

Edgar Filing: SMITH INTERNATIONAL INC - Form 10-Q

SMITH INTERNATIONAL INC  
Form 10-Q  
November 09, 2004

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, 2004

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.)

411 NORTH SAM HOUSTON PARKWAY, SUITE 600  
HOUSTON, TEXAS  
(Address of principal executive offices)

77060  
(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 an accelerated filer (as  
defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares outstanding of the Registrant's common stock as of  
November 3, 2004 was 104,877,439.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

Three Months Ended September 30,	
2004	2003
-----	-----
-----	-----

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Revenues.....	\$ 1,119,184	\$ 924,792
Costs and expenses:		
Costs of revenues.....	780,201	646,390
Selling expenses.....	172,348	150,411
General and administrative expenses.....	48,418	39,183
	-----	-----
Total costs and expenses.....	1,000,967	835,984
	-----	-----
Operating income.....	118,217	88,808
Interest expense.....	9,965	10,198
Interest income.....	(327)	(534)
	-----	-----
Income before income taxes, minority interests and cumulative effect of change in accounting principle....	108,579	79,144
Income tax provision.....	35,129	25,524
Minority interests.....	21,557	18,616
	-----	-----
Income before cumulative effect of change in accounting principle.....	51,893	35,004
Cumulative effect of change in accounting principle, net of tax and minority interests.....	-	-
	-----	-----
Net income.....	\$ 51,893	\$ 35,004
	=====	=====
Basic:		
Earnings per share before cumulative effect of change in accounting principle.....	\$ 0.51	\$ 0.35
Cumulative effect of change in accounting principle....	-	-
	-----	-----
Earnings per share.....	\$ 0.51	\$ 0.35
	=====	=====
Diluted:		
Earnings per share before cumulative effect of change in accounting principle.....	\$ 0.51	\$ 0.35
Cumulative effect of change in accounting principle....	-	-
	-----	-----
Earnings per share.....	\$ 0.51	\$ 0.35
	=====	=====
Weighted average shares outstanding:		
Basic.....	101,290	100,095
Diluted.....	102,424	101,093

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

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	September 30, 2004
	-----
ASSETS	
CURRENT ASSETS:	
Cash and cash equivalents.....	\$ 65,035
Receivables, net.....	910,281
Inventories, net.....	834,563
Deferred tax assets, net.....	43,683
Prepaid expenses and other.....	67,303
	-----
Total current assets.....	1,920,865
	-----
Property, Plant and Equipment, net.....	548,845
Goodwill, net.....	711,486
Other Assets.....	190,173
	-----
Total Assets.....	\$ 3,371,369
	=====
LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Short-term borrowings and current portion of long-term debt.....	\$ 193,605
Accounts payable.....	354,114
Accrued payroll costs.....	74,901
Income taxes payable.....	91,873
Other.....	96,294
	-----
Total current liabilities.....	810,787
	-----
Long-Term Debt.....	390,849
Deferred Tax Liabilities.....	84,503
Other Long-Term Liabilities.....	80,932
Minority Interests.....	650,107
Commitments and Contingencies (See Note 14)	
STOCKHOLDERS' EQUITY:	
Preferred stock, \$1 par value; 5,000 shares authorized; no shares issued or outstanding in 2004 or 2003.....	-
Common stock, \$1 par value; 150,000 shares authorized; 104,874 shares issued in 2004 (102,720 shares issued in 2003).....	104,874
Additional paid-in capital.....	419,769
Retained earnings.....	903,343
Accumulated other comprehensive income.....	11,088
Less - Treasury securities, at cost; 3,529 common shares in 2004 (2,384 common shares in 2003).....	(84,883)
	-----
Total stockholders' equity.....	1,354,191
	-----
Total Liabilities and Stockholders' Equity.....	\$ 3,371,369

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 M Sept
	2004
<hr/>	
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net income.....	\$ 124,220
Adjustments to reconcile net income to net cash provided by operating activities, excluding the net effects of acquisitions:	
Cumulative effect of change in accounting principle.....	-
Litigation-related charge.....	31,439
Depreciation and amortization.....	79,286
Minority interests.....	65,216
Deferred income tax provision.....	(3,747)
Provision for losses on receivables.....	3,349
Gain on disposal of property, plant and equipment.....	(7,764)
Foreign currency translation losses.....	2,363
Changes in operating assets and liabilities:	
Receivables.....	(108,189)
Inventories.....	(93,618)
Accounts payable.....	41,956
Other current assets and liabilities.....	(15,195)
Other non-current assets and liabilities.....	(1,835)
	<hr/>
Net cash provided by operating activities.....	117,481
	<hr/>
CASH FLOWS FROM INVESTING ACTIVITIES:	
Acquisition of businesses, net of cash acquired.....	(45,762)
Purchases of property, plant and equipment.....	(75,568)
Proceeds from disposal of property, plant and equipment.....	15,093
	<hr/>
Net cash used in investing activities.....	(106,237)
	<hr/>
CASH FLOWS FROM FINANCING ACTIVITIES:	
Proceeds from issuance of long-term debt.....	68,770
Principal payments of long-term debt.....	(78,946)
Net change in short-term borrowings.....	19,126
Proceeds from exercise of stock options.....	48,212
Purchases of treasury stock .....	(54,026)
	<hr/>
Net cash provided by financing activities.....	3,136
	<hr/>
Effect of exchange rate changes on cash.....	(631)

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Increase (decrease) in cash and cash equivalents.....	13,749
Cash and cash equivalents at beginning of period.....	51,286
<hr style="border-top: 1px dashed black;"/>	
Cash and cash equivalents at end of period.....	\$ 65,035
<hr style="border-top: 3px double black;"/>	
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:	
Cash paid for interest.....	\$ 35,766
Cash paid for income taxes.....	69,779

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  
(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 2003 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 periods presented may not be indicative of results for the fiscal year.

Certain reclassifications have been made to the prior year's financial information to conform to the September 30, 2004 presentation.

2. DISCLOSURE RELATED TO ACCOUNTING PRONOUNCEMENTS

The cumulative effect of a change in accounting principle reflected in the financial statements for the nine-month period ended September 30, 2003 represents the impact of the Company's adoption of Statement of Financial Accounting Standards ("SFAS") No. 143, "Accounting for Asset Retirement

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Obligations."

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. Unless otherwise discussed, management believes the impact of 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. LITIGATION-RELATED CHARGE

During the second quarter of 2004, the Company recorded litigation-related charges totaling \$31.4 million, or \$20.4 million on an after-tax basis. The second quarter charge, which consists of an estimated loss provision, legal fees and other directly related costs, results from a complaint which alleged that certain of the Company's roller cone drill bit designs infringed several of the plaintiff's U.S. patents. Approximately \$28.8 million of the charges are included in general and administrative expenses and the remainder are recorded in costs of revenues.

### 4. BUSINESS COMBINATIONS AND ANNOUNCED TRANSACTIONS

During the nine months ended September 30, 2004, the Company completed four acquisitions in exchange for aggregate cash consideration of \$36.6 million. The consideration primarily relates to the purchase of certain operating assets of CanFish Services completed in July 2004. The CanFish operations provide fishing, milling, casing exit, pipe recovery and related wireline services in the Canadian and U.S. markets.

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 the net assets acquired approximated \$14.0 million

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and has been recorded as goodwill in the Oilfield Products and Services segment. 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. Pro forma results of operations have not been presented because the effect of these acquisitions was not material to the Company's consolidated condensed financial statements.

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, 2004, the Company paid \$6.9 million of additional purchase consideration to the former shareholders of IKF Services which is reflected in the accompanying consolidated condensed balance sheet as a purchase price adjustment to goodwill. In addition, the Company paid \$2.3 million during the third quarter of 2004 to former shareholders of acquired businesses to repay seller-financed notes.

Additionally, in July 2004, the Company announced the signing of a non-binding letter of intent related to the sale of Wilson Industries, Inc. ("Wilson") to CE Franklin Ltd. Under the terms of the proposed transaction, CE Franklin would issue common stock to the Company and remit certain amounts after closing in

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exchange for the common stock of Wilson. Subsequent to the transaction, the Company's ownership interest is expected to increase from the current 55 percent to approximately 89 percent of the outstanding shares of CE Franklin, and accordingly, the Company would continue to consolidate the combined distribution operations of Wilson and CE Franklin. The transaction is subject to a number of factors, including negotiation of a definitive agreement, approval by the minority shareholders of CE Franklin, ratification by the Board of Directors of both companies and certain regulatory approvals. There are no assurances as to whether this transaction ultimately will be consummated.

### 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. 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 Sep
	2004	2003	2004
<b>BASIC EPS:</b>			
Income before cumulative effect of change in accounting principle.....	\$ 51,893	\$ 35,004	\$ 124,2
	=====	=====	=====
Weighted average number of common shares outstanding.....	101,290	100,095	101,3
	=====	=====	=====
Basic EPS before cumulative effect of change in accounting principle.....	\$ 0.51	\$ 0.35	\$ 1.
	=====	=====	=====
<b>DILUTED EPS:</b>			
Income before cumulative effect of change in accounting principle.....	\$ 51,893	\$ 35,004	\$ 124,2
	=====	=====	=====
Weighted average number of common shares outstanding.....	101,290	100,095	101,3
Dilutive effect of stock options.....	1,134	998	1,2
	-----	-----	-----
	102,424	101,093	102,5
	=====	=====	=====
Diluted EPS before cumulative effect of change in accounting principle.....	\$ 0.51	\$ 0.35	\$ 1.
	=====	=====	=====

### 6. 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, certain of the Company's U.S.-based inventories are valued utilizing the



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last-in, first-out ("LIFO") method. Inventory costs, consisting of materials, labor and factory overhead, are as follows (in thousands):

	September 30, 2004
	-----
Raw materials.....	\$ 68,440
Work-in-process.....	79,595
Products purchased for resale.....	236,991
Finished goods.....	495,581
	-----
	880,607
Reserves to state certain domestic inventories (cost of \$329,033 and \$266,328 in 2004 and 2003, respectively) on a LIFO basis.....	(46,044)
	-----
	\$ 834,563
	=====

### 7. PROPERTY, PLANT AND EQUIPMENT

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

	September 30, 2004
	-----
Land.....	\$ 35,808
Buildings.....	142,644
Machinery and equipment.....	533,387
Rental tools.....	356,660
	-----
	1,068,499
Less-Accumulated depreciation.....	519,654
	-----
	\$ 548,845
	=====

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### 8. 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 Segment	Distribution Segment
---------------------	-------------------------

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	-----	-----
		(in thousands)
Balance as of December 31, 2003.....	\$ 652,822	\$ 37,771
Goodwill acquired.....	13,993	-
Purchase price and other adjustments.....	6,900	-
	-----	-----
Balance as of September 30, 2004.....	\$ 673,715	\$ 37,771
	=====	=====

Other Intangible Assets

The Company amortizes other identifiable intangible assets on a straight-line basis over the periods expected to be benefited, ranging from three to 27 years. The components of these other intangible assets, recorded in Other Assets in the accompanying consolidated condensed balance sheets, are as follows (in thousands):

	----- September 30, 2004 -----			----- December 31, 2003 -----		
	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Ne
	-----	-----	-----	-----	-----	-----
Patents.....	\$ 42,284	\$ 13,934	\$ 28,350	\$ 38,520	\$ 12,015	\$ 2
License agreements.....	19,086	3,675	15,411	19,086	2,193	1
Non-compete agreements and trademarks.....	20,772	8,049	12,723	19,583	5,649	1
Customer lists and contracts....	9,232	1,671	7,561	8,724	877	
	-----	-----	-----	-----	-----	-----
	\$ 91,374	\$ 27,329	\$ 64,045	\$ 85,913	\$ 20,734	\$ 6
	=====	=====	=====	=====	=====	=====

Amortization expense was \$2.2 million and \$2.0 million for the three-month periods ended September 30, 2004 and 2003, respectively, and \$6.6 million and \$5.4 million for the nine-month periods ended September 30, 2004 and 2003, respectively. Additionally, estimated future amortization expense is expected to range between \$4.4 million and \$8.4 million a year for the next five fiscal years.

9. STOCK-BASED COMPENSATION

The Company's Board of Directors and its stockholders have authorized an employee stock option plan. As of September 30, 2004, 3.9 million shares were issued and outstanding under the program and an additional 2.3 million shares

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were authorized for future issuance. Options are generally granted at the fair market value on the date of grant, vest over a four-year period and expire ten years after the date of grant.

Certain option awards granted on December 4, 2001 were subject to stockholder approval which was not obtained until April 24, 2002. Accordingly, these options were granted with a strike price more than five percent below the market value on the date of issuance and do not meet the conditions necessary to qualify as a non-compensatory option grant. Compensation expense related to these grants is being recognized over the four-year vesting period and resulted in the inclusion in the accompanying consolidated condensed statement of operations of \$0.1 million of related expense for each of the three-month periods ended September 30, 2004 and 2003 and \$0.3 million of related expense for each of the nine-month periods ended September 30, 2004 and 2003.

The Company continues to apply Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for its stock option program, as allowed under SFAS No. 123, "Accounting for Stock-Based Compensation." Therefore, for all options other than those mentioned above, the Company elects to make pro forma disclosures versus recognizing the related compensation expense in the accompanying consolidated condensed financial statements. Had the Company elected to apply the accounting standards of SFAS No. 123, the Company's net income and earnings per share would have approximated the pro forma amounts indicated below (in thousands, except per share data):

	Three Months Ended September 30,		Nine M Sept
	2004	2003	2004
Net income, as reported.....	\$ 51,893	\$ 35,004	\$ 124,220
Add: Stock-based compensation expense included in reported income, net of related tax effect.....	68	68	205
Less: Total stock-based compensation expense determined under the Black- Scholes option-pricing model, net of related tax effect.....	(2,943)	(2,683)	(8,830)
Net income, pro forma.....	\$ 49,018	\$ 32,389	\$ 115,595
Earnings per share:			
As reported:			
Basic.....	\$ 0.51	\$ 0.35	\$ 1.23
Diluted.....	0.51	0.35	1.21
Pro forma:			
Basic.....	\$ 0.48	\$ 0.32	\$ 1.14
Diluted.....	0.48	0.32	1.13

In addition to the stock option program described above, the Company maintains a stock grant program. The stock grants are issued at par value and are subject to a four-year cliff-vesting schedule. Compensation expense, calculated as the difference between the market value on the date of grant and the exercise price, is being recognized ratably over the vesting period and resulted in the inclusion in the accompanying consolidated condensed statements of operations of \$0.1 million of related expense for each of the three-month periods ended

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September 30, 2004 and 2003, and \$0.2 million and \$0.4 million of related expense for the nine-month periods ended September 30, 2004 and 2003, respectively.

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### 10. STOCKHOLDERS' EQUITY

During 2001, the Company's Board of Directors authorized a share buyback program which allows for the repurchase of up to five million shares of common stock, subject to regulatory issues, market considerations and other relevant factors. During the second quarter of 2004, the Company repurchased 1.1 million shares of common stock under the program at an aggregate cost of \$54.0 million bringing the total number of shares acquired under the program to 1.7 million. The acquired shares have been added to the Company's treasury stock holdings and may be used in the future for acquisitions or other corporate purposes.

### 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, totaled \$0.2 million for each of the three-month periods ended September 30, 2004 and 2003 and \$0.5 million and \$0.6 million for the nine-month periods ended September 30, 2004 and 2003, respectively. Company contributions to the pension and postretirement benefit plans during 2004 are expected to total approximately \$2.0 million.

### 12. 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 September 30,		Nine Mo Septe
	2004	2003	2004
Net income.....	\$ 51,893	\$ 35,004	\$ 124,220
Changes in unrealized fair value of derivatives, net.....	(367)	(706)	(2,405)
Currency translation adjustments.....	4,362	2,007	1,868
	-----	-----	-----
Comprehensive income.....	\$ 55,888	\$ 36,305	\$ 123,683
	=====	=====	=====

As of September 30, 2004, accumulated other comprehensive income in the accompanying consolidated condensed balance sheet consists of the following (in thousands):

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	September 30, 2004
Currency translation adjustments.....	\$ 14,688
Unrealized fair value of derivatives.....	(66)
Pension liability adjustments.....	(3,534)
Accumulated other comprehensive income.....	\$ 11,088

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13. 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 Oilfield Products and Services 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 (in thousands):

	Three Months Ended September 30,		Nine Mo Septe
	2004	2003	2004
<b>Revenues:</b>			
Oilfield Products and Services.....	\$ 816,788	\$ 687,373	\$ 2,360,103
Distribution.....	302,396	237,419	841,319
	\$ 1,119,184	\$ 924,792	\$ 3,201,422
<b>Revenues by Area:</b>			
United States.....	\$ 510,484	\$ 401,646	\$ 1,444,217
Canada.....	112,727	94,211	328,672
North America.....	623,211	495,857	1,772,889
Latin America .....	111,088	98,554	302,194
Europe/Africa .....	238,680	222,625	708,153
Middle East .....	92,685	78,004	272,488
Far East .....	53,520	29,752	145,698
Non-North America.....	495,973	428,935	1,428,533
	\$ 1,119,184	\$ 924,792	\$ 3,201,422

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Operating Income:

Oilfield Products and Services.....	\$ 112,737	\$ 90,318	\$ 297,251
Distribution.....	7,388	229	16,920
General corporate.....	(1,908)	(1,739)	(5,958)
	-----	-----	-----
	\$ 118,217	\$ 88,808	\$ 308,213
	=====	=====	=====

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### 14. COMMITMENTS AND CONTINGENCIES

#### Standby Letters of Credit and Guarantees

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 of notes issued to former shareholders of an acquired entity as well as to insurance companies which reinsure certain liability coverages of the Company's insurance captive. Excluding the impact of these instruments, for which \$28.9 million of related liabilities are reflected in the accompanying consolidated condensed balance sheet, the Company is contingently liable for approximately \$40.3 million of standby letters of credit and bid, performance and surety bonds at September 30, 2004. Management does not expect any material amounts to be drawn on these instruments.

Subsequent to September 30, 2004, the Company obtained a surety bond in the amount of \$43.5 million in connection with its appeal of the patent infringement litigation discussed below. After taking into consideration amounts reflected in the accompanying consolidated condensed balance sheet, the Company has a contingent liability of up to \$18.4 million associated with this instrument. Management, however, does not expect any amounts to be drawn on this instrument.

The Company has also provided loan guarantees related to certain joint ventures accounted for under the equity method of accounting. As the net assets and cash flows of these entities are available to satisfy obligations as they become due, management believes the likelihood is remote that the Company will be required to perform under these guarantees. The Company's estimated maximum exposure under these loan guarantees approximated \$19.0 million as of September 30, 2004.

#### Litigation

Halliburton Energy Services, Inc. v. Smith International, Inc.  
On September 6, 2002, the Company was served with a complaint in the U.S. District Court for the Eastern District of Texas, Sherman Division entitled Halliburton Energy Services, Inc. v. Smith International, Inc. This lawsuit is a patent infringement claim alleging that certain roller cone drill bits made by the Company infringe several U.S. patents owned by Halliburton.

The case was tried in the second quarter of 2004 and, on June 25, 2004, a jury verdict was rendered against the Company awarding damages of \$24.0 million and finding the infringement willful as to certain of the claims. On August 13, 2004, the Court enhanced the damage award by \$12.0 million, and awarded \$5.1 million in attorneys' fees and prejudgment interest. On November 4, 2004, the

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court denied the Company's post-trial motions and the Company has initiated the appeal process. Although an appeal is underway, the Company is continuing to pursue other options, including possible settlement. Based on the facts and circumstances and the opinion of outside counsel, management believes that the amounts recorded reflect the best estimate of the Company's potential loss exposure.

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

On April 17, 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").

On August 25, 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. The suit was tried in the first quarter of 2004 and, on March 30, 2004, a jury verdict of approximately \$4.8 million was rendered in favor of the plaintiffs. On June 1, 2004, the court entered the judgment and the Company's post-judgment motions were subsequently denied by the court. The Company has initiated the appeal process and does not anticipate a ruling from the appellate court until the first half of 2005. Based upon the facts and circumstances and the opinion of outside legal counsel, management believes that an unfavorable outcome on this matter is not probable at this time. Accordingly, the Company has not recognized a loss provision in the accompanying consolidated condensed financial statements.

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 or results of operations.

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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.

In connection with most business acquisitions, the Company obtains contractual indemnifications from the seller related to environmental matters. These indemnifications generally provide for the reimbursement of environmental clean-up costs incurred by the Company for events occurring or circumstances existing prior to the purchase date, whether the event or circumstance was known or unknown at that time. A substantial portion of the Company's total environmental exposure is associated with its M-I SWACO operations, which are subject to various indemnifications from former owners.

As of September 30, 2004 the Company's environmental reserve approximated \$10.0 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, 2004, the Company does not

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believe that these differences will have a material impact on the Company's financial position or results of operations, subject to the indemnifications in place.

During the first quarter of 2003, the Company initiated legal action against M-I SWACO's former owners to address issues associated with certain provisions of the environmental indemnification provided. This matter is currently expected to go to trial during the second quarter of 2005. In the event that i) M-I SWACO's former owners and other parties to indemnification agreements with the Company do not fulfill their obligations, and ii) costs incurred to remediate the identified properties reach estimated maximum exposure limits, the Company would be required to record an additional charge of up to \$25.0 million, impacting earnings and cash flows in future periods.

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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 2003 Annual Report on Form 10-K.

#### COMPANY PRODUCTS AND OPERATIONS

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 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, 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, valves, fittings and 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 10 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 85 percent of the current rig



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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 over half of the Company's consolidated revenues were generated in North America during the third quarter of 2004, Smith's profitability was largely dependent upon business levels in markets outside of North America. The Distribution segment, which accounts for approximately one-quarter 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 operations, approximately 59 percent of the Company's third quarter 2004 revenues were generated in markets outside of North America.

### MARKET OUTLOOK

The Company's business is highly dependent on the general economic environment in the United States and other major world economies, which impact energy consumption and the resulting demand for our products and services. Current supply and demand fundamentals are some of the tightest experienced in a number of years, which should support modestly higher exploration and production spending. However, crude oil prices have increased over 40 percent during the past year and recently reached an all-time record high price - largely due to market instability in certain geographic regions. A significant increase in commodity prices could adversely affect global economic expansion efforts as well as the level of worldwide drilling activity that drives demand for our products and services.

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### 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 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 Mon
2004		2003		2004
Amount	%	Amount	%	Amount

#### FINANCIAL DATA: (dollars in thousands)

##### REVENUES:

M-I SWACO.....	\$	565,366	51	\$	479,724	52	\$	1,634,708
Smith Technologies.....		126,805	11		104,505	11		373,330
Smith Services.....		124,617	11		103,144	11		352,065

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Oilfield Products and Services.	816,788	73	687,373	74	2,360,103
Wilson.....	302,396	27	237,419	26	841,319
Total.....	\$ 1,119,184	100	\$ 924,792	100	\$ 3,201,422
GEOGRAPHIC REVENUES:					
United States:					
Oilfield Products and Services...	\$ 285,523	26	\$ 231,436	25	\$ 826,050
Distribution.....	224,961	20	170,210	18	618,167
Total United States.....	510,484	46	401,646	43	1,444,217
Canada:					
Oilfield Products and Services...	53,084	5	43,827	5	152,198
Distribution.....	59,643	5	50,384	5	176,474
Total Canada.....	112,727	10	94,211	10	328,672
Non-North America:					
Oilfield Products and Services...	478,181	43	412,110	45	1,381,855
Distribution.....	17,792	1	16,825	2	46,678
Total Non-North America.....	495,973	44	428,935	47	1,428,533
Total Revenue.....	\$ 1,119,184	100	\$ 924,792	100	\$ 3,201,422
OPERATING INCOME:					
Oilfield Products and Services...	\$ 112,737	14	\$ 90,318	13	\$ 297,251
Distribution.....	7,388	2	229	-	16,920
General Corporate.....	(1,908)	*	(1,739)	*	(5,958)
Total.....	\$ 118,217	11	\$ 88,808	10	\$ 308,213
MARKET DATA:					
AVERAGE WORLDWIDE RIG COUNT: (1)					
United States.....	1,475	50	1,280	48	1,390
Canada.....	311	11	340	13	328
Non-North America.....	1,146	39	1,059	39	1,124
Total.....	2,932	100	2,679	100	2,842
AVERAGE COMMODITY PRICES:					
Crude Oil (\$/Bbl) (2).....	\$ 43.83		\$ 30.19		\$ 39.03
Natural Gas (\$/mcf) (3).....	\$ 5.32		\$ 4.74		\$ 5.55

(1) Source: M-I SWACO.

(2) Average West Texas Intermediate ("WTI") spot closing prices.

(3) Average weekly composite spot U.S. wellhead prices.

\* not meaningful

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### 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, pressure control, rig instrumentation and waste-management. M-I SWACO is significantly influenced by spending in markets outside of North America, which contributes almost two-thirds of the unit's revenues, and by its exposure to the U.S. offshore market, which constitutes approximately 10 percent of the revenue base. U.S. offshore drilling programs, which account for four 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 \$565.4 million for the third quarter of 2004, an increase of 18 percent above the prior year period. Revenue growth in both North American and non-North American markets exceeded the underlying change in rig count for the corresponding period. Approximately two-thirds of the overall revenue improvement was generated in markets outside of North America, largely influenced by new contract awards and increased customer spending in the former Soviet Union ("FSU"), the Middle East and the Far East markets. North American revenues rose from the prior year level, despite a 19 percent reduction in offshore business volumes that primarily resulted from adverse drilling conditions in the U.S. Gulf. Revenues reported in the United States and Canada benefited from increased spending levels by independent oil companies on land-based projects and, to a lesser extent, incremental sales from operations acquired in the fourth quarter of 2003. While the majority of the overall revenue increase on a product basis reflects higher sales of drilling fluid products and services, revenues related to waste management offerings, which were 33 percent above the prior year level, also contributed to the improvement. For the nine-month period, M-I SWACO reported revenues of approximately \$1.6 billion, a 20 percent increase over the amount reported in the first nine months of 2003. The majority of the revenue growth was reported in markets outside North America, specifically the FSU and Middle East regions, reflecting new contract awards and increased investment by major and international exploration and production companies.

Smith Technologies designs, manufactures and sells three-cone drill bits, diamond drill bits and turbines for use in the oil and gas industry. Due to the nature of its product offerings, revenues for these operations correlate more closely to the rig count than any of the Company's other businesses. Moreover, Smith Technologies has the highest North American revenue exposure of the Oilfield segment units. Smith Technologies reported revenues of \$126.8 million for the quarter ended September 30, 2004, an increase of 21 percent over the comparable prior year period. The year-over-year comparison was impacted by the inclusion of several large international export orders in the third quarter of 2003. Excluding export orders, revenues were approximately 25 percent above the level reported in the prior year quarter, influenced by the increase in worldwide activity levels. Approximately two-thirds of the year-over-year revenue growth was reported in North America, where sales volumes grew at more than twice the rate of the underlying change in rig count. The revenue increase in the United States and Canada was attributable to a combination of higher land-based drilling activity, increased demand for diamond bit products specifically designed for the North American rental market and, to a lesser extent, higher unit pricing. Revenues generated in markets outside North America exceeded the corresponding change in activity levels as increased demand for drilling bits, primarily in the Far East and Latin America, more than offset a reduction in international export orders. For the nine-month period, Smith Technologies reported revenues of \$373.3 million, a 27 percent increase over the comparable period of 2003. Approximately 70 percent of the revenue growth was generated in North America, benefiting from a combination of increased market penetration, higher land-based drilling activity and, to a

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lesser extent, improved pricing.

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. Revenues for Smith Services are evenly distributed between North America and the international markets and are heavily influenced by the complexity of drilling projects, which drive demand for a wider range of its product offerings. For the quarter ended September 30, 2004, Smith Services' revenues totaled \$124.6 million, 21 percent above the prior year period. The year-over-year revenue comparison was impacted by a higher level of tubular product orders in the current period and incremental revenues from the CanFish acquisition completed during the quarter. Excluding the impact of the CanFish acquisition and tubular sales, which are not highly correlated to drilling activity, base business revenues grew approximately 12 percent largely associated with the general increase in global E&P spending. Three-quarters of the core business growth was reported in the United States, primarily reflecting increased customer demand for remedial and drilling-related product and service lines. For the first nine months of 2004, Smith Services reported revenues of \$352.1 million, a 17 percent increase from the comparable prior year period. The favorable revenue comparison reflects higher sales across all core product lines, driven by the general increase in global exploration and production spending levels. Two-thirds of the revenue growth was reported in the United States, influenced by strong demand for drilling-related and remedial product and service lines due, in part, to new product introductions.

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### Operating Income

Operating income for the Oilfield Products and Services segment was \$112.7 million, or 14 percent of revenues, for the three months ended September 30, 2004. Oilfield operating income increased \$22.4 million over the amount reported in the prior year quarter reflecting the effect of higher revenue volumes on the segment's reported gross profit, partially offset by growth in variable-based operating expenses. Segment operating margins increased one percentage point above the prior year quarter primarily related to reduced operating expenses as a percentage of revenues and, to a lesser extent, gross margin expansion. Oilfield gross margin improvement reflects the effect of higher sales volumes on fixed cost coverage and increased absorption in the Company's manufacturing operations. To a lesser extent, price increases implemented during the fourth quarter of 2003 and early 2004 had a favorable impact on reported margins. Although the Company has announced price increases in 2004, which should lead to margin expansion in future periods, the amount of net pricing realized has been and will continue to be impacted by rising costs, and there is no assurance that the expected benefits of the price increases will ultimately be realized. For the nine-month period, Oilfield operating margins, exclusive of the second quarter litigation-related charge of \$31.4 million, improved 1.5 percentage points reflecting gross margin expansion and, to a lesser extent, reduced operating expenses as a percentage of revenues. On an absolute dollar basis, nine-month operating income exclusive of the second quarter charge was \$87.8 million above the comparable prior year period 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.

### Distribution Segment

#### Revenues

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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 95 percent of Wilson's 2004 revenues generated in those markets. Moreover, approximately one-third 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 \$302.4 million for the third quarter of 2004, 27 percent above the comparable prior year period. The year-over-year revenue growth was relatively balanced between the energy and industrial operations influenced by increased demand for tubular products, sales of which were approximately 60 percent above the amount reported in the prior year quarter. Distribution revenues were also impacted by the higher level of North American drilling and completion activity on the energy sector operations and the implementation of new contract awards and increased project spending in the refining and petrochemical markets. In the first nine months of 2004, Wilson reported revenues totaling \$841.3 million, an increase of 27 percent from the first nine months of 2003. The majority of the revenue variance from the prior year period was generated by the energy operations, reflecting higher North American activity levels, the impact of new contract awards and, to a lesser extent, strong demand for tubular products.

### Operating Income

Operating income for the Distribution segment was \$7.4 million, or two percent of revenues, for the three months ended September 30, 2004. Segment operating income increased \$7.2 million from the near breakeven amount reported in the third quarter of 2003, equating to incremental operating income of approximately 11 percent of revenues. The incrementals, which were influenced by improvement in the energy and industrial sectors, were above those historically reported in the segment, attributable to a combination of increased tubular sales volumes and related pricing and improved coverage of fixed sales and administrative costs. On a year-to-date basis, Distribution operating margins improved 2.7 percentage points reflecting the impact of lower operating expenses as a percentage of revenues. On an absolute dollar basis, segment operating income was \$21.3 million above the amount reported in the first nine months of 2003. The operating income variance reflects the impact of higher revenue volumes and improved tubular product pricing on the segment's reported gross profit, partially offset by growth in variable-based operating expenses.

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### 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 September 30,				Nine Months	
2004		2003		2004	
Amount	%	Amount	%	Amount	%

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Revenues.....	\$ 1,119,184	100	\$ 924,792	100	\$ 3,201,422	100
Gross profit.....	338,983	30	278,402	30	980,353	30
Operating expenses.....	220,766	19	189,594	20	672,140	20
Operating income.....	118,217	11	88,808	10	308,213	11
Interest expense.....	9,965	1	10,198	1	28,803	1
Interest income.....	(327)	-	(534)	-	(981)	-
Income before income taxes, minority interests and cumulative effect of change in accounting principle.....	108,579	10	79,144	9	280,391	10
Income tax provision.....	35,129	3	25,524	3	90,955	3
Minority interests.....	21,557	2	18,616	2	65,216	2
Income before cumulative effect of change in accounting principle.....	51,893	5	35,004	4	124,220	5
Cumulative effect of change in accounting principle, net of tax and minority interests.....	-	-	-	-	-	-
Net income.....	\$ 51,893	5	\$ 35,004	4	\$ 124,220	5

Consolidated revenues were \$1.1 billion for the third quarter of 2004, 21 percent above the prior year period, primarily attributable to increased demand for Oilfield segment product offerings. Oilfield segment revenues grew 19 percent year-over-year with the increase balanced between North American and non-North American markets. The revenue variance reflects higher global activity levels as well as new contract awards and increased customer spending, primarily in international markets. The Distribution operations, influenced by strong demand for tubular products and new contract awards, reported a 27 percent increase from the prior year quarter and also contributed to the consolidated revenue improvement. For the first nine months of 2004, consolidated revenues were \$3.2 billion, 23 percent above the comparable 2003 period. Two-thirds of the consolidated revenue growth reflects higher Oilfield segment revenues, which rose 20 percent over amounts reported in the prior year period. Oilfield business volumes benefited from the 20 percent increase in U.S. land-based drilling activity and, to a lesser extent, the impact of new contract awards and additional customer spending in certain Eastern Hemisphere markets.

Gross profit totaled \$339.0 million for the third quarter of 2004, 22 percent above the prior year period. Gross profit increased \$60.6 million over the prior year quarter reflecting higher sales volumes associated with improved worldwide activity levels, predominantly in the United States. Gross profit margins for the third quarter of 2004 were 30 percent of revenues, comparable to the level reported in the prior year period. For the nine-month period, gross profit totaled \$980.4 million, or 31 percent of revenues, one percentage point above the gross profit margins reported in the comparable prior year

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period. The gross margin expansion was influenced by a combination of favorable pricing and the effect of increased sales volumes on fixed manufacturing and

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service infrastructure. On an absolute dollar basis, gross profit was \$201.7 million above the nine-month period ended September 30, 2003 primarily reflecting the increased sales volumes in the Oilfield operations.

Operating expenses, consisting of selling, general and administrative expenses, increased \$31.2 million on an absolute dollar basis; however, as a percentage of revenues, decreased one percentage point from the prior year quarter. The majority of the absolute dollar increase related to variable costs directly associated with the improved business volumes, as well as increased investment in personnel and infrastructure to support the expanding business base, including engineering support costs. To a lesser extent, increased employee profit-sharing amounts directly attributable to the higher profitability levels and increased costs associated with U.S. casualty and medical insurance programs contributed to the period-to-period variance. Operating expenses increased \$124.9 million from the first nine months of 2003 due to variable-related costs attributable to the improved business volumes and, to a lesser extent, a \$28.8 million charge recognized during the second quarter primarily for an estimated loss provision, legal fees and costs directly associated with a patent infringement case. Excluding the charge, operating expenses as a percentage of revenues decreased one percentage point from the nine-month period ended September 30, 2003.

Net interest expense, which represents interest expense less interest income, equaled \$9.6 million in the third quarter of 2004. Net interest expense was comparable to the prior year quarter but decreased \$1.9 million from the first nine months of 2003, with the variance primarily reflecting lower average debt levels.

The effective tax rate for the third quarter and first nine months of 2004 approximated 32 percent, which was comparable to the level reported in the prior year periods, but below the U.S. statutory rate. The effective tax rate was lower than the U.S. statutory rate due to the impact of M-I SWACO's U.S. partnership earnings for which the minority partner is directly responsible for its related income taxes. 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 interests reflect the portion of the results of majority-owned operations which are applicable to the minority interest partners. Minority interests was \$2.9 million and \$14.9 million above amounts reported in the prior year quarter and the first nine months of 2003, respectively, due primarily to the increased profitability of the M-I SWACO joint venture and, to a lesser extent, improved earnings reported by CE Franklin Ltd.

The cumulative effect of change in accounting principle included for the nine months ended September 30, 2003 represents the impact of the adoption of Statement of Financial Accounting Standards ("SFAS") No. 143, "Accounting for Asset Retirement Obligations."

### LIQUIDITY AND CAPITAL RESOURCES

#### General

At September 30, 2004, cash and cash equivalents equaled \$65.0 million. During the first nine months of 2004, the Company generated \$117.5 million of cash

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flows from operations as compared to the \$66.8 million generated in the comparable prior year period. The improvement in cash generated from operations was attributable to increased profitability levels.

During the first nine months of 2004, cash flows used in investing activities totaled \$106.2 million, consisting of amounts required to fund capital expenditures and, to a lesser extent, acquisitions. The Company invested \$60.5 million in property, plant and equipment, net of cash proceeds arising from certain asset disposals. Acquisition funding, which primarily related to the purchase of certain operating assets from CanFish Services, resulted in cash outflows of \$45.8 million in the first nine months of 2004. Cash used for investing activities during the first nine months of 2004 was less than the \$131.7 million required in the prior year period primarily due to the size of acquisitions and related funding levels.

Cash flows provided by financing activities totaled \$3.1 million for the first nine months of 2004. Operating cash flow and cash proceeds associated with the exercise of employee stock options were not sufficient in the aggregate to fully fund investing activities and share purchases under a stock buyback program, requiring incremental borrowings of \$9.0 million.

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

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also available, if necessary, to fund operating or investing activities. The Company has various revolving credit facilities in the United States. As of September 30, 2004, the Company had \$297.0 million of capacity available under these facilities for future operating or investing needs of its worldwide operations. 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, 2004, the Company had available borrowing capacity of \$64.6 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, 2004, 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 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.

The Company has previously announced the signing of a non-binding letter of intent related to the sale of Wilson Industries, Inc. ("Wilson") to CE Franklin Ltd., a publicly-traded entity in which the Company currently owns 55 percent of the outstanding common stock. The potential transaction is structured as a sale of shares of Wilson in exchange for additional shares of CE Franklin.



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Accordingly, the transaction would not be expected to have an impact on the Company's liquidity before certain stock sale restrictions lapse, which is currently anticipated in the second half of 2005. In the event the transaction is ultimately consummated, no material book gain or loss is expected to be realized on the sale. The Company, however, has agreed to fund certain transaction-related costs, primarily professional fees, which are expected to be immaterial. And, depending on the final terms of the transaction, the Company may be required to record a tax provision on the sale which could be material in relation to the third quarter 2004 tax provision, negatively impacting the recorded provision and effective tax rate in the period the transaction is consummated.

### Commitments and Contingencies

#### Standby Letters of Credit and Guarantees

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 of notes issued to former shareholders of an acquired entity as well as to insurance companies which reinsure certain liability coverages of the Company's insurance captive. Excluding the impact of these instruments, for which \$28.9 million of related liabilities are reflected in the accompanying consolidated condensed balance sheet, the Company is contingently liable for approximately \$40.3 million of standby letters of credit and bid, performance and surety bonds at September 30, 2004. Management does not expect any material amounts to be drawn on these instruments.

Subsequent to September 30, 2004, the Company obtained a surety bond in the amount of \$43.5 million in connection with its appeal of the patent infringement litigation discussed below. After taking into consideration amounts reflected in the accompanying consolidated condensed balance sheet, the Company has a contingent liability of up to \$18.4 million associated with this instrument. Management, however, does not expect any amounts to be drawn on this instrument.

The Company has also provided loan guarantees related to certain joint ventures accounted for under the equity method of accounting. As the net assets and cash flows of these entities are available to satisfy obligations as they become due, management believes the likelihood is remote that the Company will be required to perform under these guarantees. The Company's estimated maximum exposure under these loan guarantees approximated \$19.0 million as of September 30, 2004.

### Litigation

Halliburton Energy Services, Inc. v. Smith International, Inc.  
On September 6, 2002, the Company was served with a complaint in the U.S. District Court for the Eastern District of Texas, Sherman Division entitled Halliburton Energy Services, Inc. v. Smith International, Inc. This lawsuit is a patent infringement claim alleging that certain roller cone drill bits made by the Company infringe several U.S. patents owned by Halliburton.

The case was tried in the second quarter of 2004 and, on June 25, 2004, a jury verdict was rendered against the Company awarding damages of \$24.0 million and finding the infringement willful as to certain of the claims. On August 13, 2004, the Court enhanced the damage award by \$12.0 million, and awarded \$5.1 million in attorneys' fees and prejudgment interest. On November 4, 2004, the

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court denied the Company's post-trial motions and the Company has initiated the appeal process. Although an appeal is underway, the Company is continuing to pursue other options, including possible settlement. Based on the facts and circumstances and the opinion of outside counsel, management believes that the amounts recorded reflect the best estimate of the Company's potential loss exposure.

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

On April 17, 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").

On August 25, 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. The suit was tried in the first quarter of 2004 and, on March 30, 2004, a jury verdict of approximately \$4.8 million was rendered in favor of the plaintiffs. On June 1, 2004, the court entered the judgment and the Company's post-judgment motions were subsequently denied by the court. The Company has initiated the appeal process and does not anticipate a ruling from the appellate court until the first half of 2005. Based upon the facts and circumstances and the opinion of outside legal counsel, management believes that an unfavorable outcome on this matter is not probable at this time. Accordingly, the Company has not recognized a loss provision in the accompanying consolidated condensed financial statements.

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 or results of operations.

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.

In connection with most business acquisitions, the Company obtains contractual indemnifications from the seller related to environmental matters. These indemnifications generally provide for the reimbursement of environmental clean-up costs incurred by the Company for events occurring or circumstances existing prior to the purchase date, whether the event or circumstance was known or unknown at that time. A substantial portion of the Company's total environmental exposure is associated with its M-I SWACO operations, which are subject to various indemnifications from former owners.

As of September 30, 2004 the Company's environmental reserve approximated \$10.0 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, 2004, the Company does not believe that these differences will have a material impact on the Company's financial position or results of operations, subject to the indemnifications in place.

During the first quarter of 2003, the Company initiated legal action against M-I SWACO's former owners to address issues associated with certain provisions of the environmental indemnification provided. This matter is currently expected to

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go to trial during the second quarter of 2005. In the event that i) M-I SWACO's former owners and other parties to indemnification agreements with the Company do not fulfill their obligations, and ii) costs incurred to remediate the identified properties reach estimated maximum exposure limits, the Company would be required to record an additional charge of up to \$25.0 million, impacting earnings and cash flows in future periods.

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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 2003 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. Unless otherwise discussed, management believes the impact of 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. 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 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 2003 Annual Report on Form 10-K.

### ITEM 4. CONTROLS AND PROCEDURES

The Company maintains disclosure controls and procedures and internal controls designed to ensure that information required to be disclosed in our filings under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time frame specified in the Commission's rules and regulations. Our principal executive and financial officers have evaluated our disclosure controls and procedures and have determined that such disclosure controls and procedures are effective as of the end of the period covered by this report. There were no significant changes in the Company's internal controls or in other factors that could significantly affect those controls subsequent to the evaluation date.

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### PART II - OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS

None.

#### ITEM 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES

During 2001, the Company's Board of Directors authorized a share buyback program which allows for the repurchase of up to five million shares of common stock, subject to regulatory issues, market considerations and other relevant factors. During the second quarter of 2004, the Company repurchased 1.1 million shares of common stock under the program at an aggregate cost of \$54.0 million bringing the total number of shares acquired under the program to 1.7 million. The acquired shares have been added to the Company's treasury stock holdings and may be used in the future for acquisitions or other corporate purposes.

A summary of the Company's repurchase activity for the three months ended September 30, 2004 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 May Yet Be Under t
July 1 - 31	-	\$ -	-	
August 1 - 31	-	\$ -	-	
September 1 - 30	-	\$ -	-	
3rd Quarter 2004	-	\$ -	-	

#### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

#### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

#### ITEM 5. OTHER INFORMATION

None.

#### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits filed as part of this report:

- 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.

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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.

(b) Exhibit furnished with this report:

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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(c) Reports on Form 8-K

The Registrant furnished four reports on Form 8-K during the quarterly period ended September 30, 2004.

1. Form 8-K dated July 9, 2004 relating to a press release announcing the Company's earnings release and conference call information for the quarter ended June 30, 2004 and comments on second quarter litigation charges. The document was reported under "Item 7. Financial Statements and Exhibits" and "Item 12. Disclosure of Results of Operations and Financial Condition."
2. Form 8-K dated July 22, 2004 relating to a press release announcing the Company's results for the quarter ended June 30, 2004. The document was reported under "Item 7. Financial Statements and Exhibits" and "Item 12. Disclosure of Results of Operations and Financial Condition."
3. Form 8-K dated August 18, 2004 relating to a press release updating the status of certain legal proceedings. The document was reported under "Item 5. Other Events."
4. Form 8-K dated September 8, 2004 relating to a press release updating the status of the transaction regarding the potential purchase of the Wilson distribution operations by C.E. Franklin, Ltd. The document was reported under "Item 8.01. Other Events."

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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, 2004

By: /s/ DOUG ROCK  
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Doug Rock  
Chairman of the Board,  
Chief Executive Officer,  
President and Chief Operating Officer

Date: November 9, 2004

By: /s/ MARGARET K. DORMAN

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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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