SMITH INTERNATIONAL INC
Form 10-Q
August 13, 2002

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2002

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	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 [X] No [ ]

The number of shares outstanding of the Registrant's common stock as of August 9, 2002 was 101,350,438.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

	Three Months Ended June 30,		Six
	2002	2001	2002
Revenues	$ 801,038	$ 872,389	$ 1,628,4
Costs and expenses:			
Costs of revenues	564,783	613,453	1,150,6
Selling expenses	127,753	128,541	258,8
General and administrative expenses	34,622	35,106	70,6
Goodwill amortization	--	3,941	
Total costs and expenses	727,158	781,041	1,480,0
Operating income	73,880	91,348	148,3
Interest expense, net	9,892	10,738	19,9
Income before income taxes and minority interests	63,988	80,610	128,4
Income tax provision	19,306	26,087	38,9
Income before minority interests	44,682	54,523	89,4
Minority interests	17,760	16,841	33,8
Net income	$ 26,922	$ 37,682	$ 55,6
Basic earnings per share:			
Net income	$ 0.27	$ 0.38	$ 0.
Net income, excluding impact of goodwill amortization	$ 0.27	$ 0.40	$ 0.
Diluted earnings per share:			
Net income	$ 0.27	$ 0.37	$ 0.
Net income, excluding impact of goodwill amortization	$ 0.27	$ 0.40	$ 0.
Weighted average shares outstanding (adjusted for impact of two-for-one stock split effective Jul			
Basic	98,944	99,820	98,8
Diluted	100,272	101,034	100,0

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

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

	June 30, 2002 (Unaudited)
ASSETS	
CURRENT ASSETS:	
Cash and cash equivalents	$ 45,980
Receivables, net	712,567
Inventories	633,090
Deferred tax assets, net	25,149
Prepaid expenses and other	43,303
Total current assets	1,460,089
Property, Plant and Equipment, net	497,698
Goodwill, net	580,972
Other Assets	170,158
Total Assets	$ 2,708,917
LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Short-term borrowings and current portion of long-term debt	$ 66,014
Accounts payable	239,281
Accrued payroll costs	57,059
Income taxes payable	43,253
Other	96,116
Total current liabilities	501,723
Long-Term Debt	568,801
Deferred Tax Liabilities	49,417
Other Long-Term Liabilities	58,481
Minority Interests	510,497
Commitments and Contingencies	
STOCKHOLDERS' EQUITY:	

Preferred stock, $1 par value; 5,000 shares authorized; no shares issued or outstanding in 2002 or 2001	--
Common stock, $1 par value; 150,000 shares authorized; 101,350 shares issued in 2002 (50,594 shares issued in 2001, on a pre-split basis)	101,350
Additional paid-in capital	342,453
Retained earnings	618,106
Accumulated other comprehensive income	(12,781)
Less - Treasury securities, at cost; 2,384 common shares in 2002 (1,192 common shares in 2001, on a pre-split basis)	(29,130)
Total stockholders' equity	1,019,998
Total Liabilities and Stockholders' Equity	$ 2,708,917

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

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

	Six Months Ende June 30,	
	2002	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 55,652	$
Adjustments to reconcile net income to net cash provided by operating activities, excluding the net effects of acquisitions:		
Depreciation and amortization	43,200	
Minority interests	33,817	
Provision for losses on receivables	6,110	
Gain on disposal of property, plant and equipment	(3,730)	
Foreign currency translation (gains) losses	(1,021)	
Changes in operating assets and liabilities:		
Receivables	40,560	
Inventories	24,599	
Accounts payable	(47,678)	
Other current assets and liabilities	(35,828)	
Other non-current assets and liabilities	(2,680)	
Net cash provided by operating activities	113,001	
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of businesses, net of cash acquired	(5,049)	

Purchases of property, plant and equipment	(50,630)	
Proceeds from disposal of property, plant and equipment	10,644	
Other	--	
Net cash used in investing activities	(45,035)	
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of long-term debt	706	
Principal payments of long-term debt	(53,365)	(
Net change in short-term borrowings	(1,053)	
Proceeds from exercise of stock options	2,293	
Minority interest partners contributions (distributions)	(15,600)	
Net cash provided by (used in) financing activities	(67,019)	
Effect of exchange rate changes on cash	350	
Increase in cash and cash equivalents	1,297	
Cash and cash equivalents at beginning of period	44,683	
Cash and cash equivalents at end of period	$ 45,980	$
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for interest	$ 21,339	$
Cash paid for income taxes	$ 23,736	$

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

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SMITH INTERNATIONAL, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. BASIS OF PRESENTATION OF INTERIM FINANCIAL STATEMENTS

The accompanying unaudited consolidated financial statements of Smith International, Inc. and subsidiaries (the "Company") have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the "Commission"). Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. These financial statements should be read in conjunction with the audited financial statements and accompanying notes included in the Company's 2001 Annual Report on Form 10-K and other current filings with the Commission.

The unaudited consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments) which the Company considers

necessary for a fair presentation of the interim periods. All significant intercompany balances and transactions have been eliminated in the accompanying financial statements. Results for the interim periods are not necessarily indicative of results for the year.

2. RECENT ACCOUNTING PRONOUNCEMENTS

In July 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which is effective for fiscal periods after December 31, 2002. SFAS No. 146 requires companies to recognize costs associated with restructurings, discontinued operations, plant closings, or other exit or disposal activities, when incurred rather than at the date a plan is committed to. The Company plans to adopt the standard as of the effective date and will implement its provisions on a prospective basis.

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections." SFAS No. 145 eliminates SFAS No. 4 and as a result, gains and losses from extinguishment of debt should be classified as extraordinary items only if they meet the criteria in APB Opinion No. 30. SFAS No. 145 amends SFAS No. 13, "Accounting for Leases," to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. SFAS No. 145 also updates and amends existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. The Company does not expect that the adoption of SFAS No. 145 will have a material impact on its consolidated financial position or results of operations.

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

On January 1, 2002, the Company adopted SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." The adoption of SFAS No. 144 did not impact the Company's financial position or results of operations.

The Company has also adopted SFAS No. 142, "Goodwill and Other Intangible Assets," which addresses financial accounting and reporting for goodwill and other intangible assets. Effective January 1, 2002, goodwill and certain intangibles are no longer amortized to earnings but are tested for impairment under SFAS No. 142. During the first quarter of 2002, the Company completed the transitional impairment test required by the standard, the results of which did not impact the Company's financial position or results of operations. The accompanying Consolidated Statements of Operations provide relevant disclosures related to recorded goodwill amortization and the after-tax impact which would have resulted from the adoption of SFAS No. 142 as of January 1, 2001.

3. STOCK SPLIT

On June 6, 2002, the Company's Board of Directors approved a two-for-one stock split, effected in the form of a stock dividend. Stockholders of record as of June 20, 2002 were entitled to the dividend, which was distributed on July 8, 2002.

The June 30, 2002 consolidated balance sheet includes the reclassification of $50.7 million from additional paid-in capital to the common stock account, in order to reflect the transaction. Additionally, all amounts included in the financial statements related to weighted average shares outstanding and earnings per share amounts have been adjusted for all periods presented for the stock split.

4. NON-RECURRING CHARGES

During the first quarter of 2002, the Company recognized non-recurring charges totaling $7.9 million, or $3.4 million net of taxes and minority interests. The first quarter charge included a $4.3 million provision for losses on receivables in Argentina attributable to local economic events. The provision was necessitated by Argentinean legislation, which required the Company to settle certain U.S. dollar-denominated transactions in pesos. The remainder of the charge related to restructuring efforts undertaken in response to activity-level declines, the primary component of which is severance costs incurred in connection with employee terminations.

From a presentation standpoint, $5.8 million of the charges are included in general and administrative expenses, $1.7 million are reflected in selling expenses and the remainder are recorded in cost of revenues.

5. EARNINGS PER SHARE

Basic earnings per share ("EPS") is computed using the weighted average number of common shares outstanding during the period. Diluted EPS gives effect to the potential dilution of earnings which could have occurred if additional shares were issued for stock option exercises under the treasury stock method. Certain outstanding employee stock options were not included in the computation of diluted earnings per common share, as the exercise price was greater than the average market price for the Company's stock during the corresponding period. The following schedule reconciles the income and shares used in the basic and diluted EPS computations (in thousands, except per share data):

	Three Months Ended June 30,		Six Months June 30
	2002	2001	2002
Basic EPS:			
Net income	$ 26,922	$ 37,682	$ 55,652
Weighted average number of common shares outstanding	98,944	99,820	98,892
Basic EPS	$ 0.27	$ 0.38	$ 0.56
Diluted EPS:			

Net income	$ 26,922	$ 37,682	$ 55,652
Weighted average number of common shares outstanding	98,944	99,820	98,892
Dilutive effect of stock options	1,328	1,214	1,179
	100,272	101,034	100,071
Diluted EPS	$ 0.27	$ 0.37	$ 0.56

6. 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 (in thousands):

	Three Months Ended June 30,		
	2002	2001	
Net income	$ 26,922	$ 37,682	$
Changes in unrealized fair value of derivatives, net	1,750	(287)	
Currency translation adjustments	10,649	(765)	
Comprehensive income	$ 39,321	$ 36,630	$

As of June 30, 2002, accumulated other comprehensive income in the accompanying Consolidated Balance Sheet includes $12.7 million of cumulative currency translation losses and $0.9 million of cumulative pension liability adjustments, partially offset by $0.8 million of cumulative changes in the unrealized fair value of derivatives.

7. INVENTORIES

Inventories are stated at the lower of cost or market. Cost is determined by the first-in, first-out ("FIFO"), last-in, first-out ("LIFO") or average cost methods. Inventory costs, consisting of materials, labor and factory overhead, are as follows (in thousands):

	June 30, 2002	December 31, 2001

Raw materials	$ 42,267	$ 50,821
Work-in-process	59,344	65,008
Products purchased for resale	160,241	154,787
Finished goods	395,785	406,143
	657,637	676,759
Reserves to state certain domestic inventories ($295,758 in 2002 and $300,868 in 2001, respectively) on a LIFO basis	(24,547)	(23,608)
	$ 633,090	$ 653,151

8. PROPERTY, PLANT AND EQUIPMENT

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

	June 30, 2002	December 31, 2001
Land	$ 32,642	$ 28,390
Buildings	117,061	100,888
Machinery and equipment	484,237	482,045
Rental tools	251,823	243,913
	885,763	855,236
Less-Accumulated depreciation	388,065	366,739
	$ 497,698	$ 488,497

9. DEBT

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

	June 30, 2002	December 31, 2001
Current:		
Short-term borrowings	$ 50,095	$ 50,156
Current portion of long-term debt	15,919	98,537

	$ 66,014	$ 148,693
Long-Term:		
Notes, net of unamortized discounts	$ 499,542	$ 532,555
Revolving credit facilities	64,500	81,700
Term loans and other	20,678	23,124
	584,720	637,379
Less current portion of long-term debt ...	(15,919)	(98,537)
	$ 568,801	$ 538,842

In the second quarter of 2002, the Company repurchased and retired $30.0 million of its 6.75 percent public notes maturing in 2011. In connection with the transaction, the Company recorded $0.5 million of termination costs related to the repurchase, consisting primarily of the prorata portion of unamortized discount and issuance costs associated with the 6.75 percent notes.

Subsequent to June 30, 2002, the Company replaced its $200.0 million revolving credit facility, which was scheduled to expire in December 2002, with a new three-year, $400.0 million facility provided by a syndicate of nine financial institutions. The revolving credit agreement (the "Agreement") allows for the election of interest at a base rate, or a Eurodollar rate ranging from LIBOR plus 62.5 to 75.0 basis points depending on amounts drawn under the facility. The Agreement also requires the payment of a quarterly commitment fee on the unutilized portion of the facility and compliance with certain customary covenants, including maintenance of specified debt-to-total capitalization and interest coverage ratios, as defined.

The outstanding balance under the revolving credit facilities as of June 30, 2002 has been reclassified to long-term in the accompanying Consolidated Balance Sheet.

Principal payments of long-term debt for the twelve-month periods ending subsequent to June 30, are as follows (in thousands):

2003	$ 90,674
2004	17,617
2005	75,281
2006	8,692
Thereafter	376,537
	$568,801

10. INDUSTRY SEGMENTS

The Company manufactures and markets premium products and services to the oil and gas exploration and production industry, the petrochemical industry

and other industrial markets. The Company aggregates its operations into two reportable segments: Oilfield Products and Services and Distribution.

The following table presents financial information for each reportable segment (in thousands):

	Three Months Ended June 30,		Six J
	2002	2001	2002
Revenues:			
Oilfield Products and Services	$ 583,658	$ 585,485	$ 1,176,528
Distribution	217,380	286,904	451,887
	$ 801,038	$ 872,389	$ 1,628,415
Operating Income:			
Oilfield Products and Services	$ 76,376	$ 85,841	$ 152,315
Distribution	(881)	6,913	(813)
General corporate	(1,615)	(1,406)	(3,174)
	$ 73,880	$ 91,348	$ 148,328

	June 30, 2002	December 31, 2001
Goodwill:		
Oilfield Products and Services.........................	$ 543,651	$ 537,509
Distribution......................................	37,321	37,041
	$ 580,972	$ 574,550

The change in goodwill during the first six months of 2002 primarily reflects the impact of an acquisition and, to a lesser extent, revisions to preliminary purchase price allocations associated with the Oilfield Products and Services segment.

11. CONTINGENCIES

The Company is a party to various legal and environmental matters arising in the ordinary course of business. In the opinion of management, after considering established reserves and contractual indemnifications obtained, these matters are not expected to have a material adverse effect on the Company's consolidated financial position or results of operations. In the unlikely event that the parties providing the environmental indemnifications do not fulfill their obligations, such event could result in the recognition of up to $25.0 million related to indemnified liabilities, potentially impacting

earnings and cash flows in future periods.

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 Financial Statements of the Company and the related notes thereto included elsewhere in this Form 10-Q and the Consolidated Financial Statements of the Company and the related notes thereto and the related "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in the Company's Annual Report on Form 10-K.

The Company manufactures and markets premium products and services to the oil and gas exploration and production and petrochemical industries and other industrial markets. The Company provides a comprehensive line of technologically-advanced products and engineering services, including drilling and completion fluid systems, solids-control and separation equipment, waste-management services, three-cone and diamond drill bits, fishing services, drilling tools, underreamers, casing exit and multilateral systems, packers and liner hangers. The Company also offers supply chain management solutions through an extensive branch network providing pipe, valve, tool, safety and other maintenance products.

The Company's worldwide operations are largely driven by the level of exploration and production activity in major energy producing areas and the depth and drilling conditions of these projects. Drilling activity levels are primarily influenced by energy prices but may also be affected by expectations related to the worldwide supply of and demand for oil and natural gas, finding and development costs, decline and depletion rates, political actions and uncertainties, environmental concerns, capital expenditure plans of exploration and production companies and the overall level of global economic growth and activity.

The year-over-year decline in the worldwide rig count relates to lower North American activity levels, particularly in the United States. Drilling activity in the U.S. market is heavily influenced by natural gas fundamentals, as 85 percent of the U.S. rig count is currently natural gas-directed. After bottoming in late March 2002, activity levels in the United States have rebounded 25 percent due, in part, to declining natural gas production which has resulted in a significant increase in natural gas drilling activity. Although the U.S. rig count is currently at the highest level experienced in 2002, various factors including political and regional instabilities, oil and natural gas storage levels, commodity prices and depletion rates, will likely influence activity levels on a going forward basis. The Company's business outlook, however, is highly dependent on the general economic environment in the United States and other major world economies, which ultimately impact energy consumption and the resulting demand for our products and services. Further weakness in the global economic environment could result in a substantial

decline in worldwide drilling activity, adversely impacting the Company's future financial results.

Management also believes the increasing complexity of drilling programs has resulted in a shift in exploration and production spending toward value-added, technology-based products, which reduce operators' overall drilling costs. The Company continues to focus on investing in the development of technology-based products that considerably improve the drilling process through increased efficiency and rates of penetration and reduced formation damage. Management believes the overall savings realized by the use of the Company's premium products, such as polycrystalline diamond drill bits, diamond-enhanced three-cone drill bits and synthetic drilling fluids, compensate for the higher costs of these products over their non-premium counterparts.

RESULTS OF OPERATIONS

Segment Discussion

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

	Three Months Ended June 30,				Si
	2002		2001		2002
	Amount	%	Amount	%	Amount
Financial Data:					
Revenues:					
M-I	$ 401,642	50	$ 392,403	45	$ 798,298
Smith Bits	77,146	10	101,695	12	166,624
Smith Services	104,870	13	91,387	10	211,606
Oilfield Products and Services	583,658	73	585,485	67	1,176,528
Distribution	217,380	27	286,904	33	451,887
Total	$ 801,038	100	$ 872,389	100	$ 1,628,415
Revenues by Area:					
United States	$ 384,933	48	$ 468,434	54	$ 776,881
Canada	62,130	8	87,595	10	150,349
Non-North America	353,975	44	316,360	36	701,185

Total	$ 801,038	100	$ 872,389	100	$ 1,628,415
Operating Income:					
Oilfield Products and Services	$ 76,376	13	$ 85,841	15	$ 152,315
Distribution	(881)	*	6,913	2	(813)
General corporate	(1,615)	*	(1,406)	*	(3,174)
Total	$ 73,880	9	$ 91,348	10	$ 148,328

Market Data:					
M-I Average Worldwide Rig Count:					
United States	940	46	1,427	53	909
Canada	144	7	245	9	265
Non-North America	981	47	1,026	38	991
Total	2,065	100	2,698	100	2,165

*not meaningful

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Oilfield Products and Services Segment

Revenues

M-I provides drilling and completion fluid systems, engineering and technical services to the oil and gas industry through its M-I Fluids division. M-I's SWACO division manufactures and markets equipment and services for solids control, separation, pressure control, rig instrumentation and waste management. M-I reported revenues of $401.6 million for the second quarter of 2002, two percent above the prior year quarter. The revenue improvement over the prior year period is attributable to incremental revenues from ten acquisitions completed during the prior twelve-month period. Excluding the impact of acquisitions, revenues declined six percent, as lower U.S. energy consumption contributed to a 34 percent decline in the U.S. rig count. On a geographic basis, the base business revenue reduction was reported in the United States. For the six-month period, M-I's revenues totaled $798.3 million, a two percent increase over the amounts reported in the first half of 2001. Excluding the impact of acquisitions, revenues declined seven percent reflecting the reduction in North American activity levels which declined 32 percent between the corresponding periods. M-I Fluids' significant exposure to the U.S. deepwater market, which is more revenue-intensive and less susceptible to short-term

variations in energy prices, accounts for the favorable comparison between base business revenues and the change in rig count for both periods presented.

Smith Bits manufactures and sells three-cone and diamond drill bits primarily for use in the oil and gas industry. For the three months ended June 30, 2002, Smith Bits' revenues totaled $77.1 million, 24 percent below the prior year quarter. Excluding the impact of the mining bit operations, which were contributed to an unconsolidated joint venture in October 2001, revenues were 21 percent lower than the prior year period. On a geographic basis, the quarterly revenue reduction was reported in the United States and Latin America, as reduced drilling activity led to lower demand for petroleum three-cone bits. For the six-month period, Smith Bits reported revenues of $166.6 million, a 19 percent decline from the comparable prior year period. After excluding the impact of the mining bit operations, revenues were 14 percent below the first half of 2001 and compared favorably to the change in the average rig count between the corresponding periods. The significant decline in U.S. drilling activity resulted in lower sales volumes for petroleum three-cone bits, accounting for the base business revenue variance.

Smith Services manufactures and markets products and services used in the oil and gas industry for drilling, workover, well completion and well re-entry. Smith Services' second quarter 2002 revenues were $104.9 million, an increase of 15 percent over the prior year quarter. Incremental revenues from acquisitions completed in the last half of 2001 accounted for the reported revenue improvement. Excluding the impact of acquisitions, base business revenues decreased five percent, reflecting lower demand for drilling-related products and services in the U.S. market. For the first half of 2002, Smith Services reported revenues of $211.6 million, an increase of 19 percent over the comparable prior year period. Excluding the impact of acquisitions, revenues were relatively flat period-to-period as higher drill pipe sales served to offset the effect of lower U.S. activity levels on the underlying base business.

Operating Income

Operating income for the Oilfield Products and Services segment declined $9.5 million from the second quarter of 2001. Excluding the impact of goodwill amortization recorded in the prior year period, operating income declined $13.0 million on relatively flat revenues, reflecting a shift in mix from higher-margin drill bit sales to products with lower comparable margins. On a year-to-date basis, segment operating income declined $13.9 million from the amounts reported in the first half of 2001. The impact of goodwill amortization resulting from the adoption of SFAS No. 142 was offset by the recognition of $7.0 million in non-recurring charges in the first quarter of 2002, primarily related to establishing reserves for local Argentina receivables. The majority of the reduction in operating income from the first half of 2001 relates to the shift in revenue mix discussed above, which contributed to a one percentage point deterioration in gross profit margins. To a lesser extent, the recognition of certain costs to consolidate the manufacturing and engineering operations of M-I SWACO also contributed to the reduction in operating income on a six-month basis.

Distribution Segment

Revenues

Wilson markets pipe, valve, tool, safety and other maintenance products to energy and industrial markets, primarily through an extensive network of supply branches in the United States and Canada. Wilson's revenues totaled

$217.4 million in second quarter 2002, a decline of 24 percent from the prior year quarter. Approximately three-quarters of the revenue decrease relates to the significant decline in drilling activity in the United States and Canada. To a lesser extent, the continued weakness in downstream and industrial markets resulted in a reduction in customer spending levels. In the first six months of 2002, Wilson reported revenues totaling $451.9 million, a decline of 21 percent from the first half of 2001. The majority of the revenue variance from the prior year period was reported in the energy branch operations and was split relatively equally between the United States and Canada. The year-to-date revenue comparison was impacted, to a lesser extent, by reduced spending for major maintenance programs and projects by industrial and petrochemical customers.

Operating Income

Wilson's operating income decreased $7.8 million from the second quarter of 2001. The variance primarily reflects the effect of lower sales volumes on gross profit levels, partially offset by a reduction in variable-based operating expenses associated with the revenue decline. Operating income, as a percentage of sales, decreased three percentage points from the second quarter of 2001, as lower sales volumes impacted coverage of fixed sales and administrative support costs. On a year-to-date basis, segment operating income declined $14.5 million from the amounts reported in the first six months of 2001. The decrease in operating income from the first half of 2001 relates to the impact of the revenue decline on gross profit, partially offset by the reduction in variable costs associated with the lower volumes. The decrease in Wilson's overall sales volumes on coverage of sales and administrative support costs contributed to a three percentage point reduction in operating margins from the prior year period.

Consolidated Results

For the periods indicated, the following table summarizes the results of the Company and presents these results as a percentage of total revenues (dollars in thousands):

	Three Months Ended June 30,				Si
	2002		2001		200
	Amount	%	Amount	%	Amount
Revenues	$801,038	100	$872,389	100	$1,628,415
Gross profit	236,255	29	258,936	30	477,757
Operating expenses	162,375	20	167,588	20	329,429
Operating income	73,880	9	91,348	10	148,328
Interest expense, net	9,892	1	10,738	1	19,908
Operating income	63,988	8	80,610	9	128,420
Income tax provision	19,306	3	26,087	3	38,951

Income before minority interests	44,682	5	54,523	6	89,469
Minority interests	17,760	2	16,841	2	33,817
Net income	$ 26,922	3	$ 37,682	4	$ 55,652

Consolidated revenues totaled $801.0 million for the three months ended June 30, 2002, an eight percent decline from the prior year quarter. The revenue decline related to lower sales volumes in the Company's Distribution operations, reflecting the impact of lower North American activity levels, as well as reduced customer spending in the U.S. downstream and industrial markets. The current year revenues were influenced by the completion of 15 acquisitions in the last half of 2001. Excluding incremental revenues from acquisitions, base business revenues fell 14 percent from the prior year quarter as reduced North American drilling activity impacted demand for the Company's products and services. Revenues for the first half of 2002 were $1.6 billion, a six percent decline from the comparable period of the prior year. The revenue reduction was reported in the Company's Distribution operations, which are concentrated in North America, and were impacted by the significant decline in drilling activity in the United States and Canada. Excluding the impact of acquired and divested operations, revenues were 12 percent below the amounts reported in the first half of 2001, reflecting the 32 percent reduction in North American drilling activity between the corresponding periods.

Gross profit equaled $236.3 million, or 29 percent of revenues, in the second quarter of 2001. Lower sales volumes in the Distribution segment combined with a shift from higher to lower-margin products in the Oilfield segment resulted in a $22.7 million decline from amounts reported in the prior year quarter. Gross profit margins were 20 basis points below the prior year period, with the product mix shift from Distribution revenues to higher-margin Oilfield revenues, partially masking the margin deterioration reported in the Oilfield segment. Gross profit for the six-month period totaled $477.8 million, or 29 percent of revenues. Gross profit margins were comparable with amounts reported in the first half of 2001, with the lower gross profit levels primarily attributable to the reduction in Distribution revenues.

Operating expenses decreased $5.2 million, or three percent from the second quarter of 2001. The majority of the period-to-period expense reduction relates to the adoption of SFAS No. 142, which resulted in the elimination of $3.9 million in goodwill amortization. The remainder of the decrease is due to lower incentive-based requirements and the effect of cost-reduction efforts initiated in response to activity declines which were, for the most part, offset by incremental expenses from acquired operations. Operating expenses for the six-month period increased $1.3 million over prior year amounts, as incremental expenses related to acquisitions completed in the last half of 2001 more than offset the reduction in variable-related expenses attributable to lower base business volumes.

Net interest expense, which represents interest expense less interest income, totaled $9.9 million for the second quarter of 2002. Net interest expense decreased $0.8 million from the prior year period as lower interest rates more than offset the impact of increased floating-rate borrowings, which were utilized to finance prior year acquisitions. For the six-month period, net

interest expense declined $1.2 million, also attributable to the effect of lower interest rates on the Company's floating-rate borrowings.

The effective tax rate for the second quarter and six-month periods approximated 30 percent, which is lower than both the prior year's rate and the U.S. statutory rate. The effective tax rate is lower than the U.S. statutory rate due to the impact of M-I's U.S. partnership earnings for which the minority partner is directly responsible for their related income taxes. The Company properly consolidates the pre-tax income related to the minority partner's share of U.S. partnership earnings but excludes the related tax provision. The effective tax rate was two percentage points below the prior year periods, which is related to the higher proportion of U.S. partnership earnings in M-I and the current year elimination of goodwill amortization, a portion of which was not deductible for tax purposes.

Minority interests reflect the portion of the results of majority-owned operations, which are applicable to the minority interest partners. Minority interests increased $0.9 million over the prior year quarter and were $0.8 million above the amounts reported in the first half of 2001. The variance in both periods is related to the acquisition of a majority interest in United Engineering Services, which occurred in the fourth quarter of 2001.

LIQUIDITY AND CAPITAL RESOURCES

General

At June 30, 2002, cash and cash equivalents totaled $46.0 million. Cash flows provided by operations totaled $113.0 million in the first half of 2002 compared to $51.3 million in the prior year period. The improvement in operating cash flow is attributable to the significant decline in North American drilling activity, which favorably impacted working capital levels, particularly the required investment in accounts receivable and product inventory.

Cash flows used in investing activities in the first six months of 2002 totaled $45.0 million, which primarily consisted of investments in property, plant and equipment, net of cash proceeds arising from certain asset disposals. This compares to cash used for investing activities of $95.3 million in the first half of 2001, with the difference primarily attributable to the lower level of acquisition activity during the current year period. Net capital expenditures decreased year-over-year as lower drilling activity has led to a reduction in discretionary capital spending.

In the first half of 2002, cash generated from operations exceeded cash used in investing activities, resulting in a $53.7 million reduction in outstanding debt levels. Cash flows used in financing activities, which totaled $67.0 million for the six months ended June 30, 2002, were also impacted by cash distributions to a minority partner which totaled $15.6 million during the period.

The Company's primary internal source of liquidity is cash flow generated from operations. Cash flow generated by 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. Subsequent to June 30, 2002, the Company replaced its

$200.0 million revolving credit facilities, which were due to expire in December 2002, with a three-year, $400.0 million facility provided by a syndicate of nine financial institutions. As of June 30, 2002, after taking into consideration the current facility in place, the Company had $335.5 million of funds available under U.S. revolving credit facilities to fund future operating or investing needs of its worldwide operations. The Company also has revolving credit facilities in place outside the United States, which are generally used to finance local operating needs. At June 30, 2002, borrowing capacity of $46.1 million was available under the non-U.S. borrowing facilities.

External sources of liquidity include debt and equity financing in the public capital markets, if needed. Management believes funds generated from operations, amounts available under existing credit facilities and external sources of liquidity will be sufficient to finance capital expenditures and working capital needs of the existing operations for the foreseeable future. Management continues to evaluate opportunities to acquire products or businesses complementary to the Company's operations. These acquisitions, if they arise, may involve the use of cash or, depending upon the size and terms of the acquisition, may require debt or equity financing.

Contingencies

The Company is a party to various legal and environmental matters arising in the ordinary course of business. In the opinion of management, after considering established reserves and contractual indemnifications obtained, these matters are not expected to have a material adverse effect on the Company's consolidated financial position or results of operations. In the unlikely event that the parties providing the environmental indemnifications do not fulfill their obligations, such event could result in the recognition of up to $25.0 million related to indemnified liabilities, potentially impacting earnings and cash flows in future periods.

Critical Accounting Policies and Estimates

The discussion and analysis of financial condition and results of operations are based upon the Company's consolidated 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 on-going 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 2001 Annual Report on Form 10-K, the Company has described the critical accounting policies that require management's most significant judgements and estimates. There have been no material changes in these critical accounting policies.

Recent Accounting Pronouncements

In July 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which is effective for fiscal periods after December 31, 2002. SFAS No. 146 requires companies to recognize costs associated with restructurings, discontinued operations, plant

closings, or other exit or disposal activities, when incurred rather than at the date a plan is committed to. The Company plans to adopt the standard as of the effective date and will implement its provisions on a prospective basis.

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections." SFAS No. 145 eliminates SFAS No. 4 and as a result, gains and losses from extinguishment of debt should be classified as extraordinary items only if they meet the criteria in APB Opinion No. 30. SFAS No. 145 amends SFAS No. 13, "Accounting for Leases," to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. SFAS No. 145 also updates and amends existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. The Company does not expect that the adoption of SFAS No. 145 will have a material impact on its consolidated financial position or results of operations.

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

On January 1, 2002, the Company adopted SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." The adoption of SFAS No. 144 did not impact the Company's financial position or results of operations.

The Company has also adopted SFAS No. 142, "Goodwill and Other Intangible Assets," which addresses financial accounting and reporting for goodwill and other intangible assets. Effective January 1, 2002, goodwill and certain intangibles are no longer amortized to earnings but are tested for impairment under SFAS No. 142. During the first quarter of 2002, the Company completed the transitional impairment test required by the standard, the results of which did not impact the Company's financial position or results of operations. The accompanying Consolidated Statements of Operations provide relevant disclosures related to recorded goodwill amortization and the after-tax impact which would have resulted from the adoption of SFAS No. 142 as of January 1, 2001.

ITEM 3. QUALITATIVE AND QUANTITATIVE MARKET RISK DISCLOSURES

The Company is exposed to certain market risks arising from transactions that are entered into in the normal course of business. These risks, which are primarily related to interest rate changes and fluctuations in foreign exchange rates, are not considered to be material to the Company. During the reporting period, no events or transactions have occurred which would materially change the information disclosed in the Company's Annual Report on Form 10-K.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 2. CHANGES IN SECURITIES

None.

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, 2002, stockholders of the Company elected all nominated directors and approved an amendment to the Smith International, Inc. 1989 Long-Term Incentive Compensation Plan by the votes shown below.

	For	Withheld	Abstain
Election of directors:			
G. Clyde Buck	42,443,568	3,472	215,818
Loren K. Carroll	42,443,219	3,821	216,167
Wallace S. Wilson	42,437,285	9,755	222,101

	For	Against	Abs
Approval of an amendment to the Smith International, Inc. 1989 Long-Term Incentive Compensation Plan.....................	30,716,189	6,648,147	31

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

Exhibit 99.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

Exhibit 99.2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

(b) Reports on Form 8-K

The Registrant filed reports on Form 8-K during the quarterly period ended June 30, 2002. All filings were reported under "Item 5. Other Events" and disclosed the following:

1. Form 8-K dated April 4, 2002 relating to a press release commenting on first quarter 2002 outlook and earnings release and conference call information.

2. Form 8-K dated April 15, 2002 relating to changes in registrant's certifying accountant.

3. Form 8-K dated May 2, 2002 relating to a press release announcing the Company's results for the first quarter of 2002.

4. Form 8-K dated June 6, 2002 relating to a press release announcing a 2-for-1 common stock split to be effected in the form of a stock dividend.

5. Form 8-K dated June 24, 2002 relating to a certificate of adjusted purchase price or number of shares dated June 21, 2002.

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 13, 2002 By: /s/ Douglas L. Rock

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

Date: August 13, 2002 By: /s/ Margaret K. Dorman

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

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EXHIBIT INDEX

EXHIBIT NUMBER	DESCRIPTION
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