

SMITH INTERNATIONAL INC

Form 10-Q

May 11, 2009

**Table of Contents**

**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 March 31, 2009**

**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 1-8514**

**Smith International, Inc.**

(Exact name of Registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or  
organization)

**95-3822631**

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

**1310 Rankin Road  
Houston, Texas**

(Address of principal executive offices)

**77073**

(Zip Code)

**(281) 443-3370**

(Registrant's telephone number, including area code)

**16740 East Hardy Road, Houston, Texas 77032**

(Former name, former address and former fiscal year, if changed since last report)

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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

There were 219,306,478 shares of common stock outstanding, net of treasury shares held, on May 6, 2009.



INDEX

	<b>Page No.</b>
<b><u>PART I FINANCIAL INFORMATION</u></b>	
<b><u>Item 1. Financial Statements (Unaudited)</u></b>	
<u>CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS</u> <u>For the Three Months ended March 31, 2009 and 2008</u>	3
<u>CONSOLIDATED CONDENSED BALANCE SHEETS</u> <u>As of March 31, 2009 and December 31, 2008</u>	4
<u>CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS</u> <u>For the Three Months ended March 31, 2009 and 2008</u>	5
<u>CONSOLIDATED CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME</u> <u>For the Three Months ended March 31, 2009</u>	6
<u>NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS</u>	7
<b><u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	16
<b><u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u></b>	24
<b><u>Item 4. Controls and Procedures</u></b>	24
<b><u>PART II OTHER INFORMATION</u></b>	
<b><u>Items 1 - 1A</u></b>	25
<b><u>Items 2 - 5</u></b>	27
<b><u>Item 6</u></b>	28
<b><u>SIGNATURES</u></b>	29
<b><u>EXHIBIT INDEX</u></b>	30
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32.1</u>	

---

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****SMITH INTERNATIONAL, INC.  
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS**

(In thousands, except per share data)

(Unaudited)

	Three Months Ended March 31,	
	2009	2008
Revenues:		
Oilfield operations	\$ 1,841,737	\$ 1,802,927
Distribution operations	569,742	568,071
Total revenues	2,411,479	2,370,998
Costs and expenses:		
Cost of oilfield revenues	1,229,191	1,119,503
Cost of distribution revenues	489,986	470,011
Selling, general and administrative expenses	450,624	402,677
Total costs and expenses	2,169,801	1,992,191
Operating income	241,678	378,807
Interest expense	27,524	16,301
Interest income	(358)	(896)
Income before income taxes and noncontrolling interests	214,512	363,402
Income tax provision	70,318	117,291
Net income	144,194	246,111
Noncontrolling interests in net income of subsidiaries	47,259	71,120
Net income attributable to Smith	\$ 96,935	\$ 174,991
Earnings per share attributable to Smith:		
Basic	\$ 0.44	\$ 0.87
Diluted	0.44	0.87
Weighted average shares outstanding:		

Edgar Filing: SMITH INTERNATIONAL INC - Form 10-Q

Basic	219,201	200,808
Diluted	219,603	201,942

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

**Table of Contents**

**SMITH INTERNATIONAL, INC.**  
**CONSOLIDATED CONDENSED BALANCE SHEETS**  
(In thousands, except par value data)  
(Unaudited)

	March 31, 2009	December 31, 2008
<b>Assets</b>		
Current Assets:		
Cash and cash equivalents	\$ 201,509	\$ 162,508
Receivables, net	2,088,837	2,253,477
Inventories, net	2,291,600	2,367,166
Deferred tax assets, net	83,978	81,834
Prepaid expenses and other	156,692	221,399
<b>Total current assets</b>	<b>4,822,616</b>	<b>5,086,384</b>
Property, plant and equipment, net	1,850,724	1,844,036
Goodwill, net	3,017,086	3,016,425
Other intangible assets, net	624,564	637,450
Other assets	256,152	231,929
<b>Total assets</b>	<b>\$ 10,571,142</b>	<b>\$ 10,816,224</b>
<b>Liabilities and Stockholders Equity</b>		
Current Liabilities:		
Short-term borrowings and current portion of long-term debt	\$ 365,377	\$ 1,366,296
Accounts payable	771,225	979,000
Accrued payroll costs	147,940	178,040
Income taxes payable	94,895	92,922
Other	190,322	317,174
<b>Total current liabilities</b>	<b>1,569,759</b>	<b>2,933,432</b>
Long-term debt	2,375,720	1,440,525
Deferred tax liabilities	468,968	428,986
Other long-term liabilities	148,317	152,972
Commitments and contingencies (Note 13)		
Stockholders Equity:		
Preferred stock, \$1 par value; 5,000 shares authorized; no shares issued or outstanding in 2009 or 2008		
Common stock, \$1 par value; 250,000 shares authorized; 236,919 shares issued in 2009 (236,726 shares issued in 2008)	236,919	236,726
Additional paid-in capital	1,984,901	1,975,102

Edgar Filing: SMITH INTERNATIONAL INC - Form 10-Q

Retained earnings	2,956,355	2,885,792
Accumulated other comprehensive income (loss)	(44,409)	(73,833)
Less Treasury securities, at cost; 17,660 common shares in 2009 (17,616 common shares in 2008)	(475,431)	(474,448)
Smith stockholders' equity	4,658,335	4,549,339
Noncontrolling interests in subsidiaries	1,350,043	1,310,970
Total stockholders' equity	6,008,378	5,860,309
Total liabilities and stockholders' equity	\$ 10,571,142	\$ 10,816,224

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



**Table of Contents**

**SMITH INTERNATIONAL, INC.**  
**CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS**

(In thousands)

(Unaudited)

	Three Months Ended March 31,	
	2009	2008
<b>Cash flows from operating activities:</b>		
Net income	\$ 144,194	\$ 246,111
<i>Adjustments to reconcile net income to net cash provided by operating activities:</i>		
Depreciation and amortization	91,095	52,601
Deferred income tax provision	13,779	(806)
Increase (decrease) in LIFO inventory reserves	(7,622)	3,518
Share-based compensation expense	12,354	10,635
Provision for losses on receivables	5,020	1,438
Foreign currency translation losses (gains)	(9,514)	500
Gain on disposal of property, plant and equipment	(11,653)	(8,232)
Equity earnings, net of dividends received	(2,976)	(6,791)
<i>Changes in operating assets and liabilities:</i>		
Receivables	155,004	(163,095)
Inventories	78,109	(107,710)
Accounts payable	(206,066)	117,843
Other current assets and liabilities	(53,614)	11,061
Other non-current assets and liabilities	(10,353)	35
Net cash provided by operating activities	197,757	157,108
<b>Cash flows from investing activities:</b>		
Purchases of property, plant and equipment	(97,101)	(74,030)
Proceeds from disposal of property, plant and equipment	22,397	14,374
Proceeds from sale of operations	65,019	
Acquisitions, net of cash acquired	(7,236)	(3,361)
Net cash used in investing activities	(16,921)	(63,017)
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of long-term debt	1,000,000	765
Principal payments of long-term debt	(63,981)	(52,638)
Principal payment of short-term bridge loan	(1,000,000)	
Net change in short-term borrowings	(423)	(19,863)
Debt issuance costs	(8,099)	
Settlement of interest rate derivative contract	(33,383)	
Payment of common stock dividends	(26,290)	(20,067)
Distributions to noncontrolling joint venture partner	(4,000)	(6,000)
Purchases of common stock under Repurchase Program		(8,647)

Edgar Filing: SMITH INTERNATIONAL INC - Form 10-Q

Payments related to long-term incentive awards	(939)	(1,387)
Tax impact of share-based compensation	(2,406)	1,527
Net cash used in financing activities	(139,521)	(106,310)
Effect of exchange rate changes on cash	(2,314)	2,326
Increase (decrease) in cash and cash equivalents	39,001	(9,893)
Cash and cash equivalents at beginning of period	162,508	158,267
Cash and cash equivalents at end of period	\$ 201,509	\$ 148,374

**Supplemental disclosures of cash flow information:**

Cash paid for interest	\$ 27,554	\$ 13,549
Cash paid for income taxes	57,138	55,832

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

**Table of Contents**

**SMITH INTERNATIONAL, INC.**  
**CONSOLIDATED CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE**  
**INCOME**  
**For the Three Months Ended March 31, 2009**  
(In thousands)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Securities	Smith Stockholders Equity	Noncontrolling Interests in Subsidiaries	Total Stockholders Equity
Balance, December 31, 2008	\$ 236,726	\$ 1,975,102	\$ 2,885,792	\$ (73,833)	\$ (474,448)	\$ 4,549,339	\$ 1,310,970	\$ 5,860,309
Net income			96,935			96,935	47,259	144,194
Changes in fair value of derivatives				38,966		38,966		38,966
Currency translation adjustments and other				(9,542)		(9,542)	(4,186)	(13,728)
Comprehensive income			96,935	29,424		126,359	43,073	169,432
Common stock dividends declared			(26,372)			(26,372)		(26,372)
Distribution to noncontrolling joint venture partner							(4,000)	(4,000)
Long-term incentive compensation activity	193	9,799			(983)	9,009		9,009
Balance, March 31, 2009	\$ 236,919	\$ 1,984,901	\$ 2,956,355	\$ (44,409)	\$ (475,431)	\$ 4,658,335	\$ 1,350,043	\$ 6,008,378

The accompanying notes are an integral part of this consolidated condensed financial statement.

**Table of Contents**

**SMITH INTERNATIONAL, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**

(All dollar amounts are expressed in thousands, unless otherwise noted)

(Unaudited)

**1. Significant Accounting Policies**

*Basis of Presentation*

The accompanying unaudited consolidated condensed financial statements of Smith International, Inc. and subsidiaries ( Smith or the Company ) were prepared in accordance with U.S. generally accepted accounting principles and applicable rules and regulations of the Securities and Exchange Commission (the Commission ) pertaining to interim financial information. These interim financial statements do not include all information or footnote disclosures required by generally accepted accounting principles for complete financial statements and, therefore, should be read in conjunction with the audited financial statements and accompanying notes included in the Company s 2008 Annual Report on Form 10-K and other current filings with the Commission. All adjustments that are, in the opinion of management, of a normal and recurring nature and are necessary for a fair presentation of the interim financial statements have been included.

Preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosed amounts of contingent assets and liabilities and the reported amounts of revenues and expenses. If the underlying estimates and assumptions, upon which the financial statements are based, change in future periods, actual amounts may differ from those included in the accompanying consolidated condensed financial statements.

Management believes the consolidated condensed financial statements present fairly the financial position, results of operations and cash flows of the Company as of the dates indicated. The results of operations for the interim period presented may not be indicative of results which may be reported on a fiscal year basis.

*Recently Adopted Accounting Pronouncements*

From time to time, new accounting pronouncements are issued by the Financial Accounting Standards Board. The following standards were adopted by the Company on the specified effective date of January 1, 2009.

The Company adopted Statement of Financial Accounting Standards ( SFAS ) No. 141(R), Business Combinations ( SFAS 141(R) ) which revises the accounting and disclosure requirements for acquisition transactions. SFAS 141(R) differs from the previous standard in that it requires the Company to expense professional fees and other transaction-related costs as incurred instead of capitalizing these costs as purchase price consideration. Additionally, the Company will be required to estimate contingent assets, liabilities and transaction-related consideration as of the purchase date with future changes in the underlying estimates recognized in the statement of operations. Finally, SFAS 141(R) requires the Company to reflect any adjustments to deferred tax asset valuation allowances and income tax uncertainties associated with acquisitions completed prior to January 1, 2009 as income tax expense rather than an adjustment to goodwill.

The Company implemented SFAS No. 160 Noncontrolling Interests in Consolidated Financial Statements, an Amendment of ARB No. 51 ( SFAS 160 ) which modifies the accounting and disclosure requirements for subsidiaries which are not wholly-owned. In accordance with the provisions of SFAS 160, the Company has reclassified the noncontrolling interest previously reflected as a long-term liability and included the amount as a component of stockholders equity in the accompanying consolidated condensed balance sheets. Additionally, the Company has presented the net income attributable to the Company and the noncontrolling ownership interests separately in the accompanying consolidated condensed statements of operations.

The Company adopted SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, an Amendment of FASB Statement No. 133 ( SFAS 161 ) which requires enhanced disclosure about derivative instruments. The standard requires the inclusion of tabular information reflecting the impact of derivative financial instruments on the Company s consolidated financial position and results of operations.

Management believes the impact of other recently issued standards, which are not yet effective, will not have a material impact on the Company s consolidated financial position, results of operations or cash flows upon adoption.



**Table of Contents****2. Employee Severance and Other Costs**

During the first quarter of 2009, the Company incurred severance-related costs of approximately \$31.0 million associated with a 14 percent reduction in North American personnel levels. The Company also closed certain facilities during the quarter and incurred approximately \$1.3 million in related costs. These costs are included within selling, general and administrative expenses in the accompanying consolidated condensed statement of operations. On a reporting segment basis, M-I SWACO, Smith Oilfield and Distribution, recognized charges of \$19.3 million, \$12.3 million and \$0.7 million, respectively.

**3. Acquisitions and Dispositions***Acquisitions*

From time to time, the Company enters into transactions involving the purchase of a full or partial ownership interest in complementary business operations. No material acquisitions were finalized during the first quarter of 2009. On August 25, 2008, Smith completed the acquisition of W-H Energy Services, Inc. ( W-H ). The transaction has been recorded using the purchase method of accounting and, accordingly, the acquired operations have been included in the results of operations since the closing date. The following unaudited pro forma supplemental information presents consolidated results of operations as if the W-H acquisition had occurred on January 1, 2008. The unaudited pro forma data is based on historical information and does not include estimated cost savings; therefore, it does not purport to be indicative of the results of operations had the combination been in effect at the date indicated or of future results for the combined entities (in thousands, except per share amounts):

	Three Months Ended March 31,	
	2009	2008
Revenues	\$ 2,411,479	\$ 2,671,966
Net income attributable to Smith	\$ 96,935	\$ 194,696
Earnings per share attributable to Smith:		
Basic	\$ 0.44	\$ 0.89
Diluted	\$ 0.44	\$ 0.89

*Dispositions*

During the first quarter of 2009, the Company disposed of certain non-core operations acquired in connection with the W-H transaction. The Company received cash proceeds of \$65.0 million and is entitled to future consideration in the event financial metrics established under earn-out arrangements are met. The accompanying consolidated condensed financial statements reflect no gain or loss associated with the sale of these operations.

**Table of Contents****4. Earnings Per Share**

Basic earnings per share ( EPS ) is computed using the weighted average number of common shares outstanding during the period. Diluted EPS gives effect to the potential dilution of earnings that could have occurred if additional shares were issued for stock option and restricted stock awards under the treasury stock method. For each of the periods presented, an immaterial number of outstanding stock-based awards were excluded from the computation of diluted EPS because they were anti-dilutive. The following schedule reconciles the income and shares used in the basic and diluted EPS computations (in thousands, except per share data):

	Three Months Ended March 31,	
	2009	2008
Net income attributable to Smith	\$ 96,935	\$ 174,991
Weighted average number of common shares outstanding	219,201	200,808
<b>Basic EPS</b>	\$ 0.44	\$ 0.87
Net income attributable to Smith	\$ 96,935	\$ 174,991
Weighted average number of common shares outstanding	219,201	200,808
Dilutive effect of stock options and restricted stock units	402	1,134
	219,603	201,942
<b>Diluted EPS</b>	\$ 0.44	\$ 0.87

**5. Inventories**

Inventories are stated at the lower of cost or market. Cost is determined using the average cost method for the majority of the Company's inventories; however, a portion of the Company's U.S.-based inventories are valued utilizing the last-in, first-out ( LIFO ) method. Inventory costs, consisting of materials, labor and factory overhead, are as follows:

	March 31,	December
	2009	31, 2008
Raw materials	\$ 185,200	\$ 190,790
Work-in-process	170,671	202,019
Finished goods	2,139,953	2,186,203
	2,495,824	2,579,012
Reserves to state certain U.S. inventories (FIFO cost of \$1,034,479 and \$1,044,345 in 2009 and 2008, respectively) on a LIFO basis	(204,224)	(211,846)
	\$ 2,291,600	\$ 2,367,166

**6. Property, Plant and Equipment**

Property, plant and equipment consist of the following:

Edgar Filing: SMITH INTERNATIONAL INC - Form 10-Q

	March 31, 2009	December 31, 2008
Land and improvements	\$ 74,317	\$ 77,463
Buildings	319,339	322,569
Machinery and equipment	1,070,340	1,048,821
Rental tools	1,329,602	1,292,796
	2,793,598	2,741,649
Less Accumulated depreciation	(942,874)	(897,613)
	\$ 1,850,724	\$ 1,844,036



**Table of Contents****7. Goodwill and Other Intangible Assets***Goodwill*

The following table presents goodwill on a segment basis as of the dates indicated as well as changes in the account during the period shown. Consolidated beginning and ending goodwill balances are presented net of accumulated amortization of \$53.6 million.

	M-I SWACO	Smith Oilfield	Distribution	Consolidated
Balance as of December 31, 2008	\$ 714,663	\$ 2,250,675	\$ 51,087	\$ 3,016,425
Purchase price and other adjustments		661		661
Balance as of March 31, 2009	\$ 714,663	\$ 2,251,336	\$ 51,087	\$ 3,017,086

*Other Intangible Assets*

The components of other intangible assets are as follows:

	March 31, 2009			December 31, 2008		
	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net
Patents	\$ 426,772	\$ 59,896	\$ 366,876	\$ 426,772	\$ 52,175	\$ 374,597
Trademarks <sup>(a)</sup>	205,031	3,920	201,111	205,031	3,764	201,267
License agreements	32,416	18,086	14,330	32,416	17,311	15,105
Non-compete agreements	37,928	24,460	13,468	37,928	23,122	14,806
Customer relationships and contracts	58,438	29,659	28,779	58,438	26,763	31,675
	\$ 760,585	\$ 136,021	\$ 624,564	\$ 760,585	\$ 123,135	\$ 637,450

<sup>(a)</sup> *Included within the gross carrying amount of trademarks is \$195.7 million of indefinite-lived assets.*

Intangible amortization expense totaled \$12.9 million and \$7.5 million for the three months ended March 31, 2009 and 2008, respectively. The weighted average life for other intangible assets subject to amortization, which excludes certain indefinite-lived trademarks, approximates 13 years. Amortization expense is expected to approximate \$52 million for fiscal year 2009 and is anticipated to range between \$34 million and \$48 million per year for the 2010 2013 fiscal years.

**Table of Contents****8. Debt**

The following summarizes the Company's outstanding debt:

	March 31, 2009	December 31, 2008
<b>Current:</b>		
Short-term borrowings	\$ 96,020	\$ 1,096,443
Current portion of long-term debt	269,357	269,853
Short-term borrowings and current portion of long-term debt	\$ 365,377	\$ 1,366,296
<b>Long-Term:</b>		
Notes, net of unamortized discounts	\$ 1,493,355	\$ 494,638
Revolving credit facilities	197,000	260,000
Term loans	954,722	955,740
	2,645,077	1,710,378
Less Current portion of long-term debt	(269,357)	(269,853)
Long-term debt	\$ 2,375,720	\$ 1,440,525

In March 2009, the Company completed a public offering of \$300.0 million five-year and \$700.0 million ten-year Senior Notes issued under an existing Indenture. Net proceeds of \$991.1 million were received in connection with the offering and were used to repay outstanding indebtedness under a \$1.0 billion bridge loan facility expiring August 2009. The Senior Notes are unsecured obligations of the Company, carry a combined effective interest rate of 9.44 percent and require semi-annual interest payments.

During the first quarter of 2009, the Company also negotiated a \$525.0 million term loan facility with a syndicate of financial institutions. The facility, which expires on June 5, 2009, remained undrawn at March 31, 2009.

Principal payments of long-term debt for the twelve-month periods ending subsequent to March 31, 2010 are as follows:

2011	\$ 468,821
2012	489,055
2013	144,118
2014	299,213
Thereafter	974,513
	\$ 2,375,720

**9. Derivative Financial Instruments**

The nature of the Company's business activities involves the management of various financial and market risks, including those related to changes in currency exchange rates and interest rates. In an effort to mitigate these risks, the Company enters into derivative financial instruments which are accounted for as fair value or cash flow hedges in accordance with SFAS No. 133 Accounting for Derivative Instruments and Hedging Activities (SFAS 133). The Company does not enter into derivative instruments for speculative purposes.

For foreign exchange and interest rate derivative instruments that do not qualify as cash flow hedges, realized and unrealized gains and losses are recognized currently through earnings. At March 31, 2009, the Company had

outstanding fair value foreign exchange hedge contracts with a notional value of \$240.1 million.

For foreign exchange and interest rate derivative instruments that qualify as cash flow hedges, realized and unrealized gains and losses are deferred to accumulated other comprehensive income (loss) ( AOCI ) and recognized in the consolidated statement of operations when the hedged item affects earnings. As of March 31, 2009, the Company had one outstanding interest rate hedge contract with a notional amount of \$77.0 million and no outstanding foreign exchange cash flow contracts.

**Table of Contents**

The Company entered into three interest rate contracts and subsequent extensions during fiscal 2008 in anticipation of a planned public debt issuance. At December 31, 2008, unrealized mark-to-market losses of \$59.8 million associated with these cash flow hedge transactions were deferred as a component of AOCI. Contract extensions expiring subsequent to December 31, 2008 did not qualify as cash flow hedge transactions resulting in the recognition of a \$56.9 million mark-to-market gain in the first quarter of 2009.

The public debt transaction discussed in the above footnote did not include a longer-tenor debt issuance as contemplated in the cash flow hedge transaction and a future transaction of this tenor is probable of not occurring. Accordingly, \$59.3 million of the mark-to-market loss previously deferred as a component of AOCI was reclassified into earnings during the first quarter of 2009. Approximately \$2.3 million deferred in AOCI related to cash flow foreign exchange and interest rate derivative contracts, or \$1.6 million net of taxes and noncontrolling interests, will be reclassified into earnings during the remainder of fiscal 2009.

The following table summarizes the effect of derivative instruments within the unaudited consolidated condensed balance sheet and statement of operations for the three months ended March 31, 2009:

	Gain (Loss)	Gain (Loss)	Gain (Loss)	Gain (Loss)
	Recognized	Location of Gain (Loss) Reclassified from AOCI	Reclassified from AOCI	Location of Gain (Loss) Recognized in Income (Ineffective & Excluded)
Derivatives in SFAS 133	in AOCI			Recognized in Income (Ineffective & & Excluded)
Cash Flow Hedging Relationships	(Effective)	(Effective)	(Effective)	Excluded
Interest rate contracts	\$ (490)	Interest expense	\$ (642)	Selling, general and administrative expenses
Foreign exchange contracts	(1,061)	Cost of oilfield revenues	(1,408)	
Total	\$ (1,551)		\$ (2,050)	\$ (76)

Derivatives Not Designated as Hedging Instruments under SFAS 133	Location of Gain (Loss) Recognized in Income	Gain (Loss) Recognized in Income
Foreign exchange contracts	Selling, general and administrative expenses	\$ (4,945)

*Fair Value Measurement*

The fair values of outstanding foreign exchange derivative instruments are determined using composite pricing from published financial market sources whereas the fair values of the outstanding interest rate derivative instruments are determined by obtaining quoted prices in active markets for identical contracts. Both measurement methodologies are

Edgar Filing: SMITH INTERNATIONAL INC - Form 10-Q

classified as Level Two tier under SFAS 157. The recorded fair values of derivative instruments at March 31, 2009 are as follows:

	Asset Derivatives		Liability Derivatives	
	Classification	Fair Value	Classification	Fair Value
Derivatives Designated as Hedging Instruments under SFAS 133				
Interest rate contracts		\$	Other current liabilities	\$ (5,598)
Derivatives Not Designated as Hedging Instruments under SFAS 133				
Foreign exchange contracts <sup>(a)</sup>	Other current liabilities	3,589	Other current liabilities	(9,860)
Total		\$ 3,589		\$ (15,458)

*(a) Derivative instruments within this category are subject to master netting arrangements and are presented on a net basis in the accompanying consolidated condensed balance sheet.*

**Table of Contents****10. Accumulated Other Comprehensive Income (Loss)**

Accumulated other comprehensive income (loss) in the accompanying consolidated condensed balance sheets consist of the following:

	March 31, 2009	December 31, 2008
Currency translation adjustments	\$ (33,777)	\$ (24,235)
Changes in unrealized fair value of derivatives, net	(3,523)	(42,489)
Pension liability adjustments	(7,109)	(7,109)
Accumulated other comprehensive income (loss)	\$ (44,409)	\$ (73,833)

**11. Long-Term Incentive Compensation**

As of March 31, 2009, the Company had outstanding restricted stock units and stock options granted under the Amended and Restated 1989 Long-Term Incentive Compensation Plan (the "LTIC Plan"). As of March 31, 2009, approximately 1.8 million shares were authorized for future issuance pursuant to the LTIC Plan.

*Restricted Stock*

The restricted stock program consists of a combination of performance-based restricted stock units ( "performance-based units" ) and time-based restricted stock units ( "time-based units" ). The number of performance-based units issued under the program, which can range from zero to 130 percent of the target units granted, is solely dependent upon financial metrics achieved by the Company in the fiscal year subsequent to the award. Activity under the Company's restricted stock program for the three-month period ended March 31, 2009 is presented below (in thousands, except per share data):

	Time-Based Awards		Performance-Based Awards		Total Restricted Stock Units
	No. of Units	Fair Value <sup>(a)</sup>	No. of Units <sup>(b)</sup>	Fair Value <sup>(a)</sup>	
Outstanding at December 31, 2008	2,599	\$ 32.57	1,639	\$ 31.60	4,238
Granted	90	20.81			90
Forfeited	(78)	38.24	(34)	33.60	(112)
Vested	(58)	59.37			(58)
Outstanding at March 31, 2009	2,553	\$ 31.37	1,605	\$ 31.56	4,158

(a) *Reflects the weighted average grant-date fair value.*

(b) *Performance-based units outstanding assume achievement of target-level financial metrics*

*related to the  
December 2008  
grants.*

Restrictions on approximately 1.1 million restricted stock units outstanding at March 31, 2009 are expected to lapse and issue during the 2009 fiscal year.

*Stock Options*

Activity under the Company's stock option program for the three-month period ended March 31, 2009 is presented below

(in thousands, except per share data):

	Shares Under Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Outstanding at December 31, 2008	1,150	\$ 19.58		
Forfeited	(9)	22.82		
Exercised	(8)	5.53		
Outstanding at March 31, 2009	1,133	\$ 19.65	4.18	\$ 3,985
Exercisable at March 31, 2009	1,129	\$ 19.60	4.17	\$ 3,985

13

**Table of Contents***Share-based Compensation Expense*

Share-based compensation expense, consisting of restricted stock unit and stock option awards, was \$12.4 million and \$10.6 million for the three-month periods ended March 31, 2009 and 2008, respectively.

Assuming achievement of target-level financial metrics for performance-based awards granted in December 2008, unrecognized share-based compensation expense totaled \$110.0 million for awards outstanding as of March 31, 2009. After adjusting for taxes and noncontrolling interests, approximately \$63.1 million of additional share-based compensation is expected to be recognized over a weighted average period of 2.8 years.

**12. Industry Segments and International Operations**

The Company is a global provider of products and services used during the drilling, completion and production phases of oil and natural gas development activities. Our business is segregated into three operating divisions, M-I SWACO, Smith Oilfield and Distribution, which is the basis upon which we report our results.

The M-I SWACO segment consists of a majority-owned drilling fluid and environmental services joint venture operation. The Smith Oilfield segment is comprised of our wholly-owned drilling and completion services operations, which includes drill bits, directional drilling services and downhole tools. The Distribution segment consists of the Wilson distribution operations and a majority-owned interest in CE Franklin Ltd., a publicly-traded Canadian distribution company. Finally, general corporate primarily reflects expenses related to corporate personnel, administrative support functions and long-term incentive compensation programs.

The following table presents financial information for each reportable segment:

	Three Months Ended March 31,	
	2009	2008
Revenues:		
M-I SWACO	\$ 1,159,337	\$ 1,228,429
Smith Oilfield	682,400	574,498
Distribution	569,742	568,071
	\$ 2,411,479	\$ 2,370,998
Operating Income:		
M-I SWACO	\$ 147,508	\$ 207,798
Smith Oilfield	105,765	163,006
Distribution	15,521	29,884
General corporate	(27,116)	(21,881)
	\$ 241,678	\$ 378,807

The following table presents consolidated revenues by region:

	Three Months Ended March 31,	
	2009	2008
United States	\$ 1,089,540	\$ 1,012,679
Canada	192,284	234,425
North America	1,281,824	1,247,104
Latin America	276,107	226,977
Europe/Africa	539,815	596,492
Middle East/Asia	313,733	300,425



Non-North America	1,129,655	1,123,894
	\$ 2,411,479	\$ 2,370,998

**Table of Contents**

**13. Commitments and Contingencies**

*Standby Letters of Credit*

In the normal course of business with customers, vendors and others, the Company is contingently liable for performance under standby letters of credit and bid, performance and surety bonds. Certain of these outstanding instruments guarantee payment to insurance companies with respect to certain liability coverages of the Company's insurance captive. Excluding the impact of these instruments, for which \$23.2 million of related liabilities are reflected in the accompanying consolidated condensed balance sheet, the Company was contingently liable for approximately \$242.5 million of standby letters of credit and bid, performance and surety bonds at March 31, 2009. Management does not expect any material amounts to be drawn on these instruments.

*Insurance*

The Company maintains insurance coverage for various aspects of its business and operations. The Company has elected to retain a portion of losses that occur through the use of deductibles and retentions under its insurance programs. Amounts in excess of the self-insured retention levels are fully insured to limits believed appropriate for the Company's operations. Self-insurance accruals are based on claims filed and an estimate for claims incurred but not reported. While management believes that amounts accrued in the accompanying consolidated condensed financial statements are adequate for expected liabilities arising from the Company's portion of losses, estimates of these liabilities may change as circumstances develop.

*Litigation*

The Company is a defendant in various legal proceedings arising in the ordinary course of business. In the opinion of management, these matters will not have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

*Environmental*

The Company routinely establishes and reviews the adequacy of reserves for estimated future environmental clean-up costs for properties currently or previously operated by the Company. In the opinion of management, these matters will not have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

**Table of Contents**

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations is provided to assist readers in understanding the Company's financial performance during the periods presented and significant trends which may impact the future performance of the Company. This discussion should be read in conjunction with the consolidated condensed financial statements of the Company and the related notes thereto included elsewhere in this Form 10-Q, the Company's 2008 Annual Report on Form 10-K and other current filings with the Commission.

**Company Products and Operations**

The Company is a leading global provider of premium products and services used during the drilling, completion and production phases of oil and natural gas development activities. In August 2008, we broadened our capabilities in key drilling and completion-related product technologies with the acquisition of W-H Energy Services, Inc. ( W-H ). We provide a comprehensive line of technologically-advanced products and engineering services, including drilling and completion fluid systems, solids-control and separation equipment, waste-management services, three-cone and diamond drill bits, borehole enlargement services, tubulars, directional systems, measurement-while-drilling and logging-while-drilling services, coiled tubing, cased-hole wireline and other complementary downhole tools and services. The Company also offers supply-chain management solutions through an extensive North American branch network providing pipe, valves and fittings as well as mill, safety and other maintenance products.

The Company's operations are driven principally by the level of exploration and production ( E&P ) spending in major energy-producing regions around the world and the depth and complexity of these projects. Although E&P spending is significantly influenced by the market price of oil and natural gas, it may also be affected by supply and demand fundamentals, finding and development costs, decline and depletion rates, political actions and uncertainties, environmental concerns, the financial condition of independent E&P companies and the overall level of global economic growth and activity. In addition, approximately five percent of the Company's consolidated revenues relate to the downstream energy sector, including petrochemical plants and refineries, whose spending is largely impacted by the general condition of the U.S. economy.

Capital investment by energy companies is largely divided into two markets, which vary greatly in terms of primary business drivers and associated volatility levels. North American drilling activity is primarily influenced by natural gas fundamentals, with nearly 80 percent of the current rig count focused on natural gas finding and development activities. Conversely, drilling in areas outside of North America is more dependent on crude oil fundamentals, which influence 80 percent of current international drilling activity. Historically, business in markets outside of North America has proved to be less volatile as the high cost E&P programs in these regions are generally undertaken by major oil companies, consortiums and national oil companies as part of a longer-term strategic development plan. Although 53 percent of the Company's consolidated revenues were generated in North America during the first quarter of 2009, Smith's profitability was influenced by business levels in markets outside of North America. The Distribution segment, which accounts for approximately one-fourth of consolidated revenues and primarily supports a North American customer base, serves to distort the geographic revenue mix of the Company's oilfield operations. Excluding the impact of the Distribution segment, approximately 60 percent of the Company's revenues were generated in markets outside of North America in the first quarter of 2009.

**Business Outlook**

The Company's current year results will be influenced by a material reduction in average worldwide drilling activity attributable to the significant economic slowdown and the ongoing weakness in global credit markets. We believe the impact of lower activity levels will be partially offset by the addition of the acquired W-H business lines and the concentration of our oilfield business base in markets outside North America, areas which tend to be more stable from an oil and gas investment standpoint. Near-term activity levels will likely be impacted by the annual spring break-up in Canada, which limits land-based drilling activity in that market during a portion of the second quarter. Seasonal drilling restrictions have resulted in a significant decline in the Canadian rig count from the average level reported for the first quarter of 2009, which will contribute to the reduction in average worldwide drilling activity for the second quarter.

The majority of the rig count decline from the prior year is expected to occur in the United States where drilling activity is currently 50 percent below the average level reported in 2008 and will likely decline further in the coming

months. The decrease in U.S. drilling activity is attributable to the lower number of land-based programs, which are generally more sensitive to commodity prices. Customer spending in most international markets, which is primarily driven by oil-directed activities, has not been significantly impacted to date. Although the long-term outlook for the energy sector is favorable due to supply and demand fundamentals, the current state of the world economies could lead to further weakness in exploration and production spending levels further reducing demand for the Company's products and services and adversely impacting future results.

**Table of Contents**

**Forward-Looking Statements**

This document contains forward-looking statements within the meaning of the Section 21E of the Securities Exchange Act of 1934, as amended, concerning, among other things, our outlook, financial projections and business strategies, all of which are subject to risks, uncertainties and assumptions. These forward-looking statements are identified by their use of terms such as anticipate, believe, could, estimate, expect, project, should and similar terms. These statements are based on certain assumptions and analyses that we believe are appropriate under the circumstances. Such statements are subject to, among other things, overall demand for and pricing of the Company's products and services, general economic and business conditions, the level of oil and natural gas exploration and development activities, global economic growth and activity, political stability of oil-producing countries, finding and development costs of operations, decline and depletion rates for oil and natural gas wells, seasonal weather conditions, industry conditions, and changes in laws or regulations and other risk factors that are discussed beginning on page 25 of this Form 10-Q, in the Company's Form 10-K for the fiscal year ended December 31, 2008, and other documents filed with the Securities and Exchange Commission, many of which are beyond the control of the Company. Should one or more of these risks or uncertainties materialize, or should the assumptions prove incorrect, actual results may differ materially from those expected, estimated or projected. Management believes these forward-looking statements are reasonable. However, you should not place undue reliance on these forward-looking statements, which are based only on our current expectations. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to publicly update or revise any of them in light of new information, future events or otherwise.

**Table of Contents****Results of Operations***Segment Discussion*

Our business is segregated into three operating divisions, M-I SWACO, Smith Oilfield and Distribution, which is the basis upon which we report our results. The M-I SWACO segment consists of a majority-owned drilling fluid and environmental services joint venture operation. The Smith Oilfield segment is comprised of our wholly-owned drilling and completion services operations, which includes drill bits, directional drilling services and downhole tools. The Distribution segment consists of the Wilson distribution operations and a majority-owned interest in CE Franklin, Ltd., a publicly-traded Canadian distribution company. Finally, general corporate primarily reflects expenses related to corporate personnel, administrative support functions and long-term incentive compensation programs.

	Three Months Ended March 31,			
	2009		2008	
	Amount	%	Amount	%
<b>Financial Data: (Dollars in thousands)</b>				
<b>Revenues:</b>				
M-I SWACO	\$ 1,159,337	48	\$ 1,228,429	51
Smith Oilfield	682,400	28	574,498	25
Distribution	569,742	24	568,071	24
Total	\$ 2,411,479	100	\$ 2,370,998	100
<b>Geographic Revenues:</b>				
United States:				
M-I SWACO	\$ 259,889	11	\$ 306,265	13
Smith Oilfield	397,481	16	309,062	13
Distribution	432,170	18	397,352	17
Total United States	1,089,540	45	1,012,679	43
Canada:				
M-I SWACO	40,926	2	46,362	2
Smith Oilfield	37,938	1	47,594	2
Distribution	113,420	5	140,469	6
Total Canada	192,284	8	234,425	10
Non-North America:				
M-I SWACO	858,522	36	875,802	37
Smith Oilfield	246,981	10	217,842	9
Distribution	24,152	1	30,250	1
Total Non-North America	1,129,655	47	1,123,894	47
Total Revenues	\$ 2,411,479	100	\$ 2,370,998	100

**Operating Income:**

M-I SWACO	\$	147,508	13	\$	207,798	17
Smith Oilfield		105,765	16		163,006	28
Distribution		15,521	3		29,884	5
General corporate		(27,116)	*		(21,881)	*
Total	\$	241,678	10	\$	378,807	16

\* *not meaningful*

**Table of Contents**

	Three Months Ended March 31,			
	2009		2008	
	Amount	%	Amount	%
<b>Market Data:</b>				
<b>Average Worldwide Rig Count: <sup>(1)</sup></b>				
United States	1,347	35	2,009	44
Canada	293	7	446	10
Non-North America	2,228	58	2,142	46
Total	3,868	100	4,597	100
Onshore	3,274	85	4,024	88
Offshore	594	15	573	12
Total	3,868	100	4,597	100
<b>Average Commodity Prices:</b>				
Crude Oil (\$/Bbl) <sup>(2)</sup>	\$ 43.31		\$ 97.82	
Natural Gas (\$/mcf) <sup>(3)</sup>	4.47		8.74	

<sup>(1)</sup> Source: M-I SWACO.

<sup>(2)</sup> Average daily West Texas Intermediate ( WTI ) spot closing prices, as quoted by NYMEX.

<sup>(3)</sup> Average daily Henry Hub, Louisiana spot closing prices, as quoted by NYMEX.

**M-I SWACO****Revenues**

M-I SWACO primarily provides drilling and completion fluid systems, engineering and technical services to the oil and gas industry. Additionally, these operations provide oilfield production chemicals and manufacture and market equipment and services used for solids control, particle separation, pressure control, rig instrumentation and waste management. M-I SWACO is significantly influenced by its exposure to the global offshore market, which constitutes 50 percent of the revenue base, and to exploration and production spending for land-based projects outside of North America, which contributes approximately 33 percent of the division's revenues. Offshore drilling programs, which accounted for 15 percent of the worldwide rig count in the first quarter of 2009, are generally more revenue intensive



than land-based projects due to the complex nature of the related drilling environment. M-I SWACO reported revenues of \$1.16 billion for the first quarter of 2009, six percent below the March 2008 period. Approximately 80 percent of the year-on-year revenue decrease related to the Eastern Hemisphere markets impacted by lower land-based drilling activity in Russia, reduced customer spending in the Caspian and North Sea markets and the strengthening of the U.S. dollar relative to several key European currencies in which a material proportion of the business is transacted. Western Hemisphere revenues declined modestly from the prior year period as lower U.S. onshore business volumes were largely offset by deepwater activity expansion in Latin America.

*Operating Income*

Operating income for the M-I SWACO segment totaled \$147.5 million for the three months ended March 31, 2009 translating into operating margins of 12.7 percent. Excluding the impact of \$19.3 million of severance and facility closure costs included in the March 2009 period, operating income approximated \$166.8 million, or 14.4 percent of revenues. Excluding costs incurred in connection with downsizing initiatives, operating margins declined 2.5 percentage points from the prior year period reflecting the impact of reduced business volumes and, to a lesser extent, lower U.S. onshore-related product pricing. On an absolute dollar basis, adjusted operating income was \$41.0 million below the prior year's level as the impact of lower revenue volumes and product pricing was partially offset by reduced variable-based operating expenses.

**Table of Contents*****Smith Oilfield******Revenues***

The Smith Oilfield segment provides three-cone and diamond drill bits, tubulars, borehole enlargement tools, drill motors, directional drilling, measurement-while-drilling, and logging-while-drilling services, as well as completions, coiled tubing, cased-hole wireline and drilling related services. Approximately two-thirds of the segment's business base is concentrated in North America driven, in part, by the significance of increased unconventional drilling projects in the U.S. land-based market and the complexity of drilling programs which drive demand for a wider range of product offerings. For the three months ended March 31, 2009, Smith Oilfield's revenues totaled \$682.4 million, a 19 percent improvement over the comparable prior year period. The reported revenue growth reflects the inclusion of the W-H operations which more than offset the impact of the significant decline in North American drilling activity. Excluding the impact of acquired operations, segment revenues declined 16 percent from the prior year level driven by reduced demand for drill pipe and premium tubular products. Additionally, the revenue performance was influenced by lower drill bit volumes associated with the reduction in North American onshore projects and increased pricing pressure experienced in the U.S. market.

***Operating Income***

Operating income for the Smith Oilfield segment was \$105.8 million for the three months ended March 31, 2009. After excluding severance-related charges incurred in the current year quarter, operating income totaled \$118.1 million, or 17.3 percent of revenues. Excluding costs incurred in connection with downsizing initiatives, operating margins declined 11.1 percentage points from the prior year period reflecting the loss of a significant proportion of fixed-cost rental and service offering revenue, a decrease in higher-relative margin drill bit sales and modest pricing erosion. On an absolute dollar basis, adjusted operating income was \$44.9 million below the prior year's level influenced by reduced business volumes, lower product pricing and the inclusion of incremental operating expenses associated with the W-H business infrastructure.

***Distribution******Revenues***

The Distribution segment markets pipe, valves, fittings and mill, safety and other maintenance products to energy and industrial markets, primarily through an extensive network of supply branches in the United States and Canada. The segment has the most significant North American revenue exposure of any of the Company's operations with 96 percent of first quarter 2009 revenues generated in those markets. Moreover, just under one-quarter of the segment's revenues relate to sales to the downstream energy sector, including petrochemical plants and refineries, whose spending is largely influenced by the general state of the U.S. economic environment. Additionally, certain customers in this sector utilize petroleum products as a base material and, accordingly, are impacted by crude oil and natural gas prices. Distribution revenues totaled \$569.7 million for the first quarter of 2009, slightly above the prior year period. Increased capital project spending associated with unconventional drilling programs and pipeline expansion projects in the United States offset the impact of lower Canadian drilling and completion activity and reduced U.S. downstream business volumes.

***Operating Income***

Operating income for the Distribution segment was \$15.5 million for the three months ended March 31, 2009 translating into operating margins of 2.7 percent. After excluding the impact of \$0.7 million of severance costs included in the March 2009 period, operating income approximated \$16.2 million, or 2.8 percent of revenues. Excluding costs incurred in connection with downsizing initiatives, operating margins declined 2.5 percentage points from the prior year period influenced by growth in line pipe sales, which carry lower comparable margins, and decreased product pricing. On an absolute dollar basis, adjusted operating income was \$13.7 million below the prior year's level as the impact of the unfavorable business mix and lower pricing was partially offset by reduced variable-based operating expenses.

**Table of Contents***Consolidated Results*

For the periods indicated, the following table summarizes the results of operations of the Company and presents these results as a percentage of total revenues (dollars in thousands):

	Three Months Ended March 31,			
	2009		2008	
	Amount	%	Amount	%
Revenues	\$ 2,411,479	100	\$ 2,370,998	100
Gross profit	692,302	29	781,484	33
Selling, general and administrative expenses	450,624	19	402,677	17
Operating income	241,678	10	378,807	16
Interest expense	27,524	1	16,301	1
Interest income	(358)		(896)	
Income before income taxes and noncontrolling interests	214,512	9	363,402	15
Income tax provision	70,318	3	117,291	5
Noncontrolling interests in net income of subsidiaries	47,259	2	71,120	3
Net income attributable to Smith	\$ 96,935	4	\$ 174,991	7

Consolidated revenues totaled \$2.41 billion for the three months ended March 31, 2009, representing a two percent increase over amounts reported in the prior year quarter. Excluding the impact of incremental revenues associated with the W-H transaction, base-business levels declined seven percent from the year-ago quarter. The base-business performance reflects the sharp reduction in North American activity that resulted in decreased demand for drill pipe and premium tubular products, reduced drill bit sales volumes and, to a lesser extent, lower pricing across various product and service offerings.

Gross profit was \$692.3 million for the first quarter of 2009, reflecting an 11 percent reduction from the prior year's results. Gross margins decreased 4.3 percentage points from the year-ago period influenced by reduced revenue volumes and, to a lesser extent, lower product and service pricing. On an absolute dollar basis, gross profit was \$89.2 million below the prior year's level evidencing a significant decline in revenue volumes without a comparable reduction in associated costs, an unfavorable shift in the sales mix towards lower relative-margin offerings and reduced product pricing.

Selling, general and administrative expenses totaled \$450.6 million, a 12 percent increase over the amounts reported in the prior year quarter. Excluding the impact of \$32.3 million of severance and facility closure costs included in the March 2009 period, operating expenses increased \$15.6 million over the prior year quarter. Incremental costs associated with the W-H sales and administrative functions were partially offset by lower variable-based expenses associated with the reduced business volumes.

Net interest expense, which represents interest expense less interest income, equaled \$27.2 million in the first quarter of 2009. The \$11.8 million year-over-year reported increase in net interest reflects borrowings required to fund the W-H acquisition. The substantial decline in short-term Eurodollar interest rates experienced during the March 2009 quarter partially offset the impact of the incremental borrowings on interest expense.

The effective tax rate for the March 2009 quarter approximated 32.8 percent, approximately 50 basis points above the prior year level. The unfavorable comparison to the prior year quarter is primarily attributable to the W-H acquisition which resulted in a shift in the geographic mix of earnings towards a higher relative-rate tax jurisdiction. The effective tax rate was lower than the U.S. statutory rate due to the impact of M-I SWACO's U.S. partnership earnings for which

the noncontrolling interest partner is directly responsible for its related income taxes. The Company properly consolidates the pretax income related to the minority partner's share of U.S. partnership earnings but excludes the related tax provision.

**Table of Contents**

Noncontrolling interests reflect the portion of the results of majority-owned operations that are applicable to noncontrolling ownership interests. Noncontrolling interests totaled \$47.3 million for the March 2009 quarter, \$23.9 million below the amount reported in the prior year period primarily associated with a decline in profitability levels in the M-I SWACO joint venture.

**Liquidity and Capital Resources***General*

At March 31, 2009, cash and cash equivalents equaled \$201.5 million. During the first three months of 2009, the Company generated \$197.8 million of cash flows from operations. The amount was above the prior-year period as reduced year-on-year profitability levels related to the sharp downturn in drilling activity were offset by lower required working capital investment.

Cash flows used in investing activities for the March 2009 period totaled \$16.9 million \$46.1 million below the prior year quarter. The decrease from the prior year period reflects the sale of certain non-core businesses acquired in connection with the W-H transaction. Excluding the impact of these divestitures, cash flows used in investing activities rose \$18.9 million from the prior year, reflecting routine additions of equipment and rental tools to support market expansion and maintain the existing capital equipment base. The Company invested \$74.7 million in property, plant and equipment during the first three months of 2009, after taking into consideration cash proceeds arising from certain asset disposals.

Projected net capital expenditures for 2009 are expected to total \$300 million, approximately \$70 million below the spending levels reported in the prior fiscal year. A significant portion of the planned capital investment relates to rental tool additions for our recently acquired directional drilling operations to support geographic expansion efforts outside the United States.

Cash flows used in financing activities totaled \$139.5 million for the three months ended March 31, 2009, \$33.2 million above the prior year quarter. The Company's operating cash flow performance enabled the funding of investing activities, \$30.3 million of combined common stock dividend and noncontrolling joint venture partner distributions and other financing-related outflows, while still having sufficient capacity to repay \$64.4 million of outstanding borrowings under various loan agreements.

The Company's primary internal source of liquidity is cash flow generated from operations. Cash flows generated from operations is primarily influenced by the level of worldwide drilling activity, which affects profitability levels and working capital requirements. Capacity under revolving credit agreements is also available, if necessary, to fund operating or investing activities. As of March 31, 2009, the Company had \$197.0 million drawn and \$4.5 million of letters of credit issued under various U.S. revolving credit facilities, resulting in \$233.5 million of capacity available for future operating or investing needs. Revolving credit facilities in place outside of the United States, which are generally used to finance local operating needs, had available borrowing capacity of \$118.9 million as of March 31, 2009. Additionally, the Company negotiated a \$525.0 million term loan facility with a syndicate of financial institutions during the first quarter of 2009. The facility, which expires on June 5, 2009, was undrawn at the end of the quarter.

The Company's external sources of liquidity include debt and equity financing in the public capital markets, if needed. The Company carries an investment-grade credit rating with recognized rating agencies, generally providing the Company with access to debt markets as evidenced by the recent \$1.0 billion public debt issuance. The Company's overall borrowing capacity is, in part, dependent on maintaining compliance with financial covenants under the various credit agreements. As of March 31, 2009, the Company was within the covenant compliance thresholds under its various loan indentures, as amended, providing the ability to access available borrowing capacity. Management believes internally-generated cash flow combined with capacity available under existing credit facilities will be sufficient to finance capital expenditures and working capital needs of the existing operations for the foreseeable future.

Management continues to evaluate opportunities to acquire products or businesses complementary to the Company's operations. In addition to potential external acquisition candidates, our M-I SWACO partner can offer to sell us their entire ownership interest in the venture in exchange for a specified cash purchase price. Under the terms of the joint venture, we are provided the same sale rights. In the event a partner's offer to sell is not accepted, the offering party is

obligated to purchase the other party's interest at the same relative valuation. Additional acquisitions, if they arise, may involve the use of cash or, depending upon the size and terms of the acquisition, may require debt or equity financing.

**Table of Contents**

The Company makes regular quarterly distributions under a dividend program. The current annualized payout under the program of approximately \$106 million is expected to be funded with future cash flows from operations and, if necessary, amounts available under existing credit facilities. The level of future dividend payments will be at the discretion of the Company's Board of Directors and will depend upon the Company's financial condition, earnings, cash flows, compliance with certain debt covenants and other relevant factors.

The Company's Board of Directors has authorized a share repurchase program that allows for the repurchase of up to 20 million shares of the Company's common stock, subject to regulatory issues, market considerations and other relevant factors. No shares were repurchased during the first quarter of 2009, accordingly the Company had 15.2 million shares remaining under the current authorization as of March 31, 2009. Future repurchases under the program may be executed from time to time in the open market or in privately negotiated transactions and will be funded with cash flows from operations or amounts available under existing credit facilities.

**Commitments and Contingencies**

*Standby Letters of Credit*

In the normal course of business with customers, vendors and others, the Company is contingently liable for performance under standby letters of credit and bid, performance and surety bonds. Certain of these outstanding instruments guarantee payment to insurance companies with respect to certain liability coverages of the Company's insurance captive. Excluding the impact of these instruments, for which \$23.2 million of related liabilities are reflected in the accompanying consolidated condensed balance sheet, the Company was contingently liable for approximately \$242.5 million of standby letters of credit and bid, performance and surety bonds at March 31, 2009. Management does not expect any material amounts to be drawn on these instruments.

*Litigation*

The Company is a defendant in various legal proceedings arising in the ordinary course of business. In the opinion of management, these matters will not have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

*Environmental*

The Company routinely establishes and reviews the adequacy of reserves for estimated future environmental clean-up costs for properties currently or previously operated by the Company. In the opinion of management, these matters will not have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

**Critical Accounting Policies and Estimates**

The discussion and analysis of financial condition and results of operations are based upon the Company's consolidated condensed financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. The Company evaluates its estimates on an ongoing basis, based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. In its 2008 Annual Report on Form 10-K, the Company has described the critical accounting policies that require management's most significant judgments and estimates. There have been no material changes in these critical accounting policies.

**Table of Contents****Recently Adopted Accounting Pronouncements**

From time to time, new accounting pronouncements are issued by the Financial Accounting Standards Board. The following standards were adopted by the Company on the specified effective date of January 1, 2009.

The Company adopted Statement of Financial Accounting Standards ( SFAS ) No. 141(R), Business Combinations ( SFAS 141(R) ) which revises the accounting and disclosure requirements for acquisition transactions. SFAS 141(R) differs from the previous standard in that it requires the Company to expense professional fees and other transaction-related costs as incurred instead of capitalizing these costs as purchase price consideration. Additionally, the Company will be required to estimate contingent assets, liabilities and transaction-related consideration as of the purchase date with future changes in the underlying estimates recognized in the statement of operations. Finally, SFAS 141(R) requires the Company to reflect any adjustments to deferred tax asset valuation allowances and income tax uncertainties associated with acquisitions completed prior to January 1, 2009 as income tax expense rather than an adjustment to goodwill.

The Company implemented SFAS No. 160 Noncontrolling Interests in Consolidated Financial Statements, an Amendment of ARB No. 51 ( SFAS 160 ) which modifies the accounting and disclosure requirements for subsidiaries which are not wholly-owned. In accordance with the provisions of SFAS 160, the Company has reclassified the noncontrolling interest previously reflected as a long-term liability and included the amount as a component of stockholders' equity in the accompanying consolidated condensed balance sheets. Additionally, the Company has presented the net income attributable to the Company and the noncontrolling ownership interests separately in the accompanying consolidated condensed statements of operations.

The Company adopted SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, an Amendment of FASB Statement No. 133 ( SFAS 161 ) which requires enhanced disclosure about derivative instruments. The standard requires the inclusion of tabular information reflecting the impact of derivative financial instruments on the Company's consolidated financial position and results of operations.

Management believes the impact of other recently issued standards, which are not yet effective, will not have a material impact on the Company's consolidated financial position, results of operations or cash flows upon adoption.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

The Company is exposed to certain market risks arising from transactions that are entered into in the normal course of business which are primarily related to interest rate changes and fluctuations in foreign exchange rates. During the reporting period, no events or transactions other than discussed below have occurred which would materially change the information disclosed in the Company's 2008 Annual Report on Form 10-K.

The Company's exposure to interest rate changes is managed through the use of a combination of fixed and floating rate debt and by entering into interest rate contracts, from time to time, on a portion of its long-term borrowings. Due to the refinancing of a bridge loan with a fixed-rate public debt issuance during the first quarter of 2009, 57 percent of the Company's total debt carried a fixed interest rate as of March 31, 2009 which compares to 20 percent as of December 31, 2008. Management believes that it will be able to manage its remaining exposure to variable-rate debt instruments, if required, with interest rate contracts. Accordingly, significant interest rate changes are not expected to have a material near-term impact on the Company's future earnings or cash flows.

**Item 4. Controls and Procedures**

*Evaluation of disclosure controls and procedures.* Our management, with the participation of our principal executive and financial officers, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ( Exchange Act )) as of March 31, 2009. Based upon that evaluation, our principal executive and financial officers concluded that as of March 31, 2009, our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports we file or submit under the Exchange Act is (1) recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms, and (2) accumulated and communicated to our management, including our principal executive and financial officers, to allow timely decisions regarding required disclosure.

*Changes in internal control over financial reporting.* There has been no change in the Company's internal control over financial reporting during the quarter ended March 31, 2009 that has materially affected, or is reasonably likely to



materially affect, the Company's internal control over financial reporting.

**Table of Contents**

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

None.

**Item 1A. Risk Factors**

The risk factors discussed below update the Risk Factors previously disclosed in Item 1A to Part I of our Form 10-K for the year ended December 31, 2008.

***The significant deterioration in the global business environment and related factors could adversely impact our financial condition and results of operations.***

The deterioration in the global business environment has led to a significant reduction in commodity prices, which has contributed to lower cash flow generation for exploration and production companies. In addition, a reduction in the availability and increased cost of financing has had a significant impact on a number of our customers. These factors could contribute to a material decline in our customers' spending levels which may continue or accelerate. A continued reduction in the level of future investment could have a material adverse effect on our results of operations, financial position and cash flows.

Moreover, if the business environment experiences a significant deterioration from current levels, we may be required to record a goodwill impairment loss, which could have a material adverse effect on our results of operations and our compliance with applicable debt covenants.

***The current financial and credit market environment may limit our ability to expand our business through acquisitions.***

The current state of the global financial and credit markets has at times limited availability of financing and has increased its cost when available. Any inability to access the credit and capital markets could limit our ability to make significant business acquisitions, including transactions under the applicable provisions of our joint venture agreements in which the partners may offer to sell us their ownership interests in the joint ventures. In addition, we may need waivers of applicable debt covenants or be required to issue equity securities, resulting in dilution to our existing stockholders, or sell assets. Our ability to access the debt and/or equity capital markets may be restricted or limited at such time, which could have an impact on our flexibility to pursue these opportunities. The failure to pursue these opportunities, or the consequences of seeking waivers, issuing equity or selling assets could have a material adverse effect on our future results of operations, financial position and cash flows.

***Smith is dependent on the level of oil and natural gas exploration and development activities.***

Demand for Smith's products and services is dependent upon the level of oil and natural gas exploration and development activities. The level of worldwide oil and natural gas development activities is primarily influenced by the price of oil and natural gas, as well as price expectations. The current state of world economies could lead to further weakness in exploration and production spending levels further reducing demand for the Company's products and services and adversely impacting future results. In addition to oil and natural gas prices, the following factors impact exploration and development activity and may lead to significant changes in worldwide activity levels:

overall level of global economic growth and activity;

actual and perceived changes in the supply of and demand for oil and natural gas;

political stability and policies of oil-producing countries;

finding and development costs of operators;

decline and depletion rates for oil and natural gas wells; and

seasonal weather conditions that temporarily curtail drilling operations.

Changes in any of these factors could adversely impact Smith's financial condition, results of operations or cash flows.



**Table of Contents**

***A significant portion of Smith's revenue is derived in markets outside of North America.***

Smith is a multinational oilfield service company and generates the majority of its oilfield revenues in markets outside of North America. Changes in conditions within certain countries that have historically experienced a high degree of political and/or economic instability could adversely impact Smith's operations in such countries and as a result Smith's financial condition, results of operations or cash flows. Additional risks inherent in Smith's non-North American business activities include:

changes in political and economic conditions in the countries in which Smith operates, including civil uprisings, riots and terrorist acts;

unexpected changes in regulatory requirements affecting oil and natural gas exploration and development activities;

fluctuations in currency exchange rates and the value of the U.S. dollar;

restrictions on repatriation of earnings or expropriation of property without fair compensation;

governmental actions that result in the deprivation of contract or proprietary rights in the countries in which Smith operates; and

governmental sanctions.

***Smith operates in a highly technical and competitive environment.***

Smith operates in a highly competitive business environment. Accordingly, demand for Smith's products and services is largely dependent on its ability to provide leading-edge, technology-based solutions that reduce the operator's overall cost of developing energy assets. If competitive or other market conditions impact Smith's ability to continue providing superior-performing product offerings, Smith's financial condition, results of operations or cash flows could be adversely impacted.

***Regulatory compliance costs and liabilities could adversely impact Smith's earnings and cash available for operations.***

Smith is exposed to a variety of federal, state, local and international laws and regulations relating to matters such as the use of hazardous materials, health and safety, labor and employment, import/export control, currency exchange, bribery, corruption and taxation, and environmental, including laws and regulations governing air emissions, water discharge and waste management. These laws and regulations are complex, change frequently and have tended to become more stringent over time. In the event the scope of these laws and regulations expand in the future, the incremental cost of compliance could adversely impact Smith's financial condition, results of operations or cash flows. For example, the adoption of more stringent laws and regulations curtailing the level of oil and natural gas exploration and development activities could adversely affect Smith's operations by limiting demand for its products and services.

***Smith's industry is experiencing more litigation involving claims of infringement of intellectual property rights.***

Over the past few years, Smith's industry has experienced increased litigation related to the infringement of intellectual property rights. Although no material matters are pending or threatened at this time, Smith, as well as certain of its competitors, has been named as defendants in various intellectual property matters in the past. These types of claims are typically costly to defend, involve monetary judgments that, in certain circumstances, are subject to being enhanced and are often brought in venues that have proved to be favorable to plaintiffs. If Smith is served with an intellectual property claim that it is unsuccessful in defending, it could adversely impact Smith's results of operations and cash flows.

**Table of Contents****Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The Company's Board of Directors has approved a share repurchase program that allows for the purchase of up to 20 million shares of the Company's common stock, subject to regulatory issues, market considerations and other relevant factors. During the first quarter of 2009, the Company did not repurchase any shares of common stock under the program. Prior to January 1, 2009, the Company has repurchased 4.8 million shares at an average cost of \$43.61 per share under the program. The acquired shares have been added to the Company's treasury stock holdings.

A summary of the Company's repurchase activity for the three months ended March 31, 2009 is as follows:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Program	Number of Shares that May Yet Be Purchased Under the Program
January 1 - January 31		\$		15,158,913
February 1 - February 29				15,158,913
March 1 - March 31				15,158,913
1 <sup>st</sup> Quarter 2009		\$		15,158,913

Certain participants in the long-term incentive plans surrender shares of common stock in order to satisfy tax withholding obligations. These shares are not considered acquisitions under the Company's share repurchase program.

**Item 3. Defaults upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

None.

**Item 5. Other Information**

None.

**Table of Contents**

**Item 6. Exhibits**

Exhibits designated with an \* are filed, and with an \*\* are furnished, as an exhibit to this Quarterly Report on Form 10-Q. Exhibits designated with a + are identified as management contracts or compensatory plans or arrangements. Exhibits previously filed as indicated below are incorporated by reference.

- 3.1 - Restated Certificate of Incorporation of the Company dated July 26, 2005, as amended. Filed as Exhibit 3.1 to the Company's report on Form 10-Q for the quarter ended June 30, 2008 and incorporated herein by reference.
- 3.2 - Amended and Restated Bylaws of the Company. Filed as Exhibit 3.1 to the Company's report on Form 8-K dated October 22, 2008 and incorporated herein by reference.
- 4.1 - First Supplemental Indenture dated as of March 19, 2009, between Smith International, Inc. and the Bank of New York Mellon, as Trustee, with respect to the issuance of the 8.625% Senior Notes due 2014 and the 9.750% Senior Notes due 2019. Filed as Exhibit 4.1 to the Company's report on Form 8-K dated March 16, 2009 and incorporated herein by reference.
- 4.2 - 8.625% Senior Note due 2014. Filed as Exhibit 4.2 to the Company's report on Form 8-K dated March 16, 2009 and incorporated herein by reference.
- 4.3 - 9.750% Senior Notes due 2019. Filed as Exhibit 4.3 to the Company's report on Form 8-K dated March 16, 2009 and incorporated herein by reference.
- 10.1 - First Amendment, dated March 3, 2009, among Smith International, Inc. Fortis Bank SA/NV, New York Branch, as administrative agent, the other agents named therein and the lender parties thereto. Filed as Exhibit 10.1 to the Company's report on Form 8-K dated March 3, 2009 and incorporated herein by reference.
- 10.2 - Third Amendment, dated March 3, 2009, among Smith International, Inc., M-I L.L.C., Comerica Bank, as administrative agent, the other agents named therein, and the lender parties thereto. Filed as Exhibit 10.2 to the Company's report on Form 8-K dated March 3, 2009 and incorporated herein by reference.
- 10.3 - Credit Agreement, dated as of March 9, 2009, among Smith International, Inc., the Lenders from time to time party thereto, and DNB NOR Bank ASA, as administrative agent, Calyon New York Branch, as syndication agent, Wells Fargo Banks, N.A., as senior managing agent, and DNB NOR Bank ASA and Calyon New York Branch as co-lead arrangers and joint bookrunners. Filed as Exhibit 10.3 to the Company's report on Form 8-K dated March 3, 2009 and incorporated herein by reference.
- 31.1\* - Certification of Chief Executive Officer pursuant to Rule 13a-14 or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2\* - Certification of Chief Financial Officer pursuant to Rule 13a-14 or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1\*\* - Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**Table of Contents**

**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.

SMITH INTERNATIONAL, INC.  
Registrant

Date: May 8, 2009

/s/ John Yearwood  
John Yearwood  
Chief Executive Officer,  
President and Chief Operating Officer

Date: May 8, 2009

/s/ Margaret K. Dorman  
Margaret K. Dorman  
Executive Vice President,  
Chief Financial Officer and Treasurer  
29

---

**Table of Contents**

**EXHIBIT INDEX**

Exhibits designated with an \* are filed, and with an \*\* are furnished, as an exhibit to this Quarterly Report on Form 10-Q. Exhibits designated with a + are identified as management contracts or compensatory plans or arrangements. Exhibits previously filed as indicated below are incorporated by reference.

- 3.1 - Restated Certificate of Incorporation of the Company dated July 26, 2005, as amended. Filed as Exhibit 3.1 to the Company's report on Form 10-Q for the quarter ended June 30, 2008 and incorporated herein by reference.
- 3.2 - Amended and Restated Bylaws of the Company. Filed as Exhibit 3.1 to the Company's report on Form 8-K dated October 22, 2008 and incorporated herein by reference.
- 4.1 - First Supplemental Indenture dated as of March 19, 2009, between Smith International, Inc. and the Bank of New York Mellon, as Trustee, with respect to the issuance of the 8.625% Senior Notes due 2014 and the 9.750% Senior Notes due 2019. Filed as Exhibit 4.1 to the Company's report on Form 8-K dated March 16, 2009 and incorporated herein by reference.
- 4.2 - 8.625% Senior Note due 2014. Filed as Exhibit 4.2 to the Company's report on Form 8-K dated March 16, 2009 and incorporated herein by reference.
- 4.3 - 9.750% Senior Notes due 2019. Filed as Exhibit 4.3 to the Company's report on Form 8-K dated March 16, 2009 and incorporated herein by reference.
- 10.1 - First Amendment, dated March 3, 2009, among Smith International, Inc. Fortis Bank SA/NV, New York Branch, as administrative agent, the other agents named therein and the lender parties thereto. Filed as Exhibit 10.1 to the Company's report on Form 8-K dated March 3, 2009 and incorporated herein by reference.
- 10.2 - Third Amendment, dated March 3, 2009, among Smith International, Inc., M-I L.L.C., Comerica Bank, as administrative agent, the other agents named therein, and the lender parties thereto. Filed as Exhibit 10.2 to the Company's report on Form 8-K dated March 3, 2009 and incorporated herein by reference.
- 10.3 - Credit Agreement, dated as of March 9, 2009, among Smith International, Inc., the Lenders from time to time party thereto, and DNB NOR Bank ASA, as administrative agent, Calyon New York Branch, as syndication agent, Wells Fargo Banks, N.A., as senior managing agent, and DNB NOR Bank ASA and Calyon New York Branch as co-lead arrangers and joint bookrunners. Filed as Exhibit 10.3 to the Company's report on Form 8-K dated March 3, 2009 and incorporated herein by reference.
- 31.1\* - Certification of Chief Executive Officer pursuant to Rule 13a-14 or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2\* - Certification of Chief Financial Officer pursuant to Rule 13a-14 or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1\*\* - Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.