SMITH INTERNATIONAL INC
Form 10-Q
August 09, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**
**FORM 10-Q**

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended June 30, 2006**

**OR**

o **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 R No £

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer R Accelerated Filer £ Non-Accelerated Filer £.

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes £ No R

The number of shares outstanding of the Registrant s common stock as of August 2, 2006 was 213,994,607.

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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 June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Revenues | $ 1,738,263 | $ 1,350,203 | $ 3,420,384 | $ 2,638,401 |
| Costs and expenses: | | | | |
| Costs of revenues | 1,193,250 | 951,065 | 2,348,768 | 1,853,851 |
| Selling expenses | 228,255 | 191,320 | 449,449 | 375,194 |
| General and administrative expenses | 71,298 | 52,436 | 139,589 | 105,802 |
| Total costs and expenses | 1,492,803 | 1,194,821 | 2,937,806 | 2,334,847 |
| Operating income | 245,460 | 155,382 | 482,578 | 303,554 |
| Interest expense | 14,685 | 10,992 | 27,521 | 21,332 |
| Interest income | (696) | (436) | (1,293) | (804) |
| Income before income taxes and minority interests | 231,471 | 144,826 | 456,350 | 283,026 |
| Income tax provision | 70,910 | 46,828 | 143,572 | 91,974 |
| Minority interests | 41,728 | 29,938 | 86,729 | 56,840 |
| Net income | $ 118,833 | $ 68,060 | $ 226,049 | $ 134,212 |
| Earnings per share: | | | | |
| Basic | $ 0.59 | $ 0.34 | $ 1.13 | $ 0.66 |
| Diluted | $ 0.59 | $ 0.33 | $ 1.12 | $ 0.66 |
| Weighted average shares outstanding: | | | | |
| Basic | 200,457 | 202,215 | 200,725 | 202,597 |
| Diluted | 202,162 | 204,027 | 202,371 | 204,636 |

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

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

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| **Assets** | | |
| **Current Assets:** | | |
| Cash and cash equivalents | $ 88,502 | $ 62,543 |
| Receivables, net | 1,366,755 | 1,200,289 |
| Inventories, net | 1,295,954 | 1,059,992 |
| Deferred tax assets, net | 38,697 | 48,467 |
| Prepaid expenses and other | 81,116 | 65,940 |
| Total current assets | 2,871,024 | 2,437,231 |
| Property, Plant and Equipment, net | 734,006 | 665,389 |
| Goodwill, net | 765,792 | 737,048 |
| Other Intangible Assets, net | 103,131 | 78,779 |
| Other Assets | 165,385 | 141,467 |
| Total Assets | $ 4,639,338 | $ 4,059,914 |
| **Liabilities and Stockholders Equity** | | |
| **Current Liabilities:** | | |
| Short-term borrowings and current portion of long-term debt | $ 164,371 | $ 133,650 |
| Accounts payable | 560,836 | 479,206 |
| Accrued payroll costs | 102,077 | 108,419 |
| Income taxes payable | 95,921 | 91,303 |
| Other | 129,385 | 120,575 |
| Total current liabilities | 1,052,590 | 933,153 |
| Long-Term Debt | 792,005 | 610,857 |
| Deferred Tax Liabilities | 120,681 | 107,838 |
| Other Long-Term Liabilities | 94,480 | 86,853 |
| Minority Interests | 825,511 | 742,708 |

| | | |
|---|---|---|
| Commitments and Contingencies (Note 13) | | |
| **Stockholders Equity:** | | |
| Preferred stock, $1 par value; 5,000 shares authorized; no shares issued or outstanding in 2006 or 2005 | | |
| Common stock, $1 par value; 250,000 shares authorized; 213,971 shares issued in 2006 (213,270 shares issued in 2005) | 213,971 | 213,270 |
| Additional paid-in capital | 409,332 | 383,695 |
| Retained earnings | 1,409,461 | 1,215,483 |
| Accumulated other comprehensive income | 20,152 | 6,901 |
| Less Treasury securities, at cost; 13,831 common shares in 2006 (12,301 common shares in 2005) | (298,845) | (240,844) |
| Total stockholders equity | 1,754,071 | 1,578,505 |
| Total Liabilities and Stockholders Equity | $ 4,639,338 | $ 4,059,914 |

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

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

| | Six Months Ended June 30, | |
|---|---|---|
| | 2006 | 2005 |
| **Cash flows from operating activities:** | | |
| Net income | $ 226,049 | $ 134,212 |
| *Adjustments to reconcile net income to net cash provided by operating activities, excluding the net effects of acquisitions:* | | |
| Depreciation and amortization | 68,625 | 56,953 |
| Minority interests | 86,729 | 56,840 |
| Deferred income tax provision | 12,055 | 7,908 |
| Provision for losses on receivables | 4,215 | 2,059 |
| Increase in LIFO inventory reserves | 14,948 | 22,211 |
| Gain on disposal of property, plant and equipment | (9,717) | (6,919) |
| Foreign currency translation losses (gains) | 1,075 | (331) |
| Share-based compensation expense | 13,385 | 1,313 |
| Equity earnings, net of dividends received | (6,399) | (1,557) |
| Gain on sale of operations | (5,930) | |
| *Changes in operating assets and liabilities:* | | |
| Receivables | (161,082) | (110,156) |
| Inventories | (247,057) | (124,363) |
| Accounts payable | 71,390 | 35,019 |
| Other current assets and liabilities | (12,089) | (13,207) |
| Other non-current assets and liabilities | (16,262) | (14,480) |
| Net cash provided by operating activities | 39,935 | 45,502 |
| **Cash flows from investing activities:** | | |
| Acquisitions, net of cash acquired | (58,019) | (4,667) |
| Purchases of property, plant and equipment | (113,965) | (71,323) |
| Proceeds from disposal of property, plant and equipment | 15,807 | 12,982 |
| Proceeds from sale of operations | 9,296 | |
| Net cash used in investing activities | (146,881) | (63,008) |
| **Cash flows from financing activities:** | | |
| Proceeds from issuance of long-term debt | 393,031 | 122,960 |
| Principal payments of long-term debt | (215,290) | (46,400) |
| Net change in short-term borrowings | 36,782 | (5,054) |
| Purchases of treasury stock | (58,001) | (68,766) |
| Proceeds from share-based compensation plans | 8,598 | 25,754 |
| Payment of common stock dividends | (28,105) | (12,227) |
| Debt issuance costs | (4,744) | |

| | | |
|---|---|---|
| Net cash provided by financing activities | 132,271 | 16,267 |
| Effect of exchange rate changes on cash | 634 | (748) |
| Increase (decrease) in cash and cash equivalents | 25,959 | (1,987) |
| Cash and cash equivalents at beginning of period | 62,543 | 53,596 |
| Cash and cash equivalents at end of period | $ 88,502 | $ 51,609 |
| **Supplemental disclosures of cash flow information:** | | |
| Cash paid for interest | $ 27,448 | $ 21,242 |
| Cash paid for income taxes | 123,830 | 82,754 |

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

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

**1. Basis of Presentation of Interim Financial Statements**

The accompanying unaudited consolidated condensed financial statements of Smith International, Inc. and subsidiaries (the Company ) were prepared in accordance with U.S. generally accepted accounting principles and applicable rules and regulations of the Securities and Exchange Commission (the Commission ) pertaining to interim financial information. These interim financial statements do not include all information or footnote disclosures required by generally accepted accounting principles for complete financial statements and, therefore, should be read in conjunction with the audited financial statements and accompanying notes included in the Company s 2005 Annual Report on Form 10-K and other current filings with the Commission. All adjustments which are, in the opinion of management, of a normal and recurring nature and are necessary for a fair presentation of the interim financial statements have been included.

Preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosed amounts of contingent assets and liabilities and the reported amounts of revenues and expenses. If the underlying estimates and assumptions, upon which the financial statements are based, change in future periods, actual amounts may differ from those included in the accompanying consolidated condensed financial statements.

In July 2005, the Company s Board of Directors approved a two-for-one stock split, which was effected in the form of a stock dividend. Stockholders of record as of August 5, 2005 were entitled to the dividend, which was distributed on August 24, 2005. Unless otherwise noted, all share and earnings per share amounts included in the accompanying consolidated condensed statements of operations for the three and six-month periods ended June 30, 2005, and accompanying notes have been restated for the effect of the stock split.

Management believes the consolidated condensed financial statements present fairly the financial position, results of operations and cash flows of the Company as of the dates indicated. The results of operations for the interim periods presented may not be indicative of results for the fiscal year.

**2. Recent Accounting Pronouncements**

From time to time, new accounting pronouncements are issued by the Financial Accounting Standards Board ( FASB ) which are adopted by the Company as of the specified effective date. Effective January 1, 2006, the Company has adopted Statement of Financial Accounting Standards ( SFAS ) No. 123r, Share-Based Payment, ( SFAS No. 123r ) using the modified prospective method. Based on stock options outstanding as of December 31, 2005, the adoption of SFAS No. 123r is expected to result in the recognition of $14.4 million of future compensation expense, of which $8.9 million is expected to be recorded during the 2006 fiscal year. See Note 11 for further disclosure regarding SFAS No. 123r.

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes , and prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken, or expected to be taken, on a tax return. This interpretation is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the provisions of FIN 48 and have not yet determined the impact, if any, on our consolidated condensed financial statements.

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

**3. Acquisitions and Dispositions**

During the six months ended June 30, 2006, the Company completed four acquisitions in exchange for aggregate cash consideration of $58.0 million. The consideration primarily relates to the purchase of Norwegian-based Epcon Offshore AS, completed in February 2006, which provides proprietary technology designed to optimize the removal of hydrocarbons from produced water.

These acquisitions have been recorded using the purchase method of accounting and, accordingly, the acquired operations have been included in the results of operations since the date of acquisition. The excess of the purchase price over the estimated fair value of the net assets acquired approximated $28.7 million and has been recorded as goodwill in the June 30, 2006 consolidated condensed balance sheet. The purchase price allocations related to these acquisitions are based on preliminary information and are subject to change when additional data concerning final asset and liability valuations is obtained; however, material changes in the preliminary allocations are not anticipated by management.

Subsequent to June 30, 2006, the Company completed the acquisition of Specialised Petroleum Services Group Limited ( SPS ) of Aberdeen, Scotland in exchange for cash consideration of approximately $165 million. See Note 14 to the consolidated condensed financial statements for additional discussion regarding SPS.

Additionally, during the three months ended June 30, 2006, the Company completed the disposition of its ownership interest in two oilfield business operations for aggregate cash proceeds of $9.3 million. These transactions resulted in an aggregate pre-tax gain of approximately $5.9 million and, $2.9 million net of taxes and minority interest, which has been reflected as a reduction to general and administrative expenses in the accompanying consolidated condensed statements of operations.

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

**4. Earnings Per Share**

Basic earnings per share ( EPS ) is computed using the weighted average number of common shares outstanding during the period. Diluted EPS gives effect to the potential dilution of earnings that could have occurred if additional shares were issued for stock option exercises and restricted stock awards under the treasury stock method. As of June 30, 2006, 12,378 outstanding employee stock options were excluded from the computation of diluted earnings per common share because they were anti-dilutive during the corresponding period. All employee stock options were included in the computation in the second quarter of 2005. The following schedule reconciles the income and shares used in the basic and diluted EPS computations (in thousands, except per share data):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| **Basic EPS:** | | | | |
| Net income | $ 118,833 | $ 68,060 | $ 226,049 | $ 134,212 |
| Weighted average number of common shares outstanding | 200,457 | 202,215 | 200,725 | 202,597 |
| Basic EPS | $ 0.59 | $ 0.34 | $ 1.13 | $ 0.66 |
| **Diluted EPS:** | | | | |
| Net income | $ 118,833 | $ 68,060 | $ 226,049 | $ 134,212 |
| Weighted average number of common shares outstanding | 200,457 | 202,215 | 200,725 | 202,597 |
| Dilutive effect of stock options and restricted stock units | 1,705 | 1,812 | 1,646 | 2,039 |
| | 202,162 | 204,027 | 202,371 | 204,636 |
| Diluted EPS | $ 0.59 | $ 0.33 | $ 1.12 | $ 0.66 |

**5. Inventories**

Inventories are stated at the lower of cost or market. Cost is determined using the average cost method for the majority of the Company s inventories; however, a significant portion of the Company s U.S.-based inventories are valued utilizing the last-in, first-out ( LIFO ) method. Inventory costs, consisting of materials, labor and factory overhead, are as follows (in thousands):

| | June 30, | December 31, |
|---|---|---|

| | 2006 | 2005 |
|---|---|---|
| Raw materials | $ 112,029 | $ 86,961 |
| Work-in-process | 135,493 | 111,399 |
| Products purchased for resale | 355,556 | 303,307 |
| Finished goods | 782,424 | 632,925 |
| | 1,385,502 | 1,134,592 |
| Reserves to state certain U.S. inventories (FIFO cost of $472,379 and $386,643 in 2006 and 2005, respectively) on a LIFO basis | (89,548) | (74,600) |
| | $ 1,295,954 | $ 1,059,992 |

During the first half of 2006, the Company recorded additional LIFO reserves of $14.9 million, primarily related to the revaluation of on-hand inventories to current standards, largely reflecting higher manufacturing costs in the Oilfield segment.

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### 6. Property, Plant and Equipment

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

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| Land | $ 39,647 | $ 37,753 |
| Buildings | 167,477 | 153,467 |
| Machinery and equipment | 622,560 | 587,808 |
| Rental tools | 529,197 | 472,913 |
| | 1,358,881 | 1,251,941 |
| Less-Accumulated depreciation | (624,875) | (586,552) |
| | $ 734,006 | $ 665,389 |

### 7. Goodwill and Other Intangible Assets

*Goodwill*

The following table presents goodwill on a segment basis as of the dates indicated, as well as changes in the account during the period shown. Beginning and ending goodwill balances are presented net of accumulated amortization of $53.6 million.

| | Oilfield Segment | Distribution Segment (in thousands) | Consolidated |
|---|---|---|---|
| Balance as of December 31, 2005 | $ 699,142 | $ 37,906 | $ 737,048 |
| Goodwill acquired | 26,430 | 2,314 | 28,744 |
| Balance as of June 30, 2006 | $ 725,572 | $ 40,220 | $ 765,792 |

*Other Intangible Assets*

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

| | June 30, 2006 | | | December 31, 2005 | | | |
|---|---|---|---|---|---|---|---|
| | Gross Carrying Amount | Accumulated Amortization | Net | Gross Carrying Amount | Accumulated Amortization | Net | Weighted Average Amortization Period (years) |
| Patents | $ 69,928 | $ 18,994 | $ 50,934 | $ 43,191 | $ 16,938 | $ 26,253 | 12.9 |
| License agreements | 31,231 | 8,819 | 22,412 | 29,308 | 7,181 | 22,127 | 10.3 |
| Non-compete agreements and trademarks | 32,097 | 14,592 | 17,505 | 29,150 | 12,414 | 16,736 | 9.4 |
| Customer lists and contracts | 17,282 | 5,002 | 12,280 | 17,282 | 3,619 | 13,663 | 11.5 |
| | $ 150,538 | $ 47,407 | $ 103,131 | $ 118,931 | $ 40,152 | $ 78,779 | 11.6 |

Amortization expense of other intangible assets was $3.9 million and $2.3 million for the three-month periods ended June 30, 2006 and 2005, respectively, and $7.3 million and $4.6 million for the six-month periods ended June 30, 2006 and 2005, respectively. Additionally, estimated future amortization expense is expected to range between $9.1 million and $15.6 million per year for the next five fiscal years.

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## 8. Debt

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

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| Current: | | |
| Short-term borrowings | $ 156,388 | $ 122,174 |
| Current portion of long-term debt | 7,983 | 11,476 |
| | $ 164,371 | $ 133,650 |
| Long-Term: | | |
| Notes, net of unamortized discounts | $ 658,429 | $ 386,959 |
| Revolving credit facilities | 138,500 | 232,700 |
| Term loans and other | 3,059 | 2,674 |
| | 799,988 | 622,333 |
| Less current portion of long-term debt | (7,983) | (11,476) |
| | $ 792,005 | $ 610,857 |

During the second quarter of 2006, the Company completed a public offering of $275.0 million of 6.00 percent Senior Notes (the Notes ) which mature in June 2016. The Notes have an effective interest rate of 6.11 percent and interest is payable semi-annually. The Company received net proceeds of $272.8 million from the offering, which was primarily used to repay indebtedness under the Smith U.S. revolving credit facility.

Principal payments of long-term debt for the twelve-month periods ending subsequent to June 30, 2007 are as follows (in thousands):

| | |
|---|---|
| 2008 | $ 158,531 |
| 2009 | 649 |
| 2010 | 29 |
| 2011 | 358,073 |
| Thereafter | 274,723 |
| | $ 792,005 |

## 9. Comprehensive Income

Comprehensive income includes net income and changes in the components of accumulated other comprehensive income during the periods presented. The Company s comprehensive income is as follows (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Net income | $ 118,833 | $ 68,060 | $ 226,049 | $ 134,212 |
| Changes in unrealized fair value of derivatives, net | 1,052 | (2,013) | 1,641 | (2,199) |
| Pension liability adjustments | | | | (476) |
| Currency translation adjustments | 11,067 | (7,149) | 11,610 | (13,266) |

| | | | | |
|---|---|---|---|---|
| Comprehensive income | $ 130,952 | $ 58,898 | $ 239,300 | $ 118,271 |

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

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| Currency translation adjustments | $ 24,758 | $ 13,148 |
| Unrealized fair value of derivatives | (535) | (2,176) |
| Pension liability adjustments | (4,071) | (4,071) |
| Accumulated other comprehensive income | $ 20,152 | $ 6,901 |

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**10. Employee Benefit Plans**

The Company maintains various noncontributory defined benefit pension plans covering certain U.S. and non-U.S. employees. In addition, the Company and certain subsidiaries have postretirement benefit plans which provide health care benefits to a limited number of current, and in some cases, future retirees. Net periodic benefit expense related to the pension and postretirement benefit plans, on a combined basis, approximated $1.0 million for each of the three-month periods ended June 30, 2006 and 2005, respectively, and $2.0 million for each of the six-month periods ended June 30, 2006 and 2005, respectively. Company contributions to the pension and postretirement benefit plans during 2006 are expected to total approximately $3.2 million.

**11. Long-Term Incentive Compensation**

The Company s Board of Directors and its stockholders have authorized a long-term incentive plan for the benefit of key employees.

Restricted stock units are considered compensatory awards and compensation expense related to these units is being recognized over the established vesting period in the accompanying consolidated condensed financial statements. However, prior to the mandatory adoption of SFAS No. 123r on January 1, 2006, companies could continue to apply Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB No. 25 ) and related interpretations in accounting for its stock option program. Accordingly, for periods ended prior to January 1, 2006, the Company elected to make pro forma footnote disclosures rather than recognizing the related compensation expense in the consolidated financial statements.

Had the Company elected to apply the accounting standards of SFAS No. 123, Accounting for Stock-Based Compensation, the Company s net income and earnings per share for the three and six-month periods ended June 30, 2005 would have approximated the pro forma amounts indicated below (in thousands, except per share data):

| | For the periods ended June 30, 2005 | |
|---|---|---|
| | Three Months | Six Months |
| Net income as reported | $ 68,060 | $ 134,212 |
| Add: Stock-based compensation expense included in reported income, net of related tax effect | 744 | 903 |
| Less: Total stock-based compensation expense determined under fair value methods, net of related tax effect | (3,062) | (5,483) |
| Net income, pro forma | $ 65,742 | $ 129,632 |
| Earnings per share: | | |
| As reported: | | |
| Basic | $ 0.34 | $ 0.66 |
| Diluted | 0.33 | 0.66 |
| Pro forma: | | |
| Basic | $ 0.33 | $ 0.64 |
| Diluted | 0.32 | 0.63 |

*Restricted Stock*

The restricted stock program consists of a combination of performance-based restricted stock units ( performance-based units ) and time-based restricted stock units ( time-based units ). The number of performance-based units issued under the program, which can range from zero to 115 percent of the target units granted, is solely dependent upon the return on equity achieved by the Company in the fiscal year subsequent to the award. Estimated compensation expense for the performance-based units, calculated as the difference between the market value and the exercise price, is recognized over the three-year vesting period. Compensation expense related to time-based units is recognized over a four-year vesting period.

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Compensation expense related to restricted stock awards totaled $4.4 million and $1.1 million for the three-month periods ended June 30, 2006 and 2005, respectively, and $8.8 million and $1.4 million for the six-month periods ended June 30, 2006 and 2005, respectively. A summary of the Company s restricted stock program is presented below:

| | Time-Based Units | Weighted Average Grant-Date Fair Value | Performance-Based Units | Weighted Average Grant-Date Fair Value | Total Restricted Stock Units | Aggregate Intrinsic Value[b] (in thousands) |
|---|---|---|---|---|---|---|
| Outstanding at December 31, 2005 | 239,340 | $ 34.00 | 1,264,251[a] | $ 36.28 | 1,503,591 | $ 55,371 |
| Granted | 1,167 | 41.83 | 5,980 | 41.66 | 7,147 | 298 |
| Forfeited | (7,132) | 32.67 | (30,477) | 37.52 | (37,609) | |
| Vested | (14,500) | 15.53 | (113,827) | 29.68 | (128,327) | 5,311 |
| Outstanding at June 30, 2006 | 218,875 | $ 35.31 | 1,125,927 | $ 36.95 | 1,344,802 | $ 59,512 |

(a) Reflects achievement of performance criteria for awards granted in December 2005.

(b) Reflects the value of outstanding awards at the end of the period determined using the stock price at the end of the period and the exercise price, if any, of the related award.

*Stock Options*

Stock 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. A summary of the Company s stock option program is presented below:

| | Shares Under Option | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life | Aggregate Intrinsic Value (in thousands) |
|---|---|---|---|---|
| Outstanding at December 31, 2005 | 4,751,824 | $ 18.37 | 7.0 | $ 89,067 |
| Granted | 12,378 | 38.79 | | |
| Forfeited | (64,054) | 20.44 | | |
| Exercised | (539,426) | 15.88 | | 13,925 |
| Outstanding at June 30, 2006 | 4,160,722 | $ 18.72 | 6.8 | $ 107,149 |
| Exercisable at June 30, 2006 | 2,167,008 | $ 16.85 | 6.3 | $ 59,846 |

Compensation expense recorded for stock options in the three and six-month periods ended June 30, 2006 was $2.3 million, and $4.6 million, respectively. The pro forma net income and earnings per share data disclosed for the comparable 2005 period has been determined as if the Company had accounted for its employee stock-based compensation program under the fair value method of SFAS No. 123. The Company used an open form (lattice) model to determine the fair value of options granted during 2006 and 2005, and accordingly, calculate the stock-based compensation expense. The fair value and assumptions used for the periods ended June 30, are as follows:

| | 2006 | 2005 |
|---|---|---|
| Fair value of stock options granted | $11.92 | $8.53 |
| Expected life of option (years) | 5.0 | 5.0 |
| Expected stock volatility | 31.0% | 31.0% |
| Expected dividend yield | 0.8% | 0.2% |
| Risk-free interest rate | 4.3% | 4.0% |

*Share-based Compensation Expense*

The total unrecognized share-based compensation expense, consisting of restricted stock and stock options, for awards outstanding as of June 30, 2006 was $48.8 million and, net of taxes and minority interests, approximately $30.2 million, which will be recognized over a weighted-average period of 1.3 years.

**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 SWACO, Smith Technologies and Smith Services. The Distribution segment includes the Wilson business unit. The following table presents financial information for each reportable segment and geographical revenues on a consolidated basis (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Revenues: | | | | |
| Oilfield Products and Services | $ 1,277,104 | $ 969,003 | $ 2,488,712 | $ 1,879,164 |
| Distribution | 461,159 | 381,200 | 931,672 | 759,237 |
| | $ 1,738,263 | $ 1,350,203 | $ 3,420,384 | $ 2,638,401 |
| Revenues by Area: | | | | |
| United States | $ 815,090 | $ 631,174 | $ 1,558,401 | $ 1,202,136 |
| Canada | 178,164 | 123,298 | 447,051 | 314,956 |
| North America | 993,254 | 754,472 | 2,005,452 | 1,517,092 |
| Latin America | 134,671 | 115,039 | 259,168 | 229,273 |
| Europe/Africa | 384,467 | 296,682 | 728,838 | 555,347 |
| Middle East | 155,014 | 124,266 | 290,634 | 227,706 |
| Far East | 70,857 | 59,744 | 136,292 | 108,983 |
| Non-North America | 745,009 | 595,731 | 1,414,932 | 1,121,309 |
| | $ 1,738,263 | $ 1,350,203 | $ 3,420,384 | $ 2,638,401 |
| Operating Income: | | | | |
| Oilfield Products and Services | $ 231,948 | $ 145,876 | $ 451,743 | $ 283,732 |
| Distribution | 22,206 | 14,044 | 48,232 | 27,561 |
| General corporate | (8,694) | (4,538) | (17,397) | (7,739) |
| | $ 245,460 | $ 155,382 | $ 482,578 | $ 303,554 |

**13. Commitments and Contingencies**

*Standby Letters of Credit*

In the normal course of business with customers, vendors and others, the Company is contingently liable for performance under standby letters of credit and bid, performance and surety bonds. Certain of these outstanding instruments guarantee payment to insurance companies with respect to certain liability coverages of the Company s insurance captive. Excluding the impact of these instruments, for which $23.2 million of related liabilities are reflected in the accompanying consolidated condensed balance sheet, the Company was contingently liable for approximately $49.9 million of standby letters of credit and bid, performance and surety bonds at June 30, 2006.

Management does not expect any material amounts to be drawn on these instruments.

*Litigation*

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

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

In August 1998, the Company was added as a defendant in a First Amended Petition filed in the 15th Judicial District Court, Parish of Lafayette, Louisiana entitled *Rose Dove Egle v. John M. Egle, et al.* In the amended petition, the plaintiffs alleged that, due to an improper conveyance of ownership interest by the Tri-Tech majority partner prior to the Transaction, Smith purchased a portion of its equity interest from individuals who were not legally entitled to their Tri-Tech shares. The suit was tried in the first quarter of 2004, and a jury verdict of approximately $4.8 million was rendered in favor of the plaintiffs. The Company has appealed the verdict and does not anticipate a ruling until the first quarter of 2007. Based upon the facts and circumstances and the opinion of outside legal counsel, management believes that an unfavorable outcome on this matter is not probable at this time. Accordingly, the Company has not recognized a loss provision in the accompanying consolidated condensed financial statements.

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*Other*

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

*Environmental*

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

As of June 30, 2006, the Company s environmental reserve totaled $9.4 million. This amount reflects the future undiscounted estimated exposure related to identified properties, without regard to indemnifications from former owners. While actual future environmental costs may differ from estimated liabilities recorded at June 30, 2006, the Company does not believe that these differences will have a material impact on the Company s financial position or results of operations.

During the first quarter of 2006, the Company settled a pending legal action which sought to clarify certain contractual provisions of an environmental indemnification provided by M-I SWACO s former owners. The two parties executed a settlement agreement whereby the former owners agreed to pay an outstanding receivable owed to the Company, assume all environmental liabilities associated with two identified sites and reimburse the Company for certain future environmental remediation costs. The impact of the settlement, which was recorded in the first quarter of 2006, was not material to the Company s financial condition or results of operations as of or for the six months ended June 30, 2006.

**14. Subsequent Event**

In August 2006, M-I SWACO acquired SPS of Aberdeen, Scotland in exchange for cash consideration of approximately $165 million. The acquired operations, which provide well-bore cleaning technology for critical well applications, reported revenues of approximately $38 million for the six months ended June 30, 2006. The transaction was funded with borrowings under the Company s existing revolving credit facilities.

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

### General

The following Management s Discussion and Analysis of Financial Condition and Results of Operations is provided to assist readers in understanding the Company s financial performance during the periods presented and significant trends which may impact the future performance of the Company. This discussion should be read in conjunction with the consolidated condensed financial statements of the Company and the related notes thereto included elsewhere in this Form 10-Q and the Company s 2005 Annual Report on Form 10-K.

### Company Products and Operations

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

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

Capital investment by energy companies is largely divided into two markets, which vary greatly in terms of primary business drivers and associated volatility levels. North American drilling activity is primarily influenced by natural gas fundamentals, with approximately 85 percent of the current rig count focused on natural gas finding and development activities. Conversely, drilling in areas outside of North America is more dependent on crude oil fundamentals, which influence over three-quarters of international drilling activity. Historically, business in markets outside of North America has proved to be less volatile as the high cost E&P programs in these regions are generally undertaken by major oil companies, consortiums and national oil companies as part of a longer-term strategic development plan. Although over half of the Company s consolidated revenues were generated in North America during the second quarter of 2006, Smith s profitability was largely dependent upon business levels in markets outside of North America. The Distribution segment, which accounts for approximately 27 percent of consolidated revenues and primarily supports a North American customer base, serves to distort the geographic revenue mix of the Company s Oilfield segment operations. Excluding the impact of the Distribution operations, 56 percent of the Company s second quarter 2006 revenues were generated in markets outside of North America.

### Business Outlook

Near-term drilling activity will largely be influenced by the seasonal recovery in Canada, supported by a significant increase in the number of Canadian land-based drilling projects from the levels experienced in the second quarter of 2006. And, drilling activity in markets outside of Canada is expected to increase modestly throughout the remainder of the year as exploration and production companies continue to invest in large projects in the Eastern Hemisphere market. Tropical weather disturbances are, however, typically experienced in the Gulf of Mexico during the third calendar quarter which influences the level of planned drilling programs and, in certain circumstances, may result in the curtailment of some drilling operations in the revenue-intensive U.S. offshore market. Although a number of factors impact drilling activity levels, our business 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. A significant deterioration in the global economic environment could adversely impact worldwide drilling activity and the future financial results of the Company.

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**Forward-Looking Statements**

This document contains forward-looking statements within the meaning of the Section 21E of the Securities Exchange Act of 1934, as amended, concerning, among other things, our outlook, financial projections and business strategies, all of which are subject to risks, uncertainties and assumptions. These forward-looking statements are identified by their use of terms such as anticipate, believe, could, estimate, expect, project and similar terms. These statem based on certain assumptions and analyses that we believe are appropriate under the circumstances. Such statements are subject to, among other things, general economic and business conditions, the level of oil and natural gas exploration and development activities, global economic growth and activity, political stability of oil-producing countries, finding and development costs of operations, decline and depletion rates for oil and natural gas wells, seasonal weather conditions, industry conditions, changes in laws or regulations and other risk factors outlined in the Company s Form 10-K for the fiscal year ended December 31, 2005, and Item 1A. of this Form 10-Q, many of which are beyond the control of the Company. Should one or more of these risks or uncertainties materialize, or should the assumptions prove incorrect, actual results may differ materially from those expected, estimated or projected. Our management believes these forward-looking statements are reasonable. However, you should not place undue reliance on these forward-looking statements, which are based only on our current expectations. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to publicly update or revise any of them in light of new information, future events or otherwise.

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**Results of Operations**

*Segment Discussion*

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

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | 2006 | | 2005 | |
| | Amount | % | Amount | % | Amount | % | Amount | % |
| ***Financial Data:*** | | | | | | | | |
| *(dollars in thousands)* | | | | | | | | |
| **Revenues:** | | | | | | | | |
| M-I SWACO | $ 849,134 | 49 | $ 659,971 | 49 | $ 1,651,684 | 48 | $ 1,278,517 | 48 |
| Smith Technologies | 186,985 | 10 | 137,681 | 10 | 366,413 | 11 | 279,905 | 11 |
| Smith Services | 240,985 | 14 | 171,351 | 13 | 470,615 | 14 | 320,742 | 12 |
| Oilfield Products and Services | 1,277,104 | 73 | 969,003 | 72 | 2,488,712 | 73 | 1,879,164 | 71 |
| Wilson | 461,159 | 27 | 381,200 | 28 | 931,672 | 27 | 759,237 | 29 |
| Total | $ 1,738,263 | 100 | $ 1,350,203 | 100 | $ 3,420,384 | 100 | $ 2,638,401 | 100 |
| **Geographic Revenues:** | | | | | | | | |
| United States: | | | | | | | | |
| Oilfield Products and Services | $ 481,287 | 28 | $ 344,965 | 26 | $ 925,509 | 27 | $ 662,020 | 25 |
| Distribution | 333,803 | 19 | 286,209 | 21 | 632,892 | 19 | 540,116 | 21 |
| Total United States | 815,090 | 47 | 631,174 | 47 | 1,558,401 | 46 | 1,202,136 | 46 |
| Canada: | | | | | | | | |
| Oilfield Products and Services | 75,336 | 4 | 49,444 | 4 | 191,669 | 6 | 136,575 | 5 |
| Distribution | 102,828 | 6 | 73,854 | 5 | 255,382 | 7 | 178,381 | 7 |
| Total Canada | 178,164 | 10 | 123,298 | 9 | 447,051 | 13 | 314,956 | 12 |
| Non-North America: | | | | | | | | |
| Oilfield Products and Services | 720,481 | 41 | 574,594 | 42 | 1,371,534 | 40 | 1,080,569 | 41 |
| Distribution | 24,528 | 2 | 21,137 | 2 | 43,398 | 1 | 40,740 | 1 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Total Non-North America | 745,009 | 43 | 595,731 | 44 | 1,414,932 | 41 | 1,121,309 | 42 |
| Total Revenue | $ 1,738,263 | 100 | $ 1,350,203 | 100 | $ 3,420,384 | 100 | $ 2,638,401 | 100 |
| **Operating Income:** | | | | | | | | |
| Oilfield Products and Services | $ 231,948 | 18 | $ 145,876 | 15 | $ 451,743 | 18 | $ 283,732 | 15 |
| Distribution | 22,206 | 5 | 14,044 | 4 | 48,232 | 5 | 27,561 | 4 |
| General Corporate | (8,694) | * | (4,538) | * | (17,397) | * | (7,739) | * |
| Total | $ 245,460 | 14 | $ 155,382 | 12 | $ 482,578 | 14 | $ 303,554 | 12 |
| ***Market Data:*** | | | | | | | | |
| **Average Worldwide Rig Count:** [(1)] | | | | | | | | |
| United States | 1,867 | 53 | 1,641 | 53 | 1,837 | 51 | 1,595 | 50 |
| Canada | 258 | 8 | 211 | 7 | 417 | 11 | 352 | 11 |
| Non-North America | 1,377 | 39 | 1,264 | 40 | 1,365 | 38 | 1,240 | 39 |
| Total | 3,502 | 100 | 3,116 | 100 | 3,619 | 100 | 3,187 | 100 |
| Onshore | 2,972 | 85 | 2,596 | 83 | 3,092 | 85 | 2,680 | 84 |
| Offshore | 530 | 15 | 520 | 17 | 527 | 15 | 507 | 16 |
| Total | 3,502 | 100 | 3,116 | 100 | 3,619 | 100 | 3,187 | 100 |
| **Average Commodity Prices:** | | | | | | | | |
| Crude Oil ($/Bbl) [(2)] | $ 70.72 | | $ 53.16 | | $ 67.13 | | $ 51.66 | |
| Natural Gas ($/mcf) [(3)] | $ 6.65 | | $ 6.95 | | $ 7.24 | | $ 6.73 | |

(1) *Source: M-I SWACO.*

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

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

* *not meaningful*

*Oilfield Products and Services Segment*

*Revenues*

M-I SWACO primarily provides drilling and completion fluid systems, engineering and technical services to the oil and gas industry. Additionally, these operations provide oilfield production chemicals and manufacture and market equipment and services used for solids-control, particle separation, pressure control, rig instrumentation and waste-management. M-I SWACO s operations are significantly influenced by spending in markets outside of North America, which contributes approximately two-thirds of the unit s revenues, and by its exposure to the U.S. offshore market, which constitutes approximately 10 percent of the revenue base. U.S. offshore drilling programs, which account for approximately three percent of the worldwide rig count, are generally more revenue-intensive than land-based projects due to the complex nature of the related drilling environment. M-I SWACO s revenues totaled $849.1 million for the second quarter of 2006, an increase of 29 percent above the prior year period. The majority of the revenue increase was generated in markets outside of North America, where base revenues grew 25 percent, largely reflecting new contract awards, higher customer spending in the offshore markets of Europe/Africa and, to a lesser extent, an increase in underlying activity levels. North American revenues grew 34 percent above the prior year level, largely attributable to increased exploration and production spending related to land-based drilling programs and a favorable shift in the deepwater market customer mix. For the six-month period, M-I SWACO reported revenues of approximately $1.65 billion, a 29 percent increase over the amount reported in the first six months of 2005. Approximately 60 percent of the revenue increase was, again, generated in markets outside of North America, primarily the North Sea, Middle East and West Africa regions, reflecting new contract awards and increased customer activity in the revenue-intensive offshore market. North American revenues were 33 percent above the comparable prior year amount attributable to increased exploration and production spending on land-based drilling programs, price increases implemented in the last half of 2005 and a favorable customer mix in the U.S. offshore market.

Smith Technologies designs, manufactures and sells three-cone drill bits, diamond drill bits and turbines for use in the oil and gas industry. Due to the nature of its product offerings, revenues for these operations typically correlate more closely to the rig count than any of the Company s other businesses. Moreover, Smith Technologies has the highest North American revenue exposure of the Oilfield segment units driven, in part, by the significance of its Canadian operations. Accordingly, the seasonal Canadian drilling decline, which occurs in the second quarter, adversely impacts the unit s financial performance. Smith Technologies reported revenues of $187.0 million for the quarter ended June 30, 2006, an increase of 36 percent over the comparable prior year period. Approximately two-thirds of the year-over-year revenue growth was reported in North America, where sales volumes grew at more than twice the rate of the underlying change in rig count. The North American revenue increase was attributable to a combination of higher land-based drilling activity, increased market penetration, influenced in part by new product introductions, and the impact of price increases initiated over the past 12-month period. Revenues generated in markets outside North America grew 29 percent, comparing favorably to the corresponding change in activity levels, largely due to increased demand for diamond bits and continued market penetration of the turbodrill turbine product line. For the six-month period, Smith Technologies reported revenues of $366.4 million, a 31 percent improvement over the comparable period of 2005, influenced by the increase in worldwide activity levels. Approximately 75 percent of the revenue growth was generated in the Western Hemisphere, driven by increased demand for diamond drill bits and improved pricing in the premium North American market and, to a lesser extent, higher sales volumes of the turbodrill turbine product line.

Smith Services manufactures and markets products and services used in the oil and gas industry for drilling, work-over, well completion and well re-entry. Revenues for Smith Services are evenly distributed between North America and the international markets and are heavily influenced by the complexity of drilling projects, which drive demand for a wider range of its product offerings. For the quarter ended June 30, 2006, Smith Services revenues totaled $241.0 million, 41 percent above the prior year period. The year-over-year revenue growth was influenced, in part, by increased demand for tubular products, primarily in the U.S. market. Excluding the impact of tubular product sales, which are not highly correlated to drilling activity, business volumes increased 29 percent above the prior year period. The improvement was driven by higher worldwide exploration and production spending and strong demand for remedial product and service lines, impacted by the introduction of new sizes of the premium RHINO® Reamer downhole tool and the introduction of this tool into new geographic markets. For the first half of 2006, Smith Services reported revenues of $470.6 million, a 47 percent increase from the comparable prior year period. Excluding the impact of increased tubular sales volumes, revenues were 30 percent above the level reported in the first six months of 2005. The revenue improvement largely reflects higher sales across all core product lines, driven by the general increase in global exploration and production spending levels.

*Operating Income*

Operating income for the Oilfield Products and Services segment was $231.9 million, or 18.2 percent of revenues, for the three months ended June 30, 2006. Segment operating margins were 310 basis points above the prior year period reflecting gross margin expansion, due to the impact of higher business volumes on fixed cost coverage and a favorable shift in business mix towards higher-margin product lines and geographic areas, and reduced operating expenses as a percentage of revenues. On an absolute dollar basis, second quarter 2006 operating income increased $86.1 million, reflecting the impact of a 32 percent increase in business volumes on gross profit, partially offset by growth in variable-based operating expenses, including additional investment in personnel and infrastructure to support the expanding business base. For the six-month period, Oilfield operating margins improved 3.1 percentage points, reflecting increased coverage of fixed sales and administrative costs and, to a lesser extent, gross margin expansion related to the impact of a favorable business mix period-to-period. On an absolute dollar basis, six-month operating income was $168.0 million above the comparable prior year period, attributable to the impact of higher revenue volumes on the segment s reported gross profit, partially offset by growth in variable-based operating expenses associated with the expanding business base.

*Distribution Segment*

*Revenues*

Wilson markets pipe, valves, fittings and mill, safety and other maintenance products to energy and industrial markets, primarily through an extensive network of supply branches in the United States and Canada. The segment has the most significant North American revenue exposure of any of the Company s operations with 95 percent of Wilson s second quarter 2006 revenues generated in those markets. Moreover, approximately 30 percent of Wilson s revenues relate to sales to the industrial and downstream energy sector, including petrochemical plants and refineries, whose spending is largely influenced by the general state of the U.S. economic environment. Additionally, certain customers in this sector utilize petroleum products as a base material and, accordingly, are adversely impacted by increases in crude oil and natural gas prices. Distribution revenues were $461.2 million for the second quarter of 2006, 21 percent above the comparable prior year period. Three-fourths of the year-over-year revenue growth was reported by the energy sector operations, largely influenced by increased North American drilling and completion activity levels. Industrial and downstream revenues grew 14 percent above the prior year level, reflecting the impact of increased project spending in the refining and petrochemical markets. In the first six months of 2006, Wilson reported revenues totaling $931.7 million, an increase of 23 percent from the first six months of 2005. The majority of the revenue variance from the prior year period was generated by the upstream energy operations, reflecting higher North American activity levels and the impact of new contract awards.

*Operating Income*

Operating income for the Distribution segment was $22.2 million, or 4.8 percent of revenues, for the quarter ended June 30, 2006. Segment operating income increased $8.2 million, or 58 percent, above the amount reported in the prior year period, equating to incremental operating margins of 10.2 percent. Incremental operating income was driven by year-over-year improvement reported in the energy sector operations attributable to increased coverage of fixed sales and administrative costs. The gross profit margin expansion reflects a reduced proportion of tubular business volumes and a lower expense ratio. On a year-to-date basis, Distribution operating margins improved 1.6 percentage points, again, reflecting the impact of gross margin expansion and lower operating expenses as a percentage of revenues. On an absolute dollar basis, segment operating income was $20.7 million above the amount reported in the first half of 2005. The operating income variance reflects the impact of higher revenue volumes on the segment s reported gross profit, partially offset by growth in variable-based operating expenses.

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*Consolidated Results*

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

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | 2006 | | 2005 | |
| | Amount | % | Amount | % | Amount | % | Amount | % |
| Revenues | $ 1,738,263 | 100 | $ 1,350,203 | 100 | $ 3,420,384 | 100 | $ 2,638,401 | 100 |
| Gross profit | 545,013 | 31 | 399,138 | 30 | 1,071,616 | 31 | 784,550 | 30 |
| Operating expenses | 299,553 | 17 | 243,756 | 18 | 589,038 | 17 | 480,996 | 18 |
| Operating income | 245,460 | 14 | 155,382 | 12 | 482,578 | 14 | 303,554 | 12 |
| Interest expense | 14,685 | 1 | 10,992 | 1 | 27,521 | 1 | 21,332 | 1 |
| Interest income | (696) | | (436) | | (1,293) | | (804) | |
| Income before income taxes and minority interests | 231,471 | 13 | 144,826 | 11 | 456,350 | 13 | 283,026 | 11 |
| Income tax provision | 70,910 | 4 | 46,828 | 4 | 143,572 | 4 | 91,974 | 4 |
| Minority interests | 41,728 | 2 | 29,938 | 2 | 86,729 | 2 | 56,840 | 2 |
| Net income | $ 118,833 | 7 | $ 68,060 | 5 | $ 226,049 | 7 | $ 134,212 | 5 |

Consolidated revenues were $1.7 billion for the second quarter of 2006, 29 percent above the prior year period. More than three-fourths of the revenue growth was attributable to increased demand for Oilfield segment product offerings. Oilfield segment revenues grew 32 percent year-over-year benefiting from higher business volumes in all key geographic markets, reflecting higher activity levels, new contract awards and additional customer spending primarily in the U.S., Europe/Africa and Middle East regions. The Distribution operations, influenced by a combination of increased North American drilling and completion activity and new contract awards, reported a 21 percent increase from the prior year quarter and contributed 20 percent of the consolidated revenue improvement. For the first half of 2006, consolidated revenues were $3.4 billion, 30 percent above the comparable 2005 period, with Oilfield segment business volumes contributing the majority of the revenue growth. Oilfield segment revenues rose 32 percent over amounts reported in the prior year period with the increase balanced between North American and non-North American markets. The revenue improvement reflects higher global activity levels and increased customer spending.

Gross profit totaled $545.0 million for the second quarter, 37 percent above the prior year period. Gross profit increased $145.9 million over the prior year quarter, primarily reflecting higher sales volumes in the Oilfield operations associated with improved worldwide activity levels. Gross profit margins for the second quarter of 2006 were 31 percent of revenues, 180 basis points above the margins reported in the comparable prior year period reflecting the impact of a decreased proportion of Distribution segment sales, which historically generate lower margins than the Oilfield operations. For the six-month period, gross profit totaled $1.1 billion, or 31 percent of revenues, 160 basis points above the gross profit margins reported in the comparable prior year period. Gross margins were, again, impacted by a decreased proportion of Distribution segment sales and, to a lesser extent, an increased proportion of offshore revenues. On an absolute dollar basis, gross profit was $287.1 million above the six-month period ended June 30, 2005, largely attributable to higher sales volumes in the Oilfield operations.

Operating expenses, consisting of selling, general and administrative expenses, increased $55.8 million from the prior year quarter; however, as a percentage of revenues, decreased 80 basis points from the prior year quarter. Improved fixed cost coverage in the sales and administrative functions accounted for the operating expense percentage decline.

The majority of the absolute dollar increase was attributable to variable-related costs associated with the improved business volumes, including investment in personnel and infrastructure to support the expanding business base. Compared to the first six months of 2005, operating expenses increased $108.0 million, primarily due to variable-related costs associated with the improved business volumes.

Net interest expense, which represents interest expense less interest income, equaled $14.0 million in the second quarter of 2006. Net interest expense increased $3.4 million and $5.7 million from the prior year quarter and first six months of 2005, respectively. The variance in both periods reflects higher average debt levels and, to a lesser extent, an increase in variable interest rates.

The effective tax rate for the second quarter approximated 31 percent, impacted by the settlement of a U.S. tax audit that resulted in the release of certain deferred tax reserves during the June 2006 quarter. Excluding the tax settlement, the effective rate approximated 33 percent, which was above the 32 percent effective rate reported in the prior year period, but below the U.S. statutory rate. The effective tax rate was lower than the U.S. statutory rate due to the impact of M-I SWACO s U.S. partnership earnings for which the minority partner is directly responsible for its related income taxes. The Company properly consolidates the pretax income related to the minority partner s share of U.S. partnership earnings but excludes the related tax provision. Excluding the impact of the tax settlement, the effective rate increased 30 basis points above the second quarter of 2005, attributable to a lower proportion of M-I SWACO s U.S. partnership earnings. On a year-to-date basis, the effective tax rate of 33 percent was comparable to the rate reported in the first half of 2005.

Minority interests reflect the portion of the results of majority-owned operations which are applicable to the minority interest partners. Minority interests was $11.8 million and $29.9 million above amounts reported in the prior year quarter and first half of 2005, respectively, due to the higher profitability of the M-I SWACO joint venture and, to a lesser extent, improved earnings reported by CE Franklin Ltd.

**Liquidity and Capital Resources**

*General*

At June 30, 2006, cash and cash equivalents equaled $88.5 million. During the first six months of 2006, the Company generated $39.9 million of cash flows from operations as compared to the $45.5 million generated in the comparable prior year period. The continued improvement in worldwide drilling activity has resulted in higher working capital levels, particularly the required investment in inventories and accounts receivable, which more than offset the impact of increased profitability levels in the first half of 2006.

During the first six months of 2006, cash flows used in investing activities totaled $146.9 million, consisting of amounts required to fund capital expenditures and, to a lesser extent, acquisitions. The Company invested $98.2 million in property, plant and equipment, net of cash proceeds arising from certain asset disposals. Acquisition funding, which primarily related to the purchase of Epcon Offshore AS, resulted in cash outflows of $58.0 million in the first half of 2006. The increase in cash used for investing activities as compared to the first six months of 2005 reflects the impact of higher acquisition funding period-to-period and additional capital spending, particularly increased investment in waste management rental equipment for markets outside of the United States.

Cash flows provided by financing activities totaled $132.3 million for the first half of 2006. Due to the higher business volumes, which impacted the required investment in working capital, cash flows from operations were not sufficient to fund investing activities, share repurchases under a stock buyback program and dividend payments, resulting in incremental borrowings of $214.5 million under existing credit facilities.

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. During the second quarter of 2006, the Company received net proceeds of $272.8 million from its June 2006 public debt offering, which was primarily used to repay indebtedness under the Smith U.S. revolving credit facility. Capacity under revolving credit agreements is also available, if necessary, to fund operating or investing activities. As of June 30, 2006, the Company had $138.5 million drawn and $4.5 million of letters of credit issued under its U.S. revolving credit facilities, resulting in $257.0 million of capacity available for future operating or investing needs. The Company also has revolving credit facilities in place outside of the United States, which are generally used to finance local operating needs. At June 30, 2006, the Company had available borrowing capacity of $79.5 million under the non-U.S. borrowing facilities.

The Company s external sources of liquidity include debt and equity financing in the public capital markets, if needed. The Company carries an investment-grade credit rating with recognized rating agencies, generally providing the Company with access to debt markets. The Company s overall borrowing capacity is, in part, dependent on maintaining compliance with financial covenants under the various credit agreements. As of June 30, 2006, the Company was well within the covenant compliance thresholds under its various loan indentures, as amended, providing the ability to access available borrowing capacity. Management believes funds generated by operations, amounts available under existing credit facilities and external sources of liquidity will be sufficient to finance capital expenditures and working capital needs of the existing operations for the foreseeable future.

On March 1, 2006, the Company s Board of Directors increased the quarterly cash dividend to $0.08 per share, beginning with the distribution paid April 14, 2006 to stockholders of record on March 15, 2006. The projected annual payout of approximately $65 million is expected to be funded with cash flows from operations and, if necessary, amounts available under existing credit facilities. The level of future dividend payments will be at the discretion of the Company s Board of Directors and will depend upon the Company s financial condition, earnings, cash flows, compliance with certain debt covenants and other relevant factors.

In October 2005, the Company s Board of Directors authorized a share buyback program that allows for the repurchase of up to 20.0 million shares of the Company s common stock, subject to regulatory issues, market considerations and other relevant factors. The Company repurchased $19.0 million of its common stock in the open market during the second quarter of 2006. Future repurchases under the program may be executed from time to time in the open market or in privately negotiated transactions and will be funded with cash flows from operations or amounts available under existing credit facilities.

In August 2006, M-I SWACO acquired Specialised Petroleum Services International Group Limited ( SPS ) of Aberdeen, Scotland in exchange for cash consideration of approximately $165 million. The transaction was funded with borrowings under the Company s existing revolving credit facilities. Management continues to evaluate opportunities to acquire products or businesses complementary to the Company s operations. Additional acquisitions, if they arise, may involve the use of cash or, depending upon the size and terms of the acquisition, may require debt or equity financing.

**Commitments and Contingencies**

*Standby Letters of Credit*

In the normal course of business with customers, vendors and others, the Company is contingently liable for performance under standby letters of credit and bid, performance and surety bonds. Certain of these outstanding instruments guarantee payment to insurance companies with respect to certain liability coverages of the Company s insurance captive. Excluding the impact of these instruments, for which $23.2 million of related liabilities are reflected in the accompanying consolidated condensed balance sheet, the Company was contingently liable for approximately $49.9 million of standby letters of credit and bid, performance and surety bonds at June 30, 2006. Management does not expect any material amounts to be drawn on these instruments.

*Litigation*

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

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

In August 1998, the Company was added as a defendant in a First Amended Petition filed in the 15th Judicial District Court, Parish of Lafayette, Louisiana entitled *Rose Dove Egle v. John M. Egle, et al.* In the amended petition, the plaintiffs alleged that, due to an improper conveyance of ownership interest by the Tri-Tech majority partner prior to the Transaction, Smith purchased a portion of its equity interest from individuals who were not legally entitled to their Tri-Tech shares. The suit was tried in the first quarter of 2004, and a jury verdict of approximately $4.8 million was rendered in favor of the plaintiffs. The Company has appealed the verdict and does not anticipate a ruling until the first quarter of 2007. Based upon the facts and circumstances and the opinion of outside legal counsel, management believes that an unfavorable outcome on this matter is not probable at this time. Accordingly, the Company has not recognized a loss provision in the accompanying consolidated condensed financial statements.

*Other*

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

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*Environmental*

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

As of June 30, 2006, the Company s environmental reserve totaled $9.4 million. This amount reflects the future undiscounted estimated exposure related to identified properties, without regard to indemnifications from former owners. While actual future environmental costs may differ from estimated liabilities recorded at June 30, 2006, the Company does not believe that these differences will have a material impact on the Company s financial position or results of operations.

During the first quarter of 2006, the Company settled a pending legal action which sought to clarify certain contractual provisions of an environmental indemnification provided by M-I SWACO s former owners. The two parties executed a settlement agreement whereby the former owners agreed to pay an outstanding receivable owed to the Company, assume all environmental liabilities associated with two identified sites and reimburse the Company for certain future environmental remediation costs. The impact of the settlement, which was recorded in the first quarter of 2006, was not material to the Company s financial condition or results of operations as of or for the six months ended June 30, 2006.

**Critical Accounting Policies and Estimates**

The discussion and analysis of financial condition and results of operations are based upon the Company s consolidated condensed financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. The Company evaluates its estimates on an ongoing basis, based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. In its 2005 Annual Report on Form 10-K, the Company has described the critical accounting policies that require management s most significant judgments and estimates. There have been no material changes in these critical accounting policies.

**Recent Accounting Pronouncements**

In December 2004, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 123r, Share-Based Payment ( SFAS No. 123r ), which replaces SFAS No. 123 Accounting for Stock-Based Compensation, and supersedes Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees. SFAS No. 123r provides for the inclusion of share-based compensation expense in the consolidated financial statements, which is determined based upon the grant date fair value of equity awards, and generally expensed over the service period of the related award. Effective January 1, 2006, the Company adopted SFAS No. 123r using the modified prospective method, resulting in the recognition of compensation expense for all unvested stock options totaling $14.4 million of future compensation expense, of which $8.9 million is expected to be recorded during the 2006 fiscal year.

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes , and prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken, or expected to be taken, on a tax return. This interpretation is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the provisions of FIN 48 and have not yet determined the impact, if any, on our consolidated condensed financial statements.

From time to time, new accounting pronouncements are issued by the FASB that are adopted by the Company as of the specified effective date. Unless otherwise discussed, management believes the impact of recently issued standards, which are not yet effective, will not have a material impact on the Company s consolidated condensed financial statements upon adoption.

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**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

The Company is exposed to certain market risks arising from transactions that are entered into in the normal course of business which are primarily related to interest rate changes and fluctuations in foreign exchange rates. During the reporting period, no events or transactions have occurred which would materially change the information disclosed in the Company s 2005 Annual Report on Form 10-K.

**Item 4. Controls and Procedures**

*Evaluation of disclosure controls and procedures.* The Company maintains disclosure controls and procedures designed to provide reasonable assurances that information required to be disclosed in our filings under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time frame specified in the Commission s rules and regulations. Our principal executive and financial officers have evaluated our disclosure controls and procedures and have determined that such disclosure controls and procedures are effective as of the end of the period covered by this report.

*Changes in internal control over financial reporting.* There has been no change in the Company s internal control over financial reporting during the quarter ended June 30, 2006 that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

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## PART II OTHER INFORMATION

### Item 1. Legal Proceedings

None.

### Item 1A. Risk Factors

As of the date of this filing, except as noted below, there have been no material changes in our Risk Factors as set forth in Item 1A to Part I of our Form 10-K for the year ended December 31, 2005.

The following risk factor is in addition to, and should be read in conjunction with, the risk factors disclosed in our 2005 Annual Report on Form 10-K:

***Our industry is experiencing more litigation involving claims of infringement of intellectual property rights.***

Over the past few years, our industry has experienced increased litigation related to the infringement of intellectual property rights. We, as well as certain of our competitors, have been named as defendants in various of these intellectual property matters, although we do not consider any pending or threatened claim to be material. These types of claims are typically costly to defend, involve monetary judgments that, in certain circumstances, are subject to being enhanced and are often brought in venues which have proved to be favorable to plaintiffs. If we are ultimately unsuccessful in defending alleged intellectual property claims, it could adversely impact our results of operations and cash flows.

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

During October 2005, the Company s Board of Directors approved a repurchase program that allows for the purchase of up to 20.0 million shares of the Company s common stock, subject to regulatory issues, market considerations and other relevant factors. During the second quarter of 2006, the Company repurchased 0.5 million shares of common stock under the program at an aggregate cost of $19.0 million. The acquired shares have been added to the Company s treasury stock holdings.

A summary of the Company s repurchase activity for the three months ended June 30, 2006 is as follows:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Program | Number of Shares that May Yet Be Purchased Under the Program |
|---|---|---|---|---|
| April 1 April 30 | | $ | | 18,921,200 |
| May 1 May 31 | 150,000 | 39.01 | 150,000 | 18,771,200 |
| June 1 June 30 | 350,000 | 37.57 | 350,000 | 18,421,200 |
| 2nd Quarter 2006 | 500,000 | $ 38.01 | 500,000 | 18,421,200 |

### Item 3. Defaults upon Senior Securities

None.

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

At the Annual Meeting of Stockholders on April 25, 2006, stockholders of the Company elected all nominated directors, approved the Smith International, Inc. Executive Officer Annual Incentive Plan, and ratified Deloitte & Touche LLP as independent registered public accountants for 2006 by the votes shown below.

| | For | Withheld |
|---|---|---|
| Election of Directors: | | |
| Robert Kelley | 171,879,926 | 7,344,774 |
| Doug Rock | 172,795,963 | 6,428,737 |

| | For | Against | Abstain |
|---|---|---|---|
| Approval of the Smith International, Inc. Executive Officer Annual Incentive Plan | 173,941,728 | 5,053,322 | 229,650 |
| Ratification of Deloitte & Touche LLP as independent registered public accountants for the Company for 2006 | 178,620,708 | 580,489 | 23,503 |

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**Item 5. Other Information**

None.

**Item 6. Exhibits**

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

| Exhibit Number | Description |
|---|---|
| 3.1 | Restated Certificate of Incorporation of the Company, dated July 26, 2005. Filed as Exhibit 3.4 to the Company s report on Form 10-Q for the quarter ended June 30, 2005 and incorporated herein by reference. |
| 3.2 | Restated Bylaws of the Company. Filed as Exhibit 3.3 to the Company s report on Form 10-K for the year ended December 31, 2004 and incorporated herein by reference. |
| 4.1 | Form of Senior Notes due 2016. Filed as Exhibit 4.1 to the Company s report on Form 8-K dated June 12, 2006 and incorporated herein by reference. |
| 10.1 | Smith International, Inc. Executive Officer Annual Incentive Plan. Filed as Exhibit 10.1 to the Company s report on Form 8-K dated April 25, 2006 and incorporated herein by reference. |
| 10.2 | Form of Change-of-Control Employment Agreement. Filed as Exhibit 10.2 to the Company s report on Form 8-K dated April 25, 2006 and incorporated herein by reference. |
| 10.3 | Form of Employment Agreement for Advisors. Filed as Exhibit 10.3 to the Company s report on Form 8-K dated April 25, 2006 and incorporated herein by reference. |
| 31.1* | Certification of Chief Executive Officer pursuant to Rule 13a-14 or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2* | Certification of Chief Financial Officer pursuant to Rule 13a-14 or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1** | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

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## SIGNATURES

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

SMITH INTERNATIONAL, INC.
Registrant

| | |
|---|---|
| Date: August 9, 2006 | By: /s/ Doug Rock<br>Doug Rock<br>Chairman of the Board, Chief Executive Officer,<br>President and Chief Operating Officer<br>(principal executive officer) |
| Date: August 9, 2006 | By: /s/ Margaret K. Dorman<br>Margaret K. Dorman<br>Senior Vice President,<br>Chief Financial Officer and Treasurer<br>(principal financial and accounting officer) |

## EXHIBIT INDEX

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