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)

þ **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

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.)
411 North Sam Houston Parkway, Suite 600 **Houston, Texas**	**77060**
(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, 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 þ Accelerated Filer o Non-Accelerated Filer 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 199,997,710 shares of common stock outstanding, net of shares held in Treasury, on August 2, 2007.

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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 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.

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
Adjustments to reconcile net income to net cash provided by operating activities, excluding the net effects of acquisitions:		
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)
Changes in operating assets and liabilities:		
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)

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.

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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 30,		Six Months Ended June 30,	
	2007	2006	2007	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.

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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
	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net	(years)
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.

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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 June 30,		Six Months Ended 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