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SMITH INTERNATIONAL INC
Form 10-Q
November 14, 2001

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 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 November

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8, 2001 was 49,399,451.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

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| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|------------------------------------------------------------|-------------------------------------|------------|------------------------------------|--------------|
| | 2001 | 2000 | 2001 | 2000 |
| REVENUES | \$ 909,682 | \$ 718,470 | \$ 2,647,382 | \$ 2,647,382 |
| COSTS AND EXPENSES: | | | | |
| Costs of Revenues | 636,626 | 523,118 | 1,869,301 | 1,869,301 |
| Selling Expenses | 132,735 | 107,060 | 384,452 | 384,452 |
| General and Administrative Expenses | 36,574 | 31,269 | 105,176 | 105,176 |
| Goodwill Amortization | 3,966 | 2,804 | 11,738 | 11,738 |
| Total Costs and Expenses | 809,901 | 664,251 | 2,370,667 | 2,370,667 |
| INCOME BEFORE INTEREST AND TAXES | 99,781 | 54,219 | 276,715 | 276,715 |
| INTEREST EXPENSE, NET | 10,653 | 8,554 | 31,734 | 31,734 |
| INCOME BEFORE INCOME TAXES AND MINORITY INTERESTS | 89,128 | 45,665 | 244,981 | 244,981 |
| INCOME TAX PROVISION | 28,941 | 15,131 | 79,833 | 79,833 |
| INCOME BEFORE MINORITY INTERESTS | 60,187 | 30,534 | 165,148 | 165,148 |
| MINORITY INTERESTS | 18,121 | 10,060 | 51,182 | 51,182 |
| NET INCOME | \$ 42,066 | \$ 20,474 | \$ 113,966 | \$ 113,966 |
| EARNINGS PER SHARE: | | | | |
| Basic | \$ 0.84 | \$ 0.41 | \$ 2.29 | \$ 2.29 |
| Diluted | \$ 0.84 | \$ 0.41 | \$ 2.26 | \$ 2.26 |
| WEIGHTED AVERAGE SHARES OUTSTANDING: | | | | |
| Basic | 49,831 | 49,750 | 49,862 | 49,862 |
| Diluted | 50,210 | 50,387 | 50,400 | 50,400 |

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

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

| | September 30, 2001 ----- (Unaudited) |
|-------------------------------------------------------------------------------------------------------------------|-----------------------------------------------|
| ASSETS | |
| CURRENT ASSETS: | |
| Cash and cash equivalents | \$ 45,263 |
| Receivables, net | 774,326 |
| Inventories | 655,480 |
| Deferred tax assets, net | 25,488 |
| Prepaid expenses and other | 40,970 |
| | ----- |
| Total current assets | 1,541,527 |
| | ----- |
| PROPERTY, PLANT AND EQUIPMENT, NET | 448,776 |
| GOODWILL, NET | 479,935 |
| OTHER ASSETS | 137,288 |
| | ----- |
| TOTAL ASSETS | \$ 2,607,526 |
| | ===== |
| LIABILITIES AND SHAREHOLDERS' EQUITY | |
| CURRENT LIABILITIES: | |
| Short-term borrowings and current portion of long-term debt | \$ 83,634 |
| Accounts payable | 308,624 |
| Accrued payroll costs | 67,152 |
| Income taxes payable | 46,249 |
| Other | 126,458 |
| | ----- |
| Total current liabilities | 632,117 |
| | ----- |
| LONG-TERM DEBT | 532,532 |
| DEFERRED TAX LIABILITIES | 47,662 |
| OTHER LONG-TERM LIABILITIES | 42,567 |
| MINORITY INTERESTS | 437,704 |
| 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; 50,592 shares issued in 2001 (50,419 in 2000) | 50,592 |
| Additional paid-in capital | 390,228 |
| Retained earnings | 524,275 |

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| | |
|-----------------------------------------------------------------------------|--------------|
| Accumulated comprehensive loss | (21,021) |
| Less - treasury securities, at cost; 1,192 shares in 2001 (656 in 2000) ... | (29,130) |
| | ----- |
| Total shareholders' equity | 914,944 |
| | ----- |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$ 2,607,526 |
| | ===== |

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

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

| | Nine Months September |
|------------------------------------------------------------------------------------------------------------------------------|--------------------------|
| | ----- 2001 ----- |
| CASH FLOWS FROM OPERATING ACTIVITIES: | |
| Net income | \$ 113,966 |
| Adjustments to reconcile net income to net cash provided by Operating activities, excluding the net effects of acquisitions: | |
| Depreciation and amortization | 68,108 |
| Minority interests | 51,182 |
| Provision for losses on receivables | 2,064 |
| Gain on disposal of property, plant and equipment | (5,463) |
| Foreign currency translation losses | 516 |
| Changes in operating assets and liabilities: | |
| Receivables | (81,993) |
| Inventories | (47,741) |
| Accounts payable | (634) |
| Other current assets and liabilities | 32,878 |
| Other non-current assets and liabilities | (9,997) |
| | ----- |
| Net cash provided by operating activities | 122,886 |
| | ----- |
| CASH FLOWS FROM INVESTING ACTIVITIES: | |
| Acquisition of businesses, net of cash acquired | (97,119) |
| Purchases of property, plant and equipment | (88,313) |
| Proceeds from disposal of property, plant and equipment | 14,856 |
| Other | (2,084) |
| | ----- |
| Net cash used in investing activities | (172,660) |
| | ----- |
| CASH FLOWS FROM FINANCING ACTIVITIES: | |
| Proceeds from issuance of long-term debt | 290,742 |

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| | |
|--------------------------------------------------------|-----------|
| Principal payments of long-term debt | (213,252) |
| Net change in short-term borrowings | (14,982) |
| Purchases of treasury stock | (21,428) |
| Proceeds from exercise of stock options | 5,463 |
| Contribution by minority interest partner | 12,000 |
| | ----- |
| Net cash provided by financing activities | 58,543 |
| | ----- |
| Effect of exchange rate changes on cash | (50) |
| | ----- |
| Increase in cash and cash equivalents | 8,719 |
| Cash and cash equivalents at beginning of period | 36,544 |
| | ----- |
| Cash and cash equivalents at end of period | \$ 45,263 |
| | ===== |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | |
| Cash paid for interest | \$ 35,654 |
| Cash paid for income taxes | \$ 45,126 |

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

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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 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 August 2001, the Financial Accounting Standards Board ("FASB")

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issued Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which is effective for the Company beginning January 1, 2002. SFAS No. 144 supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," and the accounting and reporting provisions relating to the disposal of a segment of a business of Accounting Principles Board Opinion No. 30. The Company does not anticipate that the adoption of SFAS No. 144 will have a material impact on its financial position or results of operations.

In July 2001, the FASB released SFAS No. 143, "Accounting for Asset Retirement Obligations," which is required to be adopted by the Company no later than January 1, 2003. SFAS No. 143 addresses the financial accounting and reporting for retirement obligations and costs associated with tangible long-lived assets. The Company is currently reviewing the provisions of SFAS No. 143 to determine the standard's impact, if any, on its financial statements upon adoption.

The FASB issued SFAS No. 141, "Business Combinations," in July 2001, 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 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 subsequent to June 30, 2001 are subject immediately to the provisions of the statement. Although the Company continues to evaluate the impact of this recently issued standard, the adoption of SFAS No. 142 will result in the elimination of \$15.7 million of goodwill amortization recognized in fiscal 2001, or \$9.2 million net of taxes and minority interests.

The Company adopted 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 nine-month periods ended September 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 nine months of 2001, changes in foreign exchange rates and interest rates resulted in an adjustment of \$0.2 million to

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accumulated other comprehensive income in the accompanying consolidated balance sheet. Of this amount, \$0.1 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 two acquisitions 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 acquisition consideration for the six-month period. This transaction was financed with amounts borrowed under a short-term loan facility which was subsequently repaid with proceeds from the Company's public debt offering (see Note 8).

During the three months ended September 30, 2001, the Company completed eight acquisitions for aggregate cash consideration of \$50.7 million. On July 2, 2001, the Company acquired Star Tool Company ("Star Tool"), which provides fishing and rental tool services for customers in the U.S. Permian Basin market. Star Tool, which generated revenues of approximately \$18.0 million during the twelve-month period ended September 30, 2001, has been integrated into the Smith Services operations. On August 22, 2001, M-I acquired BW Group plc ("BW Group"), an Aberdeen, Scotland-based provider of drilling and completion fluids to the North Sea market. BW Group reported revenues of approximately \$22.0 million during the twelve-month period ended September 30, 2001. These two transactions accounted for the majority of the acquisition consideration for the three-month period and were financed with borrowings under credit facilities.

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 tangible assets and identifiable intangible assets acquired has been recorded as goodwill. For acquisitions completed during the first six months of 2001, goodwill is being amortized on a straight-line basis over 20 years. Goodwill recorded from acquisitions completed subsequent to June 30, 2001, in the amount of approximately \$31.5 million, is not subject to amortization, in accordance with the provisions of SFAS No. 142.

The balances included in the consolidated balance sheet as of September 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. 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 combinations been in effect at the dates indicated or of future results for the combined entities (in thousands, except per share amounts):

Nine Months Ended

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| | September 30, | |
|---------------------|---------------|--------------|
| | 2001 | 2000 |
| Revenues | \$ 2,688,294 | \$ 2,227,914 |
| Net income | 114,235 | 44,973 |
| Earnings per share: | | |
| Basic | \$ 2.29 | \$ 0.91 |
| Diluted | 2.27 | 0.90 |

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

| | |
|---------------------------------------------------------------------|------------|
| Fair value of tangible assets, net of cash acquired | \$ 113,410 |
| Goodwill and other intangible assets recorded | 36,746 |
| Total liabilities assumed | (53,037) |
| | ----- |
| Cash paid for acquisition of businesses, net of cash acquired | \$ 97,119 |
| | ===== |

On a segment basis, \$35.4 million of goodwill and other intangible assets relates to the Oilfield Products and Services group, and \$1.3 million of goodwill and other intangible assets is associated with the Distribution segment.

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. Certain outstanding employee stock options were not included in the computation of diluted earnings per common share as the exercise price was greater than the average market price for the Company's stock during the corresponding period. 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 September 30, | | Nine Mon Septem |
|-------------------------------------|-------|--------------------|
| 2001 | 2000 | 2001 |
| ----- | ----- | ----- |

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Basic EPS:

| | | | |
|---------------------------------------------------------------|-----------|-----------|------------|
| Net income | \$ 42,066 | \$ 20,474 | \$ 113,966 |
| | ===== | ===== | ===== |
| Weighted average number of common shares outstanding | 49,831 | 49,750 | 49,862 |
| | ===== | ===== | ===== |
| Basic EPS | \$ 0.84 | \$ 0.41 | \$ 2.29 |
| | ===== | ===== | ===== |

Diluted EPS:

| | | | |
|---------------------------------------------------------------|-----------|-----------|------------|
| Net income | \$ 42,066 | \$ 20,474 | \$ 113,966 |
| | ===== | ===== | ===== |
| Weighted average number of common shares outstanding | 49,831 | 49,750 | 49,862 |
| Dilutive effect of stock options | 379 | 637 | 538 |
| | ----- | ----- | ----- |
| | 50,210 | 50,387 | 50,400 |
| | ===== | ===== | ===== |
| Diluted EPS | \$ 0.84 | \$ 0.41 | \$ 2.26 |
| | ===== | ===== | ===== |

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5. COMPREHENSIVE INCOME

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 September 30, | | Nine Months Ended September |
|---------------------------------------------------------------|-------------------------------------|-----------|--------------------------------|
| | 2001 | 2000 | 2001 |
| | ----- | ----- | ----- |
| Net income | \$ 42,066 | \$ 20,474 | \$ 113,966 |
| Changes in unrealized fair value of derivatives, net | 2,497 | -- | 181 |
| Currency translation adjustments | 2,154 | (3,778) | (3,409) |
| | ----- | ----- | ----- |
| Comprehensive income | \$ 46,717 | \$ 16,696 | \$ 110,738 |
| | ===== | ===== | ===== |

As of September 30, 2001, accumulated comprehensive loss in the accompanying consolidated balance sheet includes \$21.2 million of cumulative currency translation losses, offset by \$0.2 million of cumulative changes in unrealized fair value of derivatives.

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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):

| | September 30, 2001 | December 31, 2000 |
|----------------------------------------------------------------------------------------------------------------------|-----------------------|----------------------|
| | ----- | ----- |
| Raw materials | \$ 47,808 | \$ 46,923 |
| Work-in-process | 65,332 | 57,167 |
| Products purchased for resale | 173,356 | 139,591 |
| Finished goods | 393,025 | 341,117 |
| | ----- | ----- |
| | 679,521 | 584,798 |
| Reserves to state certain domestic inventories (\$323,576 in 2001 and \$273,811 in 2000) on a LIFO basis | (24,041) | (24,771) |
| | ----- | ----- |
| | \$ 655,480 | \$ 560,027 |
| | ===== | ===== |

7. PROPERTY, PLANT AND EQUIPMENT

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

| | September 30, 2001 | December 31, 2000 |
|-------------------------------------|-----------------------|----------------------|
| | ----- | ----- |
| Land | \$ 27,515 | \$ 24,683 |
| Buildings | 94,315 | 91,432 |
| Machinery and equipment | 446,389 | 401,624 |
| Rental tools | 239,242 | 225,962 |
| | ----- | ----- |
| | 807,461 | 743,701 |
| Less-accumulated depreciation | (358,685) | (334,653) |
| | ----- | ----- |
| | \$ 448,776 | \$ 409,048 |
| | ===== | ===== |

8. DEBT

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

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| | September 30, 2001 | December 31, 2000 |
|----------------------------------------------|-----------------------|----------------------|
| | ----- | ----- |
| Current: | | |
| Short-term borrowings | \$ 60,915 | \$ 75,394 |
| Current portion of long-term debt | 22,719 | 90,557 |
| | ----- | ----- |
| | \$ 83,634 | \$ 165,951 |
| | ===== | ===== |
| Long-Term: | | |
| Notes, net of unamortized discounts | \$ 462,906 | \$ 259,529 |
| Bank revolvers payable | 76,000 | 190,386 |
| Term loans and other | 16,345 | 15,358 |
| | ----- | ----- |
| | 555,251 | 465,273 |
| Less current portion of long-term debt | (22,719) | (90,557) |
| | ----- | ----- |
| | \$ 532,532 | \$ 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, 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 September 30, 2002 are as follows (in thousands):

| | |
|------------------|------------|
| 2003 | \$ 95,690 |
| 2004 | 10,476 |
| 2005 | 10,476 |
| 2006 | 10,476 |
| Thereafter | 405,414 |
| | ----- |
| | \$ 532,532 |
| | ===== |

9. SHAREHOLDERS' EQUITY

During the current fiscal year, the Company's Board of Directors authorized a share buyback program which allows for the repurchase of up to five million shares of common stock, subject to regulatory issues, market considerations and other factors. During the third quarter of 2001, the Company repurchased 536,200 shares of common stock at an aggregate cost of \$21.4 million. The acquired shares have been added to the Company's treasury stock holdings, which equaled 1,192,054 shares at September 30, 2001, and may be used for acquisitions or other corporate purposes. Future repurchases under the program may be executed from time to time in the open market or in privately negotiated transactions.

10. INDUSTRY SEGMENTS

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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 September 30, | | Nine M Sept |
|------------------------------------------|-------------------------------------|------------|----------------|
| | 2001 | 2000 | 2001 |
| Revenues: | | | |
| Oilfield Products and Services | \$ 622,203 | \$ 485,760 | \$ 1,789,179 |
| Distribution | 287,479 | 232,710 | 858,203 |
| | \$ 909,682 | \$ 718,470 | \$ 2,647,382 |
| | ===== | ===== | ===== |
| Income before interest and taxes: | | | |
| Oilfield Products and Services | \$ 93,975 | \$ 51,343 | \$ 260,217 |
| Distribution | 7,344 | 4,231 | 21,028 |
| General corporate | (1,538) | (1,355) | (4,530) |
| | \$ 99,781 | \$ 54,219 | \$ 276,715 |
| | ===== | ===== | ===== |

11. SUBSEQUENT EVENTS

Subsequent to September 30, 2001, the Company has acquired three business operations for total cash consideration of \$144.7 million.

M-I, the operations owned jointly by the Company and Schlumberger Limited, acquired the SulfaTreat Company ("SulfaTreat") and the oilfield and industrial screen operations of Madison Filter Belgium S.A. ("Madison") for cash consideration of \$128.5 million. SulfaTreat, a natural-gas production services company headquartered in the United States, generated revenues of approximately \$12.0 million during the twelve-month period ended September 30, 2001. Madison, which includes United Wire Ltd. based in Scotland and Southwestern Wire Cloth, Inc. based in the United States, manufactures and markets screens for oilfield shakers and provides screening products for use in a broad range of industrial markets. Madison reported revenues of approximately \$61.0 million during the twelve-month period ended September 30, 2001.

On October 10, 2001, the Company acquired a majority interest in United Engineering Services LLC ("UES"), an engineering and manufacturing services company incorporated in Oman. UES generated revenues of approximately \$55.0 million during the twelve-month period ended September 30, 2001 and has been integrated into the Smith Services operations.

The acquisitions will be accounted for by the purchase method and, accordingly, included in the results of operations as of the respective dates of acquisition. The above acquisitions were financed with a combination of borrowings under revolving credit agreements, proceeds from a \$75.0 million floating rate note offering and minority partner contributions. The notes accrue interest based on a floating rate, subject to quarterly adjustments, equal to LIBOR plus 112.5 basis points. Interest on the notes is payable quarterly

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beginning January 15, 2002.

Additionally, the Company completed the formation of a joint venture with Sandvik AB to design, manufacture and market roller-cone and specialty drill bits used in the mining and construction industry. The Company will account for its interest in the joint venture under the equity method of accounting. The assets contributed by the Company to the joint venture generated revenues of approximately \$5.8 million and \$16.3 million in the three-month and nine-month periods ended September 30, 2001, respectively.

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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.

The Company's oilfield segment is primarily driven by the level of exploration and production activity in international markets, which has remained relatively stable during the current year. North American drilling activity, however, peaked during July 2001 and has subsequently declined approximately 22 percent from those levels due to the impact of lower natural gas prices. Significant exposure to the U.S. deepwater market, which is more revenue-intensive and less susceptible to short-term variations in energy prices, has limited the impact of the activity decline on sales volumes to date. However, a continued deterioration in the U.S. or other major world economies

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could further impact North American activity levels or activity in international markets. A substantial decline in activity levels could result in lower demand for the Company's products and services, and adversely impact future financial results.

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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 September 30, | | | | Nine |
|------------------------------------------|----------------------------------|-------|------------|-------|-----------|
| | 2001 | | 2000 | | |
| | Amount | % | Amount | % | Amount |
| Revenues: | | | | | |
| M-I | \$ 412,364 | 45 | \$ 326,446 | 45 | \$ 1,197, |
| Smith Bits | 105,135 | 12 | 84,018 | 12 | 309, |
| Smith Services | 104,704 | 11 | 75,296 | 10 | 282, |
| | 622,203 | 68 | 485,760 | 67 | 1,789, |
| Oilfield Products and Services | | | | | |
| Wilson | 287,479 | 32 | 232,710 | 33 | 858, |
| | 909,682 | 100 | 718,470 | 100 | 2,647, |
| Total | \$ 909,682 | 100 | \$ 718,470 | 100 | \$ 2,647, |
| | ===== | ===== | ===== | ===== | ===== |
| Revenues by Area: | | | | | |
| United States | \$ 480,125 | 53 | \$ 358,935 | 50 | \$ 1,373, |
| Export | 30,009 | 3 | 28,240 | 4 | 98, |
| Non-United States | 399,548 | 44 | 331,295 | 46 | 1,175, |
| | 909,682 | 100 | 718,470 | 100 | 2,647, |
| Total | \$ 909,682 | 100 | \$ 718,470 | 100 | \$ 2,647, |
| | ===== | ===== | ===== | ===== | ===== |
| Income Before Interest and Taxes: | | | | | |
| Oilfield Products and Services | \$ 93,975 | 15 | \$ 51,343 | 11 | \$ 260, |
| Distribution | 7,344 | 3 | 4,231 | 2 | 21, |
| General corporate | (1,538) | * | (1,355) | * | (4, |
| | 99,781 | 11 | 54,219 | 8 | 276, |
| Total | \$ 99,781 | 11 | \$ 54,219 | 8 | \$ 276, |
| | ===== | ===== | ===== | ===== | ===== |

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*not meaningful

Oilfield Products and Services Segment

Revenues

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 rose \$85.9 million, or 26 percent, from the third quarter of 2000 and \$308.4 million, or 35 percent, from the first nine months of 2000. The majority of the revenue improvement over the prior year periods reflects increased demand for base-fluid products and fluid processing and waste management services as a result of higher worldwide exploration and development activity. The favorable revenue variances also reflects the impact of the acquisitions of Sweco and other operations completed over the past 12 months, and improved pricing for product and services. After excluding the impact of acquired operations, M-I's revenues in the third quarter and first nine months of 2001 were 19 percent and 26 percent above the prior year periods, respectively, compared to corresponding increases in the M-I worldwide rig count of 15 percent and 24 percent. On a geographic basis, the majority of the growth in base business revenues was reported in the United States, Europe/Africa and Latin America.

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Smith Bits manufactures and sells three-cone and diamond drill bits primarily for use in the oil and gas industry. Smith Bits' revenues increased \$21.1 million, or 25 percent, from the third quarter 2000 and \$74.2 million, or 32 percent, from the first nine months of 2000. On a combined basis, petroleum three-cone and diamond bit revenues rose 28 percent over the level reported for the three months ended September 30, 2001. When compared to the prior year periods, the revenue increases on a percentage basis exceeded the average rig count increases in all geographic areas due to recent product introductions, increased market penetration and improved pricing. The majority of the growth from year-to-year is attributable to the improved drilling activity levels in the United States and Europe/Africa. Smith Bits' mining bit operations, which were contributed to a newly-formed joint venture with Sandvik AB in October 2001 and will no longer be consolidated, generated approximately \$5.8 million and \$16.3 million of revenues in the current year quarter and nine-month period, respectively.

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 \$29.4 million, or 39 percent, from the third quarter of 2000 and \$73.4 million, or 35 percent, from the first nine months of 2000. After excluding the effect of the acquisition of Star Tool Company and the divestiture of the directional operations, revenues for the current year periods were 39 percent over levels reported in the previous year periods. The significant increase in base business revenues is attributable to higher worldwide exploration and production activity levels, new contract awards and favorable product and service pricing. Smith Services' revenues increased over prior year levels in all geographic areas, with the majority of the improvement reported in the United States. While revenues rose in all product and service groups, increased demand for tubular products and inspection services as well as higher reported drill pipe revenues related to an alliance with a specialty drill pipe manufacturer, contributed the majority of the year-over-year base growth.

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Income Before Interest and Taxes

Income before interest and taxes for the Oilfield Products and Services segment increased \$42.6 million, or 83 percent, from the third quarter of 2000 and \$134.4 million, or 107 percent, from the first nine months of 2000. The significant improvement in income before interest and taxes resulted from the increase in reported revenues, and to a lesser extent, higher operating margins. Operating margins for the current year periods rose by four percentage points and six percentage points, respectively, over the three-month and nine-month periods ended September 30, 2000, attributable primarily to improved gross profit margins. Gross profit margins in the current year periods reflect the favorable effect of higher sales and production volumes and improved pricing. The balance of the operating margin improvement is attributable to the impact of higher revenue levels on fixed cost coverage related to sales and administrative support expenses.

Distribution Segment

Revenues

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 \$54.8 million, or 24 percent, from the third quarter of 2000 and \$190.3 million, or 28 percent, from the first nine months of 2000. Excluding the impact of the Van Leeuwen operations, acquired in early 2001, revenues were 7 percent and 11 percent, respectively, above the same periods last year. The majority of the base revenue increase was reported in the energy branch operations in the United States, reflecting the improvement in activity levels.

Income Before Interest and Taxes

Wilson's income before interest and taxes increased \$3.1 million, or 74 percent, from the third quarter of 2000 and \$9.2 million, or 78 percent, from the first nine months of 2000. The increases over the prior year period reflect the impact of the higher revenue levels and, to a lesser extent, the approximate one percentage point improvement in operating margins. 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.

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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 September 30, | | | | Nine Mo |
|----------------------------------|---|--------|---|---------|
| 2001 | | 2000 | | 2001 |
| Amount | % | Amount | % | Amount |
| | | | | |

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| | | | | | |
|---------------------------------------------------------|------------|-----|------------|-----|-------------|
| Revenues | \$ 909,682 | 100 | \$ 718,470 | 100 | \$2,647,382 |
| Gross profit | 273,056 | 30 | 195,352 | 27 | 778,081 |
| Operating expenses | 173,275 | 19 | 141,133 | 20 | 501,366 |
| Income before interest and taxes | 99,781 | 11 | 54,219 | 7 | 276,715 |
| Interest expense, net | 10,653 | 1 | 8,554 | 1 | 31,734 |
| Income before income taxes and minority interests | 89,128 | 10 | 45,665 | 6 | 244,981 |
| Income tax provision | 28,941 | 3 | 15,131 | 2 | 79,833 |
| Income before minority interests | 60,187 | 7 | 30,534 | 4 | 165,148 |
| Minority interests | 18,121 | 2 | 10,060 | 1 | 51,182 |
| Net income | \$ 42,066 | 5 | \$ 20,474 | 3 | \$ 113,966 |

Consolidated revenues rose \$191.2 million, or 27 percent, from the third quarter of 2000 and \$646.3 million, or 32 percent, from the first nine months of 2000. The majority of the revenue growth over prior year levels is attributable to the Company's base business operations. Excluding the impact of acquired and divested operations, revenues increased 18 percent and 23 percent, respectively, over the prior year quarter and year-to-date levels, and compares to corresponding increases in the M-I worldwide rig count of 15 percent and 24 percent. Higher exploration and production activity levels in the current year periods favorably impacted each of the Company's operations, with improved pricing in the oilfield operations also contributing to the growth. The majority of the revenue increase from year-to-year was reported in the United States and the North Sea area.

Gross profit increased \$77.7 million, or 40 percent, from the third quarter of 2000 and \$246.9 million, or 47 percent, from the first nine months of 2000. While the majority of the gross profit increase is attributable to the higher revenue levels, improved gross margins attributable to higher volumes and improved pricing in the oilfield operations also contributed to the favorable variance. Consolidated gross profit margins equaled 30 percent in the third quarter of 2001 and 29 percent on a current year-to-date basis, an increase of approximately three percentage points over both prior year periods.

Operating expenses, consisting of selling, general and administrative expenses, increased \$32.1 million from the third quarter of 2000 and \$103.7 million from the first nine months of 2000. The majority of the overall operating expense increase is due to the higher base business volumes, which contributed to a 12 percent increase in personnel levels from the prior year quarter. Incremental operating expenses associated with operations acquired collectively accounted for more than 35 percent of the increase over the prior year periods. Operating expenses as a percentage of revenues declined one percentage point from the comparable periods in 2000 reflecting higher fixed cost coverage related to the overall sales and administrative functions.

Net interest expense, which represents interest expense less interest income, was \$2.1 million above the third quarter of 2000 and \$5.7 million over the first nine months of 2000 due to an increase in outstanding debt. On a

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year-to-date basis, average debt levels increased approximately \$134.0 million from the prior year period in connection with the financing of acquisitions.

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The effective tax rate approximated 33 percent for the first nine 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 effective rate for the three months ended September 30, 2001 was 32.5 percent which is below the prior period rate primarily due to a favorable shift in the geographic mix of pre-tax income towards lower rate jurisdictions.

Minority interests reflect the portion of the results of majority-owned operations which are applicable to the minority interest partners. Minority interests increased \$8.1 million from the third quarter of 2000 and \$26.8 million from the first nine months of 2000 due to the higher profitability of the M-I joint venture.

LIQUIDITY AND CAPITAL RESOURCES

General

Cash and cash equivalents equaled \$45.3 million at September 30, 2001, which is \$8.7 million above the level reported at December 31, 2000. Cash flows provided by operations were \$122.9 million in the first nine months of 2001, an increase of \$94.2 million from the amount reported in the same period of 2000. The improvement in cash generated from operations primarily reflects the higher profitability levels of the overall business, with the activity-driven growth in working capital accounts remaining relatively consistent between periods.

Cash flows utilized in investing activities in the first nine months of 2001 included \$73.5 million of investments in net property, plant and equipment which consists of routine additions of capital equipment as well as \$6.0 million related to the construction of a new office facility. During the nine month period ended September 30, 2001, the Company acquired treasury stock aggregating \$21.4 million, reflected in financing activities, and purchased publicly-traded securities of a majority owned subsidiary which is included in investing activities. Although cash flows from operations were sufficient to finance the above during the first nine months of 2001, the Company completed ten acquisitions for aggregate cash consideration of \$97.1 million which required borrowings under new and existing credit agreements.

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 \$156.0 million at September 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.

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Subsequent to September 30, 2001, the Company has acquired three businesses for total cash consideration of \$144.7 million, financed with a combination of borrowings under revolving credit agreements, proceeds from a \$75.0 million floating rate note offering and minority partner contributions. M-I, the operations owned jointly by the Company and Schlumberger Limited, acquired the SulfaTreat Company ("SulfaTreat") and the oilfield and industrial screen operations of Madison Filter Belgium S.A. ("Madison") for cash consideration of \$128.5 million. SulfaTreat, a natural-gas production services company headquartered in the United States, generated revenues of approximately \$12.0 million during the twelve-month period ended September 30, 2001. Madison, which includes United Wire Ltd. based in Scotland and Southwestern Wire Cloth, Inc. based in the United States, manufactures and markets screens for oilfield shakers and provides screening products for use in a broad range of industrial markets. Madison reported revenues of approximately \$61.0 million during the twelve-month period ended September 30, 2001. Additionally, on October 10, 2001, the Company acquired a majority interest in United Engineering Services LLC ("UES"), an engineering and manufacturing services company incorporated in Oman. UES generated revenues of approximately \$55.0 million during the twelve-month period ended September 30, 2001 and has been integrated into the Smith Services operations.

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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.

NEW ACCOUNTING AND REGULATORY PRONOUNCEMENTS

In August 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which is effective for the Company beginning January 1, 2002. SFAS No. 144 supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," and the accounting and reporting provisions relating to the disposal of a segment of a business of Accounting Principles Board Opinion No. 30. The Company does not anticipate that the adoption of SFAS No. 144 will have a material impact on its financial position or results of operations.

In July 2001, the FASB released SFAS No. 143, "Accounting for Asset Retirement Obligations," which is required to be adopted by the Company no later than January 1, 2003. SFAS No. 143 addresses the financial accounting and reporting for retirement obligations and costs associated with tangible long-lived assets. The Company is currently reviewing the provisions of SFAS No. 143 to determine the standard's impact, if any, on its financial statements upon adoption.

The FASB issued SFAS No. 141, "Business Combinations," in July 2001, 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 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 subsequent to June 30, 2001 are subject immediately to the provisions of the statement. Although the Company

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continues to evaluate the impact of this recently issued standard, the adoption of SFAS No. 142 will result in the elimination of \$15.7 million of goodwill amortization recognized in fiscal 2001, or \$9.2 million net of taxes and minority interests.

The Company adopted 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 nine-month periods ended September 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 nine months of 2001, changes in foreign exchange rates and interest rates resulted in an adjustment of \$0.2 million to accumulated other comprehensive income in the accompanying consolidated balance sheet. Of this amount, \$0.1 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.

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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.

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PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 2. CHANGES IN SECURITIES

None.

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ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

4.1 Amendment to Rights Agreement dated June 8, 2000, by and among the Company and First Chicago Trust Company of New York (the "Rights Agent") and effective as of October 1, 2001.

10.1 Supplemental Executive Retirement Plan as amended and restated effective January 2, 2001.

(b) Reports on Form 8-K

The Registrant filed reports on Form 8-K during the quarterly period ended September 30, 2001. All filings were reported under "Item 5. Other Events" and disclosed the following:

1. Form 8-K dated July 2, 2001 relating to a press release announcing the acquisition of Star Tool Company and a press release announcing the earnings release and conference call information for the second quarter of 2001.
2. Form 8-K dated July 18, 2001 relating to a press release announcing the Company's results for the second quarter of 2001.
3. Form 8-K dated July 26, 2001 relating to a press release announcing the Company's stock repurchase program.

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SIGNATURES

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

SMITH INTERNATIONAL, INC.

Registrant

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Date: November 14, 2001

By: /s/ Douglas L. Rock

Douglas L. Rock
Chairman of the Board, Chief Executive
Officer, President and Chief Operating
Officer

Date: November 14, 2001

By: /s/ Margaret K. Dorman

Margaret K. Dorman
Senior Vice President and
Chief Financial Officer
(Principal Accounting Officer)

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EXHIBIT INDEX

EXHIBIT
NUMBER

DESCRIPTION

| | |
|------|----------------------------------------|
| 4.1 | Amendment to Rights Agreement |
| 10.1 | Supplemental Executive Retirement Plan |

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