SMITH INTERNATIONAL INC
Form 10-Q
November 10, 2008

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

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2008

OR

o **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	**95-3822631**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
16740 East Hardy Road **Houston, Texas**	**77032**
(Address of principal executive offices)	(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 þ No o

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

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

There were 218,856,479 shares of common stock outstanding, net of treasury shares held, on November 3, 2008.

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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 September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Revenues:				
Oilfield operations	$ 2,088,442	$ 1,685,687	$ 5,769,939	$ 4,862,286
Distribution operations	760,869	559,372	1,944,528	1,604,870
Total revenues	2,849,311	2,245,059	7,714,467	6,467,156
Costs and expenses:				
Cost of oilfield revenues	1,317,288	1,042,984	3,615,156	3,017,978
Cost of distribution revenues	625,225	473,169	1,603,577	1,347,761
Selling, general and administrative expenses	463,717	378,569	1,284,079	1,087,503
Total costs and expenses	2,406,230	1,894,722	6,502,812	5,453,242
Operating income	443,081	350,337	1,211,655	1,013,914
Interest expense	24,169	17,103	56,714	53,242
Interest income	(732)	(1,152)	(2,380)	(2,811)
Income before income taxes and minority interests	419,644	334,386	1,157,321	963,483
Income tax provision	136,765	106,579	375,611	300,569
Minority interests	73,036	60,974	213,603	182,870
Net income	$ 209,843	$ 166,833	$ 568,107	$ 480,044
Earnings per share:				
Basic	$ 1.00	$ 0.83	$ 2.79	$ 2.40
Diluted	$ 1.00	$ 0.83	$ 2.77	$ 2.38
Weighted average shares outstanding:				
Basic	208,857	200,070	203,554	200,184
Diluted	210,216	202,078	204,862	201,891

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)

	September 30, 2008	December 31, 2007
Assets		
Current Assets:		
Cash and cash equivalents	$ 192,101	$ 158,267
Receivables, net	2,434,048	1,750,561
Inventories, net	2,226,379	1,658,172
Deferred tax assets, net	80,184	46,220
Prepaid expenses and other	149,799	114,515
Total current assets	5,082,511	3,727,735
Property, Plant and Equipment, net	1,829,606	1,105,880
Goodwill, net	2,982,058	896,442
Other Intangible Assets, net	615,543	128,359
Other Assets	236,489	203,464
Total Assets	$ 10,746,207	$ 6,061,880
Liabilities and Stockholders Equity		
Current Liabilities:		
Short-term borrowings and current portion of long-term debt	$ 1,356,155	$ 139,481
Accounts payable	989,760	655,413
Accrued payroll costs	197,930	153,453
Income taxes payable	110,248	80,181
Other	238,481	144,772
Total current liabilities	2,892,574	1,173,300
Long-Term Debt	1,442,945	845,624
Deferred Tax Liabilities	477,015	160,244
Other Long-Term Liabilities	150,147	157,042
Minority Interests	1,295,802	1,130,773

Commitments and Contingencies (Note 12)		
Stockholders Equity:		
Preferred stock, $1 par value; 5,000 shares authorized; no shares issued or outstanding in 2008 or 2007		
Common stock, $1 par value; 500,000 shares authorized; 236,016 shares issued in 2008 (217,586 shares issued in 2007)	236,016	217,586
Additional paid-in capital	1,967,761	533,429
Retained earnings	2,712,840	2,219,224
Accumulated other comprehensive income	34,054	67,840
Less Treasury securities, at cost; 17,160 common shares in 2008 (16,825 common shares in 2007)	(462,947)	(443,182)
Total stockholders equity	4,487,724	2,594,897
Total Liabilities and Stockholders Equity	$ 10,746,207	$ 6,061,880

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

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

	Nine Months Ended September 30, 2008	2007
Cash flows from operating activities:		
Net income	$ 568,107	$ 480,044
Adjustments to reconcile net income to net cash provided by operating activities, excluding the net effects of acquisitions:		
Minority interests	213,603	182,870
Depreciation and amortization	173,748	141,461
Deferred income tax provision	10,299	7,536
Increase in LIFO inventory reserves	69,213	22,131
Share-based compensation expense	30,663	25,352
Provision for losses on receivables	4,198	2,740
Foreign currency translation losses (gains)	44	3,579
Gain on disposal of property, plant and equipment	(23,897)	(17,250)
Equity earnings, net of dividends received	(12,879)	(10,485)
Gain on sale of operations		(1,534)
Changes in operating assets and liabilities, excluding the net effects of acquisitions:		
Receivables	(367,779)	(179,390)
Inventories	(517,971)	(169,290)
Accounts payable	267,185	(17,211)
Other current assets and liabilities	99,253	(61,674)
Other non-current assets and liabilities	(34,792)	(20,261)
Net cash provided by operating activities	478,995	388,618
Cash flows from investing activities:		
Acquisitions, net of cash acquired	(1,667,352)	(41,073)
Purchases of property, plant and equipment	(267,824)	(248,530)
Proceeds from disposal of property, plant and equipment	45,083	33,888
Proceeds from sale of operations		16,655
Net cash used in investing activities	(1,890,093)	(239,060)
Cash flows from financing activities:		
Proceeds from issuance of long-term debt	1,027,847	233,175
Principal payments of long-term debt	(448,353)	(272,676)
Net change in short-term borrowings	968,340	36,129
Purchases of common stock under Repurchase Program	(13,084)	(78,847)
Payment of common stock dividends	(68,288)	(56,031)
Net proceeds related to long-term incentive awards	2,103	24,627
Excess tax benefit from share-based compensation	8,190	20,317
Distributions to minority interest partner	(31,587)	(40,097)

Net cash provided by (used in) financing activities	1,445,168	(133,403)
Effect of exchange rate changes on cash	(236)	2,182
Increase in cash and cash equivalents	33,834	18,337
Cash and cash equivalents at beginning of period	158,267	80,379
Cash and cash equivalents at end of period	$ 192,101	$ 98,716
Supplemental disclosures of cash flow information:		
Cash paid for interest	$ 50,349	$ 54,482
Cash paid for income taxes	324,940	271,883
Supplemental disclosures of non-cash transactions:		
Stock issued for the W-H Energy transaction	$ 1,403,616	$

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. Significant Accounting Policies

Basis of Presentation

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 2007 Annual Report on Form 10-K and other current filings with the Commission. All adjustments that are, in the opinion of management, of a normal and recurring nature and are necessary for a fair presentation of the interim financial statements have been included.

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

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

Revenue Recognition

Revenues in the accompanying unaudited results of operations are separated into our two major business lines to provide additional information for use in analyzing the Company s results. Generally, sales transactions are subject to contractual arrangements that specify price, general terms and conditions.

Transactions in our oilfield operations are primarily composed of rental and service revenues, but also include product and certain other revenues. Product revenues, net of applicable provisions for returns, are recognized when title and related risk of loss transfer to the customer and collectability is reasonably assured. In most cases, title and risk transfer upon product delivery; however, certain products are provided on a consigned basis with title and risk transferring when products are consumed. Rental, service and other revenues are recorded when such services are performed and collectability is reasonably assured. On a routine basis, our operating units provide multiple product and service offerings as part of a combined transaction. Service and rental revenues for these projects, which are of a short duration, are recognized when the project is complete.

Sales transactions in our distribution operations are primarily composed of product revenues. Distribution sales, net of applicable provisions for returns, are recognized when goods are delivered to the customer and collectability is reasonably assured.

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.

The FASB had previously issued Statement of Financial Accounting Standards (SFAS) No. 141 (revised 2007), Business Combinations ; SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51 and SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities which have been discussed in previous filings with the Commission. The Company continues to evaluate the provisions of these standards, which are required to be adopted by the Company in the first quarter of 2009.

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.

Reclassifications

Certain reclassifications have been made to the prior years financial information to conform to the current presentation.

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2. Acquisitions and Dispositions

W-H Energy Services

On August 25, 2008, Smith completed the acquisition of all of the outstanding equity interests in W-H Energy Services, Inc. (W-H), a Texas corporation. W-H is a leading provider of technologically-advanced drilling-related product offerings, including directional drilling, measurement-while-drilling and logging-while-drilling services. W-H also provides a broad range of products and services used by exploration and production companies to complete and produce wells, including coiled tubing services, cased-hole wireline and other related offerings. W-H s business operations are primarily concentrated in the United States.

In connection with the transaction, the Company issued 17.78 million common shares, valued at $78.94 per share, and paid $1.64 billion of cash to the former shareholders of W-H.

The W-H acquisition has 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 preliminary purchase price consideration consists of the following (in thousands):

Preliminary purchase price consideration:	
Shares issued[a]	$ 1,403,616
Cash paid, net	1,615,133
Consideration paid to former W-H equity holders	3,018,749
Acquired company transaction costs	10,990
	$ 3,029,739

[a] *The fair value of shares issued was determined using an average price of $78.94, which represents the Company s average closing stock price for the five-day period beginning two days before the announcement of the transaction.*

The following table indicates the preliminary purchase price allocation to net assets acquired which was based on estimated fair values as of the acquisition date. The excess of the purchase price over the net assets acquired amounted to $2.07 billion and has been recorded as goodwill in the accompanying September 30, 2008 consolidated condensed balance sheet. Based on the structure of the transaction, the majority of the goodwill related to the transaction is not expected to be deductible for tax purposes.

Purchase Price	$ 3,029,739

Receivables	344,560
Inventories	139,422
Prepaid and other current assets	89,173
Property, plant and equipment	623,687
Intangibles	487,960
Other assets	11,381
Accounts payable and accrued liabilities	(91,971)
Other current liabilities	(84,989)
Long-term debt	(261,233)
Deferred income taxes	(294,534)
Other liabilities	(4,486)
Goodwill recorded	$ 2,070,769

The preliminary purchase price allocation, which is based on relevant facts and circumstances and discussion with an independent third-party consulting firm, is subject to change upon completion of the final valuation analysis by Smith management. The final valuation, which is required to be completed by August 2009, is not expected to result in material changes to the preliminary allocation.

Other Acquisitions and Dispositions
During the nine months ended September 30, 2008, the Company completed four additional acquisitions in exchange for aggregate cash consideration of $34.7 million and the assumption of certain liabilities. The consideration primarily relates to the purchase of Norwegian-based Innovar Engineering AS, a company providing wellbore completion tool technology, and Caspian Downhole Services (CDS), a Kazakhstan-based provider of rental tool, machine shop and inspection services.
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 $11.9 million and has been recorded as goodwill in the September 30, 2008 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 first nine months of 2007, the Company completed the disposition 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.
Pro Forma Financial Information
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, 2007. 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):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Revenues	$ 3,072,845	$ 2,528,051	$ 8,585,906	$ 7,300,787
Net income	$ 220,671	$ 171,582	$ 611,512	$ 500,287
Earnings per share:				
Basic	$ 1.06	$ 0.86	$ 3.00	$ 2.50
Diluted	$ 1.05	$ 0.85	$ 2.98	$ 2.48

3. 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. 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 Months Ended September 30,	
	2008	2007	2008	2007
Net income	$ 209,843	$ 166,833	$ 568,107	$ 480,044
	208,857	200,070	203,554	200,184

Weighted average number of common shares outstanding				
Basic EPS	$ 1.00	$ 0.83	$ 2.79	$ 2.40
Net income	$ 209,843	$ 166,833	$ 568,107	$ 480,044
Weighted average number of common shares outstanding	208,857	200,070	203,554	200,184
Dilutive effect of stock options and restricted stock units	1,359	2,008	1,308	1,707
	210,216	202,078	204,862	201,891
Diluted EPS	$ 1.00	$ 0.83	$ 2.77	$ 2.38

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4. Inventories

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

	September 30, 2008	December 31, 2007
Raw materials	$ 198,101	$ 139,218
Work-in-process	196,744	173,836
Finished goods	2,017,002	1,461,373
	2,411,847	1,774,427
Reserves to state certain U.S. inventories (FIFO cost of $777,295 and $611,062 in 2008 and 2007, respectively) on a LIFO basis	(185,468)	(116,255)
	$ 2,226,379	$ 1,658,172

During the first nine months of 2008, the Company recorded additional LIFO reserves of $69.2 million, primarily related to the higher cost of steel and alloy products purchased in the Distribution segment. To a lesser extent, modest cost inflation experienced in the oilfield manufacturing operations resulted in the revaluation of on-hand inventories to current unit cost standards and contributed to the increase in LIFO reserves.

5. Property, Plant and Equipment

Property, plant and equipment consist of the following:

	September 30, 2008	December 31, 2007
Land and improvements	$ 75,338	$ 62,546
Buildings	308,059	235,545
Machinery and equipment	1,163,543	880,562
Rental tools	1,179,689	726,333
	2,726,629	1,904,986
Less Accumulated depreciation	(897,023)	(799,106)
	$ 1,829,606	$ 1,105,880

6. Goodwill and Other Intangible Assets

Goodwill

The following table presents beginning and ending goodwill balances, which are presented net of accumulated amortization of $53.6 million, as well as changes in the account during the period shown. Additionally, due to the change in reportable business segments discussed in Footnote 11, the beginning goodwill balance has been recast in order to conform to the current presentation.

	M-I SWACO	Smith Oilfield	Distribution