

SMITH INTERNATIONAL INC

Form 10-Q

November 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 September 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.)

16740 Hardy Street
Houston, Texas
(Address of principal executive offices)

77032
(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 200,315,917 shares of common stock outstanding, net of treasury shares held, on November 2, 2007.

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CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS**

(In thousands, except per share data)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Revenues	\$ 2,245,059	\$ 1,914,184	\$ 6,467,156	\$ 5,334,568
Costs and expenses:				
Costs of revenues	1,516,153	1,295,971	4,365,739	3,644,739
Selling expenses	300,084	253,569	859,579	703,018
General and administrative expenses	78,485	76,919	227,924	216,508
Total costs and expenses	1,894,722	1,626,459	5,453,242	4,564,265
Operating income	350,337	287,725	1,013,914	770,303
Interest expense	17,103	17,287	53,242	44,808
Interest income	(1,152)	(830)	(2,811)	(2,123)
Income before income taxes and minority interests	334,386	271,268	963,483	727,618
Income tax provision	106,579	88,600	300,569	232,172
Minority interests	60,974	49,743	182,870	136,472
Net income	\$ 166,833	\$ 132,925	\$ 480,044	\$ 358,974
Earnings per share:				
Basic	\$ 0.83	\$ 0.66	\$ 2.40	\$ 1.79
Diluted	\$ 0.83	\$ 0.66	\$ 2.38	\$ 1.78
Weighted average shares outstanding:				
Basic	200,070	200,009	200,184	200,484
Diluted	202,078	201,811	201,891	202,158

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, 2007	December 31, 2006
Assets		
Current Assets:		
Cash and cash equivalents	\$ 98,716	\$ 80,379
Receivables, net	1,770,691	1,592,230
Inventories, net	1,621,179	1,457,371
Deferred tax assets, net	53,139	51,070
Prepaid expenses and other	120,323	89,977
Total current assets	3,664,048	3,271,027
Property, Plant and Equipment, net	1,037,896	887,044
Goodwill, net	888,754	867,647
Other Intangible Assets, net	137,144	141,140
Other Assets	194,506	168,617
Total Assets	\$ 5,922,348	\$ 5,335,475

Liabilities and Stockholders Equity

Current Liabilities:		
Short-term borrowings and current portion of long-term debt	\$ 153,701	\$ 287,704
Accounts payable	645,142	654,215
Accrued payroll costs	131,783	154,756
Income taxes payable	102,693	130,339
Other	145,886	152,454
Total current liabilities	1,179,205	1,379,468
Long-Term Debt	931,559	800,928
Deferred Tax Liabilities	157,348	143,124
Other Long-Term Liabilities	145,083	102,904

Minority Interests	1,073,116	922,114
Commitments and Contingencies (Note 14)		
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; 216,906 shares issued in 2007 (214,947 shares issued in 2006)	216,906	214,947
Additional paid-in capital	515,256	442,155
Retained earnings	2,072,285	1,653,480
Accumulated other comprehensive income	60,733	23,227
Less Treasury securities, at cost; 16,606 common shares in 2007 (15,031 common shares in 2006)	(429,143)	(346,872)
Total stockholders equity	2,436,037	1,986,937
Total Liabilities and Stockholders Equity	\$ 5,922,348	\$ 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)

	Nine Months Ended September 30,	
	2007	2006
Cash flows from operating activities:		
Net income	\$ 480,044	\$ 358,974
<i>Adjustments to reconcile net income to net cash provided by operating activities, excluding the net effects of acquisitions:</i>		
Minority interests	182,870	136,472
Depreciation and amortization	141,461	106,937
Share-based compensation expense	25,352	20,173
Increase in LIFO inventory reserves	22,131	16,864
Deferred income tax provision (benefit)	7,536	(4,380)
Provision for losses on receivables	2,740	5,443
Foreign currency translation losses	3,579	2,992
Gain on disposal of property, plant and equipment	(17,250)	(16,060)
Equity earnings, net of dividends received	(10,485)	(7,310)
Gain on sale of operations	(1,534)	(5,930)
<i>Changes in operating assets and liabilities:</i>		
Receivables	(179,390)	(284,765)
Inventories	(169,290)	(285,098)
Accounts payable	(17,211)	101,046
Other current assets and liabilities	(61,674)	21,443
Other non-current assets and liabilities	(20,261)	(22,318)
Net cash provided by operating activities	388,618	144,483
Cash flows from investing activities:		
Acquisition-related payments, net of cash acquired	(41,073)	(224,305)
Purchases of property, plant and equipment	(248,530)	(198,824)
Proceeds from disposal of property, plant and equipment	33,888	25,649
Proceeds from sale of operations	16,655	9,296
Net cash used in investing activities	(239,060)	(388,184)
Cash flows from financing activities:		
Proceeds from issuance of long-term debt	233,175	646,471
Principal payments of long-term debt	(272,676)	(250,443)
Net change in short-term borrowings	36,129	(8,243)
Purchases of common stock under Repurchase Program	(78,847)	(91,119)
Net proceeds related to long-term incentive awards	24,627	9,984
Excess tax benefit from share-based compensation	20,317	4,545
Payment of common stock dividends	(56,031)	(44,114)

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Debt issuance costs		(4,744)
Distributions to minority partner	(40,097)	
Net cash provided by (used in) financing activities	(133,403)	262,337
Effect of exchange rate changes on cash	2,182	1,161
Increase in cash and cash equivalents	18,337	19,797
Cash and cash equivalents at beginning of period	80,379	62,543
Cash and cash equivalents at end of period	\$ 98,716	\$ 82,340

Supplemental disclosures of cash flow information:

Cash paid for interest	\$ 54,482	\$ 45,888
Cash paid for income taxes	271,883	206,199

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 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 9 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 nine months ended September 30, 2007, the Company completed four acquisitions in exchange for aggregate cash consideration of \$27.6 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. The Company may be required to fund additional cash consideration of up to \$2.0 million related to the DSI transaction 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 \$12.3 million, primarily pertaining to DSI, which has been recorded as goodwill in the September 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.

In certain situations, the Company negotiates transaction terms which provide for the payment of additional consideration if various financial and/or business objectives are met. During the nine-month period ended September 30, 2007, the Company paid \$13.5 million of additional purchase consideration to settle obligations related to earn-out arrangements. The acquisition-related payments are reflected in the September 30, 2007 consolidated condensed balance sheet as goodwill.

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From time to time, the Company divests of non-core operations in the normal course of business. During the nine months ended September 30, 2007, 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. The Company properly eliminated net assets related to the associated operations, which included \$10.2 million of goodwill, during the second quarter of 2007.

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.

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. For the three and nine-month periods ended September 30, 2007 and 2006, an immaterial number of outstanding stock-based awards were excluded from the computation of diluted EPS 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 September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Basic EPS:				
Net income	\$ 166,833	\$ 132,925	\$ 480,044	\$ 358,974
Weighted average number of common shares outstanding	200,070	200,009	200,184	200,484
Basic EPS	\$ 0.83	\$ 0.66	\$ 2.40	\$ 1.79
Diluted EPS:				
Net income	\$ 166,833	\$ 132,925	\$ 480,044	\$ 358,974
Weighted average number of common shares outstanding	200,070	200,009	200,184	200,484
Dilutive effect of stock options and restricted stock units	2,008	1,802	1,707	1,674
	202,078	201,811	201,891	202,158
Diluted EPS	\$ 0.83	\$ 0.66	\$ 2.38	\$ 1.78

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:

	September 30, 2007	December 31, 2006
Raw materials	\$ 136,049	\$ 117,812

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Work-in-process	171,627	147,543
Finished goods	1,429,177	1,285,558
	1,736,853	1,550,913
Reserves to state certain U.S. inventories (FIFO cost of \$601,819 and \$559,943 in 2007 and 2006, respectively) on a LIFO basis	(115,674)	(93,542)
	\$ 1,621,179	\$ 1,457,371

During the first nine months of 2007, the Company recorded additional LIFO reserves of \$22.1 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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Property, plant and equipment consist of the following:

	September 30, 2007	December 31, 2006
Land and improvements	\$ 60,314	\$ 55,138
Buildings	220,751	181,419
Machinery and equipment	832,067	717,761
Rental tools	688,927	597,468
	1,802,059	1,551,786
Less Accumulated depreciation	(764,163)	(664,742)
	\$ 1,037,896	\$ 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	8,459	3,820	12,279
Goodwill related to disposed operations	(10,197)		(10,197)
Purchase price and other adjustments	18,298	727	19,025
Balance as of September 30, 2007	\$ 843,556	\$ 45,198	\$ 888,754

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:

	September 30, 2007			December 31, 2006			Weighted Average Amortization Period (years)
	Gross Carrying	Accumulated	Net	Gross Carrying	Accumulated	Net	
	Amount	Amortization		Amount	Amortization		
Patents	\$ 112,096	\$ 31,667	\$ 80,429	\$ 101,269	\$ 19,547	\$ 81,722	13.3
License agreements	32,550	13,351	19,199	31,231	10,661	20,570	10.2
Non-compete agreements and trademarks	37,012	19,668	17,344	33,421	15,662	17,759	9.3
Customer lists and contracts	34,603	14,431	20,172	29,403	8,314	21,089	8.5
	\$ 216,261	\$ 79,117	\$ 137,144	\$ 195,324	\$ 54,184	\$ 141,140	11.7

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Amortization expense of other intangible assets was \$8.1 million and \$5.3 million for the three-month periods ended September 30, 2007 and 2006, respectively, and \$23.3 million and \$12.5 million for the nine-month periods ended September 30, 2007 and 2006, respectively. On a calendar year basis, amortization expense is expected to approximate \$31.0 million and \$22.7 million for fiscal years 2007 and 2008, respectively. Additionally, amortization expense is anticipated to range between \$11.4 million and \$19.8 million per year for the 2009 - 2011 fiscal years.

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The following summarizes the Company's outstanding debt:

	September 30, 2007	December 31, 2006
Current:		
Short-term borrowings	\$ 125,436	\$ 89,307
Current portion of long-term debt	28,265	198,397
Short-term borrowings and current portion of long-term debt	\$ 153,701	\$ 287,704
Long-Term:		
Senior Notes, net of unamortized discounts	\$ 494,451	\$ 651,413
Bank revolvers payable	316,000	160,500
Term loans and other	149,373	187,412
	959,824	999,325
Less current portion of long-term debt	(28,265)	(198,397)
Long-term debt	\$ 931,559	\$