | 1,505  | 441          |
| Deferred taxes  | 4,315  | 3,142        |
| Gain on sale of property and equipment  | (1,206)  | (1,085)      |
| Gain on asset dispositions  | (166)  | (8,868)      |
| Changes in operating assets and liabilities, net of acquisitions:                 |  |              |
| (Increase) in trade receivable  | (30,642)   | (36,801)     |
| (Increase) in inventories   | (6,961)  | (4,998)      |
| Decrease in prepaid expenses and other current assets                             | 544  | 10,551       |
| (Increase) decrease in other assets   | (2,271)  | 173          |
| Increase in trade accounts payable  | 16,590   | 1,326        |
| (Decrease) in accrued interest  | (10,843)   | (5,093)      |
| Increase in accrued expenses  | 12,083   | 9,957        |
| Increase in accrued salaries, benefits and payroll taxes                          | 4,780  | 2,412        |
| (Decrease) in other long-term liabilities   | (682)  | (68)         |
| <br>Net Cash Provided By Operating Activities                                     | <br>74,283   | <br>60,810   |
| <br><b>Cash Flows from Investing Activities:</b>                                  |  |              |
| Investment in note receivable   | (40,000)   |              |
| Deposits on asset commitments   | (9,219)  |              |
| Acquisition of businesses, net of cash received                                   |  | (12,860)     |
| Purchase of investment interests  | (5,763)  | (498)        |
| Proceeds from sale of property and equipment                                      | 6,004  | 5,988        |
| Proceeds from asset dispositions  | 3,000  | 16,250       |
| Purchase of property and equipment  | (117,835)  | (86,087)     |
| <br>Net Cash Used In Investing Activities   | <br>(163,813)                                      | <br>(77,207) |
| <br><b>Cash Flows from Financing Activities:</b>                                  |  |              |
| Proceeds from issuance of stock, net  |  | 100,055      |
| Proceeds from exercises of options  | 633  | 3,252        |
| Proceeds from long-term debt  | 20,001   | 250,000      |
| Net borrowings under line of credit   | 38,500   |              |



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|  |          |           |
|--|----------|-----------|
| Payments on long-term debt                     | (6,451)  | (307,542) |
| Tax benefits on stock-based compensation plans | 73       | 1,559     |
| Debt issuance costs                            | (109)    | (7,581)   |
| Net Cash Provided By Financing Activities      | 52,647   | 39,743    |
| Net change in cash and cash equivalents        | (36,883) | 23,346    |
| Cash and cash equivalents at beginning of year | 43,693   | 39,745    |
| Cash and cash equivalents at end of period     | \$ 6,810 | \$ 63,091 |

The accompanying Notes are an integral part of the Consolidated Condensed Financial Statements.

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**ALLIS-CHALMERS ENERGY INC.**

**NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**

**NOTE 1 NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Nature of Operations**

Allis-Chalmers Energy Inc. and subsidiaries ( Allis-Chalmers , we , our or us ) is a multi-faceted oilfield service company that provides services and equipment to oil and natural gas exploration and production companies, throughout the United States including Texas, Louisiana, New Mexico, Colorado, Oklahoma, Mississippi, Wyoming, Arkansas, West Virginia, offshore in the Gulf of Mexico, and internationally, primarily in Argentina and Mexico. We operate in three sectors of the oil and natural gas service industry: Oilfield Services; Drilling and Completion and Rental Services.

We derive operating revenues from rates per day and rates per job that we charge for the labor and equipment required to provide a service and rates per day for equipment and tools that we rent to our customers. The price we charge for our services depends upon several factors, including the level of oil and natural gas drilling activity and the competitive environment in the particular geographic regions in which we operate. Contracts are awarded based on price, quality of service and equipment and general reputation and experience of our personnel. The principal operating costs are direct and indirect labor and benefits, repairs and maintenance of our equipment, insurance, equipment rentals, fuel, depreciation and general and administrative expenses.

**Basis of Presentation**

Our unaudited consolidated condensed financial statements included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission, or SEC. Accordingly, certain information and disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. We believe that the presentations and disclosures herein are adequate to make the information not misleading. The unaudited consolidated condensed financial statements reflect all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the interim periods. These unaudited consolidated condensed financial statements should be read in conjunction with our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2007. The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the full year.

Certain reclassifications have been made to the prior year s consolidated condensed financial statements to conform with the current period presentation.

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 the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Future events and their effects cannot be perceived with certainty. Accordingly, our accounting estimates require the exercise of judgment. While management believes that the estimates and assumptions used in the preparation of the consolidated financial statements are appropriate, actual results could differ from those estimates. Estimates are used for, but are not limited to, determining the following: allowance for doubtful accounts, recoverability of long-lived assets and intangibles, useful lives used in depreciation and amortization, income taxes and valuation allowances. The accounting estimates used in the preparation of the consolidated financial statements may change as new events occur, as more experience is acquired, as additional information is obtained and as our operating environment changes.

On January 29, 2008, we created the positions of Senior Vice President Oilfield Services and Senior Vice President Rental Services. In conjunction with this organizational change, we reviewed the presentation of our reporting segments during the first quarter of 2008. Based on this review, we determined that our operational performance would be segmented and reviewed by the Oilfield Services, Drilling and Completion and Rental Services segments. The Oilfield Services segment includes our underbalanced drilling, directional drilling, tubular services and production services operations. The Drilling and Completion segment includes our international drilling operations. As a result, we realigned our financial reporting segments and now report the following operations as separate, distinct reporting segments: (1) Oilfield Services, (2) Drilling and Completion and (3) Rental Services. Our historical segment

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data previously reported for the three and nine months ended September 30, 2007 and year ended December 31, 2007 have been restated to conform to the new presentation (see Note 11).

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**Table of Contents****ALLIS-CHALMERS ENERGY INC.****NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

In September 2006, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, or SFAS No. 157. SFAS No. 157 clarifies the principle that fair value should be based on the assumptions that market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, with early adoption permitted. Subsequently, the FASB provided for a one-year deferral of the provisions of SFAS No. 157 for non-financial assets and liabilities that are recognized or disclosed at fair value in the consolidated financial statements on a non-recurring basis. We adopted with no impact on our financial statements all requirements of SFAS No. 157 on January 1, 2008, except as they relate to nonfinancial assets and liabilities, which will be adopted on January 1, 2009, as allowed under SFAS No. 157. We have not yet determined the impact, if any, on our financial statements for nonfinancial assets and liabilities.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, or SFAS No. 159, which permits entities to elect to measure many financial instruments and certain other items at fair value. Upon adoption of SFAS No. 159, an entity may elect the fair value option for eligible items that exist at the adoption date. Subsequent to the initial adoption, the election of the fair value option should only be made at the initial recognition of the asset or liability or upon a re-measurement event that gives rise to the new-basis of accounting. All subsequent changes in fair value for that instrument are reported in earnings. SFAS No. 159 does not affect any existing accounting literature that requires certain assets and liabilities to be recorded at fair value nor does it eliminate disclosure requirements included in other accounting standards. SFAS No. 159 is effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2007. We adopted SFAS No. 159 on January 1, 2008 and there was no impact on our financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (revised 2007), *Business Combinations*, or SFAS No. 141(R). SFAS No. 141(R) changes the requirements for an acquirer's recognition and measurement of the assets acquired and the liabilities assumed in a business combination. SFAS No. 141(R) is effective for annual periods beginning after December 15, 2008 and should be applied prospectively for all business combinations entered into after the date of adoption.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, *Non-controlling Interests in Consolidated Financial Statements – an amendment of ARB No. 51*, or SFAS No. 160. SFAS No. 160 requires (i) that non-controlling (minority) interests be reported as a component of shareholders' equity, (ii) that net income attributable to the parent and to the non-controlling interest be separately identified in the consolidated statement of operations, (iii) that changes in a parent's ownership interest while the parent retains its controlling interest be accounted for as equity transactions, (iv) that any retained non-controlling equity investment upon the deconsolidation of a subsidiary be initially measured at fair value, and (v) that sufficient disclosures are provided that clearly identify and distinguish between the interests of the parent and the interests of the non-controlling owners. SFAS No. 160 is effective for annual periods beginning after December 15, 2008 and should be applied prospectively. The presentation and disclosure requirements of the statement shall be applied retrospectively for all periods presented. We will adopt SFAS No. 160 on January 1, 2009 and have not yet determined the impact, if any, on our financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133*, or SFAS No. 161. SFAS No. 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative data about the fair value of and gains and losses on derivative contracts, and details of credit-risk-related contingent features in hedged positions. The statement also requires enhanced disclosures regarding how and why entities use derivative instruments, how derivative instruments and related hedged items are accounted and how derivative instruments and related hedged items affect entities' financial position, financial performance, and cash flows. SFAS No. 161 is effective for fiscal years beginning after November 15, 2008. We will adopt SFAS No. 161 on January 1, 2009 and do not expect the adoption to have a material impact on our financial statements.



**Table of Contents****ALLIS-CHALMERS ENERGY INC.****NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

In April 2008, the FASB issued FASB Staff Position SFAS 142-3, *Determination of the Useful Life of Intangible Assets*, or FSP SFAS 142-3. FSP SFAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*, or SFAS No. 142. The objective of FSP SFAS 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141R, *Business Combinations*, and other U.S. GAAP principles. FSP SFAS 142-3 is effective for fiscal years beginning after December 15, 2008. We will adopt FSP SFAS 142-3 on January 1, 2009 and have not yet determined the impact, if any, on our financial statements.

**NOTE 2 ASSET DISPOSITIONS**

Effective August 1, 2008, we sold our drill pipe tong manufacturing assets for approximately \$7.5 million. We received cash of approximately \$2.0 million at the time of sale, a 90-day note for \$1.0 million and a 10-year non-interest bearing note for \$4.5 million. Repayment on the 10-year note is tied to various performance targets and we have assigned a fair value of approximately \$3.1 million to this note. We reported a gain of approximately \$166,000 on this transaction. The assets sold represented a small portion of our Oilfield Services segment. On June 29, 2007, we sold our capillary tubing units and related equipment for approximately \$16.3 million. We reported a gain of approximately \$8.9 million on this transaction. The assets sold represented a small portion of our Oilfield Services segment.

**NOTE 3 STOCK-BASED COMPENSATION**

We adopted Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*, effective January 1, 2006. This statement requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their grant-date fair values. We estimated forfeiture rates for the first nine months of 2008 and 2007 based on our historical experience.

The Black-Scholes model incorporates assumptions to value stock-based awards. The risk-free rate of interest is the related U.S. Treasury yield curve for periods within the expected term of the option at the time of grant. The dividend yield on our common stock is assumed to be zero as we have historically not paid dividends and have no current plans to do so in the future. The expected volatility is based on historical volatility of our common stock.

Our net income for the three months ended September 30, 2008 and 2007 includes approximately \$1.8 million and \$1.0 million, respectively, of compensation costs related to share-based payments. Our net income for the nine months ended September 30, 2008 and 2007 includes approximately \$6.2 million and \$2.1 million, respectively, of compensation costs related to share-based payments. As of September 30, 2008, there is \$1.7 million of unrecognized compensation expense related to non-vested stock option grants. We expect approximately \$230,000 to be recognized over the remainder of 2008, and approximately \$918,000 and \$532,000 to be recognized during the years ended 2009 and 2010, respectively.

A summary of our stock option activity and related information is as follows:

|                              | Shares   | Weighted<br>Average | Weighted<br>Average | Aggregate<br>Intrinsic<br>Value |
|------------------------------|----------|---------------------|---------------------|---------------------------------|
|                              | Under    | Exercise            | Contractual<br>Life |                                 |
|                              | Option   | Price               | (Years)             | (millions)                      |
| Balance at December 31, 2007 | 986,763  | \$ 10.77            |                     |                                 |
| Granted                      |          |                     |                     |                                 |
| Canceled                     | (7,328)  | 10.53               |                     |                                 |
| Exercised                    | (71,703) | 8.83                |                     |                                 |

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|                                   |         |         |      |    |      |
|-----------------------------------|---------|---------|------|----|------|
| Outstanding at September 30, 2008 | 907,732 | 10.93   | 7.21 | \$ | 3.59 |
| Exercisable at September 30, 2008 | 731,732 | \$ 8.30 | 6.82 | \$ | 3.59 |

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**Table of Contents****ALLIS-CHALMERS ENERGY INC.****NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the closing price of our common stock on the last trading day of the third quarter of 2008 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on September 30, 2008. The total intrinsic value of options exercised during the three months and nine months ended September 30, 2008 was \$64,000 and \$542,000, respectively. The total cash received from option exercises during the three months and nine months ended September 30, 2008 was \$24,000 and \$633,000, respectively.

No options were granted during the nine months ended September 30, 2008. The following summarizes the assumptions used for the options granted in the three and nine months ended September 30, 2007 Black-Scholes model:

|  | <b>For the Three Months<br/>Ended<br/>September 30,<br/>2007</b> | <b>For the Nine Months<br/>Ended<br/>September 30,<br/>2007</b> |
|--|--|---|
| Expected dividend yield  |  |   |
| Expected price volatility                                      | 66.17%   | 66.21%  |
| Risk free interest rate  | 4.82%  | 4.81%   |
| Expected life of options                                       | 5 years  | 5 years   |
| Weighted average fair value of options granted at market value | \$ 12.90   | \$ 12.86  |

Restricted stock awards, or RSAs, activity during the nine months ended September 30, 2008 were as follows:

|                                 | <b>Number of<br/>Shares</b> | <b>Weighted Average<br/>Grant-Date Fair<br/>Value<br/>Per Share</b> |
|---------------------------------|-----------------------------|---|
| Nonvested at December 31, 2007  | 993,203                     | \$ 17.45  |
| Granted                         | 97,667                      | 16.76   |
| Vested                          | (252,574)                   | 17.06   |
| Forfeited                       |                             |   |
| Nonvested at September 30, 2008 | 838,296                     | \$ 17.49  |

We determine the fair value of RSAs based on the market price of our common stock on the date of grant. Compensation cost for RSAs is primarily recognized on a straight-line basis over the vesting or service period and is net of forfeitures. As of September 30, 2008, there was \$10.0 million of total unrecognized compensation cost related to nonvested RSAs. We expect approximately \$1.4 million to be recognized over the remainder of 2008, and approximately \$5.6 million, \$2.3 million, \$528,000 and \$209,000 to be recognized during fiscal years 2009, 2010, 2011 and 2012, respectively.

**NOTE 4 INCOME PER COMMON SHARE**

We compute income per common share in accordance with the provisions of Statement of Financial Accounting Standards No. 128, *Earnings Per Share*, or SFAS No. 128. SFAS No. 128 requires companies with complex capital structures to present basic and diluted earnings per share. Basic earnings per share are computed on the basis of the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share is similar to basic earnings per share, but presents the dilutive effect on a per share basis of potential common shares (e.g., convertible preferred stock, stock options, etc.) as if they had been converted. Potential dilutive common shares



that have an anti-dilutive effect (e.g., those that increase income per share) are excluded from diluted earnings per share.

**Table of Contents****ALLIS-CHALMERS ENERGY INC.****NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

The components of basic and diluted earnings per share are as follows (in thousands, except per share amounts):

|  | <b>For the Three Months<br/>Ended<br/>September 30,</b> |             | <b>For the Nine Months<br/>Ended<br/>September 30,</b> |             |
|--|---|-------------|--|-------------|
|  | <b>2008</b>   | <b>2007</b> | <b>2008</b>  | <b>2007</b> |
| <b>Numerator:</b>  |   |             |  |             |
| Net income   | \$ 12,312   | \$ 12,987   | \$ 30,920  | \$ 44,656   |
| <b>Denominator:</b>  |   |             |  |             |
| Weighted average common shares outstanding<br>excluding nonvested restricted stock   | 35,156  | 34,784      | 35,004   | 33,934      |
| Effect of potentially dilutive common shares:<br>Warrants and employee and director stock<br>options and restricted shares | 395   | 502         | 451  | 578         |
| Weighted average common shares outstanding<br>and assumed conversions  | 35,551  | 35,286      | 35,455   | 34,512      |
| Net income per common share  |   |             |  |             |
| Basic  | \$ 0.35   | \$ 0.37     | \$ 0.88  | \$ 1.32     |
| Diluted  | \$ 0.35   | \$ 0.37     | \$ 0.87  | \$ 1.29     |
| Potentially dilutive securities excluded as<br>anti-dilutive   | 786   | 905         | 776  | 1,031       |

**NOTE 5 GOODWILL AND INTANGIBLE ASSETS**

In accordance with Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*, or SFAS No. 142, goodwill and indefinite-lived intangible assets are not permitted to be amortized. Goodwill and indefinite-lived intangible assets remain on the balance sheet and are tested for impairment on an annual basis, or when there is reason to suspect that their values may have been diminished or impaired. Goodwill and indefinite-lived intangible assets listed on the balance sheet totaled \$137.5 million and \$138.4 million at September 30, 2008 and December 31, 2007, respectively. The decrease in the value of Goodwill and indefinite-lived intangible assets is attributable to the value of assets sold in conjunction with the sale of our drill pipe tong manufacturing. Based on impairment testing performed during 2007 pursuant to the requirements of SFAS No. 142, these assets were not impaired.

Intangible assets with definite lives continue to be amortized over their estimated useful lives. Definite-lived intangible assets that continue to be amortized under SFAS No. 142 relate to our purchase of customer-related and marketing-related intangibles. These intangibles have useful lives ranging from five to ten years. Amortization of intangible assets for the three and nine months ended September 30, 2008 were \$1.0 million and \$3.2 million, respectively, compared to \$989,000 and \$3.0 million for the same periods last year. At September 30, 2008, intangible assets totaled \$30.7 million, net of \$8.3 million of accumulated amortization.



**Table of Contents****ALLIS-CHALMERS ENERGY INC.****NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)****NOTE 6 INVENTORIES**

Inventories consisted of the following (in thousands):

|                                     | <b>September<br/>30,<br/>2008</b> | <b>December<br/>31,<br/>2007</b> |
|-------------------------------------|-----------------------------------|----------------------------------|
| Manufactured                        |                                   |                                  |
| Finished goods                      | \$ 2,984                          | \$ 2,198                         |
| Work in process                     | 1,393                             | 1,781                            |
| Raw materials                       | 1,389                             | 4,464                            |
| <br>                                |                                   |                                  |
| Total manufactured                  | 5,766                             | 8,443                            |
| Hammers                             | 2,077                             | 1,434                            |
| Drive pipe                          | 549                               | 420                              |
| Rental supplies                     | 3,372                             | 2,261                            |
| Chemicals and drilling fluids       | 3,753                             | 3,236                            |
| Rig parts and related inventory     | 10,724                            | 9,985                            |
| Coiled tubing and related inventory | 2,272                             | 1,014                            |
| Shop supplies and related inventory | 7,303                             | 5,416                            |
| <br>                                |                                   |                                  |
| Total inventories                   | \$ 35,816                         | \$ 32,209                        |

**NOTE 7 NOTE RECEIVABLE**

In January 2008, we invested \$40.0 million in cash in BCH Ltd., or BCH, in the form of a 15% Convertible Subordinated Secured debenture with a maturity date of January 31, 2010. The debenture is convertible, at any time, at our option into 49% of the common equity of BCH. At the end of two years, we have the option to acquire the remaining 51% of BCH from its parent, BrazAlta Resources Corp., or BrazAlta, based on an independent valuation from a mutually acceptable investment bank. BrazAlta is a publicly traded Canadian-based international oil and gas corporation with operations in Brazil, Northern Ireland, and Canada (TSX.V:BRX).

In addition, we acquired 2,192,750 shares of BCH, or approximately 15% of the outstanding shares of BCH, in September 2008. We converted accrued interest on the debenture into 840,739 shares and paid \$5.6 million in cash for the other 1,352,011 shares. BrazAlta owns the remaining 85% of BCH.

BCH is a Canadian-based oilfield services company engaged in contract drilling operations exclusively in Brazil.

BCH has six drilling rigs under one to three year contracts with Petroleo Brasileiro S.A., and a contract for one service rig with BrazAlta for a term of three years.

**NOTE 8 DEBT**

Our long-term debt consisted of the following (in thousands):

|                                   | <b>September<br/>30,<br/>2008</b> | <b>December<br/>31,<br/>2007</b> |
|-----------------------------------|-----------------------------------|----------------------------------|
| Senior notes                      | \$ 505,000                        | \$ 505,000                       |
| Bank term loans                   | 23,109                            | 4,926                            |
| Revolving line of credit          | 38,500                            |                                  |
| Seller notes                      | 1,250                             | 2,350                            |
| Notes payable to former directors | 32                                | 32                               |

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|  |            |            |
|--|------------|------------|
| Equipment and vehicle installment notes  |            | 595        |
| Insurance premium financing              | 1,888      | 1,707      |
| Obligations under non-compete agreements |            | 110        |
| Capital lease obligations                |            | 14         |
| Total debt                               | 569,779    | 514,734    |
| Less: current maturities                 | 8,819      | 6,434      |
| Long-term debt obligations               | \$ 560,960 | \$ 508,300 |

**Table of Contents****ALLIS-CHALMERS ENERGY INC.****NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)*****Senior notes, bank loans and line of credit agreements***

On January 18, 2006 and August 14, 2006, we closed on private offerings, to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933, of \$160.0 and \$95.0 million aggregate principal amount of our senior notes, respectively. The senior notes are due January 15, 2014 and bear interest at 9.0%. The proceeds were used to fund the acquisitions of Specialty Rental Tools, Inc. and DLS Drilling, Logistics & Services Corporation, or DLS, to repay existing debt and for general corporate purposes.

In January 2007, we closed on a private offering, to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933, of \$250.0 million aggregate principal amount of 8.5% senior notes due 2017. The proceeds of the senior notes offering, together with a portion of the proceeds of our concurrent common stock offering, were used to repay the debt outstanding under our \$300.0 million bridge loan facility, which we incurred to finance our acquisition of substantially all the assets of Oil & Gas Rental Services, Inc., or OGR.

On January 18, 2006, we also executed an amended and restated credit agreement which provided for a \$25.0 million revolving line of credit with a maturity of January 2010. On April 26, 2007, we entered into a Second Amended and Restated Credit Agreement, which increased our revolving line of credit to \$62.0 million, and has a final maturity date of April 26, 2012. On December 3, 2007, we entered into a First Amendment to the Second Amended and Restated Credit Agreement, which increased our revolving line of credit to \$90.0 million. The credit agreement contains customary events of default and financial covenants and limits our ability to incur additional indebtedness, make capital expenditures, pay dividends or make other distributions, create liens and sell assets. Our obligations under the amended and restated credit agreement are secured by substantially all of our assets located in the United States. We were in compliance with all debt covenants as of September 30, 2008. The credit agreement loan rates are based on prime or LIBOR plus a margin. The interest rate was 4.6% at September 30, 2008. The outstanding amount as of September 30, 2008 and December 31, 2007, was \$38.5 million and \$0, respectively.

As part of our acquisition of DLS, we assumed various bank loans with floating interest rates based on LIBOR plus a margin and terms ranging from two to five years. The weighted average interest rates were 5.1% and 6.7% at September 30, 2008 and December 31, 2007, respectively. The bank loans are denominated in U.S. dollars and the outstanding amount as of September 30, 2008 and December 31, 2007 were \$3.1 million and \$4.9 million, respectively.

On February 15, 2008, through our DLS subsidiary in Argentina, we entered into a \$25.0 million import finance facility with a bank. Borrowings under this facility will be used to fund a portion of the purchase price of the new drilling and service rigs ordered for our Drilling and Completion segment. The facility is available for borrowings until December 31, 2008. Each drawdown shall be repaid over four years in equal semi-annual installments beginning one year after each disbursement with the final principal payment due not later than March 15, 2013. The import finance facility is unsecured and contains customary events of default and financial covenants and limits DLS ability to incur additional indebtedness, make capital expenditures, create liens and sell assets. We were in compliance with all debt covenants as of September 30, 2008. The bank loan rates are based on LIBOR plus a margin. The interest rate was 6.7% at September 30, 2008. The bank loans are denominated in U.S. dollars and the outstanding amount as of September 30, 2008 was \$20.0 million.

***Notes payable***

In connection with the acquisition of Rogers Oil Tool Services, Inc., we issued to the seller a note in the amount of \$750,000. The note bears interest at 5.0% and is due April 3, 2009. In connection with the acquisition of Coker Directional, Inc., we issued to the seller a note in the amount of \$350,000. The interest rate on the note was 8.25% and was repaid on June 29, 2008. In connection with the acquisition of Diggar Tools, LLC, we issued to the seller a note in the amount of \$750,000. The interest rate on the note was 6.0% and was repaid on July 28, 2008. In connection with the acquisition of Rebel Rentals, Inc., we issued to the sellers notes in the aggregate amount of \$500,000. The notes bear interest at 5.0% and were paid October 29, 2008.

In 2000 we compensated directors, including current directors Nederlander and Toboroff, who served on the board of directors from 1989 to March 31, 1999 without compensation, by issuing promissory notes totaling \$325,000. The

notes bore interest at the rate of 5.0%. At September 30, 2008 and December 31, 2007, the principal and accrued interest on these notes totaled approximately \$32,000.

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**ALLIS-CHALMERS ENERGY INC.**

**NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

We had various equipment and vehicle financing loans with interest rates ranging from 8.3% to 8.7% and two year terms. As of September 30, 2008 and December 31, 2007, the outstanding balances for equipment and vehicle financing loans were \$0 and \$595,000, respectively.

In April and August 2007, we obtained insurance premium financings in the aggregate amount of \$4.4 million with a fixed weighted average interest rate of 5.9%. Under terms of the agreements, amounts outstanding are paid over 10 month and 11 month repayment schedules. The outstanding balance of these notes was approximately \$0 and \$1.7 million as of September 30, 2008 and December 31, 2007, respectively. In April and August 2008, we obtained insurance premium financings in the aggregate amount of \$3.0 million with a weighted average interest rate of 4.9%. Under terms of the agreements, amounts outstanding are paid over 10 month and 11 month repayment schedules. The outstanding balance of these notes was approximately \$1.9 million as of September 30, 2008.

***Other debt***

In connection with the purchase of Capcoil Tubing Services, Inc., we agreed to pay a total of \$500,000 to two management employees in exchange for non-compete agreements. We were required to make annual payments of \$110,000 through May 2008. Total amounts due under these non-compete agreements at September 30, 2008 and December 31, 2007 were \$0 and \$110,000, respectively.

We also had various capital leases with terms that expired in 2008. As of September 30, 2008 and December 31, 2007, amounts outstanding under capital leases were \$0 and \$14,000, respectively.

**NOTE 9 STOCKHOLDERS EQUITY**

We had options exercised in the first nine months of 2008, which resulted in 71,703 shares of our common stock being issued for approximately \$633,000. We recognized approximately \$6.2 million of compensation expense related to share-based payments in the first nine months of 2008 that was recorded as capital in excess of par value (see Note 3). We also recorded approximately \$73,000 of tax benefit related to our stock compensation plans for the nine months ended September 30, 2008.

**NOTE 10 CONDENSED CONSOLIDATING FINANCIAL INFORMATION**

Set forth on the following pages are the condensed consolidating financial statements of (i) Allis-Chalmers Energy Inc., (ii) its subsidiaries that are guarantors of the senior notes and revolving credit facility and (iii) the subsidiaries that are not guarantors of the senior notes and revolving credit facility (in thousands, except for share and per share amounts).



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**ALLIS-CHALMERS ENERGY INC.**  
**NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**  
**CONDENSED CONSOLIDATING BALANCE SHEETS**

September 30, 2008 (unaudited)

|  | <b>Allis-Chalmers<br/>(Parent/<br/>Guarantor)</b> | <b>Subsidiary<br/>Guarantors</b> | <b>Subsidiary<br/>Non-<br/>Guarantors</b> | <b>Consolidating<br/>Adjustments</b> | <b>Consolidated<br/>Total</b> |
|--|---|----------------------------------|---|--------------------------------------|-------------------------------|
| <b>Assets</b>                                  |   |                                  |   |                                      |                               |
| Cash and cash equivalents                      | \$  | \$ 5,637                         | \$ 1,173                                  | \$                                   | \$ 6,810                      |
| Trade receivables, net                         |   | 96,251                           | 62,988                                    | (8)                                  | 159,231                       |
| Inventories                                    |   | 18,246                           | 17,570                                    |                                      | 35,816                        |
| Intercompany receivables                       | 23,675  |                                  |   | (23,675)                             |                               |
| Note receivable from affiliate                 | 17,297  |                                  |   | (17,297)                             |                               |
| Prepaid expenses and other                     | 7,742   | 4,126                            | 3,648                                     |                                      | 15,516                        |
| <b>Total current assets</b>                    | <b>48,714</b>                                     | <b>124,260</b>                   | <b>85,379</b>                             | <b>(40,980)</b>                      | <b>217,373</b>                |
| Property and equipment, net                    |   | 489,567                          | 204,473                                   |                                      | 694,040                       |
| Goodwill                                       |   | 136,025                          | 1,523                                     |                                      | 137,548                       |
| Other intangible assets, net                   | 517   | 30,122                           | 31  |                                      | 30,670                        |
| Debt issuance costs, net                       | 12,774  |                                  |   |                                      | 12,774                        |
| Note receivable from affiliates                | 13,428  |                                  |   | (13,428)                             |                               |
| Investments in affiliates                      | 892,308   |                                  |   | (892,308)                            |                               |
| Note receivable                                | 40,000  |                                  |   |                                      | 40,000                        |
| Other assets                                   | 9,830   | 26,510                           | 5,132                                     |                                      | 41,472                        |
| <b>Total Assets</b>                            | <b>\$ 1,017,571</b>                               | <b>\$ 806,484</b>                | <b>\$ 296,538</b>                         | <b>\$ (946,716)</b>                  | <b>\$ 1,173,877</b>           |
| <b>Liabilities and Stockholders<br/>Equity</b> |   |                                  |   |                                      |                               |
| Current maturities of long-term debt           | \$ 782  | \$ 2,388                         | \$ 5,649                                  | \$                                   | \$ 8,819                      |
| Trade accounts payable                         |   | 22,491                           | 31,571                                    | (8)                                  | 54,054                        |
| Accrued salaries, benefits and payroll taxes   |   | 4,767                            | 15,296                                    |                                      | 20,063                        |
| Accrued interest                               | 6,780   | 23                               | 171                                       |                                      | 6,974                         |
| Accrued expenses                               | 973   | 16,641                           | 14,905                                    |                                      | 32,519                        |
| Intercompany payables                          |   | 380,208                          | 1,185                                     | (381,393)                            |                               |
| Note payable to affiliate                      |   |                                  | 17,297                                    | (17,297)                             |                               |
| <b>Total current liabilities</b>               | <b>8,535</b>                                      | <b>426,518</b>                   | <b>86,074</b>                             | <b>(398,698)</b>                     | <b>122,429</b>                |
| Long-term debt, net of current maturities      | 543,500   |                                  | 17,460                                    |                                      | 560,960                       |
| Note payable to affiliate                      |   |                                  | 13,428                                    | (13,428)                             |                               |
| Deferred income taxes                          | 13,369  | 13,695                           | 8,616                                     |                                      | 35,680                        |
| Other long-term liabilities                    |   | 75                               | 2,566                                     |                                      | 2,641                         |

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|   |              |            |            |              |              |
|---|--------------|------------|------------|--------------|--------------|
| Total liabilities                         | 565,404      | 440,288    | 128,144    | (412,126)    | 721,710      |
| Commitments and contingencies             |              |            |            |              |              |
| <b>Stockholders Equity</b>                |              |            |            |              |              |
| Common stock                              | 355          | 3,526      | 42,963     | (46,489)     | 355          |
| Capital in excess of par value            | 333,009      | 167,508    | 74,969     | (242,477)    | 333,009      |
| Retained earnings                         | 118,803      | 195,162    | 50,462     | (245,624)    | 118,803      |
| Total stockholders equity                 | 452,167      | 366,196    | 168,394    | (534,590)    | 452,167      |
| Total liabilities and stockholders equity | \$ 1,017,571 | \$ 806,484 | \$ 296,538 | \$ (946,716) | \$ 1,173,877 |

**Table of Contents****ALLIS-CHALMERS ENERGY INC.****NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**  
**CONDENSED CONSOLIDATING INCOME STATEMENTS**

For the Nine Months Ended September 30, 2008 (unaudited)

|   | <b>Allis-Chalmers<br/>(Parent/<br/>Guarantor)</b> | <b>Subsidiary<br/>Guarantors</b> | <b>Subsidiary<br/>Non-<br/>Guarantors</b> | <b>Consolidating<br/>Adjustments</b> | <b>Consolidated<br/>Total</b> |
|---|---|----------------------------------|---|--------------------------------------|-------------------------------|
| Revenues                                  | \$  | \$ 283,961                       | \$ 210,640                                | \$ (19)                              | \$ 494,582                    |
| Cost of revenues                          |   |                                  |   |                                      |                               |
| Direct costs                              |   | 158,887                          | 162,973                                   | (19)                                 | 321,841                       |
| Depreciation                              |   | 35,070                           | 10,258                                    |                                      | 45,328                        |
| Gross margin                              |   | 90,004                           | 37,409                                    |                                      | 127,413                       |
| General and administrative                | 5,480   | 30,814                           | 7,788                                     |                                      | 44,082                        |
| Gain on asset dispositions                |   | (166)                            |   |                                      | (166)                         |
| Amortization                              | 35  | 3,154                            | 25  |                                      | 3,214                         |
| Income (loss) from operations             | (5,515)   | 56,202                           | 29,596                                    |                                      | 80,283                        |
| Other income (expense):                   |   |                                  |   |                                      |                               |
| Equity earnings in affiliates, net of tax | 67,898  |                                  |   | (67,898)                             |                               |
| Interest, net                             | (31,520)  | 62                               | (638)                                     |                                      | (32,096)                      |
| Other                                     | 57  | 97                               | 437                                       |                                      | 591                           |
| Total other income (expense)              | 36,435  | 159                              | (201)                                     | (67,898)                             | (31,505)                      |
| Net income (loss) before income taxes     | 30,920  | 56,361                           | 29,395                                    | (67,898)                             | 48,778                        |
| Provision for income taxes                |   | (7,329)                          | (10,529)                                  |                                      | (17,858)                      |
| Net income (loss)                         | \$ 30,920   | \$ 49,032                        | \$ 18,866                                 | \$ (67,898)                          | \$ 30,920                     |

**Table of Contents****ALLIS-CHALMERS ENERGY INC.****NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**  
**CONDENSED CONSOLIDATING INCOME STATEMENTS**

For the Three Months Ended September 30, 2008 (unaudited)

|   | <b>Allis-Chalmers<br/>(Parent/<br/>Guarantor)</b> | <b>Subsidiary<br/>Guarantors</b> | <b>Subsidiary<br/>Non-<br/>Guarantors</b> | <b>Consolidating<br/>Adjustments</b> | <b>Consolidated<br/>Total</b> |
|---|---|----------------------------------|---|--------------------------------------|-------------------------------|
| Revenues                                  | \$  | \$ 100,510                       | \$ 77,761                                 | \$ (6)                               | \$ 178,265                    |
| Cost of revenues                          |   |                                  |   |                                      |                               |
| Direct costs                              |   | 57,642                           | 59,973                                    | (6)                                  | 117,609                       |
| Depreciation                              |   | 11,903                           | 3,698                                     |                                      | 15,601                        |
| Gross margin                              |   | 30,965                           | 14,090                                    |                                      | 45,055                        |
| General and administrative                | 1,590   | 10,826                           | 2,745                                     |                                      | 15,161                        |
| Gain on asset dispositions                |   | (166)                            |   |                                      | (166)                         |
| Amortization                              | 12  | 1,007                            | 8   |                                      | 1,027                         |
| Income (loss) from operations             | (1,602)   | 19,298                           | 11,337                                    |                                      | 29,033                        |
| Other income (expense):                   |   |                                  |   |                                      |                               |
| Equity earnings in affiliates, net of tax | 24,198  |                                  |   | (24,198)                             |                               |
| Interest, net                             | (10,299)  | 2                                | (412)                                     |                                      | (10,709)                      |
| Other                                     | 15  | 73                               | 27  |                                      | 115                           |
| Total other income (expense)              | 13,914  | 75                               | (385)                                     | (24,198)                             | (10,594)                      |
| Net income (loss) before income taxes     | 12,312  | 19,373                           | 10,952                                    | (24,198)                             | 18,439                        |
| Provision for income taxes                |   | (2,880)                          | (3,247)                                   |                                      | (6,127)                       |
| Net income (loss)                         | \$ 12,312   | \$ 16,493                        | \$ 7,705                                  | \$ (24,198)                          | \$ 12,312                     |

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**ALLIS-CHALMERS ENERGY INC.**  
**NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**  
**CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOW**

For the Nine Months Ended September 30, 2008 (unaudited)

|  | Allis-<br>Chalmers<br>(Parent/<br>Guarantor) | Subsidiary<br>Guarantor | Other<br>Subsidiaries<br>(Non-<br>Consolidating<br>Guarantor) | Adjustments | Consolidated<br>Total |
|--|--|-------------------------|---|-------------|-----------------------|
| <b>Cash Flows from Operating Activities:</b>   |  |                         |   |             |                       |
| Net income (loss)  | \$ 30,920                                    | \$ 49,032               | \$ 18,866   | \$ (67,898) | \$ 30,920             |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |  |                         |   |             |                       |
| Depreciation and amortization  | 35   | 38,224                  | 10,283  |             | 48,542                |
| Amortization and write-off of deferred financing fees                                    | 1,563  |                         |   |             | 1,563                 |
| Stock based compensation   | 6,212  |                         |   |             | 6,212                 |
| Allowance for bad debts  |  | 1,505                   |   |             | 1,505                 |
| Equity earnings in affiliates  | (67,898)                                     |                         |   | 67,898      |                       |
| Deferred taxes   | 4,708  | (108)                   | (285)   |             | 4,315                 |
| Gain on sale of property and equipment   |  | (1,097)                 | (109)   |             | (1,206)               |
| Gain on asset dispositions   |  | (166)                   |   |             | (166)                 |
| Changes in operating assets and liabilities, net of acquisitions:                        |  |                         |   |             |                       |
| (Increase) in trade receivables  |  | (14,627)                | (16,015)  |             | (30,642)              |
| (Increase) in inventories  |  | (5,901)                 | (1,060)   |             | (6,961)               |
| (Increase) decrease in prepaid expenses and other current assets                         | (8)  | 1,319                   | (767)   |             | 544                   |
| (Increase) decrease in other assets  | (4,073)                                      | 1,034                   | 768   |             | (2,271)               |
| Increase in trade accounts payable   |  | 5,673                   | 10,917  |             | 16,590                |
| (Decrease) increase in accrued interest  | (10,929)                                     | (10)                    | 96  |             | (10,843)              |
| (Decrease) increase in accrued expenses  | (687)  | 9,623                   | 3,147   |             | 12,083                |
| Increase in accrued salaries, benefits and payroll taxes                                 |  | 1,055                   | 3,725   |             | 4,780                 |
| (Decrease) in other long- term liabilities   | (31)   | (167)                   | (484)   |             | (682)                 |
| Net Cash Provided By (Used In) Operating Activities                                      | (40,188)                                     | 85,389                  | 29,082  |             | 74,283                |
| <b>Cash Flows from Investing Activities:</b>   |  |                         |   |             |                       |
| Notes receivable from affiliates   | (6,075)                                      |                         |   | 6,075       |                       |
| Investment in note receivable  | (40,000)                                     |                         |   |             | (40,000)              |
| Deposits on asset commitments  |  | (19,544)                | 10,325  |             | (9,219)               |
| Purchase of investment interests   | (5,742)                                      | (21)                    |   |             | (5,763)               |
| Proceeds from sale of property and equipment   |  | 5,738                   | 266   |             | 6,004                 |
| Proceeds from asset disposition  |  | 3,000                   |   |             | 3,000                 |
| Purchase of property and equipment   |  | (52,560)                | (65,275)  |             | (117,835)             |
| Net Cash Provided By (Used in) Investing Activities                                      | (51,817)                                     | (63,387)                | (54,684)  | 6,075       | (163,813)             |



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**ALLIS-CHALMERS ENERGY INC.**  
**NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**  
**CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOW**

For the Nine Months Ended September 30, 2008 (unaudited)

|  | <b>Allis-<br/>Chalmers<br/>(Parent/<br/>Guarantor)</b> | <b>Subsidiary<br/>Guarantors</b> | <b>Other<br/>Subsidiaries<br/>(Non-<br/>Guarantors)</b> | <b>Consolidating<br/>Adjustments</b> | <b>Consolidated<br/>Total</b> |
|--|--|----------------------------------|---|--------------------------------------|-------------------------------|
| <b>Cash Flows from Financing Activities:</b>               |  |                                  |   |                                      |                               |
| Accounts receivable from affiliates                        | 52,908   |                                  |   | (52,908)                             |                               |
| Accounts payable to affiliates                             |  | (52,908)                         |   | 52,908                               |                               |
| Note payable to affiliate                                  |  |                                  | 6,075   | (6,075)                              |                               |
| Proceeds from exercises of options                         | 633  |                                  |   |                                      | 633                           |
| Proceeds from long-term debt                               |  |                                  | 20,001  |                                      | 20,001                        |
| Net borrowing under line of credit                         | 38,500   |                                  |   |                                      | 38,500                        |
| Payments on long-term debt                                 |  | (4,633)                          | (1,818)   |                                      | (6,451)                       |
| Tax benefit on stock-based compensation plans              | 73   |                                  |   |                                      | 73                            |
| Debt issuance costs  | (109)  |                                  |   |                                      | (109)                         |
| <b>Net Cash Provided By (Used In) Financing Activities</b> | <b>92,005</b>  | <b>(57,541)</b>                  | <b>24,258</b>   | <b>(6,075)</b>                       | <b>52,647</b>                 |
| <b>Net change in cash and cash equivalents</b>             |  | <b>(35,539)</b>                  | <b>(1,344)</b>  |                                      | <b>(36,883)</b>               |
| Cash and cash equivalents at beginning of year             |  | 41,176                           | 2,517   |                                      | 43,693                        |
| Cash and cash equivalents at end of period                 | \$   | \$ 5,637                         | \$ 1,173  | \$                                   | \$ 6,810                      |

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**ALLIS-CHALMERS ENERGY INC.**  
**NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**  
**CONDENSED CONSOLIDATING BALANCE SHEETS**

December 31, 2007

|  | <b>Allis-Chalmers<br/>(Parent/<br/>Guarantor)</b> | <b>Subsidiary<br/>Guarantors</b> | <b>Subsidiary<br/>Non-<br/>Guarantors</b> | <b>Consolidating<br/>Adjustments</b> | <b>Consolidated<br/>Total</b> |
|--|---|----------------------------------|---|--------------------------------------|-------------------------------|
| <b>Assets</b>                                  |   |                                  |   |                                      |                               |
| Cash and cash equivalents                      | \$  | \$ 41,176                        | \$ 2,517                                  | \$                                   | \$ 43,693                     |
| Trade receivables, net                         |   | 83,126                           | 46,973                                    | (5)                                  | 130,094                       |
| Inventories                                    |   | 15,699                           | 16,510                                    |                                      | 32,209                        |
| Intercompany receivables                       | 76,583  |                                  |   | (76,583)                             |                               |
| Note receivable from affiliate                 | 8,270   |                                  |   | (8,270)                              |                               |
| Prepaid expenses and other                     | 7,731   | 2,564                            | 1,603                                     |                                      | 11,898                        |
| <b>Total current assets</b>                    | <b>92,584</b>                                     | <b>142,565</b>                   | <b>67,603</b>                             | <b>(84,858)</b>                      | <b>217,894</b>                |
| Property and equipment, net                    |   | 477,055                          | 149,613                                   |                                      | 626,668                       |
| Goodwill                                       |   | 136,875                          | 1,523                                     |                                      | 138,398                       |
| Other intangible assets, net                   | 552   | 34,572                           | 56  |                                      | 35,180                        |
| Debt issuance costs, net                       | 14,228  |                                  |   |                                      | 14,228                        |
| Note receivable from affiliates                | 16,380  |                                  |   | (16,380)                             |                               |
| Investments in affiliates                      | 824,410   |                                  |   | (824,410)                            |                               |
| Other assets                                   | 15  | 4,977                            | 16,225                                    |                                      | 21,217                        |
| <b>Total Assets</b>                            | <b>\$ 948,169</b>                                 | <b>\$ 796,044</b>                | <b>\$ 235,020</b>                         | <b>\$ (925,648)</b>                  | <b>\$ 1,053,585</b>           |
| <b>Liabilities and Stockholders<br/>Equity</b> |   |                                  |   |                                      |                               |
| Current maturities of long-term debt           | \$ 32   | \$ 4,026                         | \$ 2,376                                  | \$                                   | \$ 6,434                      |
| Trade accounts payable                         |   | 16,815                           | 20,654                                    | (5)                                  | 37,464                        |
| Accrued salaries, benefits and payroll taxes   |   | 3,712                            | 11,571                                    |                                      | 15,283                        |
| Accrued interest                               | 17,709  | 33                               | 75  |                                      | 17,817                        |
| Accrued expenses                               | 1,660   | 7,127                            | 11,758                                    |                                      | 20,545                        |
| Intercompany payables                          |   | 433,116                          | 1,185                                     | (434,301)                            |                               |
| Note payable to affiliate                      |   |                                  | 8,270                                     | (8,270)                              |                               |
| <b>Total current liabilities</b>               | <b>19,401</b>                                     | <b>464,829</b>                   | <b>55,889</b>                             | <b>(442,576)</b>                     | <b>97,543</b>                 |
| Long-term debt, net of current maturities      | 505,750   |                                  | 2,550                                     |                                      | 508,300                       |
| Note payable to affiliate                      |   |                                  | 16,380                                    | (16,380)                             |                               |
| Deferred income taxes                          | 8,658   | 13,809                           | 7,623                                     |                                      | 30,090                        |
| Other long-term liabilities                    | 31  | 242                              | 3,050                                     |                                      | 3,323                         |
| <b>Total liabilities</b>                       | <b>533,840</b>                                    | <b>478,880</b>                   | <b>85,492</b>                             | <b>(458,956)</b>                     | <b>639,256</b>                |



Commitments and contingencies

**Stockholders Equity**

|                                |         |         |         |           |         |
|--------------------------------|---------|---------|---------|-----------|---------|
| Common stock                   | 351     | 3,526   | 42,963  | (46,489)  | 351     |
| Capital in excess of par value | 326,095 | 167,508 | 74,969  | (242,477) | 326,095 |
| Retained earnings              | 87,883  | 146,130 | 31,596  | (177,726) | 87,883  |
| Total stockholders equity      | 414,329 | 317,164 | 149,528 | (466,692) | 414,329 |

|   |            |            |            |              |              |
|---|------------|------------|------------|--------------|--------------|
| Total liabilities and stockholders equity | \$ 948,169 | \$ 796,044 | \$ 235,020 | \$ (925,648) | \$ 1,053,585 |
|---|------------|------------|------------|--------------|--------------|

**Table of Contents****ALLIS-CHALMERS ENERGY INC.****NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**  
**CONDENSED CONSOLIDATING INCOME STATEMENTS**

For the Nine Months Ended September 30, 2007 (unaudited)

|   | <b>Allis-Chalmers<br/>(Parent/<br/>Guarantor)</b> | <b>Subsidiary<br/>Guarantors</b> | <b>Subsidiary<br/>Non-<br/>Guarantors</b> | <b>Consolidating<br/>Adjustments</b> | <b>Consolidated<br/>Total</b> |
|---|---|----------------------------------|---|--------------------------------------|-------------------------------|
| Revenues                                  | \$  | \$ 266,883                       | \$ 160,295                                | \$ (35)                              | \$ 427,143                    |
| Cost of revenues                          |   |                                  |   |                                      |                               |
| Direct costs                              |   | 134,492                          | 115,486                                   | (35)                                 | 249,943                       |
| Depreciation                              |   | 28,929                           | 8,303                                     |                                      | 37,232                        |
| Gross margin                              |   | 103,462                          | 36,506                                    |                                      | 139,968                       |
| General and administrative                | 1,856   | 33,486                           | 6,387                                     |                                      | 41,729                        |
| Gain on asset dispositions                |   | (8,868)                          |   |                                      | (8,868)                       |
| Amortization                              | 35  | 2,955                            | 25  |                                      | 3,015                         |
| Income from operations                    | (1,891)   | 75,889                           | 30,094                                    |                                      | 104,092                       |
| Other income (expense):                   |   |                                  |   |                                      |                               |
| Equity earnings in affiliates, net of tax | 82,864  |                                  |   | (82,864)                             |                               |
| Interest, net                             | (36,356)  | 2,364                            | (961)                                     |                                      | (34,953)                      |
| Other                                     | 39  | 224                              | 45  |                                      | 308                           |
| Total other income (expense)              | 46,547  | 2,588                            | (916)                                     | (82,864)                             | (34,645)                      |
| Net income before income taxes            | 44,656  | 78,477                           | 29,178                                    | (82,864)                             | 69,447                        |
| Provision for income taxes                |   | (15,069)                         | (9,722)                                   |                                      | (24,791)                      |
| Net income                                | \$ 44,656   | \$ 63,408                        | \$ 19,456                                 | \$ (82,864)                          | \$ 44,656                     |

**Table of Contents****ALLIS-CHALMERS ENERGY INC.****NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**  
**CONDENSED CONSOLIDATING INCOME STATEMENTS**

For the Three Months Ended September 30, 2007 (unaudited)

|  | <b>Allis-Chalmers<br/>(Parent/<br/>Guarantor)</b> | <b>Subsidiary<br/>Guarantors</b> | <b>Subsidiary<br/>Non-<br/>Guarantors</b> | <b>Consolidating<br/>Adjustments</b> | <b>Consolidated<br/>Total</b> |
|--|---|----------------------------------|---|--------------------------------------|-------------------------------|
| Revenues                                     | \$  | \$ 89,343                        | \$ 58,546                                 | \$ (8)                               | \$ 147,881                    |
| Cost of revenues                             |   |                                  |   |                                      |                               |
| Direct costs                                 |   | 45,943                           | 43,185                                    | (8)                                  | 89,120                        |
| Depreciation                                 |   | 10,296                           | 2,872                                     |                                      | 13,168                        |
| Gross margin                                 |   | 33,104                           | 12,489                                    |                                      | 45,593                        |
| General and administrative                   | 839   | 10,398                           | 2,219                                     |                                      | 13,456                        |
| Amortization                                 | 12  | 969                              | 8   |                                      | 989                           |
| Income from operations                       | (851)   | 21,737                           | 10,262                                    |                                      | 31,148                        |
| Other income (expense):                      |   |                                  |   |                                      |                               |
| Equity earnings in affiliates, net<br>of tax | 25,235  |                                  |   | (25,235)                             |                               |
| Interest, net                                | (11,411)  | 736                              | (279)                                     |                                      | (10,954)                      |
| Other  | 14  | 109                              | (91)                                      |                                      | 32                            |
| Total other income (expense)                 | 13,838  | 845                              | (370)                                     | (25,235)                             | (10,922)                      |
| Net income before income taxes               | 12,987  | 22,582                           | 9,892                                     | (25,235)                             | 20,226                        |
| Provision for income taxes                   |   | (4,057)                          | (3,182)                                   |                                      | (7,239)                       |
| Net income                                   | \$ 12,987   | \$ 18,525                        | \$ 6,710                                  | \$ (25,235)                          | \$ 12,987                     |

**Table of Contents****ALLIS-CHALMERS ENERGY INC.****NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**  
**CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOW**

For the Nine Months Ended September 30, 2007 (unaudited)

|   | <b>Allis-<br/>Chalmers<br/>(Parent/<br/>Guarantor)</b> | <b>Subsidiary<br/>Guarantors</b> | <b>Other<br/>Subsidiaries<br/>(Non-<br/>Guarantors)</b> | <b>Consolidating<br/>Adjustments</b> | <b>Consolidated<br/>Total</b> |
|---|--|----------------------------------|---|--------------------------------------|-------------------------------|
| <b>Cash Flows from Operating Activities:</b>                                      |  |                                  |   |                                      |                               |
| Net income  | \$ 44,656  | \$ 63,408                        | \$ 19,456   | \$ (82,864)                          | \$ 44,656                     |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |                                  |   |                                      |                               |
| Depreciation and amortization   | 35   | 31,884                           | 8,328   |                                      | 40,247                        |
| Amortization and write-off of deferred financing fees                             | 2,686  |                                  |   |                                      | 2,686                         |
| Stock-based compensation  | 2,132  |                                  |   |                                      | 2,132                         |
| Allowance for bad debts   |  | 441                              |   |                                      | 441                           |
| Equity earnings in affiliates   | (82,864)   |                                  |   | 82,864                               |                               |
| Deferred taxes  | 2,907  |                                  | 235   |                                      | 3,142                         |
| Gain on sale of property and equipment  |  | (1,011)                          | (74)  |                                      | (1,085)                       |
| Gain on asset dispositions  |  | (8,868)                          |   |                                      | (8,868)                       |
| Changes in operating assets and liabilities, net of acquisitions:                 |  |                                  |   |                                      |                               |
| (Increase) in trade receivables   |  | (21,966)                         | (14,835)  |                                      | (36,801)                      |
| (Increase) in inventories   |  | (4,022)                          | (976)   |                                      | (4,998)                       |
| (Increase) decrease in prepaid expenses and other current assets                  | 286  | 11,570                           | (1,305)   |                                      | 10,551                        |
| (Increase) decrease in other assets   | 234  | (22)                             | (39)  |                                      | 173                           |
| (Decrease) increase in trade accounts payable                                     | (31)   | (1,482)                          | 2,839   |                                      | 1,326                         |
| (Decrease) increase in accrued interest   | (5,050)  | 15                               | (58)  |                                      | (5,093)                       |
| Increase in accrued expenses  | 297  | 6,729                            | 2,931   |                                      | 9,957                         |
| (Decrease) increase in accrued salaries, benefits and payroll taxes               |  | (710)                            | 3,122   |                                      | 2,412                         |
| (Decrease) in other long- term liabilities  | (21)   | (47)                             |   |                                      | (68)                          |
| Net Cash Provided By (Used In) Operating Activities                               | (34,733)   | 75,919                           | 19,624  |                                      | 60,810                        |
| <b>Cash Flows from Investing Activities:</b>                                      |  |                                  |   |                                      |                               |
| Notes receivable from affiliates  | 1,540  |                                  |   | (1,540)                              |                               |
| Acquisition of businesses, net of cash received                                   |  | (12,860)                         |   |                                      | (12,860)                      |
| Purchase of investment interests  |  | (498)                            |   |                                      | (498)                         |
| Proceeds from asset disposition   |  | 16,250                           |   |                                      | 16,250                        |
| Proceeds from sale of property and equipment                                      |  | 5,910                            | 78  |                                      | 5,988                         |
| Purchase of property and equipment  |  | (69,212)                         | (16,875)  |                                      | (86,087)                      |
| Net Cash Provided By (Used in) Investing Activities                               | 1,540  | (60,410)                         | (16,797)  | (1,540)                              | (77,207)                      |



**Table of Contents****ALLIS-CHALMERS ENERGY INC.****NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)  
CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOW**

For the Nine Months Ended September 30, 2007 (unaudited)

|  | <b>Allis-<br/>Chalmers<br/>(Parent/<br/>Guarantor)</b> | <b>Subsidiary<br/>Guarantors</b> | <b>Other<br/>Subsidiaries<br/>(Non-<br/>Guarantors)</b> | <b>Consolidating<br/>Adjustments</b> | <b>Consolidated<br/>Total</b> |
|--|--|----------------------------------|---|--------------------------------------|-------------------------------|
| <b>Cash Flows from Financing<br/>Activities:</b>           |  |                                  |   |                                      |                               |
| Proceeds from long-term debt                               | 250,000  |                                  |   |                                      | 250,000                       |
| Payments on long-term debt                                 | (300,000)  | (4,942)                          | (2,600)   |                                      | (307,542)                     |
| Accounts receivable from<br>affiliates                     | (14,092)   |                                  |   | 14,092                               |                               |
| Accounts payable to affiliates                             |  | 12,924                           | 1,168   | (14,092)                             |                               |
| Note payable to affiliate                                  |  |                                  | (1,540)   | 1,540                                |                               |
| Proceeds from issuance of<br>common stock                  | 100,055  |                                  |   |                                      | 100,055                       |
| Proceeds from exercises of<br>options and warrants         | 3,252  |                                  |   |                                      | 3,252                         |
| Tax benefits on stock plans                                | 1,559  |                                  |   |                                      | 1,559                         |
| Debt issuance costs  | (7,581)  |                                  |   |                                      | (7,581)                       |
| <br>Net Cash Provided By (Used In)<br>Financing Activities | <br>33,193   | <br>7,982                        | <br>(2,972)   | <br>1,540                            | <br>39,743                    |
| <br>Net change in cash and cash<br>equivalents             |  | <br>23,491                       | <br>(145)   |                                      | <br>23,346                    |
| Cash and cash equivalents at<br>beginning of year          |  | 37,769                           | 1,976   |                                      | 39,745                        |
| <br>Cash and cash equivalents at end<br>of period          | <br>\$   | <br>\$ 61,260                    | <br>\$ 1,831  | <br>\$                               | <br>\$ 63,091                 |

**Table of Contents****ALLIS-CHALMERS ENERGY INC.****NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)****NOTE 11 SEGMENT INFORMATION**

On January 29, 2008, we created the positions of Senior Vice President Oilfield Services and Senior Vice President Rental Services. In conjunction with this organizational change, we reviewed the presentation of our reporting segments during the first quarter of 2008. Based on this review, we determined that our operational performance would be segmented and reviewed by the Oilfield Services, Drilling and Completion and Rental Services segments. The Oilfield Services segment includes our underbalanced drilling, directional drilling, tubular services and production services operations. The Drilling and Completion segment includes our international drilling operations. As a result, we realigned our financial reporting segments and now report the following operations as separate, distinct reporting segments: (1) Oilfield Services, (2) Drilling and Completion and (3) Rental Services. Our historical segment data previously reported for the three and nine months ended September 30, 2007 and year ended December 31, 2007 have been restated to conform to the new presentation.

All of the segments provide services to the energy industry. The revenues, operating income (loss), depreciation and amortization, capital expenditures and assets of each of the reporting segments, plus the corporate function, are reported below (in thousands):

|                                       | <b>For the Three Months<br/>Ended<br/>September 30,</b> |             | <b>For the Nine Months<br/>Ended<br/>September 30,</b> |             |
|---------------------------------------|---|-------------|--|-------------|
|                                       | <b>2008</b>   | <b>2007</b> | <b>2008</b>  | <b>2007</b> |
| <b>Revenues</b>                       |   |             |  |             |
| Oilfield Services                     | \$ 73,390   | \$ 60,432   | \$ 209,946   | \$ 173,985  |
| Drilling and Completion               | 77,761  | 58,546      | 210,640  | 160,295     |
| Rental Services                       | 27,114  | 28,903      | 73,996   | 92,863      |
|                                       | \$ 178,265  | \$ 147,881  | \$ 494,582   | \$ 427,143  |
| <b>Operating Income (Loss):</b>       |   |             |  |             |
| Oilfield Services                     | \$ 13,831   | \$ 11,782   | \$ 40,218  | \$ 44,069   |
| Drilling and Completion               | 11,337  | 10,262      | 29,596   | 30,094      |
| Rental Services                       | 8,545   | 12,519      | 24,033   | 41,212      |
| General corporate                     | (4,680)   | (3,415)     | (13,564)   | (11,283)    |
|                                       | \$ 29,033   | \$ 31,148   | \$ 80,283  | \$ 104,092  |
| <b>Depreciation and Amortization:</b> |   |             |  |             |
| Oilfield Services                     | \$ 6,101  | \$ 4,301    | \$ 17,692  | \$ 11,966   |
| Drilling and Completion               | 3,706   | 2,880       | 10,283   | 8,328       |
| Rental Services                       | 6,699   | 6,841       | 20,163   | 19,592      |
| General corporate                     | 122   | 135         | 404  | 361         |
|                                       | \$ 16,628   | \$ 14,157   | \$ 48,542  | \$ 40,247   |

**Capital Expenditures:**

|                         |           |           |            |           |
|-------------------------|-----------|-----------|------------|-----------|
| Oilfield Services       | \$ 11,782 | \$ 15,615 | \$ 35,599  | \$ 37,469 |
| Drilling and Completion | 25,782    | 11,005    | 65,476     | 16,875    |
| Rental Services         | 5,594     | 12,174    | 16,700     | 31,056    |
| General corporate       | 14        | 112       | 60         | 687       |
|                         | \$ 43,172 | \$ 38,906 | \$ 117,835 | \$ 86,087 |



**Table of Contents****ALLIS-CHALMERS ENERGY INC.****NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

|                           | As of  |                      |   |             |
|---------------------------|--|----------------------|---|-------------|
|                           | September<br>30,<br>2008   | December 31,<br>2007 |   |             |
| <b>Goodwill:</b>          |  |                      |   |             |
| Oilfield Services         | \$ 29,643  | \$ 30,493            |   |             |
| Drilling and Completion   | 1,523  | 1,523                |   |             |
| Rental Services           | 106,382  | 106,382              |   |             |
|                           | \$ 137,548   | \$ 138,398           |   |             |
| <b>Assets:</b>            |  |                      |   |             |
| Oilfield Services         | \$ 334,052   | \$ 299,300           |   |             |
| Drilling and Completion   | 316,281  | 235,020              |   |             |
| Rental Services           | 445,013  | 454,216              |   |             |
| General corporate         | 78,531   | 65,049               |   |             |
|                           | \$ 1,173,877   | \$ 1,053,585         |   |             |
| <b>Long Lived Assets:</b> |  |                      |   |             |
| United States             | \$ 673,991   | \$ 655,513           |   |             |
| International             | 282,513  | 180,178              |   |             |
|                           | \$ 956,504   | \$ 835,691           |   |             |
|                           | <b>For the Three Months<br/>Ended<br/>September 30,<br/>2008</b> | <b>2007</b>          | <b>For the Nine Months<br/>Ended<br/>September 30,<br/>2008</b> | <b>2007</b> |
| <b>Revenues:</b>          |  |                      |   |             |
| United States             | \$ 96,600  | \$ 85,160            | \$ 269,542  | \$ 255,626  |
| International             | 81,665   | 62,721               | 225,040   | 171,517     |
|                           | \$ 178,265   | \$ 147,881           | \$ 494,582  | \$ 427,143  |

**NOTE 12 SUPPLEMENTAL CASH FLOW INFORMATION****For the Nine Months  
Ended**

|  | <b>September 30,</b> |             |
|--|----------------------|-------------|
|  | <b>2008</b>          | <b>2007</b> |
| Cash paid for interest and income taxes:                   |                      |             |
| Interest   | \$ 45,904            | \$ 40,493   |
| Income taxes   | 16,564               | 8,639       |
| Non-cash financing activities:                             |                      |             |
| Insurance premium financed                                 | \$ 2,995             | \$ 4,434    |
| Note payable issued for acquisition of business            |                      | 1,100       |
| Non-cash transaction in connection with asset disposition: |                      |             |
| Value on goodwill and other intangibles disposed           | \$ 2,246             | \$          |
| Value of inventory financed                                | 509                  |             |
| Value of property and equipment disposed                   | 337                  |             |
| Accrued expenses   | 10                   |             |
| Fair value of note receivable                              | \$ 3,102             | \$          |

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**ALLIS-CHALMERS ENERGY INC.**

**NOTES TO UNAUDITED CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

**NOTE 13 LEGAL MATTERS**

We are named from time to time in legal proceedings related to our activities prior to our bankruptcy in 1988.

However, we believe that we were discharged from liability for all such claims in the bankruptcy and believe the likelihood of a material loss relating to any such legal proceeding is remote.

We have been named as a defendant in three lawsuits in connection with our attempted merger with Bronco Drilling Company, Inc. We do not believe that the suits have any merit.

We are also involved in various other legal proceedings in the ordinary course of business. The legal proceedings are at different stages; however, we believe that the likelihood of material loss relating to any such legal proceeding is remote.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion and analysis should be read in conjunction with our consolidated financial statements and the notes thereto included elsewhere in this report. This report contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from the results discussed in such forward-looking statements. Factors that might cause such differences include, but are not limited to, the general condition of the oil and natural gas drilling industry, demand for our oil and natural gas service and rental products, and competition. For more information on forward-looking statements please refer to the section entitled "Forward-Looking Statements" on page 38.*

**Overview of Our Business**

We are a multi-faceted oilfield services company that provides services and equipment to oil and natural gas exploration and production companies, throughout the United States including Texas, Louisiana, New Mexico, Colorado, Oklahoma, Mississippi, Wyoming, Arkansas, West Virginia, offshore in the Gulf of Mexico and internationally primarily in Argentina and Mexico. We currently operate in three sectors of the oil and natural gas service industry: Oilfield Services; Drilling and Completion and Rental Services.

We derive operating revenues from rates per day and rates per job that we charge for the labor and equipment required to provide a service and rates per day for equipment and tools that we rent to our customers. The price we charge for our services depends upon several factors, including the level of oil and natural gas drilling activity and the competitive environment in the particular geographic regions in which we operate. Contracts are awarded based on price, quality of service and equipment, and the general reputation and experience of our personnel. The demand for drilling services has historically been volatile and is affected by the capital expenditures of oil and natural gas exploration and development companies, which can fluctuate based upon the prices of oil and natural gas, or the expectation for the prices of oil and natural gas.

The number of working drilling rigs, typically referred to as the rig count, is an important indicator of activity levels in the oil and natural gas industry. The rig count in the United States increased from 862 as of December 31, 2002, to 1,782 as of December 31, 2007 and to 1,964 on October 24, 2008, according to the Baker Hughes rig count. Furthermore, directional and horizontal rig counts increased from 283 as of December 31, 2002 to 1,024 on October 24, 2008, which accounted for 32.8% and 52.1% of the total U.S. rig count, respectively. During the same period, however, the offshore Gulf of Mexico rig count decreased 35.2% to 70 rigs on October 24, 2008 compared to 108 rigs at December 31, 2002. Beginning in the second half of 2007 many oil and gas operators mobilized drilling rigs to the international markets.

Our cost of revenues represents all direct and indirect costs associated with the operation and maintenance of our equipment. The principal elements of these costs are direct and indirect labor and benefits, repairs and maintenance of our equipment, insurance, equipment rentals, fuel and depreciation. Operating expenses do not fluctuate in direct proportion to changes in revenues because, among other factors, we have a fixed base of inventory of equipment and facilities to support our operations, and in periods of low drilling activity we may also seek to preserve labor continuity to market our services and maintain our equipment.

**Cyclical Nature of Equipment Rental and Services Industry**

The oilfield services industry is highly cyclical. The most critical factor in assessing the outlook for the industry is the worldwide supply and demand for oil and the domestic supply and demand for natural gas. The peaks and valleys of demand are further apart than those of many other cyclical industries. This is primarily a result of the industry being driven by commodity demand and corresponding price increases. As demand increases, producers raise their prices. The price escalation enables producers to increase their capital expenditures. The increased capital expenditures ultimately result in greater revenues and profits for services and equipment companies. The increased capital expenditures also ultimately result in greater production, which historically has resulted in increased supplies and reduced prices.

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**Company Outlook**

We believe the level of our revenues are sustainable dependent on a favorable oil and natural gas price environment, a stable rig count and the level of capital expenditures of our customers. All of our segments experienced an increase in revenues for the three months ended September 30, 2008 compared to the three months ended June 30, 2008, Drilling and Completion revenue increased \$7.9 million, Oilfield Services increased \$4.7 million and Rental Services increased \$2.5 million. We expect our Rental Services revenues to continue to improve as we develop new markets for our equipment. Our gross margin for the three months ended September 30, 2008 compared to the three months ended June 30, 2008, increased \$2.0 million for our Drilling and Completion segment, and increased \$333,000 for our Oilfield Services segment while our Rental Services segment had a \$184,000 decrease in gross margin. We believe the increases in margin for our Drilling and Completion and our Oilfield Services segments are sustainable as we project utilization of our equipment to remain strong for the remainder of 2008. We believe the decrease in our Rental Services segment gross margin was somewhat impacted by Hurricanes Gustav and Ike. We expect our general and administrative and amortization expenses to remain stable throughout the balance of 2008, absent any significant acquisitions. Our net interest expense is dependent upon our level of debt and cash on hand, which are principally dependent on acquisitions we complete, our capital expenditures and our cash flows from operations.

The sustainability and future growth in our gross margin is principally dependent on our level of revenues and the pricing environment of our services. In addition, our sustainability and the demand for our services is dependent upon our customers' capital spending plans, which are largely driven by current commodity prices and their expectations of future commodity prices. Recent declines in both natural gas and oil prices may cause our customers to delay or curtail capital spending plans. In addition to the impact of the decline in natural gas prices on our customers' capital expenditures and overall liquidity, the recent credit crisis may limit the availability of funds, and therefore lead to decreased capital expenditures for our customers.

The global financial and credit crisis has reduced the availability of liquidity and credit to fund the continuation and expansion of industrial business operations worldwide. Although we do not expect the current economic climate to adversely affect our results for the fourth quarter of 2008, it is still too soon to predict to what extent current events will affect overall activity in 2009 and beyond, but a slowing in the rate of increase of customer spending is anticipated. The shortage of liquidity and credit combined with recent substantial losses in worldwide equity markets could lead to an extended global recession. A slowdown in economic activity caused by a recession would likely reduce demand for energy and result in lower oil and natural gas prices. Such a slowdown in economic activity would likely result in a corresponding decline in the demand for our equipment rental and other services, which could have a material adverse effect on our revenue and profitability. We are monitoring the credit worthiness of our customers, as well as outstanding receivable, in light of the current credit crisis.

In addition, many industry analysts are predicting a material decrease in the average rig count in the U.S. in 2009 due to the conditions in the credit markets, the economic slowdown and the decrease in natural gas prices. A significant decrease in the rig count will likely have an adverse impact on our operating results, particularly in the U.S. domestic market. We strive to mitigate cyclical risk through our international growth, by offering new equipment and technology to our customers and our focus on the U.S. land shale plays.

**Results of Operations**

In June 2007, we acquired all of the outstanding stock of Coker Directional, Inc., or Coker. In July 2007, we acquired all of the outstanding stock of Digger Tools, LLC, or Digger. In October 2007, we acquired all of the outstanding stock of Rebel Rentals, Inc., or Rebel. In November 2007, we acquired substantially all of the assets of Diamondback Oilfield Services, Inc., or Diamondback. We report the operations of Coker, Digger, Rebel and Diamondback in our Oilfield Services segment. We consolidated the results of these acquisitions from the day they were acquired.

In June 2007, we sold our capillary assets and effective August 1, 2008 we sold our drill pipe tong manufacturing assets. Both of these asset groups were part of our Oilfield Services segment.

The foregoing transactions affect the comparability from period to period of our historical results, and our historical results may not be indicative of our future results.

**Table of Contents****Comparison of Three Months Ended September 30, 2008 and 2007**

Our revenues for the three months ended September 30, 2008 were \$178.3 million, an increase of 20.5% compared to \$147.9 million for the three months ended September 30, 2007. The increase in revenues is due to the increase in revenues in our Oilfield Services and Drilling and Completion segments, partly offset by a decrease in revenues in our Rental Services segment. Revenues increased in our Oilfield Services segment by \$13.0 million in the third quarter of 2008 compared to the same period in the prior year due to our investment in new equipment in 2007 and in the first nine months of 2008, the opening of new operating locations and small acquisitions completed in the last half of 2007, which added downhole motors, measurement-while-drilling, or MWD tools, and directional drilling personnel.

Revenues increased in our Drilling and Completion segment by \$19.2 million in the third quarter of 2008 compared to the same period in the prior year due to increased pricing for our drilling and workover services in Argentina and the activation of eight new service rigs during the first quarter of 2008, two new service rigs during the second quarter of 2008 and six new service rigs and one drilling rig during the third quarter of 2008. Revenues decreased in our Rental Services segment by \$1.8 million in the third quarter of 2008 compared to the same period in the prior year due to the decrease in rental services from the Gulf of Mexico and a more competitive pricing environment, which was partially offset by increased rental revenues from domestic land activity and new international contracts.

Our gross margin for the quarter ended September 30, 2008 was \$45.1 million, or 25.3% of revenues, compared to \$45.6 million, or 30.8% of revenues, for the three months ended September 30, 2007. The decrease in gross profit is principally due to the decrease in Rental Services revenue, which has a higher gross margin percentage than our other segments. Our gross margin also decreased due to the increase in depreciation expense. Depreciation expense increased 18.5% to \$15.6 million for the third quarter of 2008 compared to \$13.2 million for the third quarter of 2007 due to additional depreciable assets resulting from capital expenditures and acquisitions. The decrease in gross profit as a percentage of revenues is primarily due to the decrease in revenue contribution and a more competitive pricing environment in our Rental Services segment and, higher wages and the significant increase in our labor force and labor related expenses in connection with the delivery of new rigs prior to their activation in our Drilling and Completion segment. Finally, the gross margin percentage for our Oilfield Services segment was adversely impacted by hurricanes in the third quarter of 2008. Our cost of revenues consists principally of our labor costs and benefits, equipment rentals, maintenance and repairs of our equipment, depreciation, insurance and fuel.

General and administrative expense was \$15.2 million in the three months ended September 30, 2008 compared to \$13.5 million for the three months ended September 30, 2007. We recorded an expense of \$1.8 million related to share-based compensation expense for the three months ended September 30, 2008 compared to \$1.0 million for the three months ended September 30, 2007. During the quarter ended September 30, 2008, we recorded bad debt expense of \$869,000 compared to \$231,000 in the same period in the prior year. The additional bad debt expense was booked to reflect the age of certain receivables. We also recorded \$600,000 of corporate bonus expense for the quarter ended September 30, 2008 compared to \$3,000 for the same period of 2007. As a percentage of revenues, general and administrative expenses decreased to 8.5% in the third quarter of 2008 compared to 9.1% in the third quarter of 2007. Effective August 1, 2008, we sold our drill pipe tong manufacturing assets that were acquired in our acquisition of Rogers Oil Tools, Inc., or Rogers, and that were part of our Oilfield Services segment. The total sale agreement was for \$7.5 million. We recognized a gain of \$166,000 related to the sale of these assets.

Amortization expense was \$1.0 million in the three months ended September 30, 2008 compared to \$989,000 in the three months ended September 30, 2007. The increase in amortization expense is due to the amortization of intangible assets in connection with our acquisitions in the later half of 2007.

Income from operations for the three months ended September 30, 2008 totaled \$29.0 million, a decrease of 6.8% compared to income from operations of \$31.1 million for the three months ended September 30, 2007, primarily due to the decrease in our gross margin in the third quarter of 2008 and the increase in our general and administrative expenses for the same period. Our income from operations as a percentage of revenues decreased to 16.3% for the third quarter of 2008, from 21.1% for the third quarter of 2007, due to the decrease in our gross margin as a percentage of revenues offset partially by the decrease in general and administrative expenses as a percentage of revenues.



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Our net interest expense was \$10.7 million in the three months ended September 30, 2008, compared to \$11.0 million for the three months ended September 30, 2007. Net interest expense decreased in the third quarter of 2008 due to an increase in interest income offset in part by an increase in our average outstanding debt. Our net interest expense includes interest income of \$1.5 million in the third quarter of 2008 from our \$40.0 million 15% subordinated convertible debenture due from BCH Ltd. which closed on January 31, 2008.

Our provision for income taxes for the three months ended September 30, 2008 was \$6.1 million, or 33.2% of our net income before income taxes, compared to \$7.2 million, or 35.8% of our net income before income taxes for the three months ended September 30, 2007. The decrease in our effective tax rate is primarily attributable to our Drilling and Completion operations, which had an effective tax rate of 29.6% for the three months ended September 30, 2008 compared to 32.2% for three months ended September 30, 2007. This decrease in effective tax rate percentage is attributable to the impact of currency exchange rates of the taxing jurisdictions compared to the currency rate of the U.S. dollar.

We had net income of \$12.3 million for the three months ended September 30, 2008, a decrease of 5.2% compared to net income of \$13.0 million for the three months ended September 30, 2007.

The following table compares revenues and income from operations for each of our business segments and loss of income for general corporate purposes. Income (loss) from operations consists of revenues less cost of revenues, general and administrative expenses, and depreciation and amortization:

|                         | Revenues<br>Three Months Ended<br>September 30, |            |                | Income (Loss) from Operations<br>Three Months Ended<br>September 30, |           |            |
|-------------------------|---|------------|----------------|--|-----------|------------|
|                         | 2008  | 2007       | Change         | 2008   | 2007      | Change     |
|                         |   |            | (in thousands) |  |           |            |
| Oilfield Services       | \$ 73,390                                       | \$ 60,432  | \$ 12,958      | \$ 13,831  | \$ 11,782 | \$ 2,049   |
| Drilling and Completion | 77,761  | 58,546     | 19,215         | 11,337   | 10,262    | 1,075      |
| Rental Services         | 27,114  | 28,903     | (1,789)        | 8,545  | 12,519    | (3,974)    |
| General corporate       |   |            |                | (4,680)  | (3,415)   | (1,265)    |
| Total                   | \$ 178,265                                      | \$ 147,881 | \$ 30,384      | \$ 29,033  | \$ 31,148 | \$ (2,115) |

**Oilfield Services**

Revenues were \$73.4 million for the three months ended September 30, 2008, an increase of 21.4% compared to \$60.4 million in revenues for the three months ended September 30, 2007. Our Oilfield Services segment revenues for the third quarter of 2008 increased compared to the third quarter of 2007 due primarily to our investment in new equipment in 2007 and the first nine months of 2008, including air-drilling compressors, foam units, casing and tubing tools and coiled tubing units. Results in the Oilfield Services segment also improved due to small acquisitions completed in the last half of 2007, which added downhole motors, MWD tools and directional drillers and enabled us to expand our directional drilling business in the Northern Rocky Mountains, the Mid-Continent and Northeast areas. Income from operations increased to \$13.8 million in the third quarter of 2008 compared to \$11.8 million in the third quarter of 2007.

**Drilling and Completion**

Revenues for the quarter ended September 30, 2008 for the Drilling and Completion segment were \$77.8 million, an increase of 32.8% compared to \$58.5 million in revenues for the quarter ended September 30, 2007. Income from operations increased to \$11.3 million in the third quarter of 2008 compared to \$10.3 million in the third quarter of 2007. Our Drilling and Completion segment revenues increased in the third quarter of 2008 due to increased pricing for our drilling and workover services in Argentina and the activation of eight new service rigs during the first quarter of 2008, two new service rigs during the second quarter of 2008 and six new service rigs and one new drilling rig during the third quarter of 2008. Operating income as a percentage of revenues for the third quarter of 2008 decreased



compared to the prior year. This was due primarily to higher wages, which included other payroll expenses, and the increase in administrative costs all relating to labor concessions in Argentina granted by the oil industry in the last half of 2007 and a significant increase in our labor force and labor-related expenses in connection with the delivery of new rigs prior to their activation.

**Table of Contents****Rental Services**

Revenues for the quarter ended September 30, 2008 for the Rental Services segment were \$27.1 million, a decrease from \$28.9 million in revenues for the quarter ended September 30, 2007. Income from operations decreased to \$8.5 million in the third quarter of 2008 compared to \$12.5 million in the third quarter of 2007. Our Rental Services segment revenues and operating income for the third quarter of 2008 decreased compared to the prior year due primarily to a more competitive pricing environment, and a decrease in rental services from the Gulf of Mexico, offset in part by increased rental revenues from domestic land drilling and new international contracts.

**General Corporate**

General corporate expenses for the quarter ended September 30, 2008 were \$4.7 million, an increase from \$3.4 million for the three months ended September 30, 2007. We recorded an expense of \$1.5 million related to share-based compensation expense at the general corporate level for the three months ended September 30, 2008 compared to \$717,000 for the three months ended September 30, 2007. We also recorded \$600,000 of corporate bonus expense for the quarter ended September 30, 2008 compared to \$3,000 for the same period of 2007.

**Comparison of Nine Months Ended September 30, 2008 and 2007**

Our revenues for the nine months ended September 30, 2008 were \$494.6 million, an increase of 15.8% compared to \$427.1 million for the nine months ended September 30, 2007. The increase in revenues is due to the increase in revenues in our Oilfield Services and Drilling and Completion segments, partly offset by a decrease in revenues in our Rental Services segment. Revenues for the nine months ended September 30, 2008 increased in our Oilfield Services segment by \$36.0 million compared to the same period in the prior year due to our investment in new equipment in 2007 and in 2008, the opening of new operating locations and small acquisitions completed in the last half of 2007 which added downhole motors, MWD tools and directional drilling personnel. Revenues for the nine months ended September 30, 2008 increased in our Drilling and Completion segment by \$50.3 million compared to the same period in the prior year due to increased pricing for our drilling and workover services in Argentina and the activation of eight new service rigs during the first quarter of 2008, two new service rigs in the second quarter of 2008 and six new service rigs and one drilling rig during the third quarter of 2008. Revenues for the nine months ended September 30, 2008 decreased in our Rental Services by \$18.9 million compared to the same period of the prior year, due to a more competitive pricing environment, and a decrease in rental services from the Gulf of Mexico.

Our gross margin for the nine months ended September 30, 2008 decreased to \$127.4 million, or 25.8% of revenues, compared to \$140.0 million, or 32.8%, of revenues for the nine months ended September 30, 2007. The decrease in gross profit is principally due to the decrease in Rental Services revenue. Our gross margin also decreased due to the increase in depreciation expense. The decrease in gross profit as a percentage of revenues is primarily due to the decrease in Rental Services revenues, the decrease in our gross margin percentage in our Drilling and Completion segment and the increase in depreciation expense. Depreciation expense increased 21.7% to \$45.3 million for the first nine months of 2008 compared to \$37.2 million for the first nine months of 2007 due to additional depreciable assets resulting from capital expenditures and acquisitions. The decrease in the gross margin percentage in our Drilling and Completion segment is due to higher wages and the impact of labor strikes and work slowdowns in the second quarter of 2008 as a result of the labor and political environment in Argentina and the significant increase in our labor force and labor related expenses in connection with the delivery of new rigs prior to their activation. Our cost of revenues consists principally of our labor costs and benefits, equipment rentals, maintenance and repairs of our equipment, depreciation, insurance and fuel.

General and administrative expense was \$44.1 million in the first nine months of 2008 compared to \$41.7 million for the first nine months of 2007. We recorded an expense of \$6.2 million related to share-based compensation expense for the nine months ended September 30, 2008 compared to \$2.1 million for the nine months ended September 30, 2007. The amount of share-based compensation expense recorded in general and administrative expense was \$6.2 million for the first nine months of 2008 and \$2.0 million for the first nine months of 2007 with the balance being recorded as a direct cost. As a percentage of revenues, general and administrative expenses decreased to 8.9% in the first nine months of 2008 compared to 9.8% in the first nine months of 2007.

Effective August 1, 2008, we sold our drill pipe tong manufacturing assets that were acquired in our acquisition of Rogers and that were part of our Oilfield Services segment. The total sale agreement was for \$7.5 million. We

recognized a gain of \$166,000 related to the sale of these assets. On June 29, 2007, we sold our capillary tubing assets that were part of our Oilfield Services segment. The total sale agreement was for \$16.3 million in cash. We recognized a gain of \$8.9 million related to the sale of these assets in the second quarter of 2007.

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Amortization expense was \$3.2 million in the first nine months of 2008 compared to \$3.0 million in the first nine months of 2007. The increase in amortization expense is due to the amortization of intangible assets in connection with our acquisitions completed in the second half of 2007.

Income from operations for the nine months ended September 30, 2008 totaled \$80.3 million, a decrease of 22.9% compared to income from operations of \$104.1 million for the nine months ended September 30, 2007, reflecting the decrease in our gross margin, the \$8.9 million gain from asset disposition in the second quarter of 2007 and increased general and administrative expenses. Our income from operations as a percentage of revenues decreased to 16.2% for the first nine months of 2008, from 24.4% for the first nine months of 2007, due to the \$8.9 million asset sale gain in the second quarter of 2007 and the decrease in our gross margin as a percentage of revenues offset partially by the decrease in general and administrative expenses as a percentage of revenues.

Our net interest expense was \$32.1 million in the first nine months of 2008, compared to \$35.0 million for the first nine months of 2007. Interest expense decreased in the first nine months of 2008 due to an increase in interest income, offset in part by an increase in our average outstanding debt. Our net interest expense includes interest income of \$4.0 million in the first nine months of 2008 from our \$40.0 million 15% subordinated convertible debenture due from BCH Ltd. which closed on January 31, 2008. In January 2007, we issued \$250.0 million of senior notes bearing interest at 8.5% to pay off, in part, the bridge loan utilized to complete the acquisition of the assets of Oil & Gas Rental Services, Inc., or OGR, and for working capital. The bridge loan was outstanding until January 29, 2007 and had an average interest rate of 10.6%. Interest expense for the first nine months of 2007 includes the write-off of deferred financing fees of \$1.2 million related to the repayment of the bridge loan.

Our provision for income taxes for the nine months ended September 30, 2008 was \$17.9 million, or 36.6% of our net income before income taxes, compared to \$24.8 million, or 35.7% of our net income before income taxes for the nine months ended September 30, 2007. The increase in our effective tax rate is primarily attributable to our Drilling and Completion operations, which had an effective tax rate of 35.8% for the nine months ended September 30, 2008 compared to 33.3% for the nine months ended September 30, 2007. This increase in effective tax rate percentage is attributable to the impact of currency exchange rates of the taxing jurisdictions compared to the currency rate of the U.S. dollar, as our Drilling and Completion segment operates primarily in Argentina. The effective tax rate for U.S. operations was 37.8% for the nine months ended September 30, 2008 compared to 37.4% for the same period in the prior year with the increase attributed to permanent differences such as non-deductible meals and entertainment. We had net income of \$30.9 million for the nine months ended September 30, 2008, a decrease of 30.8% compared to net income of \$44.7 million for the nine months ended September 30, 2007.

The following table compares revenues and income from operations for each of our business segments and loss of income for general corporate purposes. Income (loss) from operations consists of revenues less cost of revenues, general and administrative expenses, and depreciation and amortization:

|                         | Revenues                           |                   |                  | Income (Loss) from Operations      |                   |                    |
|-------------------------|------------------------------------|-------------------|------------------|------------------------------------|-------------------|--------------------|
|                         | Nine Months Ended<br>September 30, |                   |                  | Nine Months Ended<br>September 30, |                   |                    |
|                         | 2008                               | 2007              | Change           | 2008                               | 2007              | Change             |
|                         | (in thousands)                     |                   |                  |                                    |                   |                    |
| Oilfield Services       | \$ 209,946                         | \$ 173,985        | \$ 35,961        | \$ 40,218                          | \$ 44,069         | \$ (3,851)         |
| Drilling and Completion | 210,640                            | 160,295           | 50,345           | 29,596                             | 30,094            | (498)              |
| Rental Services         | 73,996                             | 92,863            | (18,867)         | 24,033                             | 41,212            | (17,179)           |
| General corporate       |                                    |                   |                  | (13,564)                           | (11,283)          | (2,281)            |
| <b>Total</b>            | <b>\$ 494,582</b>                  | <b>\$ 427,143</b> | <b>\$ 67,439</b> | <b>\$ 80,283</b>                   | <b>\$ 104,092</b> | <b>\$ (23,809)</b> |

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### **Oilfield Services**

Revenues were \$209.9 million for the nine months ended September 30, 2008, an increase of 20.7% compared to \$174.0 million in revenues for the nine months ended September 30, 2007. Our Oilfield Services segment revenues for the first nine months of 2008 increased compared to the first nine months of 2007 due primarily to our investment in new equipment in 2007 and in 2008, including air-drilling compressors, foam units, casing and tubing tools and coiled tubing units. Results in the Oilfield Services segment also improved due to small acquisitions completed in 2007, which added downhole motors, MWD tools and directional drillers, and enabled us to expand our directional drilling business in the Northern Rocky Mountains, the Mid-Continent and the Northeast areas. Income from operations decreased to \$40.2 million in the first nine months of 2008 compared to \$44.1 million in the first nine months of 2007 due to the \$8.9 million gain on the sale of capillary assets recognized in the three months ended June 30, 2007. Without this gain in the prior year, operating income would have increased period over period for the reasons enumerated above.

### **Drilling and Completion**

Revenues for the nine months ended September 30, 2008 for the Drilling and Completion segment were \$210.6 million, an increase from \$160.3 million in revenues for the nine months ended September 30, 2007. Our Drilling and Completion segment revenues increased in the first nine months of 2008 due to increased pricing for our drilling and workover services in Argentina and the activation of eight new service rigs during the first quarter of 2008, two new service rigs during the second quarter of 2008 and six new service rigs and one new drilling rig during the third quarter of 2008. Income from operations decreased to \$29.6 million in the first nine months of 2008 compared to \$30.1 million in the first nine months of 2007. The decrease in operating income was due primarily to higher wages, other payroll expenses and the increase in administrative costs, all relating to labor concessions in Argentina granted by the oil industry in the last half of 2007 and the impact of labor strikes and work slow-downs as a result of the labor and political environment in Argentina, which existed primarily during the second quarter of 2008. Additionally, operating income was also impacted by a significant increase in our labor force and labor-related expenses in connection with the delivery of new rigs prior to their activation.

### **Rental Services**

Revenues for the nine months ended September 30, 2008 for the Rental Services segment were \$74.0 million, a decrease from \$92.9 million in revenues for the nine months ended September 30, 2007. Income from operations decreased to \$24.0 million in the first nine months of 2008 compared to \$41.2 million in the first nine months of 2007. Our Rental Services segment revenues and operating income for the first nine months of 2008 decreased compared to the prior year due primarily to a more competitive pricing environment and a decrease in rental services from the Gulf of Mexico.

### **General Corporate**

General corporate expenses increased \$2.3 million to \$13.6 million for the nine months ended September 30, 2008 compared to \$11.3 million for the nine months ended September 30, 2007. We recorded an expense of \$5.3 million related to share-based compensation expense at the general corporate level for the nine months ended September 30, 2008 compared to \$1.6 million for the nine months ended September 30, 2007.

### **Liquidity and Capital Resources**

Our on-going capital requirements arise primarily from our need to service our debt, complete acquisitions, acquire and maintain equipment, and fund our working capital requirements. Our primary sources of liquidity are proceeds from the issuance of debt and equity securities and cash flows from operations. We had cash and cash equivalents of \$6.8 million at September 30, 2008 compared to \$43.7 million at December 31, 2007.

### **Operating Activities**

In the nine months ended September 30, 2008, our operating activities provided \$74.3 million in cash. Net income for the nine months ended September 30, 2008 was \$30.9 million. Non-cash expenses totaled \$60.8 million during the first nine months of 2008, consisting of \$48.5 million of depreciation and amortization, \$4.3 million for deferred income taxes related to timing differences, \$1.6 in amortization of deferred financing fees, \$6.2 million from the expensing of stock based compensation, \$1.5 million related to increases to the allowance for doubtful accounts receivables, less \$1.3 million on the gain from asset disposals.



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During the nine months ended September 30, 2008, changes in operating assets and liabilities used \$17.4 million in cash, principally due to an increase of \$30.6 million in accounts receivable, a decrease in accrued interest of \$10.8 million, an increase of \$7.0 million in inventories, an increase of \$2.3 million in other assets, offset in part by an increase of \$16.6 million in accounts payable, an increase of \$4.8 million in accrued salaries, benefits and payroll taxes and an increase of \$12.1 million in accrued expenses. Accounts receivable increased primarily due to the increase in our revenues in the first nine months of 2008. The decrease in accrued interest is due to the scheduled interest payments on our senior notes made in July and September. The increase in inventories is related to the additional supplies needed to support our increased revenue. The increase in other assets primarily relates to \$4.0 million of interest income on our \$40.0 million note receivable from BCH Ltd. offset by the sale of an investment in a partnership with a cost basis of \$1.4 million and reductions of \$756,000 of deferred mobilization costs and \$217,000 of oil and natural gas investments. The increase in accounts payable can be attributed to additional expenses related to the growth of our Drilling and Completion segment's rig fleet and our coiled tubing rig fleet. The increase in accrued salaries, benefits and payroll taxes is primarily related to a larger labor force and pay increases granted to our Drilling and Completion segment's workers based in Argentina due to labor negotiations in 2008 compared to 2007. The increase in accrued expenses is primarily related to additional operational activities and new capital expenditures in all three of our segments.

In the nine months ended September 30, 2007, our operating activities provided \$60.8 million in cash. Net income for the nine months ended September 30, 2007 was \$44.7 million. Net non-cash expenses totaled \$38.7 million during the first nine months of 2007 consisting of \$40.2 million of depreciation and amortization, \$3.1 million for deferred income taxes, \$2.7 million for the amortization and write-off of financing fees, \$2.1 million from the expensing of stock options, \$441,000 from increases to the allowance for doubtful accounts receivables, less \$10.0 million on the gain from asset disposals.

During the nine months ended September 30, 2007, changes in operating assets and liabilities used \$22.5 million in cash, principally due to an increase of \$36.8 million in accounts receivable, an increase of \$5.0 million in inventory, and a decrease of \$5.1 million in accrued interest, offset in part by a decrease in other current assets of \$10.6 million, an increase of \$1.3 million in accounts payable, an increase of \$10.0 million in accrued expenses and an increase in accrued salaries, benefits and payroll taxes of \$2.4 million. Accounts receivable increased primarily due to the increase in our revenues in the first nine months of 2007. Other inventory increased primarily due to the build-up of inventory to meet the demands of increased activity levels in our Drilling and Completion segment. The decrease in accrued interest is due to the semi-annual payment of interest on our 9.0% senior notes. The decrease in other current assets is principally due to the collection of the working capital adjustment from the OGR acquisition of approximately \$7.1 million in the first quarter of 2007. The increase in accounts payable, accrued expenses and accrued salaries, benefits and payroll taxes are attributed to additional expenses related to higher activity levels.

**Investing Activities**

During the nine months ended September 30, 2008, we used \$163.8 million in investing activities, consisting of \$117.8 million for capital expenditures, \$40.0 million convertible subordinated secured note from BCH Ltd, \$9.2 million for deposits on equipment purchases for our Drilling and Completion segment, \$5.8 million for purchases of investment opportunities, offset by \$9.0 million of proceeds from asset sales. Included in the \$117.8 million for capital expenditures was \$35.6 million for our Oilfield Services segment, including additional casing and tubing equipment and coiled tubing support equipment, \$65.5 million for additional equipment in our Drilling and Completion segment and \$16.7 million for drill pipe and other equipment used in our Rental Services segment. We made an investment of \$5.6 million to acquire a 15% stock ownership in BCH, Ltd., which compliments our \$40.0 million note receivable. We received \$3.0 million from the sale of our drill pipe tong manufacturing assets and \$6.0 million from asset sales in connection with items lost in hole or damaged beyond repair by our customers or other asset sales.

During the nine months ended September 30, 2007, we used \$77.2 million in investing activities, consisting of \$86.1 million for capital expenditures, \$12.9 million for business acquisitions and \$498,000 for oil and gas investments, offset by \$22.2 million of proceeds from asset sales. Included in the \$86.1 million for capital expenditures was \$31.1 million for drill pipe and other equipment used in our Rental Services segment, \$16.9 million

for additional equipment in our Drilling and Completion segment, \$37.5 million for our Oilfield Services segment, including additional equipment in our underbalanced drilling operations, additional coiled tubing equipment, additional casing and tubing equipment and additional MWD equipment. We received proceeds of \$16.3 million from the sale of our capillary assets and \$6.0 million from the proceeds from asset sales in connection with items lost in hole by our customers or other asset sales.



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### **Financing Activities**

During the nine months ended September 30, 2008, financing activities provided \$52.6 million in cash. We received \$38.5 million from net borrowings under our revolving line of credit and an additional \$20.0 million in proceeds from long-term debt and repaid \$6.5 million in borrowings under long-term debt facilities. Proceeds from the additional \$20.0 million in long-term borrowing were used for a portion of the purchase price of the new drilling and service rigs ordered for our Drilling and Completion segment. The \$6.5 million repayments of long-term debt facilities were scheduled repayments. We also received \$633,000 in proceeds from the exercise of options and warrants. In addition, we financed our renewal of \$3.0 million in insurance policy premiums in a non-cash transaction.

During the nine months ended September 30, 2007, financing activities provided \$39.7 million in cash. We received \$250.0 million in proceeds from long-term debt, repaid \$307.5 million in borrowings under long-term debt facilities, including the repayment of the bridge loan, and paid \$7.6 million in debt issuance costs. We also received \$100.1 million from the issuance of our common stock in a public offering, net of expenses, along with \$3.3 million in proceeds from the exercise of options and warrants. We recognized a tax benefit of \$1.6 million related to our stock compensation plans.

At September 30, 2008, we had \$569.8 million in outstanding indebtedness, of which \$561.0 million was long-term debt and \$8.8 million is due within one year.

On January 18, 2006 and August 14, 2006, we closed on private offerings, to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933, of \$160.0 and \$95.0 million aggregate principal amount of our senior notes, respectively. The senior notes are due January 15, 2014 and bear interest at 9.0%. The proceeds were used to fund the acquisitions of Specialty Rental Tools, Inc. and DLS Drilling, Logistics & Services Corporation, or DLS, to repay existing debt and for general corporate purposes.

In January 2007, we closed on a private offering, to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933, of \$250.0 million aggregate principal amount of 8.5% senior notes due 2017. The proceeds of the senior notes offering, together with a portion of the proceeds of our concurrent common stock offering, were used to repay the debt outstanding under our \$300.0 million bridge loan facility, which we incurred to finance our acquisition of substantially all the assets of OGR.

On January 18, 2006, we also executed an amended and restated credit agreement which provided for a \$25.0 million revolving line of credit with a maturity of January 2010. On April 26, 2007, we entered into a Second Amended and Restated Credit Agreement, which increased our revolving line of credit to \$62.0 million, and has a final maturity date of April 26, 2012. On December 3, 2007, we entered into a First Amendment to the Second Amended and Restated Credit Agreement, which increased our revolving line of credit to \$90.0 million. The credit agreement contains customary events of default and financial covenants and limits our ability to incur additional indebtedness, make capital expenditures, pay dividends or make other distributions, create liens and sell assets. Our obligations under the amended and restated credit agreement are secured by substantially all of our assets located in the United States. We were in compliance with all debt covenants as of September 30, 2008. The credit agreement loan rates are based on prime or LIBOR plus a margin. The interest rate was 4.6% at September 30, 2008. The outstanding amount as of September 30, 2008 and December 31, 2007, was \$38.5 million and \$0, respectively.

As part of our acquisition of DLS, we assumed various bank loans with floating interest rates based on LIBOR plus a margin and terms ranging from two to five years. The weighted average interest rates were 5.1% and 6.7% at September 30, 2008 and December 31, 2007, respectively. The bank loans are denominated in U.S. dollars and the outstanding amount as of September 30, 2008 and December 31, 2007 were \$3.1 million and \$4.9 million, respectively.

On February 15, 2008, through our DLS subsidiary in Argentina, we entered into a \$25.0 million import finance facility with a bank. Borrowings under this facility will be used to fund a portion of the purchase price of the new drilling and service rigs ordered for our Drilling and Completion segment. The facility is available for borrowings until December 31, 2008. Each drawdown shall be repaid over four years in equal semi-annual installments beginning one year after each disbursement with the final principal payment due not later than March 15, 2013. The import finance facility is unsecured and contains customary events of default and financial covenants and limits DLS ability to incur additional indebtedness, make capital expenditures, create liens and sell assets. We were in compliance with

all debt covenants as of September 30, 2008. The bank loan rates are based on LIBOR plus a margin. The interest rate was 6.7% at September 30, 2008. The bank loans are denominated in U.S. dollars and the outstanding amount as of September 30, 2008 was \$20.0 million.

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### ***Notes payable***

In connection with the acquisition of Rogers, we issued to the seller a note in the amount of \$750,000. The note bears interest at 5.0% and is due April 3, 2009. In connection with the acquisition of Coker, we issued to the seller a note in the amount of \$350,000. The interest rate on the note was 8.25% and was repaid on June 29, 2008. In connection with the acquisition of Diggar, we issued to the seller a note in the amount of \$750,000. The interest rate on the note was 6.0% and was repaid on July 28, 2008. In connection with the acquisition of Rebel, we issued to the sellers notes in the aggregate amount of \$500,000. The notes bear interest at 5.0% and were repaid October 29, 2008.

In 2000, we compensated directors, including current directors, who served on the board of directors from 1989 to March 31, 1999 without compensation, by issuing promissory notes totaling \$325,000. The notes bore interest at the rate of 5.0%. At September 30, 2008 and December 31, 2007, the principal and accrued interest on these notes totaled approximately \$32,000.

We had various equipment and vehicle financing loans with interest rates ranging from 8.3% to 8.7% and two year terms. As of September 30, 2008 and December 31, 2007, the outstanding balances for equipment and vehicle financing loans were \$0 and \$595,000, respectively.

In April and August 2007, we obtained insurance premium financings in the aggregate amount of \$4.4 million with a fixed weighted average interest rate of 5.9%. Under terms of the agreements, amounts outstanding are paid over 10 month and 11 month repayment schedules. The outstanding balance of these notes was approximately \$0 and \$1.7 million as of September 30, 2008 and December 31, 2007, respectively. In April and August 2008, we obtained insurance premium financings in the aggregate amount of \$3.0 million with a weighted average interest rate of 4.9%. Under terms of the agreements, amounts outstanding are paid over 10 month and 11 month repayment schedules. The outstanding balance of these notes was approximately \$1.9 million as of September 30, 2008.

### ***Other debt***

In connection with the purchase of Capcoil Tubing Services, Inc., we agreed to pay a total of \$500,000 to two management employees in exchange for non-compete agreements. We were required to make annual payments of \$110,000 through May 2008. Total amounts due under these non-compete agreements at September 30, 2008 and December 31, 2007 were \$0 and \$110,000, respectively.

We also had various capital leases with terms that expired in 2008. As of September 30, 2008 and December 31, 2007, amounts outstanding under capital leases were \$0 and \$14,000, respectively.

### **Off Balance Sheet Arrangements**

We have no off balance sheet arrangements, other than normal operating leases and employee contracts, that have or are likely to have a current or future material effect on our financial condition, changes in financial condition, revenues, expenses, results of operations, liquidity, capital expenditures or capital resources. We do not guarantee obligations of any unconsolidated entities. At September 30, 2008, we had a \$90.0 million revolving line of credit with a maturity of April 2012 and we had borrowed \$38.5 million on the facility and availability was further reduced by outstanding letters of credit of \$6.8 million.

### **Capital Requirements**

We have identified capital expenditure projects that will require approximately \$30.0 million for the remainder of 2008, exclusive of any acquisitions. For 2009, we have placed orders to acquire four land drilling rigs that will require an additional outlay of approximately \$41.5 million in cash. We believe that our cash generated from operations, cash available under our credit facilities, a new term credit facility for the rigs and cash on hand will provide sufficient funds for our identified projects.

We intend to pursue a growth strategy of increasing the scope of services through both internal growth and acquisitions. However, the current conditions in the credit markets and the outlook for the U.S. economy requires that we be very selective in committing to future capital expenditures and acquisitions. The acquisition of assets could require additional financing. We also expect to make capital expenditures to acquire and to maintain our existing equipment. Our performance and cash flow from operations will be determined by the demand for our services, which in turn are affected by our customers' expenditures for oil and gas exploration and development, and industry perceptions and expectations of future oil and natural gas prices in the areas where we operate. We will need to refinance our existing debt facilities as they become due and provide funds for capital expenditures and acquisitions.

To effect our expansion plans, we may require additional equity or debt financing. There can be no assurance that we will be successful in raising the additional debt or equity capital or that we can do so on terms that will be acceptable to us.

**Table of Contents****Critical Accounting Policies**

Please see our Annual Report on Form 10-K for the year ended December 31, 2007 for a description of other policies that are critical to our business operations and the understanding of our results of operations. The impact and any associated risks related to these policies on our business operations is discussed throughout Management's Discussion and Analysis of Financial Condition and Results of Operations where such policies affect our reported and expected financial results. No material changes to such information have occurred during the nine months ended September 30, 2008.

In September 2006, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, or SFAS No. 157. SFAS No. 157 clarifies the principle that fair value should be based on the assumptions that market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, with early adoption permitted. Subsequently, the FASB provided for a one-year deferral of the provisions of SFAS No. 157 for non-financial assets and liabilities that are recognized or disclosed at fair value in the consolidated financial statements on a non-recurring basis. We adopted with no impact on our financial statements all requirements of SFAS No. 157 on January 1, 2008, except as they relate to nonfinancial assets and liabilities, which will be adopted on January 1, 2009, as allowed under SFAS No. 157. We have not yet determined the impact, if any, on our financial statements for nonfinancial assets and liabilities.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, or SFAS No. 159, which permits entities to elect to measure many financial instruments and certain other items at fair value. Upon adoption of SFAS No. 159, an entity may elect the fair value option for eligible items that exist at the adoption date. Subsequent to the initial adoption, the election of the fair value option should only be made at the initial recognition of the asset or liability or upon a re-measurement event that gives rise to the new-basis of accounting. All subsequent changes in fair value for that instrument are reported in earnings. SFAS No. 159 does not affect any existing accounting literature that requires certain assets and liabilities to be recorded at fair value nor does it eliminate disclosure requirements included in other accounting standards. SFAS No. 159 is effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2007. We adopted SFAS No. 159 on January 1, 2008 and there was no impact on our financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (revised 2007), *Business Combinations*, or SFAS No. 141(R). SFAS No. 141(R) changes the requirements for an acquirer's recognition and measurement of the assets acquired and the liabilities assumed in a business combination. SFAS No. 141(R) is effective for annual periods beginning after December 15, 2008 and should be applied prospectively for all business combinations entered into after the date of adoption.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, *Non-controlling Interests in Consolidated Financial Statements – an amendment of ARB No. 51*, or SFAS No. 160. SFAS No. 160 requires (i) that non-controlling (minority) interests be reported as a component of shareholders' equity, (ii) that net income attributable to the parent and to the non-controlling interest be separately identified in the consolidated statement of operations, (iii) that changes in a parent's ownership interest while the parent retains its controlling interest be accounted for as equity transactions, (iv) that any retained non-controlling equity investment upon the deconsolidation of a subsidiary be initially measured at fair value, and (v) that sufficient disclosures are provided that clearly identify and distinguish between the interests of the parent and the interests of the non-controlling owners. SFAS No. 160 is effective for annual periods beginning after December 15, 2008 and should be applied prospectively. The presentation and disclosure requirements of the statement shall be applied retrospectively for all periods presented. We will adopt SFAS No. 160 on January 1, 2009 and have not yet determined the impact, if any, on our financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133*, or SFAS No. 161. SFAS No. 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative data about the fair value of and gains and losses on derivative contracts, and details of credit-risk-related contingent features in hedged

positions. The statement also requires enhanced disclosures regarding how and why entities use derivative instruments, how derivative instruments and related hedged items are accounted and how derivative instruments and related hedged items affect entities' financial position, financial performance, and cash flows. SFAS No. 161 is effective for fiscal years beginning after November 15, 2008. We will adopt SFAS No. 161 on January 1, 2009 and do not expect the adoption to have a material impact on our financial statements.

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In April 2008, the FASB issued FASB Staff Position SFAS 142-3, *Determination of the Useful Life of Intangible Assets*, or FSP SFAS 142-3. FSP SFAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*, or SFAS No. 142. The objective of FSP SFAS 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141R, *Business Combinations*, and other U.S. GAAP principles. FSP SFAS 142-3 is effective for fiscal years beginning after December 15, 2008. We will adopt FSP SFAS 142-3 on January 1, 2009 and have not yet determined the impact, if any, on our financial statements.

**Forward-Looking Statements**

This quarterly report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, regarding our business, financial condition, results of operations and prospects. Words such as expects, anticipates, intends, plans, believes, seeks, estimates and similar expressions or variations of such words are intended to identify forward-looking statements. However, these are not the exclusive means of identifying forward-looking statements. Although such forward-looking statements reflect our good faith judgment, such statements can only be based on facts and factors currently known to us. Consequently, forward-looking statements are inherently subject to risks and uncertainties, and actual outcomes may differ materially from the results and outcomes discussed in the forward-looking statements. Further information about the risks and uncertainties that may impact us are described under Item 1A Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2007. You should read those sections carefully. You should not place undue reliance on forward-looking statements, which speak only as of the date of this quarterly report. We undertake no obligation to update publicly any forward-looking statements in order to reflect any event or circumstance occurring after the date of this quarterly report or currently unknown facts or conditions or the occurrence of unanticipated events.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

We are exposed to market risk primarily from changes in interest rates and foreign currency exchange risks.

**Interest Rate Risk.**

Fluctuations in the general level of interest rates on our current and future fixed and variable rate debt obligations expose us to market risk. We are vulnerable to significant fluctuations in interest rates affecting our adjustable rate debt, and any future refinancing of our fixed rate debt and our future debt. We have approximately \$61.6 million of adjustable rate debt with a weighted average interest rate of 5.3% at September 30, 2008.

For additional information regarding our long-term debt, see Note 8 of the Notes to Unaudited Consolidated Condensed Financial Statements in Item 1 of Part I of this quarterly report.

**Foreign Currency Exchange Rate Risk.**

We have designated the U.S. dollar as the functional currency for our operations in international locations as we contract with customers, purchase equipment and finance capital using the U.S. dollar. Local currency transaction gains and losses, arising from remeasurement of certain assets and liabilities denominated in local currency, are included in our consolidated statements of income. We conduct business in Mexico through our Mexican partner, Matyep. This business exposes us to foreign exchange risk. To control this risk, we provide for payment in U.S. dollars. However, we have historically provided our partner a discount upon payment equal to 50% of any loss suffered by our partner as a result of devaluation of the Mexican peso between the date of invoicing and the date of payment. To date, such payments have not been material in amount.

**ITEM 4. CONTROLS AND PROCEDURES.***(a) Evaluation of Disclosure Controls and Procedures.*

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports under the Exchange Act, are recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosures.





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As of the end of the period covered by this quarterly report, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended, or the Exchange Act. This evaluation was carried out under the supervision and with the participation of our management, including our chief executive officer and chief financial officer. Based on this evaluation, these officers have concluded that, as of September 30, 2008, our disclosure controls and procedures are effective at a reasonable assurance level in ensuring that the information required to be disclosed by us in reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission, or SEC, rules and forms.

*(b) Change in Internal Control Over Financial Reporting.*

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION**

**ITEM 1A. RISK FACTORS**

We continue to be subject to the risk factors previously disclosed in our Risk Factors in our 2007 Annual Report, as well as the following risk factor.

***Our business depends on domestic spending by the oil and natural gas industry, and this spending and our business may be adversely affected by industry and financial market conditions that are beyond our control.***

We depend on our customers' willingness to make operating and capital expenditures to explore, develop and produce oil and natural gas in the United States. Customers' expectations for lower market prices for oil and natural gas, as well as the availability of capital for operating and capital expenditures, may curtail spending thereby reducing demand for our services and equipment.

Industry conditions are influenced by numerous factors over which we have no control, such as the supply of and demand for oil and natural gas, domestic and worldwide economic conditions, political instability in oil and natural gas producing countries and merger and divestiture activity among oil and natural gas producers. The volatility of the oil and natural gas industry and the consequent impact on exploration and production activity could adversely impact the level of drilling and workover activity by some of our customers. This reduction may cause a decline in the demand for our services or adversely affect the price of our services. In addition, reduced discovery rates of new oil and natural gas reserves in our market areas also may have a negative long-term impact on our business, even in an environment of stronger oil and natural gas prices, to the extent existing production is not replaced and the number of producing wells for us to service declines.

Recent adverse changes in capital markets have also caused a number of oil and natural gas producers to announce reductions in capital budgets for future periods. Limitations on the availability of capital, or higher costs of capital, for financing expenditures may cause these and other oil and natural gas producers to make additional reductions to capital budgets in the future even if commodity prices remain at historically high levels.

**ITEM 6. EXHIBITS**

(a) The exhibits listed on the Exhibit Index immediately following the signature page of this Quarterly Report on Form 10-Q are filed as part of this report.

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**SIGNATURES**

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 on November 4, 2008.

*Allis-Chalmers Energy Inc.*

*(Registrant)*

*/s/ Munawar H. Hidayatallah*

*Munawar H. Hidayatallah*  
*Chief Executive Officer and Chairman*

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**EXHIBIT INDEX**

- 10.1 Mutual Termination and Release Agreement, dated August 8, 2008, by and among Allis-Chalmers Energy Inc., Elway Merger Sub LLC and Bronco Drilling Company, Inc. (incorporated by reference to Exhibit 10.1 to the Registrant's Form 8-K filed on August 8, 2008).
- 31.1 \* Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2\* Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1\* Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- \* Filed herewith