

SCHWEITZER MAUDUIT INTERNATIONAL INC
Form 10-K
February 25, 2011

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

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2010

OR

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

For the transition period from to

(Commission file number) 1-13948
SCHWEITZER-MAUDUIT INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

62-1612879
(I.R.S. Employer
Identification No.)

100 North Point Center East, Suite 600
Alpharetta, Georgia
(Address of Principal Executive Offices)

30022-8246
(Zip Code)

1-800-514-0186

(Registrant's telephone number, including area code)

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

Title of each class
Common stock, par value \$0.10 per share
(together with associated preferred stock
purchase rights)

Name of exchange on which registered
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 by Rule 405 of the Securities Act.

Yes No

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 No

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of 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.

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 12-b2 of the Exchange Act. (Check One):

Large accelerated filer

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

The aggregate market value of the outstanding common stock, par value \$0.10 per share (the "Common Stock"), held by non-affiliates of the registrant as of June 30, 2010 (the last business day of the registrant's most recently completed second fiscal quarter) was \$902.8 million, based on the last sale price for the Common Stock of \$50.45 per share as reported on the New York Stock Exchange on said date. For purposes of the foregoing sentence only, all directors and executive officers are assumed to be affiliates.

There were 17,268,949 shares of Common Stock issued and outstanding as of February 22, 2011.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive Proxy Statement relating to its 2011 Annual Meeting of Stockholders scheduled to be held on April 28, 2011 ("the 2011 Proxy Statement") and filed pursuant to Regulation 14A are incorporated by reference into Part III of this Form 10-K.

PART I.

Item 1. Business

GENERAL

Schweitzer-Mauduit International, Inc. (referred to, with its consolidated subsidiaries, as “we”, “us”, “our”, the “Company”, “SWM INTL” or “SWM” unless the context indicates otherwise) is a multinational diversified producer of premium specialty papers headquartered in the United States of America. We manufacture and sell paper and reconstituted tobacco products to the tobacco industry as well as specialized paper products for use in other applications. Tobacco industry products comprised approximately 93% of our consolidated net sales in each of the years 2008 through 2010. The primary products in the group include cigarette, plug wrap and base tipping papers, or Cigarette Papers, used to wrap various parts of a cigarette and reconstituted tobacco leaf, or RTL, which is used as a blend with virgin tobacco in cigarettes, reconstituted tobacco wrappers and binders for cigars. These products are sold directly to the major tobacco companies or their designated converters in the Americas, Europe, Asia and elsewhere. Non-tobacco products are a diverse mix of products that includes low volume, high-value engineered papers as well as commodity paper grades produced to maximize machine utilization.

We are a manufacturer of lightweight specialty papers, which are used in manufacturing ventilated cigarettes, banded papers for the production of lower ignition propensity, or LIP, cigarettes and the leading independent producer of RTL used in producing blended cigarettes. We conduct business in over 90 countries and currently operate 11 production locations worldwide, with mills in the United States, France, the Philippines, Indonesia, Brazil and Poland. We also have a 50% equity interest in a paper mill in China that produces cigarette and porous plug wrap papers.

Our Securities and Exchange Commission, or SEC, filings, which include this Annual Report on Form 10-K, Definitive Proxy Statements on Form DEF-14A, quarterly reports on Form 10-Q, current reports on Form 8-K and all related amendments, are available, free of charge, on the Investor Relations section of our web site at www.swmintl.com. Information from our web site is not incorporated by reference into this Form 10-K. These reports are available soon after they are filed electronically with the SEC. The web site allows access to historical financial information, press releases and quarterly earnings conference calls, our Code of Conduct, corporate governance guidelines, Board of Directors committee charters, as well as disclosure of any amendment to or waivers of our Code of Conduct granted to any of the principal executive officer, principal financial officer or principal accounting officer. The web site provides additional background information about us including information on our history, products and locations. Requests for information or to contact the audit committee chair, lead non-management director or to report concerns about accounting or other issues can be made in writing and sent to the Investor Relations Department at our principal executive office address listed below.

Our quarterly earnings conference calls are typically held the morning after our quarterly earnings releases and are available through our web site via a webcast. The tentative dates for our quarterly earnings conference calls related to 2011 financial results are May 4, 2011, August 3, 2011, November 2, 2011 and February 2, 2012. These dates are subject to change. Instructions on how to listen to the webcasts and updated information on times and actual dates are available through our web site.

Our wholly-owned, majority-owned and controlled subsidiaries are Schweitzer-Mauduit Canada, Inc., or SM-Canada, Schweitzer-Mauduit Spain, S.L., or SM-Spain, a holding company organized under the Spanish holding company regime and the primary foreign investment holding company for SWM, SWM Poland, Sp.zo.o., SWM Poland, SWM RTL Philippines Inc. and Schweitzer-Mauduit International China, Limited, or SM-China, a holding company incorporated in Hong Kong which owns 50% of the equity interest in China Tobacco Mauduit (Jiangmen) Paper Industry Company Ltd., a Sino-Foreign Equity Joint Venture with China National Tobacco Corporation, or CNTC, to

manufacture and sell tobacco-related papers in China, our only unconsolidated subsidiary. We indirectly through SM-Spain have subsidiaries in France, the Philippines, Indonesia and Brazil. SM-Spain owns directly 100% of Schweitzer-Mauduit Holding S.A.S., a French holding company, or SMH, and SMH owns 100% of Schweitzer-Mauduit Industries S.A.S., a French corporation, or SMI, which, together with SM-Spain, holds 100% of a second holding company Schweitzer-Mauduit France S.A.S., a French corporation, or SMF, which holds our French, Philippine and Indonesian paper operations. SMF also owns 100% of Schweitzer-Mauduit Developpements S.A.S., a French corporation, or SMD, and SMD owns 100% of LTR Industries S.A., a French corporation, or LTRI, our French RTL operation. SMF, directly or indirectly, owns 100% of three principal French operating subsidiaries, Papeteries de Mauduit S.A.S., or PdM, Papeteries de Malaucène S.A.S., or PdMal, and Papeteries de Saint-Girons S.A.S., or PdStG, 100% of PDM Philippines Industries, Inc., or PPI, and 95% of P.T. PDM Indonesia, or PT PDM. SM-Spain also owns directly 99.99% of the issued and outstanding shares of Schweitzer-Mauduit do Brasil S.A., our Brazilian paper operations, or SWM-B. We had no special purpose entities as of December 31, 2010.

Our principal executive office is located at 100 North Point Center East, Suite 600, Alpharetta, Georgia 30022-8246 and our telephone number at that address is 1-800-514-0186. Our stock is traded on the New York Stock Exchange, or NYSE, under the symbol "SWM."

We have provided a Glossary of Terms at the end of this Annual Report on Form 10-K.

DESCRIPTION OF BUSINESS

Segment Financial Information. We operate and manage three reportable segments: United States, or U.S., France and Brazil. These segments are based on the geographical location of our manufacturing operations. These business segments manufacture and sell Cigarette Papers, reconstituted tobacco products (France and U.S. only) and certain non-tobacco industry products. While the products are similar in each segment, they vary based on customer requirements and the manufacturing capabilities of each of the operations. The Philippine and Indonesian financial results are included in the French business segment because the results of these two units are not material for segment reporting purposes and since their products are coordinated with sales of our French operations in southeast Asia. Sales by a segment into markets primarily served by a different segment occur where specific product needs cannot be cost-effectively met by the manufacturing operations domiciled in that segment.

Additional information regarding “Segment Performance” is included in Part II, Item 7, Management’s Discussion and Analysis of Financial Condition and Results of Operation. In addition, selected financial data for our segments is available in Note 18, Segment Information, of the Notes to Consolidated Financial Statements. Reference is also made to Part I, Item 1A, Risk Factors, Market Risk, for a discussion regarding the risks associated with foreign operations.

Financial information about foreign and domestic operations, contained under the caption “Management’s Discussion and Analysis of Financial Condition and Results of Operation” appearing in Part II, Item 7 herein and in Notes 10, 11, 14 and 18 (“Restructuring Activities,” “Debt,” “Income Taxes” and “Segment Information,” respectively) to the Consolidated Financial Statements contained in “Financial Statements and Supplementary Data” appearing in Part II, Item 8 herein, are incorporated in this Item 1 by reference.

PRODUCTS

We manufacture and sell paper and reconstituted tobacco products to the tobacco industry as well as specialized paper products for use in other applications.

Tobacco industry products include Cigarette Papers and RTL used as a tobacco blend with virgin tobacco in cigarettes and reconstituted tobacco wrappers and binders for cigars. These products are sold directly to tobacco companies or their designated converters in the Americas, Europe, Asia and elsewhere.

Each of the three principal types of Cigarette Papers — cigarette, plug wrap and tipping papers — serves a distinct purpose in the function of a cigarette.

Cigarette paper wraps the column of tobacco in a cigarette. Certain properties of cigarette paper, such as control of ignition propensity, basis weight, porosity, opacity, tensile strength, texture and burn rate must be controlled to tight tolerances. Many of these characteristics are critical to meet the requirements of high-speed production processes utilized by cigarette manufacturers as well as their desired attributes of finished cigarettes such as reduced deliveries of tobacco-related smoke constituents. In addition to the attributes and functional requirements of conventional cigarette papers, certain of our products facilitate our customers’ design of LIP cigarettes to enhance cigarette safety when they are not actively being smoked, including papers sold under our registered trademark ALGINEX®.

Plug wrap paper forms the outer layer of a cigarette filter and is used to hold the filter materials in a cylindrical form. Conventional plug wrap is manufactured on flat wire paper machines using wood pulp. Porous plug wrap, a highly air-permeable paper, is manufactured on inclined-wire paper machines using a furnish consisting of long-fibers, such as abaca, and wood pulp. Porosity, a measure of air-flow permeability, ranges from a typical level of less than 100 Coresta on conventional plug wrap to 35,000 Coresta on high-porosity papers.

Base tipping paper, produced in white or tan/cork color, joins the filter element to the tobacco-filled column of the cigarette. The ability to produce tipping paper, which is both printable and glueable at high speeds, is critical to producing a cigarette with a distinctive finished appearance.

Reconstituted tobacco is used by manufacturers of cigarettes and other tobacco products as a means of recycling their tobacco by-products and to achieve product performance attributes. We currently produce reconstituted tobacco in two forms: leaf, or RTL, in France, which is manufactured by LTRI, and wrapper and binder in the United States. RTL is used by cigarette manufacturers primarily to blend with virgin tobacco as a design aid to achieve certain attributes of finished cigarettes, such as taste characteristics and reduced deliveries of tobacco-related smoke constituents, and to cost-effectively utilize tobacco leaf waste by-products. Wrapper and binder are reconstituted tobacco products used by manufacturers of machine-made cigars. Binder is used to hold the tobacco leaves in a cylindrical shape during the production process. Wrapper is used to cover the outside of the cigar, providing a uniform, finished appearance.

Commercial and industrial products include lightweight printing and writing papers, battery separator paper, drinking straw wrap, filter papers and other specialized papers primarily for the western European and Brazilian markets. Like porous plug wrap, certain of these non-tobacco industry products use a fiber blend consisting of long-fibers. These products are generally sold directly to converters and other end-users in North America and western Europe and through brokers in Brazil. The non-tobacco industry products are a diverse mix that includes low volume, high-value engineered papers as well as commodity paper grades produced to maximize machine utilization.

MARKETS AND CUSTOMERS

Our U.S. segment primarily supplies the major, and many of the smaller, cigarette manufacturers in North America, and also has significant sales in South America, the European Union, or EU, and parts of Asia and Oceania. The customer base for the U.S. operations consists of more than 150 customers in approximately 40 countries. Our French segment relies predominantly on worldwide exports, primarily to western Europe, Asia (in part through our Philippine and Indonesian manufacturing facilities), eastern Europe and, in lesser but substantial amounts, to Africa, and the Middle East. The customer base for the French operations consists of a diverse group of approximately 200 customers in more than 70 countries. Our Brazilian segment primarily supplies customers in Latin and South American countries with expanding sales to North America and other export locations. The current customer base of the Brazilian operations consists of the cigarette manufacturers in Brazil, as well as approximately 50 customers in approximately 20 countries outside Brazil. Customers of all three business segments include international tobacco companies, regional tobacco manufacturers and government monopolies.

Philip Morris International Inc., Philip Morris USA, a subsidiary of Altria Group Inc., and British American Tobacco, or BAT, are our three largest customers and together with their respective affiliates and designated converters, accounted for 45%, 45% and 39% of the Company's 2010, 2009 and 2008 consolidated net sales, respectively. Although the total loss of one or more of these large customers could have a material adverse effect on our results of operations, this is not considered likely given the significant share that our capacity represents of the total worldwide supply available to meet the demand for cigarette-related fine papers. A material variation in demand from one or more of these customers or due to external factors such as government legislation or changes in consumer behavior, however, could result in a significant decline in demand for our products.

SALES AND DISTRIBUTION

Essentially all tobacco-related products manufactured by the U.S., French and Brazilian segments are sold by our marketing, sales and customer service organizations directly to cigarette manufacturers or their designated converters. Most of our U.S. and French segments' non-tobacco related products, which represent approximately 5% to 8% of each of their respective net sales, are sold on a direct basis. The Brazilian segments' non-tobacco related products comprise approximately 12% of its net sales, substantially all of which are sold through agents.

The typical modes of transportation we utilize in the delivery of product to our customers include truck, rail and ocean-going vessels. As is typical in our industry, ownership of the product generally transfers to our customer upon shipment from our mills, except for certain export sales where ownership typically transfers at the foreign port or customer facility.

COMPETITION

We are the largest producer of Cigarette Papers in the world. LTRI is the leading independent producer of RTL for use in cigarettes. We do not sell our products directly to consumers or advertise our products in consumer media. The specialized nature of these tobacco-related papers requires unique research and development capability and special papermaking equipment and skills to meet exacting customer specifications. These factors have limited the number of competitors in each of the tobacco-related paper categories discussed separately below.

Cigarette Paper As the sole domestic producer of Cigarette Papers in North America, we believe that we have the majority supply position. PdM and PdStG, indirect wholly-owned subsidiaries in France, sell most of their products in western Europe and Asia. We believe SWM-B has the majority of the cigarette paper market in Brazil and in South America. Our principal competitors include European suppliers Delfort Group AG, or Delfort, an Austrian corporation, Miquel y Costas & Miquel S.A., or Miquel y Costas, a Spanish corporation, and Julius Glatz GmbH, an independent German company. The principal competitors of our Indonesian cigarette paper business are PT Surya Zig Zag and PT Bukit Muria Jaya, or PT BMJ, which are owned by Indonesian cigarette production companies. We believe that the bases of cigarette paper competition are price, consistent quality, security of supply, level of technical service and performance requirements of the customer's cigarette-making equipment.

We have developed, individually or in conjunction with customers, technologies to address the market for cigarette paper for LIP cigarettes in the United States and Canada. We are currently the leading producer of commercially proven cigarette paper for LIP cigarettes and continue to actively develop the technologies for such products. We formed a "Center of Excellence" platform at our Newberry, South Carolina facility dedicated to the development, production and distribution of cigarette papers for LIP cigarettes and are establishing LIP capacity to serve the European market, with a new facility in Poland modeled after the successful Newberry site.

Plug Wrap Paper We estimate that our segments hold a majority of market share for plug wrap papers in each of the markets in which we compete. In the U.S. and Brazil segments, our competitors are Miquel y Costas and Delfort. In

France, our principal competitor is Delfort.

Base Tipping Paper We believe that our U.S. segment is a leading supplier for the North American market for base tipping paper, which is subsequently printed by converters. Our principal competitor in this market is Delfort. We estimate our Brazilian segment holds the majority of the market share for base tipping paper in South American, which is subsequently printed by converters. Our principal competitor in Latin America is Miquel y Costas. We believe that the bases for competition are consistent quality, price and, most importantly, the ability to meet the runability and printability requirements of converting equipment and high-speed cigarette-making machines.

Reconstituted Tobacco LTRI is the leading independent producer of RTL in the world. We believe that the basis of competition in this market is primarily quality. However, sales volumes are influenced by worldwide virgin tobacco prices and cigarette producers' various in-house tobacco reconstitution processes, as lower prices of virgin tobacco or other RTL forms may compete against reconstituted tobacco sales volumes.

LTRI's principal competitors are cigarette companies such as Philip Morris USA, R.J. Reynolds Tobacco Company, Elets, an affiliate of Japan Tobacco Inc. which operates in Russia, and STMA (China), which produce RTL primarily for internal use. As currently being experienced, low prices for tobacco leaf can adversely impact RTL demand.

We estimate that approximately 40% of reconstituted cigar wrapper and binder used in the U.S. market is produced internally by domestic cigar manufacturers. Our U.S. segment's Ancram mill and Nuway Tobacco, a privately-held cast process manufacturer, produce the balance for the U.S. market which is not produced internally by domestic cigar manufacturers. The Ancram mill and DHT, a subsidiary of NV Deli Maatschappij, are the main suppliers to the European cigar manufacturers.

Other Products We produce papers for lightweight printing and writing, battery separator papers, drinking straw wrap, filter papers and other specialized papers primarily for the western European and Brazilian markets. We believe that price is the primary basis of competition for drinking straw wrap, printing and writing and filter papers, while consistent quality and customer service are believed to be the primary competitive factors for battery separator paper.

RAW MATERIALS AND ENERGY

Wood pulp is the primary fiber used in our operations. Our operations consumed 82,000 and 81,000 metric tons of wood pulp in 2010 and 2009, respectively, all of which was purchased. Our operations also use other cellulose fibers, the most significant of which are in the form of flax fiber and tobacco leaf by-products, as the primary raw materials for Cigarette Papers and reconstituted tobacco products, respectively. While tobacco leaf by-products are generally the property of the cigarette manufacturer for whom the reconstitution is contracted, we purchase some tobacco leaf by-products for use in the production of RTL and wrapper and binder products.

Flax straw is purchased and subsequently processed into flax tow at processing facilities in Canada and France. The flax tow is then converted into flax pulp at pulping facilities in the United States and France or purchased on the open market. Certain specialty papers are manufactured by our operations in France, requiring small amounts of other cellulose fibers, all of which are purchased.

In addition to cellulose fibers, our operations use calcium carbonate as another significant raw material in the production of many of our paper products. Calcium carbonate, or chalk, is used in the production of Cigarette Papers, as well as in certain of our other paper products, to provide desired qualities and characteristics, such as opacity, as well as end-product performance attributes. All of our needs for calcium carbonate are purchased. Our Quimperlé mill in France and Pirahy mill in Brazil have on-site, vendor-operated, precipitated calcium carbonate plants which supply significant quantities toward the needs of those mills. For the balance of their needs, our mills also purchase calcium carbonate manufactured elsewhere. Our calcium carbonate purchase commitments are discussed in Note 17, Commitments and Contingencies, of the Notes to Consolidated Financial Statements.

We believe that our purchased raw materials are readily available from several sources and that the loss of a single supplier would not have a material adverse effect on our ability to procure needed raw materials from other suppliers.

The papermaking processes use significant amounts of energy, primarily electricity, natural gas and fuel oil to run the paper machines and other equipment used in the manufacture of pulp and paper. In France and in the United States, availability of energy is generally not expected to be an issue, although prices can fluctuate significantly. We enter into agreements to procure a portion of our energy requirements for future periods in order to reduce the uncertainty of future energy costs.

In France, we have entered into agreements with an energy cogeneration supplier whereby the supplier constructed and operates cogeneration facilities at our Spay and Quimperlé Mills and supply steam that is used in the operation of our mills. These cogeneration facilities are expected to provide energy cost savings and improved security of supply.

In Brazil, where production of electricity is heavily reliant upon hydroelectric plants, availability of electricity has been affected in the past by rain variations. Our Brazilian business currently has a sufficient supply of energy to

continue its current level of operation.

Additional information regarding agreements for the supply of energy is included in Note 17, Commitments and Contingencies, of the Notes to Consolidated Financial Statements.

BACKLOG AND SEASONALITY

We have historically experienced a steady flow of orders. Our mills typically receive and ship orders within a 30-day period, except for RTL where orders are generally placed well in advance of delivery. We plan our manufacturing schedules and raw material purchases based on our evaluation of customer forecasts and current market conditions.

The U.S. segment does not calculate or maintain records of order backlogs. Its largest customer Philip Morris USA provides forecasts of future demand, but actual orders for Cigarette Papers are typically placed two weeks in advance of shipment.

Our French segment does maintain records of order backlogs. For Cigarette Papers, the order backlog was approximately \$28 million and \$31 million on December 31, 2010 and 2009, respectively. This represented approximately 29 and 41 days of Cigarette Paper sales for the French segment in 2010 and 2009, respectively. LTRI's RTL business operates under a number of annual supply agreements. The order backlog for RTL was approximately \$163 million and \$161 million on December 31, 2010 and 2009, respectively.

The Brazilian segment does not calculate or maintain records of order backlogs. Souza Cruz, its largest customer, provides forecasts of its future demand, typically eight weeks in advance, in order for the Brazilian operations to manage production and ensure a sufficient supply to meet this customer's anticipated requirements.

Sales of our products are subject to significant seasonal fluctuations. In the United States and Europe, customer shutdowns of one to two weeks in duration typically occur in July and December. In Brazil, customer orders are typically lower in December due to a January and February holiday season.

RESEARCH AND DEVELOPMENT

We employ approximately 50 research personnel in research and laboratory facilities in Spay, France, Santanésia, Brazil, San Pedro, Philippines and Alpharetta, Georgia. We are dedicated to developing Cigarette Papers, reconstituted tobacco and non-tobacco paper product innovations and improvements to meet the needs of individual customers. The development of new components for tobacco products and the development of new non-tobacco paper products are the primary focuses of these research and development functions, including several development projects for our major customers. We expensed \$8.5 million in 2010, \$8.0 million in 2009 and \$7.9 million in 2008 on research and development. We believe that our research and product development capabilities are unsurpassed in the industry and have played an important role in establishing our reputation for high quality, superior products.

Our commitment to research and development has enabled us, for example, to (i) produce high-performance papers designed to run on the high-speed manufacturing machines of our customers, (ii) produce papers to exacting specifications with very high uniformity, (iii) produce cigarette paper with extremely low basis weights, (iv) develop cigarette paper for LIP cigarettes, (v) produce highly porous cigarette and plug wrap papers, (vi) produce wrapper and binder tobacco reconstituted products, in a paper process, matching the specifications of machine-made cigars and (vii) produce papers and reconstituted tobacco products with other specifically engineered properties required for end-product performance attributes. We believe we are in the forefront of the specialty paper manufacturing process, having invested heavily in modern technology, including on-line banding and off-line printing capabilities for LIP cigarette papers, laser technology and modern paper-slitting equipment. We believe that our commitment to research and development, coupled with our investment in new technology and equipment, has positioned us to take advantage of growth opportunities all around the world.

PATENTS AND TRADEMARKS

As of December 31, 2010, we owned 191 patents and had pending 88 patent applications covering a variety of Cigarette Papers, RTL and cigar wrapper and binder products and processes in the United States, western Europe and several other countries. We believe that such patents, together with our papermaking expertise and technical sales support, have been instrumental in establishing us as the leading worldwide supplier of Cigarette Papers, RTL and reconstituted wrapper and binder made by the papermaking process. We believe that patents have contributed to our position as the world's leading independent producer of papers used for LIP cigarettes.

Management believes that our "ALGINEX®" water-based technology trademark for use in banded papers for the production of LIP cigarettes, and the "SWM" logo and trade names have been important contributors to the marketing of our products.

EMPLOYEES

As of December 31, 2010, we had 2,800 regular, full-time, active employees.

North American Operations Hourly employees at the Spotswood, New Jersey, and Ancram, New York mills are represented by locals of the United Steel Workers Union. The collective bargaining agreement at our Spotswood mill is a one-year agreement which is effective through July 28, 2011. The three-year collective bargaining agreement at our Ancram mill is effective through September 30, 2011. We believe employee and union relations continue to be positive at the Spotswood and Ancram mills.

The fiber operations of our Canadian subsidiary and our Newberry, South Carolina facility are non-union. We believe that employee relations are positive.

French Operations Hourly employees at our Quimperlé, Spay, and Saint-Girons, France mills are union represented. Our Quimperlé mill is operating pursuant to an employment agreement that expired effective December 31, 2010. Negotiations are being held at this location regarding compensation issues. The collective bargaining agreements at our Spay and Saint-Girons mills are effective through February 28, 2011 and June 1, 2011, respectively. We believe our employee relations are comparable to similar French manufacturing operations.

Employees of our Philippine and Polish operations are non-union. We believe that employee relations in those locations are positive.

Our mill in Medan, Indonesia is operating pursuant to a two-year collective bargaining agreement that is effective through June 30, 2011. We believe that employee relations are positive.

Brazilian Operations Hourly employees at the Pirahy mill are represented by a union. The one-year collective bargaining agreement at SWM-B was renewed through May 31, 2011. We believe that employee relations are positive and comparable to similar Brazilian manufacturing operations.

ENVIRONMENTAL MATTERS

Capital expenditures for environmental controls to meet legal requirements and otherwise relating to the protection of the environment at our facilities in the United States, France, the Philippines, Indonesia, Brazil and Canada were \$0.5 million in 2010 and are expected to be \$2 million to \$3 million in 2011 and less than \$1 million in 2012, of which no material amounts were or are expected to be the result of environmental fines or settlements. These expenditures are not expected to have a material adverse effect on our financial condition, results of operations or competitive position; however, these estimates could be modified as a result of changes in our plans, changes in legal requirements or other factors.

WORKING CAPITAL

We normally maintain approximately 30 to 60 days of inventories to support our operations. Our sales terms average between 15 and 60 days for payment by our customers, dependent upon the products and markets served. For a portion of our business, particularly our French segment export sales, extended terms are provided. With respect to our accounts payable, we typically carry approximately a 30 to 60 day level, in accordance with our purchasing terms, which vary by business segment. The accounts payable balance varies in relationship to changes in our manufacturing operations, particularly due to changes in prices of wood pulp and purchased energy and the level and timing of capital expenditures related to projects in progress.

EXECUTIVE OFFICERS

The names and ages of the executive officers as of February 25, 2011, together with certain biographical information, are as follows:

Name	Age	Position
Frédéric P. Villoutreix	46	Chairman of the Board and Chief Executive Officer
Otto R. Herbst	51	Chief Operating Officer & Executive Vice President
Michel Fievez	53	Executive Vice President
Wilfred A. Martinez	57	Vice President
Peter J. Thompson	48	Executive Vice President, Finance and Strategic Planning
Mark A. Spears	48	Corporate Controller

There are no family relationships between any of the directors, or any of our executive officers. None of our officers were selected pursuant to any arrangement or understanding between the officer and any person other than the Company. Our executive officers serve at the discretion of the Board of Directors and are elected annually by the Board.

Frédéric P. Villoutreix was elected Chairman of the Board and Chief Executive Officer effective January 1, 2009. Mr. Villoutreix joined the Company on December 7, 2005, was elected Chief Operating Officer on February 1, 2006, and served as interim President, French Operations from December 2006 to June 2007. Mr. Villoutreix joined us in December 2005 from Compagnie de Saint-Gobain, a leading French multi-national manufacturer of engineered materials and products, where he worked since 1990. From 2001 to 2005, Mr. Villoutreix held key manufacturing positions in Europe and the United States with Saint-Gobain, including General Manager, World Construction Products and Stone, Luxemburg and Vice President, Abrasives Europe and Coated Abrasives World with 33 operating locations.

Otto R. Herbst has served as Chief Operating Officer since January 2009 and the Executive Vice President since March 2010. Previously, Mr. Herbst was President of the Americas beginning in August 2006 with responsibility for the U.S. and Brazilian business units. Mr. Herbst served as our President — Brazilian Operations from April 1999 to July 2006. Prior to April 1999, he served as General Manager for New Business and Services from 1997 through March 1999 for Interprint, a manufacturer of security documents, telephone cards and business forms. From 1990 through 1997, Mr. Herbst served as Director of Agaprint, a manufacturer of packaging materials, business forms, commercial printing papers, personalized documents and envelopes.

Michel Fievez was appointed Executive Vice President during March 2010. He held the position of President — European Operations from June 2007 to March 2010. From 2003 to May 2007, Mr. Fievez served as General Manager One Side Coated Papers and then Vice President and General Manager Packaging, Metalizing and Office and Graphic with Ahlstrom Corporation. From 1998 to 2003, he held key manufacturing positions, including Managing Director, with Chesapeake Display and Packaging in Europe, and from 1994 to 1998, held the position of Vice President Manufacturing and Technology with Mead Packaging Europe.

Wilfred A. Martinez was appointed Vice President in January 2011. He served as President Americas Paper Business since March 2010. Previously, Mr. Martinez served as President of the Americas from January 1, 2009. Mr. Martinez was Corporate Executive Vice President and Strategy Officer, President, International Division and Senior Vice President, Worldwide Operations from 1996 to 2008 with Laticrete International, Inc., a world leader of tile and stone installation systems. From 1995 to 1996, he was General Manager, Monolithic Refractories, for Harbison-Walker Refractories, Inc., a leading global manufacturer of high temperature refractory products, and from 1979 to 1995 he served as Vice-President, International Operations, Vice-President, Technology and Director, Research and Development for Minteq International, Inc., a technology based multi-national sales and manufacturing refractory company.

Peter J. Thompson has served as Executive Vice President, Finance and Strategic Planning since January 2009. He served as Vice-President — Strategic Planning since August 2008. From August 2006 to August 2008, Mr. Thompson was our Chief Financial Officer and Treasurer. Mr. Thompson served as our President — U.S. Operations from 1998 to July 2006. During 1998, Mr. Thompson was Director — Sales and Marketing for the U.S. Operations. Mr. Thompson joined us in 1997 as a Marketing Manager in the U.S. Operations. Prior to joining us, he was employed by Tape, Inc. from 1995 to 1997, where he held several senior management positions in marketing, sales and finance. Mr. Thompson was employed by Kimberly-Clark from 1984 to 1995 in a variety of financial positions.

Mark A. Spears has served as our Corporate Controller since March 2008. Mr. Spears joined the Company in 1995 as Corporate Reporting Manager and subsequently served in progressive roles in the Controller department including Director of Corporate Reporting and Assistant Controller. Prior to joining Schweitzer-Mauduit, Mr. Spears was an audit manager with Coopers and Lybrand LLP (now PricewaterhouseCoopers) from 1984 to 1995.

Item 1A. Risk Factors

Factors That May Affect Future Results

Many factors outside of our control could impact future financial results. While not an exhaustive list, the following important factors could cause our actual results for 2011 and beyond to differ materially from those expressed in any forward-looking statements we have made.

Our business can be impacted by governmental actions relating to tobacco products.

In 2010, more than 93% of our net sales were from products used by the tobacco industry in making cigarettes or other tobacco products. Governments around the world, particularly in the United States and western Europe, increasingly are regulating the advertising, promotion, sale and use of tobacco products as a result of reports and speculation with respect to the possible harmful physical effects of cigarette smoking, second-hand smoke and use of tobacco products. In addition, tobacco products are heavily taxed in many jurisdictions, and U.S. healthcare legislation — the U.S. State Children's Health Insurance Program, known as SCHIP legislation — significantly raised federal excise taxes in 2009 on all tobacco products. Cigarette consumption in the United States and western Europe has declined, in part due to these actions, which, in turn, have decreased demand for our products in these regions. In addition, litigation is pending against the major manufacturers of consumer tobacco products seeking damages for health problems allegedly resulting from the use of tobacco in various forms. It is not possible to predict the outcome of such litigation or what effect adverse developments in pending or future litigation may have on the tobacco industry or its demand for our products, but in the past, increases in taxes and litigation have adversely affected demand. In the U.S., the regulatory jurisdiction of the Federal Food and Drug Administration includes tobacco products, and product component disclosure regulations. Also, similar regulations, commonly known as REACH, are being implemented in the European Union. The impact of these legislative initiatives on the production and sale of our and our customers' products is not presently known.

Our technological advantages are unlikely to continue indefinitely.

We consider our intellectual property and patents to be a material asset. We have been at the forefront of developing new products and technology within our industry and have patented several of our innovations, particularly with regard to cigarette paper used to produce LIP cigarettes. This has enhanced our ability to sell products and to provide added function and other value to the products we sell allowing them to command higher margins. Presently, we are seeing evidence of increasing efforts and activity by our competitors to develop and sell competitive products, particularly in the area of papers used for lower ignition propensity applications. Over time, we expect our competitors to develop competitive products that are designed to avoid our patents or to license our innovations. Ultimately, our patents will expire. As we expand our production of LIP papers and RTL to more locations and countries, the risk of the loss of proprietary trade secrets will increase, and any significant loss would result in the loss of the competitive advantages provided by such trade secrets. While we cannot predict the impact or the timing of these trends and eventualities, they likely will be to reduce our sales and margins from the levels that we otherwise would have achieved.

Effectively policing our domestic and international intellectual property and patent rights is costly and may not be successful.

Our portfolio of granted patents varies by country, which could have an impact on any competitive advantage provided by patents in individual markets. We rely on patent, trademark, and other intellectual property laws of the United States and other countries to protect our intellectual property rights. In order to maintain the benefits of our patents, we may be required to enforce certain of our patents against infringement through judicial or administrative

actions. However, we may be unable to prevent third parties from using our intellectual property or infringing on our patents without our authorization, which may reduce any competitive advantage we have developed. If we have to litigate to protect these rights, any proceedings could be costly, time consuming, could divert management resources, and we may not prevail. We cannot guarantee that any United States or foreign patents, issued or pending, will continue to provide us with any competitive advantage or will not be successfully challenged by third parties. We do not believe that any of our products infringe the valid intellectual property rights of third parties. However, we may be unaware of intellectual property rights of others that may cover some of our products or services. In that event, we may be subject to significant claims for damages. Effectively policing our intellectual property and patents is time consuming and costly, and the steps taken by us may not prevent infringement of our intellectual property, patents or other proprietary rights in our products, technology and trademarks, particularly in foreign countries where in many instances the local laws or legal systems do not offer the same level of protection as in the United States.

Oppositions were filed in December 2009 with the European Patent Office (EPO) contesting the grant by the EPO to the Company of patent number EP-1482815. The Company has responded to the opposition arguments by the September 18, 2010 deadline established by the EPO. An opposition was filed with the EPO contesting the grant by the EPO to the Company of patent number EP-133729, but the EPO has not yet opened an opposition proceeding. The Company believes that the EPO properly granted the patents in opposition; however, the final resolution of the oppositions could result in the invalidation of the patent or a further limitation of the scope of the patent claims which could affect the competitive value of the patent. The outcome of this dispute would not prevent the Company from practicing its Alginex® LIP solution.

Further, the Company filed an infringement action on February 8, 2010 in the United States District Court for South Carolina, Charleston Division, against multiple defendants alleging infringement of the Company's United States Patent Number 6,725,867 and a First Amended Complaint on June 1, 2010 which added claims of alleged infringement under United States Patent Number 5,878,753 and further specification of the products alleged to violate said patents. Adversarial proceedings present uncertainties and risks, which could include invalidation of the patent in dispute, a change in the scope of the patent claims, or an adverse determination on the question of infringement, among others. As provided by statute, upon opening of the investigation by the International Trade Commission, or ITC, concerning the importation of allegedly infringing cigarette papers into the United States, the respondents in the ITC action have the right to move to stay the civil action filed in South Carolina pending completion of the ITC actions, which they have done and the court has entered an order to that effect. This action will likely be restarted once the ITC action is concluded. We believe the outcome of this dispute would not prevent the Company from practicing its Alginex® LIP solution.

On December 17, 2010, the Company filed a complaint with the International Trade Commission under Section 337 of the Tariff Act of 1930 as amended, 19 U.S.C. § 1337, against multiple respondents based on the unlawful importation into the United States, the sale for importation, and the sale within the United States after importation of certain reduced ignition proclivity cigarette paper wrappers and products containing same that infringe, or are made or produced under, or by means of, a process covered by, one or more of claims 36, 43, and 45 of United States Patent No. 6,725,867 and claims 1-6, 10-18, and 22-25 of United States Patent No. 5,878,753. Upon further investigation and discovery, SWM may identify additional accused products and/or seek to assert additional claims. The complaint requests the ITC to issue an exclusion order and cease and desist orders. By notice dated January 13, 2011, the ITC instituted an investigation. The outcome of this action will not impact on the Company's right to produce and sell its flagship Alginex® papers for LIP cigarettes. An adverse outcome would not be dispositive of the claims asserted in the civil action filed in Charleston, South Carolina, as noted above, the institution of the ITC action does give the respondents the statutory right to have the civil action filed in South Carolina stayed pending the completion of the ITC investigation.

Our financial performance can be significantly impacted by the cost of raw materials and energy.

Raw materials are a significant component of the cost of the paper that we manufacture. The cost of wood pulp, which is the largest component of the raw materials that we use, is highly cyclical and can be more volatile than general consumer or producer inflationary changes in the general economy. For instance, during the period from January 2008 through December 2010, the U.S. list price of northern bleached softwood kraft pulp, or NBSK, a representative pulp grade that we use, ranged from a low of \$635 per metric ton in April 2009 to a high of \$1,010 per metric ton in June 2010. We periodically enter into agreements with customers under which we agree to supply products at fixed prices. As a consequence, unanticipated increases in the costs of raw materials can significantly impact our financial performance. Even where we do not have fixed-price agreements, we generally cannot pass through increases in raw material costs in a timely manner and in many instances are not able to pass through the entire increase to our customers.

Paper manufacturing is energy-intensive. In France and in the United States, availability of energy generally is reliable, although prices can fluctuate significantly based on variations in overall demand. Western Europe is becoming increasingly dependent on energy supplies from the Commonwealth of Independent States, which in the past has demonstrated a willingness to restrict or cut off supplies of energy to certain customers. The volume of oil or gas flowing through pipeline systems that ultimately connect to western Europe also has been cut off or restricted in the past, and such actions also have the capability of adversely impacting the supply of energy to western Europe. In Brazil, where production of electricity is heavily reliant upon hydroelectric plants, availability of electricity can be, and has in the past been, affected by rain variations. Although our Brazilian business currently has a sufficient supply of energy to continue its current level of operation there can be no assurance that we will have sufficient supply in the future. Due to the competitive pricing for most of our products, we typically are unable to fully pass through higher energy costs to our customers. Periodically, when we believe it is advantageous to do so, we enter into agreements to procure a portion of our energy for future periods in order to reduce the uncertainty of future energy costs. However, in recent years this has only marginally slowed the increase in energy costs due to the volatile changes in energy prices we have experienced.

Because of the geographic diversity of our business, we are subject to a range of international risks.

We have manufacturing facilities in seven countries, and sell products in over 90 countries, many of which are emerging and undeveloped markets. Both our manufacturing operations and our sales, depending on their location, are subject to various international business risks, including:

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Foreign countries can impose significant tax and other regulatory restrictions on business, including limitations on repatriation of profits and proceeds of liquidated assets. While we evaluate our overall financing plans in the various jurisdictions in which we operate and attempt to manage international movements of cash from and amongst our foreign subsidiaries in a tax-efficient manner, unanticipated international movement of funds due to unexpected changes in our business or in the needs of the business could result in a material adverse impact on our financial condition or results of operations.

•We are exposed to changes in foreign currency exchange rates. We utilize a variety of practices to manage this risk, including operating and financing activities and, where considered appropriate, derivative instruments. All derivative instruments we use are either exchange traded or entered into with major financial institutions in order to reduce credit risk and risk of nonperformance by third parties. However, as recent conditions in the financial markets have demonstrated, counterparty risk cannot be eliminated and there can be no assurance that our efforts will be successful.

•Changes in foreign currency exchange rates also impact the amount reported in other income (expense), net. For instance, when a non-local currency receivable or payable is not settled in the period in which it is incurred, we are required to record a gain or loss, as applicable, to reflect the impact of any change in the exchange rate as of the end of the period. We also have to reflect the translation rate impact on the carrying value of our foreign assets and liabilities as of the end of each period, which is recorded as Unrealized Translation Adjustment in Other Comprehensive Income.

•We are exposed to global as well as regional macroeconomic and microeconomic factors, which can affect demand and pricing for our products; unsettled political and economic conditions; expropriation; import and export tariffs; regulatory controls and restrictions; and inflationary and deflationary economies.

•We participate in a joint venture in China that sells our products primarily to Chinese tobacco companies and expect to build a new reconstituted tobacco mill in China. Operations in China entail a number of risks including the need to obtain operating and other permits from the government and to operate within an evolving legal and economic system.

The recoverability of business tax credits is uncertain

Our ability to recover certain business tax credits depends on the amount of taxable transactions we have in certain jurisdictions. In Brazil, we are currently generating more value-added tax credits than we utilize. As of December, 31, 2010, these credits totaled \$14.8 million. We applied for a special government action to obtain tax exempt status in the state of Rio de Janeiro to enable more rapid utilization of these credits. We expect approval and, if successful, this and other actions should allow our Brazilian operation to utilize more credits than it generates on an annual basis. These credits do not expire; however, if the exemption is not obtained, we may record an allowance for a significant portion of the balance. For more information, see Note 9. Other Assets, of the Notes to the Consolidated Financial Statements.

We are dependent upon the availability of credit, and changes in interest rates can impact our business.

We supplement operating cash flow with bank borrowings under a credit agreement with a syndicate of banks that expires in July 2012. To date, we have been able to access credit when needed and on commercially reasonable terms. However, deterioration of credit markets could have an adverse impact on our ability to negotiate new credit facilities. Constraints on the availability of credit, or the unavailability of credit at reasonable interest rates, would negatively impact our business.

Our credit facility contains financial covenants that we have historically fulfilled, and we do not presently anticipate any events that would impair our ability to meet those covenants in the future. However, in the event of material unforeseen events that impact on our financial performance, particularly during a time when we have material amounts of debt, a situation could arise where we are unable to fully draw from our existing credit facility notwithstanding that there is otherwise available capacity.

We have a combination of variable and fixed-rate debt consisting of short-term and long-term instruments. We selectively hedge our exposure to interest rate increases on our variable rate long-term debt when we believe that it is practical to do so. We utilize various forms of interest rate hedge agreements, including interest rate swap agreements and forward rate agreements, generally with contractual terms no longer than 24 months. There can be no certainty that our hedging activities will be successful or fully protect us from interest rate exposure.

Seasonality can impact our business.

Sales of our products in the United States, Europe and Brazil are subject to seasonal fluctuations. In the United States and Europe, customer shutdowns typically occur in July and December and historically have resulted in reduced net sales and operating profit during those two months. Additionally, our mills occasionally shut down equipment to perform additional maintenance during these months, resulting in higher product costs, higher maintenance expenses and reduced operating profit. In Brazil, customer orders are typically lower in December due to a holiday season during much of January and February. As an increasing percentage of our total production capacity and product sales become Asian and southeast Asian based, we will become increasingly subject to seasonal fluctuations that reflect the holiday periods in those regions.

We face competition from several capable and established competitors.

Our three largest competitors are Delfort Group AG, Julius Glatz GmbH and Miquel y Costas. All three primarily operate from modern and cost-effective mills in western Europe and are capable and long-standing suppliers to the tobacco industry. Further, two, Delfort and Glatz, are privately held and the third, Miquel y Costas, is a closely held public company. Thus their financial results and other business developments and strategies are not disclosed to the same extent as ours, which provides them some advantage in dealing with customers. Given our mutual concentration in western Europe, which is a declining market and has labor laws that make reducing capacity expensive and slow, excess capacity exists and therefore price competition is acute. All three have good relationships with the multinational cigarette companies, as does the Company. The multinational cigarette companies have been known to use these close relationships to support development of competitive products and facilities, especially when confronted with high value new technologies such as porous plug wrap in the past and potentially LIP today. As a result of the foregoing, the Company primarily faces selling price, sales volume and new product risks from its existing competitors. Currently, fine papers used to produce cigarettes are not exported from available capacity in China to western multinational cigarette companies due to government monopoly control over these producers. Should conditions change in this regard, capacity that currently is operating in China would present a risk to our competitive position in the developed world. In the RTL market, demand is a function of smoke delivery regulations, the cigarette manufacturer's desire for a uniform and consistent product and the cost of recycling the tobacco by-product scraps relative to the cost of virgin tobacco products. The enhanced capabilities provided by RTL in the area of product design and regulatory compliance are becoming more important to the end-user.

We are dependent upon a small number of customers for a significant portion of our sales. The loss of one or more of these customers could have a materially adverse effect on our business.

Three customers accounted for over 45% of our net sales in 2010. The loss of one or more of these customers, or a significant reduction in their purchases, could have a material adverse effect on our results of operations and financial results. In addition, significant consolidation has occurred among our customers, thereby increasing our dependence upon a fewer number of customers and increasing the negotiating leverage of the customers that survive. Adverse results in the negotiation of any of our significant customer contracts, the terms of which are typically negotiated every one to three years, could significantly impact our financial performance. We are presently the sole supplier of on-line banded cigarette papers for use in LIP cigarettes to Philip Morris-USA for its U.S. requirements under a long-term supply agreement for which Philip Morris-USA is obligated to purchase 100% of its requirements for its proprietary on-line banded cigarette papers for a minimum period of 7 years, and the Company is obligated to supply such product for a minimum of 12 years which began June 1, 2007. This supply agreement is a cost plus arrangement, and Philip Morris-USA began advising us in 2009 that it disagrees with the manner in which we have determined one aspect of the cost of this product as invoiced. Philip Morris-USA has exercised its contract right to have an independent party audit our cost calculation. We have provided Philip Morris-USA with the support for our calculation and confirmed that the calculation was made consistent with methodology applied over the life of the supply agreement and in accordance with the terms of the supply agreement. This matter could result in litigation between Philip Morris-USA and us. Currently, the amount disputed is approximately \$24.4 million.

Our business is subject to various environmental risks.

Our mills are subject to significant federal, state, local and foreign environmental protection laws with respect to air, water and other emissions as well as the disposal of solid waste. We believe we are operating in substantial compliance with these laws and regularly incur capital and operating expenditures in order to assure future compliance. However, these laws may change in the future, which could require changes in our practices or the incurrence of additional capital expenditures, and we may discover aspects of our business that are not in compliance. Violation of these laws can result in the imposition of significant fines and remediation costs. In France, we presently have sufficient authorized capacity for our emissions of carbon dioxide. However, this authorization must be renewed every five years. We cannot predict that we will have sufficient authorized capacity to conduct our operations in France as presently conducted or to do so without having to make substantial capital expenditures in future years. There also is the possibility of regulation of carbon dioxide emissions in the U.S., and legislation to this end has been introduced in Congress. It is not presently possible to assess what, if any, impact such regulations might have on our domestic U.S. operations.

We are a member of a potentially responsible party group (Global PRP Group) that has entered into a settlement with the State of New Jersey concerning the remediation of a landfill site in Middlesex County, New Jersey. We have established a reserve of less than \$0.1 million that we believe is adequate to cover our liability, but we remain exposed to changes in the State's requirements and in the estimated costs to complete the remediation in accordance with the settlement terms. In 2008, we received an invitation to participate in the remediation of contamination allegedly identified at a mill complex in Elizabeth, New Jersey that was formerly owned and operated by Kimberly-Clark Corporation. Under the terms of our spin-off from Kimberly-Clark in 1995, we are obligated to indemnify Kimberly-Clark Corporation from certain exposures related to the past and future liabilities of the business spun-off, which would include the Elizabeth, New Jersey mill. We declined the invitation to participate in the proposed clean-up of this mill pending the provision of information demonstrating our responsibility to do so, which to date has not been provided.

Although we are not aware of any environmental conditions at any of our facilities that could have a material adverse effect on our financial results, as we restructure and close certain facilities in France and in the U.S. that have been operated over the course of many decades, we may be required to perform additional environmental evaluations that could identify items that might require remediation or other action, the nature, extent and cost of which are not presently known.

We are subject to various legal actions and other claims.

We regularly are involved in legal actions and other claims arising in the ordinary course of business. Although we do not believe that any of the currently pending actions or claims will have a materially adverse impact on our business or financial condition, we cannot provide any assurances in this regard. Information concerning some of the actions that currently are pending is contained in Note 17, Commitments and Contingencies, of the Notes to Consolidated Financial Statements and in Part I, Item 3, "Legal Proceedings".

Our expansion plans entail different and additional risks relative to the rest of our business.

We recently announced suspension of construction of a wholly-owned reconstituted tobacco mill in the Philippines and plans to construct a new reconstituted tobacco mill in China through a joint venture in which one of our subsidiaries would have a 50% ownership interest. Building a new mill is a major construction project and entails a number of risks, ranging from the possibility that the contractors and sub-contractors who are expected to build the facility and supply the necessary equipment do not perform as expected, to the possibility that there will be cost overruns or that design defects or omissions cause the mill to perform at less than projected efficiency or at less than

projected capacity. In addition, commencement of production at a new mill is time consuming and requires customer testing and acceptance of the products that are produced. Also, while we anticipate sufficient demand for the mill's output, there can be no assurances that the expected demand will materialize. For more information on our expansion plans, see Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation.

Restructuring activities can significantly impact our business.

We began significant restructuring activities in 2006 and 2007 in France and the United States and during 2007 in Brazil that have become part of an overall effort to improve an imbalance between demand for our products and our paper production capacity as well as improve our profitability and the quality of our products. Although now largely completed, restructuring of our existing operations involves issues that are complex, time-consuming and expensive and could significantly disrupt our business. The challenges involved in executing the remaining actions that are part of our restructuring plans include:

demonstrating to customers that the restructuring activities will not result in adverse changes in service standards or business focus;

consolidating administrative infrastructure and manufacturing operations while maintaining adequate controls throughout the execution of the restructuring;

- preserving distribution, sales and other important relationships and resolving potential conflicts that may arise;
- minimizing the diversion of management attention from ongoing business activities;

maintaining employee morale and retaining key employees while implementing restructuring programs that often include reductions in the workforce;

coordinating and combining operations, which may be subject to additional constraints imposed by collective bargaining agreements and local laws and regulations; and

- achieving the anticipated levels of cost savings and efficiency as a result of the restructuring activities.

In the aggregate including continuing and discontinued operations, we have incurred \$138.9 million in restructuring and related impairment expenses from 2006 through December 31, 2010, including \$86.0 million in cash-related expenses. As a result of actions taken as of December 31, 2010, we expect future payments of approximately \$19 million in cash-related restructuring costs through 2011.

One portion of our business is dependent upon a single mill.

Sales of reconstituted tobacco leaf products represent a substantial portion of our revenues. We presently produce reconstituted tobacco leaf at only one facility located in France. Although reasonable measures have been taken to minimize the risk of a casualty event at this facility, its loss or the interruption of operations for a significant length of time could have a material adverse effect on our business. Our RTL business is also subject to competitive risk from lower cost natural tobacco.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

As of December 31, 2010, we operated 11 production facilities (which include three fiber pulping operations) on four continents.

We have approximately 141,000 metric tons of annual paper production capacity and approximately 84,000 metric tons of annual reconstituted tobacco products production capacity, dependent upon the production mix. Capacity utilization increased in 2010 to 92% for paper products and decreased to 91% for reconstituted tobacco products compared with 82% and 98%, respectively, in 2009. We also operate flax fiber processing operations in France and Canada. We own each of these facilities and the associated operating equipment except for a flax tow storage facility in Winkler, Manitoba, which is leased.

We maintain administrative and sales offices in Alpharetta, Georgia, in Quimperlé and Spay, France, in Shanghai, China, in Pirai and Rio de Janeiro, Brazil, in Madrid, Spain, in San Pedro, Philippines, in Medan, Indonesia, Moscow,

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Russia and Strykow, Poland. Our world headquarters are also located in Alpharetta. All of these offices are owned except for those located in Alpharetta, Shanghai, Rio de Janeiro, Madrid, Moscow and Strykow.

We consider all of our facilities to be well-maintained, suitable for conducting our operations and business, and adequately insured.

The following are locations of our principal production facilities which are owned, except for the Strykow, Poland facility which is leased, as of December 31, 2010:

French Segment Production Locations	U.S. Segment Production Locations	Brazil Segment Production Locations
Papeteries de Mauduit Mill Quimperlé, France	Spotswood Mill Spotswood, New Jersey	Pirahy Mill Piraí, Brazil
Papeteries de Saint-Girons Mill Saint-Girons, France	Ancram Mill Ancram, New York	
LTR Industries Mill Spay, France	Newberry Operation Newberry, South Carolina	
PDM Philippines Industries San Pedro, Philippines	Fiber Operation Manitoba, Canada	
P.T. PDM Indonesia Medan, Indonesia	SWM-Poland Strykow, Poland	

Item 3. Legal Proceedings

General

We are involved in various legal proceedings relating to contracts, commercial disputes, taxes, environmental issues, employment and workers' compensation claims, product liability and other matters. We periodically review the status of these proceedings with both inside and outside counsel. We believe that the ultimate disposition of these matters will not have a material adverse effect on the results of operations in a given quarter or year. Below is a summary of our major outstanding litigation.

Class Action

On March 31, 2010, the City of Pontiac General Employees' Retirement System, individually and on behalf of all others similarly situated, sued Schweitzer-Mauduit International, Inc., its Chief Executive Officer, Frédéric P. Villoutreix, and its Chief Financial Officer, Peter J. Thompson, in the United States District Court for the Northern District of Georgia for alleged violations of certain sections and rules of the Securities Act of 1934. The plaintiffs' identified a putative class period covering August 5, 2009 to February 10, 2010. The primary allegations of the suit contend that the defendants misrepresented the strength of the Company's competitive position in the U.S. and its ability to withstand European competition, particularly in the area of lower ignition propensity papers. Further, the complaint alleges that the defendants concealed threats to the Company's relationship with Phillip Morris USA, Inc. As a consequence of these alleged misrepresentations or omissions, the plaintiffs contend that the Company's stock price was artificially inflated causing the plaintiffs to be damaged in an unspecified amount. The court issued an order on August 26, 2010 appointing as co-Lead Plaintiffs the City of Pontiac General Employees' Retirement System and the Western Washington Laborers-Employers Pension Trust. Robbins Geller Rudman & Dowd was appointed Lead Counsel. Plaintiffs filed an Amended Consolidated Complaint, which becomes the operative complaint in the case going forward. The matter has been fully briefed by the parties. The Company believes that the allegations are without merit as to all defendants and intends to vigorously defend the matter as to itself and its two officers. The Company has not recorded any liability associated with this matter and believes the outcome of this litigation will not have a material adverse impact on the Company's financial condition.

Imposto sobre Circulação de Mercadorias e Serviços, or ICMS, a form of value-added tax in Brazil, was assessed to SWM-B in December of 2000. SWM-B received 2 assessments from the tax authorities of the State of Rio de Janeiro for unpaid ICMS taxes from January 1995 through November 2000, which together with interest and penalties totaled approximately \$14 million based on the foreign currency exchange rate at December 31, 2000, collectively the Assessment.

The Assessment concerned the accrual and use by SWM-B of ICMS tax credits generated from the production and sale of certain non-tobacco related grades of paper sold domestically that are immune from the tax to offset ICMS taxes otherwise owed on the sale of products that are not immune. One of the 2 assessments related in part to tax periods that predated our acquisition of Pirahy and is covered in part by an indemnification from the sellers of Pirahy, or Assessment 1 (case number 2001.001.115144-5). The second assessment pertains exclusively to periods that SWM-B owned the Pirahy mill, or Assessment 2 (case number 2001.001.064544-6). While SWM-B is primarily responsible for the full payment of the Assessment in the event of an ultimate unfavorable outcome, SWM-B is not aware of any difficulties that would be encountered in obtaining reimbursement of that portion of any payment resulting from Assessment 1 from the previous owner under the indemnification.

SWM-B has contested the Assessment based on Article 150, VI of the Brazilian Federal Constitution of 1988, which grants immunity from ICMS taxes to papers used in the production of books, newspapers and periodicals, or immune papers, and the raw material inputs used to produce immune papers.

Presently, part of the Assessment, for which we have received favorable lower court rulings, is pending on appeal before the Federal Supreme Court under case number A1588187 and another part of the Assessment, for which we have primarily received unfavorable lower court rulings, is pending on appeal before the Third Vice Presidency under case no. 2005.134.05319. In January 2010, the State of Rio de Janeiro attempted to execute a tax foreclosure to collect Assessment 2. In June 2010, the Supreme Court of Brazil granted a writ of prevention that blocks any attempt by the State of Rio de Janeiro from attempting to execute a tax foreclosure against SWM-B on Assessment 2. As to Assessment 1, there is no ruling in favor of the State of Rio de Janeiro that would allow it to execute a tax foreclosure.

SWM-B continues to vigorously contest the Assessment and believes that the Assessment will ultimately be resolved in its favor. However, since the final resolution involves presentation of the matter to the Supreme Court of Brazil, it is not likely to be finally resolved in the near future. Based on the foreign currency exchange rate at December 31, 2010, the Assessment totaled approximately \$34 million, of which approximately \$16 million is covered by the above-discussed indemnification. No liability has been recorded in our consolidated financial statements for the Assessment based on our evaluation that SWM-B is more likely than not to prevail in its challenge of the Assessment under the facts and law as presently understood.

In February 2004, SWM-B filed suit against the State of Rio de Janeiro in the 11th Court of Public sitting in Rio de Janeiro, case number 2004.001.022063-6, to recover ICMS credits previously reversed in 2000 following receipt of the Assessment. After the Assessment was filed against us, SWM-B changed its procedures and did not utilize ICMS tax credits through the end of production and sale of immune papers during 2001. As a result of having received favorable lower court rulings to the Assessment, SWM-B petitioned the court for permission to offset overpaid ICMS taxes against current tax liabilities. The amount of the claim totals approximately \$2 million, based on the foreign currency exchange rate at December 31, 2010. In August 2006, SWM-B filed an interlocutory appeal, which has not yet been ruled upon. As of December 31, 2010, no asset has been recorded for this potential recovery.

Imposto sobre Produtos Industrializados, or IPI, a form of federal value-added tax in Brazil. Schweitzer-Mauduit do Brasil v. Federal Union, Federal Regional Tribunal sitting in Rio de Janeiro, case number 2004.51.04.000502-4 (March 5, 2004).

SWM-B instituted action in March 2004 to recover credits on past and future purchases of raw materials that are exempt from IPI taxes or that carry an IPI tax rate of zero, for which a favorable ruling was received at the first court level. The recovery would be in the form of presumed credits that could be applied to offset other IPI tax liabilities. The action for recovery is based on the principle in Brazilian law of non-cumulative taxes. The potential recovery of IPI credits, depending upon several contested factors, could be in the range of \$10 to \$20 million, which amounts we consider a gain contingency and have not recorded in the Company's consolidated financial statements. During 2007, we received an unfavorable ruling on appeal in the Second Degree and we have appealed that ruling to the Supreme Court of Justice where the matter is still pending. The final resolution of this matter will likely entail judicial proceedings up to and including presentation of the matter to the Supreme Court of Brazil and is not likely to be resolved for several years.

Indemnification Matters

In connection with our spin-off from Kimberly-Clark in 1995, we undertook to indemnify and hold Kimberly-Clark harmless from claims and liabilities related to the businesses transferred to us that were not identified as excluded liabilities in the related agreements. As of December 31, 2010, there are no material claims pending under this indemnification.

PART II.

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

Market Information

Since November 30, 1995, our common stock, \$0.10 par value, or Common Stock, has been listed on the New York Stock Exchange, trading under the symbol "SWM." On February 22, 2011, our stock closed at \$55.05 per share.

The table below presents the high and low prices of our Common Stock on the New York Stock Exchange — Composite Transactions reporting system for the periods indicated.

	High	Low
2011		
First Quarter (through February 22, 2011)	\$ 68.38	\$ 52.95
2010		
Fourth Quarter	\$ 69.33	\$ 53.08
Third Quarter	60.48	42.62
Second Quarter	62.63	47.28
First Quarter	83.63	42.39
2009		
Fourth Quarter	\$ 72.18	\$ 49.08
Third Quarter	57.28	27.47
Second Quarter	27.99	18.07
First Quarter	23.22	12.65

Performance Graph

The following graph compares the total cumulative stockholder return on our Common Stock during the period from December 31, 2005 through December 31, 2010, with the comparable cumulative total returns of the Wilshire 5000 Index and a self-constructed peer group which reflects, but is not exactly comparable to, the Dow Jones Paper Products Index. We have selected the following companies as our peer group: Neenah Paper Inc., P.H. Glatfelter Co., Wausau-Mosinee Paper Corp., and Buckeye Technologies Inc.

The graph assumes that the value of the investments in the Common Stock and each index were \$100 on December 31, 2005 and that all dividends were reinvested. The stock price performance shown on the graph below is not necessarily indicative of future price performance.

Holders

As of February 22, 2011, there were 2,763 stockholders of record.

Dividends

We have declared and paid cash dividends of \$0.15 per share of our Common Stock every fiscal quarter since the second quarter of 1996. We currently expect to continue this level of quarterly dividend. Our Credit Agreement covenants require that we maintain certain financial ratios, as disclosed in Note 11, Debt, of the Notes to Consolidated Financial Statements, none of which under normal business conditions materially limit our ability to pay such dividends. We will continue to assess our dividend policy in light of our cash generation, debt levels and ongoing requirements for cash to fund operations and to pursue possible strategic opportunities.

Securities Authorized for Issuance under Equity Compensation Plans

The following table provides information, as of December 31, 2010, with respect to the shares of our Common Stock that may be issued under our existing equity compensation plans:

Plan Category	Number of Securities To be Issued Upon Exercise of Outstanding Options	Weighted-Average Exercise Price of Outstanding Options	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding securities reflected in the first column)
Equity Compensation Plans approved by stockholders:			
Equity Participation Plan (1)	174,987	\$ 31.56	—
Outside Directors Stock Plan (2)	N/A	N/A	68,061
Restricted Stock Plan (3)	N/A	N/A	161,046
Total approved by stockholders	N/A	N/A	229,107
Equity Compensation Plans not approved by stockholders:			
Grand Total	N/A	N/A	229,107

N/A — Not applicable.

- (1) The Equity Participation Plan is described in Note 16, Stockholders' Equity, of the Notes to Consolidated Financial Statements appearing in Part II, Item 8 herein.
- (2) The Outside Directors Stock Plan consists of shares registered for the purpose of issuance to our outside Directors for payment of their retainer fees quarterly in advance. Director's retainer fees in 2010 were \$15,000 quarterly which are payable in our Common Stock. The number of shares issued each quarter is determined based on the then fair market value of the shares, which is determined in accordance with the plan as closing price on the date one day prior to the date of distribution. Certain Directors have elected to defer receipt of quarterly retainer fees under the terms of our Deferred Compensation Plan for Non-Employee Directors, resulting in an accumulation of

stock unit credits. The Director has the option, upon retirement or earlier termination from the Board of Directors, to have these stock unit credits distributed in the form of our Common Stock or cash. While held in the deferred compensation plan account, these stock unit credits carry no voting rights and cannot be traded as Common Stock, although declared dividends create additional stock unit credits. As of December 31, 2010, deferred retainer fees have resulted in 36,082 accumulated stock unit credits, excluding credited dividends (40,445 accumulated stock unit credits including credited dividends).

- (3) The Restricted Stock Plan is described in Note 16, Stockholders' Equity, of the Notes to Consolidated Financial Statements appearing in Part II, Item 8 herein. Shares awarded under the terms of this plan are both subject to forfeiture and cannot be sold or otherwise transferred until fully vested or such restrictions are otherwise lifted. Such shares are deemed by us to be issued and outstanding and are subject to all other financial interests, including our declared dividends. As of December 31, 2010, 539,314 shares issued under this plan remained restricted.

Recent Sales of Unregistered Securities

We had no unregistered sales of equity securities during the fiscal year ended December 31, 2010.

Repurchases of Equity Securities

The following table indicates the number of shares and amount of our Common Stock repurchased during 2010 and the remaining number of shares and amount of share repurchases currently authorized by our Board of Directors as of December 31, 2010:

	Total Number Of Shares Repurchased	Average Price Paid Per Share	Total Number of Shares Repurchased As Part of Publicly Announced Programs (# shares)	(\$ in millions)	Maximum Amount Of Shares that May Yet be Repurchased Under the Program (\$ in millions)
First Quarter	8,491	\$70.35	8,491	0.6	
Second Quarter	3,300	48.34	3,300	0.2	
Third Quarter	376,903	48.35	376,903	18.2	
October	—	—	—	—	
November	—	—	—	—	
December	—	—	—	—	
Fourth Quarter	—	—	—	—	
Full Year 2010	388,694	\$48.83	388,694	19.0	\$ 30.0 *

*In December 2010, the Board of Directors authorized the repurchase of shares of our Common Stock during the period January 2, 2011 to December 31, 2011 in an amount not to exceed \$30.0 million. During February 2011, the Company repurchased 525,000 shares for \$30.0 million.

The Company sometimes uses corporate 10b5-1 plans so that share repurchases can be made at predetermined stock price levels, without restricting such repurchases to specific windows of time. Future Common Stock repurchases will be dependent upon various factors, including the stock price, strategic opportunities and cash availability.

Item 6. Selected Financial Data

The following selected financial data should be read in conjunction with Item 7, “ Management’s Discussion and Analysis of Financial Condition and Results of Operation ,” and the consolidated financial statements and related notes within this Annual Report on Form 10-K. The results of our closed Malaucène, France mill have been retrospectively presented as discontinued operations for all periods. All dollar amounts are in millions except per share amounts, statistical data and ratios.

	For the Years Ended December 31,				
	2010	2009	2008	2007	2006
Results of Operations					
Net Sales	\$740.2	\$719.6	\$724.5	\$676.4	\$617.7
Cost of products sold	543.6	531.8	617.9	565.3	532.8
Gross Profit	196.6	187.8	106.6	111.1	84.9
Nonmanufacturing expenses	73.6	74.7	60.2	62.2	53.7
Restructuring & impairment expense	13.4	23.9	6.5	18.7	20.8
Operating Profit	109.6	89.2	39.9	30.2	10.4
Income from Continuing Operations	71.4	59.6	16.7	20.0	6.8
Loss from Discontinued Operations	(6.1)	(24.0)	(15.8)	(8.6)	(3.5)
Net Income	65.3	35.6	0.9	11.4	3.3
Net Income Attributable to Noncontrolling Interest					
Net Income (Loss) Attributable to SWM	65.3	35.6	0.7	3.4	(0.8)
Net Income (Loss) Per Share- Basic:					
Income per share from continuing operations					
Income per share from continuing operations	\$3.94	\$3.80	\$1.06	\$0.77	\$0.18
Loss from discontinued operations	(0.34)	(1.53)	(1.02)	(0.55)	(0.23)
Net income (loss) per share - Basic	\$3.60	\$2.27	\$0.04	\$0.22	\$(0.05)
Net Income (Loss) Per Share – Diluted:					
Income per share from continuing operations					
Income per share from continuing operations	\$3.86	\$3.69	\$1.05	\$0.77	\$0.18
Loss from discontinued operations	(0.33)	(1.49)	(1.01)	(0.55)	(0.23)
Net income (loss) per share - Diluted	\$3.53	\$2.20	\$0.04	\$0.22	\$(0.05)
Cash Dividends Declared and Paid Per Share					
Cash Dividends Declared and Paid Per Share	\$0.60	\$0.60	\$0.60	\$0.60	\$0.60
EBITDA from Continuing Operations (Earnings before interest, taxes, depreciation and amortization) (1)					
EBITDA from Continuing Operations (1)	\$145.8	\$128.0	\$74.4	\$71.5	\$46.3
Adjusted EBITDA from Continuing Operations (1)					
Adjusted EBITDA from Continuing Operations (1)	\$159.2	\$151.9	\$80.9	\$90.2	\$67.1
Percent of Net Sales					
Gross Profit	26.6	% 26.1	% 14.7	% 16.4	% 13.7
Nonmanufacturing expenses	9.9	% 10.4	% 8.3	% 9.2	% 8.7
Financial Position					
Capital spending	\$73.7	\$15.3	\$35.3	\$47.7	\$9.6
Depreciation	33.0	37.1	41.0	39.9	40.7
Total Assets	850.4	791.9	728.7	775.0	697.1

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Total Debt	51.8		60.1		179.8		100.9		97.3	
Total debt to capital ratio	9.0	%	11.1	%	39.3	%	21.5	%	23.4	%

(1) Earnings before interest, taxes, depreciation and amortization (EBITDA) from Continuing Operations is a non-GAAP financial measure that is calculated by adding interest expense, income tax provision, net income attributable to controlling interest, depreciation and amortization expense to income (loss) from continuing operations. Adjusted EBITDA from continuing operations is a non-GAAP financial measure that is calculated by adding restructuring and impairment expense to EBITDA from continuing operations. Reconciliations to income from continuing operations for the years ended December 31 are as follows (\$ in millions):

	2010	2009	2008	2007	2006
Income from Continuing Operations	\$71.4	\$59.6	\$16.7	\$20.0	\$6.8
Plus: Interest expense	1.8	4.3	9.5	5.3	5.3
Plus: Tax provision (benefit)	39.8	25.3	6.4	5.0	(2.2)
Plus: Depreciation and amortization	40.0	43.9	47.4	39.2	38.2
Less: Amortization of deferred revenue	(7.2)	(5.1)	(5.8)	(6.0)	(5.9)
Plus: Net income attributable to noncontrolling interest	—	—	0.2	8.0	4.1
EBITDA from Continuing Operations	\$145.8	\$128.0	\$74.4	\$71.5	\$46.3
Restructuring and impairment expense	13.4	23.9	6.5	18.7	20.8
Adjusted EBITDA from Continuing Operations	\$159.2	\$151.9	\$80.9	\$90.2	\$67.1

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation

The following is a discussion of our results of operations and financial condition. This discussion should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this report and the selected financial data included in Item 6. The discussion of our results of operations and financial condition includes various forward-looking statements about our markets, the demand for our products and our future prospects. These statements are based on certain assumptions that we consider reasonable. For information about risks and exposures relating to us and our business, you should read the section entitled "Factors That May Affect Future Results," in Part I, Item 1A of this Form 10-K.

The Management's Discussion and Analysis of Financial Condition and Results of Operation is designed to provide a reader of our financial statements with an understanding of our recent performance, our financial condition and our prospects. The following will be discussed and analyzed:

- Chief Executive Officer's Summary
 - Recent Developments
- Critical Accounting Policies and Estimates
 - Recent Accounting Pronouncements
 - Results of Operations
 - Liquidity and Capital Resources
- Other Factors Affecting Liquidity and Capital Resources
 - Outlook
 - Forward-Looking Statements

Chief Executive Officer's Summary

In 2010, SWM reported net income of \$65.3 million on total net sales of \$740.2 million.

Sustained growth of highly differentiated LIP products resulted in overall year-on-year revenue increase of 4.1% at constant currency, an inflexion point after several years of relatively stagnant revenue generation.

In 2010, we reported diluted earnings per share of \$3.53, higher than the \$2.20 earned in 2009, despite unfavorable impacts from higher pulp prices and share count dilution partially offset by lower losses from discontinued operations at our closed Malaucène, France mill and lower restructuring and impairment expenses. The Company generated \$141.1 million in operating cash flow during 2010, as a result of higher levels of net income and a \$26.7 million reduction in working capital. That was more than enough to fund large strategic capital projects and \$29.0 million in restructuring-related cash severances for our continuing and discontinued operations.

SWM performance of recent years reflects, in large part, the repositioning of our business portfolio towards higher-value products and in growing our market presence in Asia.

We managed to deliver more profit from a lean slate of productive assets in 2010, resulting in a higher return on invested capital (ROIC). This measure, at the core of our executive compensation plans, reflects our determination to invest in products, projects and businesses that consistently yield returns in excess of our underlying cost of capital. ROIC increased to another record high of 17.1% in 2010.

During 2010, we sharpened our strategic focus and accelerated the deployment of Lean Six Sigma to achieve our operational excellence ambitions. Our renewed focus on driving business efficiency will benefit both top-line and bottom-line growth as we commit to achieving business excellence in every area of our organization including sales and marketing, research and development, procurement, production and global supply. Our commitment to operational excellence will support our efforts to deliver the best total value to customers.

Recent Developments

With the expected advent of the LIP requirements in the European Union in 2011, we are poised to further strengthen our market position in this premium application and significantly improve the margin profile of our core paper business. During 2010, we completed the construction of a new LIP facility in Poland, established third party printing capacity and purchased an LIP press in France at PdM in anticipation of supplying our customers' needs with compliant papers.

In light of increased volatility and a developing oversupply condition within the leaf tobacco sector, in January 2011, we announced changes to our Asian reconstituted tobacco strategy. The decision to suspend the construction of the greenfield reconstituted tobacco leaf, or RTL, facility in the Philippines and redirect the capacity expansion plan to serve the Chinese market is both opportunistic and strategic. By accelerating establishment of a domestic production site in China through a joint venture, at a time when RTL demand is expected to more than double in China over the next five years, SWM can fully leverage its leading technology and expertise in the area of tar reduction. The Chinese expansion is expected to considerably strengthen our business platform in this strategic market with direction to better serve domestic customers on the fast growing premium cigarette segment and help China achieve success as new regulations targeting smoke delivery reductions become implemented.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States, which require management to make estimates that affect the amounts of revenues, expenses, assets and liabilities reported and disclosure of contingencies. Changes in these estimates could have a significant impact on our results of operations, financial position, or cash flows. We discussed with the Audit Committee of the Board of Directors the estimates and judgments made for each of the following items and our accounting for and presentation of these items in the accompanying financial statements:

Accounting for Income Taxes

We must make assumptions, judgments and estimates to determine our current provision for income taxes and also our deferred income tax assets and liabilities and any valuation allowance to be recorded against a deferred income tax asset. Our judgments, assumptions and estimates take into account our interpretation of current tax laws. Changes in tax law or our interpretation of tax laws could significantly impact the amounts provided for income taxes in our consolidated financial statements. Our assumptions, judgments and estimates relative to the value of a deferred tax asset take into account projections of the amount and category of future taxable income. Actual operating results and the underlying amount and category of income in future years could render our current assumptions, judgments and estimates of recoverable net deferred taxes inaccurate. Any of the assumptions, judgments and estimates mentioned above could cause our actual income tax obligations to differ from our estimates, thus materially impacting our financial position and results of operations.

We record and maintain income tax valuation allowances to reduce deferred tax assets to an amount we estimate will be realizable more likely than not. We have available net operating loss carryforwards, or NOLs, and other various tax credits in the jurisdictions in which we operate, for which we have recorded deferred tax assets totaling \$57.0 million as of December 31, 2010. Certain of these potential future benefits are not expected to be fully realized or utilized prior to their expiration. As a result, at December 31, 2010, we have \$6.9 million of valuation allowances against certain of the deferred tax assets, as follows (\$ in millions):

	Total Asset	Valuation Allowance	Net Asset
Net operating loss carryforwards	\$ 56.0	\$ (5.9)	\$ 50.1
U.S. states tax credit carryforwards	1.0	(1.0)	--
	\$ 57.0	\$ (6.9)	\$ 50.1

Expiration periods vary for our NOLs depending on the tax laws governing the jurisdiction where the NOL was generated. Under current tax laws, remaining NOLs in France and Brazil carry forward indefinitely, and NOLs in Spain expire in 15 years subsequent to the year generated. Valuation allowances related to NOLs in Spain totaled \$4.1 million as of December 31, 2010, fully reserving the related deferred tax asset in Spain, since we believe that it is reasonably likely that we will not generate taxable income in Spain prior to the expiration of these NOLs, as SM-Spain only functions as our primary foreign investment holding company. The remaining NOLs at December 31, 2010, in Spain will fully expire in 2023 if not utilized against taxable income in Spain. Valuation allowances related to NOLs in Brazil totaled \$1.8 million as of December 31, 2010, partially reserving the related \$13.1 million deferred tax asset in Brazil, since we believe that we will not generate sufficient taxable income in Brazil within an acceptable time frame and given the annual limit of NOL utilization of 30% of taxable income. In 2010, the Company wrote off \$0.1 million in Philippine deferred tax assets related to NOLs that did not have a valuation allowance due to it not being fully utilized prior to expiration.

We expect sufficient future taxable income in France and Brazil to fully utilize the respective French and Brazilian NOL carryforward deferred tax assets, net of valuation allowances, of \$38.8 million and \$11.3 million, respectively, and plan to utilize available tax planning strategies in France. However, operating losses have been incurred in past periods in Brazil and France as a result of lower operating earnings together with substantial restructuring expenses incurred. The Company's assumptions, judgments and estimates relative to the valuation of these net deferred tax assets take into account available positive and negative evidence of realizability, including recent financial performance, the ability to realize benefits of restructuring and other recent actions, projections of the amount and category of future taxable income and tax planning strategies. Actual future operating results and the underlying amount and category of income in future periods could differ from the Company's current assumptions, judgments and estimates. Although realization is not assured, the Company believes it is more likely than not that these net deferred tax assets at December 31, 2010, will be realized. Future operating losses in Brazil and the Company's paper operations in France could result in recording additional valuation allowance in a future period which could be material to our results of operations in the period that such valuation allowance was recorded. If at a future date the Company determines that the weight of the positive evidence is not sufficient to overcome the negative evidence, additional valuation allowances against these deferred tax assets to reduce the net deferred tax asset to an amount we believe will more likely than not be realizable would be recorded in the period such determination is made.

We receive credits in our U.S. federal income tax return for income taxes paid in foreign jurisdictions. Income from foreign sources, including dividend income from foreign subsidiaries, is included in taxable income of the U.S. parent. In some cases, the amount of credits realized in the tax return is more or less than the tax owed on the foreign source income. When the amount of credits exceeds the amount of taxes owed on that foreign source income, foreign tax credit carryforwards are generated. When the credits are less than the tax owed, unexpired credit carryforwards from prior years can be utilized in certain circumstances. These circumstances are dependent upon both foreign source and domestic taxable income. At December 31, 2010, we utilized all current year foreign tax credits generated and all unexpired credit carryforwards from prior years. Depending on the U.S. business unit's profitability, we may implement certain income tax elections to accelerate taxable income or to delay deductions in order to maintain positive domestic taxable income or to minimize a domestic taxable loss (e.g., our election for U.S. income tax purposes to capitalize research costs in the year incurred and amortize over a 10-year life, as opposed to taking the income tax deduction in the year incurred). However, many such actions cannot be repeated in future years and certain of those elections may make it more difficult to have positive domestic taxable income in future periods. The profitability of our U.S. business operations must be maintained to provide us an opportunity to utilize any foreign tax credits in the future in a manner that will be beneficial to our financial results. Under current tax law, the carryforward period of foreign tax credits is 10 years. Based on the 10-year carryforward period, together with the current and forecasted profitability of our U.S. business operations and the requirements of the foreign source income and credit calculations, we would evaluate whether it is more likely than not that we could fully utilize any foreign tax credit carryforwards in a beneficial manner prior to their expiration and reduce a net deferred tax asset to an estimated realizable amount. We regularly update our estimates of domestic taxable income in order to evaluate whether the facts and circumstances have changed such that we must change our expected utilization of foreign tax credits and valuation allowances on these deferred tax assets.

Our carryforwards of federal research credits and U.S. state tax credits require applicable taxable income in the respective tax returns in order to be utilized prior to their expirations. At December 31, 2010, we utilized our federal research credits, which have a 20 year carryforward period, prior to their expiration. However, we do not currently expect sufficient future taxable income in our U.S. state income tax returns to utilize all of our state tax credits prior to their expiration. In Massachusetts, where we have substantially completed plant shut-down activities, New York and New Jersey, the carryforward periods are 15, 15 and 7 years, respectively, and credit utilization is limited to 50% of the income tax liability. At December 31, 2010, we have \$1.0 million of valuation allowances reducing these deferred tax assets to our estimated realizable amounts. We regularly update these estimates in order to evaluate whether the facts and circumstances have changed such that we must change our valuation allowances on these deferred tax assets.

At December 31, 2010 and 2009, we had no significant unrecognized tax benefits related to income taxes at January 1, 2009, December 31, 2009 and December 31, 2010. Changes in tax laws or interpretations of tax laws, as well as outcomes of current and future audits conducted by foreign and domestic tax authorities, could materially impact the amounts provided for income taxes in our consolidated financial statements.

For additional information regarding income taxes and valuation allowances, see Note 14, Income Taxes, of the Notes to Consolidated Financial Statements.

Accounting for Contingencies

We accrue an estimated loss by taking a charge to income when the likelihood that a future event, such as a legal proceeding, will result in a loss or the incurrence of a liability is probable and the amount of loss can be reasonably estimated. We disclose material contingencies if there is at least a reasonable possibility that a loss has been incurred. In determining whether a loss should be accrued, we evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Changes in these factors could materially impact our results of operations, financial position, or our cash flows.

For further information, please see "Litigation" in Part I, Item 3, "Legal Proceedings" and Note 17, Commitments and Contingencies, of the Notes to Consolidated Financial Statements.

Property, Plant and Equipment Valuation

Paper manufacturing, which is our primary manufacturing process, is a capital intensive process. As a result, we make substantial investments in property, plant and equipment which are recorded at cost. Net property, plant and equipment comprised 52% of our total assets as of December 31, 2010. Property, plant and equipment is depreciated on the straight-line method over the estimated useful lives of the assets. Paper machines and related equipment are not subject to substantial technological changes rendering them obsolete and are generally depreciated over estimated useful lives of 20 years. In the United States, banded cigarette paper production assets at the Spotswood Mill are generally depreciated over estimated useful lives of 10 years. When indications of impairment exist, we assess the likelihood of recovering the cost of long-lived assets based on our expectation of future profitability and undiscounted cash flow of the related operations. These factors, along with management's plans with respect to the operations, are considered in assessing the recoverability of property, plant and equipment. Changes in management's estimates and plans could significantly impact our results of operations, financial position or cash flows.

As a result of excess capacity in the tobacco-related papers industry and increased purchased material and operating costs experienced in the last several years, competitive selling prices for certain of our products are not sufficient to cover our costs with a reasonable margin. Such competitive pressures have resulted in downtime of certain paper machines and, in some cases, accelerated depreciation or impairment of certain equipment. Over the past four years, we have restructured our operations to improve our competitiveness and profitability. As a result, we incurred

significant charges related to asset impairments, accelerated depreciation and employee severances. Due to the closure of our mill in Malaucène, France, the activities of Malaucène have been retrospectively presented as a discontinued operation.

Certain of our Spotswood Mill's banded cigarette paper production assets remain underutilized and likely would otherwise be shut down except that we have a contractual commitment to stand ready to produce commercial quantities of banded cigarette paper for a customer. Also, we have \$6.0 million of unamortized deferred revenue as of December 31, 2010, which is being amortized to revenue as product is being purchased by that customer through 2011. Further, certain of the infrastructure improvements and other assets installed to be able to produce commercial quantities of banded cigarette paper would still be used by a scaled down operation even if we stopped manufacture of that product. As of December 31, 2010, the net book value of Spotswood Mill property, plant and equipment was \$42.1 million, of which \$2.5 million related to 10-year-life banded cigarette paper specific assets and \$5.9 million related to three paper machines capable of producing banded cigarette paper, but not currently in operation.

In January 2011, the Company revised its Asian RTL expansion plans to suspend the construction of the Philippine greenfield site. Due to this change, the carrying value of partially constructed assets will be evaluated for impairment during the first quarter of 2011 by assessing the recoverability of the costs based on the undiscounted cash flows of the operation, likelihood of its reactivation and alternative uses for the equipment. The net book value of the RTL Philippines property, plant and equipment was \$57.6 million as of December 31, 2010. If indicated, impairment losses will be measured by comparing the projected carrying value of the completed assets to their fair value as determined by discounted cash flows, potential alternative uses and appraised market prices.

Management continues to evaluate how to operate our production facilities more effectively with reduced tobacco-related papers volumes. Further restructuring actions are possible that might require additional write-offs or accelerated depreciation of some equipment.

Recent Accounting Pronouncements

For a discussion regarding recent accounting pronouncements, see "Recent Accounting Pronouncements" included in Note 2, Summary of Significant Accounting Policies, of the Notes to Consolidated Financial Statements.

Results of Operations

	For the Years Ended December 31,		
	2010	2009	2008
	(\$ in millions, except per share amounts)		
Net Sales	\$740.2	\$719.6	\$724.5
Cost of products sold	543.6	531.8	617.9
Gross Profit	196.6	187.8	106.6
Selling expense	19.0	19.4	20.8
Research expense	8.5	8.0	7.9
General expense	46.1	47.3	31.5
Total nonmanufacturing expenses	73.6	74.7	60.2
Restructuring and impairment expense	13.4	23.9	6.5
Operating Profit	109.6	89.2	39.9
Interest expense	1.8	4.3	9.5
Other income (expense), net	0.2	(1.1)	(3.3)
Income from Continuing Operations Before Income Taxes and Loss from Equity Affiliates	108.0	83.8	27.1
Provision for income taxes	39.8	25.3	6.4
Income (Loss) from equity affiliates	3.2	1.1	(4.0)
Income from Continuing Operations	71.4	59.6	16.7
Loss from Discontinued Operations	(6.1)	(24.0)	(15.8)
Net Income	65.3	35.6	0.9
Less: Net income attributable to noncontrolling interest	—	—	0.2
Net Income Attributable to SWM	\$65.3	\$35.6	\$0.7
Net Income Per Share - Basic:			

ANNUAL REPORT AND FINANCIAL INFORMATION

A copy of our 2007 Annual Report to Stockholders is being mailed with this Proxy Statement. We will provide without charge the Company's annual report on Form 10-K for the fiscal year ended December 31, 2007, to any person requesting a copy in writing and stating that he or she was a beneficial holder of the Company's Common Stock on March 14, 2008. The annual report on Form 10-K is also available on our website at www.smith.com using the Investor Relations caption and following the SEC Filings links. The Company will also furnish copies of any exhibits to the Form 10-K at \$0.50 per page, paid in advance. Requests and inquiries should be addressed to:

Investor Relations
Smith International, Inc.
P. O. Box 60068
Houston TX 77205-0068

The Company's 2007 Annual Report to Stockholders should not be regarded as proxy soliciting material or as a communication for which a solicitation of proxies is to be made.

By Order of the Board of Directors

Richard E. Chandler, Jr.
Secretary

APPENDIX A

**SMITH INTERNATIONAL, INC.
THIRD AMENDED AND RESTATED
1989 LONG-TERM INCENTIVE
COMPENSATION PLAN**

(Effective as of January 1, 2008)

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SMITH INTERNATIONAL, INC.
1989 LONG-TERM INCENTIVE COMPENSATION PLAN

SECTION 1

**GENERAL PROVISIONS RELATING TO
PLAN GOVERNANCE, COVERAGE AND BENEFITS**

1.1 Background and Purpose

Smith International, Inc., (the **Company**) established and adopted the Smith International, Inc. 1989 Long-Term Incentive Compensation Plan (the **Plan**). The Plan has been amended from time to time, and most recently amended and restated effective as of January 1, 2005.

The Company hereby amends and restates the Plan under the form of this Plan document primarily to (i) incorporate various changes for the benefit of the Company and the participants in the Plan, (ii) to comply with the requirements of Section 409A of the Internal Revenue Code of 1986, as amended (the **Code**) and (iii) to increase the number of shares of Common Stock eligible for Incentive Awards. This amendment and restatement is generally effective as of January 1, 2008 (the **Effective Date**), except as may otherwise be noted under certain terms and provisions of the Plan.

The purpose of the Plan is to foster and promote the long-term financial success of the Company and to increase stockholder value by: (a) encouraging the commitment of selected key Employees, (b) motivating superior performance of key Employees by means of long-term performance related incentives, (c) encouraging and providing key Employees with a program for obtaining ownership interests in the Company which link and align their personal interests to those of the Company's stockholders, (d) attracting and retaining key Employees by providing competitive compensation opportunities, (e) enabling key Employees to share in the long-term growth and success of the Company, (f) providing additional incentives for securing and retaining qualified individuals who are not employees of the Company to serve on the Board of Directors of the Company (**Outside Directors**), and (g) to enhance the future growth of the Company by furthering Outside Directors' identification with the interests of the Company and its stockholders.

The Plan provides for payment of various forms of compensation. It is not intended to be a plan that is subject to the Employee Retirement Income Security Act of 1974, as amended (**ERISA**). The Plan shall be interpreted, construed and administered consistent with its status as a plan that is not subject to ERISA.

The Plan will remain in effect, subject to the right of the Board to amend or terminate the Plan at any time pursuant to Section 9.7, until all Shares subject to the Plan have been purchased or acquired according to its provisions.

1.2 Definitions

The following terms shall have the meanings set forth below:

(a) Advisory Director. An individual who (i) is not an officer or employee of the Company or any Subsidiary and (ii) serves as an advisory director on the Board.

(b) Authorized Officer. The Chairman of the Board, the CEO or any other senior officer of the Company to whom either of them delegate the authority to execute any Incentive Agreement for and on behalf of the Company. No officer or director shall be an Authorized Officer with respect to any Incentive Agreement for himself.

(c) Award Date. The annual date or other date upon which a Common Stock Award is granted by the Independent Directors of the Board to a Grantee as provided in Section 3.

(d) Board. The Board of Directors of the Company.

(e) Cause. When used in connection with the termination of a Grantee's Employment, shall mean the termination of the Grantee's Employment by the Company or any Subsidiary by reason of (i) the conviction of

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the Grantee by a court of competent jurisdiction as to which no further appeal can be taken of a crime involving moral turpitude or a felony; (ii) the proven commission by the Grantee of a material act of fraud upon the Company or any Subsidiary, or any customer or supplier thereof; (iii) the misappropriation of any funds or property of the Company or any Subsidiary, or any customer or supplier thereof; (iv) the willful and continued failure by the Grantee to perform the material duties assigned to him that is not cured to the reasonable satisfaction of the Company within 30 days after written notice of such failure is provided to Grantee by the Board or CEO (or by another officer of the Company or a Subsidiary who has been designated by the Board or CEO for such purpose); (v) the knowing engagement by the Grantee in any direct and material conflict of interest with the Company or any Subsidiary without compliance with the Company's or Subsidiary's conflict of interest policy, if any, then in effect; or (vi) the knowing engagement by the Grantee, without the written approval of the Board or CEO, in any material activity which competes with the business of the Company or any Subsidiary or which would result in a material injury to the business, reputation or goodwill of the Company or any Subsidiary.

(f) CEO. The Chief Executive Officer of the Company.

(g) Change in Control. Any of the events described in and subject to Section 8.8.

(h) Code. The Internal Revenue Code of 1986, as amended, and the regulations and other authority promulgated thereunder by the appropriate governmental authority. References herein to any provision of the Code shall refer to any successor provision thereto.

(i) Committee. A committee appointed by the Board to administer the Plan. While the Company is a Publicly Held Corporation, the Plan shall be administered by a Committee appointed by the Board consisting of not less than two directors who fulfill the nonemployee director requirements of Rule 16b-3 under the Exchange Act and the outside director requirements of Code Section 162(m). In either case, the Committee may be the Compensation and Benefits Committee of the Board, or any subcommittee of the Compensation and Benefits Committee, provided that the members of the Committee satisfy the requirements of the previous provisions of this paragraph. Notwithstanding the preceding provisions of this subsection, with regard to Incentive Awards granted to Outside Directors, the Independent Directors of the Board shall have the sole power and authority to administer the Plan, and thus all references to the Committee herein shall mean the Independent Directors of the Board with respect to Incentive Awards granted to Outside Directors.

The Board shall have the power to fill vacancies on the Committee arising by resignation, death, removal or otherwise. The Board, in its sole discretion, may bifurcate the powers and duties of the Committee among one or more separate committees, or retain all powers and duties of the Committee in a single Committee. The members of the Committee shall serve at the discretion of the Board.

(j) Common Stock. The common stock of the Company, \$1.00 par value per share, and any class of common stock into which such common shares may hereafter be converted, reclassified or recapitalized.

(k) Common Stock Award. An authorization of the Independent Directors of the Board to issue or transfer common stock to a Grantee who is an Outside Director pursuant to Section 3.

(l) Company. Smith International, Inc. and any successor in interest thereto.

(m) Covered Employee. A named executive officer who is one of the group of covered employees, as defined in Code Section 162(m) and Treasury Regulation § 1.162-27(c) (or its successor), during any period that the Company is a Publicly Held Corporation.

(n) Disability. A condition of a Grantee which (a) renders him unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, or (b) is a medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, for which the Grantee is receiving income replacement benefits for a period of not less than three months under an accident and health plan or long-term disability plan covering Employees of the Company or any Subsidiary. A determination of Disability shall be made by a physician selected or approved by the Committee and, in this respect, the Grantee shall submit to any

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reasonable examination(s) required by such physician upon request. In addition, any determination of Disability shall be made in accordance with the requirements of Code Section 409A as determined by the Committee.

(o) Employee. Any full-time, salaried employee of the Company (or any Subsidiary) within the meaning of Code Section 3401(c) who, in the opinion of the Committee, is in a position to contribute to the growth, development or financial success of the Company (or any Subsidiary), including, without limitation, officers who are members of the Board.

(p) Employment. Employment means that the individual is employed as an Employee by the Company or any Subsidiary. In this regard, neither the transfer of a Grantee from Employment by the Company to Employment by any Subsidiary, nor the transfer of a Grantee from Employment by any Subsidiary to Employment by the Company, shall be deemed to be a termination of Employment of the Grantee. Moreover, the Employment of a Grantee shall not be deemed to have been terminated because of an approved leave of absence from active Employment on account of temporary illness, authorized vacation or granted for reasons of professional advancement, education, or health, or during any period required to be treated as a leave of absence by virtue of any applicable statute, Company personnel policy or written agreement. All determinations regarding Employment, and the termination of Employment hereunder, shall be made by the Committee.

(q) Exchange Act. The Securities Exchange Act of 1934, as amended.

(r) Fair Market Value. While the Company is a Publicly Held Corporation, the Fair Market Value of one Share of Common Stock on the date in question is deemed to be (i) the closing sales price of a Share as reported on the New York Stock Exchange or other principal securities exchange on which Shares are then listed or admitted to trading, or (ii) the closing sales price for a Share as quoted on the National Association of Securities Dealers Automated Quotation System (NASDAQ), or (iii) if not quoted on NASDAQ, the average of the closing bid and asked prices for a Share as quoted by the National Quotation Bureau's Pink Sheets or the National Association of Securities Dealers OTC Bulletin Board System. If there was no public trade of Common Stock on the date in question, Fair Market Value shall be determined by reference to the last preceding date on which such a trade was so reported.

If the Company is not a Publicly Held Corporation at the time a determination of the Fair Market Value of the Common Stock is required to be made hereunder, the determination of Fair Market Value for purposes of the Plan shall be made by the Committee in its sole and absolute discretion. In this respect, the Committee may rely on such financial data, appraisals, valuations, experts, and other sources as, in its sole and absolute discretion, it deems advisable under the circumstances.

(s) Grantee. Any Employee or Outside Director who is granted an Incentive Award under the Plan.

(t) Immediate Family. With respect to a Grantee, the Grantee's child, stepchild, grandchild, parent, stepparent, grandparent, spouse, former spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, including adoptive relationships.

(u) Incentive Agreement. A separate written agreement entered into between the Company and the Grantee setting forth the terms and conditions pursuant to which an Incentive Award is granted under the Plan, as such agreement is further defined in Section 8.1.

(v) Incentive Award or Award. A grant of an award under the Plan to a Grantee, including any Stock Option, Stock Appreciation Right (SAR), Restricted Stock Award, Performance-Based Restricted Award, Common Stock Award, Restricted Stock Unit Award or Other Stock-Based Award.

(w) Independent Director. A director who is an independent director as defined in the New York Stock Exchange current listings, or by such other stock exchange as may be applicable.

(x) Independent SAR or SAR. A Stock Appreciation Right described in Section 2.4.

(y) Insider. While the Company is a Publicly Held Corporation, an individual who is, on the relevant date, an officer, director or ten percent (10%) beneficial owner of any class of the Company's equity securities

that is registered pursuant to Section 12 of the Exchange Act, all as defined under Section 16 of the Exchange Act.

(z) Option Price. The exercise price at which a Share may be purchased by the Grantee of a Stock Option.

(aa) Other Stock-Based Award. An award granted by the Committee to a Grantee under Section 6.1 that is valued in whole or in part by reference to, or is otherwise based upon, Common Stock.

(bb) Outside Director. A member of the Board, or an Advisory Director, who is not, at the time the Incentive Award is granted to him, an officer or employee of the Company or any Subsidiary.

(cc) Performance-Based Exception. The performance-based exception from the tax deductibility limitations of Code Section 162(m), as prescribed in Code Section 162(m)(4)(C) and Treasury Regulation § 1.162-27(e) (or its successor), which is applicable during such period that the Company is a Publicly Held Corporation.

(dd) Performance-Based Restricted Award. Restricted Stock Awards or Restricted Stock Unit Awards awarded to a Grantee pursuant to Section 4 or Section 5, as applicable, the grant of which is contingent upon the attainment of specified Performance Criteria, and/or the vesting of which are subject to a risk of forfeiture if the specified Performance Criteria are not met within the Performance Period.

(ee) Performance Criteria. The business criteria that are specified by the Committee pursuant to Section 7 for an Incentive Award that is intended to qualify for the Performance-Based Exception; the satisfaction of such business criteria during the Performance Period being required for the grant or vesting of the particular Incentive Award to occur, as specified in the Incentive Agreement.

(ff) Performance Period. A period of time determined by the Committee over which performance is measured for the purpose of determining a Grantee's right to and the payment value of any Performance-Based Restricted Award or Other Stock-Based Award that is intended to qualify for the Performance-Based Exception.

(gg) Plan. Smith International, Inc. 1989 Long-Term Incentive Compensation Plan, as set forth herein and as it may be amended from time to time.

(hh) Publicly Held Corporation. A corporation issuing any class of common equity securities required to be registered under Section 12 of the Exchange Act.

(ii) Restricted Stock. Shares of Common Stock issued or transferred to a Grantee pursuant to Section 4.

(jj) Restricted Stock Award. An authorization by the Committee to issue or transfer Restricted Stock to a Grantee pursuant to Section 4.

(kk) Restricted Stock Unit. A unit granted to a Grantee pursuant to Section 5 which entitles him to receive one share of Common Stock on the date specified in the Incentive Agreement.

(ll) Restricted Stock Unit Award. An authorization to award Restricted Stock Units to Grantee pursuant to Section 5.

(mm) Restriction Period. The period of time determined by the Committee and set forth in the Incentive Agreement during which the transfer of an Incentive Award by the Grantee is restricted.

(nn) Retirement. The voluntary termination of Employment by an Employee from the Company and any Subsidiary constituting retirement, and as confirmed through the Company's Human Resources Department (i) on any date after

the Employee attains the normal retirement age, (ii) on an earlier retirement date as expressly agreed to by the Committee prior to termination of Employment, or (iii) as of such other age as may be designated by the Committee in the Employee's individual Incentive Agreement.

(oo) Share. A share of the Common Stock of the Company.

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(pp) Share Pool. The number of Shares authorized for issuance under Section 1.4, as adjusted for awards and payouts under Section 1.5 and as adjusted for changes in corporate capitalization under Section 8.6.

(qq) Spread. The difference between the exercise price per Share specified in a SAR grant and the Fair Market Value of a Share on the date of exercise of the SAR.

(rr) Stock Appreciation Right or SAR. A Stock Appreciation Right as described in Section 2.4.

(ss) Stock Option or Option. A stock option that is a nonstatutory stock option (and not an incentive stock option as described in Code Section 422), as described in Section 2.

(tt) Stock Option Award. An authorization to award a Stock Option to a Grantee pursuant to Section 2.

(uu) Subsidiary. Any corporation (whether now or hereafter existing) which constitutes a subsidiary of the Company, as defined in Code Section 424(f) of the Code, and any limited liability company, partnership, or other entity in which the Company controls fifty percent (50%) or more of the voting power or equity interests.

(vv) Termination of Directorship. The date upon which a Grantee who is an Outside Director ceases to be an Outside Director for whatever reason, voluntary or involuntary. The effective date of such Termination of Directorship shall be the actual date of such termination (whether occasioned by death, Disability, retirement, resignation, non-election or otherwise). The change in an Outside Director's position to an Advisory Director shall not be a Termination of Directorship hereunder.

1.3 Plan Administration

(a) Authority of the Committee. Except as may be limited by law or applicable stock exchange requirements, and subject to the provisions herein, the Committee shall have full power to (i) select Grantees who shall participate in the Plan; (ii) determine the amounts, duration and types of Incentive Awards; (iii) determine the terms and conditions of Incentive Awards and Incentive Agreements; (iv) determine whether any Shares subject to Incentive Awards will be subject to any restrictions on transfer; (v) construe and interpret the Plan and any Incentive Agreement or other agreement entered into under the Plan; and (vi) establish, amend, or waive rules for the Plan's administration. Further, the Committee shall make all other determinations which may be necessary or advisable for the administration of the Plan.

With respect to Incentive Awards granted under the Plan to Outside Directors, the Independent Directors of the Board shall constitute the Committee.

(b) Meetings. The Committee shall designate a chairman from among its members who shall preside at its meetings, and shall designate a secretary, without regard to whether that person is a member of the Committee, who shall keep the minutes of the proceedings and all records, documents, and data pertaining to its administration of the Plan. Meetings shall be held at such times and places as shall be determined by the Committee and the Committee may hold telephonic meetings. The Committee may take any action otherwise proper under the Plan by the affirmative vote, taken with or without a meeting, of a majority of its members. The Committee may authorize any one or more of its members or any officer of the Company to execute and deliver documents on behalf of the Committee.

(c) Decisions Binding. All determinations and decisions of the Committee shall be made in its discretion pursuant to the terms and provisions of the Plan, and shall be final, conclusive and binding on all persons including the Company, its stockholders, Employees, Grantees, and their estates and beneficiaries. The Committee's decisions with respect to any Incentive Award need not be uniform and may be made selectively among Incentive Awards and Grantees,

whether or not such Incentive Awards are similar or such Grantees are similarly situated.

(d) Modification of Outstanding Incentive Awards. Subject to the stockholder approval requirements of Section 9.7 if applicable, the Committee may, in its discretion, provide for the extension of the exercisability of an Incentive Award, accelerate the vesting or exercisability of an Incentive Award, eliminate or make less restrictive any restrictions contained in an Incentive Award, waive any restriction or other provisions of an Incentive Award, or

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otherwise amend or modify an Incentive Award in any manner that is either (i) not adverse to the Grantee to whom such Incentive Award was granted or (ii) consented to by such Grantee. Notwithstanding the preceding provisions of this subsection, (i) no amendment or other modification of an Incentive Award shall be made to the extent such modification results in any Stock Option with an exercise price less than 100% of the Fair Market Value per Share on the date of grant, (ii) no acceleration of the vesting of any Incentive Award shall be made, except in the event of the Grantee's death, Disability, or Retirement, or a Change in Control, or another type of similar circumstance as determined by the Committee, and (iii) no acceleration of vesting, extension of exercisability or other modification shall be made that will subject the Grantee to adverse taxation under Code Section 409A.

(e) Delegation of Authority. The Committee may delegate to designated officers or other employees of the Company any of its duties and authority under the Plan pursuant to such conditions or limitations as the Committee may establish from time to time; provided, however, the Committee may not delegate to any person the authority (i) to grant Incentive Awards or (ii) if the Company is a Publicly Held Corporation, to take any action which would contravene the requirements of Rule 16b-3 under the Exchange Act, the Performance-Based Exception under Code Section 162(m), or the Sarbanes-Oxley Act of 2002.

(f) Expenses of Committee. The Committee may employ legal counsel, including, without limitation, independent legal counsel and counsel regularly employed by the Company, and other agents as the Committee may deem appropriate for the administration of the Plan. The Committee may rely upon any opinion or computation received from any such counsel or agent. All expenses incurred by the Committee in interpreting and administering the Plan, including, without limitation, meeting expenses and professional fees, shall be paid by the Company.

(g) Indemnification. Each person who is or was a member of the Committee shall be indemnified by the Company against and from any damage, loss, liability, cost and expense that may be imposed upon or reasonably incurred by him in connection with or resulting from any claim, action, suit, or proceeding to which he may be a party or in which he may be involved by reason of any action taken or failure to act under the Plan, except for any such act or omission constituting willful misconduct or gross negligence. Each such person shall be indemnified by the Company for all amounts paid by him in settlement thereof, with the Company's approval, or paid by him in satisfaction of any judgment in any such action, suit, or proceeding against him, provided he shall give the Company an opportunity, at its own expense, to handle and defend the same before he undertakes to handle and defend it on his own behalf. The foregoing right of indemnification shall not be exclusive of any other rights of indemnification to which such persons may be entitled under the Company's Articles or Certificate of Incorporation or Bylaws, as a matter of law, or otherwise, or any power that the Company may have to indemnify them or hold them harmless.

1.4 Shares of Common Stock Available for Incentive Awards

Subject to adjustment under Section 8.6, there shall be available for Incentive Awards that are granted wholly or partly in Common Stock (including rights or Stock Options that may be exercised for or settled in Common Stock) Thirty Three Million and Forty Thousand (33,040,000) Shares of Common Stock. The number of Shares of Common Stock that are the subject of Incentive Awards under the Plan, and which are forfeited or terminated, expire, are settled in a manner such that all or some of the Shares covered by an Incentive Award are not issued to a Grantee or are exchanged for Incentive Awards that do not involve Common Stock, shall again immediately become available for Incentive Awards hereunder. The Committee may from time to time adopt and observe such procedures concerning the counting of Shares against the Plan maximum as it may deem appropriate.

During any period that the Company is a Publicly Held Corporation, then unless and until the Committee determines that a particular Incentive Award granted to a Covered Employee is not intended to comply with the Performance-Based Exception, the following rules shall apply to grants of Incentive Awards to Covered Employees:

(a) Subject to adjustment as provided in Section 8.6, the maximum aggregate number of Shares of Common Stock (including Stock Options, SARs, Restricted Stock, Performance-Based Restricted Awards, and Other Stock-Based Awards that are paid out in Shares) that may be granted (in the case of Stock Options and SARs) or that may vest (in the case of Restricted Stock Awards, Performance-Based Restricted Awards, Restricted Stock Unit Awards or Other Stock-Based Awards), as applicable, in any calendar year pursuant to any Incentive Award held by any individual Covered Employee shall be One Million (1,000,000) Shares.

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(b) With respect to any Stock Option or SAR granted to a Covered Employee that is canceled or repriced (which may only occur subject to the approval of the Company's stockholders, as required under applicable securities laws and stock exchange requirements), the number of Shares subject to such Stock Option or SAR shall continue to count against the maximum number of Shares that may be the subject of Stock Options or SARs granted to such Covered Employee hereunder and, in this regard, such maximum number shall be determined in accordance with Code Section 162(m).

(c) The limitations of subsections (a), (b) and (c) above shall be construed and administered so as to comply with the Performance-Based Exception.

1.5 Share Pool Adjustments for Awards and Payouts

The following Incentive Awards and payouts shall reduce, on a one Share for one Share basis, the number of Shares authorized for issuance under the Share Pool:

- (a) Stock Option Award;
- (b) SAR;
- (c) Common Stock Award;
- (d) Restricted Stock Award;
- (e) Performance-Based Restricted Award;
- (f) Restricted Stock Unit Awards; and
- (g) Other Stock-Based Awards.

A cancellation, termination, expiration, forfeiture, or lapse for any reason of any Shares subject to an Award shall restore, on a one Share for one Share basis, the number of Shares authorized for issuance under the Share Pool.

1.6 Common Stock Available

The Common Stock available for issuance or transfer under the Plan shall be made available from Shares now or hereafter (a) held in the treasury of the Company, (b) authorized but unissued Shares, or (c) Shares to be purchased or acquired by the Company. No fractional Shares shall be issued under the Plan; payment for fractional Shares shall be made in cash.

1.7 Eligibility

Outside Directors and Employees shall be eligible to receive Incentive Awards under the Plan. The Committee shall from time to time designate those Employees to be granted Incentive Awards, the type of Incentive Awards granted, the number of Shares, Stock Options, rights or units, as the case may be, which are subject to an Award, and any other terms or conditions relating to each Award, as it may deem appropriate to the extent consistent with the provisions of the Plan. A Grantee who has been granted an Incentive Award may, if otherwise eligible, be granted additional Incentive Awards at any time.

No Insider shall be eligible to be granted an Incentive Award that is subject to Rule 16a-3 under the Exchange Act unless and until such Insider has granted a limited power of attorney to those employees of the Company who have been designated by the Company for purposes of future required filings under the Exchange Act.

1.8 Types of Incentive Awards

The types of Incentive Awards under the Plan are (a) Stock Options and Stock Appreciation Rights, (b) Common Stock Awards as described in Section 3, (c) Restricted Stock and Performance-Based Restricted Awards, (d) Restricted Stock Units as described in Section 5, (e) Other Stock-Based Awards, or (f) any combination of the foregoing.

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SECTION 2

STOCK OPTIONS AND STOCK APPRECIATION RIGHTS

2.1 Grant of Stock Options

The Committee is authorized to grant Stock Options to Employees and the Independent Directors of the Board are authorized to grant Stock Options to Outside Directors, in accordance with the terms and conditions of the Plan, and with such additional terms and conditions, not inconsistent with the Plan, as the Committee or Independent Directors, as applicable, shall determine in its discretion. Successive grants may be made to the same Grantee regardless of whether any Stock Option previously granted to such person remains unexercised.

2.2 Stock Option Terms

(a) Written Agreement. Each grant of a Stock Option shall be evidenced by a written Incentive Agreement. Among its other provisions, each Incentive Agreement shall set forth the extent to which the Grantee shall have the right to exercise the Stock Option following termination of the Grantee's Employment or Termination of Directorship, as the case may be. Such provisions shall be determined in the discretion of the Committee, shall be included in the Grantee's Incentive Agreement, and need not be uniform among all Stock Options issued pursuant to the Plan.

(b) Number of Shares. Each Stock Option Award shall specify the number of Shares of Common Stock to which it pertains.

(c) Exercise Price. The exercise price per Share of Common Stock under each Stock Option shall be determined by the Committee, but in no event shall the exercise price be less than 100% of the Fair Market Value per Share on the date the Stock Option is granted. Each Stock Option shall specify the method of exercise which shall be consistent with the requirements of Section 2.3(a).

(d) Term. In the Incentive Agreement, the Committee shall fix the term of each Stock Option, not to exceed ten (10) years from the date of grant. In the event no term is fixed, such term shall be ten (10) years from the date of grant.

(e) Exercise. The Committee shall determine the time or times at which a Stock Option may be exercised, in whole or in part. Each Stock Option may specify the required period of continuous Employment or service as an Outside Director, as applicable, and/or the performance objectives to be achieved before the Stock Option (or any portion thereof) will become exercisable. Each Stock Option Award, the exercise (or timing of the exercise) of which is dependent, in whole or in part, on the achievement of designated performance objectives, may specify a minimum level of achievement in respect of the specified performance objectives below which no Stock Options will be exercisable, as well as a method for determining the number of Stock Options that will be exercisable if performance is at or above such minimum but short of full achievement of the performance objectives. All such terms and conditions shall be set forth in the Incentive Agreement.

2.3 Stock Option Exercises

(a) Method of Exercise and Payment. Stock Options shall be exercised by the delivery of a signed written notice of exercise to the Company as of a date set by the Company on the effective date of the proposed exercise. The notice shall set forth the number of Shares with respect to which the Stock Option is to be exercised, accompanied by full payment for the Shares.

The Stock Option exercise price upon exercise of any Stock Option shall be payable to the Company in full either: (i) in cash or its equivalent; or (ii) subject to prior approval by the Committee in its discretion, by tendering previously acquired Shares having an aggregate Fair Market Value at the time of exercise equal to the Option Price (provided that the Shares which are tendered must have been held by the Grantee for at least six (6) months prior to their tender to satisfy the Option Price); or (iii) subject to prior approval by the Committee in its discretion, by withholding Shares which otherwise would be acquired on exercise having an aggregate Fair Market Value at the

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time of exercise equal to the total Option Price; or (iv) subject to prior approval by the Committee in its discretion, by a combination of (i), (ii), and (iii) above.

Any payment in Shares shall be effected by the surrender of such Shares to the Company in good form for transfer and shall be valued at their Fair Market Value on the date when the Stock Option is exercised. Unless otherwise permitted by the Committee in its discretion, the Grantee shall not surrender, or attest to the ownership of, Shares in payment of the Option Price if such action would cause the Company to recognize compensation expense (or additional compensation expense) with respect to the Stock Option for financial accounting reporting purposes.

The Committee, in its discretion, also may allow the Option Price to be paid with such other consideration as shall constitute lawful consideration for the issuance of Shares (including, without limitation, effecting a cashless exercise with a broker of the Stock Option), subject to applicable securities law restrictions and tax withholdings, or by any other means which the Committee determines to be consistent with the Plan's purpose and applicable law. At the direction of the Grantee, the broker will either (i) sell all of the Shares received when the Stock Option is exercised and pay the Grantee the proceeds of the sale (minus the Option Price, withholding taxes and any fees due to the broker); or (ii) sell enough of the Shares received upon exercise of the Stock Option to cover the Option Price, withholding taxes and any fees due the broker and deliver the remaining Shares to the Grantee (either directly or through the Company). Dispositions to a broker effecting a cashless exercise are not exempt under Section 16 of the Exchange Act while the Company is a Publicly Held Corporation. Moreover, in no event will the Committee allow the Option Price to be paid with a form of consideration, including a loan or a cashless exercise, if such form of consideration would violate the Sarbanes-Oxley Act of 2002 as determined by the Committee.

As soon as practicable after receipt of a written notification of exercise and full payment, the Company shall deliver, or cause to be delivered, to or on behalf of the Grantee, in the name of the Grantee or other appropriate recipient, evidence of ownership for the number of Shares purchased under the Stock Option.

Subject to Section 8.4, during the lifetime of a Grantee, each Stock Option granted to him shall be exercisable only by the Grantee (or his legal guardian in the event of his Disability) or by a broker-dealer acting on his behalf pursuant to a cashless exercise under the foregoing provisions of this Section 2.3(a).

(b) Restrictions on Share Transferability. The Committee may impose such restrictions on any grant of Stock Options or on any Shares acquired pursuant to the exercise of a Stock Option as it may deem advisable, including, without limitation, restrictions under (i) any stockholders' agreement, buy/sell agreement, right of first refusal, non-competition, and any other agreement between the Company and any of its securities holders or employees; (ii) any applicable federal securities laws; (iii) the requirements of any stock exchange or market upon which such Shares are then listed and/or traded; or (iv) any blue sky or state securities law applicable to such Shares. Any certificate issued to evidence Shares issued upon the exercise of an Incentive Award may bear such legends and statements as the Committee shall deem advisable to assure compliance with federal and state laws and regulations.

Any Grantee or other person exercising an Incentive Award shall be required, if requested by the Committee, to give a written representation that the Incentive Award and the Shares subject to the Incentive Award will be acquired for investment and not with a view to public distribution; provided, however, that the Committee in its discretion, may release any person receiving an Incentive Award from any such representations either prior to or subsequent to the exercise of the Incentive Award.

(c) Proceeds of Option Exercise. The proceeds received by the Company from the sale of Shares pursuant to Stock Options exercised under the Plan shall be used for general corporate purposes.

2.4 Stock Appreciation Rights

(a) Grant. The Committee may grant to Employees Stock Appreciation Rights that are independent of Stock Options. All SARs granted under the Plan are intended to be exempt from taxation as deferred compensation under Code Section 409A.

(b) General Provisions. The terms and conditions of each SAR shall be evidenced by an Incentive Agreement. The exercise price per Share shall be not less than one hundred percent (100%) of the Fair Market Value of a Share on the grant date of the SAR. The term of the SAR shall be determined by the Committee. The

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Committee cannot include any feature for the deferral of compensation other than the deferral of recognition of income until exercise of the SAR.

(c) Exercise. SARs shall be exercisable subject to such terms and conditions as the Committee shall specify in the Incentive Agreement for the SAR grant. No SAR granted to an Insider may be exercised prior to six (6) months from the date of grant, except in the event of his death or Disability which occurs prior to the expiration of such six-month period if so permitted under the Incentive Agreement.

(d) Settlement. Effective for any SARs issued on or after January 1, 2005, upon exercise of the SAR, the Grantee shall receive an amount equal to the Spread. The Spread, less applicable withholdings, shall be payable only in Shares, the number of which shall be determined based on the Fair Market Value of the Shares as of the exercise date, within 30 calendar days after the exercise date. In no event shall any SAR be settled in any manner other than by delivery of Shares. In addition, the Incentive Agreement under which such SARs are awarded, or any other agreements or arrangements, shall not provide that the Company will purchase any Shares delivered as a result of the exercise or vesting of a SAR. Any SARs issued under the Plan prior to January 1, 2005 shall be subject to the settlement provisions of the Plan as in effect prior to January 1, 2005, but only to the extent that such settlement is not considered a payment of deferred compensation that would be subject to Code Section 409A after December 31, 2004.

SECTION 3

COMMON STOCK AWARDS FOR OUTSIDE DIRECTORS

3.1 Initial Award

Each Outside Director shall receive, upon initial election or appointment to the Board, the grant of a Common Stock Award for the number of Shares as deemed appropriate to provide equity compensation to such Grantee having a Fair Market Value, effective as of the first date of such Outside Director's service on the Board, as determined and voted upon by the Independent Directors of the Board from time to time in its discretion.

3.2 Annual Award

Each Outside Director shall receive an annual Common Stock Award on each Award Date with respect to service rendered by the Grantee during the 12-month period ending on such annual Award Date. The Shares subject to the annual Common Stock Award shall be such number as deemed appropriate to provide equity compensation to such Grantee having a Fair Market Value as determined by the Independent Directors of the Board from time to time, and effective as of the Award Date. The Award Date for annual Common Stock Awards shall be made on the date of the annual Board meeting with respect to the Grantee's service as an Outside Director during the 12-month period ending on such annual Award Date. The annual Common Stock Awards shall not be prorated for partial service of any Outside Director, except as described in Section 3.3.

3.3 Termination of Directorship

If a Termination of Directorship occurs to an Outside Director, then in lieu of the annual Common Stock Award under Section 3.2, as of the next following annual Award Date such Outside Director shall be entitled to receive a number of Shares equal to the nearest whole number of Shares obtained by multiplying the number of Shares having a Fair Market Value approximately equal to a dollar amount set by the Board from time to time pursuant to Section 3.2 by a fraction, the numerator of which is the number of days from the last previous annual Award Date up to and including the date of his Termination of Directorship, and the denominator of which is the number of days from the last previous annual Award Date up to and including his next following regularly scheduled annual Award Date. Such Shares shall

be delivered to the Outside Director within thirty (30) days following the date of his Termination of Directorship.

3.4 Issuance of Common Stock

Within thirty (30) days of the Award Date of a Common Stock Award pursuant to Sections 3.1, 3.2 or 3.3, the Company shall cause Shares of Common Stock to be issued in the name of the Grantee.

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3.5 Deferral of Common Stock Award

At the discretion of the Committee, a Grantee may elect in writing to defer the receipt of a Common Stock Award; provided, however, that such election be made by the Grantee not later than by the end of the calendar year that precedes the calendar year in which the applicable 12-month performance period begins. Notwithstanding the previous sentence, at the discretion of the Committee, a Grantee who is eligible to receive an initial award pursuant to Section 3.1 may elect in writing to defer receipt of such initial award within thirty (30) days after the Grantee first becomes eligible to participate in the Plan or any other plan maintained by the Company that is an account balance plan within the meaning of, and subject to, Code Section 409A.

3.6 Subsequent Deferrals

At the discretion of the Committee, a Grantee may elect in writing to defer the receipt of a Common Stock Award which has previously been deferred pursuant to Section 3.5; provided, however, that (i) such election will not take effect until at least twelve (12) months after the date upon which the election is made by the Grantee, (ii) except in the case of payment on account of the Grantee's death or Disability, the payment with respect to which such election is made must be deferred for a period of not less than five (5) years from the date the payment would otherwise have been paid, and (iii) such election may not be made less than twelve (12) months prior to the date the payment was otherwise scheduled to be made. Any subsequent deferral election made by the Grantee pursuant to this Section 3.5 must be consistent with the requirements of Code Section 409A.

SECTION 4

RESTRICTED STOCK

4.1 Award of Restricted Stock

(a) Grant. In consideration of the Grantee's Employment or service as an Outside Director, as applicable, Shares of Restricted Stock may be awarded by the Committee (or, with respect to Outside Directors, by the Independent Directors of the Board) with such restrictions during the Restriction Period as may be imposed by the Committee or the Independent Directors, as applicable, in its discretion. The minimum Restriction Period for a Restricted Stock Award shall be three (3) years, and for a Performance Based Restricted Stock Award shall be one (1) year. Any such restrictions may differ with respect to a particular Grantee. Restricted Stock shall be awarded for no additional consideration or such additional consideration as the Committee may determine, which consideration may be less than, equal to, or more than the Fair Market Value of the Shares of Restricted Stock on the grant date. The terms and conditions of each Restricted Stock Award shall be evidenced by an Incentive Agreement and, during the Restriction Period, Shares of Restricted Stock must remain subject to a substantial risk of forfeiture within the meaning given to such term under Code Section 83. Any Restricted Stock Award granted to an Employee may, at the time of grant, be designated by the Committee as a Performance-Based Restricted Award that is intended to qualify for the Performance-Based Exception.

(b) Immediate Transfer Without Immediate Delivery of Restricted Stock. Unless otherwise specified in the Grantee's Incentive Agreement, each Restricted Stock Award shall constitute an immediate transfer of the record and beneficial ownership of the Shares of Restricted Stock to the Grantee in consideration of his performance of services as an Employee or Outside Director, as applicable, entitling such Grantee to all voting and other ownership rights in such Shares.

As specified in the Incentive Agreement, a Restricted Stock Award may limit the Grantee's dividend rights during the Restriction Period in which the Shares of Restricted Stock are subject to a substantial risk of forfeiture (within the

meaning given to such term under Code Section 83) and restrictions on transfer. In the Incentive Agreement, the Committee may apply any restrictions to the dividends that the Committee deems appropriate. Without limiting the generality of the preceding sentence, if the grant or vesting of Shares of Performance-Based Restricted Stock granted to a Covered Employee is designed to comply with the requirements of the Performance-Based Exception, the Committee may apply any restrictions it deems appropriate to the payment of dividends declared with respect to such Shares of Restricted Stock, such that the dividends and/or the Shares of Restricted

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Stock maintain eligibility for the Performance-Based Exception. In the event that any dividend constitutes a derivative security or an equity security pursuant to the rules under Section 16 of the Exchange Act, if applicable, such dividend shall be subject to a vesting period equal to the remaining vesting period of the Shares subject to the Restricted Stock Award with respect to which the dividend is paid.

Shares awarded pursuant to a Restricted Stock Award or Performance-Based Restricted Stock Award may be issued in the name of the Grantee and held, together with a stock power endorsed in blank, by (i) the Committee (or its delegate), (ii) Company (or its delegate), (iii) in trust or in escrow pursuant to an agreement satisfactory to the Committee, or (iv) in a restricted account held by the transfer agent, as shall be determined by the Committee, until such time as the restrictions on transfer have expired. All such terms and conditions shall be set forth in the particular Grantee's Incentive Agreement. The Company or Committee, or its delegate, shall issue to the Grantee a receipt evidencing the Shares held by it which are registered in the name of the Grantee.

4.2 Restrictions

(a) Forfeiture of Restricted Stock. Restricted Stock awarded to a Grantee may be subject to the following restrictions until the expiration of the Restriction Period: (i) a restriction that constitutes a substantial risk of forfeiture (as defined under Code Section 83), or a restriction on transferability; (ii) unless otherwise specified by the Committee in the Incentive Agreement, the Shares of Restricted Stock that are subject to restrictions which are not satisfied shall be forfeited and all rights of the Grantee to such Shares shall terminate; and (iii) any other restrictions that the Committee determines in advance are appropriate, including, without limitation, rights of repurchase or first refusal in the Company or provisions subjecting the Restricted Stock to a continuing substantial risk of forfeiture in the hands of any transferee. Any such restrictions shall be set forth in the Grantee's Incentive Agreement.

(b) Issuance of Certificates. Reasonably promptly after the date of grant with respect to the Restricted Stock Award, and unless the Committee has approved the use of electronic stock accounts that do not require the issuance of stock certificates, the Company shall cause to be issued a stock certificate, registered in the name of the Grantee to whom the Restricted Stock Award was granted, evidencing such Shares; provided, however, that the Company shall not cause to be issued such a stock certificate unless it has received a stock power duly endorsed in blank with respect to such Shares. Each such stock certificate shall bear the following legend or any other legend approved by the Company:

The transferability of this certificate and the shares of stock represented hereby are subject to the restrictions, terms and conditions (including forfeiture and restrictions against transfer) contained in the Smith International, Inc. 1989 Long-Term Incentive Compensation Plan and an Incentive Agreement entered into between the registered owner of such shares and Smith International, Inc. A copy of the Plan and Incentive Agreement are on file in the main corporate office of Smith International, Inc.

Such legend shall not be removed from the certificate evidencing such Shares of Restricted Stock unless and until such Shares vest pursuant to the terms of the Incentive Agreement.

(c) Removal of Restrictions. The Committee, in its discretion, shall have the authority to provide in an Incentive Agreement that the restrictions on the Restricted Stock shall lapse upon the occurrence of the Grantee's death or Disability, or in the event of a Change in Control. In addition, the Committee shall have the authority, in its discretion, to remove any or all of the restrictions on the Restricted Stock if it determines that, by reason of a change in applicable law or another change in circumstance arising after the grant date of the Restricted Stock Award, such action is necessary or appropriate.

4.3 Delivery of Shares of Common Stock

When the restrictions in the Incentive Agreement have been satisfied, subject to (a) withholding taxes under Section 9.3 with respect to Employees and (b) the terms of the Incentive Agreement, the Company shall cause Shares of Common Stock to be issued in the name of the Grantee free of restrictions.

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SECTION 5

RESTRICTED STOCK UNITS

5.1 Award of Restricted Stock Units

In consideration of the Grantee's Employment or service as an Outside Director, as applicable, Restricted Stock Unit Awards may be awarded by the Committee (or, with respect to Outside Directors, by the Independent Directors of the Board) to designated Grantees, as determined in the discretion of the Committee or the Independent Directors, as applicable. Any Restricted Stock Unit Award to an Employee may, at the time of grant, be designated by the Committee as a Performance-Based Restricted Award that is intended to qualify for the Performance-Based Exception. The minimum Restriction Period for a Restricted Stock Unit Award shall be three (3) years, and for a Performance Based Restricted Stock Unit Award shall be one (1) year.

5.2 Restricted Stock Unit Award Terms

(a) Written Agreement. The terms and conditions of each grant of a Restricted Stock Unit Award shall be evidenced by an Incentive Agreement, which shall specify among other provisions (i) the number of Restricted Stock Units awarded to the Grantee, (ii) a specified period during which such Restricted Stock Units must remain subject to a substantial risk of forfeiture within the meaning given to such term under Code Section 409A, and (iii) the Performance Criteria, if applicable.

(b) Vesting. The Committee, in its discretion, shall specify in the Grantee's Incentive Agreement the date or dates upon which the substantial risk of forfeiture (as described in Section 4.2(a)) will lapse (the **Vesting Date**), and the events upon which such lapse occurs.

(c) Payment. When the restrictions in the Incentive Agreement have been satisfied, subject to (i) withholding taxes under Section 9.3 with respect to Employees and (ii) the terms of the Incentive Agreement, Restricted Stock Units shall be paid in Shares within thirty (30) days after the later of (A) the Vesting Date (as defined in Section 5.2(b)) or (B) the date that satisfaction of any Performance Criteria for the Restricted Stock Units have been certified by the Committee but, in either event, not later than 21/2 months following the last day of the calendar year containing the Vesting Date.

(d) Subsequent Deferrals. At the discretion of the Committee, a Grantee may elect in writing to defer the receipt of Shares payable upon vesting of a Restricted Stock Unit Award; provided, however, that (i) such election will not take effect until at least twelve (12) months after the date upon which the election is made by the Grantee, (ii) except in the case of payment on account of the Grantee's death or Disability, the payment with respect to which such election is made must be deferred for a period of not less than five (5) years from the date the payment would otherwise have been paid, and (iii) such election may not be made less than twelve (12) months prior to the date the payment was otherwise scheduled to be made. Any subsequent deferral election made by the Grantee pursuant to this Section 5.2(d) must be consistent with the requirements of Code Section 409A.

SECTION 6

OTHER STOCK-BASED AWARDS

6.1 Grant of Other Stock-Based Awards

Other Stock-Based Awards may be awarded by the Committee to selected Grantees that are payable in Shares, as determined by the Committee to be consistent with the goals of the Company. Other types of Stock-Based Awards include, without limitation, purchase rights, Shares of Common Stock awarded that are not subject to any restrictions or conditions other than Common Stock Awards pursuant to Section 3 (limited, however, to not more than five percent (5%) of the Shares available under the Plan under Section 1.4), convertible or exchangeable debentures, other rights convertible into Shares, Incentive Awards valued by reference to the performance of a specified Subsidiary, division or department of the Company, and settlement in cancellation of rights of any person with a vested interest in any other plan, fund, program or arrangement that is or was sponsored, maintained or

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participated in by the Company or any Subsidiary. As is the case with other types of Incentive Awards, Other Stock-Based Awards may be awarded either alone or in addition to or in conjunction with any other Incentive Awards. Other Stock-Based Awards are not intended to be deferred compensation that is subject to Code Section 409A unless otherwise determined by the Committee.

6.2 Other Stock-Based Award Terms

(a) Written Agreement. The terms and conditions of each grant of an Other Stock-Based Award shall be evidenced by an Incentive Agreement.

(b) Purchase Price. Except to the extent that an Other Stock-Based Award is granted in substitution for an outstanding Incentive Award or is delivered upon exercise of a Stock Option, the amount of consideration required to be received by the Company shall be either (i) no consideration other than services actually rendered (in the case of authorized and unissued Shares) or to be rendered, or (ii) as otherwise specified in the Incentive Agreement.

(c) Performance Criteria and Other Terms. In its discretion, the Committee may specify Performance Criteria for (i) vesting in Other Stock-Based Awards and (ii) payment thereof to the Grantee, as it may determine in its discretion. The extent to which any such Performance Criteria have been met shall be determined and certified by the Committee in accordance with the requirements to qualify for the Performance-Based Exception under Code Section 162(m). All terms and conditions of Other Stock-Based Awards shall be determined by the Committee and set forth in the Incentive Agreement.

(d) Payment. Other Stock-Based Awards shall be paid in Shares, in a single payment or in installments on such dates as determined by the Committee; all as specified in the Incentive Agreement.

SECTION 7

PERFORMANCE CRITERIA

As determined by the Committee at the time of grant, Performance-Based Restricted Awards, Other Stock-Based Awards and other types of Incentive Awards made under the Plan may be granted to an Employee subject to performance objectives relating to one or more of the following within the meaning of Code Section 162(m) in order to qualify for the Performance-Based Exception (the **Performance Criteria**):

- (a) profits (including, but not limited to, profit growth, net operating profit or economic profit);
- (b) profit-related return ratios;
- (c) return measures (including, but not limited to, return on assets, capital, equity, investment or sales);
- (d) cash flow (including, but not limited to, operating cash flow, free cash flow or cash flow return on capital or investments);
- (e) earnings (including but not limited to, total shareholder return, earnings per share or earnings before or after taxes);
- (f) net sales growth;
- (g) net earnings or income (before or after taxes, interest, depreciation and/or amortization);

(h) gross, operating or net profit margins;

(i) productivity ratios;

(j) share price (including, but not limited to, growth measures and total shareholder return);

(k) turnover of assets, capital, or inventory;

(l) expense targets;

(m) margins;

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(n) measures of health, safety or environment;

(o) operating efficiency;

(p) customer service or satisfaction;

(q) market share;

(r) credit quality; and

(s) working capital targets.

Performance Criteria may be stated in absolute terms or relative to comparison companies or indices to be achieved during a Performance Period.

The Committee shall establish one or more Performance Criteria for each Incentive Award that is intended to qualify for the Performance-Based Exception no later than ninety (90) days after the beginning of the Performance Period to which the Award relates. In establishing the Performance Criteria for each applicable Incentive Award, the Committee may provide that the effect of specified extraordinary or unusual events will be included or excluded (including, but not limited to, all items of gain, loss or expense determined to be extraordinary or unusual in nature or infrequent in occurrence or related to the disposal of a segment of business or related to a change in accounting principle, all as determined in accordance with standards by Opinion No. 30 of the Accounting Principles Board (APB Opinion 30) or other authoritative financial accounting standards). The terms of the stated Performance Criteria for each applicable Incentive Award must preclude the Committee's discretion to increase the amount payable to any Grantee that would otherwise be due upon attainment of the Performance Criteria. The Performance Criteria specified in any Incentive Agreement need not be applicable to all Incentive Awards, and may be particular to an individual Grantee's function or business unit. The Committee may establish the Performance Criteria of the Company or any entity which is affiliated by common ownership with the Company as determined and designated by the Committee, in its discretion, in the Incentive Agreement.

SECTION 8

PROVISIONS RELATING TO PLAN PARTICIPATION

8.1 Incentive Agreement

Each Grantee to whom an Incentive Award is granted (other than a Common Stock Award) shall be required to enter into an Incentive Agreement with the Company, in such a form as is provided by the Committee. The Incentive Agreement shall contain such specific terms as determined by the Committee, in its discretion, with respect to the Grantee's particular Incentive Award. Such terms need not be uniform among all Grantees or any similarly situated Grantees. The Incentive Agreement may include, without limitation, vesting, forfeiture and other provisions that are specific to the individual Grantee's Incentive Award, as well as, for example, provisions to the effect that the Grantee (a) shall not disclose any confidential information acquired during Employment with the Company, (b) shall abide by all the terms and conditions of the Plan and such other terms and conditions as may be imposed by the Committee, (c) shall not interfere with the employment or other service of any employee, (d) shall not compete with the Company or become involved in a conflict of interest with the interests of the Company, (e) shall forfeit an Incentive Award if terminated for Cause, (f) shall not be permitted to make an election under Code Section 83(b) when applicable, and (g) shall be subject to any other agreement between the Grantee and the Company regarding Shares that may be acquired under an Incentive Award including, without limitation, a stockholders' agreement, buy-sell agreement, or

other agreement restricting the transferability of Shares by Grantee. An Incentive Agreement shall include such terms and conditions as are determined by the Committee, in its discretion, to be appropriate with respect to the Grantee. The Incentive Agreement shall be signed by the Grantee to whom the Incentive Award is made and by an Authorized Officer; provided, however, effective as of January 1, 2006, the Committee, in its discretion, may from time to time approve another method of acceptance.

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8.2 No Right to Employment

Nothing in the Plan or any instrument executed pursuant to the Plan shall create any Employment rights (including without limitation, rights to either continued Employment or service as an Outside Director) in any Grantee or affect any right to terminate the Employment of any Grantee or service as an Outside Director at any time without regard to the existence of the Plan.

8.3 Securities Requirements

The Company shall be under no obligation to effect the registration pursuant to the Securities Act of 1933 of any Shares to be issued hereunder or to effect similar compliance under any state laws. Notwithstanding anything herein to the contrary, the Company shall not be obligated to cause to be issued or delivered any certificates evidencing Shares pursuant to the Plan unless and until the Company is advised by its counsel that the issuance and delivery of such certificates is in compliance with all applicable laws, regulations of governmental authorities, and the requirements of any securities exchange on which Shares are traded. The Committee may require, as a condition of the issuance and delivery of certificates evidencing Shares pursuant to the terms hereof, that the recipient of such Shares make such covenants, agreements and representations, and that such certificates bear such legends, as the Committee, in its discretion, deems necessary or desirable.

The Committee may, in its discretion, defer the effectiveness of any payment under an Incentive Award to allow the issuance of Shares to be made pursuant to registration or an exemption from registration or other methods for compliance available under federal or state securities laws. The Committee shall inform the Grantee in writing of its decision to defer the effectiveness of the exercise of an Incentive Award. During the period that the effectiveness of the exercise of an Incentive Award has been deferred, the Grantee may, by written notice to the Committee withdraw such exercise and obtain the refund of any amount paid with respect thereto.

If the Shares issuable on payment of an Incentive Award are not registered under the Securities Act of 1933, the Company may imprint on the certificate for such Shares the following legend or any other legend which counsel for the Company considers necessary or advisable to comply with the Securities Act of 1933:

THE SECURITIES REPRESENTED BY THIS CERTIFICATE HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (ACT), OR THE SECURITIES LAWS OF ANY STATE. THE SECURITIES MAY NOT BE TRANSFERRED EXCEPT PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER SUCH ACT AND APPLICABLE STATE SECURITIES LAWS OR PURSUANT TO ANY APPLICABLE EXEMPTION FROM THE REGISTRATION REQUIREMENTS OF SUCH ACT AND SUCH LAWS OR PURSUANT TO A WRITTEN OPINION OF COUNSEL REASONABLY SATISFACTORY TO THE COMPANY THAT SUCH REGISTRATION IS NOT REQUIRED.

8.4 Transferability

Incentive Awards granted under the Plan shall not be transferable or assignable other than: (a) by will or the laws of descent and distribution or (b) pursuant to a qualified domestic relations order (as defined under Code Section 414(p)); provided, however, only with respect to Incentive Awards consisting of Stock Options awarded to an Employee, the Committee may, in its discretion, authorize all or a portion of the Stock Options to be granted on terms which permit transfer by the Grantee to (i) the members of the Grantee's Immediate Family, (ii) a trust or trusts for the exclusive benefit of Immediate Family members, (iii) a partnership in which such Immediate Family members are the only partners, or (iv) any other entity owned solely by Immediate Family members; provided that (A) there may be no consideration for any such transfer, (B) the Incentive Agreement pursuant to which such Stock Options are granted must be approved by the Committee, and must expressly provide for transferability in a manner consistent with this

Section 8.4, (C) subsequent transfers of transferred Stock Options shall be prohibited except in accordance with clauses (a) and (b) (above) of this sentence, and (D) there may be no transfer of any Incentive Award in a listed transaction as described in IRS Notice 2003-47. Following any permitted transfer, the Stock Option shall continue to be subject to the same terms and conditions as were applicable immediately prior to transfer, provided that the term Grantee shall be deemed to refer to the transferee. The events of termination of employment, as set out in Section 8.7 and in the Incentive Agreement, shall continue to be applied with respect to

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the original Grantee, and the Incentive Award shall be exercisable by the transferee only to the extent, and for the periods, specified in the Incentive Agreement.

Except as may otherwise be permitted under the Code, in the event of a permitted transfer of a Stock Option hereunder, the original Grantee shall remain subject to withholding taxes upon exercise. In addition, the Company and the Committee shall have no obligation to provide any notices to any Grantee or transferee thereof, including, for example, notice of the expiration of an Incentive Award following the original Grantee's termination of Employment.

The designation by a Grantee of a beneficiary of an Incentive Award shall not constitute transfer of the Incentive Award. No transfer by will or by the laws of descent and distribution shall be effective to bind the Company unless the Committee has been furnished with a copy of the deceased Grantee's enforceable will or such other evidence as the Committee deems necessary to establish the validity of the transfer. Any attempted transfer in violation of this Section 8.4 shall be void and ineffective. All determinations under this Section 8.4 shall be made by the Committee.

8.5 Rights as a Stockholder

(a) No Stockholder Rights. Except as otherwise provided in Section 4.1(b) for grants of Restricted Stock, a Grantee of an Incentive Award (or a permitted transferee of such Grantee) shall have no rights as a stockholder with respect to any Shares of Common Stock until the issuance of a stock certificate or other record of ownership for such Shares.

(b) Representation of Ownership. In the case of the exercise of an Incentive Award by a person or estate acquiring the right to exercise such Incentive Award by reason of the death or Disability of a Grantee, the Committee may require reasonable evidence as to the ownership of such Incentive Award or the authority of such person. The Committee may also require such consents and releases of taxing authorities as it deems advisable.

8.6 Change in Stock and Adjustments

(a) Changes in Law or Circumstances. Subject to Section 8.8 (which only applies in the event of a Change in Control), in the event of any change in applicable law or any change in circumstances which results in or would result in any dilution of the rights granted under the Plan, or which otherwise warrants an equitable adjustment because it interferes with the intended operation of the Plan, then, if the Board or Committee should so determine, in its absolute discretion, that such change equitably requires an adjustment in the number or kind of shares of stock or other securities or property theretofore subject, or which may become subject, to issuance or transfer under the Plan or in the terms and conditions of outstanding Incentive Awards, such adjustment shall be made in accordance with such determination. Such adjustments may include changes with respect to (i) the aggregate number of Shares that may be issued under the Plan, (ii) the number of Shares subject to Incentive Awards, and (iii) the price per Share for outstanding Incentive Awards, but shall not result in the grant of any Stock Option with an exercise price less than 100% of the Fair Market Value per Share on the date of grant. The Board or Committee shall give notice to each applicable Grantee of such adjustment which shall be effective and binding.

(b) Exercise of Corporate Powers. The existence of the Plan or outstanding Incentive Awards hereunder shall not affect in any way the right or power of the Company or its stockholders to make or authorize any or all adjustments, recapitalization, reorganization or other changes in the Company's capital structure or its business or any merger or consolidation of the Company, or any issue of bonds, debentures, preferred or prior preference stocks ahead of or affecting the Common Stock or the rights thereof, or the dissolution or liquidation of the Company, or any sale or transfer of all or any part of its assets or business, or any other corporate act or proceeding whether of a similar character or otherwise.

(c) Recapitalization of the Company. Subject to Section 8.8 (which only applies in the event of a Change in Control), if while there are Incentive Awards outstanding, the Company shall effect any subdivision or consolidation of Shares of Common Stock or other capital readjustment, the payment of a stock dividend, stock split, combination of Shares, recapitalization or other increase or reduction in the number of Shares outstanding, without receiving compensation therefor in money, services or property, then the number of Shares available under the Plan

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and the number of Incentive Awards which may thereafter be settled shall (i) in the event of an increase in the number of Shares outstanding, be proportionately increased and the Option Price or Fair Market Value of the Incentive Awards awarded shall be proportionately reduced; and (ii) in the event of a reduction in the number of Shares outstanding, be proportionately reduced, and the Option Price or Fair Market Value of the Incentive Awards awarded shall be proportionately increased. The Board or Committee shall take such action and whatever other action it deems appropriate, in its discretion, so that the value of each outstanding Incentive Award to the Grantee shall not be adversely affected by a corporate event described in this Section 8.6(c).

(d) Issue of Common Stock by the Company. Except as hereinabove expressly provided in this Section 8.6 and subject to Section 8.8 in the event of a Change in Control, the issue by the Company of shares of stock of any class, or securities convertible into shares of stock of any class, for cash or property, or for labor or services, either upon direct sale or upon the exercise of rights or warrants to subscribe therefor, or upon any conversion of shares or obligations of the Company convertible into such shares or other securities, shall not affect, and no adjustment by reason thereof shall be made with respect to, the number of, Option Price or Fair Market Value of, any Incentive Awards then outstanding under previously granted Incentive Awards; provided, however, in such event, outstanding Shares of Restricted Stock shall be treated the same as outstanding unrestricted Shares of Common Stock.

(e) Assumption under the Plan of Outstanding Stock Options. Notwithstanding any other provision of the Plan, the Board or Committee, in its discretion, may authorize the assumption and continuation under the Plan of outstanding and unexercised stock options or other types of stock-based incentive awards that were granted under a stock option plan (or other type of stock incentive plan or agreement) that is or was maintained by a corporation or other entity that was merged into, consolidated with, or whose stock or assets were acquired by, the Company as the surviving corporation. Any such action shall be upon such terms and conditions as the Board or Committee, in its discretion, may deem appropriate, including provisions to preserve the holder's rights under the previously granted and unexercised stock option or other stock-based incentive award; such as, for example, retaining an existing exercise price under an outstanding stock option. Any such assumption and continuation of any such previously granted and unexercised incentive award shall be treated as an outstanding Incentive Award under the Plan and shall thus count against the number of Shares reserved for issuance pursuant to Section 1.4. In addition, any Shares issued by the Company through the assumption or substitution of outstanding grants from an acquired company shall reduce the Shares available for grants under Section 1.4 and, if not prohibited by any applicable rule or regulation and after obtaining any required shareholder approval, shall likewise increase the number of Shares available for Incentive Awards.

(f) Assumption of Incentive Awards by a Successor. Subject to the accelerated vesting and other provisions of Section 8.8 that apply in the event of a Change in Control, in the event of a Corporate Event (defined below), each Grantee shall be entitled to receive, in lieu of the number of Shares subject to Incentive Awards, such shares of capital stock or other securities or property as may be issuable or payable with respect to or in exchange for the number of Shares which Grantee would have received had he been entitled to exercise Shares subject to the Award immediately prior to such Corporate Event, together with any conforming adjustments. For this purpose, Shares of Restricted Stock shall be treated the same as unrestricted outstanding Shares of Common Stock. A Corporate Event means any of the following: (i) a dissolution or liquidation of the Company, (ii) a sale of all or substantially all of the Company's assets, or (iii) a merger, consolidation or combination involving the Company (other than a merger, consolidation or combination (A) in which the Company is the continuing or surviving corporation and (B) which does not result in the outstanding Shares being converted into or exchanged for different securities, cash or other property, or any combination thereof). The Board or Committee shall take whatever other action it deems appropriate to preserve the rights of Grantees holding outstanding Incentive Awards.

Notwithstanding the previous paragraph of this Section 8.6(f), but subject to any accelerated vesting or other provisions of Section 8.8 or the Incentive Agreement that apply in the event of a Change in Control, in the event of a

Corporate Event (described in the previous paragraph), the Board or Committee, in its discretion, shall have the right and power to:

(i) cancel, effective immediately prior to the occurrence of the Corporate Event, each outstanding Incentive Award (whether or not then exercisable) and, in full consideration of such cancellation, pay to the Grantee an amount in cash equal to the excess of (A) the value, as determined by the Board or Committee, of

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the property (including cash) received by the holders of Common Stock as a result of such Corporate Event over (B) the exercise price of such Incentive Award, if any; provided, however, this subsection (i) shall be inapplicable to an Incentive Award granted within six (6) months before the occurrence of the Corporate Event if the Grantee is an Insider and such disposition is not exempt under Rule 16b-3 (or other rules preventing liability of the Insider under Section 16(b) of the Exchange Act) and, in that event, the provisions hereof shall be applicable to such Incentive Award after the expiration of six (6) months from the date of grant; or

(ii) provide for the exchange or substitution of each Incentive Award outstanding immediately prior to such Corporate Event (whether or not then exercisable) for another award with respect to the Common Stock or other property for which such Incentive Award is exchangeable and, incident thereto, make an equitable adjustment as determined by the Board or Committee, in its discretion, in the Option Price or exercise price of the Incentive Award, if any, or in the number of Shares or amount of property (including cash) subject to the Incentive Award; or

(iii) provide for assumption of the Plan and such outstanding Incentive Awards by the surviving entity or its parent.

The Board or Committee, in its discretion, shall have the authority to take whatever action it deems to be necessary or appropriate to effectuate the provisions of this Section 8.6(f).

8.7 Termination of Employment or Directorship, Death, Disability and Retirement

(a) Termination of Employment. Unless otherwise expressly provided in the Grantee's Incentive Agreement with respect to a Grantee who is an Employee, if the Grantee's Employment is terminated (i) involuntarily by the Company without Cause or (ii) for any other reason except due to his death, Disability, Retirement, for Cause, or his voluntary resignation, as subject to the following provisions of this Section 8.7, then any non-vested portion of any Stock Option or other Incentive Award at the time of such termination shall automatically expire and terminate and no further vesting shall occur after the termination date unless the Committee, in its discretion, provides for an extension of exercisability or other modification pursuant to Section 1.3(d) or Section 8.7(g). In such event, except as otherwise expressly provided in his Incentive Agreement or as determined by the Committee in its discretion, the Grantee shall be entitled to exercise his rights only with respect to the vested portion of the Incentive Award for a period that shall end on the earlier of (i) the expiration date set forth in the Incentive Agreement or (ii) one (1) year after the date of his termination of Employment.

(b) Termination of Directorship. With respect to a Grantee who is an Outside Director, unless otherwise specifically provided in the Grantee's Incentive Agreement, and except as provided in Section 3.3, upon a Grantee's Termination of Directorship, all outstanding Awards that are not vested as of such Termination of Directorship will be forfeited.

(c) Termination of Employment for Cause. Unless otherwise expressly provided in the Grantee's Incentive Agreement with respect to a Grantee who is an Employee, in the event of termination of the Grantee's Employment for Cause, all vested and non-vested Incentive Awards granted to such Grantee shall immediately expire, and shall not be exercisable to any extent, as of 12:01 a.m. (CST) on the date of such termination of Employment.

(d) Voluntary Resignation. Unless otherwise expressly provided in the Grantee's Incentive Agreement, with respect to a Grantee who is an Employee, in the event of termination of the Grantee's Employment due to his voluntary resignation except resulting from his Disability or Retirement:

(i) any non-vested portion of any outstanding Incentive Award shall immediately terminate and no further vesting shall occur; and

(ii) any vested Incentive Award shall expire on the earlier of (A) the expiration date set forth in the Incentive Agreement for such Incentive Award, or (B) the expiration of ninety (90) days after the date of his termination of Employment.

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(e) Retirement. Unless otherwise expressly provided in the Grantee's Incentive Agreement, with respect to a Grantee who is an Employee, upon the termination of Employment due to Retirement:

(i) any non-vested portion of any outstanding Incentive Award shall immediately terminate and no further vesting shall occur; and

(ii) any vested Incentive Award shall expire on the earlier of (A) the expiration date set forth in the Incentive Agreement for such Incentive Award, or (B) the expiration of three (3) years after the date of his termination of Employment.

(f) Disability or Death. Unless otherwise expressly provided in the Grantee's Incentive Agreement, with respect to a Grantee who is an Employee, upon termination of Employment as a result of the Grantee's Disability or death:

(i) any non-vested portion of any outstanding Incentive Award shall immediately terminate upon termination of Employment and no further vesting shall occur; and

(ii) any vested Incentive Award shall expire on the earlier of (A) the expiration date set forth in the Incentive Agreement for such Incentive Award or (B) the expiration of three (3) years after the date of his termination of Employment.

In the event that the Grantee dies or becomes permanently and totally disabled as determined by the Committee within the one-year period specified in Section 8.7(a) (above), then notwithstanding Section 8.7(a), the Incentive Award shall expire on the earlier of (A) the expiration date set forth in the Incentive Agreement for such Incentive Award or (B) the expiration of one (1) year after the date of his death or the date he is determined to be permanently and totally disabled as such date is determined by the Committee.

In the event that the Grantee dies or becomes permanently and totally disabled as determined by the Committee within the three-year period specified in Section 8.7(e) (above), then notwithstanding Section 8.7(e), the Incentive Award shall expire on the earlier of: (A) the expiration date set forth in the Incentive Agreement for such Incentive Award or (B) the later of either (i) the expiration of three (3) years after the date of his Retirement or (ii) one (1) year from the date of his death or the date he is determined to be permanently and totally disabled as such date is determined by the Committee.

(g) Continuation. Subject to the conditions and limitations of the Plan and applicable law and regulation, with respect to a Grantee who is an Employee, in the event that the Grantee ceases to be an Employee, the Committee and Grantee, in their discretion, may mutually agree with respect to any outstanding Incentive Award then held by the Grantee

(i) for an acceleration or other adjustment in any vesting schedule applicable to the Incentive Award; (ii) for a continuation of the exercise period following termination for a longer period than is otherwise provided under such Incentive Award; or (iii) to any other change in the terms and conditions of the Incentive Award. In the event of any such change to an outstanding Incentive Award, a written amendment to the Grantee's Incentive Agreement shall be required.

8.8 Change in Control

Notwithstanding any contrary provision in the Plan, with respect to a Grantee who is an Employee, in the event of a Change in Control (as defined below), the following actions shall automatically occur as of the day immediately preceding the Change in Control date unless expressly provided otherwise in the individual Grantee's Incentive Agreement:

(a) all of the Stock Options and Stock Appreciation Rights then outstanding shall become 100% vested and immediately and fully exercisable;

(b) all of the restrictions and conditions of any Restricted Stock and any Other Stock-Based Awards then outstanding shall be deemed satisfied, and the Restriction Period with respect thereto shall be deemed to have expired, and thus each such Incentive Award shall become free of all restrictions and fully vested; and

(c) all of the Performance-Based Restricted Awards and any Other Stock-Based Awards shall become fully vested and deemed earned in full at the specified 100% target amounts, and promptly paid in full within

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thirty (30) days to the affected Grantees without regard to payment schedules and notwithstanding that the applicable performance cycle, retention cycle or other restrictions and conditions have not been completed or satisfied.

For all purposes of the Plan, a Change in Control of the Company means the occurrence of any one or more of the following events:

(a) The acquisition by any individual, entity or group (a **Person**) (within the meaning of Section 13(d)(3) or 14(d)(2) of the Exchange Act) of beneficial ownership (within the meaning of Rule 13d-3 promulgated under the Exchange Act) of twenty percent (20%) or more of either (i) the then outstanding Shares (the Outstanding Company Stock) or (ii) the combined voting power of the then outstanding voting securities of the Company entitled to vote generally in the election of directors (the Outstanding Company Voting Securities); provided, however, that the following acquisitions shall not constitute a Change in Control: (i) any acquisition directly from the Company or any Subsidiary, (ii) any acquisition by the Company or any Subsidiary or by any employee benefit plan (or related trust) sponsored or maintained by the Company or any Subsidiary, or (iii) any acquisition by any corporation pursuant to a reorganization, merger, consolidation or similar business combination involving the Company (a Merger), if, following such Merger, the conditions described in Section 8.8(c) (below) are satisfied;

(b) Individuals who, as of the Effective Date, constitute the Board of Directors of the Company (the Incumbent Board) cease for any reason to constitute at least a majority of the Board; provided, however, that any individual becoming a director subsequent to the Effective Date whose election, or nomination for election by the Company's stockholders, was approved by a vote of at least a majority of the directors then comprising the Incumbent Board shall be considered as though such individual were a member of the Incumbent Board, but excluding, for this purpose, any such individual whose initial assumption of office occurs as a result of either an actual or threatened election contest (as such terms are used in Rule 14a-11 of Regulation 14A promulgated under the Exchange Act) or other actual or threatened solicitation of proxies or consents by or on behalf of a Person other than the Board;

(c) Consummation of a reorganization, merger or consolidation, or sale or other disposition of all or substantially all of the assets of the Company (a Business Combination), in each case, unless, following such Business Combination, (1) all or substantially all of the individuals and entities who were the beneficial owners, respectively, of the Outstanding Company Stock and Outstanding Company Voting Securities immediately prior to such Business Combination beneficially own, directly or indirectly, more than sixty percent (60%) of, respectively, the then outstanding Shares and the combined voting power of the then outstanding voting securities entitled to vote generally in the election of directors, as the case may be, of the corporation resulting from such Business Combination (including, without limitation, a corporation which as a result of such transaction owns the Company or all or substantially all of the Company's assets either directly or through one or more subsidiaries) in substantially the same proportions as their ownership, immediately prior to such Business Combination of the Outstanding Company Stock and Outstanding Company Voting Securities, as the case may be, (2) no Person (excluding any corporation resulting from such Business Combination or any employee benefit plan (or related trust) of the Company or such corporation resulting from such Business Combination) beneficially owns, directly or indirectly, twenty (20%) or more of, respectively, the then outstanding Shares resulting from such Business Combination or the combined voting power of the then outstanding voting securities of such corporation except to the extent that such ownership existed prior to the Business Combination, and (3) at least a majority of the members of the board of directors of the corporation resulting from such Business Combination were members of the Incumbent Board at the time of the execution of the initial agreement, or the action of the Board, providing for such Business Combination;

(d) The adoption of any plan or proposal for the liquidation or dissolution of the Company; or

(e) Any other event that a majority of the Board, in its sole discretion, determines to constitute a Change in Control hereunder.

Notwithstanding the occurrence of any of the foregoing events set out in this Section 8.8 which would otherwise result in a Change in Control, the Board may determine in its discretion, if it deems it to be in the best

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interest of the Company, that an event or events otherwise constituting or reasonably leading to a Change in Control shall not be deemed a Change in Control hereunder. Such determination shall be effective only if it is made by the Board (i) prior to the occurrence of an event that otherwise would be, or reasonably lead to, a Change in Control, or (ii) after such event only if made by the Board a majority of which is composed of directors who were members of the Board immediately prior to the event that otherwise would be, or reasonably lead to, a Change in Control.

Notwithstanding the foregoing provisions of this Section 8.8, to the extent that any payment or acceleration hereunder is subject to Code Section 409A, whether a Change in Control has occurred with respect to such amount shall be determined within the meaning set forth in Code Section 409A(a)(2)(A)(v), but only to the extent inconsistent with the foregoing provisions as determined in the discretion of the Committee.

8.9 Exchange of Incentive Awards

Subject to the approval of the Company's stockholders, as required under applicable securities laws and stock exchange requirements, the Committee may permit any Grantee to surrender outstanding Incentive Awards in order to exercise or realize his rights under other Incentive Awards or in exchange for the grant of new Incentive Awards, or require holders of Incentive Awards to surrender outstanding Incentive Awards (or comparable rights under other plans or arrangements) as a condition precedent to the grant of new Incentive Awards.

8.10 Financing

Subject to the requirements of the Sarbanes-Oxley Act of 2002, the Company may extend and maintain, or arrange for and guarantee, the extension and maintenance of financing to any Grantee to purchase Shares pursuant to exercise of an Incentive Award upon such terms as are approved by the Committee in its discretion.

SECTION 9

GENERAL

9.1 Effective Date and Grant Period

The Plan is adopted by the Board effective as of the Effective Date, subject to the approval of the stockholders of the Company. Incentive Awards may be granted under the Plan at any time prior to receipt of such stockholder approval; provided, however, (a) no Shares may be issued pursuant to Incentive Awards granted after the Effective Date until the requisite stockholder approval is obtained, and (b) if the requisite stockholder approval is not obtained then any Incentive Awards granted hereunder after the Effective Date shall automatically become null and void and of no force or effect. Notwithstanding the foregoing, any Incentive Award that is intended to satisfy the Performance-Based Exception shall not be granted until the terms of the Plan are disclosed to, and approved by, stockholders of the Company in accordance with the requirements of the Performance-Based Exception.

9.2 Funding and Liability of Company

No provision of the Plan shall require the Company, for the purpose of satisfying any obligations under the Plan, to purchase assets or place any assets in a trust or other entity to which contributions are made, or to otherwise segregate any assets. In addition, the Company shall not be required to maintain separate bank accounts, books, records or other evidence of the existence of a segregated or separately maintained or administered fund for purposes of the Plan. Although bookkeeping accounts may be established with respect to Grantees who are entitled to cash, Common Stock or rights thereto under the Plan, any such accounts shall be used merely as a bookkeeping convenience. The Company shall not be required to segregate any assets that may at any time be represented by cash, Common Stock or rights

thereto. The Plan shall not be construed as providing for such segregation, nor shall the Company, the Board or the Committee be deemed to be a trustee of any cash, Common Stock or rights thereto. Any liability or obligation of the Company to any Grantee with respect to an Incentive Award shall be based solely upon any contractual obligations that may be created by the Plan and any Incentive Agreement, and no such liability or obligation of the Company shall be deemed to be secured by any pledge or other encumbrance on any property of

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the Company. Neither the Company, the Board nor the Committee shall be required to give any security or bond for the performance of any obligation that may be created by the Plan.

9.3 Withholding Taxes

(a) Tax Withholding. The Company shall have the power and the right to deduct or withhold, or require a Grantee to remit to the Company, an amount sufficient to satisfy federal, state, and local taxes, domestic or foreign, required by law or regulation to be withheld with respect to any taxable event arising as the result of an Incentive Award. Upon the lapse of restrictions on Restricted Stock, the Committee, in its discretion, may elect to satisfy the tax withholding requirement, in whole or in part, by having the Company withhold Shares having a Fair Market Value on the date the tax is to be determined equal to the minimum withholding taxes which could be imposed on the transaction as determined by the Committee.

(b) Share Withholding. With respect to tax withholding required upon the exercise of Stock Options or SARs, upon the lapse of restrictions on Restricted Stock or Restricted Stock Units, or upon any other taxable event arising as a result of any Incentive Awards, Grantees may elect, subject to the approval of the Committee in its discretion, to satisfy the withholding requirement, in whole or in part, by having the Company withhold Shares having a Fair Market Value on the date the tax is to be determined equal to the minimum withholding taxes which could be imposed on the transaction as determined by the Committee. All such elections shall be made in writing, signed by the Grantee, and shall be subject to any restrictions or limitations that the Committee, in its discretion, deems appropriate.

(c) Loans. To the extent permitted by the Sarbanes-Oxley Act of 2002 or other applicable law, the Committee may provide for loans, on either a short term or demand basis, from the Company to a Grantee who is an Employee to permit the payment of taxes required by law.

9.4 No Guarantee of Tax Consequences

The Company, the Committee and the Board do not make any commitment or guarantee that any federal, state or local tax treatment will apply or be available to any person participating or eligible to participate in the Plan.

9.5 Designation of Beneficiary by Grantee

Each Grantee may, from time to time, name any beneficiary or beneficiaries (who may be named contingently or successively) to whom any benefit under the Plan is to be paid in case of his death before he receives any or all of such benefit. Each such designation shall revoke all prior designations by the same Grantee, shall be in a form prescribed by the Company and will be effective only when filed by the Grantee in writing with the Company during the Grantee's lifetime. In the absence of any such designation, benefits remaining unpaid at the Grantee's death shall be paid to the Grantee's estate.

9.6 Deferrals

Except as set forth in Section 5.2, the Committee shall not permit a Grantee to defer such Grantee's receipt of the payment of cash or the delivery of Shares that would otherwise be due to such Grantee by virtue of the lapse or waiver of restrictions with respect to Restricted Stock or Restricted Stock Units, or the satisfaction of any requirements or goals with respect to Performance-Based Restricted Awards or Other Stock-Based Awards.

9.7 Amendment and Termination

The Board shall have the power and authority to terminate or amend the Plan at any time, provided, however, the Board shall not, without the approval of the stockholders of the Company within the time period required by applicable law:

(a) except as provided in Section 8.6, increase the maximum number of Shares which may be issued under the Plan pursuant to Section 1.4;

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(b) amend the requirements as to the class of individuals eligible to purchase Common Stock under the Plan;

(c) extend the term of the Plan; or,

(d) while the Company is a Publicly Held Corporation (i) increase the maximum limits on Incentive Awards to Covered Employees as set for compliance with the Performance-Based Exception or (ii) decrease the authority granted to the Committee under the Plan in contravention of Rule 16b-3 under the Exchange Act.

No termination, amendment, or modification of the Plan shall adversely affect in any material way any outstanding Incentive Award previously granted to a Grantee under the Plan, without the written consent of such Grantee or other designated holder of such Incentive Award.

In addition, to the extent that the Committee determines that (a) the listing for qualification requirements of any national securities exchange or quotation system on which the Company's Common Stock is then listed or quoted, if applicable, or (b) the Code (or regulations promulgated thereunder), require stockholder approval in order to maintain compliance with such listing requirements or to maintain any favorable tax advantages or qualifications, then the Plan shall not be amended in such respect without approval of the Company's stockholders.

9.8 Requirements of Law

(a) Governmental Entities and Securities Exchanges. The granting of Incentive Awards and the issuance of Shares under the Plan shall be subject to all applicable laws, rules, and regulations, and to such approvals by any governmental agencies or national securities exchanges as may be required. Certificates evidencing Shares delivered under the Plan (to the extent that such Shares are so evidenced) may be subject to such stop transfer orders and other restrictions as the Committee may deem advisable under the rules and regulations of the Securities and Exchange Commission, any securities exchange or transaction reporting system upon which the Common Stock is then listed or to which it is admitted for quotation, and any applicable federal or state securities law, if applicable. The Committee may cause a legend or legends to be placed upon such certificates (if any) to make appropriate reference to such restrictions.

(b) Securities Act Rule 701. If no class of the Company's securities is registered under Section 12 of the Exchange Act, then unless otherwise determined by the Committee, grants of Incentive Awards to Rule 701 Grantees (as defined below) and issuances of the underlying Shares, if any, on the exercise or conversion of such Incentive Awards are intended to comply with all applicable conditions of Securities Act Rule 701 (Rule 701), including, without limitation, the restrictions as to the amount of securities that may be offered and sold in reliance on Rule 701, so as to qualify for an exemption from the registration requirements of the Securities Act. Any ambiguities or inconsistencies in the construction of an Incentive Award or the Plan shall be interpreted to give effect to such intention. In accordance with Rule 701, each Grantee shall receive a copy of the Plan on or before the date an Incentive Award is granted to him, as well as the additional disclosure required by Rule 701(e) if the aggregate sales price or amount of securities sold during any consecutive 12-month period exceeds \$5,000,000 as determined under Rule 701(e). If Rule 701 (or any successor provision) is amended to eliminate or otherwise modify any of the requirements specified in Rule 701, then the provisions of this Section 9.8(b) shall be interpreted and construed in accordance with Rule 701 as so amended. For purposes of this Section 9.8(b), as determined in accordance with Rule 701, Rule 701 Grantees shall mean any Grantee other than a director of the Company, the Company's chairman, CEO, president, chief financial officer, controller and any vice president of the Company, and any other key employee of the Company who generally has access to financial and other business related information and possesses sufficient sophistication to understand and evaluate such information.

9.9 Rule 16b-3 Securities Law Compliance for Insiders

While the Company is a Publicly Held Corporation, transactions under the Plan with respect to Insiders are intended to comply with all applicable conditions of Rule 16b-3 under the Exchange Act. Any ambiguities or inconsistencies in the construction of an Incentive Award or the Plan shall be interpreted to give effect to such intention, and to the extent any provision of the Plan or action by the Committee fails to so comply, it shall be deemed null and void to the extent permitted by law and deemed advisable by the Committee in its discretion.

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9.10 Compliance with Code Section 162(m) for Publicly Held Corporation

While the Company is a Publicly Held Corporation, unless otherwise determined by the Committee with respect to any particular Incentive Award, it is intended that the Plan shall comply fully with the applicable requirements so that any Incentive Awards subject to Section 162(m) that are granted to Covered Employees shall qualify for the Performance-Based Exception, except for grants of Stock Options with an Option Price set at less than the Fair Market Value of a Share on the date of grant. If any provision of the Plan or an Incentive Agreement would disqualify the Plan or would not otherwise permit the Plan or Incentive Award to comply with the Performance-Based Exception as so intended, such provision shall be construed or deemed to be amended to conform to the requirements of the Performance-Based Exception to the extent permitted by applicable law and deemed advisable by the Committee; provided, however, no such construction or amendment shall have an adverse effect on the prior grant of an Incentive Award or the economic value to a Grantee of any outstanding Incentive Award.

9.11 Notices

(a) Notice From Insiders to Secretary of Change in Beneficial Ownership. Within two business days after the date of a change in beneficial ownership of the Common Stock issued or delivered pursuant to the Plan, an Insider should report to the Secretary of the Company, or his delegate, any such change to the beneficial ownership of Common Stock that is required to be reported with respect to such Insider under Rule 16(a)-3 promulgated pursuant to the Exchange Act. Whenever reasonably feasible, Insiders will provide the Committee or Company with advance notification of such change in beneficial ownership.

(b) Notice to Insiders and Securities and Exchange Commission. The Company shall provide notice to any Insider, as well as to the Securities and Exchange Commission, of any blackout period, as defined in Section 306(a)(4) of the Sarbanes-Oxley Act of 2002, in any case in which Insider is subject to the requirements of Section 304 of said Act in connection with such blackout period.

9.12 Pre-Clearance Agreement with Brokers

Notwithstanding anything in the Plan to the contrary, no Shares issued pursuant to the Plan will be delivered to a broker or dealer that receives such Shares for the account of an Insider unless and until the broker or dealer enters into an agreement with the Company whereby such broker or dealer agrees to report immediately to the Secretary of the Company (or other designated person) a change in the beneficial ownership of such Shares.

9.13 Successors to Company

All obligations of the Company under the Plan with respect to Incentive Awards granted hereunder shall be binding on any successor to the Company, whether the existence of such successor is the result of a direct or indirect purchase, merger, consolidation, or otherwise, of all or substantially all of the business and/or assets of the Company.

9.14 Miscellaneous Provisions

(a) No Employee, Outside Director, or other person shall have any claim or right to be granted an Incentive Award under the Plan. Neither the Plan, nor any action taken hereunder, shall be construed as giving any Employee or Outside Director any right to be retained in the Employment or other service of the Company or any Subsidiary.

(b) The expenses of the Plan shall be borne by the Company.

(c) By accepting any Incentive Award, each Grantee and each person claiming by or through him shall be deemed to have indicated his acceptance of the Plan.

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9.15 Severability

In the event that any provision of the Plan shall be held illegal, invalid or unenforceable for any reason, such provision shall be fully severable, but shall not affect the remaining provisions of the Plan, and the Plan shall be construed and enforced as if the illegal, invalid, or unenforceable provision was not included herein.

9.16 Gender, Tense and Headings

Whenever the context so requires, words of the masculine gender used herein shall include the feminine and neuter, and words used in the singular shall include the plural. Section headings as used herein are inserted solely for convenience and reference and constitute no part of the interpretation or construction of the Plan.

9.17 Governing Law

The Plan shall be interpreted, construed and constructed in accordance with the laws of the State of Delaware without regard to its conflicts of law provisions, except as may be superseded by applicable laws of the United States.

9.18 Section 409A Compliance

To the extent that the Plan provides for the payment of amounts that constitute nonqualified deferred compensation under Code Section 409A, the Plan is intended to comply with the provisions of Section 409A so as to prevent the inclusion of gross income of any amounts deferred hereunder in a taxable year that is prior to the taxable year or years in which such amounts would otherwise be actually distributed and made available to Grantees or beneficiaries. Notwithstanding any other provision of the Plan, at the discretion of the Committee, the timing of the payment for any Incentive Award that was issued to a Grantee prior to December 31, 2008 may, at the election of the Grantee, be changed to an earlier or later date in accordance with IRS Notice 2006-79, IRS Notice 2007-86 or other authority, as applicable, provided that such election change is made not later than by December 31 of the applicable year as required pursuant to the terms and conditions for such transition relief as set forth in the applicable IRS Notice or other authority.

[Signature page follows.]

IN WITNESS WHEREOF, on this day of , 2008, the Company has caused the Plan to be duly executed in its name and on its behalf by its duly authorized officer.

SMITH INTERNATIONAL, INC.

Name: Richard E. Chandler, Jr.

By: /s/ RICHARD E. CHANDLER, JR.

Title: Senior Vice President, General Counsel and
Secretary

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Electronic Voting Instructions

**You can vote by Internet or telephone!
Available 24 hours a day, 7 days a week!**

Instead of mailing your proxy, you may choose one of the two voting methods outlined below to vote your proxy.

VALIDATION DETAILS ARE LOCATED BELOW IN THE TITLE BAR.

Proxies submitted by the Internet or telephone must be received by 1:00 a.m., Central Time, on May 13, 2008.

Vote by Internet

Log on to the Internet and go to www.envisionreports.com/Sii
Follow the steps outlined on the secured website.

Vote by telephone

Call toll free 1-800-652-VOTE (8683) within the United States, Canada & Puerto Rico any time on a touch tone telephone. There is NO CHARGE to you for the call. Follow the instructions provided by the recorded message.

Using a **black ink** pen, mark your votes with an **X** as shown in this example. Please do not write outside the designated areas. x

Annual Meeting Proxy Card

A Election of Directors

PLEASE REFER TO THE REVERSE SIDE FOR INTERNET AND TELEPHONE VOTING INSTRUCTIONS.

1. The Board of Directors recommends a vote FOR the listed nominees.

	For	Withhold
01 Loren K. Carroll	<input type="radio"/>	<input type="radio"/>

	For	Withhold
02 Dod A. Fraser	<input type="radio"/>	<input type="radio"/>

B Issues

The Board of Directors recommends a vote FOR the following proposals.

For Against Abstain

2. Approval of Third Amended and Restated
1989 Long-Term Incentive Compensation Plan

3. Approval of Amendment to Restated
Certificate of Incorporation

For Against Abstain

4. Ratification of Independent Registered Public
Accounting Firm

For Against Abstain

C Authorized Signatures Sign Here This section must be completed for your instructions to be executed.

NOTE: Please sign your name(s) EXACTLY as your name(s) appear(s) on this proxy. All joint holders must sign. When signing as attorney, trustee, executor, administrator, guardian or corporate officer, please provide your FULL title.

Signature 1 Please keep signature
within the box

Signature 2 Please keep signature
within the box

Date (mm/dd/yyyy)

Proxy Smith International, Inc.

Meeting Details

700 King Street, Wilmington, Delaware

Proxy Solicited by Board of Directors for Annual Meeting May 13, 2008

Doug Rock and Richard E. Chandler, Jr., or any of them, each with the power of substitution, are hereby authorized to represent and vote the shares of the undersigned, with all the powers which the undersigned would possess if personally present, at the Annual Meeting of Stockholders of Smith International, Inc. to be held on May 13, 2008 or at any postponement or adjournment thereof.

Shares represented by this proxy will be voted by the stockholder. If no such directions are indicated, the Proxies will have authority to vote FOR Loren K. Carroll, FOR Dod A. Fraser, FOR item 2 Third Amended and Restated 1989 Long-Term Incentive Compensation Plan, FOR item 3 Amendment to Restated Certificate of Incorporation and FOR item 4 Ratification of Independent Registered Public Accounting Firm.

In their discretion, the Proxies are authorized to vote upon such other business as may properly come before the meeting.

Additionally, you may choose to receive future Annual Meeting materials (annual report, proxy statement and proxy card) on-line. By choosing to receive materials on-line, you help support Smith International, Inc. in its efforts to control printing and postage costs.

If you choose the option of electronic delivery and voting on-line, you will receive an e-mail before all future annual or special meetings of shareholders, notifying you of the website containing the Proxy Statement and other materials to be carefully reviewed before casting your vote. To enroll to receive future materials on-line if you are a participant in any of the Company's 401(K) plans, please go to www.econsent.com/sii and if you are a registered holder, please go to www.computershare.com/us/ecomms.