SMITH INTERNATIONAL INC
Form 10-Q
November 15, 2002

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2002

OR

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

For the transition period from ____ to ____

Commission file number
1-8514

SMITH INTERNATIONAL, INC.
(Exact name of Registrant as specified in its charter)

DELAWARE	95-3822631
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

411 NORTH SAM HOUSTON PARKWAY, SUITE 600	
HOUSTON, TEXAS	77060
(Address of principal executive offices)	(Zip Code)

(281) 443-3370
(Registrant's telephone number, including area code)

NOT APPLICABLE
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

The number of shares outstanding of the Registrant's common stock as of November 11, 2002 was 101,527,034.

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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, 2002	Three Months Ended September 30, 2001
Revenues	$777,232	$909,682
Costs and expenses:		
Costs of revenues	559,507	636,626
Selling expenses	128,265	132,735
General and administrative expenses	34,517	36,574
Goodwill amortization	--	3,966
Total costs and expenses	722,289	809,901
Operating income	54,943	99,781

Interest expense, net	9,299	10,653
Income before income taxes and minority interests	45,644	89,128
Income tax provision	14,542	28,941
Income before minority interests	31,102	60,187
Minority interests	11,312	18,121
Net income	$ 19,790	$ 42,066
Basic earnings per share (See Note 4):		
Net income	$ 0.20	$ 0.42
Net income, excluding impact of goodwill amortization	$ 0.20	$ 0.45
Diluted earnings per share (See Note 4):		
Net income	$ 0.20	$ 0.42
Net income, excluding impact of goodwill amortization	$ 0.20	$ 0.44
Weighted average shares outstanding (See Note 4):		
Basic	99,002	99,662
Diluted	100,069	100,420

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)

	September 3 2002 (Unaudited
ASSETS	
CURRENT ASSETS:	
Cash and cash equivalents	$ 62,86
Receivables, net	651,94
Inventories, net	634,22
Deferred tax assets, net	25,35
Prepaid expenses and other	48,69
Total current assets	1,423,07
Property, Plant and Equipment, net	498,41
Goodwill, net	594,36
Other Assets	175,16

Total Assets	$ 2,691,02

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES:	
Short-term borrowings and current portion of long-term debt	$ 58,50
Accounts payable	235,47
Accrued payroll costs	54,15
Income taxes payable	50,27
Other	86,07
Total current liabilities	484,48
Long-Term Debt	553,91
Deferred Tax Liabilities	49,17
Other Long-Term Liabilities	59,22
Minority Interests	502,22
Commitments and Contingencies (See Note 13)	
STOCKHOLDERS' EQUITY:	
Preferred stock, $1 par value; 5,000 shares authorized; no shares issued or outstanding in 2002 or 2001	-
Common stock, $1 par value; 150,000 shares authorized; 101,509 shares issued in 2002 (50,594 shares issued in 2001, on a pre-split basis)	101,50
Additional paid-in capital	345,62
Retained earnings	637,89
Accumulated other comprehensive income	(13,92
Less - Treasury securities, at cost; 2,384 common shares in 2002 (1,192 common shares in 2001, on a pre-split basis)	(29,13
Total stockholders' equity	1,041,97
Total Liabilities and Stockholders' Equity	$ 2,691,02

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

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

CASH FLOWS FROM OPERATING ACTIVITIES:

Net income ...

Adjustments to reconcile net income to net cash provided by operating activities, excluding the net effects of acquisitions:

Depreciation and amortization
Minority interests
Provision for losses on receivables
Gain on disposal of property, plant and equipment
Foreign currency translation (gains) losses
Changes in operating assets and liabilities:
Receivables
Inventories
Accounts payable
Other current assets and liabilities
Other non-current assets and liabilities
Net cash provided by operating activities
CASH FLOWS FROM INVESTING ACTIVITIES:
Acquisition of businesses, net of cash acquired
Purchases of property, plant and equipment
Proceeds from disposal of property, plant and equipment
Purchase of stock of majority-owned subsidiary
Net cash used in investing activities
CASH FLOWS FROM FINANCING ACTIVITIES:
Proceeds from issuance of long-term debt
Principal payments of long-term debt
Net change in short-term borrowings
Purchases of treasury stock
Proceeds from exercise of stock options
Minority interest partner contributions (distributions)
Net cash provided by (used in) financing activities
Effect of exchange rate changes on cash
Increase in cash and cash equivalents
Cash and cash equivalents at beginning of period
Cash and cash equivalents at end of period
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:
Cash paid for interest
Cash paid for income taxes

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 were prepared in accordance with U.S. generally accepted accounting principles and all applicable financial statement 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 our 2001 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 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 Smith International, Inc. and subsidiaries (the "Company") as of the dates indicated. The results of operations for the three and nine months ended September 30, 2002 and 2001 may not be indicative of results for the fiscal year.

From time to time, new accounting pronouncements are issued by the Financial Accounting Standards Board (the "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 financial statements upon adoption.

2. BUSINESS COMBINATION

In July 2002, the Company acquired certain turbodrilling assets of Neyrfor-Weir Ltd. in exchange for cash consideration of $25.3 million. The acquired operations, which design proprietary turbodrilling equipment and provide related services for horizontal and directional drilling applications, have been integrated into the Company's Oilfield Products and Services segment. For the fiscal year ended December 31, 2001, the acquired operations reported revenues of approximately $17 million.

This acquisition has 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 has been recorded as goodwill. The purchase price allocation related to this acquisition is based upon preliminary information and is subject to change when additional data concerning final asset and liability valuations is obtained. Material changes in the preliminary allocations are not anticipated by management.

Pro forma results of operations have not been presented because the effect of this acquisition was not material to the Company's consolidated condensed financial statements.

3. NON-RECURRING CHARGES

During the first quarter of 2002, the Company recognized non-recurring charges totaling $7.9 million, or $3.4 million net of taxes and minority interests. The first quarter charge included a $4.3 million provision for losses on receivables in Argentina attributable to local economic events. The provision was necessitated by Argentinean legislation, which required the Company to settle certain U.S. dollar-denominated transactions in pesos. The remainder of the charge related to restructuring efforts undertaken in response to activity-level declines, the primary component of which is severance costs incurred in connection with employee terminations. All such restructuring costs have been paid prior to September 30, 2002.

In the accompanying consolidated condensed financial statements, $5.8 million of the charges are included in general and administrative expenses, $1.7 million are reflected in selling expenses with the remainder recorded as cost of revenues.

4. STOCK SPLIT

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

The Consolidated Condensed Balance Sheet includes the reclassification of $50.7 million from additional paid-in capital to the common stock account, in order to reflect the transaction. Additionally, all prior year amounts included in the financial statements related to weighted average shares outstanding and earnings per share amounts have been restated for the effect of the stock split.

5. EARNINGS PER SHARE

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

	Three Months Ended September 30,	
	2002	2001
Basic EPS:		
Net income	$ 19,790	$ 42,066
Weighted average number of common shares outstanding	99,002	99,662
Basic EPS	$ 0.20	$ 0.42
Diluted EPS:		
Net income	$ 19,790	$ 42,066
Weighted average number of common shares outstanding	99,002	99,662
Dilutive effect of stock options	1,067	758

	100,069	100,420
Diluted EPS	$ 0.20	$ 0.42

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6. INVENTORIES

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

	September 30, 2002	December 31, 2001
Raw materials	$ 47,861	$ 50,821
Work-in-process	53,498	65,008
Products purchased for resale	165,466	154,787
Finished goods	393,379	406,143
	660,204	676,759
Reserves to state certain domestic inventories ($298,749 in 2002 and $300,868 in 2001, respectively) on a LIFO basis	(25,980)	(23,608)
	$ 634,224	$ 653,151

7. PROPERTY, PLANT AND EQUIPMENT

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

	September 30, 2002	December 31, 2001
Land	$ 33,196	$ 28,390
Buildings	123,500	100,888
Machinery and equipment	485,237	482,045
Rental tools	257,902	243,913
	899,835	855,236
Less-Accumulated depreciation	401,422	366,739
	$498,413	$488,497

8. GOODWILL AND OTHER INTANGIBLE ASSETS

On January 1, 2002, the Company adopted FASB Statement No. 142 ("SFAS

No. 142"), "Goodwill and Other Intangible Assets," which addresses financial accounting and reporting matters. In accordance with SFAS No. 142, the Company discontinued amortizing goodwill to earnings as of January 1, 2002. The Statement also requires that goodwill be tested for impairment on an annual basis, or more frequently if circumstances indicate that an impairment may exist.

During the first quarter of 2002, the Company completed the transitional impairment test required by SFAS No. 142 for goodwill recorded as of the adoption date. The transitional goodwill impairment test involved a comparison of the fair value of each of the Company's reporting units, as defined, with their carrying value and resulted in the identification of no impairment.

The accompanying Consolidated Condensed Statements of Operations provide relevant disclosures related to recorded goodwill amortization and the after-tax impact which would have resulted from the adoption of SFAS No. 142 as of January 1, 2001.

The changes in the carrying amount of goodwill on a segment basis for the nine months ended September 30, 2002 are as follows (in thousands):

	Oilfield Segment	Distribution Segment	Consolidated
Balance as of December 31, 2001	$537,509	$37,041	$574,550
Goodwill acquired	10,600	--	10,600
Purchase price and currency translation adjustments	9,070	142	9,212
Balance as of September 30, 2002	$557,179	$37,183	$594,362

The accompanying Consolidated Condensed Balance Sheet as of September 30, 2002 includes $41.3 million of intangible assets, which are classified in Other Assets. The Company amortizes identifiable intangible assets, generally consisting of patents, trademarks and non-compete agreements, on a straight-line basis over their expected useful lives, which range from three to 27 years. The adoption of SFAS No. 142 also required the Company to re-evaluate the remaining useful lives of its intangible assets to determine whether the periods being used were appropriate. No changes to the carrying value of the intangibles, nor the remaining useful lives, were recorded as a result of the review.

9. DEBT

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

	September 30, 2002	December 31, 2001
Current:		
Short-term borrowings	$ 43,356	$ 50,156
Current portion of long-term debt	15,153	98,537

	$ 58,509	$ 148,693
Long-Term:		
Notes, net of unamortized discounts	$ 492,497	$ 532,555
Revolving credit facilities	54,000	81,700
Term loans and other	22,575	23,124
	569,072	637,379
Less current portion of long-term debt ...	(15,153)	(98,537)
	$ 553,919	$ 538,842

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

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

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

2003	$ 90,715
2004	72,782
2005	13,145
2006	157,372
Thereafter	219,905
	$553,919

10. 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,	
	2002	2001

Net income	$ 19,790	$42,066
Changes in unrealized fair value of derivatives, net	554	2,497
Currency translation adjustments	(1,693)	2,154
Comprehensive income	$ 18,651	$46,717

As of September 30, 2002, accumulated other comprehensive income in the accompanying Consolidated Condensed Balance Sheet includes $14.4 million of cumulative currency translation losses and $0.9 million of cumulative pension liability adjustments, partially offset by $1.4 million of cumulative changes in the unrealized fair value of derivatives.

11. EMPLOYEE STOCK OPTIONS

The Company's Board of Directors and its stockholders have authorized an employee stock option plan. As of September 30, 2002, 5.0 million shares were issued and outstanding under the program and an additional 4.6 million shares 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 15 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 of $0.1 million and $0.2 million of related expense in the accompanying Consolidated Condensed Statements of Operations for the three month and nine month periods ended September 30, 2002, respectively.

The Company continues to apply Accounting Principles Board Opinion No. 25 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 on a diluted basis would have approximated the pro forma amounts indicated below:

	Three Months Ended September 30,	
	2002	2001
Net Income:		
As reported	$ 19,790	$ 42,066
Pro forma	17,894	40,572
Diluted earnings per share:		

As reported	$ 0.20	$ 0.42
Pro forma	0.18	0.40

12. 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, Smith Bits and Smith Services. The Distribution segment includes the Wilson business unit. The following table presents financial information for each reportable segment (in thousands):

	Three Months Ended September 30,	
	2002	2001
Revenues:		
Oilfield Products and Services	$ 557,033	$ 622,203
Distribution	220,199	287,479
	$ 777,232	$ 909,682
Operating Income:		
Oilfield Products and Services	$ 57,268	$ 93,975
Distribution	(705)	7,344
General corporate	(1,620)	(1,538)
	$ 54,943	$ 99,781

13. CONTINGENCIES

The Company is a party to various legal and environmental matters arising in the ordinary course of business. In the opinion of management, after considering established reserves and contractual indemnifications obtained, these matters are not expected to have a material adverse effect on the Company's consolidated financial statements. In the unlikely event that the parties providing the environmental indemnifications do not fulfill their obligations, such event could result in the recognition of up to $30.0 million related to indemnified liabilities, potentially impacting earnings and cash flows in future periods.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL

The following "Management's Discussion and Analysis of Financial Condition and Results of Operations" is provided to assist readers in understanding the Company's financial performance during the periods presented and significant trends which may impact the future performance of the Company. This discussion should be read in conjunction with the Consolidated Condensed

Financial Statements of the Company and the related notes thereto included elsewhere in this Form 10-Q and the Consolidated Financial Statements of the Company and the related notes thereto and the related "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in the Company's 2001 Annual Report on Form 10-K.

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

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

The year-over-year decline in the worldwide rig count relates to lower North American activity levels, particularly in the United States. Drilling activity in the U.S. market is heavily influenced by natural gas fundamentals, as over 80 percent of the U.S. rig count is currently natural gas-directed. After bottoming in late March 2002, activity levels in the United States have improved 11 percent due, in part, to declining natural gas production which has resulted in increased natural gas drilling activity. Although the U.S. rig count has shown moderate improvement, various factors including political and regional instabilities, oil and natural gas storage levels, commodity prices and depletion rates, will likely influence activity levels on a going forward basis. The Company's business outlook, however, is highly dependent on the general economic environment in the United States and other major world economies, which ultimately impact energy consumption and the resulting demand for our products and services. Further weakness in the global economic environment could result in a substantial decline in worldwide drilling activity, adversely impacting the Company's future financial results.

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

RESULTS OF OPERATIONS

Segment Discussion

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

	Three Months Ended September 30,				Nine
	2002		2001		2002
	Amount	%	Amount	%	Amount
Financial Data:					
Revenues:					
M-I	$ 376,785	49	$ 412,364	45	$ 1,175,083
Smith Bits	78,853	10	105,135	12	245,477
Smith Services	101,395	13	104,704	11	313,001
Oilfield Products and Services	557,033	72	622,203	68	1,733,561
Distribution	220,199	28	287,479	32	672,086
Total	$ 777,232	100	$ 909,682	100	$ 2,405,647
Revenues by Area:					
United States	$ 359,953	46	$ 480,125	53	$ 1,136,832
Canada	68,560	9	96,603	11	218,909
Non-North America	348,719	45	332,954	36	1,049,906
Total	$ 777,232	100	$ 909,682	100	$ 2,405,647
Operating Income:					
Oilfield Products and Services .	$ 57,268	10	$ 93,975	15	$ 209,583
Distribution	(705)	*	7,344	3	(1,518)
General corporate	(1,620)	*	(1,538)	*	(4,794)
Total	$ 54,943	7	$ 99,781	11	$ 203,271
Market Data:					
M-I Average Worldwide Rig Count:					
United States	997	46	1,413	51	938
Canada	219	10	306	11	250
Non-North America	970	44	1,046	38	984
Total	2,186	100	2,765	100	2,172

*not meaningful

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Oilfield Products and Services Segment

Revenues

M-I provides drilling and completion fluid systems, engineering and technical services to the oil and gas industry through its M-I Fluids division.

M-I's SWACO division manufactures and markets equipment and services for solids control, separation, pressure control, rig instrumentation and waste management. M-I's business operations are largely influenced by the number of offshore drilling programs, which are more revenue-intensive than land-based projects due to the complex nature of the related drilling environment. For the three months ended September 30, 2002, M-I's revenues totaled $376.8 million, nine percent below the prior year quarter. Incremental revenues from acquisitions partially offset the impact of the decline in base business operations. Excluding the impact of acquisitions, revenues fell 14 percent due, primarily, to the reduction in U.S. offshore drilling activity which declined 22 percent from the prior year period. Over 90 percent of the base revenue reduction from the prior year quarter was reported in the United States, with lower U.S. offshore revenue levels accounting for two-thirds of the overall base revenue decline. For the nine-month period, M-I reported revenues of $1.2 billion, a two percent decline from the comparable prior year period. Excluding the impact of acquisitions, revenues declined nine percent attributable to the reduction in Western Hemisphere activity levels which declined 30 percent between the corresponding periods. The impact of the Western Hemisphere activity decline was partially offset by base revenue growth in all other geographic regions.

Smith Bits manufactures and sells three-cone and diamond drill bits for use in the oil and gas industry. Smith Bits reported revenues of $78.9 million for the third quarter of 2002, a decline of 25 percent from the prior year quarter. Base revenues also declined 25 percent as the impact of current year acquisitions were offset by lower revenues resulting from the contribution of the mining bit operations to an unconsolidated joint venture in October 2001. The revenue decline was reported in the Western Hemisphere markets as the 28 percent reduction in related drilling activity primarily influenced demand for three-cone drill bits. For the first nine months of 2002, Smith Bits' revenues totaled $245.5 million, a 21 percent decline from the amounts reported in the comparable prior year period. After excluding the net impact of the mining bit operations and incremental revenues from current year acquisitions, revenues were 18 percent below the first nine months of 2001 and compared favorably to the 21 percent decline in the worldwide average rig count between the corresponding periods. Over three-quarters of the year-to-year base revenue variance resulted from lower sales volumes of three-cone bits, reflecting the significant decline in U.S. drilling activity.

Smith Services manufactures and markets products and services used in the oil and gas industry for drilling, workover, well completion and well re-entry. For the three months ended September 30, 2002, Smith Services' revenues totaled $101.4 million, three percent below the prior year quarter. Excluding the impact of acquisitions completed in the fourth quarter of 2001, revenues declined 16 percent from the prior year quarter. The base revenue decline was reported in the Western Hemisphere reflecting lower demand for drilling-related products and services associated with the significant reduction in drilling activity. For the nine-month period, Smith Services reported revenues of $313.0 million, an increase of 11 percent over the first nine months of 2001. Excluding the impact of acquisitions, revenues were seven percent lower period-to-period, reflecting the effect of the 31 percent decline in North American activity levels on the underlying base business. Increased sales of drill pipe related to an alliance with a specialty drill pipe manufacturer and base revenue growth in Europe/Africa, due to higher export sales and increased activity in the North Sea, served to partially offset the revenue variance from the corresponding period.

Operating Income

Operating income for the Oilfield Products and Services segment decreased $36.7 million from the third quarter of 2001 as lower gross profit in the segment was partially offset by reduced operating expenses. Decreased demand for higher-margin products, specifically drill bits and premium synthetic drilling fluids which accounted for approximately two-thirds of the revenue decline from the prior year period, contributed to a four percentage point deterioration in gross profit margins from the third quarter of 2001. The reduction in gross profit margins relates to lower volumes and a shift in revenue mix, as no significant pricing deterioration was experienced during the period. Operating expenses fell approximately six percent from the third quarter of 2001 attributable, in part, to cost reduction efforts undertaken in response to the Western Hemisphere activity level decline. On a year-to-date basis, segment operating income declined $50.6 million from the first nine months of 2001. As a percentage of revenues, operating income declined approximately two percentage points, reflecting the deterioration in gross profit margins from the prior year period. The gross profit margins were impacted by the reduction in higher-margin sales discussed above.

Distribution Segment

Revenues

Wilson markets pipe, valve, tool, safety and other maintenance products to energy and industrial markets, primarily through an extensive network of supply branches in the United States and Canada. Wilson reported revenues of $220.2 million for the third quarter of 2002, 23 percent below the prior year quarter. Over three-quarters of the revenue variance was reported in the energy branch operations related to the impact of the decline in North American drilling and completion activity combined with lower project spending by pipeline customers. To a lesser extent, the continued weakness in the industrial and petrochemical markets, primarily in the United States, resulted in reduced spending for major maintenance programs and projects. For the first nine months of 2002, Wilson reported revenues totaling $672.1 million, a decline of 22 percent from the comparable prior year period. Lower activity levels in the United States and Canada impacted the energy branch operations, which reported over three-quarters of the year-to-date revenue variance. The balance of the revenue decline was reported by the industrial sector due to a reduction in customer spending levels.

Operating Income

Operating income for the Distribution segment decreased $8.0 million from the third quarter of 2001. The decline in operating income relates to the impact of the revenue decline on gross profit, partially offset by the reduction in variable costs associated with the lower sales volumes. The decrease in Wilson's overall sales volumes on coverage of sales and administrative support costs contributed to a three percentage point reduction in operating margins from the prior year period. On a year-to-date basis, Distribution segment operating income declined $22.5 million from the amounts reported in the first nine months of 2001. The operating income variance reflects lower gross profit levels associated with the reported revenue decline, partially offset by a reduction in variable-based operating expenses. As a percentage of sales, operating income decreased three percentage points from the prior year comparable period, as lower sales volumes impacted coverage of fixed sales and administrative support costs.

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,				Ni
	2002		2001		20
	Amount	%	Amount	%	Amount
Revenues	$777,232	100	$909,682	100	$2,405,64
Gross profit	217,725	28	273,056	30	695,48
Operating expenses	162,782	21	173,275	19	492,21
Operating income	54,943	7	99,781	11	203,27
Interest expense, net	9,299	1	10,653	1	29,20
Income before income taxes and minority interests	45,644	6	89,128	10	174,06
Income tax provision	14,542	2	28,941	3	53,49
Income before minority interests	31,102	4	60,187	7	120,57
Minority interests	11,312	1	18,121	2	45,12
Net income	$ 19,790	3	$ 42,066	5	$ 75,44

Consolidated revenues totaled $777.2 million for the third quarter of 2002, 15 percent below the prior year period. The revenue decline was split relatively equally between the Oilfield segment and the Distribution segment. The current year revenues were influenced by the completion of 13 acquisitions, partially offset by the contribution of the Smith Bits' mining operations to an unconsolidated joint venture in October 2001. Excluding the net impact of acquired and divested operations, base revenues fell 18 percent from the third quarter of 2001, as demand for the Company's products and services were impacted by a 29 percent reduction in North American drilling activity. Base revenue growth in the Eastern Hemisphere markets, due to new contract awards and higher export sales, served to partially offset the revenue decline stemming from the reduction in North American drilling activity. For the nine-month period, consolidated revenues were $2.4 billion, nine percent lower than the comparable period in 2001. Over three-quarters of the revenue reduction was reported in the Company's Distribution operations, which are concentrated in North America, and were impacted by the significant decline in drilling activity in the United States and Canada. Excluding the impact of acquired and divested operations, consolidated revenues were 14 percent below the amounts reported in the first nine months of 2001, reflecting the 31 percent reduction in North American drilling activity between the nine-month periods.

Gross profit totaled $217.7 million, or 28 percent of revenues, in the third quarter of 2002. The $55.3 million decline from the amounts reported in the prior year quarter primarily reflects the reduction of sales of higher-margin Oilfield segment products. Consolidated gross profit margins fell two percentage points from the prior year period driven by the margin deterioration in the Oilfield segment. The higher year-over-year percentage decline in Distribution segment revenues, which traditionally generate lower gross profit margins than the Oilfield operations, served to mask the margin deterioration reported in the Oilfield segment. For the nine-month period gross profit totaled $695.5 million, or 29 percent of revenues, less than one percentage point below the comparable period of the prior year. The majority of the $82.6 million decline was attributable to the Oilfield operations, reflecting a shift from higher to lower-margin products combined with reduced overall sales volumes.

Operating expenses decreased $10.5 million, or six percent from the third quarter of 2001. The operating expense reduction is attributable to cost reduction efforts initiated in response to the reduction in Western Hemisphere activity levels, reduced employee profit-sharing requirements and the elimination of goodwill amortization in accordance with SFAS No. 142. The operating expense reduction in the base business operations were partially offset by incremental expenses from acquired operations and the recognition of certain costs to consolidate the manufacturing and engineering functions within certain M-I operations. Operating expenses for the first nine months of 2002 decreased $9.2 million from amounts recorded in the prior year period. The reduction in operating expenses was driven by lower incentive-based requirements and, to a lesser extent, the elimination of goodwill amortization. Incremental expenses associated with acquisitions completed in the last twelve months of 2001 and the recognition of non-recurring charges in the first quarter of 2002 served to partially offset the overall expense decline.

Net interest expense, which represents interest expense less interest income, equaled $9.3 million in the third quarter of 2002. Net interest expense decreased $1.4 million from the prior year period as lower variable interest rates combined with a higher proportion of floating-rate borrowings more than offset the impact of increased debt levels associated with the financing of acquisitions. Net interest expense for the nine-month period declined $2.5 million attributable to the effect of lower interest rates on the Company's floating-rate borrowings.

The effective tax rate for the third quarter approximated 32 percent, which is lower than both the prior year's rate and the U.S. statutory rate. The effective tax rate is lower than the U.S. statutory rate due to the impact of M-I's U.S. partnership earnings for which the minority partner is directly responsible for their related income taxes. The Company properly consolidates the pre-tax income related to the minority partner's share of U.S. partnership earnings but excludes the related tax provision. The effective tax rate was 60 basis points below the prior year quarter due to the elimination of goodwill amortization, a portion of which was not deductible for tax purposes, partially offset by the lower proportion of M-I's U.S. partnership earnings. The effective tax rate for the nine-month period approximated 31 percent, two percentage points below the level reported in the comparable prior year period. The lower tax rate in the current nine-month period primarily reflects the discontinuance of amortizing goodwill, as noted above, and to a lesser extent, a shift in the geographic mix of pre-tax income towards lower rate jurisdictions.

Minority interests reflect the portion of the results of majority-owned operations, which are applicable to the minority interest partners. Minority interests was $6.8 million below amounts reported in the prior year quarter and $6.1 million lower than amounts reported in the first nine months of 2001. The variance in both periods is related to the lower profitability reported in the M-I operations, partially offset by the acquisition of a majority interest in United Engineering Services, which occurred in the fourth quarter of 2001.

LIQUIDITY AND CAPITAL RESOURCES

General

At September 31, 2002, cash and cash equivalents totaled $62.9 million. Cash flows provided by operations totaled $210.4 million in the first nine months of 2002 compared to $122.9 million in the prior year period. The improvement in operating cash flow is attributable to the significant decline in North American drilling activity, which favorably impacted working capital levels, particularly the required investment in accounts receivable and inventories.

Cash flows used in investing activities in the first nine months of 2002 totaled $83.9 million, which primarily consisted of investments in property, plant and equipment, net of cash proceeds arising from certain asset disposals, and to a lesser extent, funding associated with two acquisitions. This compares to cash used for investing activities of $172.7 million in the first nine months of 2001, with the difference primarily attributable to the lower level of acquisition activity during the current year period. Net capital expenditures also decreased year-over-year, contributing to the improvement, as lower drilling activity has led to a reduction in discretionary capital spending.

In the first nine months of 2002, cash generated from operations exceeded cash used in investing activities, resulting in an $81.4 million reduction in outstanding debt levels. Cash flows used in financing activities, which totaled $108.6 million for the nine months ended September 30, 2002, were also impacted by cash distributions to a minority partner which totaled $31.6 million during the period.

The Company's primary internal source of liquidity is cash flow generated from operations. Cash flow generated by operations is primarily influenced by the level of worldwide drilling activity, which affects profitability

levels and working capital requirements. Capacity under revolving credit agreements is also available, if necessary, to fund operating or investing activities. During the third quarter, the Company replaced its $200.0 million revolving credit facilities, which were due to expire in December 2002, with a three-year, $400.0 million facility provided by a syndicate of nine financial institutions. As of September 30, 2002, the Company had $346.0 million of funds available under U.S. revolving credit facilities to fund future operating or investing needs of its worldwide operations. The Company also has revolving credit facilities in place outside the United States, which are generally used to finance local operating needs. At September 30, 2002, borrowing capacity of $45.4 million was available under the non-U.S. borrowing facilities.

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

Contingencies

The Company is a party to various legal and environmental matters arising in the ordinary course of business. In the opinion of management, after considering established reserves and contractual indemnifications obtained, these matters are not expected to have a material adverse effect on the Company's consolidated financial position or results of operations. In the unlikely event that the parties providing the environmental indemnifications do not fulfill their obligations, such event could result in the recognition of up to $30.0 million related to indemnified liabilities, potentially impacting earnings and cash flows in future periods.

Critical Accounting Policies and Estimates

The discussion and analysis of financial condition and results of operations are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. The Company evaluates its estimates on an on-going basis, based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. In its 2001 Annual Report on Form 10-K, the Company has described the critical accounting policies that require management's most significant judgments and estimates. There have been no material changes in these critical accounting policies.

ITEM 3. QUALITATIVE AND QUANTITATIVE MARKET RISK DISCLOSURES

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

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 within 90 days prior to the filing of the Quarterly Report on Form 10-Q and have determined that such disclosure controls and procedures are effective.

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.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 2. CHANGES IN SECURITIES

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

10.1 Credit Agreement dated as of July 10, 2002 among Smith International, Inc. and M-I L.L.C., the Lenders from time to time party hereto and Comerica Bank, as Administrative Agent, ABN AMRO Bank N.V., as Syndication Agent, Den Norske Bank ASA, as Documentation Agent, J.P. Morgan Securities Inc., and Credit Lyonnais New York Branch, as Co-Lead Arrangers and Joint Bookrunners.

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

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

(b) Reports on Form 8-K

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

1. Form 8-K dated July 19, 2002 relating to a press release announcing the Company's results for the quarter ended June 30, 2002.

2. Form 8-K dated August 8, 2002 announcing the acquisition of Neyrfor-Weir turbodrilling operations.

3. Form 8-K dated August 14, 2002 submitting sworn statements by the Company's Principal Executive Officer and Principal Financial Officer in compliance with the Securities and Exchange Commission's order of June 27, 2002, requiring the submission of sworn statements pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934.

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 14, 2002 By: /s/ Doug Rock

Doug Rock
Chairman of the Board, Chief Executive
Officer, President and Chief Operating Officer

Date: November 14, 2002 By: /s/ Margaret K. Dorman

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

CERTIFICATION 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

I, Doug Rock, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Smith International, Inc;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

   a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

   b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

   c. presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

   a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

   b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 14, 2002

/s/ Doug Rock

Doug Rock
Chairman of the Board, Chief Executive Officer,
President and Chief Operating Officer

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CERTIFICATION 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

I, Margaret K. Dorman, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Smith International, Inc;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

   a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c. presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 14, 2002

/s/ Margaret K. Dorman

Margaret K. Dorman
Senior Vice President,
Chief Financial Officer and Treasurer

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EXHIBIT INDEX

Exhibit Number	Description
10.1	Credit Agreement dated as of July 10, 2002 among Smith International, Inc. and M-I L.L.C., the Lenders from time to time party hereto and Comerica Bank, as Administrative Agent, ABN AMRO Bank N.V., as Syndication Agent, Den Norske Bank ASA, as Documentation Agent, J.P. Morgan Securities Inc., and Credit Lyonnais New York Branch, as Co-Lead Arrangers and Joint Bookrunners.
99.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.
99.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.