

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.

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

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 |

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 | \$ 800,928 |

During the third quarter of 2007, the Company utilized amounts available under existing revolving credit facilities to retire \$150.0 million of Senior Notes which matured in September 2007.

Principal payments, net of unamortized discounts, of long-term debt for the twelve-month periods subsequent to September 30, 2008 are as follows:

| | |
|------------|------------|
| 2009 | \$ 26,938 |
| 2010 | 342,909 |
| 2011 | 246,594 |
| 2012 | 26,892 |
| Thereafter | 288,226 |
| | \$ 931,559 |

9. 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 nine 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 | 2001 |
| Norway | 1997 |
| Russia | 2004 |
| United Kingdom | 2001 |
| United States | 1999 |

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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 | | Nine Months Ended | |
|--|--------------------|------------|-------------------|------------|
| | September 30, | | September 30, | |
| | 2007 | 2006 | 2007 | 2006 |
| Net income | \$ 166,833 | \$ 132,925 | \$ 480,044 | \$ 358,974 |
| Currency translation adjustments | 19,427 | 1,522 | 37,045 | 13,132 |
| Changes in unrealized fair value of derivatives, net | 312 | 354 | 461 | 1,995 |
| Comprehensive income | \$ 186,572 | \$ 134,801 | \$ 517,550 | \$ 374,101 |

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

| | September 30, 2007 | December 31, 2006 |
|--|--------------------------|-------------------------|
| Currency translation adjustments | \$ 62,600 | \$ 25,555 |
| Unrealized fair value of derivatives | 710 | 249 |
| Pension liability adjustments | (2,577) | (2,577) |
| Accumulated other comprehensive income | \$ 60,733 | \$ 23,227 |

11. Employee Benefit Plans

The Company maintains various noncontributory defined benefit pension plans covering certain U.S. and non-U.S. employees. In addition, the Company and certain subsidiaries have postretirement benefit plans, which provide health care benefits to a limited number of current, and in some cases, future retirees. Net periodic benefit expense related to the pension and postretirement benefit plans, on a combined basis, approximated \$1.2 million and \$1.0 million for each of the three-month periods ended September 30, 2007 and 2006, respectively, and \$3.6 million and \$2.9 million for each of the nine-month periods ended September 30, 2007 and 2006, respectively. Company contributions to the pension and postretirement benefit plans for the 2007 fiscal year are expected to approximate the \$5 million amount funded in the prior year period.

12. Long-Term Incentive Compensation

As of September 30, 2007, the Company had outstanding restricted stock units and stock options granted under the 1989 Long-Term Incentive Compensation Plan, as amended (the "Plan"). As of September 30, 2007, 1,918,609 shares were authorized for future issuance pursuant to the Plan.

Restricted Stock

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

| | Time-based Awards | | Performance-based Awards | | Total Restricted Stock Units |
|----------------------------------|-------------------|---------------------------|--------------------------|---------------------------|------------------------------|
| | No. of Units | Fair Value ^(a) | No. of Units | Fair Value ^(a) | |
| Outstanding at December 31, 2006 | 524,552 | \$ 40.84 | 1,565,649 | \$ 39.64 | 2,090,201 |
| Granted | 29,200 | 45.47 | | | 29,200 |

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| | | | | | |
|-----------------------------------|----------|----------|-----------|----------|-----------|
| Forfeited | (14,609) | 40.11 | (23,669) | 36.61 | (38,278) |
| Vested | (3,412) | 33.68 | (301,948) | 38.74 | (305,360) |
| Outstanding at September 30, 2007 | 535,731 | \$ 41.16 | 1,240,032 | \$ 39.91 | 1,775,763 |

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

Restrictions on 395,087 performance-based units and 150,416 time-based units outstanding at September 30, 2007 are expected to lapse during the fourth quarter of 2007.

Table of Contents*Stock Options*

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

| | Shares Under Option | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life | Aggregate Intrinsic Value (in thousands) |
|-----------------------------------|---------------------------|--|---|--|
| Outstanding at December 31, 2006 | 3,351,381 | \$ 18.78 | | |
| Granted | | | | |
| Forfeited | (54,254) | 21.32 | | |
| Exercised | (1,612,044) | 17.39 | | |
| Outstanding at September 30, 2007 | 1,685,083 | 20.03 | 5.8 | \$ 86,570 |
| Exercisable at September 30, 2007 | 973,467 | \$ 18.02 | 5.2 | \$ 51,963 |

Share-based Compensation Expense

Share-based compensation expense, consisting of restricted stock and stock options, was \$8.6 million and \$6.8 million for the three-month periods ended September 30, 2007 and 2006, respectively, and \$25.4 million and \$20.2 million for the nine-month periods ended September 30, 2007 and 2006, respectively.

Moreover, the total unrecognized share-based compensation expense for awards outstanding as of September 30, 2007 approximated \$52.0 million, or \$30.9 million net of taxes and minority interests, which will be recognized over a weighted-average period of 2.1 years.

13. Industry Segments

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-------------------|-------------------------------------|--------------|------------------------------------|--------------|
| | 2007 | 2006 | 2007 | 2006 |
| Revenues: | | | | |
| Oilfield | \$ 1,685,687 | \$ 1,412,934 | \$ 4,862,286 | \$ 3,901,646 |
| Distribution | 559,372 | 501,250 | 1,604,870 | 1,432,922 |
| | \$ 2,245,059 | \$ 1,914,184 | \$ 6,467,156 | \$ 5,334,568 |
| Revenues by Area: | | | | |
| United States | \$ 1,017,936 | \$ 905,002 | \$ 2,966,486 | \$ 2,463,403 |
| Canada | 195,330 | 221,953 | 571,172 | 669,004 |
| North America | 1,213,266 | 1,126,955 | 3,537,658 | 3,132,407 |

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| | | | | |
|-------------------|--------------|--------------|--------------|--------------|
| Latin America | 208,193 | 139,872 | 529,744 | 399,040 |
| Europe/Africa | 534,012 | 418,845 | 1,525,025 | 1,147,683 |
| Middle East/Asia | 289,588 | 228,512 | 874,729 | 655,438 |
| Non-North America | 1,031,793 | 787,229 | 2,929,498 | 2,202,161 |
| | \$ 2,245,059 | \$ 1,914,184 | \$ 6,467,156 | \$ 5,334,568 |
| Operating Income: | | | | |
| Oilfield | \$ 336,482 | \$ 270,710 | \$ 970,435 | \$ 722,453 |
| Distribution | 24,533 | 25,359 | 73,799 | 73,591 |
| General corporate | (10,678) | (8,344) | (30,320) | (25,741) |
| | \$ 350,337 | \$ 287,725 | \$ 1,013,914 | \$ 770,303 |

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14. Commitments and Contingencies

Standby Letters of Credit

In the normal course of business with customers, vendors and others, the Company is contingently liable for performance under standby letters of credit and bid, performance and surety bonds. Certain of these outstanding instruments guarantee payment to insurance companies with respect to certain liability coverages of the Company's insurance captive. Excluding the impact of these instruments, for which \$22.0 million of related liabilities are reflected in the accompanying consolidated condensed balance sheet, the Company was contingently liable for approximately \$118.5 million of standby letters of credit and bid, performance and surety bonds at September 30, 2007. Management does not expect any material amounts to be drawn on these instruments.

Litigation

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

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

In August 1998, the Company was added as a defendant in a First Amended Petition filed in the 15th Judicial District Court, Parish of Lafayette, Louisiana entitled *Rose Dove Egle v. John M. Egle, et al.* In the amended petition, the plaintiffs alleged that, due to an improper conveyance of ownership interest by the Tri-Tech majority partner prior to the Transaction, Smith purchased a portion of its equity interest from individuals who were not legally entitled to their Tri-Tech shares.

After an extended period of litigation, the Egle matter was concluded in October 2007. The Louisiana Supreme Court denied the plaintiffs' final appeal, effectively closing the matter.

Other

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

Environmental

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

As of September 30, 2007, the Company's environmental reserve totaled \$7.8 million. This amount reflects the future undiscounted estimated exposure related to identified properties, without regard to indemnifications from former owners. While actual future environmental costs may differ from estimated liabilities recorded at September 30, 2007, the Company does not believe that these differences will have a material impact on the Company's financial position, results of operations or cash flows.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

General

The following Management's Discussion and Analysis of Financial Condition and Results of Operations is provided to assist readers in understanding the Company's financial performance during the periods presented and significant trends which may impact the future performance of the Company. This discussion should be read in conjunction with the consolidated condensed financial statements of the Company and the related notes thereto included elsewhere in this Form 10-Q and the Company's 2006 Annual Report on Form 10-K.

Company Products and Operations

The Company is a leading global provider of premium products and services to the oil and gas exploration and production industry. The Company provides a comprehensive line of technologically-advanced products and engineering services, including drilling and completion fluid systems, solids-control and separation equipment, waste-management services, oilfield production chemicals, three-cone and diamond drill bits, turbine products, tubulars, fishing services, drilling tools, underreamers, casing exit and multilateral systems, packers and liner hangers. The Company also offers supply chain management solutions through an extensive North American branch network providing pipe, valves and fittings as well as mill, safety and other maintenance products.

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

Capital investment by energy companies is largely divided into two markets, which vary greatly in terms of primary business drivers and associated volatility levels. North American drilling activity is primarily influenced by natural gas fundamentals, with approximately 81 percent of the current rig count focused on natural gas finding and development activities. Conversely, drilling in areas outside of North America is more dependent on crude oil fundamentals, which influence over three-quarters of international drilling activity. Historically, business in markets outside of North America has proved to be less volatile as the high cost E&P programs in these regions are generally undertaken by major oil companies, consortiums and national oil companies as part of a longer-term strategic development plan. Although 55 percent of the Company's consolidated revenues were generated in North America during the first nine months of 2007, Smith's profitability was largely dependent upon business levels in markets outside of North America. The Distribution segment, which accounts for approximately 25 percent of consolidated revenues and primarily supports a North American customer base, serves to distort the geographic revenue mix of the Company's Oilfield segment operations. Excluding the impact of the Distribution segment, 58 percent of the Company's revenues were generated in markets outside of North America during the first nine months of 2007.

Business Outlook

After experiencing 15 percent compound annual rig count growth in North America over the past five-year period, North American activity levels are forecasted to remain relatively flat during the near-term. Markets outside North America should continue to expand as the increased number of drilling programs in Europe/Africa and Latin America, combined with the addition of a number of newbuild offshore rigs scheduled for delivery in 2008 and beyond, contribute to increased customer spending levels.

Although a number of factors influence forecasted exploration and production spending, the Company's business is highly dependent on the general economic environment in the United States and other major world economies which ultimately impacts energy consumption and the resulting demand for our products and services. High crude oil prices, which have risen over 50 percent during the past six month period, could contribute to a global economic slowdown adversely impacting business volumes across the operations and the future financial results of the Company.

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Forward-Looking Statements

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

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

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

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|-----------------------------------|----------------------------------|-----|--------------|-----|---------------------------------|-----|--------------|-----|
| | 2007 | | 2006 | | 2007 | | 2006 | |
| | Amount | % | Amount | % | Amount | % | Amount | % |
| Financial Data: | | | | | | | | |
| <i>(dollars in thousands)</i> | | | | | | | | |
| Revenues: | | | | | | | | |
| M-I SWACO | \$ 1,110,542 | 49 | \$ 942,191 | 49 | \$ 3,232,150 | 50 | \$ 2,593,875 | 48 |
| Smith Technologies ⁽¹⁾ | 259,104 | 12 | 228,765 | 12 | 751,489 | 12 | 643,494 | 12 |
| Smith Services ⁽¹⁾ | 316,041 | 14 | 241,978 | 13 | 878,647 | 13 | 664,277 | 13 |
| Oilfield | 1,685,687 | 75 | 1,412,934 | 74 | 4,862,286 | 75 | 3,901,646 | 73 |
| Distribution | 559,372 | 25 | 501,250 | 26 | 1,604,870 | 25 | 1,432,922 | 27 |
| Total | \$ 2,245,059 | 100 | \$ 1,914,184 | 100 | \$ 6,467,156 | 100 | \$ 5,334,568 | 100 |
| Geographic Revenues: | | | | | | | | |
| United States: | | | | | | | | |
| Oilfield | \$ 606,254 | 27 | \$ 539,995 | 28 | \$ 1,781,080 | 28 | \$ 1,465,504 | 27 |
| Distribution | 411,682 | 18 | 365,007 | 19 | 1,185,406 | 18 | 997,899 | 19 |
| Total United States | 1,017,936 | 45 | 905,002 | 47 | 2,966,486 | 46 | 2,463,403 | 46 |
| Canada: | | | | | | | | |
| Oilfield | 83,861 | 4 | 104,902 | 6 | 252,548 | 4 | 296,571 | 6 |
| Distribution | 111,469 | 5 | 117,051 | 6 | 318,624 | 5 | 372,433 | 7 |
| Total Canada | 195,330 | 9 | 221,953 | 12 | 571,172 | 9 | 669,004 | 13 |
| Non-North America: | | | | | | | | |
| Oilfield | 995,572 | 44 | 768,037 | 40 | 2,828,658 | 43 | 2,139,571 | 40 |
| Distribution | 36,221 | 2 | 19,192 | 1 | 100,840 | 2 | 62,590 | 1 |
| Total Non-North America | 1,031,793 | 46 | 787,229 | 41 | 2,929,498 | 45 | 2,202,161 | 41 |
| Total Revenue | \$ 2,245,059 | 100 | \$ 1,914,184 | 100 | \$ 6,467,156 | 100 | \$ 5,334,568 | 100 |

Operating Income:

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| | | | | | | | | |
|-------------------|------------|----|------------|----|--------------|----|------------|----|
| Oilfield | \$ 336,482 | 20 | \$ 270,710 | 19 | \$ 970,435 | 20 | \$ 722,453 | 19 |
| Distribution | 24,533 | 4 | 25,359 | 5 | 73,799 | 5 | 73,591 | 5 |
| General Corporate | (10,678) | * | (8,344) | * | (30,320) | * | (25,741) | * |
| Total | \$ 350,337 | 16 | \$ 287,725 | 15 | \$ 1,013,914 | 16 | \$ 770,303 | 14 |

Market Data:

Average Worldwide

Rig Count: ⁽²⁾

| | | | | | | | | |
|-------------------|-------|-----|-------|-----|-------|-----|-------|-----|
| United States | 1,998 | 45 | 1,947 | 47 | 1,944 | 46 | 1,874 | 47 |
| Canada | 313 | 7 | 437 | 10 | 307 | 7 | 424 | 10 |
| Non-North America | 2,087 | 48 | 1,778 | 43 | 1,979 | 47 | 1,707 | 43 |
| Total | 4,398 | 100 | 4,162 | 100 | 4,230 | 100 | 4,005 | 100 |
| Onshore | 3,819 | 87 | 3,627 | 87 | 3,669 | 87 | 3,468 | 87 |
| Offshore | 579 | 13 | 535 | 13 | 561 | 13 | 537 | 13 |
| Total | 4,398 | 100 | 4,162 | 100 | 4,230 | 100 | 4,005 | 100 |

Average Commodity

Prices:

| | | | | |
|-------------------------------------|----------|----------|----------|----------|
| Crude Oil (\$/Bbl) ⁽³⁾ | \$ 73.24 | \$ 70.60 | \$ 66.22 | \$ 68.29 |
| Natural Gas (\$/mcf) ⁽⁴⁾ | \$ 6.56 | \$ 6.18 | \$ 7.03 | \$ 6.88 |

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

(2)

*Source: M-I
SWACO.*

*(3) Average daily
West Texas
Intermediate
(WTI) spot
closing prices,
as quoted by
NYMEX.*

*(4) Average daily
Henry Hub,
Louisiana spot
closing prices,
as quoted by
NYMEX.*

** not meaningful*

Table of Contents*Oilfield Segment**Revenues*

M-I SWACO primarily provides drilling and completion fluid systems, engineering and technical services to the oil and gas industry. Additionally, these operations provide oilfield production chemicals and manufacture and market equipment and services used for solids-control, particle separation, pressure control, rig instrumentation and waste-management. M-I SWACO is significantly influenced by its exposure to the global offshore market, which constitutes over 50 percent of the revenue base, and to exploration and production spending for land-based projects outside of North America, which contributes approximately 30 percent of the unit's revenues. Offshore drilling programs, which account for approximately 13 percent of the worldwide rig count, are generally more revenue-intensive than land-based projects due to the complex nature of the related drilling environment. M-I SWACO's revenues totaled \$1.1 billion for the third quarter of 2007, an 18 percent increase from the prior year quarter. Approximately 85 percent of the year-over-year revenue growth was reported in the Eastern Hemisphere operations, driven by increased customer activity and new contract awards in the Former Soviet Union, West Africa and North Sea markets. To a lesser extent, increased offshore project activity in the Middle East/Asia region also contributed to the Eastern Hemisphere revenue growth. The remainder of the reported increase related to higher land-based revenues in Latin America influenced, in part, by the impact of recent drilling fluid contract awards in Mexico. For the nine-month period, M-I SWACO reported revenues of \$3.2 billion, a 25 percent increase over the amounts reported in the nine months ended September 30, 2006. Approximately three-fourths of the revenue improvement was attributable to growth in Eastern Hemisphere markets, largely reflecting a 42 percent increase in offshore business volumes related to new contract awards and increased customer activity. Western Hemisphere revenues grew 13 percent above the comparable nine-month period of 2006 due to the impact of new land-based contract awards in Latin America and higher customer spending in the revenue-intensive U.S. offshore market. Smith Technologies designs and manufactures three-cone and diamond drill bits, turbines and borehole enlargement tools for use in the oil and gas industry. Due to the nature of its product offerings, revenues for these operations typically correlate more closely to the rig count than any of the Company's other businesses. Moreover, Smith Technologies has a high level of North American revenue exposure driven, in part, by the significance of its Canadian operations. Smith Technologies reported revenues of \$259.1 million for the quarter ended September 30, 2007, an increase of 13 percent over the comparable prior year period. The majority of the revenue growth was generated in markets outside North America, driven by higher activity levels and increased customer demand for borehole enlargement tools. To a lesser extent, improved business volumes in the U.S. operations, influenced by higher diamond bit rental volumes and price increases introduced during the past 12-month period, also contributed to the favorable year-over-year comparison. For the nine-month period, Smith Technologies reported revenues of \$751.5 million, a 17 percent improvement over the comparable period of 2006. More than 60 percent of the year-over-year revenue growth was reported outside North America, benefiting from higher activity levels and strong drill bit sales volumes in Europe/Africa and Asia. Growing demand for borehole enlargement products outside North America also contributed to the year-over-year revenue expansion. Revenue growth in North America compared favorably to the nine-month period of 2006 and the corresponding change in activity levels, largely reflecting the influence of improved diamond bit rental volumes and pricing realization in the U.S. across all core product lines. Smith Services manufactures and markets products and services used in the oil and gas industry for drilling, work-over, well completion and well re-entry. Excluding the impact of tubular sales volumes, which are not highly correlated to drilling activity levels, revenues for Smith Services are relatively balanced between North America and the international markets. In addition, Smith Services' revenues are heavily influenced by the complexity of drilling projects, which drive demand for a wider range of its product offerings. Smith Services' revenues for the three months ended September 30, 2007 totaled \$316.0 million, 31 percent above the prior year period. The majority of the year-over-year revenue increase was attributable to growth in U.S. business volumes, driven by increased demand for tubular products. To a lesser extent, improved activity levels contributed to higher sales of drilling products and services in the U.S. and Eastern Hemisphere markets. For the nine months ended September 30, 2007, Smith Services reported revenues of \$878.6 million, a 32 percent increase from the comparable prior year period. Excluding tubular sales and rentals, revenues were 17 percent above the level reported in the first nine months of 2006, driven by

increased demand for high-performance drilling and remedial products and services, including the hydra-jar[®] tool, and higher activity levels outside North America.

Operating Income

Operating income for the Oilfield segment was \$336.5 million, or 20.0 percent of revenues, for the three months ended September 30, 2007. Oilfield segment margins increased 80 basis points above the prior year quarter. The margin expansion was influenced by improved fixed cost coverage in general and administrative support functions and higher gross profit margins attributable to offshore business volume growth and the impact of year-over-year pricing initiatives. On an absolute dollar basis, third quarter 2007 operating income increased \$65.8 million over the prior year quarter, primarily reflecting the impact of higher business volumes and, to a lesser extent, pricing on gross profit. On a year-to-date basis, Oilfield operating margins improved 1.5 percentage points, reflecting gross margin expansion related to increased business volumes and pricing initiatives period-to-period and, to a lesser extent, improved fixed cost coverage associated with general and administrative support functions. On an absolute dollar basis, nine-month operating income was \$248.0 million above the first nine months of 2006, largely attributable to the impact of higher revenue volumes on the segment's reported gross profit, partially offset by growth in variable-based operating expenses associated with the expanding business base.

Table of Contents*Distribution Segment**Revenues*

Wilson markets pipe, valves, fittings and mill, safety and other maintenance products to energy and industrial markets, primarily through an extensive network of supply branches in the United States and Canada. The segment has the most significant North American revenue exposure of any of the Company's operations with 94 percent of Wilson's third quarter 2007 revenues generated in those markets. Moreover, approximately 24 percent of Wilson's revenues relate to sales to the downstream energy sector, including petrochemical plants and refineries, whose spending is largely influenced by the general state of the U.S. economic environment. Additionally, certain customers in this sector utilize petroleum products as a base material and, accordingly, are adversely impacted by increases in crude oil and natural gas prices. Distribution revenues were \$559.4 million for the third quarter of 2007, 12 percent above the comparable prior year period. The year-over-year revenue growth was reported by the energy operations, reflecting increased drilling and completion activity in the upstream sector and, to a lesser extent, additional spending for line pipe projects by midstream customers. On a geographic basis, approximately one-fourth of the year-over-year improvement is attributable to the Europe/Africa region, due to increased project-related spending in the engineering and construction market. In the first nine months of 2007, Wilson reported revenues totaling \$1.6 billion, an increase of 12 percent from the nine months ended September 30, 2006. Three-fourths of the revenue variance from the prior year period was generated by the upstream energy operations, influenced by higher U.S. drilling activity levels and increased line pipe project spending. The impact of lower Canadian business volumes for the first nine months of 2007, related to the corresponding decline in drilling activity levels, was partially offset by new project-related spending in Europe/Africa.

Operating Income

Operating income for the Distribution segment was \$24.5 million, or 4.4 percent of revenues, for the quarter ended September 30, 2007. Segment operating margins were 70 basis points below the prior year period, reflecting the impact of an increased proportion of line pipe sales and project orders, which carry relatively lower margins, on gross profit. On an absolute dollar basis, third quarter 2007 operating income decreased \$0.8 million below the amount reported in the prior year period driven by the impact of an unfavorable shift in product mix on gross profit. On a year-to-date basis, Distribution operating margins deteriorated 50 basis points, again, driven by an unfavorable shift in business mix consisting of a higher proportion of line pipe and international project business volumes. The impact of lower Canadian activity levels also contributed to the decline in operating margins. On an absolute dollar basis, operating income was \$0.2 million above the amount reported in the first nine months of 2006, largely reflecting improved fixed selling and administrative cost coverage.

Table of Contents*Consolidated Results*

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

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|---|----------------------------------|-----|--------------|-----|---------------------------------|-----|--------------|-----|
| | 2007 | | 2006 | | 2007 | | 2006 | |
| | Amount | % | Amount | % | Amount | % | Amount | % |
| Revenues | \$ 2,245,059 | 100 | \$ 1,914,184 | 100 | \$ 6,467,156 | 100 | \$ 5,334,568 | 100 |
| Gross profit | 728,906 | 33 | 618,213 | 32 | 2,101,417 | 33 | 1,689,829 | 31 |
| Operating expenses | 378,569 | 17 | 330,488 | 17 | 1,087,503 | 17 | 919,526 | 17 |
| Operating income | 350,337 | 16 | 287,725 | 15 | 1,013,914 | 16 | 770,303 | 14 |
| Interest expense | 17,103 | 1 | 17,287 | 1 | 53,242 | 1 | 44,808 | 1 |
| Interest income | (1,152) | | (830) | | (2,811) | | (2,123) | |
| Income before income taxes and minority interests | 334,386 | 15 | 271,268 | 14 | 963,483 | 15 | 727,618 | 13 |
| Income tax provision | 106,579 | 5 | 88,600 | 5 | 300,569 | 5 | 232,172 | 4 |
| Minority interests | 60,974 | 3 | 49,743 | 2 | 182,870 | 3 | 136,472 | 2 |
| Net income | \$ 166,833 | 7 | \$ 132,925 | 7 | \$ 480,044 | 7 | \$ 358,974 | 7 |

Consolidated revenues were \$2.2 billion for the third quarter of 2007, 17 percent above the prior year period. More than three-fourths of the revenue growth was attributable to increased demand for Oilfield segment product offerings. Oilfield segment revenues grew 19 percent year-over-year primarily driven by higher Eastern Hemisphere offshore business volumes and the impact of new Latin American land-based drilling fluid contracts. To a lesser extent, higher demand for tubular and diamond drilling bit products in the U.S. market, which more than offset the impact of lower Canadian activity levels, also contributed to the year-over-year Oilfield revenue expansion. The Distribution operations reported a 12 percent increase from the prior year quarter, driven by higher drilling and completion activity in the U.S. and, to a lesser extent, project activity in the West Africa market. For the first nine months of 2007, consolidated revenues were \$6.5 billion, 21 percent above the comparable 2006 period, with Oilfield segment business volumes contributing approximately 85 percent of the revenue growth. Oilfield segment revenues rose 25 percent over amounts reported in the prior year period, driven by higher global offshore business volumes due, in part, to a favorable customer mix and increased activity levels outside North America. To a lesser extent, the revenue comparison to the nine-month period ended September 30, 2006 also reflects the impact of a 75 percent increase in tubular sales and rentals in the U.S. market.

Gross profit totaled \$728.9 million for the third quarter of 2007, or 33 percent of revenues approximately 20 basis points above the level reported in the prior year period. For the nine-month period, gross profit totaled \$2.1 billion, or 33 percent of revenues, 80 basis points above the gross profit margins reported in the first nine months of 2006. The results for both periods reflect improved Oilfield margins and, to a lesser extent, an increased proportion of Oilfield revenues, which generate higher comparable margins. On an absolute dollar basis, gross profit increased \$110.7 million, or 18 percent, over the prior year quarter and \$411.6 million, or 24 percent, above the nine-month period ended September 30, 2006, with the improvement for both comparisons largely attributable to higher sales volumes in the Oilfield operations.

Operating expenses, consisting of selling, general and administrative expenses, increased \$48.1 million from the prior year quarter; however, as a percentage of revenues, decreased 40 basis points. Improved fixed cost coverage in general and administrative functions accounted for the operating expense percentage decline. The majority of the absolute dollar increase was attributable to variable-related costs associated with the improved business volumes, including

increased investment in personnel and infrastructure in support of the expanding business base. Compared to the first nine months of 2006, operating expenses increased \$168.0 million; although, as a percentage of revenues, decreased 40 basis points, again, reflecting improved coverage of general and administrative costs.

Net interest expense, which represents interest expense less interest income, equaled \$16.0 million in the third quarter of 2007. Net interest expense decreased \$0.5 million from the prior year quarter, influenced by lower average short-term interest rates. For the first nine months of 2007, net interest expense increased \$7.7 million from the comparable period of 2006, reflecting higher average debt levels largely associated with acquisition-related borrowings in the later half of 2006.

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The effective tax rate approximated 32 percent and 31 percent for the three and nine-month periods ended September 30, 2007, approximately 70 basis points below the effective rates reported for the comparable periods of 2006. The favorable comparison to the prior year effective rates, as well as to the U.S. statutory rate, was influenced by the higher proportion of M-I SWACO's U.S. partnership earnings and lower state income tax accrual rates. Based on the structure of M-I SWACO's U.S. operations, the minority partner is directly responsible for taxes on its share of U.S. partnership earnings. Accordingly, the Company properly consolidates the pretax income related to the minority partner's share of U.S. partnership earnings but excludes the related tax provision.

Minority interest expense reflects the portion of the results of majority-owned operations which are applicable to the minority interest partners. Minority interest expense was \$11.2 million and \$46.4 million above amounts reported in the prior year quarter and first nine months of 2006, respectively, primarily associated with improved profitability levels in the M-I SWACO joint venture.

Liquidity and Capital Resources*General*

At September 30, 2007, cash and cash equivalents equaled \$98.7 million. During the first nine months of 2007, the Company generated \$388.6 million of cash flows from operations, significantly above the amount reported in the comparable prior year period. The favorable comparison was attributable to the year-over-year increase in overall profitability levels and, to a lesser extent, the reduced level of incremental working capital investment.

During the first nine months of 2007, cash flows used in investing activities totaled \$239.1 million, primarily consisting of amounts required to fund capital expenditures and, to a lesser extent, acquisition-related payments. The Company invested \$214.6 million in property plant and equipment, after taking into consideration cash proceeds arising from certain asset disposals. Cash invested in acquired business operations, net of dispositions, totaled \$24.4 million during the first nine months of 2007. The amount was attributable to the DSI purchase and, to a lesser extent, the settlement of certain earn-out arrangements related to previously acquired operations. Net cash used in investing activities declined significantly from the prior year period due to lower required acquisition funding levels. Cash flows used in financing activities totaled \$133.4 million for the first nine months of 2007. The significant level of borrowings required in the prior year period were not necessary in the first nine months of 2007, attributable to improved operating cash flow generation and lower acquisition funding needs.

The Company's primary internal source of liquidity is cash flow generated from operations. Cash flows generated from operations is primarily influenced by the level of worldwide drilling activity, which affects profitability levels and working capital requirements. Capacity under revolving credit agreements is also available, if necessary, to fund operating or investing activities. During the third quarter of 2007, the Company utilized available capacity under its existing U.S. revolving credit facilities to retire \$150.0 million of debt that matured during the period. Accordingly, as of September 30, 2007, the Company had \$316.0 million drawn and \$4.5 million of letters of credit issued under its U.S. revolving credit facilities, resulting in \$79.5 million of capacity available for future operating or investing needs. The Company also has revolving credit facilities in place outside of the United States, which are generally used to finance local operating needs. At September 30, 2007, the Company had available borrowing capacity of \$105.4 million under the non-U.S. borrowing facilities.

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

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

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

The Company's Board of Directors has authorized a share buyback program that allows for the repurchase of up to 20.0 million shares of the Company's common stock, subject to regulatory issues, market considerations and other relevant factors. As of September 30, 2007, the Company had 15.8 million shares remaining under the current authorization. Future repurchases under the program may be executed from time to time in the open market or in privately negotiated transactions and will be funded with cash flows from operations or amounts available under existing credit facilities.

Commitments and Contingencies

Standby Letters of Credit

In the normal course of business with customers, vendors and others, the Company is contingently liable for performance under standby letters of credit and bid, performance and surety bonds. Certain of these outstanding instruments guarantee payment to insurance companies with respect to certain liability coverages of the Company's insurance captive. Excluding the impact of these instruments, for which \$22.0 million of related liabilities are reflected in the accompanying consolidated condensed balance sheet, the Company was contingently liable for approximately \$118.5 million of standby letters of credit and bid, performance and surety bonds at September 30, 2007. Management does not expect any material amounts to be drawn on these instruments.

Litigation

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

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

In August 1998, the Company was added as a defendant in a First Amended Petition filed in the 15th Judicial District Court, Parish of Lafayette, Louisiana entitled *Rose Dove Egle v. John M. Egle, et al.* In the amended petition, the plaintiffs alleged that, due to an improper conveyance of ownership interest by the Tri-Tech majority partner prior to the Transaction, Smith purchased a portion of its equity interest from individuals who were not legally entitled to their Tri-Tech shares.

After an extended period of litigation, the Egle matter was concluded in October 2007. The Louisiana Supreme Court denied the plaintiffs' final appeal, effectively closing the matter.

Other

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

Environmental

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

As of September 30, 2007, the Company's environmental reserve totaled \$7.8 million. This amount reflects the future undiscounted estimated exposure related to identified properties, without regard to indemnifications from former owners. While actual future environmental costs may differ from estimated liabilities recorded at September 30, 2007, the Company does not believe that these differences will have a material impact on the Company's financial position, results of operations or cash flows.

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Critical Accounting Policies and Estimates

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

Recent Accounting Pronouncements

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

Effective January 1, 2007, the Company has adopted Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48), which establishes accounting and disclosure requirements for uncertain tax positions. The adoption did not have a material impact on the Company's results of operations or financial position. See Note 9 to the consolidated condensed financial statements for further discussion regarding FIN 48.

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

Item 4. Controls and Procedures

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

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

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

None.

Item 1A. Risk Factors

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

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

During October 2005, the Company's Board of Directors approved a repurchase program that allows for the purchase of up to 20.0 million shares of the Company's common stock, subject to regulatory issues, market considerations and other relevant factors. During the third quarter of 2007, the Company repurchased 743,000 shares of common stock under the program at an aggregate cost of \$43.7 million. The acquired shares have been added to the Company's treasury stock holdings.

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

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Program | Number of Shares that May Yet Be Purchased Under the Program |
|------------------------------|---|--|--|--|
| July 1 - July 31 | 225,000 | \$ 61.34 | 225,000 | 16,290,413 |
| August 1 - August 31 | 493,000 | 57.15 | 493,000 | 15,797,413 |
| September 1 - September 30 | 25,000 | 67.02 | 25,000 | 15,772,413 |
| 3 rd Quarter 2007 | 743,000 | \$ 58.75 | 743,000 | 15,772,413 |

Item 3. Defaults upon Senior Securities

None.

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

None.

Item 5. Other Information

None.

Table of Contents**Item 6. Exhibits**

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

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

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SMITH INTERNATIONAL, INC.
Registrant

Date: November 9, 2007

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

Date: November 9, 2007

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

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