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SMITH INTERNATIONAL INC
Form 10-Q
May 15, 2002

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 March 31, 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
(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

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requirements for the past 90 days. Yes [X] No ____

The number of shares outstanding of the Registrant's common stock as of May 9, 2002 was 50,664,435.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SMITH INTERNATIONAL, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS

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(Unaudited, in thousands except per share data)

	Three Months Ended March 31,	
	2002	2001
Revenues	\$827,377	\$865,311
Costs and expenses:		
Costs of revenues	585,875	619,222
Selling expenses	131,059	123,176
General and administrative expenses	35,995	33,496
Goodwill amortization	--	3,831
Total costs and expenses	752,929	779,725
Operating income	74,448	85,586
Interest expense, net	10,016	10,343
Income before income taxes and minority interests	64,432	75,243
Income tax provision	19,645	24,805
Income before minority interests	44,787	50,438
Minority interests	16,057	16,220
Net income	\$ 28,730	\$ 34,218
Basic earnings per share:		
Net income	\$ 0.58	\$ 0.69
Net income, excluding impact of goodwill amortization	\$ 0.58	\$ 0.73
Diluted earnings per share:		
Net income	\$ 0.58	\$ 0.68
Net income, excluding impact of goodwill amortization	\$ 0.58	\$ 0.72
Weighted average shares outstanding:		
Basic	49,420	49,844
Diluted	49,919	50,439

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

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

March 31,
2002

(Unaudited)

ASSETS

CURRENT ASSETS:

Cash and cash equivalents	\$ 43,935
Receivables, net	723,617
Inventories	644,567
Deferred tax assets, net	32,789
Prepaid expenses and other	39,459

Total current assets 1,484,367

Property, Plant and Equipment, net 490,197

Goodwill, net 577,124

Other Assets 163,564

Total Assets \$2,715,252
=====

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES:

Short-term borrowings and current portion of long-term debt	\$ 133,352
Accounts payable	262,509
Accrued payroll costs	56,056
Income taxes payable	43,319
Other	95,139

Total current liabilities 590,375

Long-Term Debt 534,420

Deferred Tax Liabilities 50,152

Other Long-Term Liabilities 54,469

Minority Interests 506,240

Commitments and Contingencies

STOCKHOLDERS' EQUITY:

Preferred stock, \$1 par value; 5,000 shares authorized; no shares issued or outstanding in 2002 or 2001	--
Common stock, \$1 par value; 150,000 shares authorized; 50,649 shares issued in 2002 (50,594 in 2001)	50,649
Additional paid-in capital	392,073
Retained earnings	591,184
Accumulated other comprehensive income	(25,180)
Less - Treasury securities, at cost; 1,192 common shares	(29,130)

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Total stockholders' equity	979,596
Total Liabilities and Stockholders' Equity	\$2,715,252

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

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

CASH FLOWS FROM OPERATING ACTIVITIES:

Net income	
Adjustments to reconcile net income to net cash provided by (used in) 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 (used in) 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	
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	
Proceeds from exercise of stock options	
Contributions from minority interest partners	

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Net cash provided by (used in) financing activities	
Effect of exchange rate changes on cash	
Decrease 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 financial statements.

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

1. BASIS OF PRESENTATION OF INTERIM FINANCIAL STATEMENTS

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

The unaudited consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments) which the Company considers necessary for a fair presentation of the interim periods. All significant intercompany balances and transactions have been eliminated in the accompanying financial statements. Results for the interim periods are not necessarily indicative of results for the year.

2. RECENT ACCOUNTING PRONOUNCEMENTS

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

On January 1, 2002, the Company adopted SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." The adoption of SFAS No. 144

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did not impact the Company's financial position or results of operations.

The Company has also adopted SFAS No. 142, "Goodwill and Other Intangible Assets," which addresses financial accounting and reporting for goodwill and other intangible assets. Effective January 1, 2002, goodwill and some intangibles are no longer amortized to earnings but are tested for impairment under SFAS No. 142. During the first quarter of 2002, the Company completed the transitional impairment test required by the standard, the results of which did not impact the Company's financial position or results of operations. If SFAS No. 142 had been adopted effective January 1, 2001, goodwill amortization of \$3.8 million, or \$2.2 million net of taxes and minority interests, for the quarter ended March 31, 2001 would not have been recognized.

3. NON-RECURRING CHARGES

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

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

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4. EARNINGS PER SHARE

Basic earnings per share ("EPS") is computed using the weighted average number of common shares outstanding during the period. Diluted EPS gives effect to the potential dilution of earnings 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 March 31,	
	2002	2001
Basic EPS:		
Net income.....	\$ 28,730 =====	\$ 34,218 =====
Weighted average number of common shares outstanding.....	49,420 =====	49,844 =====

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Basic EPS.....	\$ 0.58	\$ 0.69
	=====	=====
Diluted EPS:		
Net income.....	\$ 28,730	\$ 34,218
	=====	=====
Weighted average number of common shares outstanding.....	49,420	49,844
Dilutive effect of stock options.....	499	595
	-----	-----
	49,919	50,439
	=====	=====
Diluted EPS.....	\$ 0.58	\$ 0.68
	=====	=====

5. 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 March 31,	
	2002	2001
	-----	-----
Net income.....	\$ 28,730	\$ 34,218
Changes in unrealized fair value of derivatives, net..	35	(2,029)
Currency translation adjustments.....	(467)	(4,798)
	-----	-----
Comprehensive income.....	\$ 28,298	\$ 27,391
	=====	=====

As of March 31, 2002, accumulated other comprehensive income in the accompanying consolidated balance sheet includes \$23.3 million of cumulative currency translation losses, \$1.0 million of cumulative changes in unrealized fair value of derivatives and \$0.9 million of cumulative pension liability adjustments.

6. INVENTORIES

Inventories are stated at the lower of cost or market. Cost is determined by the first-in, first-out ("FIFO") method for the majority of the Company's inventories. The remaining inventories are costed under the last-in, first-out ("LIFO") or average cost methods. Inventory costs, consisting of materials, labor and factory overhead, are as follows (in thousands):

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	March 31, 2002	December 31, 2001
	-----	-----
Raw materials	\$ 48,096	\$ 50,821
Work-in-process	60,345	65,008
Products purchased for resale	159,153	154,787
Finished goods	402,119	406,143
	-----	-----
	669,713	676,759
Reserves to state certain U.S. inventories (\$305,040 in 2002 and \$300,868 in 2001, respectively) on a LIFO basis	(25,146)	(23,608)
	-----	-----
	\$ 644,567	\$ 653,151
	=====	=====

7. PROPERTY, PLANT AND EQUIPMENT

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

	March 31, 2002	December 31, 2001
	-----	-----
Land.....	\$ 30,595	\$ 28,390
Buildings.....	101,164	100,888
Machinery and equipment.....	485,959	482,045
Rental tools.....	246,862	243,913
	-----	-----
	864,580	855,236
Less-Accumulated depreciation.....	374,383	366,739
	-----	-----
	\$ 490,197	\$ 488,497
	=====	=====

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8. INDUSTRY SEGMENTS

The Company manufactures and markets premium products and services to the oil and gas exploration and production industry, the petrochemical industry and other industrial markets. The Company aggregates its operations into two reportable segments: Oilfield Products and Services and Distribution.

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

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	Three Months Ended March 31,	
	2002	2001
Revenues:		
Oilfield Products and Services.....	\$ 592,870	\$ 581,491
Distribution.....	234,507	283,820
	\$ 827,377	\$ 865,311
Operating income:		
Oilfield Products and Services.....	\$ 75,939	\$ 80,401
Distribution.....	68	6,771
General corporate.....	(1,559)	(1,586)
	\$ 74,448	\$ 85,586
	March 31, 2002	December 31, 2001
Goodwill:		
Oilfield Products and Services.....	\$ 540,083	\$ 537,509
Distribution.....	37,041	37,041
	\$ 577,124	\$ 574,550

The change in goodwill during the first quarter of 2002 reflects revisions to preliminary purchase price allocations.

9. CONTINGENCIES

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

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trends which may impact the future performance of the Company. This discussion should be read in conjunction with the Consolidated Financial Statements of the Company and the related notes thereto included elsewhere in this Form 10-Q and the Consolidated Financial Statements of the Company and the related notes thereto and the related "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in the Company's Annual Report on Form 10-K.

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

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

The year-over-year decline in the worldwide rig count relates to lower North American activity levels, particularly in the United States. Drilling activity in the U.S. market is primarily 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 increased eight percent due, in part, to declining natural gas production and a strengthening U.S. economy. The long-term outlook for exploration and production activity is favorable based upon expected growth in worldwide energy consumption; however, several factors including political and regional instabilities, commodity prices, oil and natural gas storage levels and the global economic environment could impact activity levels on a short-term basis.

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.

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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 March 3		
	2002		2001
	Amount	%	Amount
Revenues:			
M-I.....	\$ 396,656	48	\$ 392,102
Smith Bits.....	89,478	11	102,866
Smith Services.....	106,736	13	86,134
	592,870	72	581,134
Oilfield Products and Services.....	592,870	72	581,134
Distribution.....	234,507	28	283,134
	827,377	100	865,134
Total.....	\$ 827,377	100	\$ 865,134
Revenues by Area:			
United States.....	\$ 391,948	47	\$ 424,126
Canada.....	88,219	11	126,314
Non-North America.....	347,210	42	314,134
	827,377	100	865,134
Total.....	\$ 827,377	100	\$ 865,134
Operating Income:			
Oilfield Products and Services.....	\$ 75,939	13	\$ 80,616
Distribution.....	68	*	6,134
General corporate.....	(1,559)	*	(1,134)
	74,448	9	85,134
Total.....	\$ 74,448	9	\$ 85,134

	Three Months Ended March		
	2002	%	2001
	M-I Average Worldwide Rig Count:		
United States.....	877	39	1,134

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Canada.....	386	17	
Non-North America.....	1,001	44	1,
	-----	----	-----
Total.....	2,264	100	2,
	=====	====	=====

*not meaningful

Oilfield Products and Services Segment

Revenues

M-I provides drilling and completion fluid systems, engineering and technical services to the oil and gas industry through its M-I Fluids division. M-I's SWACO division manufactures and markets equipment and services for solids control, separation, pressure control, rig instrumentation and waste management. M-I reported revenues in the first quarter of 2002 of \$396.7 million, an increase of \$4.4 million from the first quarter of 2001. Incremental revenues from acquisitions completed in 2001 offset the effect of the decline in drilling activity from the prior year period. After excluding the impact of acquired operations, M-I's revenues in the first quarter of 2002 were seven percent below the prior year period, compared to a corresponding 20 percent decrease in the M-I worldwide rig count. The decline in base business revenues was attributable primarily to a reduction in offshore U.S. shelf-based drilling programs and lower Latin American activity levels, primarily Venezuela, Argentina and Brazil. M-I's base operation revenues compared favorably to the activity level decline due, in part, to an increase in revenues from the U.S. deepwater market and from new customer contracts in the Middle East region.

Smith Bits manufactures and sells three-cone and diamond drill bits primarily for use in the oil and gas industry. Smith Bits' revenues of \$89.5 million in the first quarter of 2002 were \$13.3 million, or 13 percent, below the first quarter of 2001. Excluding the effect of the mining bit operations contributed to an unconsolidated venture in the fourth quarter of 2001, revenues declined eight percent from the prior year quarter. The base business revenue reduction was driven by a 30 percent decline in the North American rig count, which impacted demand for petroleum three-cone drill bits. Smith Bits reported several, large international export sales in the Eastern Hemisphere during the first quarter of 2002, which partially offset the lower North American revenue base.

Smith Services manufactures and markets products and services used in the oil and gas industry for drilling, workover, well completion and well re-entry. Smith Services' revenues were \$106.7 million in the first quarter of 2002, an increase of \$20.3 million, or 23 percent, from the first quarter of 2001. Incremental revenues from operations acquired in the last half of 2001 contributed substantially all of the year-over-year improvement, with base business revenues increasing two percent over the previous year period. Increased tubular sales related to an alliance with a drill pipe manufacturer accounted for the majority of the year-over-year organic growth. The base business revenue increase also reflects the impact of higher sales of completion products and services, which rose approximately 30 percent from the prior year quarter due to new contracts and higher demand in markets outside the United

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States.

Operating Income

Operating income for the Oilfield Products and Services segment decreased \$4.5 million, or six percent, from the first quarter of 2001. The variance results from the inclusion of a \$7.0 million non-recurring charge during the first quarter of 2002, primarily related to establishing bad debt provisions in Argentina and recording employee termination costs. The impact of the charge was partially offset by lower goodwill amortization associated with the adoption of SFAS No. 142. Excluding the effect of the charge and goodwill amortization, adjusted operating income declined \$0.9 million from the prior year period to \$82.9 million. On an adjusted basis, operating margins were 14 percent of revenues in the first quarter of 2002, which is relatively consistent with the year ago period.

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 in the first quarter of 2002 of \$234.5 million, a decrease of \$49.3 million, or 17 percent, from the first quarter of 2001. The majority of the revenue decline was related to the C.E. Franklin Ltd. operations, which were impacted by lower Canadian activity levels and the completion of a large customer contract in the second half of 2001. The balance of the revenue decrease is attributable to Wilson's U.S. operations, where reported sales declined ten percent from the prior year quarter due to reduced drilling and completion activity, and lower customer spending in the refining and petrochemical markets.

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Operating Income

Wilson's operating income decreased \$6.7 million from the first quarter of 2001. The decline in operating income from the prior year period reflects the impact of the 17 percent decrease in revenues and, to a lesser extent, \$0.9 million of employee severance and restructuring costs incurred during the quarter. After excluding charges and goodwill amortization from the respective quarters, adjusted operating margins declined two percentage points from the prior year level primarily as a result of the impact of lower revenue levels on coverage of 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 March 31,			
2002		2001	
Amount	%	Amount	%

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Revenues	\$827,377	100	\$865,311	100
Gross profit	241,502	29	246,089	28
Operating expenses	167,054	20	160,503	18
Operating income	74,448	9	85,586	10
Interest expense, net	10,016	1	10,343	1
Income before income taxes and minority interests .	64,432	8	75,243	9
Income tax provision	19,645	2	24,805	3
Income before minority interests	44,787	6	50,438	6
Minority interests	16,057	2	16,220	2
Net income	\$ 28,730	4	\$ 34,218	4

Consolidated revenues declined \$37.9 million, or four percent, from the first quarter of 2001. The revenue decrease from the prior year quarter was concentrated in the Western Hemisphere attributable to the 28 percent reduction in drilling activity. Incremental revenues from operations acquired in the second half of 2001 partially offset the impact of the activity decline. Excluding the effect of acquired and divested operations, consolidated revenues decreased ten percent from the prior year quarter and compared to a 20 percent decline in the M-I worldwide rig count between the periods. Base business revenue growth in the Eastern Hemisphere regions, which, on a combined basis grew at twice the rate of the underlying market, also mitigated the impact of the revenue decrease in the Western Hemisphere.

Gross profit decreased \$4.6 million, or two percent, from the first quarter of 2001. The gross profit decline is attributable to the period-to-period reduction in Distribution segment revenues, which was partially offset by higher sales volumes and gross profits in the Oilfield Products and Services segment. Consolidated gross profit margins equaled 29 percent in the first quarter of 2002, an increase of one percentage point over the prior year level. The gross margin improvement reflects a higher proportion of oilfield operation revenues to total consolidated revenues and, to a lesser extent, a favorable shift in revenue mix within the distribution operations.

Operating expenses, consisting of selling, general and administrative expenses, increased \$6.6 million from the first quarter of 2001. First quarter 2002 operating expenses include \$7.5 million of non-recurring charges recognized primarily for estimated receivable write-downs in Argentina and employee termination costs. On a comparable

basis, excluding non-recurring charges and \$3.8 million of goodwill amortization from the first quarter of 2001, operating expenses increased \$2.9 million from the year ago quarter. The period-to-period increase is attributable

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to incremental operating expenses associated with 15 businesses acquired in 2001, and was partially offset by reduced employee incentive provisions. After excluding charges and goodwill amortization, operating expenses as a percentage of revenues increased one percentage point from the prior year level, reflecting the effect of the base business revenue decline on fixed cost coverage related to the overall sales and administrative functions.

Net interest expense, which represents interest expense less interest income, equaled \$10.0 million in the first quarter of 2002, which is \$0.3 million below the first quarter of 2001. While average debt levels increased approximately \$93.4 million from the prior year period in connection with the financing of acquisitions in 2001, the effect of higher borrowing levels was more than offset by a decline in interest rates.

The tax provision for the first quarter of 2002 equaled \$19.6 million, or 31 percent on an effective tax rate basis, which is below the prior year 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 in the first quarter of 2002 declined two percentage points from prior year period rate of 33 percent, reflecting a favorable shift in the pre-tax income to lower rate jurisdictions and the impact of no longer amortizing non-deductible goodwill.

Minority interests reflect the portion of the results of majority-owned operations, which are applicable to the minority interest partners. Minority interests decreased \$0.2 million from the first quarter of 2001 due to the lower profitability of the M-I joint venture partially offset by the impact of acquiring a majority interest in United Engineering Services in the second half of 2001.

LIQUIDITY AND CAPITAL RESOURCES

General

At March 31, 2002, cash and cash equivalents equaled \$43.9 million. Cash flows provided by operations totaled \$39.4 million in the first quarter of 2002 compared to the \$0.9 million utilized in the prior year period. The improvement in cash generated from operations was driven by the reduced investment in working capital, primarily accounts receivable and inventories.

Cash flows used in investing activities in the first quarter of 2002 totaled \$21.7 million, consisting of investments in property, plant and equipment, net of cash proceeds arising from certain asset disposals. In the first quarter of 2002, cash generated from operations exceeded cash used in investing activities, resulting in a \$19.7 million reduction of short-term borrowings and amounts outstanding under revolving credit agreements.

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. As of March 31, 2002, the Company had \$125.8 million of funds available under various revolving credit facilities in the United States for future operating or investing needs. The U.S. revolving credit facilities, which expire in December 2002, are expected to be renegotiated in the second quarter of 2002. The Company also has revolving credit facilities in place outside the United States, which are generally used to finance local operating needs. At March 31, 2002, borrowing capacity of \$53.3 million was available

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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.

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Contingencies

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

Recent Accounting Pronouncements

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

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

The Company has also adopted SFAS No. 142, "Goodwill and Other Intangible Assets," which addresses financial accounting and reporting for goodwill and other intangible assets. Effective January 1, 2002, goodwill and some intangibles are no longer amortized to earnings but are tested for impairment under SFAS No. 142. During the first quarter of 2002, the Company completed the transitional impairment test required by the standard, the results of which did not impact the Company's financial position or results of operations. If SFAS No. 142 had been adopted effective January 1, 2001, goodwill amortization of \$3.8 million, or \$2.2 million net of taxes and minority interests, for the quarter ended March 31, 2001 would not have been recognized.

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ITEM 3. QUALITATIVE AND QUANTITATIVE MARKET RISK DISCLOSURES

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

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 2. CHANGES IN SECURITIES

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

(b) Reports on Form 8-K

The Registrant filed a report on Form 8-K dated January 31, 2002, reporting under "Item 5. Other Events," related to a press release announcing the Company's results for the fourth quarter of 2001.

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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.

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Registrant

Date: May 15, 2002

By: /s/ Douglas L. Rock

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

Date: May 15, 2002

By: /s/ Margaret K. Dorman

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