

LSB INDUSTRIES INC
Form 10-Q
November 06, 2008
LSB Industries, Inc.

Form 10-Q (9-30-2008)

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

Form 10-Q

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

For the quarterly period ended September 30, 2008

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 1-7677

LSB Industries, Inc.
Exact name of Registrant as specified in its charter

Delaware 73-1015226
State or other jurisdiction of I.R.S. Employer Identification No.
incorporation or organization

16 South Pennsylvania Avenue, Oklahoma City, Oklahoma 73107
Address of principal executive offices (Zip Code)

(405) 235-4546
Registrant's telephone number, including area code

____ None ____
Former name, former address and former fiscal year, if changed since last report.

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

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Yes ☒ No ☐

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

Large accelerated filer ☐ Accelerated filer ☒

Non-accelerated filer ☐ Smaller reporting company ☐

(Do not check if a smaller reporting company)

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

The number of shares outstanding of the Registrant's voting common stock, as of October 31, 2008 was 21,299,652 shares, excluding 3,648,518 shares held as treasury stock.

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FORM 10-Q OF LSB INDUSTRIES, INC.

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PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

LSB INDUSTRIES, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Information at September 30, 2008 is unaudited)

	September 30, 2008	December 31, 2007
	(In Thousands)	
Assets		
Current assets:		
Cash and cash equivalents	\$ 47,478	\$ 58,224
Restricted cash	276	203
Accounts receivable, net	106,348	70,577
Inventories:		
Finished goods	38,888	28,177
Work in process	3,526	3,569
Raw materials	32,031	25,130
Total inventories	74,445	56,876
Supplies, prepaid items and other:		
Prepaid insurance	927	3,350
Prepaid income taxes	1,535	-
Precious metals	14,400	10,935
Supplies	4,371	3,849
Other	1,619	1,464
Total supplies, prepaid items and other	22,852	19,598
Deferred income taxes	5,877	10,030
Total current assets	257,276	215,508
Property, plant and equipment, net	95,952	79,692
Other assets:		
Debt issuance and other debt-related costs, net	4,233	4,639
Investment in affiliate	3,568	3,426
Goodwill	1,724	1,724
Other, net	2,613	2,565
Total other assets	12,138	12,354
	\$ 365,366	\$ 307,554

(Continued on following page)

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LSB INDUSTRIES, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS (continued)
(Information at September 30, 2008 is unaudited)

	September 30, 2008	December 31, 2007
	(In Thousands)	
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 55,190	\$ 39,060
Short-term financing and drafts payable	-	919
Accrued and other liabilities	44,193	38,942
Current portion of long-term debt	1,495	1,043
Total current liabilities	100,878	79,964
Long-term debt	122,032	121,064
Noncurrent accrued and other liabilities:		
Deferred income taxes	5,601	5,330
Other	8,343	6,913
	13,944	12,243
Contingencies (Note 10)		
Stockholders' equity:		
Series B 12% cumulative, convertible preferred stock, \$100 par value; 20,000 shares issued and outstanding	2,000	2,000
Series D 6% cumulative, convertible Class C preferred stock, no par value; 1,000,000 shares issued	1,000	1,000
Common stock, \$.10 par value; 75,000,000 shares authorized, 24,898,170 shares issued (24,466,506 at December 31, 2007)	2,490	2,447
Capital in excess of par value	128,056	123,336
Accumulated other comprehensive loss	(193)	(411)
Retained earnings (accumulated deficit)	16,232	(16,437)
	149,585	111,935
Less treasury stock at cost:		
Common stock, 3,648,518 shares (3,448,518 at December 31, 2007)	21,073	17,652
Total stockholders' equity	128,512	94,283
	\$ 365,366	\$ 307,554

(See accompanying notes)

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LSB INDUSTRIES, INC.
CONDENSED CONSOLIDATED STATEMENT OF INCOME
(Unaudited)
Nine and Three Months Ended September 30, 2008 and 2007

	Nine Months		Three Months	
	2008	2007	2008	2007
	(In Thousands, Except Per Share Amounts)			
Net sales	\$ 569,427	\$ 451,754	\$ 210,920	\$ 147,613
Cost of sales	456,760	349,873	179,751	112,441
Gross profit	112,667	101,881	31,169	35,172
Selling, general and administrative expense	62,633	55,821	22,411	18,827
Provisions for (recovery of) losses on accounts receivable	159	874	(133)	253
Other expense	946	853	289	335
Other income	(8,417)	(3,440)	(88)	(3,340)
Operating income	57,346	47,773	8,690	19,097
Interest expense	6,363	8,062	2,643	3,482
Non-operating other income, net	(1,125)	(605)	(263)	(532)
Income from continuing operations before provisions (benefits) for income taxes and equity in earnings of affiliate	52,108	40,316	6,310	16,147
Provisions (benefits) for income taxes	19,817	(1,017)	2,388	(1,549)
Equity in earnings of affiliate	(697)	(654)	(235)	(223)
Income from continuing operations	32,988	41,987	4,157	17,919
Net loss (income) from discontinued operations	13	(348)	(4)	(377)
Net income	32,975	42,335	4,161	18,296
Dividends, dividend requirements and stock dividend on preferred stocks	306	5,608	-	203
Net income applicable to common stock	\$ 32,669	\$ 36,727	\$ 4,161	\$ 18,093
Weighted-average common shares:				
Basic	21,156	19,150	21,237	20,220
Diluted	24,884	22,990	22,654	25,072
Income per common share:				
Basic:				
Income from continuing operations	\$ 1.54	\$ 1.90	\$.20	\$.87
Net income (loss) from discontinued operations	-	.02	-	.02
Net income	\$ 1.54	\$ 1.92	\$.20	\$.89
Diluted:				
Income from continuing operations	\$ 1.40	\$ 1.65	\$.18	\$.75
Net income (loss) from discontinued operations	-	.02	-	.02
Net income	\$ 1.40	\$ 1.67	\$.18	\$.77

(See accompanying notes)

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LSB INDUSTRIES, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(Unaudited)
Nine Months Ended September 30, 2008

	Common Stock Shares	Non- Redeemable Preferred Stock	Common Stock Par Value	Capital in Excess of Par Value	Accumulated Other Comprehensive Loss	Retained Earnings (Accumulated Deficit)	Treasury Stock- Common	Total
(In Thousands)								
Balance at December 31, 2007	24,467	\$ 3,000	\$ 2,447	\$ 123,336	\$ (411)	\$(16,437)	\$(17,652)	\$ 94,283
Net income						32,975		32,975
Amortization of cash flow hedge					218			218
Total comprehensive income								33,193
Dividends paid on preferred stock						(306)		(306)
Stock-based compensation				577				577
Exercise of stock options	430		43	728				771
Income tax benefit from exercise of stock options				3,412				3,412
Acquisition of 200,000 shares of common stock							(3,421)	(3,421)
Conversion of shares of redeemable preferred stock to common stock	1			3				3
Balance at September 30, 2008	24,898	\$ 3,000	\$ 2,490	\$ 128,056	\$ (193)	\$ 16,232	\$(21,073)	\$ 128,512

(See accompanying notes)

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LSB INDUSTRIES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
Nine Months Ended September 30, 2008 and 2007

	2008	2007
	(In Thousands)	
Cash flows from continuing operating activities:		
Net income	\$ 32,975	\$ 42,335
Adjustments to reconcile net income to net cash provided by continuing operating activities:		
Net loss (income) from discontinued operations	13	(348)
Deferred income taxes	4,424	(3,150)
Gain on litigation judgment associated with property, plant and equipment	(3,943)	-
Loss on sales of property and equipment	130	446
Depreciation of property, plant and equipment	9,784	9,201
Amortization	914	841
Stock-based compensation	577	228
Provisions for losses on accounts receivable	159	874
Provision for (realization of) losses on inventory	400	(360)
Provisions for impairment of long-lived assets	192	250
Realization of losses on firm sales commitments	-	(328)
Equity in earnings of affiliate	(697)	(654)
Distributions received from affiliate	555	570
Changes in fair value of commodities contracts	4,931	(133)
Changes in fair value of interest rate contracts	(237)	241
Other	-	(8)
Cash provided (used) by changes in assets and liabilities:		
Accounts receivable	(36,043)	(20,656)
Inventories	(17,969)	(1,587)
Other supplies and prepaid items	(3,254)	(2,541)
Accounts payable	14,410	(3,849)
Customer deposits	(269)	(233)
Deferred rent expense	(2,909)	(2,423)
Other current and noncurrent liabilities	5,178	7,889
Net cash provided by continuing operating activities	9,321	26,605
Cash flows from continuing investing activities:		
Capital expenditures	(22,693)	(10,300)
Proceeds from litigation judgment associated with property, plant and equipment	5,948	-
Payment of legal costs relating to litigation judgment associated with property, plant and equipment	(1,884)	-
Proceeds from sales of property and equipment	63	192
Proceeds from (deposits of) restricted cash	(73)	3,651
Purchase of interest rate cap contracts	-	(621)
Other assets	(305)	(70)
Net cash used by continuing investing activities	(18,944)	(7,148)

(Continued on following page)

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LSB INDUSTRIES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
(Unaudited)
Nine Months Ended September 30, 2008 and 2007

	2008	2007
	(In Thousands)	
Cash flows from continuing financing activities:		
Proceeds from revolving debt facilities	\$ 475,372	\$ 381,835
Payments on revolving debt facilities	(475,372)	(408,242)
Proceeds from 5.5% convertible debentures, net of fees	-	56,985
Proceeds from other long-term debt, net of fees	-	2,424
Payments on other long-term debt	(524)	(7,629)
Payments of debt issuance costs	-	(143)
Proceeds from short-term financing and drafts payable	-	56
Payments on short-term financing and drafts payable	(919)	(2,909)
Proceeds from exercise of stock options	771	1,112
Acquisition of common stock	(3,421)	-
Excess income tax benefit on stock options exercised	3,412	-
Dividends paid on preferred stock	(306)	(2,934)
Acquisition of non-redeemable preferred stock	-	(1,292)
Net cash provided (used) by continuing financing activities	(987)	19,263
Cash flows of discontinued operations:		
Operating cash flows	(136)	(106)
Net increase (decrease) in cash and cash equivalents	(10,746)	38,614
Cash and cash equivalents at beginning of period	58,224	2,255
Cash and cash equivalents at end of period	\$ 47,478	\$ 40,869
Supplemental cash flow information:		
Cash payments for income taxes, net of refunds	\$ 16,814	\$ 1,399
Noncash investing and financing activities:		
Accounts payable and other long-term debt associated with purchases of property, plant and equipment	\$ 4,009	\$ 2,203
Debt issuance costs	\$ -	\$ 3,026
Debt issuance costs associated with 7% convertible debentures converted to common stock	\$ -	\$ 266
7% convertible debentures converted to common stock	\$ -	\$ 4,000
Series 2 preferred stock converted to common stock of which \$12,303,000 was charged to accumulated deficit	\$ -	\$ 27,593

(See accompanying notes)

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1: Basis of Presentation The accompanying condensed consolidated financial statements include the accounts of LSB Industries, Inc. (the "Company", "We", "Us", or "Our") and its subsidiaries. We are a manufacturing, marketing and engineering company which is primarily engaged, through our wholly-owned subsidiary ThermaClima, Inc. ("ThermaClima") and its subsidiaries, in the manufacture and sale of geothermal and water source heat pumps and air handling products (the "Climate Control Business") and the manufacture and sale of chemical products (the "Chemical Business"). The Company and ThermaClima are holding companies with no significant assets or operations other than cash and cash equivalents and our investments in our subsidiaries. Entities that are 20% to 50% owned and for which we have significant influence are accounted for on the equity method. All material intercompany accounts and transactions have been eliminated.

In the opinion of management, the unaudited condensed consolidated financial statements of the Company as of September 30, 2008 and for the nine and three-month periods ended September 30, 2008 and 2007 include all adjustments and accruals, consisting only of normal, recurring accrual adjustments which are necessary for a fair presentation of the results for the interim periods. These interim results are not necessarily indicative of results for a full year due, in part, to the seasonality of our sales of agricultural products and the timing of performing our major plant maintenance activities. Our selling seasons for agricultural products are primarily during the spring and fall planting seasons, which typically extend from March through June and from September through November.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles ("GAAP") have been condensed or omitted in this Form 10-Q pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). These condensed consolidated financial statements should be read in connection with the consolidated financial statements and notes thereto included in our Form 10-K for the year ended December 31, 2007 ("2007 Form 10-K").

Note 2: Recently Issued Accounting Pronouncements In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 157 - Fair Value Measurements ("SFAS 157"). SFAS 157 is definitional and disclosure oriented and addresses how companies should approach measuring fair value when required by GAAP; it does not create or modify any current GAAP requirements to apply fair value accounting. SFAS 157 provides a single definition for fair value that is to be applied consistently for all accounting applications, and also generally describes and prioritizes according to reliability the methods and input used in valuations. SFAS 157 prescribes various disclosures about financial statement categories and amounts which are measured at fair value, if such disclosures are not already specified elsewhere in GAAP. The new measurement and disclosure requirements of SFAS 157 became effective for the Company on January 1, 2008. The provisions of SFAS 157 were applied prospectively. See Note 11 - Derivatives, Hedges and Financial Instruments.

In February 2008, the FASB issued FASB Staff Position No. FAS 157-2 ("FSP 157-2"), which delayed the effective date of SFAS 157 for nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. FSP 157-2 will become effective for the Company beginning in the first quarter of 2009. We have not yet

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 2: Recently Issued Accounting Pronouncements (continued)

determined if the adoption of FSP 157-2 will significantly impact our consolidated financial statements and disclosures.

In March 2008, the FASB issued SFAS No. 161 - Disclosures about Derivative Instruments and Hedging Activities; an Amendment of SFAS 133 ("SFAS 161"). SFAS 161 requires enhanced disclosures about an entity's derivative and hedging activities for the purpose of improving the transparency of financial reporting. The new disclosure requirements of SFAS 161 will become effective for the Company beginning in the first quarter of 2009. We have not yet determined if the adoption of SFAS 161 will significantly impact our consolidated financial statements and disclosures.

Note 3: Accounts Receivable

	September 30, 2008	December 31, 2007
	(In Thousands)	
Trade receivables	\$ 105,646	\$ 68,234
Insurance claims	174	2,469
Other	1,099	1,182
	106,919	71,885
Allowance for doubtful accounts	(571)	(1,308)
	\$ 106,348	\$ 70,577

Note 4: Inventories Inventories are priced at the lower of cost or market, with cost being determined using the first-in, first-out ("FIFO") basis. Finished goods and work-in-process inventories include material, labor, and manufacturing overhead costs. At September 30, 2008 and December 31, 2007, inventory reserves for certain slow-moving inventory items (primarily Climate Control products) were \$544,000 and \$460,000, respectively. In addition, inventory reserves for certain nitrogen-based inventories provided by our Chemical Business were \$191,000 and \$13,000, at September 30, 2008 and December 31, 2007, respectively, because cost exceeded the net realizable value.

Changes in our inventory reserves are as follows:

	Nine Months Ended September 30, 2008		Three Months Ended September 30, 2008	
		2007		2007
	(In Thousands)			
Balance at beginning of period	\$ 473	\$ 1,255	\$ 583	\$ 847
Provisions for (realization of) losses	400	(360)	216	(15)
Write-offs/disposals	(138)	(327)	(64)	(264)
Balance at end of period	\$ 735	\$ 568	\$ 735	\$ 568

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 4: Inventories (continued)

The provisions for losses are included in cost of sales (realization of losses is a reduction to cost of sales) in the accompanying condensed consolidated statements of income.

Note 5: Precious Metals Precious metals are used as a catalyst in the Chemical Business manufacturing process. Precious metals are carried at cost, with cost being determined using the FIFO basis. Because some of the catalyst consumed in the production process cannot be readily recovered and the amount and timing of recoveries are not predictable, we follow the practice of expensing precious metals as they are consumed.

Occasionally, during major maintenance and/or capital projects, we may be able to perform procedures to recover precious metals (previously expensed) which have accumulated over time within our manufacturing equipment. When we accumulate precious metals in excess of our production requirements, we may sell a portion of the excess metals.

Precious metals expense, net, consists of the following:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2008	2007	2008	2007
	(In Thousands)			
Precious metals expense	\$ 6,209	\$ 4,779	\$ 1,855	\$ 1,665
Recoveries of precious metals	(1,343)	(1,233)	(551)	-
Gains on sales of precious metals	-	(1,876)	-	(1,387)
Precious metals expense, net	\$ 4,866	\$ 1,670	\$ 1,304	\$ 278

Precious metals expense is included in cost of sales (recoveries and gains on sales of precious metals are reductions to cost of sales) in the accompanying condensed consolidated statements of income.

Note 6: Investment in Affiliate Cepolk Holding, Inc. ("CHI"), a subsidiary of the Company, is a limited partner and has a 50% equity interest in Cepolk Limited Partnership ("Partnership") which is accounted for on the equity method. The Partnership owns an energy savings project located at the Ft. Polk Army base in Louisiana ("Project"). As of September 30, 2008, the Partnership and general partner to the Partnership is indebted to a term lender ("Term Lender") of the Project. CHI has pledged its limited partnership interest in the Partnership to the Term Lender as part of the Term Lender's collateral securing all obligations under the loan. This guarantee and pledge is limited to CHI's limited partnership interest and does not expose CHI or the Company to liability in excess of CHI's limited partnership interest. No liability has been established for this pledge since it was entered into prior to adoption of FASB Interpretation ("FIN") 45. CHI has no recourse provisions or available collateral that would enable CHI to recover its partnership interest should the Term Lender be required to perform under this pledge.

Note 7: Product Warranty Our Climate Control Business sells equipment that has an expected life, under normal circumstances and use, that extends over several years. As such, we provide warranties after equipment shipment/start-up covering defects in materials and workmanship.

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 7: Product Warranty (continued)

Generally, the base warranty coverage for most of the manufactured equipment in the Climate Control Business is limited to eighteen months from the date of shipment or twelve months from the date of start-up, whichever is shorter, and to ninety days for spare parts. The warranty provides that most equipment is required to be returned to the factory or an authorized representative and the warranty is limited to the repair and replacement of the defective product, with a maximum warranty of the refund of the purchase price. Furthermore, companies within the Climate Control Business generally disclaim and exclude warranties related to merchantability or fitness for any particular purpose and disclaim and exclude any liability for consequential or incidental damages. In some cases, the customer may purchase or a specific product may be sold with an extended warranty. The above discussion is generally applicable to such extended warranties, but variations do occur depending upon specific contractual obligations, certain system components, and local laws.

Our accounting policy and methodology for warranty arrangements is to periodically measure and recognize the expense and liability for such warranty obligations using a percentage of net sales, based upon our historical warranty costs. It is possible that future warranty costs could exceed our estimates.

Changes in our product warranty obligation are as follows:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2008	2007	2008	2007
	(In Thousands)			
Balance at beginning of period	\$ 1,944	\$ 1,251	\$ 2,278	\$ 1,521
Add: Charged to costs and expenses	3,406	2,097	1,119	762
Deduct: Costs and expenses incurred	(3,032)	(1,838)	(1,079)	(773)
Balance at end of period	\$ 2,318	\$ 1,510	\$ 2,318	\$ 1,510

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 8: Current and Noncurrent Accrued and Other Liabilities

	September 30, 2008	December 31, 2007
	(In Thousands)	
Customer deposits	\$ 9,256	\$ 9,525
Accrued payroll and benefits	7,363	5,362
Deferred income taxes	5,601	5,330
Fair value of derivatives	5,060	172
Deferred revenue on extended warranty contracts	3,901	3,387
Accrued precious metals costs	2,669	1,359
Accrued death benefits	2,525	2,051
Accrued contractual manufacturing obligations	2,467	1,548
Accrued commissions	2,429	2,256
Accrued warranty costs	2,318	1,944
Accrued insurance	2,032	2,975
Accrued property and franchise taxes	1,944	707
Accrued interest	1,722	1,056
Accrued income taxes	1,241	4,540
Deferred rent expense	1,391	4,300
Billings in excess of costs and estimated earnings on uncompleted contracts	1,350	62
Accrued executive benefits	989	1,040
Other	3,879	3,571
	58,137	51,185
Less noncurrent portion	13,944	12,243
Current portion of accrued and other liabilities	\$ 44,193	\$ 38,942

Note 9: Long-Term Debt

	September 30, 2008	December 31, 2007
	(In Thousands)	
Working Capital Revolver Loan due 2012 (A)	\$ -	\$ -
5.5% Convertible Senior Subordinated Notes due 2012 (B)	60,000	60,000
Secured Term Loan due 2012 (C)	50,000	50,000
Other, with a current weighted-average interest rate of 6.71%, most of which is secured by machinery, equipment and real estate	13,527	12,107
	123,527	122,107
Less current portion of long-term debt	1,495	1,043
Long-term debt due after one year	\$ 122,032	\$ 121,064

(A) ThermaClima and its subsidiaries (the "Borrowers") are parties to a \$50 million revolving credit facility (the "Working Capital Revolver Loan") that provides for advances based on specified percentages of eligible accounts receivable and inventories for ThermaClima, and its subsidiaries. The Working Capital Revolver Loan, as amended, accrues interest at a base rate

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 9: Long-Term Debt (continued)

(generally equivalent to the prime rate) plus .50% or LIBOR plus 1.75%. The interest rate at September 30, 2008 was 5.50%. Interest is paid monthly. The facility provides for up to \$8.5 million of letters of credit. All letters of credit outstanding reduce availability under the facility. At September 30, 2008, amounts available for additional borrowing under the Working Capital Revolver Loan were \$49.5 million. Under the Working Capital Revolver Loan, as amended, the lender also requires the Borrowers to pay a letter of credit fee equal to 1% per annum of the undrawn amount of all outstanding letters of credit, an unused line fee equal to .375% per annum for the excess amount available under the facility not drawn and various other audit, appraisal and valuation charges.

The lender may, upon an event of default, as defined, terminate the Working Capital Revolver Loan and make the balance outstanding due and payable in full, if any. The Working Capital Revolver Loan is secured by the assets of all the ThermaCline entities other than El Dorado Nitric Company and its subsidiaries ("EDNC") but excluding the assets securing the \$50 million secured term loan discussed in (C) below and certain distribution-related assets of El Dorado Chemical Company ("EDC"). EDNC is neither a borrower nor guarantor of the Working Capital Revolver Loan. The carrying value of the pledged assets is approximately \$230 million at September 30, 2008.

The Working Capital Revolver Loan, as amended, requires ThermaCline to meet certain financial covenants measured quarterly. ThermaCline was in compliance with those covenants for the twelve-month period ended September 30, 2008. The Working Capital Revolver Loan also contains covenants that, among other things, limit the Borrowers' (which does not include the Company) ability, without consent of the lender, to:

- incur additional indebtedness,
 - incur liens,
- make restricted payments or loans to affiliates who are not Borrowers,
- engage in mergers, consolidations or other forms of recapitalization, or dispose assets.

The Working Capital Revolver Loan also requires all collections on accounts receivable be made through a bank account in the name of the lender or their agent.

(B) In June 2007, we entered into a purchase agreement with each of twenty two qualified institutional buyers ("QIBs"), pursuant to which we sold \$60 million aggregate principal amount of the 5.5% Convertible Senior Subordinated Notes (the "2007 Debentures") in a private placement to the QIBs pursuant to the exemptions from the registration requirements of the Securities Act of 1933, as amended (the "Act"), afforded by Section 4(2) of the Act and Regulation D promulgated under the Act. The 2007 Debentures are eligible for resale by the investors under Rule 144A under the Act. We received net proceeds of approximately \$57 million, after discounts and commissions. In connection with the closing, we entered into an indenture (the "Indenture") with UMB Bank, as trustee (the "Trustee"), governing the 2007 Debentures. The Trustee receives customary compensation from us for such services.

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 9: Long-Term Debt (continued)

The 2007 Debentures bear interest at the rate of 5.5% per year and mature on July 1, 2012. Interest is payable in arrears on January 1 and July 1 of each year, which began on January 1, 2008.

The 2007 Debentures are unsecured obligations and are subordinated in right of payment to all of our existing and future senior indebtedness, including indebtedness under our revolving debt facilities. The 2007 Debentures are effectively subordinated to all present and future liabilities, including trade payables, of our subsidiaries.

The 2007 Debentures are convertible by the holders in whole or in part into shares of our common stock prior to their maturity. The conversion rate of the 2007 Debentures for the holders electing to convert all or any portion of a debenture is 36.4 shares of our common stock per \$1,000 principal amount of debentures (representing a conversion price of \$27.47 per share of common stock), subject to adjustment under certain conditions as set forth in the Indenture.

We may redeem some or all of the 2007 Debentures at any time on or after July 2, 2010, at a price equal to 100% of the principal amount of the 2007 Debentures, plus accrued and unpaid interest, all as set forth in the Indenture. The redemption price will be payable at our option in cash or, subject to certain conditions, shares of our common stock (valued at 95% of the weighted average of the closing sale prices of the common stock for the 20 consecutive trading days ending on the fifth trading day prior to the redemption date), subject to certain conditions being met on the date we mail the notice of redemption.

If a designated event (as defined in the Indenture) occurs prior to maturity, holders of the 2007 Debentures may require us to repurchase all or a portion of their 2007 Debentures for cash at a repurchase price equal to 101% of the principal amount of the 2007 Debentures plus any accrued and unpaid interest, as set forth in the Indenture. If a fundamental change (as defined in the Indenture) occurs on or prior to June 30, 2010, under certain circumstances, we will pay, in addition to the repurchase price, a make-whole premium on the 2007 Debentures converted in connection with, or tendered for repurchase upon, the fundamental change. The make-whole premium will be payable in our common stock or the same form of consideration into which our common stock has been exchanged or converted in the fundamental change. The amount of the make-whole premium, if any, will be based on our stock price on the effective date of the fundamental change. No make-whole premium will be paid if our stock price in connection with the fundamental change is less than or equal to \$23.00 per share.

At maturity, we may elect, subject to certain conditions as set forth in the Indenture, to pay up to 50% of the principal amount of the outstanding 2007 Debentures, plus all accrued and unpaid interest thereon to, but excluding, the maturity date, in shares of our common stock (valued at 95% of the weighted average of the closing sale prices of the common stock for the 20 consecutive trading days ending on the fifth trading day prior to the maturity date), if the common stock is then listed on an eligible market, the shares used to pay the 2007 Debentures and any interest thereon are freely tradable, and certain required opinions of counsel are received.

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 9: Long-Term Debt (continued)

We have used a portion of the net proceeds to redeem our remaining outstanding shares of Series 2 \$3.25 convertible, exchangeable Class C preferred stock ("Series 2 Preferred"); to repay certain outstanding mortgages and equipment loans; to pay dividends in arrears on our outstanding shares of Series B 12% cumulative, convertible preferred stock ("Series B Preferred") and Series D 6% cumulative, convertible Class C preferred stock ("Series D Preferred"), all of which were owned by an affiliate; and the balance to initially reduce the outstanding borrowings under the Working Capital Revolver Loan. In addition, we have currently invested a portion of the net proceeds in U.S. Treasury obligations (cash equivalents). We intend to use the remaining portion of the net proceeds for certain discretionary capital expenditures and general working capital purposes.

In conjunction with the 2007 Debentures, we entered into a Registration Rights Agreement with the QIBs. In connection with the Registration Rights Agreement, we filed a post-effective amendment No. 1, to our previously filed registration statement, which amendment was declared effective by the SEC on April 21, 2008.

(C) ThermaCline and certain of its subsidiaries are parties to a \$50 million loan agreement (the "Secured Term Loan") with a certain lender. The Secured Term Loan matures on November 2, 2012. The Secured Term Loan accrues interest at a defined LIBOR rate plus 3%. The interest rate at September 30, 2008 was 5.79%. The Secured Term Loan requires quarterly interest payments with the final payment of interest and principal at maturity.

The Secured Term Loan is secured by the real property and equipment located at our El Dorado, Arkansas and Cherokee, Alabama chemical production facilities. The carrying value of the pledged assets is approximately \$58 million at September 30, 2008.

The Secured Term Loan borrowers are subject to numerous covenants under the agreement including, but not limited to, limitation on the incurrence of certain additional indebtedness and liens, limitations on mergers, acquisitions, dissolution and sale of assets, and limitations on declaration of dividends and distributions to us, all with certain exceptions. At September 30, 2008, the carrying value of the restricted net assets of ThermaCline and its subsidiaries was approximately \$72 million. The Secured Term Loan borrowers are also subject to a minimum fixed charge coverage ratio and a maximum leverage ratio, both measured quarterly on a trailing twelve-month basis. The Secured Term Loan borrowers were in compliance with these financial covenants for the twelve-month period ended September 30, 2008.

Note 10: Contingencies We accrue for contingent losses when such losses are probable and reasonably estimable. In addition, we recognize contingent gains when such gains are realizable.

Following is a summary of certain legal matters involving the Company.

A. Environmental Matters

Our operations are subject to numerous environmental laws ("Environmental Laws") and to other federal, state and local laws regarding health and safety matters ("Health Laws"). In

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 10: Contingencies (continued)

particular, the manufacture and distribution of chemical products are activities which entail environmental risks and impose obligations under the Environmental Laws and the Health Laws, many of which provide for certain performance obligations, substantial fines and criminal sanctions for violations. There can be no assurance that material costs or liabilities will not be incurred by us in complying with such laws or in paying fines or penalties for violation of such laws. The Environmental Laws and Health Laws and enforcement policies thereunder relating to our Chemical Business have in the past resulted, and could in the future result, in compliance expenses, cleanup costs, penalties or other liabilities relating to the handling, manufacture, use, emission, discharge or disposal of effluents at or from our facilities or the use or disposal of certain of its chemical products. Historically, significant expenditures have been incurred by subsidiaries within our Chemical Business in order to comply with the Environmental Laws and Health Laws and are reasonably expected to be incurred in the future.

We are required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated in accordance with FIN 47. We are obligated to monitor certain discharge water outlets at our Chemical Business facilities should we discontinue the operations of a facility. We also have certain facilities in our Chemical Business that contain asbestos insulation around certain piping and heated surfaces, which we plan to maintain or replace, as needed, with non-asbestos insulation through our standard repair and maintenance activities to prevent deterioration. Since we currently have no plans to discontinue the use of these facilities and the remaining life of the facilities is indeterminable, an asset retirement liability has not been recognized. Currently, there is insufficient information to estimate the fair value of the asset retirement obligations. However, we will continue to review these obligations and record a liability when a reasonable estimate of the fair value can be made.

1. Discharge Water Matters

The chemical production facility located in El Dorado, Arkansas (the “El Dorado Facility”) within our Chemical Business generates process wastewater, which includes storm water. The process water discharge and storm-water run off are governed by a state National Pollutant Discharge Elimination System (“NPDES”) water discharge permit issued by the Arkansas Department of Environmental Quality (“ADEQ”), which permit is to be renewed every five years. The ADEQ issued to the El Dorado Facility a NPDES water discharge permit in 2004, and the El Dorado Facility had until June 1, 2007 to meet the compliance deadline for the more restrictive limits under the 2004 NPDES permit. In order to meet the El Dorado Facility’s June 2007 limits, the El Dorado Facility has significantly reduced the contaminant levels of its wastewater.

The El Dorado Facility has demonstrated its ability to comply with the more restrictive permit limits, and the rules which support the more restrictive dissolved minerals rules have been revised to authorize a permit modification to adopt achievable dissolved minerals permit limits. The ADEQ and the El Dorado Facility have entered into a consent administration order to authorize the El Dorado Facility to continue operations without incurring permit violations pending the modification of the permit to implement the revised rule and to dispose of the El

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 10: Contingencies (continued)

Dorado Facility's wastewater into the creek adjacent to the El Dorado Facility. As of September 30, 2008, the ADEQ has not issued the revised permit.

In addition, the El Dorado Facility has entered into a consent administrative order ("CAO") that recognizes the presence of nitrate contamination in the shallow groundwater at the El Dorado Facility. A new CAO to address the shallow groundwater contamination became effective on November 16, 2006 and requires the evaluation of the current conditions and remediation based upon a risk assessment. The CAO requires the El Dorado Facility to continue semi-annual groundwater monitoring, to continue operation of a groundwater recovery system and to submit a human health and ecological risk assessment to the ADEQ. The final remedy for shallow groundwater contamination, should any remediation be required, will be selected pursuant to the new CAO and based upon the risk assessment. As an interim measure, the El Dorado Facility has installed two recovery wells to recycle groundwater and to recover nitrates. The cost of any additional remediation that may be required will be determined based on the results of the investigation and risk assessment and cannot currently be reasonably estimated. Therefore, no liability has been established at September 30, 2008.

2. Air Matters

In December 2006, the El Dorado Facility entered into a new CAO ("2006 CAO") with the ADEQ to resolve a problem with ammonia emissions from certain nitric acid units. The catalyst suppliers had represented the volume of ammonia emissions anticipated. The representation was the basis for the permitted emission limit, but the representation of the catalyst suppliers was not accurate. Under the 2006 CAO, the ADEQ allowed the El Dorado Facility to re-evaluate the catalyst performance and required the El Dorado Facility to submit a permit modification with the appropriate ammonia limits. The permit modification was submitted to ADEQ on June 11, 2007. An air permit modification was issued on August 26, 2008, which sets new limits for ammonia for the nitric acid units and requires compliance testing to be performed no later than February 21, 2009. Based on a previous study, the nitric acid units can meet these new limits. As a result of the air permit modification, continuous monitoring and monthly reporting of ammonia for these nitric acid units is no longer required.

3. Other Environmental Matters

In April 2002, Slurry Explosive Corporation ("Slurry"), later renamed Chemex I Corp., a subsidiary within our Chemical Business, entered into a Consent Administrative Order ("Slurry Consent Order") with the Kansas Department of Health and Environment ("KDHE"), regarding Slurry's Hallowell, Kansas manufacturing facility ("Hallowell Facility"). The Slurry Consent Order addressed the release of contaminants from the facility into the soils and groundwater and surface water at the Hallowell Facility. There are no known users of the groundwater in the area.

The adjacent strip pit is used for fishing. Under the terms of the Slurry Consent Order, Slurry is required to, among other things, submit an environmental assessment work plan to the KDHE for review and approval, and agree with the KDHE as to any required corrective actions to be performed at the Hallowell Facility.

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 10: Contingencies (continued)

In December 2002, Slurry and Universal Tech Corporation (“UTeC”), both subsidiaries within our Chemical Business, sold substantially all of their operating assets but retained ownership of the real property. At December 31, 2002, even though we continued to own the real property, we did not assess our continuing involvement with our former Hallowell facility to be significant and therefore accounted for the sale as discontinued operations. In connection with this sale, UTeC leased the real property to the buyer under a triple net long-term lease agreement. However, Slurry retained the obligation to be responsible for, and perform the activities under, the Slurry Consent Order. In addition, certain of our subsidiaries agreed to indemnify the buyer of such assets for these environmental matters. The successor (“Chevron”) of a prior owner of the Hallowell Facility has agreed, within certain limitations, to pay and has been paying one-half of the costs incurred under the Slurry Consent Order subject to reallocation.

Based on additional modeling of the site, Slurry and Chevron are pursuing a course with the KDHE of long-term surface and ground water monitoring to track the natural decline in contamination, instead of the soil excavation proposed previously. On September 12, 2007, the KDHE approved our proposal to perform two years of surface and groundwater monitoring and to implement a Mitigation Work Plan to acquire additional field data in order to more accurately characterize the nature and extent of contaminant migration off-site. The two-year monitoring program will terminate in February 2009.

At September 30, 2008, the total estimated liability (which is included in current accrued and other liabilities) in connection with this remediation matter is approximately \$132,000 and Chevron’s share for these costs (which is included in accounts receivable) is approximately \$69,000. These amounts are not discounted to their present value. It is reasonably possible that a change in estimate of our liability and receivable will occur in the near term.

B. Other Pending, Threatened or Settled Litigation

1. Climate Control Business

A proposed class action was filed in the Illinois state district court in September 2007 alleging that certain evaporator coils sold by one of our subsidiaries in the Climate Control Business, Climate Master, Inc. (“Climate Master”) in the state of Illinois from 1990 to approximately 2003 were defective. The complaint requests certification as a class action for the State of Illinois, which request has not yet been heard by the court. The plaintiff asserts claims based upon negligence, strict liability, breach of implied warranties, and the Illinois Consumer Fraud and Deceptive Business Practices Act. Climate Master has timely filed its pleadings to remove this action to federal court. Climate Master has also filed its answer denying the plaintiff’s claims and asserting several affirmative defenses. Climate Master’s insurers have been placed on notice of this matter. Several of our insurers have denied coverage and one insurer advised that it will monitor the litigation subject to a reservation of rights to decline coverage. The policies associated with insurers that have not declined coverage in this matter have deductible amounts ranging from \$100,000 to \$250,000. The Company intends to vigorously defend Climate Master in connection with this matter. Currently, the Company is unable to determine the amount of damages or the likelihood of any losses resulting from this claim. Therefore, no liability has been established at September 30, 2008.

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 10: Contingencies (continued)

2. Other

Zeller Pension Plan

In February 2000, our board of directors authorized management to proceed with the sale of the automotive products business, since the automotive products business was no longer a “core business” of the Company. In May 2000, the Company sold substantially all of its assets in its automotive products business. After the authorization by the board, but prior to the sale, the automotive products business purchased the assets and assumed certain liabilities of Zeller Corporation (“Zeller”). The liabilities of Zeller assumed by the automotive products business included Zeller’s pension plan, which is not a multi-employer pension plan. In June 2003, the principal owner (“Owner”) of the buyer of the automotive products business was contacted by a representative of the Pension Benefit Guaranty Corporation (“PBGC”) regarding the plan. The Owner was informed by the PBGC of a possible under-funding of the plan and a possible takeover of the plan by the PBGC. The PBGC previously advised the Company that the PBGC may consider the Company potentially liable for the under-funding of the Zeller Plan in the event that the plan is taken over by the PBGC and alleged that the under-funding is approximately \$600,000. Our ERISA counsel has advised us that, based on certain assumptions and representations made by us to them, they believe that the possibility of an unfavorable non-appealable verdict against us in a lawsuit if the PBGC attempts to hold us liable for under-funding of the Zeller Plan is remote.

MEI Drafts

Cromus, as an assignee of Masinexportimport Foreign Trade Company (“MEI”), filed a lawsuit against us, our subsidiary, Summit Machine Tool Manufacturing Corp. (“Summit”), certain of our other subsidiaries, our chief executive officer and another officer of our Company, Bank of America, and others, alleging that it was owed \$1,533,000, plus interest from 1990, in connection with Cromus’ attempted collection of ten non-negotiable bank drafts payable to the order of MEI. The bank drafts were issued by Aerobit Ltd. (“Aerobit”), a non-U.S. company, which at the time of issuance of the bank drafts, was one of our subsidiaries. Each of the bank drafts has a face value of \$153,300, for an aggregate principal face value of \$1,533,000. The bank drafts were issued in September 1992, and had a maturity date of December 31, 2001. Each bank draft was endorsed by LSB Corp., which at the time of endorsement, was also one of our subsidiaries. The complaint also seeks \$1,000,000 from us and Summit for failure to purchase certain equipment and \$1,000,000 in punitive damages. During May 2008, the court dismissed the complaint against us and our subsidiaries and our officers (including our Chief Executive Officer). Cromus has appealed this dismissal against our subsidiaries and our officers but did not appeal the dismissal against us. Cromus must perfect its appeal not later than April 1, 2009.

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 10: Contingencies (continued)

The Jayhawk Group

During July 2007, we mailed to all holders of record of our Series 2 Preferred a notice of redemption of all of the outstanding shares of Series 2 Preferred. The redemption of our Series 2 Preferred was completed on August 27, 2007, the redemption date. The terms of the Series 2 Preferred required that for each share of Series 2 Preferred so redeemed, we would pay, in cash, a redemption price equal to \$50.00 plus \$26.25 representing dividends in arrears thereon pro-rata to the date of redemption. There were 193,295 shares of Series 2 Preferred outstanding, net of treasury stock, as of the date the notice of redemption was mailed. Pursuant to the terms of the Series 2 Preferred, the holders of the Series 2 Preferred could convert each share into 4.329 shares of our common stock. If a holder of the Series 2 Preferred elected to convert his, her or its shares into our common stock pursuant to its terms, the Certificate of Designations for the Series 2 Preferred provided, and it is our position, that the holder that so converts would not be entitled to receive payment of any dividends in arrears on the shares so converted. Jayhawk Capital Management, L.L.C., and certain of its affiliates (the "Jayhawk Group"), a former affiliate of ours, converted 155,012 shares of Series 2 Preferred into 671,046 shares of common stock. The Jayhawk Group has advised us that it may bring legal action against us for all dividends in arrears (approximately \$4.0 million) on the shares of Series 2 Preferred that it converted after receipt of the notice of redemption and that it should have been able to tender all of its preferred shares under the tender offer notwithstanding an agreement between the Jayhawk Group and us that the Jayhawk Group would tender only approximately one-half of its preferred shares. The general counsel of the Jayhawk Group orally offered to settle all claims against us in return for a payment of \$100,000, representing the approximate legal fees the Jayhawk Group alleged it had incurred investigating these claims. Through counsel, we agreed to the settlement offer. After we agreed to the settlement offer verbally and by e-mail, the Jayhawk Group's general counsel purported to withdraw the settlement offer and asserted the Jayhawk Group was not bound by any settlement agreement. We believe the likelihood that the Jayhawk Group may recover the dividends in arrears is not probable, and we further believe that the settlement agreement is binding on the Jayhawk Group. As a result, a liability of \$100,000 has been established at September 30, 2008.

Securities and Exchange Commission

We have previously disclosed that the Securities and Exchange Commission ("SEC") was conducting an informal inquiry of us relating to the change in inventory accounting from LIFO to FIFO during 2004 involving approximately \$500,000 by one of our subsidiaries, which change resulted in the restatement of our financial statements for each of the three years in the period ended December 31, 2004 and our March 31, 2005 and June 30, 2005 quarterly financial statements. During April 2008, the staff of the SEC delivered a formal Wells Notice to us informing us that the staff has preliminarily decided to recommend to the SEC that it institute a civil enforcement action against us in connection with the above described matter. All assertions against us involve alleged violations of Section 13 of the 1934 Act and do not assert allegations of fraudulent conduct nor seek a monetary civil fine against us. During May 2008, we made a written submission to the senior staff of the SEC, and we have had discussions with the senior staff after such submission. The staff has indicated that it is still their intention to recommend to

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 10: Contingencies (continued)

the SEC to bring a civil injunction action against us and seek authority from the SEC to file such action. In addition, the SEC has also made assertions against our former principal accounting officer based on Section 13 of the 1934 Act, and the SEC staff has also stated its intention to recommend civil proceedings against him. The former principal accounting officer resigned as principal accounting officer, effective August 15, 2008, but remains with the Company as a senior vice president in charge of lending compliance and cash management and will be involved in our banking relationships, acquisitions and corporate planning. We are currently in discussions with the staff of the SEC regarding the settlement of this matter. There are no assurances this matter will be settled.

Other Claims and Legal Actions

We are also involved in various other claims and legal actions which in the opinion of management, after consultation with legal counsel, if determined adversely to us, would not have a material effect on our business, financial condition or results of operations.

Note 11: Derivatives, Hedges and Financial Instruments We account for derivatives in accordance with SFAS 133, which requires the recognition of derivatives in the balance sheet and the measurement of these instruments at fair value. Changes in fair value of derivatives are recorded in results of operations unless the normal purchase or sale exceptions apply or hedge accounting is elected.

In 1997, we entered into an interest rate forward agreement to effectively fix the interest rate of a long-term lease commitment (not for trading purposes). In 1999, we executed a long-term lease agreement (initial lease term of ten years) and terminated the forward agreement at a net cost of \$2.8 million. We historically accounted for this cash flow hedge under the deferral method (as an adjustment of the initial term lease rentals). Upon adoption of SFAS 133 in 2001, the remaining deferred cost amount was reclassified from other assets to accumulated other comprehensive loss and is being amortized to operations over the term of the lease arrangement. At September 30, 2008 and December 31, 2007, accumulated other comprehensive loss consisted of the remaining deferred cost of \$193,000 and \$411,000, respectively. The amount amortized to operations was \$218,000 for each of the nine months ended September 30, 2008 and 2007 and \$129,000 and \$73,000 for the three months ended September 30, 2008 and 2007, respectively. The associated income tax benefits were minimal in 2008 and there were no income tax benefits allocated to these expenses in 2007.

We have three types of contracts that are accounted for on a fair value basis, which are interest rate contracts, commodities futures/forward contracts and foreign currency contracts as discussed below. The valuation of these contracts was determined based on quoted market prices or, in instances where market quotes are not available, other valuation techniques or models used to estimate fair values.

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LSB INDUSTRIES, INC.
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(Unaudited)

Note 11: Derivatives, Hedges and Financial Instruments (continued)

Interest Rate Contracts

As part of our interest rate risk management, we periodically purchase and/or enter into various interest rate contracts. In March 2005, we purchased two interest rate cap contracts for a cost of \$590,000, which mature in March 2009. In April 2007, we purchased two interest rate cap contracts for a cost of \$621,000, which set a maximum three-month LIBOR base rate of 5.35% on \$50 million. In April 2008, we exchanged the two interest rate cap contracts purchased in 2007 for an interest rate cap contract ("2008 Interest Rate Cap Contract"), which sets a maximum three-month LIBOR base rate of 4.56% on \$25 million. The cost basis of the 2008 Interest Rate Cap Contract was \$239,000 based on the estimated fair value of the two contracts surrendered (which was also the carrying value at the time of the exchange) in accordance with Accounting Principle Board Opinion No. 29, as amended ("APB 29"). In April 2008, we also entered into an interest rate swap at no cost, which sets a fixed three-month LIBOR rate of 3.24% on \$25 million and matures in April 2012. In September 2008, we exchanged the 2008 Interest Rate Cap Contract for an interest rate swap, which sets a fixed three-month LIBOR rate of 3.595% on \$25 million and matures in April 2012. The cost basis of the new interest rate swap is \$354,000 based on the estimated fair value of the 2008 Interest Rate Cap Contract surrendered (which was also the carrying value at the time of the exchange) in accordance with APB 29.

These contracts are free-standing derivatives and are accounted for on a mark-to-market basis in accordance with SFAS 133. At September 30, 2008 and December 31, 2007, the fair values of these contracts were \$663,000 and \$426,000, respectively, and are included in other assets in the accompanying consolidated balance sheets. For the nine months ended September 30, 2008, we recognized a gain of \$209,000 and a loss of \$64,000 for the nine months ended September 30, 2007. For the three months ended September 30, 2008 and 2007, we recognized losses of \$499,000 and \$488,000, respectively. In addition, the cash used to purchase these contracts is included in cash flows from continuing investing activities.

Commodities Futures/Forward Contracts

Raw materials for use in our manufacturing processes include copper used by our Climate Control Business and natural gas used by our Chemical Business. As part of our raw material price risk management, we periodically enter into futures/forward contracts for these materials, which contracts are generally accounted for on a mark-to-market basis in accordance with SFAS 133. At September 30, 2008 and December 31, 2007, the fair value of these contracts was \$4,931,000 and \$172,000 and is included in current and noncurrent accrued and other liabilities. Pursuant to the terms of these contracts, the fair values are classified as current or noncurrent liabilities in the accompanying condensed consolidated balance sheets. For the nine months ended September 30, 2008 and 2007, we recognized losses of \$3,766,000 and \$456,000, respectively, and for the three months ended September 30, 2008 and 2007, we recognized losses of \$8,254,000 and \$480,000, respectively, on such contracts. In addition, the cash flows relating to these contracts are included in cash flows from continuing operating activities.

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 11: Derivatives, Hedges and Financial Instruments (continued)

Foreign Currency Contracts

One of our business operations purchases industrial machinery and related components from vendors outside of the United States. During 2008 as part of our foreign currency risk management, we entered into several foreign currency contracts, which set the U.S. Dollar/Euro exchange rates through December 2008. These contracts are free-standing derivatives and are accounted for on a mark-to-market basis in accordance with SFAS 133. At September 30, 2008, the fair value of these contracts (unrealized loss) was \$129,000 and is included in accrued and other liabilities in the accompanying consolidated balance sheet (none at December 31, 2007). For the nine and three-month periods ended September 30, 2008, we recognized losses of \$172,000 and \$137,000, respectively, (none in 2007) on such contracts. In addition, the cash flows relating to these contracts are included in cash flows from continuing operating activities.

The following details our assets and liabilities at September 30, 2008 that are measured at fair value on a recurring basis:

Description	September 30, 2008	Fair Value Measurements at September 30, 2008 Using	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
		(In Thousands)	
Assets:			
Interest rate contracts	\$ 663	\$ -	\$ 663
Liabilities:			
Commodities futures/forward contracts	\$ 4,931	\$ 246	\$ 4,685
Foreign currency contracts	129	-	129
Total	\$ 5,060	\$ 246	\$ 4,814

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 11: Derivatives, Hedges and Financial Instruments (continued)

Realized and unrealized gains (losses) included in earnings and the income statement classification are as follows:

	Nine Months Ended September 30, 2008	Three Months Ended September 30, 2008
	(In Thousands)	
Total gains (losses) included in earnings:		
Cost of sales	\$ (3,938)	\$ (8,391)
Interest expense	209	(499)
	\$ (3,729)	\$ (8,890)
Change in unrealized gains and losses relating to contracts still held at September 30, 2008:		
Cost of sales	\$ (5,060)	\$ (5,514)
Interest expense	275	(361)
	\$ (4,785)	\$ (5,875)

Note 12: Approval of Stock Incentive Plan During the second quarter of 2008, our board of directors adopted our 2008 Incentive Stock Plan (the “2008 Plan”), which plan was approved by our shareholders at our annual meeting of shareholders held on June 5, 2008. The number of shares of our common stock available for issuance under the 2008 Plan is 1,000,000 shares, subject to adjustment. Under the 2008 Plan, awards may be made to any employee, officer or director of the Company and its affiliated companies. An award may also be granted to any consultant, agent, advisor or independent contractor for bona fide services rendered to the Company or any affiliate (as defined in the 2008 Plan), subject to certain conditions. The 2008 Plan will be administered by the compensation and stock option committee (the “Committee”) of our board of directors.

Our board of directors or the Committee may amend the 2008 Plan, except that if any applicable statute, rule or regulation requires shareholder approval with respect to any amendment of the 2008 Plan, then to the extent so required, shareholder approval will be obtained. Shareholder approval will also be obtained for any amendment that would increase the number of shares stated as available for issuance under the 2008 Plan. Unless sooner terminated by our board of directors, the 2008 Plan expires on June 5, 2018.

The following may be granted by the Committee under the 2008 Plan:

Stock Options - The Committee may grant either incentive stock options or non-qualified stock options. The Committee sets option exercise prices and terms, except that the exercise price of a stock option may be no less than 100% of the fair market value, as defined in the 2008 Plan, of the shares on the date of grant. At the time of grant, the Committee will have sole discretion in determining when stock options are exercisable and when they expire, except that the term of a stock option cannot exceed 10 years.

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 12: Approval of Stock Incentive Plan (continued)

Stock Appreciation Rights (“SARs”) - The Committee may grant SARs as a right in tandem with the number of shares underlying stock options granted under the 2008 Plan or on a stand-alone basis. SARs are the right to receive payment per share of the SAR exercised in stock or in cash equal to the excess of the share’s fair market value, as defined in the 2008 Plan, on the date of exercise over its fair market value on the date the SAR was granted. Exercise of an SAR issued in tandem with stock options will result in the reduction of the number of shares underlying the related stock option to the extent of the SAR exercise.

Stock Awards, Restricted Stock, Restricted Stock Units, and Other Awards - The Committee may grant awards of restricted stock, restricted stock units, and other stock and cash-based awards, which may include the payment of stock in lieu of cash (including cash payable under other incentive or bonus programs) or the payment of cash (which may or may not be based on the price of our common stock).

As of September 30, 2008, no awards have been granted under the 2008 Plan; however, see discussion in Note 18-Subsequent Events.

Note 13: Income Per Common Share Net income applicable to common stock is computed by adjusting net income by the amount of preferred stock dividends, dividend requirements and the stock dividend. Basic income per common share is based upon net income applicable to common stock and the weighted-average number of common shares outstanding during each period.

Diluted income per share is based on net income applicable to common stock plus preferred stock dividends and dividend requirements on preferred stock assumed to be converted, if dilutive, and interest expense including amortization of debt issuance cost, net of income taxes, on convertible debt assumed to be converted, if dilutive, and the weighted-average number of common shares and dilutive common equivalent shares outstanding, and the assumed conversion of dilutive convertible securities outstanding.

The following is a summary of certain transactions which affected basic income per share or diluted income per share, if dilutive:

During the nine months ended September 30, 2008,

- we acquired 200,000 shares of our common stock;
- we issued 430,304 shares of our common stock as the result of the exercise of stock options; and
- we paid cash dividends on our Series B Preferred, Series D Preferred and noncumulative redeemable preferred stock (“Noncumulative Preferred”) totaling approximately \$240,000, \$60,000 and \$6,000, respectively.

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 13: Income Per Common Share (continued)

During the nine months ended September 30, 2007,

- we sold \$60 million of the 2007 Debentures;
- \$4,000,000 of the 7% Convertible Senior Subordinated Debentures (the “2006 Debentures”) was converted into 564,789 shares of common stock;
 - we issued 2,262,965 shares of common stock for 305,807 shares of our Series 2 Preferred that were tendered pursuant to a tender offer;
- we redeemed 25,820 shares of our Series 2 Preferred and issued 724,993 shares of common stock for 167,475 shares of our Series 2 Preferred;
 - we received shareholders’ approval in granting 450,000 shares of non-qualified stock options;
 - we issued 291,100 shares of our common stock as the result of the exercise of stock options;
- we paid cash dividends of approximately \$678,000 on the shares of Series 2 Preferred we redeemed as discussed above; and
- we paid cash dividends on our Series B Preferred, Series D Preferred and Noncumulative Preferred totaling approximately \$1,890,000, \$360,000 and \$6,000, respectively.

At September 30, 2008, there were no dividends in arrears.

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 13: Income Per Common Share (continued)

The following table sets forth the computation of basic and diluted net income per common share:

(Dollars In Thousands, Except Per Share Amounts)				
	Nine Months Ended September 30,		Three Months Ended September 30,	
	2008	2007	2008	2007
Numerator:				
Net income	\$ 32,975	\$ 42,335	\$ 4,161	\$ 18,296
Dividends and dividend requirements on Series B Preferred	(240)	(240)	-	(120)
Dividend requirements on shares of Series 2 Preferred which did not exchange pursuant to tender offer or redemption in 2007	-	(272)	-	-
Dividends and dividend requirements on shares of Series 2 Preferred redeemed in 2007	-	(59)	-	(17)
Stock dividend on shares of Series 2 Preferred pursuant to tender offer in 2007(1)	-	(4,971)	-	-
Dividends on Series D Preferred	(60)	(60)	-	(60)
Dividends on Noncumulative Preferred	(6)	(6)	-	(6)
Total dividends, dividend requirements and stock dividend on preferred stock	(306)	(5,608)	-	(203)
Numerator for basic net income per common share - net income applicable to common stock	32,669	36,727	4,161	18,093
Dividends and dividend requirements on preferred stock assumed to be converted, if dilutive	306	637	-	203
Interest expense including amortization of debt issuance costs, net of income taxes, on convertible debt assumed to be converted, if dilutive	1,805	1,007	-	924
Numerator for diluted net income per common share	\$ 34,780	\$ 38,371	\$ 4,161	\$ 19,220
Denominator:				
Denominator for basic net income per common share - weighted-average shares	21,155,724	19,150,030	21,237,268	20,220,419
Effect of dilutive securities:				
Convertible notes payable	2,188,000	870,725	4,000	2,188,000
Convertible preferred stock	938,999	1,657,335	939,286	1,414,784
Stock options	600,917	1,222,133	473,882	1,154,480
Warrants	-	90,241	-	94,209
Dilutive potential common shares	3,727,916	3,840,434	1,417,168	4,851,473
Denominator for diluted net income per common share - adjusted weighted-average shares and assumed conversions	24,883,640	22,990,464	22,654,436	25,071,892

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Basic net income per common share	\$	1.54	\$	1.92	\$.20	\$.89
Diluted net income per common share	\$	1.40	\$	1.67	\$.18	\$.77

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 13: Income Per Common Share (continued)

(1) As discussed in our 2007 Form 10-K, in February 2007, we began a tender offer to exchange shares of our common stock for up to 309,807 of the 499,102 outstanding shares of the Series 2 Preferred. The tender offer expired on March 12, 2007 and our board of directors accepted the shares tendered on March 13, 2007. Because the exchanges under the tender offer were pursuant to terms other than the original terms, the transactions were considered extinguishments of the preferred stock. In addition, the transactions qualified as induced conversions under SFAS 84. In accordance with Emerging Issues Task Force (“EITF”) Topic No. D-42, the excess of the fair value of the common stock issued over the fair value of the securities issuable pursuant to the original conversion terms was subtracted from net income in computing net income per share. Because our Series 2 Preferred are cumulative and the dividend requirements have been included in computing net income per share in previous periods and as an element of the exchange transactions, we effectively settled the dividends in arrears, the amount subtracted from net income in 2007 represents the excess of the fair value of the common stock issued over the fair value of the securities issuable pursuant to the original conversion terms less the dividends in arrears as March 13, 2007.

The following weighted-average shares of securities were not included in the computation of diluted net income per common share as their effect would have been antidilutive:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2008	2007	2008	2007
Stock options	425,000	177,747	425,000	444,293
Convertible notes payable	-	-	2,184,000	-
Series 2 Preferred pursuant to tender offer in 2007 (2)	-	348,120	-	-
	425,000	525,867	2,609,000	444,293

(2) In accordance with EITF Topic No. D-53, the shares associated with the tender offer in 2007 were considered separately from other convertible shares of securities in computing net income per common share for the nine and three months ended September 30, 2007.

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 14: Income Taxes Provisions (benefits) for income taxes are as follows:

	Nine Months Ended September 30, 2008		September 30, 2007		Three Months Ended September 30, 2008		2007	
	(In Thousands)							
Current:								
Federal	\$	13,641	\$	1,550	\$	2,121	\$	1,104
State		1,752		583		28		497
Total Current	\$	15,393	\$	2,133	\$	2,149	\$	1,601
Deferred:								
Federal	\$	3,927	\$	(2,827)	\$	388	\$	(2,827)
State		497		(323)		(149)		(323)
Total Deferred		4,424		(3,150)		239		(3,150)
Provisions (benefits) for income taxes	\$	19,817	\$	(1,017)	\$	2,388	\$	(1,549)

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 14: Income Taxes (continued)

As the result of improving financial results during the third quarter of 2007 including some unusual transactions (settlement of pending litigation and insurance recovery of business interruption claim) and our expectation of generating taxable income in the future, we determined in the third quarter of 2007 that there was sufficient objective and verifiable evidence to conclude that it was more-likely-than-not that we would be able to realize the net deferred tax assets. As a result, we reversed the valuation allowances as a benefit for income taxes and recognized deferred tax assets and deferred tax liabilities.

When non-qualified stock options ("NSOs") are exercised, the grantor of the options is permitted to deduct the spread between the fair market value and the exercise price of the NSOs as compensation expense in determining taxable income. Under SFAS 109, income tax benefits related to stock-based compensation deductions in excess of the compensation expense recorded for financial reporting purposes are not recognized in earnings as a reduction of income tax expense for financial reporting purposes. As a result, the stock-based compensation deduction for the nine months ended September 30, 2008 to be recognized in our 2008 income tax return will exceed the related stock-based compensation expense recognized in earnings. The excess tax benefit realized (i.e., the resulting reduction in the current tax liability) related to the excess stock-based compensation tax deduction of \$3,412,000 is accounted for as an increase in capital in excess of par value for the nine months ended September 30, 2008.

We account for income taxes in accordance with FIN 48, which requires that realization of an uncertain income tax position must be "more likely than not" (i.e., greater than 50% likelihood) that the position will be sustained upon examination by taxing authorities before it can be recognized in the financial statements. Further, FIN 48 prescribes the amount to be recorded in the financial statements as the amount most likely to be realized assuming a review by tax authorities having all relevant information and applying current conventions.

We believe that we do not have any material uncertain tax positions that meet the FIN 48 more likely than not recognition criteria other than the failure to file state income tax returns in some jurisdictions where we or some of our subsidiaries may have a filing responsibility. We had approximately \$1,241,000 and \$1,617,000 accrued for uncertain tax liabilities at September 30, 2008 and December 31, 2007, respectively, which are included in accrued and other liabilities in the accompanying condensed consolidated balance sheets.

We plan to negotiate voluntary disclosure agreements and file prior year tax returns with various taxing authorities in 2008. Therefore, we anticipate that the total amounts of unrecognized tax benefits will decrease by approximately \$911,000 by December 31, 2008 as a result of state tax payments made as part of the voluntary disclosure agreement process or other resolutions.

We and certain of our subsidiaries file income tax returns in the U.S. federal jurisdiction and various state jurisdictions. The federal tax returns for 1994 through 2004 remain subject to examination for the purpose of determining the amount of remaining tax NOL and other carryforwards. With few exceptions, the 2005-2007 years remain open for all purposes of examination by the IRS and other major tax jurisdictions.

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 15: Other Expense, Other Income and Non-Operating Other Income, net (continued)

recovery of certain environmental-related costs incurred in previous periods relating to property used by Corporate and other business operations. During the nine and three months ended September 30, 2007, our Chemical Business reached a settlement with Dynegy, Inc. and one of its subsidiaries, relating to a previously reported lawsuit. This settlement of \$3.3 million reflects the net proceeds of approximately \$2.7 million received by our Cherokee, Alabama facility (the "Cherokee Facility") and the retention by the Cherokee Facility of a disputed accounts payable amount of approximately \$0.6 million.

Note 16: Segment Information

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2008	2007	2008	2007
	(In Thousands)			
Net sales:				
Climate Control	\$	230,303	\$ 221,464	\$ 83,354
Chemical		329,271	222,394	124,483
Other		9,853	7,896	3,083
	\$	569,427	\$ 451,754	\$ 210,920
			\$ 210,920	\$ 147,613
Gross profit: (1)				
Climate Control	\$	72,346	\$ 65,061	\$ 24,892
Chemical (2) (3)		37,181	33,980	5,329
Other		3,140	2,840	948
	\$	112,667	\$ 101,881	\$ 31,169
			\$ 31,169	\$ 35,172
Operating income (loss): (4)				
Climate Control	\$	31,017	\$ 27,875	\$ 9,835
Chemical (2) (3) (5)		34,487	27,123	1,860
General corporate expenses and other business operations, net (6)		(8,158)	(7,225)	(3,005)
		57,346	47,773	8,690
			8,690	19,097
Interest expense		(6,363)	(8,062)	(2,643)
Non-operating other income (expense), net:				
Climate Control		1	2	-
Chemical		64	92	-
Corporate and other business operations		1,060	511	263
Benefits (provisions) for income taxes		(19,817)	1,017	(2,388)
Equity in earnings of affiliate-Climate Control		697	654	235
Income from continuing operations	\$	32,988	\$ 41,987	\$ 4,157
			\$ 4,157	\$ 17,919

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 16: Segment Information (continued)

- (1) Gross profit by industry segment represents net sales less cost of sales. Gross profit classified as “Other” relates to the sales of industrial machinery and related components.
- (2) As the result of the change in the fair value of our natural gas futures/forward contracts still held at September 30, 2008 and 2007, our Chemical Business recognized unrealized losses of \$4,931,000 and \$5,391,000 for the nine and three months ended September 30, 2008, respectively, and unrealized losses of \$111,000 and \$96,000 for the nine and three months ended September 30, 2007, respectively. In addition, during the nine and three months ended September 30, 2008, the Cherokee Facility incurred costs of approximately \$5,100,000 as the result of unplanned downtime during the third quarter of 2008. These costs include estimates of lost fixed overhead absorption, repair cost, and losses incurred to purchase anhydrous ammonia to replace lost production in order to meet firm sales commitments. These unrealized losses and costs contributed to a decrease in gross profit and operating income. During the three months ended September 30, 2008, our Chemical Business recognized unrealized gains of \$447,000 associated with natural gas forward contracts, which were deferred at June 30, 2008 due to uncertainties involving a sales contract with a customer. These unrealized gains contributed to an increase in gross profit and operating income.
- (3) During the nine months ended September 30, 2008 and 2007, the amounts expensed for precious metals, net of recoveries and gains, were \$4,866,000 and \$1,670,000, respectively. In addition, during the three months ended September 30, 2008 and 2007, the amounts expensed for precious metals, net of recoveries and gains, were \$1,304,000 and \$278,000, respectively. Also for the nine months ended September 30, 2008 and 2007, we incurred expenses of \$1,494,000 and \$879,000, respectively, relating to planned major maintenance activities. These net expenses contributed to a decrease in gross profit and operating income. During the nine and three months ended September 30, 2007, we realized insurance recoveries of \$1,500,000 relating to a business interruption claim associated with the Cherokee Facility. These recoveries contributed to an increase in gross profit and operating income in 2007.
- (4) Our chief operating decision makers use operating income by industry segment for purposes of making decisions, which include resource allocations and performance evaluations. Operating income by industry segment represents gross profit by industry segment less selling, general and administration expense (“SG&A”) incurred by each industry segment plus other income and other expense earned/incurred by each industry segment before general corporate expenses and other business operations, net. General corporate expenses and other business operations, net, consist of unallocated portions of gross profit, SG&A, other income and other expense.
- (5) For the nine-month period ended September 30, 2008, we recognized income of \$7,560,000, net of attorneys’ fees, relating to a litigation judgment. For each of the nine and three-month periods ended September 30, 2007, we recognized income of \$3,272,000 relating to a litigation settlement.

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 16: Segment Information (continued)

(6) The amounts included are not allocated to our Climate Control and Chemical Businesses since these items are not included in the operating results reviewed by our chief operating decision makers for purposes of making decisions as discussed above. A detail of these amounts are as follows:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2008	2007	2008	2007
	(In Thousands)			
Gross profit-Other	\$ 3,140	\$ 2,840	\$ 948	\$ 1,001
Selling, general and administrative:				
Personnel	(5,810)	(5,121)	(1,740)	(1,569)
Professional fees	(3,349)	(2,708)	(1,362)	(941)
Office overhead	(499)	(510)	(122)	(134)
Property, franchise and other taxes	(299)	(232)	(83)	(76)
Advertising	(204)	(189)	(67)	(49)
Shareholders relations	(67)	(147)	(7)	(17)
All other	(1,130)	(1,121)	(428)	(293)
Total selling, general and administrative	(11,358)	(10,028)	(3,809)	(3,079)
Other income	736	47	32	15
Other expense	(676)	(84)	(176)	(67)
Total general corporate expenses and other business operations, net	\$ (8,158)	\$ (7,225)	\$ (3,005)	\$ (2,130)

Information about our total assets by industry segment is as follows:

	September 30, 2008	December 31, 2007
	(In Thousands)	
Climate Control	\$ 122,316	\$ 102,737
Chemical	173,583	121,864
Corporate assets and other	69,467	82,953
Total assets	\$ 365,366	\$ 307,554

Note 17: Related Party Transactions

Golsen Group

In connection with the completion of our March 2007 tender offer for our outstanding shares of our Series 2 Preferred, members of the Golsen Group tendered 26,467 shares of Series 2 Preferred in exchange for our issuance to them of 195,855 shares of our common stock. As a result, we effectively settled approximately \$0.63 million in dividends in arrears on the shares of Series 2 Preferred tendered by the Golsen Group. The tender by the Golsen Group was a condition to Jayhawk Group's Agreement to tender shares of Series 2 Preferred in the tender offer as discussed in Note

10-Contingencies.

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 17: Related Party Transactions (continued)

After the completion of our March 2007 tender offer relating to the Series 2 Preferred, the Golsen Group held 23,083 shares of Series 2 Preferred. Pursuant to our redemption of the remaining outstanding Series 2 Preferred during August 2007, the Golsen Group redeemed 23,083 shares of Series 2 Preferred and received the cash redemption amount of approximately \$1.76 million pursuant to the terms of our redemption of all of our outstanding Series 2 Preferred. The redemption price was \$50.00 per share of Series 2 Preferred, plus \$26.25 per share in dividends in arrears pro-rata to the date of redemption.

During October 2008 and during the nine months ended September 30, 2007, the Company and certain of its subsidiaries remodeled their offices and incurred costs of \$19,000 and \$13,000, respectively, for the replacement of carpet and flooring involving a company ("Designer Rugs") owned by Linda Golsen Rappaport, the daughter of Jack E. Golsen, our Chairman and Chief Executive Officer, and sister of Barry H. Golsen, our President.

Cash Dividends

As discussed above, in August 2007, we paid cash dividends to the Golsen Group of approximately \$606,000 related to 23,083 shares of Series 2 Preferred redeemed.

In September 2007, we paid the dividends in arrears on our outstanding preferred stock utilizing a portion of the net proceeds of the sale of the 2007 Debentures and working capital, including approximately \$2,250,000 of dividends in arrears on our Series B Preferred and our Series D Preferred, all of the outstanding shares of which are owned by the Golsen Group.

In March 2008, we paid the dividends totaling approximately \$240,000 and \$60,000 on our Series B Preferred and our Series D Preferred, respectively, all of the outstanding shares of which are owned by the Golsen Group.

Quail Creek Bank

Bernard Ille, a member of our board of directors, is a director of Quail Creek Bank, N.A. (the "Bank"). The Bank was a lender to one of our subsidiaries. During the nine months ended September 30, 2007, the subsidiary made interest and principal payments on outstanding debt owed to the Bank in the respective amount of \$0.1 million and \$3.3 million. The debt accrued interest at an annual interest rate of 8.25%. The loan was secured by certain of the subsidiary's property, plant and equipment. This loan was paid in full in June 2007 utilizing a portion of the net proceeds of our sale of the 2007 Debentures.

Note 18: Subsequent Events

Bayer Agreement

On October 23, 2008, El Dorado Nitrogen, L.P. ("EDN"), and EDC, both subsidiaries of the Company, entered into a new Nitric Acid Supply Operating and Maintenance Agreement (the "Bayer Agreement") with Bayer MaterialScience, LLC ("Bayer"). The Bayer Agreement will replace the current Baytown Nitric Acid Project and Supply Agreement, dated June 27, 1997 (the "Original Bayer Agreement"), as of June 24, 2009. The Bayer Agreement is for a term of five

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LSB INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Unaudited)

Note 18: Subsequent Events (continued)

years commencing on June 24, 2009, following the termination of the Original Bayer Agreement. The Bayer Agreement provides up to five renewal terms of five years each, subject to either party opting against renewal prior to each new renewal period.

Under the terms of the Bayer Agreement, Bayer will purchase from EDN all of Bayer's requirements for nitric acid for use in Bayer's chemical manufacturing facility located in Baytown, Texas (the "Baytown Plant"). Bayer will also supply ammonia as required for production of nitric acid at the Baytown Plant, in addition to certain utilities, chemical additives and services that are required for such production. Any surplus nitric acid manufactured at the Baytown Plant that is not required by Bayer may be marketed to third parties by EDN. The Bayer Agreement provides that Bayer will make certain net monthly payments to EDN which will be sufficient for EDN to recover all of its costs plus a profit.

Pursuant to the terms of the Original Bayer Agreement, Bayer has provided notice of exercise of its option to purchase from a third party all of the assets comprising the Baytown Plant, except certain assets which will be owned by EDN for use in the production process (the "EDN Assets"). EDN will continue to be responsible for the maintenance and operation of the Baytown Plant in accordance with the terms of the Bayer Agreement.

If there is a change in control of EDN, Bayer will have the right to terminate the Bayer Agreement upon payment of a termination fee of approximately \$6.3 million, plus 1.1 times the then current net book value of the EDN Assets. In addition, if EDN receives a third-party offer to purchase any voting equity securities of EDN or the assets comprising the EDN Assets that EDN would like to accept, Bayer will have the option to pay the termination fee or the amount of the third party offer and to terminate the Bayer Agreement.

Grant of Stock Options

During October 2008, we granted 303,000 shares of incentive stock options under the 2008 Plan to certain employees who are not executive officers of the Company or members of our disclosure committee. The exercise price of these options was equal to the market value of our common stock at the date of grant. These options vest at the end of each one-year period at the rate of 16.5% per year for the first five years and the remaining unvested options will vest at the end of the sixth year. In addition, these options expire in October 2018.

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") should be read in conjunction with our September 30, 2008 condensed consolidated financial statements. Certain statements contained in this MD&A may be deemed forward-looking statements. See "Special Note Regarding Forward-Looking Statements".

Overview

General

We are a manufacturing, marketing and engineering company, operating through our subsidiaries. Our wholly-owned subsidiary, ThermaClima, through its subsidiaries, owns substantially all of our core businesses consisting of the:

- Climate Control Business engages in the manufacturing and selling of a broad range of air conditioning and heating products in the niche markets we serve consisting of geotherma