

SMITH INTERNATIONAL INC

Form 10-Q

August 09, 2007

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

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2007
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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

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

There were 199,997,710 shares of common stock outstanding, net of shares held in Treasury, on August 2, 2007.

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

(In thousands, except per share data)

(Unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|--------------|------------------------------|--------------|
| | 2007 | 2006 | 2007 | 2006 |
| Revenues | \$ 2,114,373 | \$ 1,738,263 | \$ 4,222,097 | \$ 3,420,384 |
| Costs and expenses: | | | | |
| Costs of revenues | 1,417,827 | 1,193,250 | 2,849,586 | 2,348,768 |
| Selling expenses | 287,162 | 228,255 | 559,495 | 449,449 |
| General and administrative expenses | 76,935 | 71,298 | 149,439 | 139,589 |
| Total costs and expenses | 1,781,924 | 1,492,803 | 3,558,520 | 2,937,806 |
| Operating income | 332,449 | 245,460 | 663,577 | 482,578 |
| Interest expense | 17,605 | 14,685 | 36,139 | 27,521 |
| Interest income | (895) | (696) | (1,659) | (1,293) |
| Income before income taxes and minority interests | 315,739 | 231,471 | 629,097 | 456,350 |
| Income tax provision | 100,891 | 70,910 | 193,990 | 143,572 |
| Minority interests | 61,795 | 41,728 | 121,896 | 86,729 |
| Net income | \$ 153,053 | \$ 118,833 | \$ 313,211 | \$ 226,049 |
| Earnings per share: | | | | |
| Basic | \$ 0.76 | \$ 0.59 | \$ 1.56 | \$ 1.13 |
| Diluted | \$ 0.76 | \$ 0.59 | \$ 1.55 | \$ 1.12 |
| Weighted average shares outstanding: | | | | |
| Basic | 200,499 | 200,457 | 200,241 | 200,725 |
| Diluted | 202,097 | 202,162 | 201,815 | 202,371 |

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

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SMITH INTERNATIONAL, INC.
CONSOLIDATED CONDENSED BALANCE SHEETS

(In thousands, except par value data)

(Unaudited)

| | June 30, 2007 | December 31, 2006 |
|---|------------------|----------------------|
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 94,903 | \$ 80,379 |
| Receivables, net | 1,597,371 | 1,592,230 |
| Inventories, net | 1,564,345 | 1,457,371 |
| Deferred tax assets, net | 39,467 | 51,070 |
| Prepaid expenses and other | 116,257 | 89,977 |
| Total current assets | 3,412,343 | 3,271,027 |
| Property, Plant and Equipment, net | 986,422 | 887,044 |
| Goodwill, net | 870,004 | 867,647 |
| Other Intangible Assets, net | 142,582 | 141,140 |
| Other Assets | 185,871 | 168,617 |
| Total Assets | \$ 5,597,222 | \$ 5,335,475 |
| Liabilities and Stockholders Equity | | |
| Current Liabilities: | | |
| Short-term borrowings and current portion of long-term debt | \$ 298,399 | \$ 287,704 |
| Accounts payable | 610,968 | 654,215 |
| Accrued payroll costs | 107,686 | 154,756 |
| Income taxes payable | 97,002 | 130,339 |
| Other | 145,084 | 152,454 |
| Total current liabilities | 1,259,139 | 1,379,468 |
| Long-Term Debt | 741,979 | 800,928 |
| Deferred Tax Liabilities | 152,994 | 143,124 |
| Other Long-Term Liabilities | 144,730 | 102,904 |
| Minority Interests | 1,015,287 | 922,114 |

Commitments and Contingencies (Note 13)

Stockholders Equity:

Preferred stock, \$1 par value; 5,000 shares authorized; no shares issued or outstanding in 2007 or 2006

Common stock, \$1 par value; 250,000 shares authorized; 216,270 shares issued in 2007

| | | |
|--|--------------|--------------|
| (214,947 shares issued in 2006) | 216,270 | 214,947 |
| Additional paid-in capital | 485,846 | 442,155 |
| Retained earnings | 1,925,446 | 1,653,480 |
| Accumulated other comprehensive income | 40,994 | 23,227 |
| Less Treasury securities, at cost; 15,863 common shares in 2007 (15,031 common shares in 2006) | (385,463) | (346,872) |
| Total stockholders equity | 2,283,093 | 1,986,937 |
| Total Liabilities and Stockholders Equity | \$ 5,597,222 | \$ 5,335,475 |

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

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SMITH INTERNATIONAL, INC.
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

| | Six Months Ended June 30, | |
|---|------------------------------|------------|
| | 2007 | 2006 |
| Cash flows from operating activities: | | |
| Net income | \$ 313,211 | \$ 226,049 |
| <i>Adjustments to reconcile net income to net cash provided by operating activities, excluding the net effects of acquisitions:</i> | | |
| Minority interests | 121,896 | 86,729 |
| Depreciation and amortization | 91,947 | 68,625 |
| Deferred income tax provision | 18,932 | 12,055 |
| Increase in LIFO inventory reserves | 21,777 | 14,948 |
| Share-based compensation expense | 16,721 | 13,385 |
| Provision for losses on receivables | 1,584 | 4,215 |
| Foreign currency translation losses | 2,330 | 1,075 |
| Gain on disposal of property, plant and equipment | (11,210) | (9,717) |
| Equity earnings, net of dividends received | (5,594) | (6,399) |
| Gain on sale of operations | (1,534) | (5,930) |
| <i>Changes in operating assets and liabilities:</i> | | |
| Receivables | (20,371) | (161,082) |
| Inventories | (121,812) | (247,057) |
| Accounts payable | (44,371) | 71,390 |
| Other current assets and liabilities | (76,138) | (12,089) |
| Other non-current assets and liabilities | (13,163) | (16,262) |
| Net cash provided by operating activities | 294,205 | 39,935 |
| Cash flows from investing activities: | | |
| Acquisitions, net of cash acquired | (18,604) | (58,019) |
| Purchases of property, plant and equipment | (168,088) | (113,965) |
| Proceeds from disposal of property, plant and equipment | 23,712 | 15,807 |
| Proceeds from sale of operations | 16,655 | 9,296 |
| Net cash used in investing activities | (146,325) | (146,881) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of long-term debt | 43,251 | 393,031 |
| Principal payments of long-term debt | (115,514) | (215,290) |
| Net change in short-term borrowings | 24,009 | 36,782 |
| Purchases of common stock under Repurchase Program | (35,195) | (58,001) |
| Net proceeds related to long-term incentive awards | 13,083 | 8,598 |
| Payment of common stock dividends | (35,984) | (28,105) |
| Debt issuance costs | | (4,744) |

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| | | |
|---|-----------|-----------|
| Distributions to minority partner | (28,000) | |
| Net cash provided by (used in) financing activities | (134,350) | 132,271 |
| Effect of exchange rate changes on cash | 994 | 634 |
| Increase in cash and cash equivalents | 14,524 | 25,959 |
| Cash and cash equivalents at beginning of period | 80,379 | 62,543 |
| Cash and cash equivalents at end of period | \$ 94,903 | \$ 88,502 |

Supplemental disclosures of cash flow information:

| | | |
|----------------------------|-----------|-----------|
| Cash paid for interest | \$ 37,568 | \$ 27,448 |
| Cash paid for income taxes | 163,967 | 123,830 |

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

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SMITH INTERNATIONAL, INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

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

(Unaudited)

1. Basis of Presentation of Interim Financial Statements

The accompanying unaudited consolidated condensed financial statements of Smith International, Inc. and subsidiaries (the Company) were prepared in accordance with U.S. generally accepted accounting principles and applicable rules and regulations of the Securities and Exchange Commission (the Commission) pertaining to interim financial information. These interim financial statements do not include all information or footnote disclosures required by generally accepted accounting principles for complete financial statements and, therefore, should be read in conjunction with the audited financial statements and accompanying notes included in the Company's 2006 Annual Report on Form 10-K and other current filings with the Commission. All adjustments which are, in the opinion of management, of a normal and recurring nature and are necessary for a fair presentation of the interim financial statements have been included.

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

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

2. Recent Accounting Pronouncements

From time to time, new accounting pronouncements are issued by the Financial Accounting Standards Board (FASB) which are adopted by the Company as of the specified effective date.

Effective January 1, 2007, the Company has adopted Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48), which establishes accounting and disclosure requirements for uncertain tax positions. The adoption did not have a material impact on the Company's results of operations or financial position. See Note 8 for further discussion regarding FIN 48.

Management believes the impact of other recently issued standards, which are not yet effective, will not have a material impact on the Company's consolidated condensed financial statements upon adoption.

3. Acquisitions and Dispositions

During the six months ended June 30, 2007, the Company completed two acquisitions in exchange for aggregate cash consideration of \$18.6 million and the assumption of certain liabilities. The majority of the current year acquisition consideration relates to the purchase of D.S.I. Inspection Services, Inc. (DSI), a U.S.-based provider of inspection, machine shop and other related services. In addition, the Company may be required to fund additional cash consideration of up to \$2.0 million upon the lapse of certain contingencies.

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 date of acquisition. The excess of the purchase price over the estimated fair value of net assets acquired approximated \$4.8 million, primarily pertaining to DSI, which has been recorded as goodwill in the June 30, 2007 consolidated condensed balance sheet. The purchase price allocations related to these acquisitions are based on preliminary information and are subject to change when additional data concerning final asset and liability valuations is obtained; however, material changes in the preliminary allocations are not anticipated by management.

From time to time, the Company divests of non-core operations in the normal course of business. During the second quarter, the Company disposed of certain majority-owned venture operations in exchange for cash consideration of \$16.7 million. Although the transaction had a positive effect on cash flows, it did not materially impact results of operations. In connection with the disposition, the Company removed net assets related to the associated operations, which included \$10.2 million of goodwill.

Pro forma results of operations have not been presented because the effect of these transactions was not material to the Company's consolidated condensed financial statements.

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

Basic earnings per share (EPS) is computed using the weighted average number of common shares outstanding during the period. Diluted EPS gives effect to the potential dilution of earnings that could have occurred if additional shares were issued for stock option and restricted stock awards under the treasury stock method. Although all stock-based awards were included in diluted EPS computations for the three and six-month periods ended June 30, 2007, an immaterial number of outstanding stock option awards were excluded from the computation of diluted EPS as of June 30, 2006 because they were anti-dilutive. The following schedule reconciles the income and shares used in the basic and diluted EPS computations (in thousands, except per share data):

| | Three Months Ended June | | Six Months Ended June | |
|---|-------------------------|-------------|-----------------------|-------------|
| | 2007 | 30, 2006 | 2007 | 30, 2006 |
| Basic EPS: | | | | |
| Net income | \$ 153,053 | \$ 118,833 | \$ 313,211 | \$ 226,049 |
| Weighted average number of common shares outstanding | 200,499 | 200,457 | 200,241 | 200,725 |
| Basic EPS | \$ 0.76 | \$ 0.59 | \$ 1.56 | \$ 1.13 |
| Diluted EPS: | | | | |
| Net income | \$ 153,053 | \$ 118,833 | \$ 313,211 | \$ 226,049 |
| Weighted average number of common shares outstanding | 200,499 | 200,457 | 200,241 | 200,725 |
| Dilutive effect of stock options and restricted stock units | 1,598 | 1,705 | 1,574 | 1,646 |
| | 202,097 | 202,162 | 201,815 | 202,371 |
| Diluted EPS | \$ 0.76 | \$ 0.59 | \$ 1.55 | \$ 1.12 |

5. Inventories

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

| | June 30, 2007 | December 31, 2006 |
|--|------------------|----------------------|
| Raw materials | \$ 143,834 | \$ 117,812 |
| Work-in-process | 154,918 | 147,543 |
| Finished goods | 1,380,912 | 1,285,558 |
| | 1,679,664 | 1,550,913 |
| Reserves to state certain U.S. inventories (FIFO cost of \$616,883 and \$559,943 in 2007 and 2006, respectively) on a LIFO basis | (115,319) | (93,542) |

\$ 1,564,345 \$ 1,457,371

During the first half of 2007, the Company recorded additional LIFO reserves of \$21.8 million. The increase primarily relates to the revaluation of on-hand inventories to current unit cost standards during the first quarter of 2007, which were increased to reflect modest cost inflation experienced in the Oilfield manufacturing operations.

Table of Contents**6. Property, Plant and Equipment**

Property, plant and equipment consist of the following:

| | June 30, 2007 | December 31, 2006 |
|-------------------------------|------------------|----------------------|
| Land and improvements | \$ 57,705 | \$ 55,138 |
| Buildings | 207,069 | 181,419 |
| Machinery and equipment | 783,909 | 717,761 |
| Rental tools | 657,903 | 597,468 |
| | 1,706,586 | 1,551,786 |
| Less Accumulated depreciation | (720,164) | (664,742) |
| | \$ 986,422 | \$ 887,044 |

7. Goodwill and Other Intangible Assets*Goodwill*

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

| | Oilfield | Distribution | Consolidated |
|---|------------|--------------|--------------|
| Balance as of December 31, 2006 | \$ 826,996 | \$ 40,651 | \$ 867,647 |
| Goodwill acquired | 4,833 | 1,721 | 6,554 |
| Goodwill related to disposed operations | (10,197) | | (10,197) |
| Purchase price and other adjustments | 5,273 | 727 | 6,000 |
| Balance as of June 30, 2007 | \$ 826,905 | \$ 43,099 | \$ 870,004 |

Other Intangible Assets

The Company amortizes other identifiable intangible assets on a straight-line basis over the periods expected to be benefited, ranging from two to 27 years. The components of these other intangible assets are as follows:

| | June 30, 2007 | | | December 31, 2006 | | | Weighted Average Amortization Period (years) |
|---------------------------------------|-------------------|--------------|------------|-------------------|--------------|------------|--|
| | Gross Carrying | Accumulated | Net | Gross Carrying | Accumulated | Net | |
| | Amount | Amortization | | Amount | Amortization | | |
| Patents | \$ 111,414 | \$ 28,167 | \$ 83,247 | \$ 101,269 | \$ 19,547 | \$ 81,722 | 13.1 |
| License agreements | 31,688 | 12,436 | 19,252 | 31,231 | 10,661 | 20,570 | 10.4 |
| Non-compete agreements and trademarks | 35,921 | 18,262 | 17,659 | 33,421 | 15,662 | 17,759 | 9.2 |
| Customer lists and contracts | 34,603 | 12,179 | 22,424 | 29,403 | 8,314 | 21,089 | 8.2 |
| | \$ 213,626 | \$ 71,044 | \$ 142,582 | \$ 195,324 | \$ 54,184 | \$ 141,140 | 11.5 |

Amortization expense of other intangible assets was \$7.7 million and \$3.9 million for the three-month periods ended June 30, 2007 and 2006, respectively, and \$15.2 million and \$7.3 million for the six-month periods ended June 30, 2007 and 2006, respectively. On a calendar year basis, amortization expense is expected to approximate \$30.9 million and \$22.1 million for fiscal years 2007 and 2008, respectively. Additionally, amortization expense is anticipated to range between \$10.9 million and \$19.3 million per year for the 2009 - 2011 fiscal years.

Table of Contents**8. Income Taxes**

The Company adopted the provisions of FIN 48 on January 1, 2007. This interpretation addresses the determination of whether tax benefits claimed, or expected to be claimed, on a tax return should be recorded in the financial statements. Under FIN 48, the tax benefit from an uncertain tax position is to be recognized when, based on technical merits, it is more likely than not the position will be sustained on examination by the taxing authorities. Pursuant to this newly issued guidance, the Company was required to record an additional \$1.2 million of tax liabilities, including related interest and penalties, with a corresponding reduction in stockholders' equity during the first quarter of 2007. From a policy standpoint, penalty and interest amounts related to income tax matters are classified as income tax expense in the Company's financial statements.

The Company's balance sheet at January 1, 2007 reflected \$30.8 million of tax liabilities for uncertain tax positions, including \$7.0 million of accrued interest and penalties. Approximately \$0.9 million of this amount was classified as Income Taxes Payable with the remainder included in Other Long-Term Liabilities. There were no material changes in the liability established for uncertain tax positions during the first six months of 2007.

Although the Company does not expect to report a significant change in the amount of liabilities recorded for uncertain tax positions during the next twelve month period, changes in the recorded reserves could impact future reported results. The tax liability for uncertain tax positions includes \$17.5 million of reserves established for tax matters which, if allowed by the relevant taxing authorities, would reduce reported tax expense and the related effective tax rate.

The Company operates in more than 70 countries and is subject to income taxes in most of those jurisdictions. The following table summarizes the earliest tax years that remain subject to examination by taxing authorities in the major jurisdictions in which the Company operates:

| Jurisdiction | Earliest Open Tax Period |
|----------------|--------------------------------|
| Canada | 2000 |
| Italy | 2000 |
| Norway | 1997 |
| Russia | 2004 |
| United Kingdom | 1999 |
| United States | 1999 |

9. Comprehensive Income

Comprehensive income includes net income and changes in the components of accumulated other comprehensive income during the periods presented. The Company's comprehensive income is as follows:

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|------------|------------------|------------|
| | June 30, | | June 30, | |
| | 2007 | 2006 | 2007 | 2006 |
| Net income | \$ 153,053 | \$ 118,833 | \$ 313,211 | \$ 226,049 |
| Currency translation adjustments | 13,045 | 11,067 | 17,618 | 11,610 |
| Changes in unrealized fair value of derivatives, net | (114) | 1,052 | 149 | 1,641 |
| Comprehensive income | \$ 165,984 | \$ 130,952 | \$ 330,978 | \$ 239,300 |

Accumulated other comprehensive income in the accompanying consolidated condensed balance sheet consists of the following:

| | June 30, | December 31, |
|--|----------|--------------|
|--|----------|--------------|

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| | 2007 | 2006 |
|--|-----------|-----------|
| Currency translation adjustments | \$ 43,173 | \$ 25,555 |
| Unrealized fair value of derivatives | 398 | 249 |
| Pension liability adjustments | (2,577) | (2,577) |
| Accumulated other comprehensive income | \$ 40,994 | \$ 23,227 |

Table of Contents**10. Employee Benefit Plans**

The Company maintains various noncontributory defined benefit pension plans covering certain U.S. and non-U.S. employees. In addition, the Company and certain subsidiaries have postretirement benefit plans, which provide health care benefits to a limited number of current, and in some cases, future retirees. Net periodic benefit expense related to the pension and postretirement benefit plans, on a combined basis, approximated \$1.0 million for each of the three-month periods ended June 30, 2007 and 2006, respectively, and \$2.0 million for each of the six-month periods ended June 30, 2007 and 2006, respectively. Company contributions to the pension and postretirement benefit plans for the 2007 fiscal year are expected to approximate the prior year's funding level of \$5 million.

11. Long-Term Incentive Compensation

As of June 30, 2007, the Company had outstanding restricted stock units and stock options granted under the 1989 Long-Term Incentive Compensation Plan, as amended (the Plan). As of June 30, 2007, 1,896,302 shares were authorized for future issuance pursuant to the Plan.

Restricted Stock

The restricted stock program consists of a combination of performance-based restricted stock units (performance-based units) and time-based restricted stock units (time-based units). Activity under the Company's restricted stock program for the six-month period ended June 30, 2007 is presented below:

| | Time-based Awards | | Performance-based Awards | | Total Restricted Stock Units |
|----------------------------------|-------------------|---------------------------|--------------------------|---------------------------|------------------------------|
| | No. of Units | Fair Value ^(a) | No. of Units | Fair Value ^(a) | |
| Outstanding at December 31, 2006 | 524,552 | \$ 40.84 | 1,565,649 | \$ 39.64 | 2,090,201 |
| Granted | 21,700 | 42.78 | | | 21,700 |
| Forfeited | (4,477) | 39.11 | (14,904) | 35.50 | (19,381) |
| Vested | (500) | 27.73 | (301,724) | 38.74 | (302,224) |
| Outstanding at June 30, 2007 | 541,275 | \$ 40.94 | 1,249,021 | \$ 39.90 | 1,790,296 |

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

Restrictions on 398,995 performance-based units and 153,939 time-based units outstanding at June 30, 2007 are expected to lapse during the 2007 fiscal year.

Stock Options

Activity under the Company's stock option program for the six-month period ended June 30, 2007 is presented below:

| | Shares Under Option | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life | Aggregate Intrinsic Value (in thousands) |
|----------------------------------|---------------------|---------------------------------|---|--|
| | | | | |
| Outstanding at December 31, 2006 | 3,351,381 | \$ 18.78 | | |
| Granted | | | | |
| Forfeited | (43,344) | 21.39 | | |
| Exercised | (978,894) | 16.82 | | |

| | | | | |
|------------------------------|-----------|----------|-----|-----------|
| Outstanding at June 30, 2007 | 2,329,143 | 19.55 | 6.0 | \$ 91,037 |
| Exercisable at June 30, 2007 | 1,610,543 | \$ 18.12 | 5.6 | \$ 65,265 |

Share-based Compensation Expense

Share-based compensation expense, consisting of restricted stock and stock options, was \$8.5 million and \$6.7 million for the three-month periods ended June 30, 2007 and 2006, respectively, and \$16.7 million and \$13.4 million for the six-month periods ended June 30, 2007 and 2006, respectively. The total unrecognized share-based compensation expense for awards outstanding as of June 30, 2007 was \$58.3 million, or approximately \$34.9 million net of taxes and minority interests, which will be recognized over a weighted-average period of 2.2 years.

Table of Contents**12. Industry Segments**

The Company provides premium products and services to the oil and gas exploration and production industry, aggregating its operations into two reportable segments: Oilfield and Distribution. The Oilfield segment consists of three business units: M-I SWACO, Smith Technologies and Smith Services. The Distribution segment includes the Wilson business unit. The following table presents financial information for each reportable segment and geographical revenues on a consolidated basis:

| | Three Months Ended | | Six Months Ended | |
|-------------------|--------------------|--------------|------------------|--------------|
| | June 30, | | June 30, | |
| | 2007 | 2006 | 2007 | 2006 |
| Revenues: | | | | |
| Oilfield | \$ 1,614,915 | \$ 1,277,104 | \$ 3,176,599 | \$ 2,488,712 |
| Distribution | 499,458 | 461,159 | 1,045,498 | 931,672 |
| | \$ 2,114,373 | \$ 1,738,263 | \$ 4,222,097 | \$ 3,420,384 |
| Revenues by Area: | | | | |
| United States | \$ 987,046 | \$ 815,090 | \$ 1,948,550 | \$ 1,558,401 |
| Canada | 138,703 | 178,164 | 375,842 | 447,051 |
| North America | 1,125,749 | 993,254 | 2,324,392 | 2,005,452 |
| Latin America | 173,213 | 134,671 | 321,551 | 259,168 |
| Europe/Africa | 512,335 | 384,467 | 991,013 | 728,838 |
| Middle East/Asia | 303,076 | 225,871 | 585,141 | 426,926 |
| Non-North America | 988,624 | 745,009 | 1,897,705 | 1,414,932 |
| | \$ 2,114,373 | \$ 1,738,263 | \$ 4,222,097 | \$ 3,420,384 |
| Operating Income: | | | | |
| Oilfield | \$ 322,940 | \$ 231,948 | \$ 633,953 | \$ 451,743 |
| Distribution | 20,031 | 22,206 | 49,266 | 48,232 |
| General corporate | (10,522) | (8,694) | (19,642) | (17,397) |
| | \$ 332,449 | \$ 245,460 | \$ 663,577 | \$ 482,578 |

13. Commitments and Contingencies*Standby Letters of Credit*

In the normal course of business with customers, vendors and others, the Company is contingently liable for performance under standby letters of credit and bid, performance and surety bonds. Certain of these outstanding instruments guarantee payment to insurance companies with respect to certain liability coverages of the Company's insurance captive. Excluding the impact of these instruments, for which \$20.2 million of related liabilities are reflected in the accompanying consolidated condensed balance sheet, the Company was contingently liable for approximately \$105.5 million of standby letters of credit and bid, performance and surety bonds at June 30, 2007. Management does not expect any material amounts to be drawn on these instruments.

Litigation

Rose Dove Egle v. John M. Egle, et al.

In April 1997, the Company acquired all of the equity interests in Tri-Tech Fishing Services, L.L.C. (Tri-Tech) in exchange for cash consideration of approximately \$20.4 million (the Transaction).

In August 1998, the Company was added as a defendant in a First Amended Petition filed in the 15th Judicial District Court, Parish of Lafayette, Louisiana entitled *Rose Dove Egle v. John M. Egle, et al.* In the amended petition, the plaintiffs alleged that, due to an improper conveyance of ownership interest by the Tri-Tech majority partner prior to the Transaction, Smith purchased a portion of its equity interest from individuals who were not legally entitled to their Tri-Tech shares. The suit was tried in the first quarter of 2004, and a jury verdict of approximately \$4.8 million was rendered in favor of the plaintiffs. In June 2007, the Louisiana Appellate Court reversed the 2004 verdict and ruled in favor of the Company; however, the plaintiffs have subsequently filed an appeal with the Louisiana Supreme Court. Based upon the facts and circumstances and discussions with outside legal counsel, management believes that an unfavorable outcome on this matter is not probable at this time. Accordingly, the Company has not recognized a loss provision in the accompanying consolidated condensed financial statements.

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Other

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

Environmental

The Company routinely establishes and reviews the adequacy of reserves for estimated future environmental clean-up costs for properties currently or previously operated by the Company.

As of June 30, 2007, the Company's environmental reserve totaled \$8.0 million. This amount reflects the future undiscounted estimated exposure related to identified properties, without regard to indemnifications from former owners. While actual future environmental costs may differ from estimated liabilities recorded at June 30, 2007, the Company does not believe that these differences will have a material impact on the Company's financial position, results of operations or cash flows.

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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. This discussion should be read in conjunction with the consolidated condensed financial statements of the Company and the related notes thereto included elsewhere in this Form 10-Q and the Company's 2006 Annual Report on Form 10-K.

Company Products and Operations

The Company is a leading global provider of premium products and services to the oil and gas exploration and production industry. 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, oilfield production chemicals, three-cone and diamond drill bits, turbine products, tubulars, 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 North American branch network providing pipe, valves and fittings as well as mill, safety and other maintenance products.

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

Capital investment by energy companies is largely divided into two markets, which vary greatly in terms of primary business drivers and associated volatility levels. North American drilling activity is primarily influenced by natural gas fundamentals, with approximately 80 percent of the current rig count focused on natural gas finding and development activities. Conversely, drilling in areas outside of North America is more dependent on crude oil fundamentals, which influence over three-quarters of international drilling activity. Historically, business in markets outside of North America has proved to be less volatile as the high cost E&P programs in these regions are generally undertaken by major oil companies, consortiums and national oil companies as part of a longer-term strategic development plan. Although 55 percent of the Company's consolidated revenues were generated in North America during the first six months of 2007, Smith's profitability was largely dependent upon business levels in markets outside of North America. The Distribution segment, which accounts for approximately 25 percent of consolidated revenues and primarily supports a North American customer base, serves to distort the geographic revenue mix of the Company's Oilfield segment operations. Excluding the impact of the Distribution segment, 58 percent of the Company's first half 2007 revenues were generated in markets outside of North America.

Business Outlook

The Company believes the industry is in the midst of a long-term energy cycle, supported by favorable supply and demand fundamentals. In the near-term, drilling activity levels are expected to be influenced by a modest seasonal recovery in Canadian business operations, as well as incremental investment in key Latin American markets.

Although our U.S. business operations are expected to show continued growth during the second half of 2007, tropical weather disturbances in the U.S. Gulf are typically encountered during the third calendar quarter. This factor generally influences the planned number of offshore drilling programs during the September quarter and, in the event tropical storms form and enter the Gulf, could result in the curtailment of offshore operations.

Although a number of factors influence forecasted exploration and production spending, the Company's business is highly dependent on the general economic environment in the United States and other major world economies which ultimately impacts energy consumption and the resulting demand for our products and services. Any significant deterioration in the global economic environment or prolonged weakness in commodity prices could adversely affect worldwide drilling activity and the future financial results of the Company.

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Forward-Looking Statements

This document contains forward-looking statements within the meaning of the Section 21E of the Securities Exchange Act of 1934, as amended, concerning, among other things, our outlook, financial projections and business strategies, all of which are subject to risks, uncertainties and assumptions. These forward-looking statements are identified by their use of terms such as anticipate, believe, could, estimate, expect, project and similar terms. These statements are based on certain assumptions and analyses that we believe are appropriate under the circumstances. Such statements are subject to, among other things, general economic and business conditions, the level of oil and natural gas exploration and development activities, global economic growth and activity, political stability of oil-producing countries, finding and development costs of operations, decline and depletion rates for oil and natural gas wells, seasonal weather conditions, industry conditions, changes in laws or regulations and other risk factors outlined in the Company's Form 10-K for the fiscal year ended December 31, 2006, many of which are beyond the control of the Company. Should one or more of these risks or uncertainties materialize, or should the assumptions prove incorrect, actual results may differ materially from those expected, estimated or projected. Management believes these forward-looking statements are reasonable. However, you should not place undue reliance on these forward-looking statements, which are based only on our current expectations. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to publicly update or revise any of them in light of new information, future events or otherwise.

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

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

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|-----------------------------------|-----------------------------|-----|--------------|-----|---------------------------|-----|--------------|-----|
| | 2007 | | 2006 | | 2007 | | 2006 | |
| | Amount | % | Amount | % | Amount | % | Amount | % |
| Financial Data: | | | | | | | | |
| <i>(dollars in thousands)</i> | | | | | | | | |
| Revenues: | | | | | | | | |
| M-I SWACO | \$ 1,086,524 | 51 | \$ 849,134 | 49 | \$ 2,121,608 | 50 | \$ 1,651,684 | 48 |
| Smith Technologies ⁽¹⁾ | 248,294 | 12 | 214,317 | 12 | 492,385 | 12 | 414,729 | 12 |
| Smith Services ⁽¹⁾ | 280,097 | 13 | 213,653 | 12 | 562,606 | 13 | 422,299 | 13 |
| Oilfield | 1,614,915 | 76 | 1,277,104 | 73 | 3,176,599 | 75 | 2,488,712 | 73 |
| Distribution | 499,458 | 24 | 461,159 | 27 | 1,045,498 | 25 | 931,672 | 27 |
| Total | \$ 2,114,373 | 100 | \$ 1,738,263 | 100 | \$ 4,222,097 | 100 | \$ 3,420,384 | 100 |
| Geographic Revenues: | | | | | | | | |
| United States: | | | | | | | | |
| Oilfield | \$ 599,901 | 29 | \$ 481,287 | 28 | \$ 1,174,826 | 28 | \$ 925,509 | 27 |
| Distribution | 387,145 | 18 | 333,803 | 19 | 773,724 | 18 | 632,892 | 19 |
| Total United States | 987,046 | 47 | 815,090 | 47 | 1,948,550 | 46 | 1,558,401 | 46 |
| Canada: | | | | | | | | |
| Oilfield | 62,032 | 3 | 75,336 | 4 | 168,687 | 4 | 191,669 | 6 |
| Distribution | 76,671 | 3 | 102,828 | 6 | 207,155 | 5 | 255,382 | 7 |
| Total Canada | 138,703 | 6 | 178,164 | 10 | 375,842 | 9 | 447,051 | 13 |
| Non-North America: | | | | | | | | |
| Oilfield | 952,982 | 45 | 720,481 | 41 | 1,833,086 | 43 | 1,371,534 | 40 |
| Distribution | 35,642 | 2 | 24,528 | 2 | 64,619 | 2 | 43,398 | 1 |
| Total Non-North America | 988,624 | 47 | 745,009 | 43 | 1,897,705 | 45 | 1,414,932 | 41 |
| Total Revenue | \$ 2,114,373 | 100 | \$ 1,738,263 | 100 | \$ 4,222,097 | 100 | \$ 3,420,384 | 100 |

Operating Income:

| | | | | | | | | |
|-------------------|------------|----|------------|----|------------|----|------------|----|
| Oilfield | \$ 322,940 | 20 | \$ 231,948 | 18 | \$ 633,953 | 20 | \$ 451,743 | 18 |
| Distribution | 20,031 | 4 | 22,206 | 5 | 49,266 | 5 | 48,232 | 5 |
| General Corporate | (10,522) | * | (8,694) | * | (19,642) | * | (17,397) | * |
| Total | \$ 332,449 | 16 | \$ 245,460 | 14 | \$ 663,577 | 16 | \$ 482,578 | 14 |

Market Data:**Average
Worldwide Rig
Count: ⁽²⁾**

| | | | | | | | | |
|-------------------|-------|-----|-------|-----|-------|-----|-------|-----|
| United States | 1,934 | 48 | 1,867 | 49 | 1,917 | 46 | 1,837 | 47 |
| Canada | 126 | 3 | 258 | 7 | 305 | 7 | 417 | 11 |
| Non-North America | 1,960 | 49 | 1,700 | 44 | 1,924 | 47 | 1,672 | 42 |
| Total | 4,020 | 100 | 3,825 | 100 | 4,146 | 100 | 3,926 | 100 |
| Onshore | 3,456 | 86 | 3,283 | 86 | 3,595 | 87 | 3,388 | 86 |
| Offshore | 564 | 14 | 542 | 14 | 551 | 13 | 538 | 14 |
| Total | 4,020 | 100 | 3,825 | 100 | 4,146 | 100 | 3,926 | 100 |

**Average
Commodity
Prices:**

| | | | | |
|--|----------|----------|----------|----------|
| Crude Oil (\$/Bbl) ⁽³⁾ | \$ 65.02 | \$ 70.72 | \$ 61.68 | \$ 67.13 |
| Natural Gas (\$/mcf) ⁽⁴⁾ | \$ 7.65 | \$ 6.65 | \$ 7.42 | \$ 7.24 |

⁽¹⁾ In 2007, the Company formed the Smith Borehole Enlargement (SBE) group, combining various product and service offerings from Smith Technologies and Smith Services. Due to the formation of SBE, prior period revenues

*were
reclassified to
conform to the
current
presentation.*

- (2) Source: M-I
SWACO.*
- (3) Average daily
West Texas
Intermediate
(WTI) spot
closing prices,
as quoted by
NYMEX.*
- (4) Average daily
Henry Hub,
Louisiana spot
closing prices,
as quoted by
NYMEX.*

** not meaningful*

Table of Contents*Oilfield Segment**Revenues*

M-I SWACO primarily provides drilling and completion fluid systems, engineering and technical services to the oil and gas industry. Additionally, these operations provide oilfield production chemicals and manufacture and market equipment and services used for solids-control, particle separation, pressure control, rig instrumentation and waste-management. M-I SWACO is significantly influenced by exploration and production spending in markets outside of North America, which contributes approximately two-thirds of the unit's revenues, and by its exposure to the U.S. offshore market, which constitutes approximately 10 percent of the revenue base. U.S. offshore drilling programs, which account for approximately three percent of the worldwide rig count, are generally more revenue-intensive than land-based projects due to the complex nature of the related drilling environment. M-I SWACO's revenues totaled \$1.1 billion for the second quarter of 2007, a 28 percent increase from the prior year quarter. Excluding the impact of operations acquired during the prior twelve-month period, revenues grew 25 percent over the second quarter of 2006. Offshore revenues increased 49 percent over the June 2006 quarter, contributing 80 percent of the improvement in base business volumes. On a geographic basis, a favorable customer mix in the Europe/Africa market and new deepwater drilling programs in Asia accounted for the majority of the offshore revenue expansion. To a lesser extent, offshore business levels in the United States increased 33 percent over the prior year quarter, primarily influenced by higher completion activities in the Gulf of Mexico. For the six-month period, M-I SWACO reported revenues of \$2.1 billion, a 28 percent increase over the amounts reported in the first half of 2006. The majority of the revenue increase was reported in markets outside of North America, largely reflecting expansion of offshore business volumes in the Europe/Africa and Asia regions related to new contract awards and increased customer activity. North American base revenues grew 13 percent above the comparable prior year amount due to increased customer spending in the revenue-intensive U.S. offshore market and, to a lesser extent, the impact of additional land-based drilling programs.

Smith Technologies designs and manufactures three-cone and diamond drill bits, turbines and borehole enlargement tools for use in the oil and gas industry. Due to the nature of its product offerings, revenues for these operations typically correlate more closely to the rig count than any of the Company's other businesses. Moreover, Smith Technologies has a high level of North American revenue exposure driven, in part, by the significance of its Canadian operations. Accordingly, the seasonal Canadian drilling decline, which occurs in the second quarter, adversely impacts the unit's financial performance. Smith Technologies reported revenues of \$248.3 million for the quarter ended June 30, 2007, an increase of 16 percent over the comparable prior year period. The revenue growth over the June 2006 quarter was driven by a combination of higher activity levels outside North America, the impact of price increases introduced during the past 12-month period and further market penetration in key focus areas. From a geographic perspective, approximately 60 percent of the period-to-period revenue growth was reported in the United States, reflecting the impact of increased activity levels on drill bit products specifically designed for the premium land-based market. For the six-month period, Smith Technologies reported revenues of \$492.4 million, a 19 percent improvement over the comparable prior year period. The majority of the year-over-year revenue growth was reported outside North America, reflecting higher activity levels and increased demand for borehole enlargement products which grew 69 percent above the comparable prior year amount.

Smith Services manufactures and markets products and services used in the oil and gas industry for drilling, work-over, well completion and well re-entry. Excluding the impact of tubular sales volumes, which are not highly correlated to drilling activity levels, revenues for Smith Services are relatively balanced between North America and the international markets. In addition, Smith Services' revenues are heavily influenced by the complexity of drilling projects, which drive demand for a wider range of its product offerings. For the quarter ended June 30, 2007, Smith Services' revenues totaled \$280.1 million, 31 percent above the prior year period. The year-over-year revenue growth was influenced, in part, by increased demand for tubular products, primarily in the U.S. market. Excluding the impact of tubular product sales, business volumes increased 18 percent above the prior year period, reflecting increased demand for the hydra-jar[®] tool and other high-performance drilling products in the U.S. and Europe/Africa. For the first half of 2007, Smith Services reported revenues of \$562.6 million, a 33 percent increase from the comparable prior year period. Excluding tubular sales, revenues were 18 percent above the level reported in the first six months of

2006, largely reflecting increased demand for fishing/remedial and high-performance drilling products and services. To a lesser extent, higher activity levels in Eastern Hemisphere markets also contributed to the favorable year-over-year comparison.

Table of Contents*Operating Income*

Operating income for the Oilfield segment was \$322.9 million, or 20.0 percent of revenues, for the three months ended June 30, 2007. Segment operating margins were 1.8 percentage points above the prior year quarter, translating into 27 percent incremental operating income as a percentage of revenues. The impact of a favorable business mix, pricing and, to a lesser extent, improved cost coverage contributed to the year-over-year margin expansion. On an absolute dollar basis, second quarter 2007 operating income increased \$91.0 million, primarily reflecting the impact of a 26 percent increase in business volumes on gross profit, partially offset by growth in variable-based operating expenses related to additional investment in personnel and infrastructure in support of the expanding business base. On a year-to-date basis, Oilfield operating margins improved 1.8 percentage points, reflecting gross margin expansion related to the impact of a favorable business mix and pricing initiatives period-to-period and, to a lesser extent, increased coverage of fixed and administrative costs. On an absolute dollar basis, six-month operating income was \$182.2 million above the first half of 2006 level, largely attributable to the impact of higher revenue volumes on the segment's reported gross profit, partially offset by growth in variable-based operating expenses associated with the expanding business base.

*Distribution Segment**Revenues*

Wilson markets pipe, valves, fittings and mill, safety and other maintenance products to energy and industrial markets, primarily through an extensive network of supply branches in the United States and Canada. The segment has the most significant North American revenue exposure of any of the Company's operations with 93 percent of Wilson's second quarter 2007 revenues generated in those markets. Moreover, approximately 27 percent of Wilson's revenues relate to sales to the downstream energy sector, including petrochemical plants and refineries, whose spending is largely influenced by the general state of the U.S. economic environment. Additionally, certain customers in this sector utilize petroleum products as a base material and, accordingly, are adversely impacted by increases in crude oil and natural gas prices. Distribution revenues were \$499.5 million for the second quarter of 2007, eight percent above the comparable prior year period. The year-over-year revenue growth was reported by the domestic upstream and midstream energy sector operations, influenced by drilling and completion activity levels, new contract awards and customer spending for new line pipe projects. In addition, approximately one-third of the year-over-year improvement is attributable to the Europe/Africa region, reflecting increased project-related spending in the engineering and construction market. In the first six months of 2007, Wilson reported revenues totaling \$1.0 billion, an increase of 12 percent from the first half of 2006. Three-fourths of the revenue variance from the prior year period was generated by the upstream energy operations, reflecting the impact of higher U.S. activity levels and increased line pipe project spending.

Operating Income

Operating income for the Distribution segment was \$20.0 million, or 4.0 percent of revenues, for the quarter ended June 30, 2007. Segment operating margins were 80 basis points below the prior year period, reflecting an unfavorable shift in business mix that resulted from the combined impact of a more severe seasonal slowdown in Canada and a higher proportion of domestic line pipe and Non-North American project sales volumes which carry lower relative gross margins. On an absolute dollar basis, second quarter 2007 operating income decreased \$2.2 million below the amount reported in the prior year period, largely due to the impact of the unfavorable shift in business mix on gross profit. On a year-to-date basis, Distribution operating margins deteriorated 50 basis points, as improved fixed sales and administrative cost coverage, due to increased business volumes, were more than offset by the unfavorable shift in business mix. On an absolute dollar basis, operating income was \$1.0 million above the amount reported in the first half of 2006. The operating income variance reflects the impact of higher revenue volumes on the segment's reported gross profit, offset by growth in variable-based operating expenses.

Table of Contents*Consolidated Results*

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

| | Three Months Ended June 30, 2007 | | 2006 | | Six Months Ended June 30, 2007 | | 2006 | |
|---|-------------------------------------|-----|--------------|-----|-----------------------------------|-----|--------------|-----|
| | Amount | % | Amount | % | Amount | % | Amount | % |
| Revenues | \$ 2,114,373 | 100 | \$ 1,738,263 | 100 | \$ 4,222,097 | 100 | \$ 3,420,384 | 100 |
| Gross profit | 696,546 | 33 | 545,013 | 31 | 1,372,511 | 33 | 1,071,616 | 31 |
| Operating expenses | 364,097 | 17 | 299,553 | 17 | 708,934 | 17 | 589,038 | 17 |
| Operating income | 332,449 | 16 | 245,460 | 14 | 663,577 | 16 | 482,578 | 14 |
| Interest expense | 17,605 | 1 | 14,685 | 1 | 36,139 | 1 | 27,521 | 1 |
| Interest income | (895) | | (696) | | (1,659) | | (1,293) | |
| Income before income taxes and minority interests | 315,739 | 15 | 231,471 | 13 | 629,097 | 15 | 456,350 | 13 |
| Income tax provision | 100,891 | 5 | 70,910 | 4 | 193,990 | 5 | 143,572 | 4 |
| Minority interests | 61,795 | 3 | 41,728 | 2 | 121,896 | 3 | 86,729 | 2 |
| Net income | \$ 153,053 | 7 | \$ 118,833 | 7 | \$ 313,211 | 7 | \$ 226,049 | 7 |

Consolidated revenues were \$2.1 billion for the second quarter of 2007, 22 percent above the prior year period. Approximately 90 percent of the revenue growth was attributable to increased demand for Oilfield segment product offerings. Oilfield segment revenues grew 26 percent year-over-year, influenced by new contract awards and a favorable customer mix in the Eastern Hemisphere offshore markets and, to a lesser extent, higher tubular product sales volumes in the U.S. market. The Distribution operations reported an eight percent increase from the prior year quarter, driven by higher drilling and completion activity in the U.S. and, to a lesser extent, project activity in the North Sea and West Africa markets. For the first half of 2007, consolidated revenues were \$4.2 billion, 23 percent above the comparable 2006 period, with Oilfield segment business volumes contributing the majority of the revenue growth. Oilfield segment revenues rose 28 percent over amounts reported in the prior year period with the increase largely attributable to a favorable customer mix and increased activity levels outside North America, primarily Europe/Africa. To a lesser extent, increased demand for tubular products in the U.S., which grew 78 percent over the first half of 2006 level, also contributed to the revenue expansion.

Gross profit totaled \$696.5 million for the second quarter, or 33 percent of revenues, 1.6 percentage points above the margins reported in the comparable prior year period. The impact of higher business volumes on fixed costs coupled with an improved business mix and pricing realization influenced the gross margin expansion. On an absolute dollar basis, gross profit increased \$151.5 million, or 28 percent, over the prior year quarter, primarily reflecting higher sales volumes in the Oilfield operations. For the six-month period, gross profit totaled \$1.4 billion, or 33 percent of revenues, 1.2 percentage points above the gross profit margins reported in the first half of 2006. The gross margin improvement reflects an increased proportion of Oilfield revenues, largely driven by growth in the level of offshore business volumes, which are generally more profitable than land-based or Distribution segment operations. On an absolute dollar basis, gross profit was \$300.9 million above the six-month period ended June 30, 2006, again, largely attributable to higher sales volumes in the Oilfield operations.

Operating expenses, consisting of selling, general and administrative expenses, increased \$64.5 million from the prior year quarter and were consistent as a percentage of revenues. The majority of the absolute dollar increase was attributable to variable-related costs associated with the improved business volumes, including increased investment in personnel and infrastructure in support of the expanding business base. Compared to the first six months of 2006, operating expenses increased \$119.9 million; however, as a percentage of revenues, decreased 40 basis points. Improved fixed cost coverage in the sales and administrative functions accounted for the operating expense percentage decline.

Net interest expense, which represents interest expense less interest income, equaled \$16.7 million in the second quarter of 2007. Net interest expense increased \$2.7 million and \$8.3 million from the prior year quarter and first six months of 2006, respectively. The variance primarily reflects higher average debt levels, largely associated with acquisition-related borrowings in the later half of 2006.

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The effective tax rate approximated 32 percent and 31 percent for the three and six-month periods ended June 30, 2007. Income tax expense and the resulting effective rates for the six-month periods are impacted by the inclusion of non-recurring tax benefits. Excluding the impact of non-recurring tax benefits, the effective rate declined 60 basis points below the June 2006 rate and was 40 basis points below the rate for the first half of 2006. The favorable comparison to the prior year effective rates, as well as to the U.S. statutory rate, was attributable to the higher proportion of M-I SWACO's U.S. partnership earnings. Based on the structure of M-I SWACO's U.S. operations, the minority partner is directly responsible for taxes on its share of U.S. partnership earnings. Accordingly, the Company properly consolidates the pretax income related to the minority partner's share of U.S. partnership earnings but excludes the related tax provision.

Minority interest expense reflects the portion of the results of majority-owned operations which are applicable to the minority interest partners. Minority interest expense was \$20.1 million and \$35.2 million above amounts reported in the prior year quarter and first half of 2006, respectively, primarily associated with improved profitability levels in the M-I SWACO joint venture.

Liquidity and Capital Resources*General*

At June 30, 2007, cash and cash equivalents equaled \$94.9 million. During the first six months of 2007, the Company generated \$294.2 million of cash flows from operations, which is \$254.3 million above the amount reported in the comparable prior year period. The favorable comparison was attributable to the reduced level of incremental working capital investment, largely influenced by improved receivable collections and, to a lesser extent, the year-over-year increase in overall profitability levels.

During the first six months of 2007, cash flows used in investing activities totaled \$146.3 million, primarily consisting of amounts required to fund capital expenditures and, to a lesser extent, acquisitions. The Company invested \$144.4 million in property plant and equipment, net of cash proceeds arising from certain asset disposals. Acquisition funding, which primarily related to the purchase of DSI, resulted in cash outflows of \$18.6 million in the first half of 2007. Cash required to fund investing activities was consistent with the prior year level as higher capital spending requirements, influenced by new contract awards and continued geographic expansion, were largely offset by reduced acquisition funding levels and proceeds from the sale of certain business operations.

Cash flows used in financing activities totaled \$134.4 million for the first half of 2007. The significant improvement in operating cash flows enabled the return of \$71.2 million of cash to investors, in the form of regular dividends and share repurchases, and minority partner distributions of \$28.0 million while providing sufficient funds to repay \$48.3 million of outstanding indebtedness.

The Company's primary internal source of liquidity is cash flow generated from operations. Cash flows generated from operations is primarily influenced by the level of worldwide drilling activity, which affects profitability levels and working capital requirements. Capacity under revolving credit agreements is also available, if necessary, to fund operating or investing activities. As of June 30, 2007, the Company had \$127.0 million drawn and \$4.5 million of letters of credit issued under its U.S. revolving credit facilities, resulting in \$268.5 million of capacity available for future operating or investing needs. The Company also has revolving credit facilities in place outside of the United States, which are generally used to finance local operating needs. At June 30, 2007, the Company had available borrowing capacity of \$103.9 million under the non-U.S. borrowing facilities.

The Company's external sources of liquidity include debt and equity financing in the public capital markets, if needed. The Company carries an investment-grade credit rating with recognized rating agencies, generally providing the Company with access to debt markets. The Company's overall borrowing capacity is, in part, dependent on maintaining compliance with financial covenants under the various credit agreements. As of June 30, 2007, the Company was well within the covenant compliance thresholds under its various loan indentures, as amended, providing the ability to access available borrowing capacity. Management believes funds generated by 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.

Additionally, \$150.0 million of principal currently outstanding related to the 7.0 percent Senior Notes becomes due in the third quarter of 2007. The Company currently intends to use amounts available under existing credit facilities to

fund the debt retirement. Management also continues to evaluate opportunities to acquire products or businesses complementary to the Company's operations. Additional acquisitions, if they arise, may involve the use of cash or, depending upon the size and terms of the acquisition, may require debt or equity financing.

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The Company makes regular quarterly distributions under a dividend program. The current annualized payout under the program of approximately \$80 million is expected to be funded with future cash flows from operations and, if necessary, amounts available under existing credit facilities. The level of future dividend payments will be at the discretion of the Company's Board of Directors and will depend upon the Company's financial condition, earnings, cash flows, compliance with certain debt covenants and other relevant factors.

The Company's Board of Directors has authorized a share buyback program that allows for the repurchase of up to 20.0 million shares of the Company's common stock, subject to regulatory issues, market considerations and other relevant factors. As of June 30, 2007, the Company had 16.5 million shares remaining under the current authorization. Future repurchases under the program may be executed from time to time in the open market or in privately negotiated transactions and will be funded with cash flows from operations or amounts available under existing credit facilities.

Commitments and Contingencies*Standby Letters of Credit*

In the normal course of business with customers, vendors and others, the Company is contingently liable for performance under standby letters of credit and bid, performance and surety bonds. Certain of these outstanding instruments guarantee payment to insurance companies with respect to certain liability coverages of the Company's insurance captive. Excluding the impact of these instruments, for which \$20.2 million of related liabilities are reflected in the accompanying consolidated condensed balance sheet, the Company was contingently liable for approximately \$105.5 million of standby letters of credit and bid, performance and surety bonds at June 30, 2007. Management does not expect any material amounts to be drawn on these instruments.

*Litigation**Rose Dove Egle v. John M. Egle, et al.*

In April 1997, the Company acquired all of the equity interests in Tri-Tech Fishing Services, L.L.C. ("Tri-Tech") in exchange for cash consideration of approximately \$20.4 million (the "Transaction").

In August 1998, the Company was added as a defendant in a First Amended Petition filed in the 15th Judicial District Court, Parish of Lafayette, Louisiana entitled *Rose Dove Egle v. John M. Egle, et al.* In the amended petition, the plaintiffs alleged that, due to an improper conveyance of ownership interest by the Tri-Tech majority partner prior to the Transaction, Smith purchased a portion of its equity interest from individuals who were not legally entitled to their Tri-Tech shares. The suit was tried in the first quarter of 2004, and a jury verdict of approximately \$4.8 million was rendered in favor of the plaintiffs. In June 2007, the Louisiana Appellate Court reversed the 2004 verdict and ruled in favor of the Company; however, the plaintiffs have subsequently filed an appeal with the Louisiana Supreme Court. Based upon the facts and circumstances and discussions with outside legal counsel, management believes that an unfavorable outcome on this matter is not probable at this time. Accordingly, the Company has not recognized a loss provision in the accompanying consolidated condensed financial statements.

Other

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

Environmental

The Company routinely establishes and reviews the adequacy of reserves for estimated future environmental clean-up costs for properties currently or previously operated by the Company.

As of June 30, 2007, the Company's environmental reserve totaled \$8.0 million. This amount reflects the future undiscounted estimated exposure related to identified properties, without regard to indemnifications from former owners. While actual future environmental costs may differ from estimated liabilities recorded at June 30, 2007, the Company does not believe that these differences will have a material impact on the Company's financial position, results of operations or cash flows.

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Critical Accounting Policies and Estimates

The discussion and analysis of financial condition and results of operations are based upon the Company's consolidated condensed financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. The Company evaluates its estimates on an ongoing basis, based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. In its 2006 Annual Report on Form 10-K, the Company has described the critical accounting policies that require management's most significant judgments and estimates. There have been no material changes in these critical accounting policies.

Recent Accounting Pronouncements

From time to time, new accounting pronouncements are issued by the Financial Accounting Standards Board (FASB) which are adopted by the Company as of the specified effective date.

Effective January 1, 2007, the Company has adopted Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48), which establishes accounting and disclosure requirements for uncertain tax positions. The adoption did not have a material impact on the Company's results of operations or financial position. See Note 8 to the consolidated condensed financial statements for further discussion regarding FIN 48.

Management believes the impact of other recently issued standards, which are not yet effective, will not have a material impact on the Company's consolidated condensed financial statements upon adoption.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

The Company is exposed to certain market risks arising from transactions that are entered into in the normal course of business which are primarily related to interest rate changes and fluctuations in foreign exchange rates. During the reporting period, no events or transactions have occurred which would materially change the information disclosed in the Company's 2006 Annual Report on Form 10-K.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures. Our management, with the participation of our principal executive and financial officers, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (Exchange Act)) as of June 30, 2007. Based upon that evaluation, our principal executive and financial officers concluded that as of June 30, 2007, our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports we file or submit under the Exchange Act is (1) recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms, and (2) accumulated and communicated to our management, including our principal executive and financial officers, to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting. There has been no change in the Company's internal control over financial reporting during the quarter ended June 30, 2007 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents**PART II OTHER INFORMATION****Item 1. Legal Proceedings**

None.

Item 1A. Risk Factors

There have been no material changes in our Risk Factors as set forth in Item 1A to Part I of our Form 10-K for the year ended December 31, 2006.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

During October 2005, the Company's Board of Directors approved a repurchase program that allows for the purchase of up to 20.0 million shares of the Company's common stock, subject to regulatory issues, market considerations and other relevant factors. During the second quarter of 2007, the Company repurchased 398,800 shares of common stock under the program at an aggregate cost of \$21.3 million. The acquired shares have been added to the Company's treasury stock holdings.

A summary of the Company's repurchase activity for the three months ended June 30, 2007 is as follows:

| Period | | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Program | Number of Shares that May Yet Be Purchased Under the Program |
|------------------------------|----------|---|------------------------------------|---|---|
| April 1 | April 30 | 206,900 | \$49.82 | 206,900 | 16,707,313 |
| May 1 | May 31 | 16,900 | 51.18 | 16,900 | 16,690,413 |
| June 1 | June 30 | 175,000 | 57.72 | 175,000 | 16,515,413 |
| 2 nd Quarter 2007 | | 398,800 | \$53.35 | 398,800 | 16,515,413 |

Item 3. Defaults upon Senior Securities

None.

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

At the Annual Meeting of Stockholders on April 24, 2007, stockholders of the Company elected all nominated directors, approved the Smith International, Inc. Second Amended and Restated 1989 Long-Term Incentive Compensation Plan and ratified Deloitte & Touche LLP as independent registered public accountants for 2007 by the votes shown below.

| | For | Withheld | | Broker Non-Votes |
|---|-------------|-----------|-----------|---------------------|
| Election of Directors: | | | | |
| James R. Gibbs | 179,578,579 | 6,606,526 | | |
| John Yearwood | 183,391,870 | 2,793,235 | | |
| Approval of the Smith International, Inc. Second Amended and Restated 1989 Long-Term Incentive Compensation Plan | 156,476,161 | 5,544,008 | 1,340,941 | 22,823,995 |
| Ratification of Deloitte & Touche LLP as independent registered public | 184,872,188 | 127,511 | 1,185,406 | |

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Item 5. Other Information

None.

Item 6. Exhibits

Exhibits designated with an * are filed, and with an ** furnished, as an exhibit to this Quarterly Report on Form 10-Q. Exhibits previously filed, as indicated below, are incorporated by reference.

| Exhibit Number | Description |
|-------------------|---|
| 3.1 | Restated Certificate of Incorporation of the Company, dated July 26, 2005. Filed as Exhibit 3.4 to the Company's report on Form 10-Q for the quarter ended June 30, 2005 and incorporated herein by reference. |
| 3.2 | Restated Bylaws of the Company. Filed as Exhibit 3.3 to the Company's report on Form 10-K for the year ended December 31, 2004 and incorporated herein by reference. |
| 10.1 | Smith International, Inc. Second Amended and Restated 1989 Long-Term Incentive Compensation Plan, effective January 1, 2005. Filed as Exhibit 10.1 to the Company's report on Form 8-K dated April 24, 2007 and incorporated herein by reference. |
| 31.1* | Certification of Chief Executive Officer pursuant to Rule 13a-14 or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2* | Certification of Chief Financial Officer pursuant to Rule 13a-14 or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1** | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

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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

Date: August 9, 2007

By: /s/ Doug Rock
Doug Rock
Chairman of the Board, Chief Executive
Officer,
President and Chief Operating Officer
(principal executive officer)

Date: August 9, 2007

By: /s/ Margaret K. Dorman
Margaret K. Dorman
Senior Vice President,
Chief Financial Officer and Treasurer
(principal financial and accounting
officer)

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