SMITH INTERNATIONAL INC
Form 10-K
February 29, 2008

Table of Contents

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

Form 10-K

(Mark One)

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

For the Fiscal Year Ended December 31, 2007

OR

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

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.)**
16740 East Hardy Road **Houston, Texas**	**77032**
(Address of principal executive offices)	**(Zip Code)**

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

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Each Exchange on Which Registered**
Common Stock, $1.00 par value	**New York Stock Exchange, Inc.**

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes þ No o.

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ.

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 þ No o.

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o Smaller reporting company o
(Do not check if a smaller reporting company)

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

The aggregate market value of the voting stock held by non-affiliates on June 30, 2007 was $11,592,318,768 (197,686,200) shares at the closing price on the New York Stock Exchange of $58.64. On June 30, 2007, 216,269,869 shares of common stock were outstanding. For this purpose all shares held by officers and directors and their respective affiliates are considered to be held by affiliates, but neither the Registrant nor such persons concede that they are affiliates of the Registrant.

There were 200,810,969 shares of common stock outstanding, net of shares held in Treasury, on February 22, 2008.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement related to the Registrant s 2008 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form.

TABLE OF CONTENTS

PART I

Item 1.	Business	2
Item 1A.	Risk Factors	10
Item 1B.	Unresolved Staff Comments	11
Item 2.	Properties	12
Item 3.	Legal Proceedings	13
Item 4.	Submission of Matters to a Vote of Security Holders	13

PART II

Item 5.	Market for the Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	13
Item 6.	Selected Financial Data	14
Item 7.	Management s Discussion and Analysis of Financial Condition and Results of Operations	15
Item 7A.	Quantitative and Qualitative Disclosures about Market Risk	25
Item 8.	Financial Statements and Supplementary Data	26
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	54
Item 9A.	Controls and Procedures	54
Item 9B.	Other Information	54

PART III

Item 10.	Directors, Executive Officers and Corporate Governance	55
Item 11.	Executive Compensation	55
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	55
Item 13.	Certain Relationships and Related Transactions, and Director Independence	55
Item 14.	Principal Accountant Fees and Services	55

PART IV

Item 15.	Exhibits and Financial Statement Schedules	56

First Amendment to Second Amended and Restated 1989 Long-Term Incentive Compensation Plan
Form of Restricted Stock Unit Agreement
Form of Performance-Based Restricted Stock Unit Agreement
Director Compensation Summary
Amended and Restated Executive Officer Annual Incentive Plan
Consent of Independent Registered Public Accounting Firm
Certification of CEO Pursuant to Section 302
Certification of CFO Pursuant to Section 302
Certification Pursuant to Section 906

Table of Contents

PART I

Item 1. *Business*

General

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

The Company was incorporated in the state of California in January 1937 and reincorporated under Delaware law in May 1983. The Company s executive offices are headquartered at 16740 East Hardy Road, Houston, Texas 77032 and its telephone number is (281) 443-3370. The Company s annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are made available free of charge on the Company s Internet website at www.smith.com as soon as reasonably practicable after the Company has electronically filed such material with, or furnished it to, the Securities and Exchange Commission. The Company s Corporate Governance Guidelines, Code of Business Conduct and Ethics and the charters of the Audit Committee, Compensation and Benefits Committee and Nominating and Corporate Governance Committee are also available on the Investor Relations section of the Company s Internet website. The Company intends to disclose on its website any amendments or waivers to its Code of Business Conduct and Ethics that are required to be disclosed pursuant to Item 5.05 of Form 8-K. Printed copies of these documents are available to stockholders upon request.

The Company s operations are aggregated into two reportable segments: Oilfield and Distribution. The Oilfield segment consists of three business units: M-I SWACO, a 60 percent-owned joint venture which provides drilling and completion fluid systems, engineering and technical services, oilfield production chemicals and manufactures and markets equipment and services used for solids-control, particle separation, pressure control, rig instrumentation and waste-management; Smith Technologies, which designs and manufactures three-cone and diamond drill bits, turbines and borehole enlargement tools; and Smith Services, which manufactures and markets products and services used for drilling, work-over, well completion and well re-entry operations. The Distribution segment consists of one business unit, Wilson, which markets pipe, valves and fittings as well as mill, safety and other maintenance products to energy and industrial markets.

Financial information regarding reportable segments and international operations appears in Management s Discussion and Analysis of Financial Condition and Results of Operations and in Note 15 of the Notes to Consolidated Financial Statements included elsewhere in this Form 10-K. Information related to business combinations appears in Note 2 of the Notes to Consolidated Financial Statements included elsewhere in this Form 10-K.

Business Operations

Oilfield Segment

M-I SWACO

Fluid Products and Services. Fluid product offerings, which account for approximately 60 percent of M-I SWACO s total revenues, include premium drilling fluids, reservoir drill-in fluids and other products and engineering services used in the development of oil and natural gas wells. Drilling fluids are used to cool and lubricate the bit during drilling operations, contain formation pressures, suspend and remove rock cuttings from the hole and maintain the stability of the wellbore. Engineering services are provided to ensure that the fluid products are applied effectively to optimize drilling operations. These services include recommending products and services during the well planning phase; monitoring drilling fluid properties; recommending adjustments during the drilling phase; and analyzing/benchmarking well results after completion of the project to improve the efficiencies of future wells.

M-I SWACO offers water-base, oil-base and synthetic-base drilling fluid systems. Water-base drilling fluids are the world s most widely utilized systems, having application in both land and offshore environments. Typically, these systems comprise an engineered blend of weighting materials used to contain formation pressures, and a broad range of chemical additives, designed to yield the specific drilling performance characteristics required for a given drilling project. Oil-base drilling fluids, which primarily are used to drill water-sensitive shales, reduce torque and drag and are widely used in areas where stuck pipe is likely to occur. In certain drilling areas of the world, oil-base systems exhibit comparably higher penetration rates when

Table of Contents

compared to water-base systems, significantly reducing time on location and overall drilling costs. Synthetic-base drilling fluids are used in drilling environments where oil-base fluids are environmentally prohibited and provide the performance benefits of oil-base systems. Synthetic-base systems are particularly advantageous in the deepwater environment. M-I SWACO also provides a comprehensive line of reservoir drill-in fluids which combine the high performance properties of a premium drilling fluid with minimal damaging characteristics of a brine completion fluid.

Fluid Competition. The major competitors in the worldwide drilling fluids market, which approximated $6.9 billion in 2007, are Halliburton Energy Services (a division of Halliburton Company (Halliburton)) and Baker Hughes Drilling Fluids (a division of Baker Hughes, Inc. (Baker Hughes)). While M-I SWACO and these companies supply a majority of the market, the drilling fluids industry is highly competitive, with a significant number of smaller, locally based competitors.

Generally competition for sales of drilling and completions fluids is based on a number of factors, including wellsite engineering services, product quality and availability, technical support, service response and price.

M-I SWACO Environmental Solutions Products and Services. M-I SWACO manufactures and markets equipment and services used for solids-control, particle separation, pressure control, rig instrumentation and waste-management to the worldwide drilling market. Environmental Solution product and service offerings account for approximately 20 percent of M-I SWACO s total revenues.

Solids-control equipment is used to remove drill cuttings from the fluid system, allowing the drilling fluid to be cleaned and recirculated. Solids are normally separated from the drilling fluid using one or a combination of the following: balanced elliptical and linear-motion shale shakers, desanders, desilters, hydroclones, mud cleaners and centrifuges. M-I SWACO designs, manufactures, sells and rents a comprehensive, proprietary line of this equipment for oil and gas drilling processes throughout the world. The Company is also a leading manufacturer and supplier of screens used in solids-control equipment for both oilfield and certain industrial markets. M-I SWACO complements its product offering by providing engineering and technical support to operators and drilling contractors from the planning stages of their projects through waste removal and site remediation.

Operators employ M-I SWACO-manufactured pressure-control equipment to drill in sour-gas and high-pressure zones. Well killing and high-pressure control drilling chokes, together with related operating consoles, are used in the drilling process during well kicks and well clean-up and testing operations. Degassers and mud gas separators are designed to remove and vent entrained gases, including toxic gases such as hydrogen sulfide and corrosive oxygen, from the drilling mud. This equipment reduces the risk of dangerous and costly blowouts caused by recirculating mud that contains natural gas. Key products in M-I SWACO s pressure control product line include the Mud D-Gasser® and Super Choke , both of which hold strong market positions as do the Super Mud Gas SeparatorÔ and the Super AutochokeÔ.

With drilling operations expanding into more environmentally sensitive areas, there has been increased focus on the effective collection, treatment and disposal of waste produced during the drilling of a well. M-I SWACO provides operators with solutions designed to minimize and treat drilling waste. The Company provides a suite of waste handling, minimization and management products and services, including the CleanCut® pneumatic conveyance system for collection and transportation of drill cuttings related to offshore drilling programs. M-I SWACO also provides rig vacuum systems for cuttings recovery, high-gravity force drying equipment for liquid/solid separation and cuttings slurification and re-injection processes for reducing haul-off waste. In addition, through the Thermal Phase Separation process, M-I SWACO provides operators a proven technology for maximizing the recovery of drilling fluids, while minimizing wastes. M-I SWACO s waste treatment services encompass a wide range of activities, including site assessment, drill cuttings injection, water treatment, pit closure and remediation, bioremediation, dewatering and thermal processing. The Company has established EnviroCenters® in Norway, Germany and the United States designed specifically for recovering, treating and recycling solid and liquid drilling wastes.

M-I SWACO Environmental Solutions Competition. M-I SWACO competes with Brandt/Rigtech (a subsidiary of National Oilwell Varco, Inc. (National-Oilwell Varco)) and Derrick/Oil Tools. Additionally, there are a number of regional suppliers that provide a limited range of equipment and services tailored for local markets. Competition is based on product availability, equipment performance, technical support and price.

M-I SWACO Wellbore Assurance Products and Services. Wellbore Assurance product offerings, which account for approximately 15 percent of M-I SWACO s total revenues, include completion fluids, completion tools and completion fluid filtration services. These offerings are used during the completion phase of the well to facilitate maximum production.

Table of Contents

Completion fluids (clear brines) are solids-free, clear-salt solutions that are non-damaging to the producing formation. Operators use these specially designed fluid systems in combination with a comprehensive range of specialty chemicals to control bottom-hole pressures, while meeting the specific corrosion inhibition, viscosity and fluid loss requirements necessary during the completion and workover phase of a well. These systems are specially engineered to maximize well production by minimizing formation damage that can be caused by solids-laden systems. M-I SWACO provides a complete line of completion fluids products, including low- and high-density brines, specialty chemicals, wellsite engineering and technical and laboratory support services.

Completion tools, also known as specialized tools, are used in the critical stage of displacing drilling fluids with completion fluids. The tools work in connection with completion fluids to promote a clean wellbore, facilitating the installation of essential hardware used in the completion process. M-I SWACO provides a broad range of tools including casing cleaning, debris recovery and circulating tools. Filtration services are used to remove solids from brine fluids during completion operations.

Wellbore Assurance Competition. The major competitors in the worldwide wellbore assurance market, which approximated $1.5 billion in 2007, are Baroid Completion Fluids (a division of Halliburton), Tetra Technologies, Inc. and Baker Hughes. Generally, competition is based on a number of factors including wellsite engineering services, product quality and availability, technical support, service response and price.

Oilfield Production Chemicals. M-I SWACO provides a line of oilfield specialty chemicals and related technical services through its Oilfield Production Chemical division. Oilfield production chemicals are used to enhance the flow of hydrocarbons from the wellbore by eliminating paraffin, scale and other byproducts encountered during the production process. Oilfield production chemicals are also used to protect piping and other equipment associated with the production, transportation and processing of oil and gas.

Production Chemical Competition. The major competitors in the worldwide oilfield production chemical market include Baker Petrolite (a division of Baker Hughes), Nalco Energy Services (a division of Nalco Company) and Champion Technologies, Inc. Generally, competition is based on product quality, product performance, technical support and price.

Smith Technologies

Products and Services. Smith Technologies is a worldwide leader in the design, manufacture and marketing of drill bits primarily used in drilling oil and natural gas wells. In addition, Smith Technologies is a leading provider of borehole enlargement tools and downhole turbine drilling products (referred to as turbodrills) and services that enhance the operating performance of petroleum drill bits in certain applications. Smith Technologies product offerings are designed principally for the premium market segments where faster drilling rates and greater footage drilled provide significant economic benefits in reducing the total cost of a well.

Smith Technologies designs, manufactures and markets three-cone drill bits for the petroleum industry, ranging in size from 3 1/2 to 32 inches in diameter. Three-cone bits work by crushing and shearing the rock formation as the bit is turned. These three-cone bits comprise two major components the body and the cones, which contain different types of pointed structures referred to as cutting structures or teeth. The cutting structures are either an integral part of the steel cone with a hardmetal-applied surface (referred to as milled tooth) or made of an inserted material (referred to as insert), which is usually tungsten carbide. The Company also produces three-cone drill bits in which the tungsten carbide insert is coated with polycrystalline diamond. In certain formations, bits produced with diamond-enhanced inserts last longer and increase penetration rates, which substantially decreases overall drilling costs. For the year ended December 31, 2007, three-cone drill bits accounted for approximately 50 percent of the Company s total drill bit sales.

In addition, Smith Technologies designs, manufactures and markets diamond drill bits. Diamond bits consist of a single body made of either a matrix powder alloy or steel. The cutting structures of diamond bits consist of either polycrystalline diamond cutters, which are brazed on the bit, or natural or synthetic diamonds, which are impregnated in the bit. These bits, which range in size from 2 3/4 to 26 inches in diameter, work by shearing the rock formation with a milling action as the bit is turned. Over the past few years, the drill bit market has shifted towards a higher mix of diamond bit products as improved designs and manufacturing processes have enabled diamond products to be used in a wider array of drilling applications. For the year ended December 31, 2007, diamond drill bits accounted for

approximately 50 percent of the Company s total drill bit sales.

Table of Contents

Additionally, the Company manufactures and markets hole openers and underreamers which are designed to create larger hole diameters in certain sections of the wellbore. The patented Rhino® Reamer, Reamaster® and simultaneous drilling and hole enlargement system are three examples of products that aid the customer in realizing lower drilling costs through technology. Through the use of the simultaneous drilling and hole enlargement system above the drill bit, the operator may drill the main well bore with the bit and enlarge the diameter of the hole above the drill bit in the same run.

Smith Technologies also designs, assembles and markets a comprehensive line of turbodrills and provides related technical support. Turbodrills, which operate directly above the drill bit, use the hydraulic energy provided by drilling fluid pumps on the rig floor to deliver torque to and rotate the drill bit. These proprietary tools are designed to provide faster rates of penetration, operate in much higher temperature formations, deliver longer downhole life and produce better wellbore quality than conventional positive displacement drilling motors. The turbine drilling motor provides operators with cost effective solutions in demanding environments such as horizontal applications, hard formations and high-temperature zones.

The Company manufactures polycrystalline diamond and cubic boron nitride materials that are used in the Company s three-cone and diamond drill bits and other specialized cutting tools. The Company believes that it is one of the world s largest manufacturers of polycrystalline diamond for use in oilfield applications. Smith Technologies also develops and uses patented processes for applying diamonds to a curved surface which optimize the performance of inserts used in drill bits. As a result, the Company believes that Smith Technologies enjoys a competitive advantage in both material cost and technical ability over other drill bit companies. In addition, the Company s in-house diamond research, engineering and manufacturing capabilities enhance the Company s ability to develop the application of diamond technology across other Smith product lines and into non-energy markets.

Competition. Smith Technologies major competitors in the drill bit business are Hughes Christensen (a division of Baker Hughes), Security DBS (a division of Halliburton) and ReedHycalog (a division of Grant Prideco, Inc.). While Smith Technologies and these companies supply the majority of the worldwide drill bit market, which approximated $2.9 billion in 2007, they compete with more than 20 companies. The main competitors in the borehole enlargement business are Andergauge (a division of Grant Prideco, Inc.), Security DBS and Sperry Drilling Services (divisions of Halliburton). Generally, competition in these markets is based on a number of factors, including performance, quality, reliability, service, price, technological advances and breadth of products.

Smith Services

Products and Services. Smith Services is a leading global provider of technologically advanced drilling, tubular, fishing, remedial, multilateral and completion products, services and solutions to the oil and gas drilling industry.

Smith Services Drilling Products and Services business provides a broad range of downhole impact tools for drilling applications as well as numerous other specialized downhole drilling products and services. Smith Services sells and rents impact drilling tools such as the Hydra-Jar®Tool and the Accelerator®Tool, which are used to free stuck drill strings during the drilling process. Additionally, Drilling on Gauge Subs and Borrox AP Reamers are some of the Company s tools used by operators for maintaining hole gauge and quality of the wellbore. Smith Services also offers tubular drill string components, such as drill collars, subs, stabilizers, kellys and Hevi-Wate DrillPipe, and provides related inspection services, including drillstring repair and rebuild services. These components and their placement in the drillstring are supported by engineering and field technical services in order to optimize bottom hole management techniques. Through state-of-the-art software, Smith Services aids the customer in maximizing the life of drillstring components. Rotating control devices for flow control in underbalanced / managed pressure drilling applications, such as the Hold 1500®Tool and the Hold 2500®Tool, and automatic connection torque monitoring and control systems are designed and manufactured by Smith Services.

Smith Services Fishing and Remedial Services business provides a comprehensive package of fishing, remedial and thru-tubing services. Fishing operations clear and remove obstructions from a wellbore that may arise during drilling, completion or workover activities or during a well s production phase. This operation requires a wide variety of specialty tools, including fishing jars, milling tools and casing cutters, most of which are manufactured by Smith Services. These tools are operated by Company service personnel or sold or rented to third-party fishing companies.

Table of Contents

Smith Services provides Wellbore Departure Systems through the manufacture of proprietary casing exit tools which are installed by trained technicians. These systems, which include the patented Trackmaster® Plus Whipstock System, allow the operator to divert around obstructions in the main wellbore or reach multiple production zones from the main wellbore (known as multilateral completions). In addition, Smith Services Geotrack Whipstock System mills the casing exit and continues to drill several hundred feet of formation in a single trip, saving the customer time and reducing their overall drilling costs. The Company also provides mechanical, hydraulic and explosive pipe-cutting services to remove casing during well or platform abandonment.

Smith Services Completion Systems business specializes in providing fit-for-purpose liner hanger systems, liner cementing equipment, isolation packers, retrievable and permanent packers, and drillable bridge and frac plugs. Liner hangers allow strings of casing to be suspended within the wellbore without having to extend the string all the way to the surface and are also used to isolate production zones and formations. Most directional and multilateral wells include one or more hangers due to complex casing programs and need for zonal isolation. Using Smith Services Pocket Slip liner hanger system, long or heavy liners can be suspended with minimal casing distortion and maximum flow-by area. Packers are mechanically or hydraulically actuated devices which lock into place at specified depths in the well and provide a seal between zones through expanding-element systems. The devices therefore create isolated zones within the wellbore to permit either specific formation production or allow for certain operations, such as cementing or acidizing, to take place without damaging the reservoir. The Smith Services Isofrac packer selectively isolates multiple zones in a single trip to reduce fracturing job time, while the Long Reach packer facilitates successful liner deployment in vertical and long reach horizontal wellbores without excessive work string manipulation. In addition, Smith Services top drive cementing manifold eliminates cement contamination of top drive components by creating a flow path for cement that bypasses the drilling rig s top drive assembly.

Competition. Smith Services major competitors in the drilling, remedial, re-entry and fishing services markets are Weatherford International, Inc. (Weatherford), Baker Oil Tools (a division of Baker Hughes) and numerous small local companies. The main competitors in the liner hanger and packer markets are Baker Oil Tools, Weatherford and TIW Corporation. The main competitors in the drilling and fishing jar market and the fishing product and service market are Weatherford and National-Oilwell Varco. Competition in the drilling and completions sales, rental and services market is primarily based on performance, quality, reliability, service, price and response time and, in some cases, breadth of products.

Distribution Segment

Wilson

Products and Services. Wilson is a supply-chain management company which provides products and services to the energy, refining, petrochemical, power generation and mining industries. Wilson operates an extensive network of supply branches, service centers and sales offices through which it markets pipe, valves and fittings as well as mill, safety and other maintenance products, predominately in the United States and Canada. In addition, Wilson provides warehouse management, vendor integration and various surplus and inventory management services. The majority of Wilson s operations are focused on North American distribution of maintenance, repair and operating supplies and equipment with the remainder associated with line pipe and automated valve products (including valve, actuator and control packages).

Approximately three-fourths of Wilson s 2007 revenues were generated in the energy sector, which includes exploration and production companies and companies with operations in the petroleum industry s pipeline sector. The remainder related to sales in the downstream and industrial market, including refineries, petrochemical and power generation plants and other energy-focused operations. Approximately 20 percent of Wilson s 2007 revenues were reported in Canada, attributable to the CE Franklin Ltd. operations, a publicly-traded distribution business in which the Company owns the majority of the outstanding common stock.

Competition. Wilson s competitors in its energy sector operations include National-Oilwell Varco, McJunkin Red Man Corporation and a significant number of smaller, locally based operations. Wilson s competitors in the downstream and industrial market include Hagemeyer NV, Ferguson Enterprises, Inc., McJunkin Red Man Corporation and W.W. Grainger, Inc. The distribution market that Wilson participates in is highly competitive. Generally, competition involves numerous factors, including price, experience, customer service and equipment

availability.

Table of Contents

Non-U.S. Operations

Sales to oil and gas exploration and production markets outside the United States are a key strategic focus of Smith s management. The Company markets its products and services through subsidiaries, joint ventures and sales agents located in virtually all petroleum-producing areas of the world, including Canada, Latin America, Europe/Africa, and Middle East/Asia. Approximately 55 percent, 54 percent and 55 percent of the Company s revenues in 2007, 2006 and 2005, respectively, were derived from equipment or services sold or provided outside the United States. The Company s Distribution operations constitute a significant portion of the consolidated revenue base and are concentrated in North America which serves to distort the geographic revenue mix of the Company s Oilfield segment operations. Excluding the impact of the Distribution operations, approximately 64 percent, 63 percent and 65 percent of the Company s revenues were generated in non-U.S. markets in 2007, 2006 and 2005, respectively.

Historically, drilling activity outside the United States has been less volatile than U.S.-based activity as the high cost exploration and production programs outside the United States are generally undertaken by major oil companies, consortiums and national oil companies. These entities operate under longer-term strategic priorities than do the independent drilling operators that are more common in the U.S. market.

Sales and Distribution

Sales and service efforts are directed to end users in the exploration and production industry, including major and independent oil companies, national oil companies and independent drilling contractors. The Company s products and services are primarily marketed through the direct sales force of each business unit. In certain non-U.S. markets where direct sales efforts are not practicable, the Company utilizes independent sales agents, distributors or joint ventures.

Smith maintains field service centers, which function as repair and maintenance facilities for rental tools, operations for remedial and completion services and a base for the Company s global sales force, in all major oil and gas producing regions of the world. The location of these service centers near the Company s customers is an important factor in maintaining favorable customer relations.

Manufacturing

The Company s manufacturing operations, along with quality control support, are designed to ensure that all products and services marketed by the Company will meet standards of performance and reliability consistent with the Company s reputation in the industry.

Management believes that it generally has sufficient internal manufacturing capacity to meet anticipated demand for its products and services. During periods of peak demand, certain business units utilize outside resources to provide additional manufacturing capacity.

Raw Materials

Through its company-owned mines in and outside the United States, M-I SWACO has the capability to produce a large portion of its requirements for barite and bentonite, which are typically added to engineered fluid systems. Barite reserves are mined in the United States, the United Kingdom and Morocco. Bentonite is produced from ore deposits in the U.S. Mining exploration activities continue worldwide to locate and evaluate ore bodies to ensure deposits are readily available for production when market conditions dictate. In addition to its own production, M-I SWACO purchases the majority of its worldwide barite requirement from suppliers outside the United States, mainly the People s Republic of China, India and Morocco.

The Company purchases a variety of raw materials for its Smith Technologies and Smith Services units, including alloy and stainless steel bars, tungsten carbide inserts and forgings. Generally, the Company is not dependent on any single source of supply for any of its raw materials or purchased components, and believes that numerous alternative supply sources are available for all such materials. The Company does not expect any interruption in supply, but there can be no assurance that there will be no price or supply issues over the long-term. The Company produces polycrystalline diamond materials in Provo, Utah and Scurelle, Italy for utilization in various Company products as well as direct customer sales.

Table of Contents

Product Development, Engineering and Patents

The Company s business units maintain product development and engineering departments whose activities are focused on improving existing products and services and developing new technologies to meet customer demands for improved drilling performance and environmental-based solutions for drilling and completion operations. The Company s primary research facilities are located in Houston, Texas; Stavanger, Norway; Aberdeen, Scotland; and Florence, Kentucky.

The Company also maintains a drill bit database which records the performance of drill bits over the last 20 years, including those manufactured by competitors. This database gives the Company the ability to monitor, among other things, drill bit failures and performance improvements related to product development. The Company believes this proprietary database gives it a competitive advantage in the drill bit business.

The Company has historically invested significant resources in research and engineering in order to provide customers with broader product lines and technologically-advanced products and services. The Company s expenditures for research and engineering activities are attributable to the Company s Oilfield segment and totaled $110.7 million in 2007, $88.3 million in 2006 and $73.6 million in 2005. Research and engineering expenditures approximated 1.7 percent, 1.6 percent and 1.8 percent of the Company s Oilfield segment revenues in 2007, 2006 and 2005, respectively.

Although the Company has over 4,400 issued and pending patents and regards its patents and patent applications as important in the operation of its business, it does not believe that any significant portion of its business is materially dependent upon any single patent.

Employees

At December 31, 2007, the Company had 19,865 full-time employees throughout the world. Most of the Company s employees in the United States are not covered by collective bargaining agreements except in certain U.S. mining operations of M-I SWACO and several distribution locations of Wilson. The Company considers its labor relations to be satisfactory.

Table of Contents

Officers of the Registrant

The names and ages of all officers of the Company, all positions and offices with the Company presently held by each person named and their business experience are stated below. Positions, unless otherwise specified, are with the Company.

Name, Age and Positions	Principal Current Occupation and Other Significant Positions Held
Doug Rock (61) Chairman of the Board, Chief Executive Officer, President and Chief Operating Officer	Chairman of the Board since February 1991, elected Chief Executive Officer in March 1989 and served as President and Chief Operating Officer since December 1987. Held various positions since joining the Company in June 1974.
Malcolm W. Anderson (60) Senior Vice President, Human Resources	Senior Vice President, Human Resources since December 2006. Joined Company as Vice President, Human Resources in May 2004. Vice President Human Resources at Hewlett Packard from January 2001 to April 2004. Vice President Human Resources at Weatherford International Ltd. from April 1996 to December 2000.
Richard E. Chandler, Jr. (51) Senior Vice President, General Counsel and Secretary	Senior Vice President and Secretary since January 2006 and General Counsel since August 2005. Joined predecessor to M-I SWACO in December 1986 as Vice President, General Counsel and Secretary. Named Senior Vice President Administration, General Counsel and Secretary of M-I SWACO in January 2004.
Margaret K. Dorman (44) Senior Vice President, Chief Financial Officer and Treasurer	Senior Vice President, Chief Financial Officer and Treasurer since June 1999. Joined Company as Director of Financial Reporting in December 1995 and named Vice President, Controller and Assistant Treasurer in February 1998.
Bryan L. Dudman (51) President, Smith Services	President, Smith Services since January 2006. Held various positions since joining the Company in January 1979. Prior to being named to current position, served as Senior Vice President of M-I SWACO s Western Hemisphere Operations since May 1994.
John J. Kennedy (55) President and Chief Executive Officer, Wilson	President and Chief Executive Officer, Wilson since June 1999. Held various positions since joining the Company in November 1986. Elected Vice President, Chief Accounting Officer and Treasurer in March 1994 and named Senior Vice President, Chief Financial Officer and Treasurer in April 1997.
Donald McKenzie (58) President and Chief Executive Officer, M-I SWACO	President and Chief Executive Officer, M-I SWACO since May 2006. Held various positions since joining the Company in 1989. Named Senior Vice President of M-I SWACO s Eastern Hemisphere Operations of M-I SWACO in April 1994. Appointed Chief Operating Officer of M-I SWACO in January 2006.
Michael D. Pearce (60) President, Smith Technologies	President, Smith Technologies since May 2005. Joined Company as Vice President Sales of the Company s GeoDiamond Division in April 1995 and named Vice President Sales of Smith Technologies in August 1998.

Peter J. Pintar (49) Vice President, Corporate Strategy and Development	Vice President Corporate Strategy and Development since September 2005. Held various positions at DTE Energy Company between October 1997 and August 2005, including Director Corporate Development, Managing Director Venture Capital Investments, and Director Investor Relations.
Joseph S. Rinando, III (36) Vice President and Controller	Vice President and Controller since April 2006. Joined Company as Director of Financial Reporting in May 2003. Served as Audit Manager for PricewaterhouseCoopers LLP from July 2000 to June 2002 and Senior Manager from July 2002 to May 2003.
Geraldine D. Wilde (57) Vice President, Taxes and Assistant Treasurer	Vice President, Taxes since February 1998. Joined Company as Manager of Taxes and Payroll of predecessor to M-I SWACO in December 1986 and named Director of Taxes and Assistant Treasurer in April 1997.

All officers of the Company are elected annually by the Board of Directors. They hold office until their successors are elected and qualified. There are no family relationships between the officers of the Company.

Table of Contents

Item 1A. ***Risk Factors***

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. statements are based on certain assumptions and analyses that we believe are appropriate under the circumstances. Such statements are subject to, among other things, general economic and business conditions, the level of oil and natural gas exploration and development activities, global economic growth and activity, political stability of oil-producing countries, finding and development costs of operations, decline and depletion rates for oil and natural gas wells, seasonal weather conditions, industry conditions, and changes in laws or regulations, many of which are beyond the control of the Company. Should one or more of these risks or uncertainties materialize, or should the assumptions prove incorrect, actual results may differ materially from those expected, estimated or projected. Management believes these forward-looking statements are reasonable. However, you should not place undue reliance on these forward-looking statements, which are based only on our current expectations. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to publicly update or revise any of them in light of new information, future events or otherwise.

With this in mind, you should consider the risks discussed elsewhere in this report and other documents we file with the Securities and Exchange Commission from time to time and the following important factors that could cause our actual results to differ materially from those expressed in any forward-looking statement made by us or on our behalf.

We are dependent on the level of oil and natural gas exploration and development activities.

Demand for our products and services is dependent upon the level of oil and natural gas exploration and development activities. The level of worldwide oil and natural gas development activities is primarily influenced by the price of oil and natural gas, as well as price expectations. In addition to oil and natural gas prices, the following factors impact exploration and development activity and may lead to significant changes in worldwide activity levels:

Overall level of global economic growth and activity;

Actual and perceived changes in the supply and demand for oil and natural gas;

Political stability and policies of oil-producing countries;

Finding and development costs of operators;

Decline and depletion rates for oil and natural gas wells; and

Seasonal weather conditions that temporarily curtail drilling operations.

Changes in any of these factors could adversely impact our financial condition, results of operations or cash flows.

There are certain risks associated with conducting business in markets outside of North America.

We are a multinational oilfield service company and generate the majority of our Oilfield segment revenues in markets outside of North America. Changes in conditions within certain countries that have historically experienced a high degree of political and/or economic instability could adversely impact our financial condition, results of operations or cash flows. Additional risks inherent in our non-North American business activities include:

Changes in political and economic conditions in the countries in which we operate, including civil uprisings, riots and terrorist acts;

Unexpected changes in regulatory requirements;

Fluctuations in currency exchange rates and the value of the U.S. dollar;

Restrictions on repatriation of earnings or expropriation of property without fair compensation;

Governmental actions that result in the deprivation of contract or proprietary rights; and

Governmental sanctions.

Table of Contents

We operate in a highly technical and competitive environment.

We operate in a highly-competitive business environment. Accordingly, demand for our products and services is largely dependent on our ability to provide leading-edge, technology-based solutions that reduce the operator s overall cost of developing energy assets. If competitive or other market conditions impact our ability to continue providing superior-performing product offerings, our financial condition, results of operations or cash flows could be adversely impacted.

Our businesses are subject to a variety of governmental regulations.

We are exposed to a variety of federal, state, local and international laws and regulations relating to matters such as environmental, health and safety, labor and employment, import/export control, currency exchange, bribery and corruption and taxation. These laws and regulations are complex, change frequently and have tended to become more stringent over time. In the event the scope of these laws and regulations expand in the future, the incremental cost of compliance could adversely impact our financial condition, results of operations or cash flows.

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. Although no material matters are pending or threatened at this time, we, as well as certain of our competitors, have been named as defendants in various intellectual property matters in the past. 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 served with an intellectual property claim which we are unsuccessful in defending, it could adversely impact our results of operations and cash flows.

Item 1B. ***Unresolved Staff Comments***

None.

Table of Contents

Item 2. ***Properties***

The principal facilities and properties utilized by the Company at December 31, 2007 are shown in the table below. Generally, the facilities and properties are owned by the Company.

Location	Principal Products Processed, Manufactured or Distributed	Land (Acres)	Approx. Bldg. Space (sq.ft.)
Oilfield Segment:			
Houston, Texas	Smith corporate headquarters, tubulars, surface and downhole tools, remedial products, liner hangers, diamond drill bits, turbodrills, drilling and fishing jars and fishing tool equipment	96	1,075,800
Volgograd, Russia	Drilling fluid and waste management products	17	719,350
Houston, Texas	M-I SWACO corporate headquarters and research center	22	268,400
Macae, Brazil	Drilling fluid chemical products	5	234,870
Florence, Kentucky	Separator units, mill units, parts, screens and motors	6	214,000
Ponca City, Oklahoma	Three-cone drill bits	15	207,000
Oruro, Bolivia	Drilling fluids	5	202,740
Aberdeen, Scotland	Downhole tools and remedial products	10	155,000
Changzhou, China	Drilling and downhole tools	3	146,360
Greybull, Wyoming	Bentonite mine and processing	8,394	110,000
Saline di Volterra, Italy	Three-cone drill bits	11	99,900
Tulsa, Oklahoma	Oilfield and industrial screening products	7	95,000
Edinburgh, Scotland	Wire cloth and oilfield screening products	3	92,450
Salzweld, Germany	Drilling fluid processing	2	86,000
Nisku, Alberta, Canada	Fishing and remedial services	10	83,000
Provo, Utah	Synthetic diamond materials	5	68,300
Aberdeen, Scotland	Production chemical processing	2	66,000
Karmoy, Norway	Barite and bentonite processing	5	51,000
Greystone, Nevada	Barite mine and processing	268	50,000
Macon, Georgia	Separator units and screens	1	49,000
Battle Mountain, Nevada	Barite processing	23	43,000
Zelmou, Morocco	Barite mine	3,954	41,000
Nisku, Alberta, Canada	Drilling fluid chemical products	4	37,280
Zavalla, Texas	Drilling fluid chemical products	33	36,000
Nivellas, Belgium	Separator units, mill units, parts, screens and motors	5	31,780
Scurelle, Italy	Diamond drill bits and synthetic diamond materials	4	31,000
Spruce Grove, Canada	Drilling fluid processing	7	30,450
Amelia, Louisiana	Barite processing	26	25,000
Berra, Italy	Solids control equipment	4	24,930
Port Fouchon, Louisiana	Drilling fluid storage, processing and distribution	11	24,600
Galveston, Texas	Barite processing	6	21,000
Grand Prairie, Canada	Fishing and remedial services	4	13,960
Foss/Aberfeldy, Scotland	Barite mine and processing	102	10,000
Mountain Springs, Nevada	Barite mine	900	
Distribution Segment:			
La Porte, Texas	Pipe, valves and fittings	15	440,000

Tampa, Florida	Pipe, valves and fittings	4	86,200
Trainer, Pennsylvania	Pipe, valves and fittings	3	23,000

The Company considers its mines and manufacturing and processing facilities to be in good condition and adequately maintained. The Company also believes its facilities are suitable for their present and intended purposes and are generally adequate for the Company s current and anticipated level of operations.

The Company s Corporate headquarters is located in Houston, Texas. The Company also leases various administrative and sales offices, as well as warehouses and service centers in the United States and other countries in which it conducts business. The Company believes that it will be able to renew and extend its property leases on terms satisfactory to the Company or, if necessary, locate substitute facilities on acceptable terms.

Table of Contents

Item 3. ***Legal Proceedings***

Information relating to various commitments and contingencies, including legal proceedings, is described in Note 16 of the Consolidated Financial Statements included elsewhere in this report on Form 10-K and is incorporated herein by reference.

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

None.

PART II

Item 5. ***Market for the Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

The common stock of the Company is traded on several market exchanges, including the New York Stock Exchange, under the symbol SII . The following are the high and low sale prices for the Company s common stock as reported on the New York Stock Exchange Composite Tape for the periods indicated.

	2006 Common Stock				2007 Common Stock			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
High	$44.63	$44.35	$45.79	$44.11	$48.41	$60.34	$74.00	$75.34
Low	$35.66	$36.17	$36.05	$35.89	$36.01	$48.84	$56.78	$59.16

On February 22, 2008, the Company had 1,771 common stock holders of record and the last reported closing price on the New York Stock Exchange Composite Tape was $62.33.

Stock Repurchases

During October 2005, the Company s Board of Directors approved a repurchase program that allows for the purchase of up to 20 million shares of the Company s common stock, subject to regulatory issues, market considerations and other relevant factors. During the fourth quarter of 2007, the Company repurchased 78,500 shares of common stock in the open market at an aggregate cost, including commissions, of $4.7 million. As of December 31, 2007, the Company has repurchased 4.3 million shares at an average cost of $44.03 per share under the current program. The acquired shares have been added to the Company s treasury stock holdings.

The following table summarizes the Company s repurchase activity for the three months ended December 31, 2007:

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
October 1 31		$		15,772,413
November 1 30	78,500	59.64	78,500	15,693,913
December 1 31				15,693,913
4th Quarter 2007	78,500	$ 59.64	78,500	15,693,913

Dividend Program

In February 2005, the Company s Board of Directors approved a regular quarterly cash dividend program. The Board of Directors declared dividends of $80.1 million, $64.0 million and $48.4 million for the years ended December 31, 2007, 2006 and 2005, respectively.

On February 6, 2008, the Company s Board of Directors increased the quarterly cash dividend to $0.12 per share, beginning with the distribution payable April 14, 2008 to stockholders of record on March 14, 2008. The level of future dividend payments will be at the discretion of the Board of Directors and will depend upon the Company s

financial condition, earnings and cash flow from operations, the level of its capital expenditures, compliance with certain debt covenants, future business prospects and other factors that the Board of Directors deem relevant.