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SMITH INTERNATIONAL INC

Form 10-Q

August 14, 2001

1

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 June 30, 2001

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.)

411 NORTH SAM HOUSTON PARKWAY, SUITE 600  
HOUSTON, TEXAS  
(Address of principal executive offices)

77060  
(Zip Code)

(281) 443-3370  
(Registrant's telephone number, including area code)

NOT APPLICABLE  
(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

The number of shares outstanding of the Registrant's common stock as of August

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10, 2001 was 49,935,351.

2

INDEX

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

CONSOLIDATED STATEMENTS OF OPERATIONS

For the Three Months and Six Months ended June 30, 2001 and 2000.....

CONSOLIDATED BALANCE SHEETS

As of June 30, 2001 and December 31, 2000.....

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Six Months ended June 30, 2001 and 2000.....

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.....

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

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

PART II - OTHER INFORMATION

Items 1-6.....

SIGNATURES.....

3

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SMITH INTERNATIONAL, INC.  
 CONSOLIDATED STATEMENTS OF OPERATIONS  
 (Unaudited, in thousands except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2001	2000	2001	2000
REVENUES .....	\$ 872,389	\$ 657,229	\$ 1,737,700	\$ 1,232,675
COSTS AND EXPENSES:				
Costs of Revenues .....	613,453	482,894	1,232,675	987,541
Selling Expenses .....	128,541	99,794	251,717	187,541
General and Administrative Expenses .....	35,106	28,532	68,602	54,106
Goodwill Amortization .....	3,941	2,699	7,772	5,941
	781,041	613,919	1,560,766	1,232,675
INCOME BEFORE INTEREST AND TAXES .....	91,348	43,310	176,934	105,000
INTEREST EXPENSE, NET .....	10,738	8,758	21,081	16,738
INCOME BEFORE INCOME TAXES AND MINORITY INTERESTS .....	80,610	34,552	155,853	88,262
INCOME TAX PROVISION .....	26,087	11,413	50,892	21,541

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INCOME BEFORE MINORITY INTERESTS .....	54,523	23,139	104,961	
MINORITY INTERESTS .....	16,841	8,165	33,061	
	-----	-----	-----	-----
NET INCOME .....	\$ 37,682	\$ 14,974	\$ 71,900	\$
	=====	=====	=====	=====
EARNINGS PER SHARE:				
Basic .....	\$ 0.75	\$ 0.30	\$ 1.44	\$
	=====	=====	=====	=====
Diluted .....	\$ 0.75	\$ 0.30	\$ 1.42	\$
	=====	=====	=====	=====
WEIGHTED AVERAGE SHARES OUTSTANDING:				
Basic .....	49,910	49,725	49,877	
Diluted .....	50,517	50,363	50,505	

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

2

5

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

	June 30, 2001
	----- (Unaudited)
ASSETS	
CURRENT ASSETS:	
Cash and cash equivalents .....	\$ 39,938
Receivables, net .....	726,096
Inventories .....	646,192
Deferred tax assets, net .....	27,785
Prepaid expenses and other .....	38,334
	-----
Total current assets .....	1,478,345
	-----
PROPERTY, PLANT AND EQUIPMENT, NET .....	426,951
GOODWILL, NET .....	454,464
OTHER ASSETS .....	136,034
	-----
TOTAL ASSETS .....	\$ 2,495,794
	=====
LIABILITIES AND SHAREHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Short-term borrowings and current portion of long-term debt .....	\$ 86,266

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Accounts payable .....	298,488
Accrued payroll costs .....	54,742
Income taxes payable .....	30,710
Other .....	135,093
	-----
Total current liabilities .....	605,299
	-----
LONG-TERM DEBT .....	494,101
DEFERRED TAX LIABILITIES .....	44,405
OTHER LONG-TERM LIABILITIES .....	42,183
MINORITY INTERESTS .....	420,157
COMMITMENTS AND CONTINGENCIES	
SHAREHOLDERS' EQUITY:	
Preferred stock, \$1 par value; 5,000 shares authorized; no shares issued or outstanding in 2001 or 2000 .....	--
Common stock, \$1 par value; 150,000 shares authorized; 50,591 shares issued in 2001 (50,419 in 2000) .....	50,591
Additional paid-in capital .....	390,223
Retained earnings .....	482,209
Accumulated comprehensive loss .....	(25,672)
Less - treasury securities, at cost; 656 common shares in 2001 and 2000 ....	(7,702)
	-----
Total shareholders' equity .....	889,649
	-----
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY .....	\$ 2,495,794
	=====

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

SMITH INTERNATIONAL, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited, in thousands)

	Six Months Ended June 30,	
	2001	2000
	-----	-----
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income .....	\$ 71,900	\$ 20,000
Adjustments to reconcile net income to net cash provided by (used in) operating activities, excluding the net effects of acquisitions:		
Depreciation and amortization .....	44,937	30,000
Minority interests .....	33,061	10,000
Provision for losses on receivables .....	1,303	(1,000)
Gain on disposal of property, plant and equipment .....	(3,302)	(1,000)
Foreign currency translation losses .....	571	(1,000)

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Changes in operating assets and liabilities:		
Receivables .....	(42,608)	(4)
Inventories .....	(54,063)	(2)
Accounts payable .....	(3,517)	(1)
Other current assets and liabilities .....	12,179	1
Other non-current assets and liabilities .....	(9,143)	(
	-----	-----
Net cash provided by (used in) operating activities .....	51,318	(
	-----	-----
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of businesses, net of cash acquired .....	(46,396)	(4)
Purchases of property, plant and equipment .....	(56,820)	(3)
Proceeds from disposal of property, plant and equipment .....	9,264	
Other .....	(1,325)	
	-----	-----
Net cash used in investing activities .....	(95,277)	(7)
	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of long-term debt .....	273,724	7
Principal payments of long-term debt .....	(201,899)	(
Net change in short-term borrowings .....	(41,838)	
Proceeds from exercise of stock options .....	5,455	1
Contribution by minority interest partner .....	12,000	
	-----	-----
Net cash provided by financing activities .....	47,442	8
	-----	-----
Effect of exchange rate changes on cash .....	(89)	
	-----	-----
Increase in cash and cash equivalents .....	3,394	
Cash and cash equivalents at beginning of period .....	36,544	2
	-----	-----
Cash and cash equivalents at end of period .....	\$ 39,938	\$ 3
	=====	=====
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for interest .....	\$ 17,450	\$ 1
Cash paid for income taxes .....	\$ 37,503	\$

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

4

7

SMITH INTERNATIONAL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

1. BASIS OF PRESENTATION OF INTERIM FINANCIAL STATEMENTS

The accompanying unaudited consolidated financial statements of Smith International, Inc. and subsidiaries (the "Company") have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the "Commission"). Accordingly, certain information and footnote disclosures

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normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. These financial statements should be read in conjunction with the audited financial statements and accompanying notes included in the Company's 2000 Annual Report on Form 10-K and other current filings with the Commission.

The unaudited consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments) which the Company considers necessary for a fair presentation of the interim periods. All significant intercompany balances and transactions have been eliminated in the accompanying financial statements. Results for the interim periods are not necessarily indicative of results for the year. Certain prior year amounts have been reclassified to conform to current year presentation.

### 2. RECENT ACCOUNTING PRONOUNCEMENTS

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 141 ("SFAS No. 141"), "Business Combinations," which is effective for business combinations initiated after June 30, 2001. SFAS No. 141 eliminates the pooling-of-interest method of accounting for business combinations and modifies the application of the purchase accounting method.

The FASB also issued Statement of Financial Accounting Standards No. 142 ("SFAS No. 142"), "Goodwill and Other Intangible Assets," in July 2001 which addresses financial accounting and reporting for goodwill and other intangible assets. Under SFAS No. 142, goodwill and some intangibles will no longer be amortized to earnings but will be tested for impairment. While most provisions of SFAS No. 142 are effective for the Company beginning January 1, 2002, goodwill and intangible assets acquired during the remainder of the current fiscal year will be subject immediately to the provisions of the statement. Although the Company continues to evaluate the impact of this recently issued standard, assuming no asset impairment, the adoption of SFAS No. 142 will result in the elimination of \$15.7 million of goodwill amortization expected to be recognized in fiscal 2001, or \$9.2 million net of taxes and minority interests.

The Company adopted Statement of Financial Accounting Standards No. 133 ("SFAS No. 133"), "Accounting for Derivative Instruments and Hedging Activities," effective January 1, 2001. SFAS No. 133 requires that the Company record derivatives on the balance sheet at fair value and establishes criteria for designation and effectiveness of hedging relationships. 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. The Company occasionally employs derivative financial instruments such as foreign exchange contracts, foreign exchange options and interest rate swap contracts to mitigate or eliminate certain of those risks. The Company does not enter into derivative instruments for speculative purposes.

The adoption of SFAS No. 133 on January 1, 2001 did not have a material impact on the Company's financial position or results of operations. During the three-month and six-month periods ended June 30, 2001, the Company recorded the change in fair market value related to fair value hedges, which included foreign exchange contracts, to general and administrative expenses in the accompanying consolidated statement of operations. These amounts were not material. Additionally, the Company recorded the change in value related to cash flow hedges, which included foreign exchange contracts and interest rate swaps, to accumulated other comprehensive income. During the first six months of 2001, changes in foreign exchange rates and interest rates resulted in an adjustment of \$2.3 million to accumulated other comprehensive income in the accompanying consolidated balance sheet. Of this amount, \$2.1 million is expected to be recognized in the statement of operations during the next 12 months, offset by the effect of changes in the underlying basis of the hedged transactions.

## 3. BUSINESS COMBINATIONS

During the six months ended June 30, 2001, the Company completed the acquisitions of certain businesses for aggregate cash consideration of \$46.4 million. The January 2001 acquisition of substantially all of the U.S. net assets of Van Leeuwen Pipe and Tube Corporation ("Van Leeuwen"), a leading provider of pipe, valves and fittings to the refining, petrochemical and power generation industries, accounted for the majority of the current year activity. This transaction was financed with cash consideration of \$41.1 million, borrowed under a short-term loan facility which was subsequently repaid with proceeds from the Company's public debt offering (see Note 8).

These acquisitions have been recorded using the purchase method of accounting and, accordingly, the acquired operations have been included in the results of operations since the dates of acquisition. The purchase price was allocated to the net assets acquired based upon their estimated fair market values at the dates of acquisition. The excess of the purchase price over the estimated fair value of the net assets acquired has been recorded as goodwill and is currently being amortized on a straight-line basis over 20 years.

The balances included in the consolidated balance sheet as of June 30, 2001 related to these acquisitions are based upon preliminary information and are subject to change when additional information concerning final asset and liability valuations is obtained. Material changes in the preliminary allocations are not anticipated by management.

The following unaudited pro forma supplemental information presents consolidated results of operations as if the Company's significant current and prior year acquisitions had occurred on January 1, 2000 (in thousands, except per share amounts):

	Six Months Ended June 30,	
	2001	2000
Revenues.....	\$ 1,752,941	\$ 1,422,054
Net income.....	71,255	26,003
Earnings per share:		
Basic.....	\$ 1.43	\$ 0.53
Diluted.....	1.41	0.52

The unaudited pro forma supplemental information 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 combinations been in effect at the dates indicated or of future results for the combined entities.

The following schedule summarizes investing activities related to the current year acquisitions included in the consolidated statements of cash flows (in thousands):



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Fair value of assets, net of cash acquired.....	\$ 76,032
Goodwill recorded.....	5,947
Total liabilities assumed.....	(35,583)
	-----
Cash paid for acquisition of businesses, net of cash acquired.....	\$ 46,396
	=====

6

9

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 which could have occurred if additional shares were issued for stock option exercises under the treasury stock method. 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 June 30,		Six Months Ended June 30,	
	2001	2000	2001	2000
	-----	-----	-----	-----
Basic EPS:				
Net income .....	\$ 37,682	\$ 14,974	\$ 71,900	\$ 26,297
	=====	=====	=====	=====
Weighted average number of common shares outstanding .....	49,910	49,725	49,877	49,448
	=====	=====	=====	=====
Basic EPS .....	\$ 0.75	\$ 0.30	\$ 1.44	\$ 0.53
	=====	=====	=====	=====
Diluted EPS:				
Net income .....	\$ 37,682	\$ 14,974	\$ 71,900	\$ 26,297
	=====	=====	=====	=====
Weighted average number of common shares outstanding .....	49,910	49,725	49,877	49,448
Dilutive effect of stock options .....	607	638	628	705
	-----	-----	-----	-----
	50,517	50,363	50,505	50,153
	=====	=====	=====	=====
Diluted EPS .....	\$ 0.75	\$ 0.30	\$ 1.42	\$ 0.52
	=====	=====	=====	=====

5. COMPREHENSIVE INCOME

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Comprehensive income encompasses net income and changes in the components of accumulated other comprehensive income during the periods presented. Accumulated other comprehensive income consists of currency translation adjustments and changes in the unrealized fair value of certain derivative financial instruments. The Company's comprehensive income is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2001	2000	2001	2000
Net income .....	\$ 37,682	\$ 14,974	\$ 71,900	\$ 26,297
Changes in unrealized fair value of derivatives .....	(287)	--	(2,316)	--
Currency translation adjustments .....	(765)	(3,182)	(5,563)	(4,430)
Comprehensive income .....	<u>\$ 36,630</u>	<u>\$ 11,792</u>	<u>\$ 64,021</u>	<u>\$ 21,867</u>

7

10

### 6. INVENTORIES

Inventories are stated at the lower of cost or market. Cost is determined by the first-in, first-out ("FIFO") method for the majority of the Company's inventories. The remaining inventories are costed under the last-in, first-out ("LIFO") or average cost methods. Inventory costs, consisting of materials, labor and factory overhead, are as follows (in thousands):

	June 30, 2001	December 31, 2000
Raw materials .....	\$ 50,313	\$ 46,923
Work-in-process .....	68,063	57,167
Products purchased for resale .....	185,045	139,591
Finished goods .....	367,570	341,117
	<u>670,991</u>	<u>584,798</u>
Reserves to state certain domestic inventories (\$334,987 and \$273,811 in 2001 and 2000, respectively) on a LIFO basis .....	(24,799)	(24,771)
	<u>\$ 646,192</u>	<u>\$ 560,027</u>

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7. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consists of the following (in thousands):

	June 30, 2001 -----	December 31, 2000 -----
Land .....	\$ 26,617	\$ 24,683
Buildings .....	93,195	91,432
Machinery and equipment .....	425,493	401,624
Rental tools .....	226,235	225,962
	-----	-----
	771,540	743,701
Less-accumulated depreciation .....	(344,589)	(334,653)
	-----	-----
	\$ 426,951	\$ 409,048
	=====	=====

8. DEBT

The following summarizes the Company's outstanding debt (in thousands):

	June 30, 2001 -----	December 31, 2000 -----
Current:		
Short-term borrowings .....	\$ 59,448	\$ 75,394
Current portion of long-term debt .....	26,818	90,557
	-----	-----
	\$ 86,266	\$ 165,951
	=====	=====
Long-Term:		
Notes, net of unamortized discounts .....	\$ 469,993	\$ 259,529
Bank revolvers payable .....	31,800	190,386
Term loans and other .....	19,126	15,358
	-----	-----
	520,919	465,273
Less current portion of long-term debt .....	(26,818)	(90,557)
	-----	-----
	\$ 494,101	\$ 374,716
	=====	=====

During the first quarter of 2001, the Company completed a public offering of \$250.0 million of 6.75 percent senior notes which mature in February 2011. The Company received net proceeds of \$246.7 million from the offering,

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which was used to repay short-term borrowings and indebtedness under revolving credit agreements.

Principal payments of long-term debt for the twelve-month periods ending subsequent to June 30, 2002 are as follows (in thousands):

2003.....	\$	50,172
2004.....		10,476
2005.....		10,476
2006.....		10,476
Thereafter.....		412,501
		-----
	\$	494,101
		=====

### 9. INDUSTRY SEGMENTS

The Company manufactures and markets premium products and services to the oil and gas exploration and production industry, the petrochemical industry and other industrial markets. The Company has two reportable segments: Oilfield Products and Services and Distribution.

The following table presents financial information for each reportable segment (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2001	2000	2001	2000
	-----	-----	-----	-----
<b>Revenues:</b>				
Oilfield Products and Services.....	\$ 585,485	\$ 439,613	\$ 1,166,976	\$
Distribution.....	286,904	217,616	570,724	
	-----	-----	-----	-----
	\$ 872,389	\$ 657,229	\$ 1,737,700	\$
	=====	=====	=====	=====
<b>Income before interest and taxes:</b>				
Oilfield Products and Services.....	\$ 85,841	\$ 41,044	\$ 166,242	\$
Distribution.....	6,913	3,724	13,684	
General corporate.....	(1,406)	(1,458)	(2,992)	
	-----	-----	-----	-----
	\$ 91,348	\$ 43,310	\$ 176,934	\$
	=====	=====	=====	=====

### 10. SUBSEQUENT EVENT

On July 26, 2001, the Company announced that its Board of Directors had authorized a stock repurchase plan. The plan allows for the repurchase of up to five million shares of common stock, subject to regulatory issues, market considerations and other factors. The program will be executed from time to time in the open market or in privately negotiated transactions. Repurchased shares will be added to the Company's existing treasury stock and may be used for acquisitions or other corporate purposes.

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

GENERAL

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. The following discussion should be read in conjunction with the Consolidated Financial Statements of the Company and the related notes thereto included elsewhere in this Form 10-Q and the Consolidated Financial Statements of the Company and the related notes thereto and the related "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in the Company's Annual Report on Form 10-K.

The Company manufactures and markets premium products and services to the oil and gas exploration and production industry, the petrochemical industry and other industrial markets. The Company provides 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, fishing services, drilling tools, underreamers, casing exit and multilateral systems, packers and liner hangers. The Company also offers supply-chain management solutions through an extensive branch network providing pipe, valves, fittings, mill, safety and other maintenance products.

The Company's worldwide operations are largely driven by the level of exploration and production activity in major energy producing areas and the depth and drilling conditions of these projects. Drilling activity levels are primarily influenced by energy prices but may also be affected by expectations related to the worldwide supply of and demand for oil and natural gas, finding and development costs, decline and depletion rates, political actions and uncertainties, environmental concerns, capital expenditure plans of exploration and production companies and the overall level of global economic growth and activity.

During the first half of the current fiscal year, the average worldwide rig count reached the highest level reported in the last 15 years. The majority of the worldwide activity improvement has been attributable to increased U.S. natural gas drilling due, in part, to higher commodity prices. After reaching levels in excess of \$9 per thousand British thermal units ("Btu") during late 2000 and early 2001, natural gas prices weakened in the second quarter and have since declined further, currently equaling approximately \$3 per thousand Btu. To date, the decrease in the price of natural gas has not had a significant impact on the level of U.S. drilling activity. Although a substantial slowdown in the major global economies could impact energy demand and have an adverse effect on the Company's financial results; the moderate decline in U.S. drilling activity currently anticipated is not expected to have a significant impact on demand for the Company's products and services.

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10

13

RESULTS OF OPERATIONS

Segment Discussion

The Company markets its products and services throughout the world through four business units which are aggregated into two reportable segments. The Oilfield Products and Services segment consists of three business units: M-I, Smith Bits and Smith Services. The Distribution segment includes the Wilson business unit. The revenue information below has been summarized by business unit in order to provide additional information in analyzing the Company's operations (dollars in thousands).

	Three Months Ended June 30,				Six Months Ended June 30,	
	2001		2000		2001	
	Amount	%	Amount	%	Amount	%
<b>Revenues:</b>						
M-I.....	\$ 392,403	45	\$ 294,425	45	\$ 784,672	45
Smith Bits.....	101,695	12	75,991	12	204,482	12
Smith Services.....	91,387	10	69,197	10	177,822	10
	-----	---	-----	---	-----	---
Oilfield Products and Services	585,485	67	439,613	67	1,166,976	67
Wilson.....	286,904	33	217,616	33	570,724	33
	-----	---	-----	---	-----	---
Total.....	\$ 872,389	100	\$ 657,229	100	\$ 1,737,700	100
	=====	===	=====	===	=====	===
<b>Revenues by Area:</b>						
United States.....	\$ 468,434	54	\$ 328,759	50	\$ 892,984	50
Export.....	32,262	4	30,193	5	68,714	5
Non-United States.....	371,693	42	298,277	45	776,002	45
	-----	---	-----	---	-----	---
Total.....	\$ 872,389	100	\$ 657,229	100	\$ 1,737,700	100
	=====	===	=====	===	=====	===
<b>Income Before Interest and Taxes:</b>						
Oilfield Products and Services.	\$ 85,841	15	\$ 41,044	9	\$ 166,242	9
Distribution.....	6,913	2	3,724	2	13,684	2
General corporate.....	(1,406)	*	(1,458)	*	(2,992)	*
	-----	---	-----	---	-----	---
Total.....	\$ 91,348	10	\$ 43,310	7	\$ 176,934	7
	=====	===	=====	===	=====	===

\* not meaningful

Oilfield Products and Services Segment

Revenues

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M-I provides drilling and completion fluid systems, engineering and technical services to the oil and gas industry through its M-I Fluids division. M-I's SWACO division manufactures and markets equipment and services for solids control, separation, pressure control, rig instrumentation and waste management. M-I's revenues increased \$98.0 million, or 33 percent, from the second quarter of 2000 and \$222.5 million, or 40 percent, from the first six months of 2000. The revenue growth from the prior year comparable periods is attributable to the approximate 28 percent increase in worldwide drilling activity and, to a lesser extent, acquisitions and improvements in product and service pricing. After excluding the effect of acquisitions, M-I's revenues in the second quarter of 2001 were 25 percent above the prior year period. The majority of the base business revenue increase was reported in the United States and Europe/Africa.

11

14

Smith Bits manufactures and sells three-cone and diamond drill bits primarily for use in the oil and gas industry. Smith Bits' revenues rose \$25.7 million, or 34 percent, from the second quarter 2000 and \$53.1 million, or 35 percent, from the first six months of 2000. During the same periods, petroleum bit revenues, including three-cone and diamond bits, rose 37 percent and 38 percent, respectively, compared to an approximate 28 percent increase in the M-I worldwide rig count. While revenues increased in all geographic areas over amounts reported in the prior year quarter, the majority of the growth between the current and prior year periods is attributable to the higher drilling activity levels in the United States, Europe/Africa and Latin America. Additionally, price increases for petroleum drill bits and recent product introductions also contributed to the revenue increase from the comparable 2000 periods.

Smith Services manufactures and markets products and services used in the oil and gas industry for drilling, workover, well completion and well re-entry. Smith Services' revenues increased \$22.2 million, or 32 percent, from the second quarter of 2000 and \$44.0 million, or 33 percent, from the first six months of 2000. Excluding the impact of the directional operations sold in early 2001, revenues were 39 percent above prior year levels on both a quarter and year-to-date basis. The base business revenue growth reflects the impact of the higher worldwide exploration and production activity levels, new contract awards and improved pricing. The majority of the revenue increase was reported in the United States, Latin America and the Middle East with significant year-over-year revenue growth across all product and service groups. Increased demand for drilling products and services, primarily tubular and inspection-related revenues, contributed over half of the base revenue growth.

### Income Before Interest and Taxes

Income before interest and taxes for the Oilfield Products and Services segment rose \$44.8 million, or 109 percent, from the second quarter of 2000 and \$91.8 million, or 123 percent, from the first six months of 2000. These increases reflect the impact of the significant revenue growth as well as the improvement in operating margins. On a quarter and six-month basis, operating margins for the oilfield operations increased by over five percentage points due primarily to the expansion in gross profit margins. The gross profit margins were favorably impacted by the higher sales and production volumes, pricing and, to a lesser extent, a favorable shift in sales mix. The balance of the operating margin improvement is attributable to the impact of higher revenue levels on sales and administrative support expenses.

### Distribution Segment

#### Revenues

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Wilson markets pipe, valves, fittings, 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. Wilson's revenues increased \$69.3 million, or 32 percent, from the second quarter of 2000 and \$135.6 million, or 31 percent, from the first six months of 2000. After excluding the effect of the Van Leeuwen operations, acquired in January 2001, revenues were 12 percent and 13 percent, respectively, above the comparable prior year periods. Over 80 percent of the base revenue growth was reported in the United States where Wilson's energy branches were favorably impacted by the higher exploration and production levels.

### Income Before Interest and Taxes

Wilson's income before interest and taxes increased \$3.2 million, or 86 percent, from the second quarter of 2000 and \$6.1 million, or 80 percent, from the first six months of 2000. The majority of this growth is attributable to the approximate one percentage point improvement in operating margins due to increased fixed cost coverage in the operating expense line. The effect of improved gross margins in the U.S. energy branches in the current year periods was impacted by the higher proportion of industrial and downstream revenues, which traditionally generate lower gross profit margins.

12

15

### Consolidated Results

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

	Three Months Ended June 30,				Six Months	
	2001		2000		2001	
	Amount	%	Amount	%	Amount	%
Revenues.....	\$ 872,389	100	\$ 657,229	100	\$ 1,737,700	100
Gross profit.....	258,936	30	174,335	26	505,025	29
Operating expenses.....	167,588	20	131,025	20	328,091	19
Income before interest and taxes	91,348	10	43,310	6	176,934	10
Interest expense, net.....	10,738	1	8,758	1	21,081	1
Income before income taxes and minority interests..	80,610	9	34,552	5	155,853	9
Income tax provision.....	26,087	3	11,413	2	50,892	3
Income before minority interests.....	54,523	6	23,139	3	104,961	6
Minority interests.....	16,841	2	8,165	1	33,061	2



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Net income.....	\$ 37,682	4	\$ 14,974	2	\$ 71,900	4
	=====	===	=====	===	=====	===

Consolidated revenues increased \$215.2 million, or 33 percent, from the second quarter of 2000 and \$445.0 million, or 35 percent, from the first six months of 2000. Approximately 70 percent of the revenue improvement over the prior year periods is attributable to base business growth. After excluding the effect of acquired operations and the sale of Smith Services' directional business, consolidated revenues were 23 percent above the second quarter of 2000. The year-to-year increase in revenues is attributable to the higher drilling activity levels as well as improved pricing for the oilfield operations' products and services. On a geographic basis, the majority of the increase was generated in the United States and Europe/Africa.

Gross profit rose \$84.6 million, or 49 percent, from the second quarter of 2000 and \$169.2 million, or 50 percent, from the first six months of 2000. Higher revenue levels together with improved oilfield operation gross margins accounted for the gross profit increases from the 2000 levels. Consolidated gross profit margins were 30 percent in the second quarter of 2001 and 29 percent on a year-to-date basis, an increase of four percentage points and three percentage points, respectively, over the prior year periods. The improvement is attributable to the Oilfield Products and Services segment reflecting primarily the effect of higher sales and production volumes and product and service pricing improvements.

Operating expenses, consisting of selling, general and administrative expenses, increased \$36.6 million from the second quarter of 2000 and \$71.5 million from the first six months of 2000. The majority of the overall operating expense increase is attributable to the growth in base revenue volumes, which contributed to a 16 percent increase in personnel levels. Incremental expenses associated with acquired operations since June 30, 2000 also contributed to the increase, and collectively accounted for over one-third of the increase over the prior year periods. Operating expenses as a percentage of revenues declined one percentage point from the first half of 2000 reflecting higher fixed cost coverage related to the overall sales and administrative functions.

16

Net interest expense, which represents interest expense less interest income, was \$2.0 million above the second quarter of 2000 and \$3.6 million above the first six months of 2000. The increase reflects the addition of \$107.8 million in outstanding debt during the twelve-month period, which was incurred primarily in connection with acquisitions completed in the fourth quarter of 2000 and the first quarter of 2001.

The effective tax rate approximated 33 percent for the first six months of 2001, which is below the prior year rate and the U.S. statutory rate. The effective tax rate in 2001 is lower than the U.S. statutory rate due to the impact of M-I's U.S. partnership earnings for which the minority partner is directly responsible for their related income taxes. The Company properly consolidates the pre-tax income related to the minority partner's share of U.S. partnership earnings but excludes the related tax provision. The current period effective rate is below the prior period rate as a result primarily of a favorable shift in the geographic mix of pre-tax income and the impact of higher pre-tax income on certain non-deductible expenses.

Minority interests reflect the portion of the results of majority-owned

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operations which are applicable to the minority interest partners. Minority interests increased \$8.7 million from the second quarter of 2000 and \$18.7 million from the first six months of 2000 as a result of the improved profitability of the M-I joint venture.

### LIQUIDITY AND CAPITAL RESOURCES

#### General

Cash and cash equivalents totaled \$39.9 million at June 30, 2001, an increase of \$3.4 million from December 31, 2000. Cash flows provided by operations were \$51.3 million in the first six months of 2001, which is \$57.8 million above the amount reported in the comparable period in 2000. This improvement reflects the higher profitability levels; however, cash flows from operations were not sufficient to fund capital expenditure and acquisition needs resulting in borrowings of \$30.0 million during the first six months of 2001.

Cash flows utilized in investing activities equaled \$95.3 million consisting of \$47.6 million of investments in net property, plant and equipment and \$47.7 million for acquisitions and other investing activities. On January 31, 2001, the Company acquired substantially all of the U.S. net assets of Van Leeuwen Pipe and Tube Corporation for cash consideration of \$41.1 million. Additionally, the Company completed other acquisitions in the second quarter of 2001 for combined cash consideration of \$5.3 million. Management continues to evaluate opportunities to acquire products or businesses complementary to the Company's operations. These 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.

The Company's primary internal source of liquidity is cash flow generated from operations. External sources of liquidity include debt and, if needed, equity financing. In February 2001, the Company completed a public offering of \$250.0 million of 6.75 percent senior notes which was used to repay short-term borrowings and the majority of the Company's indebtedness under revolving credit agreements. The Company's revolving lines of credit facilities, which are available for operating and financing needs, had additional borrowing capacity of \$202.9 million at June 30, 2001. The Company believes funds generated from operations, amounts available under existing credit facilities and external sources of liquidity will be sufficient to finance capital expenditures and working capital needs of the existing operations for the foreseeable future.

On July 26, 2001, the Company announced that its Board of Directors had authorized a stock repurchase plan. The plan allows for the repurchase of up to five million shares of common stock, subject to regulatory issues, market considerations and other factors. Share repurchases, if they arise, will be financed with cash on-hand or borrowings under existing credit facilities.

### NEW ACCOUNTING AND REGULATORY PRONOUNCEMENTS

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 141 ("SFAS No. 141"), "Business Combinations," which is effective for business combinations initiated after June 30, 2001. SFAS No. 141 eliminates the pooling-of-interest method of accounting for business combinations and modifies the application of the purchase accounting method.

The FASB also issued Statement of Financial Accounting Standards No. 142 ("SFAS No. 142"), "Goodwill and Other Intangible Assets," in July 2001 which

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addresses financial accounting and reporting for goodwill and other intangible assets. Under SFAS No. 142, goodwill and some intangibles will no longer be amortized to earnings but will be tested for impairment. While most provisions of SFAS No. 142 are effective for the Company beginning January 1, 2002, goodwill and intangible assets acquired during the remainder of the current fiscal year will be subject immediately to the provisions of the statement. Although the Company continues to evaluate the impact of this recently issued standard, assuming no asset impairment, the adoption of SFAS No. 142 will result in the elimination of \$15.7 million of goodwill amortization expected to be recognized in fiscal 2001, or \$9.2 million net of taxes and minority interests.

The Company adopted Statement of Financial Accounting Standards No. 133 ("SFAS No. 133"), "Accounting for Derivative Instruments and Hedging Activities," effective January 1, 2001. SFAS No. 133 requires that the Company record derivatives on the balance sheet at fair value and establishes criteria for designation and effectiveness of hedging relationships. 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. The Company occasionally employs derivative financial instruments such as foreign exchange contracts, foreign exchange options and interest rate swap contracts to mitigate or eliminate certain of those risks. The Company does not enter into derivative instruments for speculative purposes.

The adoption of SFAS No. 133 on January 1, 2001 did not have a material impact on the Company's financial position or results of operations. During the three-month and six-month periods ended June 30, 2001, the Company recorded the change in fair market value related to fair value hedges, which included foreign exchange contracts, to general and administrative expenses in the accompanying consolidated statement of operations. These amounts were not material. Additionally, the Company recorded the change in value related to cash flow hedges, which included foreign exchange contracts and interest rate swaps, to accumulated other comprehensive income. During the first six months of 2001, changes in foreign exchange rates and interest rates resulted in an adjustment of \$2.3 million to accumulated other comprehensive income in the accompanying consolidated balance sheet. Of this amount, \$2.1 million is expected to be recognized in the statement of operations during the next 12 months, offset by the effect of changes in the underlying basis of the hedged transactions.

### ITEM 3. QUALITATIVE AND QUANTITATIVE MARKET RISK DISCLOSURES

The Company is exposed to certain market risks arising from transactions that are entered into in the normal course of business. These risks, which are primarily related to interest rate changes and fluctuations in foreign exchange rates, are not considered to be material to the Company. During the reporting period, no events or transactions have occurred which would materially change the information disclosed in the Company's Annual Report on Form 10-K.

### PART II - OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS

None.

#### ITEM 2. CHANGES IN SECURITIES

None.

#### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

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None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

At the Annual Meeting of Shareholders on May 22, 2001, shareholders of the Company elected all nominated directors, ratified the Company's appointment of auditors, approved an amendment to the Company's Restated Certificate of Incorporation to increase the number of authorized shares of common stock to 150 million shares, and approved amendments to the Smith International, Inc. Stock Plan for Outside Directors by the votes shown below.

	For -----	Withheld -----	Abstain -----
Election of directors:			
James R. Gibbs.....	39,280,989	4,536	7,412,745
Jerry W. Neely.....	39,213,513	72,012	7,480,221
	For -----	Against -----	Abstain -----
Approval of amendment to increase the number of authorized shares of common stock.....	33,801,634	2,869,522	22,578
	For -----	Against -----	Abstain -----
Approval of amendment to Stock Plan for Outside Directors.....	42,254,614	4,383,136	55,984
	For -----	Against -----	Abstain -----
Ratification of auditors.....	46,626,205	52,479	15,050

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits  
    None.

(b) Reports on Form 8-K

The Registrant filed a Form 8-K dated April 18, 2001, reporting under "Item 5. Other Events," related to a press release announcing the Company's results for the three months ended March 31, 2001.

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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: August 13, 2001  
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By: /s/ Douglas L. Rock  
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Douglas L. Rock  
Chairman of the Board, Chief Executive  
Officer, President and  
Chief Operating Officer

Date: August 13, 2001  
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By: /s/ Margaret K. Dorman  
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Margaret K. Dorman  
Senior Vice President and  
Chief Financial Officer  
(Principal Accounting Officer)