

LSB INDUSTRIES INC  
Form 10-Q  
November 07, 2011

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**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, 2011  
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  
incorporation or organization

I.R.S. Employer Identification No.

**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. ☐ Yes ○ No

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

Indicate by check mark 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

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The number of shares outstanding of the Registrant's voting common stock, as of October 31, 2011 was 22,289,813 shares, excluding 4,320,462 shares held as treasury stock.

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FINANCIAL INFORMATION****Item 1. Financial Statements****LSB INDUSTRIES, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(Information at September 30, 2011 is unaudited)**

	September 30, 2011	December 31, 2010
	(In Thousands)	
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 107,983	\$ 66,946
Restricted cash	512	31
Short-term investments		10,003
Accounts receivable, net	85,866	74,259
Inventories:		
Finished goods	38,553	32,072
Work in process	4,367	2,981
Raw materials	31,277	25,053
Total inventories	74,197	60,106
Supplies, prepaid items and other:		
Prepaid income taxes	3,467	
Prepaid insurance	745	4,449
Precious metals	17,595	12,048
Supplies	7,866	6,802
Fair value of derivatives and other	7	1,454
Other	1,915	1,174
Total supplies, prepaid items and other	31,595	25,927
Deferred income taxes	6,064	5,396
Total current assets	306,217	242,668
Property, plant and equipment, net	154,621	135,755
Other assets:		
Debt issuance costs, net	1,151	1,023
Investment in affiliate	3,168	4,016
Goodwill	1,724	1,724
Other, net	3,479	2,795
Total other assets	9,522	9,558
	\$ 470,360	\$ 387,981

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**LSB INDUSTRIES, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS (continued)**  
**(Information at September 30, 2011 is unaudited)**

	September 30, 2011	December 31, 2010
(In Thousands)		
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 57,512	\$ 51,025
Short-term financing	386	3,821
Accrued and other liabilities	32,977	31,507
Current portion of long-term debt	6,059	2,328
 Total current liabilities	 96,934	 88,681
 Long-term debt	 77,245	 93,064
 Noncurrent accrued and other liabilities	 14,882	 12,605
 Deferred income taxes	 17,145	 14,261
 Commitments and 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 and outstanding	1,000	1,000
Common stock, \$.10 par value; 75,000,000 shares authorized, 26,584,650 shares issued (25,476,534 at December 31, 2010)	2,658	2,548
Capital in excess of par value	160,970	131,845
Retained earnings	125,900	70,351
	292,528	207,744
 Less treasury stock at cost:		
Common stock, 4,320,462 shares	28,374	28,374
 Total stockholders equity	 264,154	 179,370
	\$ 470,360	\$ 387,981

See accompanying notes.

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**LSB INDUSTRIES, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
**(Unaudited)**  
**Nine and Three Months Ended September 30, 2011 and 2010**

	Nine Months		Three Months	
	2011	2010	2011	2010
	(In Thousands, Except Per Share Amounts)			
Net sales	\$ 589,892	\$ 437,750	\$ 176,780	\$ 138,948
Cost of sales	429,695	344,897	142,523	109,509
Gross profit	160,197	92,853	34,257	29,439
Selling, general and administrative expense	64,737	70,775	21,635	23,948
Provision for (recoveries of) losses on accounts receivable	160	(14)	39	21
Other expense	2,532	575	149	273
Other income	(2,035)	(4,179)	(58)	(3,273)
Operating income	94,803	25,696	12,492	8,470
Interest expense	5,481	5,943	1,901	1,864
Losses on extinguishment of debt	136	52		
Non-operating other expense (income), net	(3)	(48)	2	(10)
Income from continuing operations before provisions for income taxes and equity in earnings of affiliate	89,189	19,749	10,589	6,616
Provisions for income taxes	33,582	8,821	4,433	2,930
Equity in earnings of affiliate	(375)	(719)	(168)	(191)
Income from continuing operations	55,982	11,647	6,324	3,877
Net loss from discontinued operations	128	122	18	79
Net income	55,854	11,525	6,306	3,798
Dividends on preferred stocks	305	305		
Net income applicable to common stock	\$ 55,549	\$ 11,220	\$ 6,306	\$ 3,798
Weighted-average common shares:				
Basic	21,851	21,182	22,241	21,094
Diluted	23,499	22,281	23,526	22,193

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Income (loss) per common share:

Basic:

Income from continuing operations	\$	2.55	\$	.54	\$	.28	\$	.18
Net loss from discontinued operations		(.01)		(.01)				

Net income	\$	2.54	\$	.53	\$	.28	\$	.18
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Diluted:

Income from continuing operations	\$	2.40	\$	.53	\$	.27	\$	.17
Net loss from discontinued operations		(.01)		(.01)				

Net income	\$	2.39	\$	.52	\$	.27	\$	.17
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See accompanying notes.

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**LSB INDUSTRIES, INC.**  
**CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY**  
**(Unaudited)**  
**Nine Months Ended September 30, 2011**

	Common Stock Shares	Non- Redeemable Preferred Stock	Common Stock Par Value	Capital in Excess of Par Value (In Thousands)	Retained Earnings	Treasury Stock- Common	Total
Balance at December 31, 2010	25,477	\$ 3,000	\$ 2,548	\$ 131,845	\$ 70,351	\$ (28,374)	\$ 179,370
Net income					55,854		55,854
Dividends paid on preferred stocks					(305)		(305)
Stock-based compensation				761			761
Conversion of convertible debt to common stock	965		96	26,304			26,400
Exercise of stock options	143		14	960			974
Excess income tax benefit associated with stock-based compensation				1,100			1,100
Balance at September 30, 2011	26,585	\$ 3,000	\$ 2,658	\$ 160,970	\$ 125,900	\$ (28,374)	\$ 264,154

See accompanying notes.

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**LSB INDUSTRIES, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**  
**Nine Months Ended September 30, 2011 and 2010**

	2011	2010
	(In Thousands)	
<b>Cash flows from continuing operating activities:</b>		
Net income	\$ 55,854	\$ 11,525
Adjustments to reconcile net income to net cash provided by continuing operating activities:		
Net loss from discontinued operations	128	122
Deferred income taxes	2,216	2,325
Losses on extinguishment of debt	136	52
Expense associated with modification of secured term loan	387	
Expense associated with induced conversion of 5.5% convertible debentures	558	
Net gain on carbon credits	(92)	
Losses on sales and disposals of property and equipment	996	508
Gain on property insurance recoveries associated with property, plant and equipment		(3,964)
Depreciation of property, plant and equipment	13,861	12,880
Amortization	354	466
Stock-based compensation	761	752
Provision for (recovery of) losses on accounts receivable	160	(14)
Provision for (realization of) losses on inventory	1,351	(86)
Realization of losses on firm sales commitments		(337)
Equity in earnings of affiliate	(375)	(719)
Distributions received from affiliate	1,223	425
Changes in fair value of commodities contracts	482	(141)
Changes in fair value of interest rate contracts	635	344
Other		(10)
Cash provided (used) by changes in assets and liabilities (net of effects of discontinued operations):		
Accounts receivable	(11,777)	(14,373)
Inventories	(15,392)	(1,967)
Other supplies, prepaid items and other	(2,838)	1,449
Accounts payable	3,744	6,635
Accrued payroll and benefits	(2,020)	1,794
Accrued and prepaid income taxes	(7,538)	319
Customer deposits	5,395	2,306
Other current and noncurrent liabilities	4,322	2,394
Net cash provided by continuing operating activities	52,531	22,685
<b>Cash flows from continuing investing activities:</b>		
Capital expenditures	(31,145)	(26,129)
Proceeds from property insurance recoveries associated with property, plant and equipment		5,293
Proceeds from sales of property and equipment	190	44
Proceeds from short-term investments	10,012	20,053

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Purchases of short-term investments	(9)	(20,006)
Deposits of restricted cash	(481)	(167)
Proceeds from sales of carbon credits	1,665	
Payments on contractual obligations carbon credits	(1,573)	
Other assets	(635)	(427)
Net cash used by continuing investing activities	(21,976)	(21,339)

(Continued on following page)

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**LSB INDUSTRIES, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)**  
**(Unaudited)**  
**Nine Months Ended September 30, 2011 and 2010**

	2011	2010
	(In Thousands)	
<b>Cash flows from continuing financing activities:</b>		
Proceeds from revolving debt facility	\$ 498,858	\$ 394,221
Payments on revolving debt facility	(498,858)	(394,221)
Proceeds from modification of secured term loan, net of fees	10,347	
Proceeds from secured term loan, net of fees	14,766	
Proceeds from other long-term debt, net of fees		47
Payments associated with induced conversion of 5.5% convertible debentures	(558)	
Acquisition of 5.5% convertible debentures		(2,494)
Payments on other long-term debt	(12,001)	(3,370)
Payments on loans secured by cash value of life insurance policies	(84)	(380)
Payments of debt issuance costs	(112)	
Payments on short-term financing	(3,435)	(3,017)
Proceeds from exercise of stock options	974	347
Purchase of treasury stock		(2,421)
Excess income tax benefit associated with stock-based compensation	1,100	212
Dividends paid on preferred stocks	(305)	(305)
Net cash provided (used) by continuing financing activities	10,692	(11,381)
Cash flows of discontinued operations:		
Operating cash flows	(210)	(267)
Net increase (decrease) in cash and cash equivalents	41,037	(10,302)
Cash and cash equivalents at beginning of period	66,946	61,739
Cash and cash equivalents at end of period	\$ 107,983	\$ 51,437
<b>Supplemental cash flow information:</b>		
Cash payments for income taxes, net of refunds	\$ 37,757	\$ 5,993
Noncash investing and financing activities:		
Receivable associated with a property insurance claim	\$	\$ 171
Accounts payable and long-term debt associated with property, plant and equipment	\$ 4,332	\$ 7,272
Debt issuance costs incurred associated with secured term loan	\$ 839	\$
Debt issuance costs written off associated with 5.5% debentures	\$ 350	\$ 58
Accrued liabilities extinguished associated with 5.5% debentures	\$ 342	\$
5.5% debentures converted to common stock	\$ 26,400	\$

See accompanying notes.



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

**Note 1: Summary of Significant Accounting Policies**

For a complete discussion of our significant accounting policies, refer to the notes to our audited consolidated financial statements included in our Form 10-K for the year ended December 31, 2010 ( 2010 Form 10-K ), filed with the Securities and Exchange Commission ( SEC ) on March 3, 2011.

**Basis of Consolidation and Presentation** LSB Industries, Inc. ( LSB ) and its subsidiaries (the Company , We , Us

Our ) are consolidated in the accompanying condensed consolidated financial statements. We are involved in manufacturing, marketing and engineering operations. We are primarily engaged 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 ). LSB is a holding company with no significant operations or assets other than cash, cash equivalents, and investments in its 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, 2011 and for the nine and three-month periods ended September 30, 2011 and 2010 include all adjustments and accruals, consisting 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 United States generally accepted accounting principles ( GAAP ) have been condensed or omitted in this Form 10-Q pursuant to the rules and regulations of the SEC. These condensed consolidated financial statements should be read in connection with our audited consolidated financial statements and notes thereto included in our 2010 Form 10-K.

**Use of Estimates** The preparation of condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Income per Common Share** Net income applicable to common stock is computed by adjusting net income by the amount of preferred stock dividends and dividend requirements, if applicable. 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 year. 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.

**Short-Term Investments** Investments, which consisted of certificates of deposit with an original maturity of 13 weeks, are considered short-term investments. These investments are carried at cost which approximates fair value. All of these investments were held by financial institutions within the United States ( U.S. ) and none of these investments were in excess of the federally insured limits.

**Accounts Receivable** Our accounts receivable are stated at net realizable value. This value includes an appropriate allowance for estimated uncollectible accounts to reflect any loss anticipated on accounts receivable balances. Our estimate is based on historical experience and periodic assessment of outstanding accounts receivable, particularly those accounts which are past due (based upon the terms of the sale). Our periodic assessment of our accounts receivable is based on our best estimate of amounts that are not recoverable.



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

**Note 1: Summary of Significant Accounting Policies (continued)**

**Inventories** Inventories are stated at the lower of cost (determined using the first-in, first-out ( FIFO ) basis) or market (net realizable value). Finished goods and work-in-process inventories include material, labor, and manufacturing overhead costs. Additionally, we review inventories and record inventory reserves for slow-moving inventory items.

**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 or capital projects, we may be able to perform procedures to recover precious metals (previously expensed) which have accumulated over time within the manufacturing equipment. Recoveries of precious metals are recognized at historical FIFO costs. When we accumulate precious metals in excess of our production requirements, we may sell a portion of the excess metals.

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

Our accounting policy and methodology for warranty arrangements is to measure and recognize the expense and liability for such warranty obligations at the time of sale using a percentage of sales and cost per unit of equipment, based upon our historical and estimated future warranty costs. We also recognize the additional warranty expense and liability to cover atypical costs associated with a specific product, or component thereof, or project installation, when such costs are probable and reasonably estimable. It is reasonably possible that our estimated accrued warranty costs could change in the near term.

**Contingencies** Certain conditions may exist which may result in a loss, but which will only be resolved when future events occur. We and our legal counsel assess such contingent liabilities, and such assessment inherently involves an exercise of judgment. If the assessment of a contingency indicates that it is probable that a loss has been incurred, we would accrue for such contingent losses when such losses can be reasonably estimated. If the assessment indicates that a potentially material loss contingency is not probable but reasonably possible, or is probable but cannot be estimated, the nature of the contingent liability, together with an estimate of the range of possible loss if determinable and material, would be disclosed. Estimates of potential legal fees and other directly related costs associated with contingencies are not accrued but rather are expensed as incurred. Loss contingency liabilities are included in current and noncurrent accrued and other liabilities and are based on current estimates that may be revised in the near term. In addition, we recognize contingent gains when such gains are realized or realizable and earned.

**Derivatives, Hedges, Financial Instruments and Carbon Credits** Derivatives are recognized in the balance sheet and are measured 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.

Climate reserve tonnes ( carbon credits ) are recognized in the balance sheet and are measured at fair value. Changes in fair value of carbon credits are recorded in results of operations. Contractual obligations associated with carbon credits are recognized in the balance sheet and are measured at fair value unless we enter into a firm sales commitment to sell the associated carbon credits. When we enter into a firm sales commitment, the sales price, pursuant to the terms of the firm sales commitment, establishes the amount of the associated contractual obligation. Changes in fair value of contractual obligations associated with carbon credits are recorded in results of operations.

**Income Taxes** We do not recognize a tax benefit unless we conclude that it is more-likely-than-not that the benefit will be sustained on audit by the taxing authority based solely on the technical merits of the associated tax position. If the recognition threshold is met, we recognize a tax benefit measured at the largest amount of the tax benefit that, in our judgment, is greater than 50% likely to be realized. We also record interest related to unrecognized tax positions in interest expense and penalties in operating other expense.



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

**Note 1: Summary of Significant Accounting Policies (continued)**

Income tax benefits associated with amounts that are deductible for income tax purposes but that do not affect earnings are credited to equity. These benefits are principally generated from exercises of non-qualified stock options.

**Recognition of Insurance Recoveries** If an insurance claim relates to a recovery of our losses, we recognize the recovery when it is probable and reasonably estimable. If our insurance claim relates to a contingent gain, we recognize the recovery when it is realized or realizable and earned. Amounts recoverable from our insurance carriers, if any, are included in accounts receivable.

**Recently Issued Accounting Pronouncements** In January 2010, the Financial Accounting Standards Board ( FASB ) issued an accounting standards update ( ASU ) requiring additional disclosures about an entity s derivative and hedging activities for the purpose of improving the transparency of financial reporting. A portion of the new disclosure requirements became effective for us on January 1, 2010 and the remaining new disclosure requirements became effective for us on January 1, 2011. These disclosure requirements were applied prospectively. See Note 11 Derivatives, Hedges, Financial Instruments and Carbon Credits.

In May 2011, the FASB issued an ASU clarifying how to measure and disclose fair value. The requirements under this ASU become effective for us on January 1, 2012 and are to be applied prospectively. We currently do not expect a significant impact from adopting this ASU.

In June 2011, the FASB issued an ASU amending current comprehensive income guidance. This ASU eliminates the option to present the components of other comprehensive income as part of the statement of stockholders equity. Instead, we must report comprehensive income in either a single continuous statement of comprehensive income which contains two sections, net income and other comprehensive income, or in two separate but consecutive statements. The requirements under this ASU become effective for us on January 1, 2012 and are to be applied retrospectively; however, the FASB is considering issuing an exposure draft to propose a deferral of certain requirements under this ASU. We currently expect the impact from adopting this ASU to change the format of our presentation.

In September 2011, the FASB issued an ASU amending current guidance for testing goodwill for impairment. This ASU added an option to first assess qualitative factors to determine if the current two-step impairment test is required. The assessment of qualitative factors is performed to determine whether the existence of events or circumstances leads to the determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. Pursuant to the provisions of this ASU, we early adopted this ASU effective July 1, 2011, which provisions were applied prospectively. Our financial statements were not impacted from the adoption of this ASU.

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

**Note 2: Income Per Common Share**

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,	
	2011	2010	2011	2010
Numerator:				
Net income	\$ 55,854	\$ 11,525	\$ 6,306	\$ 3,798
Dividends on Series B Preferred	(240)	(240)		
Dividends on Series D Preferred	(60)	(60)		
Dividends on Noncumulative Preferred	(5)	(5)		
Total dividends on preferred stocks	(305)	(305)		
Numerator for basic net income per common share net income applicable to common stock	55,549	11,220	6,306	3,798
Dividends on preferred stocks assumed to be converted, if dilutive	305	305		
Interest expense including amortization of debt issuance costs, net of income taxes, on convertible debt assumed to be converted, if dilutive	298		8	
Numerator for diluted net income per common share	\$ 56,152	\$ 11,525	\$ 6,314	\$ 3,798
Denominator:				
Denominator for basic net income per common share weighted-average shares	21,851,184	21,182,180	22,240,536	21,093,732
Effect of dilutive securities:				
Convertible preferred stocks	935,540	937,080	935,366	936,536
Convertible notes payable	366,894	4,000	32,391	4,000
Stock options	345,245	157,682	317,420	158,886
Dilutive potential common shares	1,647,679	1,098,762	1,285,177	1,099,422
Denominator for diluted net income per common share adjusted weighted-average shares and assumed conversions	23,498,863	22,280,942	23,525,713	22,193,154
Basic net income per common share	\$ 2.54	\$ .53	\$ .28	\$ .18

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Diluted net income per common share                   \$     2.39   \$     .52   \$     .27   \$     .17

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,	
	2011	2010	2011	2010
Convertible notes payable		979,160		979,160
Stock options		365,659	5,000	350,000
		1,344,819	5,000	1,329,160

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

**Note 3: Accounts Receivable, net** Our accounts receivables, net, consists of the following:

	September 30, 2011	December 31, 2010
	(In Thousands)	
Trade receivables	\$ 85,691	\$ 73,367
Other	946	1,528
	86,637	74,895
Allowance for doubtful accounts	(771)	(636)
	\$ 85,866	\$ 74,259

**Note 4: Inventories** At September 30, 2011 and December 31, 2010, inventory reserves for certain slow-moving inventory items (Climate Control products) were \$1,984,000 and \$1,616,000, respectively. In addition, because cost exceeded the net realizable value, inventory reserves for certain nitrogen-based inventories provided by our Chemical Business were \$1,075,000 and \$177,000 at September 30, 2011 and December 31, 2010, respectively.

Changes in our inventory reserves are as follows:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2011	2010	2011	2010
	(In Thousands)			
Balance at beginning of period	\$ 1,793	\$ 1,676	\$ 1,988	\$ 1,302
Provisions for (realization of) losses	1,351	(87)	1,072	237
Write-offs and disposals	(85)	(54)	(1)	(4)
Balance at end of period	\$ 3,059	\$ 1,535	\$ 3,059	\$ 1,535

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

**Note 5: Precious Metals** Precious metals are included in supplies, prepaid items and other in the accompanying condensed consolidated balance sheets. In addition, precious metals expense (recoveries), net, is included in cost of sales in the accompanying condensed consolidated statements of income.

Precious metals expense (recoveries), net, consists of the following:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2011	2010	2011	2010
	(In Thousands)			
Precious metals expense	\$ 6,101	\$ 4,508	\$ 1,591	\$ 1,047
Recoveries of precious metals	(4,654)	(751)	(2,012)	(751)
Gains on sales of precious metals	(33)	(112)	(33)	
Precious metals expense (recoveries), net	\$ 1,414	\$ 3,645	\$ (454)	\$ 296

**Note 6: Investment in Affiliate** Cepolk Holdings, Inc. ( CHI ), a subsidiary within the Climate Control Business, 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. The income recognized from the Partnership is reported as equity in earnings of affiliate. During 2010, CHI filed a lawsuit against the general partner of the Partnership and subsequently, the general partner filed a lawsuit against CHI. During June 2011, these lawsuits involving the Partnership were settled through mediation. As the result of this settlement, our equity in earnings of affiliate decreased by approximately \$480,000 for the nine months ended September 30, 2011. In addition, CHI will receive an increase of \$74,000 in the quarterly distribution from the Partnership, which began during the third quarter of 2011.

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

**Note 7: Current and Noncurrent Accrued and Other Liabilities** Our current and noncurrent accrued and other liabilities consist of the following:

	September 30, 2011	December 31, 2010
	(In Thousands)	
Customer deposits	\$ 7,981	\$ 2,586
Deferred revenue on extended warranty contracts	6,250	5,675
Accrued warranty costs	4,993	3,996
Accrued payroll and benefits	4,722	6,742
Accrued death benefits	4,028	4,058
Accrued group health and workers compensation insurance claims	3,062	2,459
Fair value of derivatives and other	3,019	2,539
Accrued contractual manufacturing obligations	2,480	1,968
Deferred revenue on product sales	1,309	453
Accrued executive benefits	1,296	1,187
Accrued precious metals costs	1,206	449
Accrued general liability insurance claims	1,145	1,230
Accrued commissions	1,121	1,279
Accrued income taxes	764	4,835
Accrued interest	589	1,343
Other	3,894	3,313
	47,859	44,112
Less noncurrent portion	14,882	12,605
Current portion of accrued and other liabilities	\$ 32,977	\$ 31,507

**Note 8: Accrued Warranty Costs** Our Climate Control Business sells equipment that has an expected life, under normal circumstances and use, which extends over several years. As such, we provide warranties after equipment shipment/start up covering defects in materials and workmanship. Generally for commercial/institutional products, 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. For residential products, the base warranty coverage for manufactured equipment in the Climate Control Business is limited to ten years from the date of shipment for material and to five years from the date of shipment for labor associated with the repair. 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.

Changes in our product warranty obligation (accrued warranty costs) are as follows:

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	Nine Months Ended September 30,		Three Months Ended September 30,	
	2011	2010	2011	2010
	(In Thousands)			
Balance at beginning of period	\$ 3,996	\$ 3,138	\$ 4,598	\$ 3,129
Charged to costs and expenses	4,870	2,669	1,636	1,026
Costs and expenses incurred	(3,873)	(2,673)	(1,241)	(1,021)
Balance at end of period	\$ 4,993	\$ 3,134	\$ 4,993	\$ 3,134

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

**Note 9: Long-Term Debt** Our long-term debt consists of the following:

	September 30, 2011	December 31, 2010
	(In Thousands)	
Working Capital Revolver Loan due 2012 (A)	\$	\$
5.5% Convertible Senior Subordinated Notes due 2012 (B)	500	26,900
Secured Term Loan (C)	73,125	48,773
Other, with a current weighted-average interest rate of 6.56%, most of which is secured by machinery, equipment and real estate	9,679	19,719
	83,304	95,392
Less current portion of long-term debt	6,059	2,328
Long-term debt due after one year	\$ 77,245	\$ 93,064

(A) Our wholly-owned subsidiary, ThermaClime, LLC ( ThermaClime ) and its subsidiaries (collectively, 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 ThermaClime and its subsidiaries. The Working Capital Revolver Loan accrues interest at a base rate (generally equivalent to the prime rate) plus .50% or LIBOR plus 1.75% and matures on April 13, 2012. The interest rate at September 30, 2011 was 3.75%. Interest is paid monthly, if applicable.

The Working Capital Revolver Loan provides for up to \$8.5 million of letters of credit. All letters of credit outstanding reduce availability under the Working Capital Revolver Loan. As of September 30, 2011, amounts available for borrowing under the Working Capital Revolver Loan were approximately \$48.6 million. Under the Working Capital Revolver Loan, 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 Working Capital Revolver Loan 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, if any, due and payable in full. The Working Capital Revolver Loan is secured by the assets of all the ThermaClime entities other than El Dorado Nitric Company and its subsidiaries ( EDN ) but excluding the assets securing the secured term loan discussed in (C) below, certain production equipment and facilities utilized by the Climate Control Business, and certain distribution-related assets of El Dorado Chemical Company ( EDC ). In addition, EDN is neither a borrower under, nor guarantor of, the Working Capital Revolver Loan. The carrying value of the pledged assets is approximately \$256 million at September 30, 2011.

The Working Capital Revolver Loan requires ThermaClime to meet certain financial covenants, including an EBITDA requirement of greater than \$25 million; a minimum fixed charge coverage ratio of not less than 1.10 to 1; and a maximum senior leverage coverage ratio of not greater than 4.50 to 1. These requirements are measured quarterly on a trailing twelve-month basis and as defined in the agreement. ThermaClime was in compliance with those covenants for the twelve-month period ended September 30, 2011. The Working Capital Revolver Loan also contains covenants that, among other things, limit the Borrowers (which does not include LSB) ability, without consent of the lender and with certain exceptions, 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.

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

**Note 9: Long-Term Debt (continued)**

(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 debentures (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 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.

In previous periods, we acquired a certain portion of the 2007 Debentures, with each purchase being negotiated, including \$2.5 million during the nine months ended September 30, 2010. In March 2011, one of the holders converted \$24.4 million principal amount of the 2007 Debentures into 888,160 shares of LSB common stock. For financial reporting purposes, the March 2011 transaction is considered an induced conversion.

In July 2011, Jack E. Golsen, our chairman of the board and chief executive officer ( CEO ), members of his immediate family (spouse and children), entities owned by them and trusts for which they possess voting or dispositive power as trustee (collectively, the Golsen Group ) converted \$2.0 million principal amount of the 2007 Debentures into 72,800 shares of LSB common stock in accordance with the terms of the 2007 Debentures as discussed in Note 16-Related Party Transactions. As a result of these acquisitions and conversions, only \$0.5 million of the 2007 Debentures remain outstanding at September 30, 2011, all of which were converted into 18,200 shares of LSB common stock in October 2011.

(C) On March 29, 2011, ThermaClime and certain of its subsidiaries entered into an amended and restated term loan agreement (the Amended Agreement ), which amended ThermaClime s existing term loan agreement (the Original Agreement ), dated November 2, 2007, as previously amended. Pursuant to the terms of the Amended Agreement, the maximum principal amount of ThermaClime s term loan facility (the Secured Term Loan ) was increased from \$50 million to \$60 million. On May 26, 2011, the principal amount of the Secured Term Loan was increased an additional \$15 million to \$75 million pursuant to the terms of the Amended Agreement. The Amended Agreement also extended the maturity of the Secured Term Loan from November 2, 2012, to March 29, 2016. The Secured Term Loan continues to be guaranteed by LSB. For financial reporting purposes, this transaction is considered a non-substantial modification of the Original Agreement.

The Secured Term Loan requires quarterly principal payments of approximately \$0.9 million, plus interest and a final balloon payment of \$56.3 million due on March 29, 2016. At September 30, 2011, the stated interest rate on the Secured Term Loan includes a variable interest rate of approximately 3.36% on the principal amount of \$48.7 million (the variable interest rate is based on three-month LIBOR plus 300 basis points, which rate is adjusted quarterly) and a fixed interest rate of 5.15% on the principal amount of \$24.4 million. At September 30, 2011, the resulting weighted-average interest rate was approximately 3.96%.

The Secured Term Loan is secured by the real property and equipment located at our chemical production facilities located in El Dorado, Arkansas (the El Dorado Facility ) and Cherokee, Alabama (the Cherokee Facility ). The carrying value of the pledged assets is approximately \$68 million at September 30, 2011.

The Secured Term Loan borrowers are subject to numerous covenants under the Amended 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 LSB, all with certain exceptions. At September 30, 2011, the carrying value of the restricted net assets of ThermaClime and its subsidiaries was approximately \$84 million. As defined in the agreement, the Secured Term Loan borrowers are also subject to a minimum fixed charge coverage ratio of not less than 1.10 to 1 and a maximum leverage ratio of not greater than 4.50 to 1. Both of these requirements are 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, 2011.

The maturity date of the Secured Term Loan can be accelerated by the lender upon the occurrence of a continuing event of default, as defined.

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

**Note 9: Long-Term Debt (continued)**

The Working Capital Revolver Loan agreement (discussed in (A) above) and the Secured Term Loan contain cross-default provisions. If ThermaClime fails to meet the financial covenants of either of these agreements, the lenders may declare an event of default.

A prepayment premium equal to 2.5% of the principal amount prepaid is due to the lenders should the borrowers elect to prepay on or prior to March 29, 2012. This premium is reduced to 1.0% during the following 24-month period and is eliminated thereafter.

**Note 10: Commitments and Contingencies**

**Purchase Commitments** We entered into the following significant purchase commitments during the nine months ended September 30, 2011:

During the first nine months of 2011, certain subsidiaries within the Chemical Business entered into contracts to purchase natural gas for anticipated production needs at the Cherokee Facility and the chemical production facility located in Pryor, Oklahoma (the Pryor Facility ). Since these contracts are considered normal purchases because they provide for the purchase of natural gas that will be delivered in quantities expected to be used over a reasonable period of time in the normal course of business and are documented as such, these contracts are exempt from the accounting and reporting requirements relating to derivatives. At September 30, 2011, our purchase commitments under these contracts were for approximately 1.2 million MMBtu of natural gas through December 2011 at the weighted-average cost of \$4.14 per MMBtu (\$5.1 million).

**Legal Matters** 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 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 we will not incur material costs or liabilities 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 will recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. We are obligated to monitor certain discharge water outlets at our Chemical Business facilities should we discontinue the operations of a facility. We are also contractually obligated to pay a portion of the operating costs of a municipally owned wastewater pipeline currently being constructed, which will serve the El Dorado Facility through at least December 2053. Additionally, we 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. Currently, there is insufficient information to estimate the fair value for most of our asset retirement obligations. In addition, we currently have no plans to discontinue the use of these facilities and the remaining life of the facilities is indeterminable. As a result, no asset retirement obligations have been recognized except for \$75,000 to retire an injection well at the Pryor Facility. However, we will continue to review these obligations and record a liability when a reasonable estimate of the fair value can be made.



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

**Note 10: Commitments and Contingencies (continued)**

**1. Discharge Water Matters**

The El Dorado Facility owned by EDC generates process wastewater, which includes cooling tower and boiler blowdowns, contact storm water (rain water inside the facility area which picks up contaminants) and miscellaneous spills and leaks from process equipment. The process water discharge, storm-water runoff and miscellaneous spills and leaks are governed by a state National Pollutant Discharge Elimination System ( NPDES ) discharge water permit issued by the Arkansas Department of Environmental Quality ( ADEQ ), which permit is generally required to be renewed every five years. The El Dorado Facility is currently operating under a NPDES discharge water permit, which became effective in 2004 ( 2004 NPDES permit ). In November 2010, a preliminary draft of a discharge water permit renewal, which contains more restrictive ammonia limits, was issued by the ADEQ for EDC 's review. EDC submitted comments to the ADEQ on the draft permit in December 2010.

The El Dorado Facility has generally demonstrated its ability to comply with applicable ammonia and nitrate permit limits, and believes that if it is required to meet the more restrictive dissolved minerals permit levels, it should be able to do so. However, as part of our long-term compliance plan, EDC is pursuing a rulemaking and permit modification with the ADEQ. The ADEQ approved a rule change, but on August 31, 2011, the United States Environmental Protection Agency ( EPA ) formally disapproved the rule change. EDC has filed an appeal of the EPA 's decision in Federal District Court in El Dorado, Arkansas. EDC has intermittently failed the more restrictive dissolved minerals permit limits while the rulemaking has been pursued. However, we do not believe that the occasional noncompliance will have a material adverse impact on EDC. While we are hopeful that EDC will prevail in the appeal, it is unknown how the Court will rule. We do not believe this matter regarding the dissolved minerals will be an issue once the pipeline is operational as discussed below.

During January 2010, EDC received an Administrative Order from the EPA noting certain violations of the 2004 NPDES permit and requesting EDC to demonstrate compliance with the permit or provide a plan and schedule for returning to compliance. EDC has provided the EPA a response which states that the El Dorado Facility is now in compliance with the permit, that the El Dorado Facility expects to maintain compliance and that a majority of the alleged violations were resolved through a consent administrative order with the ADEQ. In June 2011, EDC received an Administrative Complaint from the EPA acknowledging EDC had achieved compliance with the 2004 NPDES permit but has assessed a penalty of \$124,000 for past violations of the permit. EDC has met, and continues to meet, with the EPA to explain its objections against the proposed penalty. However, a liability of \$124,000 has been established at September 30, 2011 as a result of the Administrative Complaint.

The city of El Dorado, Arkansas received approval to construct a pipeline for disposal of wastewater generated by the city and by certain companies in the El Dorado area. The companies intending to use the pipeline will contribute to the cost of construction and operation of the pipeline. Although EDC believes it can comply with the more restrictive permit limits without the pipeline, EDC will participate in the construction of the pipeline that will be owned by the city in order to ensure that EDC will be able to comply with future permit limits. During April 2011, certain companies, including EDC, and the City entered into a funding agreement and operating agreement, pursuant to which each party to the agreements has agreed to contribute to the cost of construction and the annual operating costs of the pipeline. EDC anticipates its capital cost in connection with the construction of the pipeline including EDC 's right to use the pipeline to dispose of its wastewater will be approximately \$4.0 million, of which \$0.4 million has been capitalized as of September 30, 2011. The City plans to complete the construction of the pipeline in 2013. Once the pipeline is completed, EDC 's estimated share of the annual operating costs is to be \$100,000 to \$150,000. The initial term of the operating agreement is through December 2053.

In addition, the El Dorado Facility is currently operating under a consent administrative order ( 2006 CAO ) that recognizes the presence of nitrate contamination in the shallow groundwater. The 2006 CAO required EDC 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 relating to the El Dorado Facility. The final remedy for

shallow groundwater contamination, should any remediation be required, will be selected pursuant to a new consent administrative order and based upon the risk assessment. The cost of any additional remediation that may be required will be determined based on the results of the investigation and risk assessment, which costs (or range of costs) cannot currently be reasonably estimated. Therefore, no liability has been established at September 30, 2011, in connection with this matter.

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

**Note 10: Commitments and Contingencies (continued)****2. Air Matters**

The EPA has sent information requests to most, if not all, of the operators of nitric acid plants in the United States, including our El Dorado and Cherokee Facilities and the Baytown, Texas nitric acid plant operated by EDN (the Baytown Facility ) under Section 114 of the Clean Air Act as to construction and modification activities at each of these facilities over a period of years. These information requests will enable the EPA to determine whether these facilities are in compliance with certain provisions of the Clean Air Act. In connection with a review by our Chemical Business of these facilities in obtaining information for the EPA pursuant to the EPA's request, our Chemical Business management believes, subject to further review, investigation and discussion with the EPA, that certain facilities within our Chemical Business may be required to make certain capital improvements to certain emission equipment in order to comply with the requirements of the Clean Air Act. If changes to the production equipment at these facilities are required in order to bring this equipment into compliance with the Clean Air Act, the type of emission control equipment that might be required is unknown and, as a result, the amount of capital expenditures necessary in order to bring the equipment into compliance is unknown at this time but could be substantial.

Further, if it is determined that the equipment at any of our chemical facilities has not met the requirements of the Clean Air Act, our Chemical Business could be subject to penalties in an amount not to exceed \$27,500 per day as to each facility not in compliance and be required to retrofit each facility with the best available control technology. We are currently unable to determine the amount (or range of amounts) of any penalties that may be assessed by the EPA. Therefore no liability has been established at September 30, 2011, in connection with this matter.

**3. Other Environmental Matters**

In 2002, two subsidiaries within our Chemical Business, sold substantially all of their operating assets relating to a Kansas chemical facility ( Hallowell Facility ) 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, our subsidiary leased the real property to the buyer under a triple net long-term lease agreement. However, our subsidiary retained the obligation to be responsible for, and perform the activities under, a previously executed consent order to investigate the surface and subsurface contamination at the real property and a corrective action strategy based on the investigation. In addition, certain of our subsidiaries agreed to indemnify the buyer of such assets for these environmental matters. Based on the assessment discussed above, we account for transactions associated with the Hallowell Facility as discontinued operations.

The successor ( Chevron ) of a prior owner of the Hallowell Facility has agreed in writing, within certain limitations, to pay and has been paying one-half of the costs of the interim measures relating to this matter as approved by the Kansas Department of Environmental Quality, subject to reallocation.

Our subsidiary and Chevron are pursuing a course with the state of Kansas of long-term surface and groundwater monitoring to track the natural decline in contamination. Currently, our subsidiary and Chevron are in the process of performing additional surface and groundwater testing. We have accrued for our allocable portion of costs for the additional testing, monitoring and risk assessments that could be reasonably estimated.

In addition, the Kansas Department of Health and Environment ( KDHE ) notified our subsidiary and Chevron that the Hallowell Facility has been referred to the KDHE's Natural Resources Trustee, who is to consider and recommend restoration, replacement and/or whether to seek compensation. KDHE will consider the recommendations in their evaluation.

Currently, it is unknown what damages, if any, the KDHE would claim, if any. The ultimate required remediation, if any, is unknown. The nature and extent of a portion of the requirements are not currently defined and the associated costs (or range of costs) are not reasonably estimable.

At September 30, 2011, our estimated allocable portion of the total estimated liability (which is included in current accrued and other liabilities) related to the Hallowell Facility is \$165,000. The estimated amount is not discounted to

its present value. It is reasonably possible that a change in the estimate of our liability could occur in the near term.

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

**Note 10: Commitments and Contingencies (continued)**

**B. Other Pending, Threatened or Settled Litigation**

**The Jayhawk Group**

In November 2006, we entered into an agreement with Jayhawk Capital Management, LLC, Jayhawk Investments, L.P., Jayhawk Institutional Partners, L.P. and Kent McCarthy, the manager and sole member of Jayhawk Capital, (collectively, the Jayhawk Group), in which the Jayhawk Group agreed, among other things, that if we undertook, in our sole discretion, within one year from the date of agreement a tender offer for our Series 2 \$3.25 convertible exchangeable Class C preferred stock ( Series 2 Preferred ) or to issue our common stock for a portion of our Series 2 Preferred pursuant to a private exchange, that they would tender or exchange an aggregate of no more than 180,450 shares of the 340,900 shares of the Series 2 Preferred beneficially owned by the Jayhawk Group, subject to, among other things, the entities owned and controlled by Jack E. Golsen, our chairman and chief executive officer ( Golsen ), and his immediate family, that beneficially own Series 2 Preferred only being able to exchange or tender approximately the same percentage of shares of Series 2 Preferred beneficially owned by them as the Jayhawk Group was able to tender or exchange under the terms of the agreement.

During 2007, we made a tender offer for our outstanding Series 2 Preferred at the rate of 7.4 shares of our common stock for each share of Series 2 Preferred so tendered. In July 2007, we redeemed the balance of our outstanding shares of Series 2 Preferred. Pursuant to its terms, the Series 2 Preferred was convertible into 4.329 shares of our common stock for each share of Series 2 Preferred. As a result of the redemption, the Jayhawk Group converted the balance of its Series 2 Preferred pursuant to the terms of the Series 2 Preferred in lieu of having its shares redeemed.

The Jayhawk Group has filed suit against us and Golsen alleging that the Jayhawk Group should have been able to tender all of its Series 2 Preferred pursuant to the tender offer, notwithstanding the above-described agreement, based on the following claims against us and Golsen:

- fraudulent inducement and fraud,
- violation of 10(b) of the Exchange Act and Rule 10b-5,
- violation of 17-12A501 of the Kansas Uniform Securities Act, and
- breach of contract.

The Jayhawk Group seeks damages up to \$12 million based on the additional number of common shares it allegedly would have received on conversion of all of its Series 2 Preferred through the February 2007 tender offer, plus punitive damages. In May 2008, the General Counsel for the Jayhawk Group offered to settle its claims against us and Golsen in return for a payment of \$100,000, representing the approximate legal fees it had incurred investigating the claims at that time. Through counsel, we verbally agreed to the settlement offer and confirmed the agreement by e-mail. Afterward, the Jayhawk Group's General Counsel purported to withdraw the settlement offer, and asserted that Jayhawk is not bound by any settlement agreement. We contend that the settlement agreement is binding on the Jayhawk Group. We intend to contest the lawsuit vigorously, and have asserted that Jayhawk is bound by an agreement to settle the claims for \$100,000. On April 28, 2011, the court granted Golsen's summary judgment motion, and dismissed all claims against Golsen. During September 2011, this case was tried before the court in the United States District Court for the District of Kansas. We are awaiting the court's decision in this matter. Our insurer, Chartis, a subsidiary of AIG, has agreed to defend this lawsuit on our behalf and on behalf of Golsen and to indemnify under a reservation of rights to deny liability under certain conditions. We have incurred expenses associated with this matter up to our insurance deductible of \$250,000, and our insurer is paying defense costs in excess of our deductible in this matter. Although our insurer is defending this matter under a reservation of rights, we are not currently aware of any material issue in this case that would result in our insurer denying coverage. Therefore, no liability has been established at September 30, 2011 as a result of this matter.

**Pryor Chemical Company**

A subsidiary within our Chemical Business, Pryor Chemical Company ( PCC ) has filed lawsuits against certain vendors of PCC related to work performed during the start-up of the Pryor Facility. The claims allege certain damages

resulting from improperly performed work by the vendors and for lost profits and other costs due to delays in restarting the Pryor Facility. The total amount for damages and lost profits claimed is substantial but the amount and timing of the ultimate recovery is uncertain. As a result, any recovery from litigation or settlement of these claims is a gain contingency and will be recognized if, and when, realized or realizable and earned.

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

**Note 10: Commitments and Contingencies (continued)****Other Claims and Legal Actions**

We are also involved in various other claims and legal actions including claims for damages resulting from water leaks related to our Climate Control products and other product liability occurrences. Most of the product liability claims are covered by our general liability insurance, which generally includes a deductible of \$250,000 per claim. For any claims or legal actions that we have assessed the likelihood of our liability as probable, we have recognized our estimated liability up to the applicable deductible. At September 30, 2011, our accrued general liability insurance claims were \$1,145,000 and are included in accrued and other liabilities. It is possible that the actual development of claims could be different than our estimates but, after consultation with legal counsel, if those general liability insurance claims for which we have not recognized a liability were determined adversely to us, it would not have a material effect on our business, financial condition or results of operations.

**Note 11: Derivatives, Hedges, Financial Instruments and Carbon Credits** We have three classes of contracts that are accounted for on a fair value basis, which are commodities futures/forward contracts ( commodities contracts ), foreign exchange contracts and interest rate contracts as discussed below. All of these contracts are used as economic hedges for risk management purposes but are not designated as hedging instruments. In addition as discussed below, periodically we are issued carbon credits, which a certain portion of the carbon credits are to be sold and the proceeds given to Bayer Material Science LLC ( Bayer ). The carbon credits are accounted for on a fair value basis as discussed below. Also the contractual obligations associated with these carbon credits are accounted for on a fair value basis (as discussed below) unless we enter into a firm sales commitment to sell the carbon credits as discussed in Note 1 Summary of Significant Accounting Policies. The valuations of these assets and liabilities were 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.

The valuations of contracts classified as Level 1 are based on quoted prices in active markets for identical contracts. The valuations of contracts classified as Level 2 are based on quoted prices for similar contracts and valuation inputs other than quoted prices that are observable for these contracts. At September 30, 2011, the valuations of contracts classified as Level 2 related to interest rate swap contracts. For interest rate swap contracts, we utilize valuation software and market data from a third-party provider. These interest rate contracts are valued using a discounted cash flow model that calculates the present value of future cash flows pursuant to the terms of the contracts and using market information for forward interest-rate yield curves. The valuation inputs included the total contractual weighted-average pay rate of 3.29% and the total estimated market weighted-average receive rate of 1.06%. No valuation input adjustments were considered necessary relating to nonperformance risk for the contracts. The valuations of assets and liabilities classified as Level 3 are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. At September 30, 2011, the valuations (\$1.50 per carbon credit) of the carbon credits and the contractual obligations associated with these carbon credits are classified as Level 3 and are based on the range of ask/bid prices (\$1.50 to \$3.00) per carbon credit obtained from a broker involved in this low volume market, pricing terms included in sales agreements entered into during the first nine months of 2011, and inquiries from market participants concerning our listed ask price through a broker. The valuations are using undiscounted cash flows based on management's assumption that the carbon credits would be sold and the associated contractual obligations would be extinguished in the near term.

In addition, no valuation input adjustments were considered necessary relating to nonperformance risk for the carbon credits and associated contractual obligations. At December 31, 2010, the valuations (\$3.25 per carbon credit) of contracts classified as Level 3 related to carbon credits and contractual obligations associated with these carbon credits.

**Commodities Contracts**

Raw materials for use in our manufacturing processes include copper used by our Climate Control Business and anhydrous ammonia 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. At December 31, 2010, our futures/forward copper contracts were for 750,000 pounds of copper through May 2011 at a weighted-average cost of \$3.75 per pound. At September 30, 2011, our futures/forward copper contracts were for 375,000 pounds of copper through December 2011 at a weighted-average cost of \$4.44 per pound. At December 31, 2010, our futures/forward natural gas contracts were for 800,000 MMBtu of natural gas through February 2011 at a weighted-average cost of \$4.10 per MMBtu. At September 30, 2011, we did not have any futures/forward natural gas contracts. 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, Financial Instruments and Carbon Credits (continued)**

**Foreign Exchange Contracts**

One of our business operations purchases industrial machinery and related components from vendors outside of the United States. As part of our foreign currency risk management, we periodically enter into foreign exchange contracts, which set the U.S. Dollar/Euro exchange rates. These contracts are free-standing derivatives and are accounted for on a mark-to-market basis. At December 31, 2010, our foreign exchange contracts were for the receipt of approximately 783,000 Euros through June 2011 and for the payment of approximately 110,000 Euros through March 2011, at the total contractual weighted-average exchange rate of 1.26 (U.S. Dollar/Euro). At September 30, 2011, we did not have any foreign exchange contracts. The cash flows relating to these contracts are included in cash flows from continuing operating activities.

**Interest Rate Contracts**

As part of our interest rate risk management, we periodically purchase and/or enter into various interest rate contracts. In April 2008, we 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 acquired an interest rate swap at a cost basis of \$0.4 million, which sets a fixed three-month LIBOR rate of 3.595% on \$25 million and matures in April 2012. In February 2011, we entered into an interest rate swap at no cost, which sets a fixed three-month LIBOR rate of 3.23% on a declining balance (from \$23.8 million to \$18.8 million) for the period beginning in April 2012 through March 2016.

These contracts are free-standing derivatives and are accounted for on a mark-to-market basis. During the nine months ended September 30, 2011 and 2010, no cash flows occurred relating to the purchase or sale of interest rate contracts. The cash flows associated with the interest rate swap payments are included in cash flows from continuing operating activities.

**Carbon Credits and Associated Contractual Obligation**

During December 2010 and May 2011, we were issued carbon credits by the Climate Action Reserve in relation to a greenhouse gas reduction project ( Project ) performed at the Baytown Facility. Pursuant to the terms of the agreement with Bayer (the Bayer Agreement ), a certain portion of the carbon credits are to be used to recover the costs of the Project, and any balance thereafter to be allocated between Bayer and EDN. We have no obligation to reimburse Bayer for their costs associated with the Project, except through the transfer or sale of the carbon credits when such credits are issued to us. The carbon credits are accounted for on a fair value basis and the contractual obligations associated with these carbon credits are also accounted for on a fair value basis (unless we enter into a firm sales commitment to sell the carbon credits). At December 31, 2010, we had approximately 198,000 carbon credits, all of which were subject to contractual obligations. At September 30, 2011, we had a minimal amount of carbon credits, all of which were subject to contractual obligations. The cash flows associated with the carbon credits and the associated contractual obligations are included in cash flows from continuing investing activities.

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

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

The following details our assets and liabilities that are measured at fair value on a recurring basis at September 30, 2011 and December 31, 2010:

Description	Fair Value Measurements at September 30, 2011 Using					Total Fair Value at December 31, 2010
	Total Fair Value at September 30, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2) (In Thousands)	Significant Unobservable Inputs (Level 3)	Total Fair Value at September 30, 2011	
Assets						
Supplies, prepaid items and other:						
Commodities contracts	\$	\$	\$	\$	\$	761
Carbon credits	7			7		644
Foreign exchange contracts						49
<b>Total</b>	<b>\$ 7</b>	<b>\$</b>	<b>\$</b>	<b>\$ 7</b>	<b>\$</b>	<b>1,454</b>
Liabilities						
Current and noncurrent accrued and other liabilities:						
Commodities contracts	\$ 482	\$ 482	\$	\$	\$	
Contractual obligations - carbon credits	7			7		644
Interest rate contracts	2,530		2,530			1,895
<b>Total</b>	<b>\$ 3,019</b>	<b>\$ 482</b>	<b>\$ 2,530</b>	<b>\$ 7</b>	<b>\$</b>	<b>2,539</b>

During the nine months ended September 30, 2011 and 2010, none of our assets or liabilities measured at fair value on a recurring basis transferred between Level 1 and Level 2 classifications. In addition, the following is a reconciliation of the beginning and ending balances for assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the nine and three months ended September 30, 2011 (not applicable for the nine and three months ended September 30, 2010):

	Nine Months Ended September 30, 2011		Three Months Ended September 30, 2011	
	Assets	Liabilities	Assets	Liabilities
	(In Thousands)			
Beginning balance	\$ 644	\$ (644)	\$ 9	\$ (7)

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Transfers into Level 3					
Transfers out of Level 3					
Total realized and unrealized gain (loss) included in earnings	1,028	(936)	(2)		
Purchases					
Issuances					
Sales	(1,665)				
Settlements		1,573			
Ending balance	\$ 7	\$ (7)	\$ 7	\$ (7)	

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

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

Realized and unrealized net losses included in earnings and the income statement classifications are as follows:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2011	2010	2011	2010
	(In Thousands)			
Total net gains (losses) included in earnings:				
Cost of sales    Commodities contracts	\$     (624)	\$     (764)	\$     (430)	\$     140
Cost of sales    Foreign exchange contracts	46	42		66
Other income    Carbon credits	1,028		(2)	
Other expense    Contractual obligations relating to carbon credits	(936)			
Interest expense    Interest rate contracts	(1,825)	(1,512)	(799)	(375)
	\$   (2,311)	\$   (2,234)	\$   (1,231)	\$     (169)

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2011	2010	2011	2010
	(In Thousands)			
Change in unrealized gains (losses) relating to contracts still held at period end:				
Cost of sales    Commodities contracts	\$     (482)	\$     141	\$     (430)	\$     342
Other income    Carbon credits	7	66	(2)	66
Other expense    Contractual obligations relating to carbon credits	(7)			
Interest expense    Interest rate contracts	(635)	(344)	(395)	4
	\$   (1,117)	\$     (137)	\$     (827)	\$     412

The following discussion of fair values is not indicative of the overall fair value of our assets and liabilities since it does not include all assets, including intangibles.

Our long-term debt agreements are the only financial instruments with fair values significantly different from their carrying amounts. At September 30, 2011 and December 31, 2010, the fair value for variable interest rate debt (excluding the secured term loan at December 31, 2010) is believed to approximate their carrying value. At December 31, 2010, the estimated fair value of the secured term loan is based on defined LIBOR rates plus 6% utilizing information obtained from the lender. The fair values of fixed interest rate borrowings, other than the 2007 Debentures, are estimated using a discounted cash flow analysis that applies interest rates currently being offered on borrowings of similar amounts and terms to those currently outstanding while also taking into consideration our current credit worthiness. At September 30, 2011, the estimated fair value of the 2007 Debentures is based on the conversion rate and market price of LSB common stock. At December 31, 2010, the estimated fair value of the 2007 Debentures is based on quoted prices obtained from a broker for these debentures.



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

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

The estimated fair value and carrying value of our long-term debt are as follows:

	September 30, 2011		December 31, 2010	
	Estimated Fair Value	Carrying Value	Estimated Fair Value	Carrying Value
	(In Thousands)			
<b>Variable Interest Rate:</b>				
Secured Term Loan (1)	\$ 73,125	\$ 73,125	\$ 26,721	\$ 48,773
Working Capital Revolver Loan				
Other debt (2)			2,437	2,437
<b>Fixed Interest Rate:</b>				
5.5% Convertible Senior Subordinated Notes	522	500	27,976	26,900
Other bank debt and equipment financing	9,631	9,679	17,251	17,282
	\$ 83,278	\$ 83,304	\$ 74,385	\$ 95,392

(1) Includes a fixed interest rate of 5.15% on the principal amount of \$24.4 million at September 30, 2011.

(2) At December 31, 2010, the balance includes a variable interest rate debt agreement with a minimum interest rate of 6%, which interest rate was 6%.

**Note 12: Income Taxes** Provisions for income taxes are as follows:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2011	2010	2011	2010
	(In Thousands)			
<b>Current:</b>				
Federal	\$ 24,497	\$ 5,059	\$ 2,583	\$ 586
State	6,869	1,437	1,200	263
Total current provisions	\$ 31,366	\$ 6,496	\$ 3,783	\$ 849
<b>Deferred:</b>				
Federal	\$ 1,932	\$ 2,026	\$ 554	\$ 1,800
State	284	299	96	281
Total deferred provisions	2,216	2,325	650	2,081
Provisions for income taxes	\$ 33,582	\$ 8,821	\$ 4,433	\$ 2,930

For the nine and three months ended September 30, 2011 and 2010, the current provision for federal income taxes shown above includes regular federal income tax after the consideration of permanent and temporary differences between income for GAAP and tax purposes. For the nine and three months ended September 30, 2011 and 2010, the

current provision for state income taxes shown above includes regular state income tax and provisions for uncertain state income tax positions. At December 31, 2010, we have remaining state tax net operating loss ( NOL ) carryforwards of approximately \$7,200,000 that begin expiring in 2011.

Our annual estimated effective tax rate for 2011 includes the impact of permanent tax differences, such as the domestic manufacturer's deduction, the advanced energy credit and other permanent items.

During June 2010, we determined that certain nondeductible expenses had not been properly identified relating to the 2007-2009 provisions for income taxes. As a result, we recorded an additional income tax provision of approximately \$800,000 for the nine months ended September 30, 2010. For the nine months ended September 30, 2010, the effect of this adjustment decreased basic and diluted net income per share by \$.04. Management of the Company evaluated the impact of this accounting error and concluded the effect of this adjustment was immaterial to our 2007-2010 consolidated financial statements.

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

**Note 12: Income Taxes (continued)**

The tax provision for the nine months ended September 30, 2011 and 2010 was \$33,582,000 (37% of pre-tax income) and \$8,821,000 (43% of pre-tax income), respectively.

We had approximately \$764,000 and \$700,000 accrued for uncertain tax liabilities at September 30, 2011 and December 31, 2010, respectively, which are included in current and noncurrent accrued and other liabilities.

LSB and certain of its subsidiaries file income tax returns in the U.S. federal jurisdiction and various state jurisdictions. With few exceptions, the 2008-2010 years remain open for all purposes of examination by the U.S. Internal Revenue Service ( IRS ) and other major tax jurisdictions. Currently we are under examination by the IRS and certain state tax authorities for the tax years 2007-2010.

**Note 13: Other Expense, Other Income and Non-Operating Other Income (Expense), net**

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2011	2010	2011	2010
	(In Thousands)			
<b>Other expense:</b>				
Losses on sales and disposals of property and equipment	\$ 996	\$ 508	\$ 101	\$ 249
Loss on contractual obligations associated with carbon credits	936			
Other miscellaneous expense (1)	600	67	48	24
Total other expense	\$ 2,532	\$ 575	\$ 149	\$ 273
<b>Other income:</b>				
Gain on carbon credits	\$ 1,028	\$	\$ (2)	\$
Settlements of litigation and potential litigation (2)	757			
Property insurance recoveries in excess of losses incurred (3)		3,982		3,243
Miscellaneous income (1)	250	197	60	30
Total other income	\$ 2,035	\$ 4,179	\$ 58	\$ 3,273
<b>Non-operating other income (expense), net:</b>				
Interest income	\$ 61	\$ 107	\$ 20	\$ 30
Miscellaneous income (1)		1		1
Miscellaneous expense (1)	(58)	(60)	(22)	(21)
Total non-operating other income (expense), net	\$ 3	\$ 48	\$ (2)	\$ 10

(1) Amounts represent numerous unrelated transactions, none of which are individually significant requiring separate disclosure.

(2)

Amount relates primarily to the Chemical Business relating to a lawsuit filed in 2009 by Cherokee Nitrogen Company ( CNC ) against a vendor, which alleged that CNC suffered property damages and lost income as a result of the vendor's negligence in installing certain equipment at the Cherokee Facility. In January 2011, a settlement at mediation was finalized, which included a payment to CNC of \$735,000.

(3) Amount relates to recoveries from property insurance claims associated with our Chemical Business.

**Note 14: Business Interruption Insurance Claim and Recovery** In June 2010, a pipe failure in the primary reformer of the ammonia plant at the Pryor Facility resulted in a fire that damaged the ammonia plant. The fire was immediately extinguished and there were no injuries. As a result of this damage, the Pryor Facility was unable to produce anhydrous ammonia or urea ammonium nitrate ( UAN ) during substantially all of third quarter of 2010. Our insurance policy provides for business interruption coverage for certain lost profits and extra expense with a 30-day waiting period. Therefore, we filed an insurance claim for business interruption. During the nine months ended September 30, 2011, we recognized an insurance recovery of \$8.6 million relating to this business interruption claim, which was recorded as a reduction to cost of sales. As of September 30, 2011, we do not have any remaining insurance claims associated with our business interruption coverage relating to this event.

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

**Note 15: Segment Information**

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2011	2010	2011	2010
	(In Thousands)			
Net sales:				
Climate Control	\$ 212,628	\$ 178,045	\$ 71,804	\$ 64,546
Chemical (1)	369,820	253,828	102,769	72,578
Other	7,444	5,877	2,207	1,824
	\$ 589,892	\$ 437,750	\$ 176,780	\$ 138,948
Gross profit: (2)				
Climate Control	\$ 67,689	\$ 60,195	\$ 22,808	\$ 22,964
Chemical (1)	89,789	30,631	10,677	5,871
Other	2,719	2,027	772	604
	\$ 160,197	\$ 92,853	\$ 34,257	\$ 29,439
Operating income: (3)				
Climate Control	\$ 26,357	\$ 22,632	\$ 8,738	\$ 10,112
Chemical (1)	78,923	12,310	7,105	1,247
General corporate expenses and other business operations, net (4)	(10,477)	(9,246)	(3,351)	(2,889)
	94,803	25,696	12,492	8,470
Interest expense	(5,481)	(5,943)	(1,901)	(1,864)
Losses on extinguishment of debt	(136)	(52)		
Non-operating other income (expense), net:				
Climate Control	1	1		
Chemical	1	6		1
Corporate and other business operations	1	41	(2)	9
Provisions for income taxes	(33,582)	(8,821)	(4,433)	(2,930)
Equity in earnings of affiliate-Climate Control	375	719	168	191
Income from continuing operations	\$ 55,982	\$ 11,647	\$ 6,324	\$ 3,877

- (1) During most of the first nine months of 2011, the Pryor Facility had sustained production of anhydrous ammonia and UAN compared to limited production during the first nine months of 2010. For the nine and three months ended September 30, 2011, the Pryor Facility had net sales to unrelated third parties of \$63.3 million and \$10.5 million, respectively and operating income of \$30.6 million and \$0.1 million, respectively, resulting from those sales and an insurance recovery of \$8.6 million recognized during the first nine months of 2011 relating to a business interruption claim, which was recorded as a reduction to cost of sales. In addition for the nine and three

months ended September 30, 2011, the Chemical Business realized a net benefit of \$4.4 million and \$0.6 million, respectively, from the utilization by our other facilities of lower cost ammonia produced at the Pryor Facility. For the nine and three months ended September 30, 2010, the Pryor Facility had net sales to unrelated third parties of \$7.8 million and \$1.8 million and an operating loss of \$11.2 million and \$3.2 million, respectively. Due to limited and intermittent production at the Pryor Facility during the first nine months of 2010, most of its operating loss related to nonproduction-related expenses incurred and were classified as selling, general and administrative expenses ( SG&A ).

- (2) Gross profit by business segment represents net sales less cost of sales. Gross profit classified as Other relates to the sales of industrial machinery and related components.
- (3) Our chief operating decision makers use operating income by business segment for purposes of making decisions, which include resource allocations and performance evaluations. Operating income by business segment represents gross profit by business segment less SG&A incurred by each business segment plus other income and other expense earned/incurred by each business 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.

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

**Note 15: Segment Information (continued)**

- (4) 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		Three Months Ended	
	September 30,		September 30,	
	2011	2010	2011	2010
	(In Thousands)			
Gross profit-Other	\$ 2,719	\$ 2,027	\$ 772	\$ 604
Selling, general and administrative:				
Personnel costs	(6,338)	(6,054)	(2,187)	(1,787)
Professional fees	(3,046)	(3,105)	(957)	(1,180)
All other	(3,420)	(2,333)	(909)	(682)
Total selling, general and administrative	(12,804)	(11,492)	(4,053)	(3,649)
Other income	102	230	26	160
Other expense	(494)	(11)	(96)	(4)
Total general corporate expenses and other business operations, net	\$ (10,477)	\$ (9,246)	\$ (3,351)	\$ (2,889)

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

	September	
	30, 2011	December 31, 2010
	(In Thousands)	
Climate Control	\$ 122,790	\$ 112,894
Chemical	215,294	179,033
Corporate assets and other	132,276	96,054
Total assets	\$ 470,360	\$ 387,981

**Note 16: Related Party Transactions****Golsen Group**

In January 2010, we paid interest of \$137,500 relating to \$5,000,000 of the 2007 Debentures held by the Golsen Group that was accrued at December 31, 2009. In March 2010, we paid dividends totaling \$300,000 on our Series B Preferred and our Series D Preferred, all of the outstanding shares of which are owned by the Golsen Group. During the nine months ended September 30, 2010, we incurred interest expense of \$206,250 relating to the debentures held by the Golsen Group, of which \$137,500 was paid in June 2010.

In January 2011, we paid interest of \$137,500 relating to the debentures held by the Golsen Group that was accrued at December 31, 2010. In March 2011, we paid dividends totaling \$300,000 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 2011, the Golsen Group

sold \$3,000,000 of the 2007 Debentures it held to a third party. In July 2011, the Golsen Group converted \$2,000,000 of the 2007 Debentures into 72,800 shares of LSB common stock in accordance with the terms of the 2007 Debentures. During the nine months ended September 30, 2011, we incurred interest expense of \$60,500 relating to the \$2,000,000 of the 2007 Debentures that was held by the Golsen Group, of which \$55,000 was paid in June 2011 and the remaining amount was forfeited and credited to capital in excess of par value as the result of the conversion. In addition in July 2011, the Golsen Group converted an \$8,000 convertible promissory note into 4,000 shares of LSB common stock in accordance with the terms of such note.

The Series B Preferred and Series D Preferred are non-redeemable preferred stocks issued in 1986 and 2001, respectively.

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

**Note 16: Related Party Transactions (continued)****Landmark Transactions**

As approved by a special committee of our board of directors, in May 2011, Prime Financial L.L.C. ( Prime ), a subsidiary of LSB, entered into an agreement (the First Purchase Agreement ) to purchase from Landmark Land Company, Inc. ( Landmark ) certain undeveloped real estate located in Oklahoma City, Oklahoma (the Oklahoma Real Estate ) for the purchase price of \$2,250,000, which transaction was consummated in June 2011. The First Purchase Agreement grants Prime put options to sell the Oklahoma Real Estate to Landmark or to Gerald G. Barton ( Barton ), who is the chief executive officer and a substantial stockholder of Landmark. The put option may be exercised during the sixth year following Prime s purchase of the Oklahoma Real Estate. If a put option is exercised, the purchase price for the Oklahoma Real Estate will be \$2,250,000, plus a premium equal to a simple 10% annual return on the purchase price beginning as of the closing of the First Purchase Agreement, subject to certain adjustments. For financial reporting purposes, no value from the purchase price was allocated to the put options because the appraised value of the Oklahoma Real Estate exceeded the purchase price.

As approved by a special committee of our board of directors, in September 2011, Prime entered into an agreement (the Second Purchase Agreement ) to purchase from Landmark certain undeveloped real estate located in Laguna Vista, Texas (the Texas Real Estate ) for the purchase price of \$2,500,000, which transaction is expected to consummate during the fourth quarter of 2011. The Second Purchase Agreement grants Prime put options to sell the Texas Real Estate to Landmark or to Barton. The put option may be exercised during the sixth year following Prime s purchase of the Texas Real Estate. If a put option is exercised, the purchase price for the Texas Real Estate will be \$2,500,000, plus a premium equal to a simple 10% annual return on the purchase price beginning as of the closing of the Second Purchase Agreement, subject to certain adjustments. The Second Purchase Agreement also grants Prime warrants to purchase up to 1,000,000 shares of Landmark s common stock, at \$1.00 per share. The right of Prime to acquire Landmark shares under any unexercised warrants shall terminate on the completed exercise of the put options. Landmark has also agreed to enter into a separate agreement at the closing to use its reasonable efforts to use, where technically feasible, geothermal heating and air conditioning units manufactured by one of the LSB s subsidiaries on other Landmark properties in the development where the Texas Real Estate is located.

Jack E. Golsen ( Golsen ), our chairman of the board of directors and chief executive officer and another individual previously formed a limited liability company ( LLC ), and each contributed \$1,000,000 to the LLC. The LLC subsequently loaned Landmark approximately \$2,000,000. In March 2011, Golsen sold his membership interest in the LLC to Barton in consideration for a promissory note in the principal amount of approximately \$1,100,000, representing the amount that Golsen had invested in the LLC, plus interest (the Barton Note ). The Barton Note was due and payable in June 2011. Pursuant to the terms of the First and Second Purchase Agreements, until the expiration of the put options, no payment will be made on the Barton Note and payment of the amounts owing under the Barton Note will be subordinate to any amounts owing Prime upon the exercise of a put option. Further, Golsen has agreed under the Second Purchase Agreement that no portion of the purchase price shall be used by Landmark to repay any indebtedness owing to Golsen.

In addition, Bernard Ille, one of our directors, served as a director of Landmark for many years until he resigned in March 2011. In light of the Barton Note and Mr. Ille s past relationship with Landmark, our board of directors appointed a special committee for the purpose of reviewing and determining whether the LSB should purchase the Oklahoma and Texas Real Estate. Also the special committee believed, based on an analysis of a real estate consultant, that the price that we were to pay for the properties approximated the market value, and also believed that these properties, when developed, have the potential to establish a model geothermal community.

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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, 2011 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**

LSB is a manufacturing, marketing and engineering company operating through our subsidiaries. LSB and its wholly-owned subsidiaries own the following core businesses:

Climate Control Business manufactures and sells a broad range of air conditioning and heating products in the niche markets we serve consisting of geothermal and water source heat pumps, hydronic fan coils, large custom air handlers, modular geothermal chillers and other related products used to control the environment in commercial/institutional and residential new building construction, renovation of existing buildings and replacement of existing systems. For the first nine months of 2011, approximately 36% of our consolidated net sales relates to the Climate Control Business.

Chemical Business manufactures and sells nitrogen based chemical products produced from four facilities located in El Dorado, Arkansas; Cherokee, Alabama; Pryor, Oklahoma; and Baytown, Texas for the agricultural, industrial and mining markets. Our products include high purity and commercial grade anhydrous ammonia, industrial and fertilizer grade ammonium nitrate ( AN ), UAN, sulfuric acids, nitric acids in various concentrations, nitrogen solutions, DEF and various other products. For the first nine months of 2011, approximately 63% of our consolidated net sales relates to the Chemical Business.

During most of the first nine months of 2011, the Pryor Facility had sustained production of anhydrous ammonia and UAN compared to limited production during the first nine months of 2010. Also as discussed below under Chemical Business , during the third quarter of 2011, planned major maintenance activities ( Turnarounds ) were performed at the Pryor, Cherokee, and El Dorado Facilities, which along with unplanned maintenance downtime, resulted in lower production, fixed overhead absorption and sales for the quarter.

**Economic Conditions**

Since our two core business segments serve several diverse markets, we consider market fundamentals for each market individually as we evaluate economic conditions.

Climate Control Business Sales for the first nine months of 2011 were 19% higher than the same period in 2010, including a 64% increase in hydronic fan coil sales, an 11% increase in geothermal and water source heat pump sales, and a 14% increase in other HVAC sales. From a market sector perspective, the increase is due to a 28% improvement in commercial/institutional product sales partially offset by a 6% decrease in residential product sales. The improvement in commercial/institutional sales was in all major product lines and was primarily related to the increased backlog of customer orders for our products entering into 2011 resulting from increases in the level of customer orders in prior quarters. For the first nine months of 2011, sales and order levels of our residential products decreased from the comparable period in 2010 reflecting the slowdown in new residential construction. The latest information available from the Construction Market Forecasting Service provided by McGraw-Hill ( CMFS ) indicates that in 2011 both commercial/institutional construction and residential construction sectors we serve are expected to decline slightly from 2010 levels. The National Architectural Billings Index published by American Institute of Architects ( AIA ) continues to swing between increasing and decreasing design activity with no significant developing trends due to the weak economy.

Chemical Business Our Chemical Business primary markets are agricultural, industrial and mining. During the first nine months of 2011, approximately 56% of our Chemical Business sales were into industrial and mining markets of which approximately 64% of these sales are to customers that have contractual obligations to purchase a minimum quantity or allow us to recover our cost plus a profit, irrespective of the volume of product sold. During the first nine months of 2011, customer demand for our industrial products increased over the same period in 2010. However, we

have begun to see some softening of demand for certain of our industrial chemical and agricultural grade AN products during the recent weeks, which could result in a reduction to the operating rates at the El Dorado Facility in the fourth quarter.

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The remaining 44% of our Chemical Business sales in the first nine months of 2011 were made into the agricultural fertilizer markets to customers that primarily purchase at spot market prices and not pursuant to contractual pricing arrangements. Our agricultural sales volumes and prices depend upon the supply of and the demand for fertilizer, which in turn depends on the market fundamentals for crops including corn, wheat, cotton and forage. The current outlook according to most market indicators, including reports in Green Markets, Fertilizer Week and the USDA's World Agricultural Supply and Demand Estimates, point to positive supply and demand fundamentals for the types of nitrogen fertilizer products we produce and sell. However, it is possible that the fertilizer outlook could change if there are unanticipated changes in commodity prices, acres planted or unfavorable weather conditions. Our Cherokee and Pryor Facilities produce anhydrous ammonia from natural gas and UAN from ammonia. During the first nine months of 2011, agricultural customer demand for and the selling prices of ammonia and UAN continued to increase while natural gas prices were generally lower compared to the same period of 2010. As a result, gross profit increased significantly at these two facilities. On the other hand, our El Dorado Facility is at a current cost disadvantage for their agricultural grade AN, which is produced from purchased ammonia, compared to competitive product produced from natural gas. Based on Fertecon and FMB Ammonia reports, purchased ammonia is in tight supply globally and the U.S. Tampa price increased significantly in the third quarter and is expected to continue to increase in the fourth quarter. Currently, certain of the El Dorado Facility's mid-south market area for agricultural grade AN remains in a drought condition, which is negatively affecting customer demand for that product. As a result, we are shipping agricultural grade AN to other freight logical markets and are attempting to divert production capacity to other products to help mitigate the negative effects of the drought.

**Results for the Third Quarter of 2011**

Our consolidated net sales for the third quarter of 2011 were \$176.8 million compared to \$138.9 million for the same period in 2010. The sales increase of approximately \$37.9 million includes an increase of \$30.2 million in our Chemical Business and an increase of \$7.3 million in our Climate Control Business.

Our Chemical Business operating income increased \$5.9 million to \$7.1 million. Our Climate Control Business operating income decreased \$1.4 million to \$8.7 million.

Our resulting effective income tax rate for the third quarter of 2011 was approximately 41% compared to 44% for the third quarter of 2010.

**Climate Control Business**

Our Climate Control sales for the third quarter of 2011 were \$71.8 million, or \$7.3 million higher than the same period of 2010, comprised of approximately \$2.5 million increase in geothermal and water source heat pump sales and a \$5.3 million increase in hydronic fan coil sales, partially offset by a \$0.5 million decrease in other HVAC sales. From a market sector perspective, there was a \$9.3 million improvement in commercial/institutional product sales partially offset by an approximately \$2.0 million decrease in residential product sales. The improvement in the commercial/institutional sector of our business is primarily attributable to a higher beginning backlog. The decline in the residential sector is related to the soft housing market.

We continue to closely follow economic indicators and have attempted to assess the impact on the commercial/institutional and residential construction sectors that we serve, including, but not limited to, new construction and/or renovation of facilities in the following sectors:

- Education
- Single-Family Residential
- Multi-Family Residential
- Healthcare
- Hospitality
- Government/Public
- Retail

- Industrial



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During the third quarter of 2011, approximately 79% of our Climate Control Business sales were to the commercial/institutional and multi-family construction markets, and the remaining 21% were sales of geothermal heat pumps ( GHPs ) to the single-family residential market.

For the third quarter of 2011, the product order intake level was \$65.7 million as compared to \$64.3 million for the second quarter of 2011; \$71.6 million for the first quarter of 2011; \$61.3 million for the fourth quarter of 2010; and \$67.5 million for the third quarter of 2010. For the third quarter of 2011, product orders for commercial/institutional products decreased 4% whereas residential product orders increased 2% as compared to the same period of 2010. Order levels between quarters may be uneven and should not be taken as a strong indication of either deterioration or improvement in a particular sector that we serve, although, in general, our order levels reflect the slowdown in the economic recovery. Our product order level consists of confirmed purchase orders from customers that have been accepted and received credit approval.

Our order backlog was \$48.4 million at September 30, 2011 as compared to \$49.9 million at June 30, 2011; \$58.3 million at March 31, 2011; \$47.6 million at December 31, 2010; and \$54.8 million at September 30, 2010. The backlog consists of confirmed customer orders for product to be shipped at a future date. Historically, we have not experienced significant cancellations relating to our backlog of confirmed customer product orders, and we expect to ship substantially all of these orders within the next twelve months; however, it is possible that some of our customers could cancel a portion of our backlog or extend the shipment terms.

Product orders and backlog, as reported, generally do not include amounts relating to shipping and handling charges, service orders or service contract orders. In addition, product orders and backlog, as reported, exclude contracts related to our engineering and construction business due to the relative size of individual projects and, in some cases, extended timeframe for completion beyond a twelve-month period.

Our GHPs use a form of renewable energy and, under certain conditions, can reduce energy costs up to 80% compared to conventional HVAC systems. Tax legislation continues to provide incentives for customers purchasing products using forms of renewable energy. Homeowners who install GHPs are eligible for a 30% tax credit. Businesses that install GHPs are eligible for a 10% tax credit and five year accelerated depreciation on the balance of the system cost. During 2011, businesses also have the option of electing 100% bonus depreciation on qualifying equipment, such as GHPs, that are placed in service during the year.

As previously reported, we expect a slow recovery in the short-term and it is currently unclear when we will return to pre-recession levels. We continue to increase our sales and marketing efforts for all of our Climate Control products, primarily to expand the market for and application of our products, including GHPs.

**Chemical Business**

Our Chemical Business operates four chemical facilities. The Cherokee and Pryor Facilities produce anhydrous ammonia and nitrogen products from natural gas delivered by pipeline but can also receive supplemental anhydrous ammonia by other modes of delivery. The El Dorado and Baytown Facilities produce nitrogen products from anhydrous ammonia delivered by pipeline. The El Dorado Facility also produces sulfuric acid from recovered elemental sulfur delivered by truck and rail.

Our Chemical Business sales for the third quarter of 2011 were \$102.8 million, an increase of \$30.2 million. Sales increased across all product lines due to both increased pricing and volume. Sales from our Pryor Facility to unrelated parties were \$10.5 million during the third quarter of 2011 compared to \$1.8 million for the same period in 2010, with the majority of these sales going into the agricultural market. Agricultural sales for the third quarter of 2011 were \$30.1 million compared to \$18.5 million for the same period in 2010 primarily due to the increased sales volume from our Pryor Facility, higher selling prices of nitrogen fertilizer, partially offset by lower sales volume of agricultural grade AN due to drought conditions in certain of the El Dorado Facility's market areas. In addition, increases in raw material feedstock costs resulted in higher selling prices to certain industrial and mining customers that have contractual obligations allowing us to recover our costs.

The Chemical Business operating income for the third quarter of 2011 was \$7.1 million or \$5.9 million higher than the third quarter of 2010 primarily as a result of increased sales volume and higher margins on UAN produced at Cherokee and Pryor Facilities.



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Although our Chemical Business results for the third quarter were improved over last year, historically our third quarter results are typically lower than the other three quarters of the year due to Turnarounds. Our Turnarounds are usually scheduled during the third quarter when we are past our major fertilizer production and sales season. As a result, agricultural sales are seasonally lower, Turnaround costs are expensed as incurred, and a significant amount of fixed overhead absorption is lost when our plants are not producing during the Turnarounds resulting in seasonally lower operating income than in other periods.

Our operating income during the third quarter of 2011 was significantly lower than it would otherwise have been primarily because the Pryor Facility's anhydrous ammonia plant was down for a Turnaround considerably longer than originally anticipated and for unplanned maintenance. As a result, the Pryor Facility's production of anhydrous ammonia and UAN was only 70% of the production volume experienced during the second quarter of 2011, thereby reducing fixed overhead absorption and limiting sales volume.

During October 2011, the Pryor Facility's production rate, expressed in tons per day, is approximately the same as in the second quarter. The demand for anhydrous ammonia and UAN is strong. A significant percentage of the fourth quarter production capacity of these two agricultural products has been presold on firm sales commitments. In addition, approximately 65% of our projected natural gas consumption for the fourth quarter is covered by purchase commitments or customer pricing agreements that pass through the cost of natural gas.

The percentage change in sales (volume and dollars) for the third quarter of 2011 compared to the third quarter of 2010 is as follows:

	Percentage Change of	
	Tons	Dollars
	<i>Increase</i>	
Chemical products:		
Agricultural	22%	63%
Industrial acids and other	9%	42%
Mining	1%	25%
Total weighted-average change	9%	42%

The increase in agricultural tons and dollars is due to increased tons of ammonia and UAN sales partially offset by lower tons of agricultural grade AN. The lower production of agricultural grade AN was primarily due to intermittent production issues, drought conditions in our primary Texas market area, and increased industrial acid sales volumes, which reduced the amount of acid available for conversion into AN. In addition, our Chemical Business experienced higher selling prices for all of our agricultural nitrogen fertilizers.

The increase in industrial acids and mining sales was partially due to improved economic conditions resulting in increased customer demand, but primarily resulted from higher ammonia prices in the third quarter of 2011 that were passed through in the selling price pursuant to pricing arrangements with certain customers.

As indicated above under Overview General, the Pryor Facility continued production of ammonia and UAN during the third quarter of 2011 after the completion of the Turnaround. During the third quarter of 2011, the production rate for ammonia (excluding Turnaround and unplanned downtime) was approximately 500 tons per day ( TPD ). The production rate for UAN (excluding Turnaround and unplanned downtime) was approximately 800 TPD.

During the third quarter of 2010, the Pryor Facility was unable to produce anhydrous ammonia or UAN due to a pipe failure and fire in June 2010 that damaged the ammonia plant's primary reformer. As a result, the Pryor Facility's overhead and other costs of approximately \$6.2 million during the third quarter of 2010 were expensed as incurred. Costs associated with a Turnaround of \$1.3 million were charged to cost of sales. As a result of the absence of production during the third quarter of 2010, the remaining \$4.9 million included \$4.6 million charged to SG&A and \$0.3 million to other expense. In addition during the third quarter of 2010, the Pryor Facility recognized other income of \$2.8 million relating a property insurance claim.



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Our primary raw material feedstocks (anhydrous ammonia, natural gas and sulfur), which we generally purchase at prices in effect at the time of delivery, are commodities subject to significant price fluctuations. During the third quarter of 2011, the average prices for those commodities compared to the same period in 2010 were as follows:

	2011	2010
Natural gas average price per MMBtu based upon Tennessee 500 pipeline pricing point	\$ 4.40	\$ 4.67
Ammonia average price based upon low Tampa price per metric ton	\$ 574	\$ 386
Sulfur price based upon Tampa average quarterly price per long ton	\$ 220	\$ 95

Most of our Chemical Business sales in the industrial and mining markets were pursuant to sales contracts and/or pricing arrangements on terms that include the cost of raw material feedstock as a pass through component in the sales price. Our Chemical Business sales in the agricultural markets primarily were at the market price in effect at the time of sale or at a negotiated future price.

**Business Interruption Insurance Claim and Recovery**

In June 2010, a pipe failure in the primary reformer of the ammonia plant at the Pryor Facility resulted in a fire that damaged the ammonia plant. The fire was immediately extinguished and there were no injuries. As a result of this damage, the Pryor Facility was unable to produce anhydrous ammonia or UAN during substantially all of third quarter of 2010. Our insurance policy provides for business interruption coverage for certain lost profits and extra expense with a 30-day waiting period. Therefore, we filed an insurance claim for business interruption. During the nine months ended September 30, 2011, we recognized an insurance recovery of \$8.6 million relating to this business interruption claim, which was recorded as a reduction to cost of sales. As of September 30, 2011, we do not have any remaining insurance claims associated with our business interruption coverage relating to this event.

**Liquidity and Capital Resources**

The following is our cash and cash equivalents, short-term investments, total interest bearing debt and stockholders equity:

	September 30, 2011	December 31, 2010
	(Dollars In Millions)	
Cash and cash equivalents	\$ 108.0	\$ 66.9
Short-term investments (1)		10.0
	\$ 108.0	\$ 76.9
Long-term debt:		
2007 Debentures	\$ 0.5	\$ 26.9
Secured Term Loan	73.1	48.8
Other	9.7	19.7
Total long-term debt, including current portion	\$ 83.3	\$ 95.4
Total stockholders equity	\$ 264.2	\$ 179.4

Long-term debt to stockholders equity ratio (2) 0.3 0.5

- (1) These investments consisted of certificates of deposit with an original maturity of 13 weeks. All of these investments were held by financial institutions within the United States and none of these investments were in excess of the federally insured limits.
- (2) This ratio is based on total long-term debt divided by total stockholders equity and excludes the use of cash, cash equivalents and short-term investments to pay down debt.

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At September 30, 2011, our cash and cash equivalents totaled \$108.0 million and our \$50 million revolving credit facility (the Working Capital Revolver Loan ) was undrawn and available to fund operations, if needed, subject to the amount of our eligible collateral and outstanding letters of credit.

For the fourth quarter of 2011, we expect our primary cash needs will be for working capital to fund our operations, capital expenditures, and general obligations. We expect to fund these cash needs from internally generated cash flows and cash on hand. Our internally generated cash flows and liquidity could be affected by possible declines in sales volumes resulting from the uncertainty relative to the current economic conditions.

As previously reported, during March 2011, one of the holders of the 2007 Debentures converted \$24.4 million principal amount of the 2007 Debentures into 888,160 shares of LSB common stock in accordance with the conversion terms of the debentures. In addition, during July 2011, an additional \$2.0 million was converted as discussed below under Related Party Transactions . As of September 30, 2011, only \$0.5 million of the 2007 Debentures remain outstanding, all of which were converted into 18,200 shares of LSB common stock in October 2011.

As previously reported and discussed below under Loan Agreements-Terms and Conditions, on March 29, 2011, ThermaClime and certain of its subsidiaries entered into an amended and restated term loan agreement (the Amended Agreement ), which amended ThermaClime s existing term loan agreement. Pursuant to the terms of the Amended Agreement, the maximum principal amount of ThermaClime s term loan facility (the Secured Term Loan ) was increased from \$50 million to \$60 million. The Amended Agreement also extended the maturity of the Secured Term Loan from November 2, 2012, to March 29, 2016.

On May 26, 2011, the principal amount of the Secured Term Loan was increased an additional \$15 million to \$75 million pursuant to the terms of the Amended Agreement.

The Secured Term Loan requires quarterly principal payments of approximately \$0.9 million, plus interest and a final balloon payment of \$56.3 million due on March 29, 2016. At September 30, 2011, the resulting weighted-average interest rate was approximately 3.96%. The Secured Term Loan is secured by the real property and equipment located at our El Dorado and Cherokee Facilities.

Certain subsidiaries are subject to numerous covenants under the Secured Term Loan 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.

The Working Capital Revolver Loan, which certain subsidiaries (the Borrowers ) are parties to, is available to fund these subsidiaries working capital requirements, if necessary, through April 13, 2012. Under the Working Capital Revolver Loan, the Borrowers may borrow on a revolving basis up to \$50.0 million based on specific percentages of eligible accounts receivable and inventories. At September 30, 2011, we had approximately \$48.6 million of borrowing availability under the Working Capital Revolver Loan based on eligible collateral and outstanding letters of credit. We consider the Working Capital Revolver Loan to be important to our overall capital structure and our current intention is to negotiate a renewal on or before maturity of April 2012.

The financial covenants of the Working Capital Revolver Loan and the Secured Term Loan are discussed below under Subordinated Debentures and Loan Agreements Terms and Conditions . The Borrowers ability to maintain borrowing availability under the Working Capital Revolver Loan depends on their ability to comply with the terms and conditions of the loan agreements and their ability to generate cash flow from operations. The Borrowers are restricted under their credit agreements as to the funds they may transfer to LSB and its subsidiaries that are not parties to the loan agreement. This limitation does not prohibit payment to LSB of amounts due under a Services Agreement, Management Agreement and a Tax Sharing Agreement with ThermaClime. Based upon our current projections, we believe our working capital is adequate to fund operations for the near term.

In 2009, we filed a universal shelf registration statement on Form S-3, with the SEC. The shelf registration statement provides that we could offer and sell up to \$200 million of our securities consisting of equity (common and preferred), debt (senior and subordinated), warrants and units, or a combination thereof. **This disclosure shall not constitute an offer to sell or the solicitation of an offer to buy, nor shall there be any sale of these securities in any state in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the**

**securities laws of any such state.**

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**Income Taxes**

We recognize and pay federal income taxes at regular corporate tax rates. With few exceptions, the 2008-2010 years remain open for all purposes of examination by the IRS and other major tax jurisdictions. Currently, we are under examination by the IRS and certain state tax authorities for the tax years 2007-2010.

We believe that we do not have any material uncertain tax positions other than the failure to file original or amended state income tax returns in some jurisdictions where LSB or some of its subsidiaries may have a filing responsibility. We had approximately \$764,000 and \$700,000 accrued for uncertain tax liabilities at September 30, 2011 and December 31, 2010, respectively.

**Capital Expenditures**

**Capital Expenditures-First Nine Months of 2011**

Cash used for capital expenditures during the first nine months of 2011 was \$31.1 million, including \$4.3 million primarily for production equipment and other upgrades for additional capacity in our Climate Control Business and \$24.5 million for our Chemical Business, primarily for process and reliability improvements of our operating facilities. During the first nine months of 2011, we had capital expenditures of \$0.4 million associated with maintaining compliance with environmental laws, regulations and guidelines. The capital expenditures were primarily funded from working capital.

**Committed and Planned Capital Expenditures-Fourth Quarter of 2011**

At September 30, 2011, we had committed capital expenditures of approximately \$11.4 million for the fourth quarter of 2011. The committed expenditures included \$10.6 million in the Chemical Business. The Chemical Business committed capital expenditures included \$6.4 million for process and reliability improvements; \$3.7 million for plant expansion at our Pryor Facility; and \$0.4 million to maintain compliance with environmental laws, regulations and guidelines including costs associated with the wastewater pipeline discussed below. In addition, our commitments included \$0.8 million in our Climate Control Business primarily for facility upgrades and production equipment. We plan to fund these expenditures from available cash and working capital.

In addition to committed capital expenditures at September 30, 2011, we had additional planned capital expenditures for the fourth quarter of 2011 in our Chemical Business of approximately \$3.4 million and in our Climate Control Business of approximately \$3.0 million.

The planned capital expenditures are subject to economic conditions and approval by senior management. If these capital expenditures are approved, most of these expenditures will likely be funded from working capital and internal cash flows. In addition, see discussion below under Information Request from EPA that may require additional capital improvement to certain emission equipment not currently included in our committed or planned capital expenditures for the fourth quarter of 2011.

**Wastewater Pipeline**

The El Dorado Facility generates process wastewater, which is subject to a wastewater discharge permit issued by the ADEQ, which permit is generally renewed every five years. During April 2011, certain companies, including EDC, and the city of El Dorado, Arkansas (the City) entered into a funding agreement and operating agreement related to a wastewater pipeline to be constructed by the City. Each party to the agreements has agreed to contribute to the cost of construction and the annual operating costs of the pipeline. EDC anticipates its capital cost in connection with the construction of the pipeline including EDC's right to use the pipeline to dispose of its wastewater will be approximately \$4.0 million, of which \$0.4 million has been capitalized as of September 30, 2011. The City plans to complete the construction of the pipeline in 2013. Once the pipeline is completed, EDC's estimated share of the annual operating costs is to be \$100,000 to \$150,000. The initial term of the operating agreement is through December 2053.

**Table of Contents****Information Request from EPA**

The EPA has sent information requests to most, if not all, of the operators of nitric acid plants in the United States, including our El Dorado and Cherokee Facilities and the Baytown Facility under Section 114 of the Clean Air Act as to construction and modification activities at each of these facilities over a period of years. These information requests will enable the EPA to determine whether these facilities are in compliance with certain provisions of the Clean Air Act. In connection with a review by our Chemical Business of these facilities in obtaining information for the EPA pursuant to the EPA's request, our Chemical Business management believes, subject to further review, investigation and discussion with the EPA, that certain facilities within our Chemical Business may be required to make certain capital improvements to certain emission equipment in order to comply with the requirements of the Clean Air Act. If changes to the production equipment at these facilities are required in order to bring this equipment into compliance with the Clean Air Act, the type of emission control equipment that might be imposed is unknown and, as a result, the amount of capital expenditures necessary in order to bring the equipment into compliance is unknown at this time but could be substantial.

Further, if it is determined that the equipment at any of our chemical facilities has not met the requirements of the Clean Air Act, our Chemical Business could be subject to penalties in an amount not to exceed \$27,500 per day as to each facility not in compliance and be required to retrofit each facility with the best available control technology. We believe this technology is already employed at the Baytown Facility. We are currently unable to determine the amount (or range of amounts) of any penalties that may be assessed by the EPA. Therefore no liability has been established at September 30, 2011, in connection with this matter.

**Advanced Manufacturing Energy Credits**

On January 8, 2010, two subsidiaries within the Climate Control Business were awarded Internal Revenue Code § 48C tax credits (also referred to as Advanced Manufacturing Energy Credits) of approximately \$9.6 million. The award is based on anticipated capital expenditures made from February 2009 through June 2014 for machinery that will be used to produce geothermal heat pumps and green modular chillers. As these subsidiaries invest in the qualifying machinery, we will be entitled to an income tax credit equal to 30% of the machinery cost, up to the total credit amount awarded. We anticipate utilizing approximately \$0.8 million of these tax credits to partially offset our federal income tax liability for 2011.

**Transactions with Landmark**

As previously reported and as approved by a special committee of our board of directors, in May 2011, Prime Financial L.L.C. (Prime), a subsidiary of LSB, entered into an agreement (the First Purchase Agreement) to purchase from Landmark Land Company, Inc. (Landmark) certain undeveloped real estate located in Oklahoma City, Oklahoma (the Oklahoma Real Estate) for the purchase price of \$2.25 million, which transaction was consummated in June 2011 and funded from working capital. The First Purchase Agreement grants Prime put options to sell the Oklahoma Real Estate to Landmark or to Gerald G. Barton (Barton), who is the chief executive officer and a substantial stockholder of Landmark. The put option may be exercised during the sixth year following Prime's purchase of the Oklahoma Real Estate. If a put option is exercised, the purchase price for the Oklahoma Real Estate will be \$2.25 million, plus a premium equal to a simple 10% annual return on the purchase price beginning as of the closing of the First Purchase Agreement, subject to certain adjustments. For financial reporting purposes, no value from the purchase price was allocated to the put options because the appraised value of the Oklahoma Real Estate exceeded the purchase price.

As previously reported and as approved by a special committee of our board of directors, in September 2011, Prime entered into an agreement (the Second Purchase Agreement) to purchase from Landmark certain undeveloped real estate located in Laguna Vista, Texas (the Texas Real Estate) for the purchase price of \$2.5 million, which transaction is expected to consummate during the fourth quarter of 2011 and be funded from working capital. The Second Purchase Agreement grants Prime put options to sell the Texas Real Estate to Landmark or to Barton. The put option may be exercised during the sixth year following Prime's purchase of the Texas Real Estate. If a put option is exercised, the purchase price for the Texas Real Estate will be \$2.5 million, plus a premium equal to a simple 10% annual return on the purchase price beginning as of the closing of the Second Purchase Agreement, subject to certain adjustments. The Second Purchase Agreement also grants Prime warrants to purchase up to one million shares of

Landmark's common stock, at \$1.00 per share. The right of Prime to acquire Landmark shares under any unexercised warrants shall terminate on the completed exercise of the put options.

Landmark has also agreed to enter into a separate agreement at the closing to use its reasonable efforts to use, where technically feasible, geothermal heating and air conditioning units manufactured by one of the LSB's subsidiaries on other Landmark properties in the development where the Texas Real Estate is located.

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As previously reported, Jack E. Golsen ( Golsen ), our chairman of the board of directors and chief executive officer and another individual previously formed a limited liability company ( LLC ), and each contributed \$1.0 million to the LLC. The LLC subsequently loaned Landmark approximately \$2.0 million. In March 2011, Golsen sold his membership interest in the LLC to Barton in consideration for a promissory note in the principal amount of approximately \$1.1 million, representing the amount that Golsen had invested in the LLC, plus interest (the Barton Note ). The Barton Note was due and payable in June 2011. Pursuant to the terms of the First and Second Purchase Agreements, until the expiration of the put options, no payment will be made on the Barton Note and payment of the amounts owing under the Barton Note will be subordinate to any amounts owing Prime upon the exercise of a put option. Further, Golsen has agreed under the Second Purchase Agreement that no portion of the purchase price shall be used by Landmark to repay any indebtedness owing to Golsen.

In addition, Bernard Ille, one of our directors, served as a director of Landmark for many years until he resigned in March 2011. In light of the Barton Note and Mr. Ille s past relationship with Landmark, our board of directors appointed a special committee for the purpose of reviewing and determining whether the LSB should purchase the Oklahoma and Texas Real Estate. Also the special committee believed, based on an analysis of a real estate consultant, that the price that we were to pay for the properties approximated the market value, and also believed that these properties, when developed, have the potential to establish a model geothermal community.

**Plant Turnaround Costs**

Our Chemical Business expenses the costs of Turnarounds as they are incurred. During the third quarter of 2011, we incurred \$6.3 million of Turnaround costs compared to approximately \$3.9 million for the same period of 2010. These costs do not include the costs relating to lost absorption or reduced margins due to the associated plants being shut down. Based on our current plan for Turnarounds during the fourth quarter of 2011, we currently estimate that we will incur approximately \$1.0 million of Turnaround costs. However, it is possible that the timing and actual costs of our Turnarounds could be significantly different from our estimates.

**Expenses Associated with Environmental Regulatory Compliance**

Our Chemical Business is subject to specific federal and state environmental compliance laws, regulations and guidelines. As a result, our Chemical Business incurred expenses of \$3.7 million in the first nine months of 2011 in connection with environmental regulatory issues. For the fourth quarter of 2011, we expect to incur expenses ranging from \$0.9 million to \$1.0 million in connection with environmental regulatory issues. However, it is possible that the actual costs could be significantly different than our estimates.

**Proposed Legislation and Regulations Concerning Greenhouse Gas Emissions**

The manufacturing facilities within our Chemical Business use significant amounts of electricity, natural gas and other raw materials necessary for the production of their chemical products that result, or could result, in certain greenhouse gas emissions into the environment. Federal and state courts and administrative agencies, including the EPA, are considering the scope and scale of greenhouse gas emission regulation. There are bills pending or that have been proposed in Congress that would regulate greenhouse gas emissions through a cap-and-trade system under which emitters would be required to either install abatement systems where feasible or buy allowances for offsets of emissions of greenhouse gas. The EPA has instituted a mandatory greenhouse gas reporting requirement that began in 2010, which impacts all of our chemical manufacturing sites. Greenhouse gas regulations, if adopted, could increase the price of the electricity and other energy sources purchased by our chemical facilities; increase costs for natural gas and other raw materials (such as anhydrous ammonia); potentially restrict access to or the use of natural gas and other raw materials necessary to produce our chemical products; and require us to incur substantial expenditures to retrofit our chemical facilities to comply with the proposed new laws and regulations regulating greenhouse gas emissions. Federal, state and local governments may also pass laws mandating the use of alternative energy sources, such as wind power and solar energy, which may increase the cost of energy use in certain of our chemical and other manufacturing operations. While future emission regulations or new laws appear possible, it is too early to predict how these regulations, if and when adopted, will affect our businesses, operations, liquidity or financial results.



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**Dividends**

LSB is a holding company and, accordingly, its ability to pay cash dividends on its preferred stock and common stock depends in large part on its ability to obtain funds from its subsidiaries. The ability of ThermaClime (which owns a substantial portion of the companies comprising the Climate Control Business and Chemical Business) and its wholly-owned subsidiaries to pay dividends and to make distributions to LSB is restricted by certain covenants contained in the Working Capital Revolver Loan and the Secured Term Loan agreements. Under the terms of these agreements, so long as no default or event of default has occurred, is continuing or would result therefrom, ThermaClime cannot transfer funds to LSB in the form of cash dividends or other distributions or advances, except for the following:

unrestricted payments up to \$15.0 million to LSB, which amount was paid during the second quarter of 2011;

loans to LSB entered into subsequent to March 29, 2011, provided the aggregate amount of such loans do not exceed \$2.0 million at any time outstanding;

amounts not to exceed \$5.0 million annually under a certain management agreement between LSB and ThermaClime, provided certain conditions are met;

the repayment of costs and expenses incurred by LSB that are directly allocable to ThermaClime or its subsidiaries for LSB's provision of services under certain services agreement;

the amount of income taxes that ThermaClime would be required to pay if they were not consolidated with LSB; and

an amount not to exceed fifty percent (50%) of ThermaClime's consolidated net income during each fiscal year determined in accordance with generally accepted accounting principles plus income taxes paid to LSB within the previous bullet above, provided that certain other conditions are met.

Holders of our common stock and preferred stocks are entitled to receive dividends only when and if declared by our board of directors. We have not paid cash dividends on our outstanding common stock in many years, and we do not currently anticipate paying cash dividends on our outstanding common stock in the near future. However, our board of directors has not made a decision whether or not to pay such dividends on our common stock in 2011.

During the first nine months of 2011, dividends totaling \$304,700 were declared and paid on our outstanding preferred stock using funds from our working capital. Each share of preferred stock is entitled to receive an annual dividend, only when declared by our board of directors, payable as follows:

\$0.06 per share on our outstanding non-redeemable Series D Preferred for an aggregate dividend of \$60,000;

\$12.00 per share on our outstanding non-redeemable Series B Preferred for an aggregate dividend of \$240,000; and

\$10.00 per share on our outstanding Noncumulative Preferred for an aggregate dividend of approximately \$4,700.

All shares of the Series D Preferred and Series B Preferred are owned by the Golsen Group. See "Related Party Transactions" of this MD&A for a discussion as to the amount of dividends paid to the Golsen Group during the first nine months of 2011. There are no optional or mandatory redemption rights with respect to the Series B Preferred or Series D Preferred.

**Compliance with Long Term Debt Covenants**

As discussed below under "Subordinated Debentures and Loan Agreements - Terms and Conditions", the Working Capital Revolver Loan and Secured Term Loan of ThermaClime and its subsidiaries require, among other things, that ThermaClime meet certain financial covenants. Currently, ThermaClime's forecast is that ThermaClime will be able to

meet all financial covenant requirements for the fourth quarter of 2011.

**Table of Contents****Loan Agreements Terms and Conditions**

**Working Capital Revolver Loan** - ThermaClime's Working Capital Revolver Loan is available to fund its working capital requirements, if necessary, through April 13, 2012. Under the Working Capital Revolver Loan, ThermaClime and its subsidiaries may borrow on a revolving basis up to \$50.0 million based on specific percentages of eligible accounts receivable and inventories. At September 30, 2011, there were no outstanding borrowings. In addition, the net credit available for borrowings under our Working Capital Revolver Loan was approximately \$48.6 million at September 30, 2011, based on our eligible collateral and outstanding letters of credit as of that date. The Working Capital Revolver Loan requires that ThermaClime meet certain financial covenants, including an EBITDA requirement of greater than \$25.0 million; a minimum fixed charge coverage ratio of not less than 1.10 to 1; and a maximum senior leverage coverage ratio of not greater than 4.50 to 1. These requirements are measured quarterly on a trailing twelve-month basis and as defined in the agreement. As of September 30, 2011 and as defined in the agreement, ThermaClime's EBITDA was approximately \$89.6 million; the fixed charge coverage ratio was 6.8 to 1; and the senior leverage coverage ratio was 0.8 to 1.

**Secured Term Loan** - On March 29, 2011, ThermaClime and certain of its subsidiaries entered into the Amended Agreement, which amended ThermaClime's existing term loan agreement, dated November 2, 2007, as previously amended. Pursuant to the terms of the Amended Agreement, the maximum principal amount of ThermaClime's Secured Term Loan was increased from \$50.0 million to \$60.0 million. On May 26, 2011, the principal amount of the Secured Term Loan was increased an additional \$15.0 million to \$75.0 million pursuant to the terms of the Amended Agreement. The Amended Agreement also extends the maturity of the Secured Term Loan from November 2, 2012, to March 29, 2016. The Secured Term Loan continues to be guaranteed by LSB.

The Secured Term Loan requires quarterly principal payments of approximately \$0.9 million, plus interest and a final balloon payment of \$56.3 million due on March 29, 2016. At September 30, 2011, the stated interest rate on the Secured Term Loan includes a variable interest rate of approximately 3.36% on the principal amount of \$48.7 million (the variable interest rate is based on three-month LIBOR plus 300 basis points, which rate is adjusted quarterly) and a fixed interest rate of 5.15% on the principal amount of \$24.4 million. At September 30, 2011, the resulting weighted-average interest rate was approximately 3.96%.

The Secured Term Loan is secured by the real property and equipment located at our El Dorado and Cherokee Facilities. The carrying value of the pledged assets is approximately \$68 million at September 30, 2011.

The Secured Term Loan borrowers are subject to numerous covenants under the Amended 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 LSB, all with certain exceptions. At September 30, 2011, the carrying value of the restricted net assets of ThermaClime and its subsidiaries was approximately \$84 million. As defined in the agreement, the Secured Term Loan borrowers are also subject to a minimum fixed charge coverage ratio of not less than 1.10 to 1 and a maximum leverage ratio of not greater than 4.50 to 1. Both of these requirements are measured quarterly on a trailing twelve-month basis. As of September 30, 2011 and as defined in the agreement, Secured Term Loan borrowers' fixed charge coverage ratio was 5.2 to 1 and the leverage coverage ratio was 0.9 to 1.

The maturity date of the Secured Term Loan can be accelerated by the lender upon the occurrence of a continuing event of default, as defined.

A prepayment premium equal to 2.5% of the principal amount prepaid is due to the lenders should the borrowers elect to prepay on or prior to March 29, 2012. This premium is reduced to 1.0% during the following 24-month period and is eliminated thereafter.

**Cross-Default Provisions** - The Working Capital Revolver Loan and the Secured Term Loan contain cross-default provisions. If ThermaClime fails to meet the financial covenants of either of these agreements, the lenders may declare an event of default.

**Seasonality**

We believe that our only significant seasonal products are fertilizer and related chemical products sold by our Chemical Business to the agricultural industry. The selling seasons for those products are primarily during the spring and fall planting seasons, which typically extend from March through June and from September through November in

the geographical markets in which the majority of our agricultural products are distributed. As a result, historically our Chemical Business increases its inventory of agricultural products prior to the beginning of each planting season. The amount and timing of sales to the agricultural markets is further dependent upon weather conditions and other circumstances beyond our control.

**Table of Contents****Related Party Transactions****Golsen Group**

In January 2011, we paid interest of \$137,500 relating to the debentures held by the Golsen Group that was accrued at December 31, 2010. In March 2011, we paid dividends totaling \$300,000 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 2011, the Golsen Group sold \$3,000,000 of the 2007 Debentures it held to a third party. In July 2011, the Golsen Group converted \$2,000,000 principal amount of the 2007 Debentures into 72,800 shares of LSB common stock in accordance with the term of the 2007 Debentures. During the nine months ended September 30, 2011, we incurred interest expense of \$60,500 relating to the \$2,000,000 of the 2007 Debentures that was held by the Golsen Group, of which \$55,000 was paid in June 2011 and the remaining amount was forfeited and credited to capital in excess of par value as the result of the conversion. In addition in July 2011, the Golsen Group converted an \$8,000 convertible promissory note into 4,000 shares of LSB common stock in accordance with the terms of such note.

Also see discussion under Liquidity and Capital Resources Transactions with Landmark.

**Results of Operations****Nine Months Ended September 30, 2011 Compared To Nine Months Ended September 30, 2010****Climate Control Business**

The following table contains certain information about our net sales, gross profit and operating income in our Climate Control segment for the nine months ended September 30,

	2011	2010	Change	Percentage Change
	(Dollars In Thousands)			
Net sales:				
Geothermal and water source heat pumps	\$ 136,644	\$ 122,967	\$ 13,677	11.1%
Hydronic fan coils	43,689	26,711	16,978	63.6%
Other HVAC products	32,295	28,367	3,928	13.8%
Total Climate Control	\$ 212,628	\$ 178,045	\$ 34,583	19.4%
Gross profit Climate Control	\$ 67,689	\$ 60,195	\$ 7,494	12.4%
Gross profit percentage Climate Control (1)	31.8%	33.8%	(2.0)%	
Operating income Climate Control	\$ 26,357	\$ 22,632	\$ 3,725	16.5%

(1) As a percentage of net sales

**Net Sales Climate Control**

Net sales of our geothermal and water source heat pump products increased primarily as a result of a 21% improvement in sales of our commercial products due to the higher backlog at the beginning of 2011 and stronger product order levels during the first nine months of 2011 partially offset by a 6% decline in sales of our residential products primarily due to lower product order levels in the first nine months of 2011. During the first nine months of 2011, we continued to maintain a market share leadership position of approximately 41%, based on preliminary market data supplied by the Air-Conditioning, Heating and Refrigeration Institute ( AHRI );

Net sales of our hydronic fan coils increased primarily due to a 34% increase in the number of units sold due to increased construction and renovation activities in the markets we serve and a 22% increase in the average unit sales price due to change in product mix. During the first nine months of 2011, we continued to have a market share leadership position of approximately 31% based on preliminary market data supplied by the AHRI;

Net sales of our other HVAC products increased primarily as the result of an increase in the sales of our large custom air handlers, modular chillers, and engineering and construction services.

**Table of Contents****Gross Profit Climate Control**

The increase in gross profit in our Climate Control Business was primarily the result of higher sales volume as discussed above. The gross profit percentage declined primarily as a result of higher material costs and a higher mix of commercial products having a lower gross margin than residential products.

**Operating Income Climate Control**

Operating income increased as a result of the increase in gross profit as discussed above partially offset by an increase in variable expenses related primarily to warranty expenses of \$2.2 million due to increased sales volume and the impact of increasing our warranty coverage period for certain products effective during 2010. In addition, freight expenses increased \$1.3 million due to increased sales volume and the impact from changes in customer/product mix.

**Chemical Business**

The following table contains certain information about our net sales, gross profit and operating income in our Chemical segment for the nine months ended September 30,

	2011	2010	Change	Percentage Change
	(Dollars In Thousands)			
Net sales:				
Agricultural products	\$ 163,060	\$ 94,018	\$ 69,042	73.4%
Industrial acids and other chemical products	124,038	94,058	29,980	31.9%
Mining products	82,722	65,752	16,970	25.8%
 Total Chemical	 \$ 369,820	 \$ 253,828	 \$ 115,992	 45.7%
 Gross profit Chemical	 \$ 89,789	 \$ 30,631	 \$ 59,158	 193.1%
 Gross profit percentage Chemical (1)	 24.3%	 12.1%	 12.2%	
 Operating income Chemical	 \$ 78,923	 \$ 12,310	 \$ 66,613	 541.1%

(1) As a percentage of net sales

**Net Sales Chemical**

The El Dorado and Cherokee Facilities produce all the chemical products described in the table above and the Baytown Facility produces only industrial acids. The Pryor Facility, which began sustained production in the fourth quarter of 2010, produces agricultural and industrial chemical products. For the first nine months of 2011, overall sales prices for the Chemical Business increased 31% and the volume of tons sold increased 12%, compared with the same period of 2010, generally as a result of the following:

**Agricultural products sales** Agricultural products sales increased \$69.0 million, or 73%, primarily due to increased sales volumes and selling prices for UAN, partially offset by lower sales of agricultural grade AN. Tons of agricultural products sold increased 31% including 116,000 tons of UAN and 20,000 tons of ammonia from the Pryor Facility. The increase in UAN sales was driven by an increase in market demand for crop nutrients and strong grain commodity prices.

**Industrial acids and other chemical products sales** Industrial acids and other products sales increased \$30.0 million, or 32%, primarily due to new customers and increased selling prices resulting from the pass through of higher raw material costs pursuant to the terms of sales agreements with certain customers.

**Mining products sales** Mining products sales increased \$17.0 million, or 26% and volumes increased 7%. Sales prices were higher driven by a general increase in raw material and other costs, which we are able to pass through to certain customers pursuant to the terms of supply agreements. Our industrial grade AN is primarily sold to one customer pursuant to a multi-year supply contract in which the customer agreed to purchase, and we agreed to reserve certain minimum volumes of industrial grade AN during 2011. Pursuant to the terms of the contract, the customer has been invoiced for the fixed costs and amounts associated with the reserved capacity despite not taking the total minimum volume requirement during the first nine months of 2011.

**Table of Contents****Gross Profit Chemical**

The increase in gross profit of \$59.2 million primarily relates to an increase of \$46.7 million on the increase in agricultural products sales reflecting a much stronger demand for UAN accompanied by lower cost per ton as the result of higher volumes, improved production efficiencies and positive results attributable to the Pryor Facility. The increase in gross profit percentage was attributable to the favorable sales mix of the higher margin UAN product including, but not limited, to the Pryor Facility sales in 2011. In addition, we recognized an \$8.6 million business interruption recovery in 2011.

**Operating Income Chemical**

In addition to the increase in gross profit of \$59.2 million discussed above, our Chemical Business operating income includes operating and other expenses associated with the Pryor Facility of approximately \$2.8 million for the first nine months of 2011 compared to \$13.4 million for the same period of 2010. Due to limited and intermittent production at the Pryor Facility during the first nine months of 2010, costs identifiable with production were classified as cost of sales and the remaining operational expenses were primarily classified as SG&A. This increase in operating income was partially offset by a gain of \$3.9 million from property insurance recoveries received in 2010.

**Other**

The business operation classified as Other primarily sells industrial machinery and related components to machine tool dealers and end users. General corporate expenses and other business operations, net consist of unallocated portions of gross profit, SG&A, other income and other expense. The following table contains certain information about our net sales and gross profit classified as Other and general corporate expenses and other business operations, net, for the nine months ended September 30,

	2011	2010	Change	Percentage Change
	(Dollars In Thousands)			
Net sales Other	\$ 7,444	\$ 5,877	\$ 1,567	26.7%
Gross profit Other	\$ 2,719	\$ 2,027	\$ 692	34.1%
Gross profit percentage Other (1)	36.5%	34.5%	2.0%	
General corporate expense and other business operations, net	\$ (10,477)	\$ (9,246)	\$ (1,231)	13.3%

(1) As a percentage of net sales

**Provision For Income Taxes**

The provision for income taxes for the first nine months of 2011 was \$33.6 million compared to \$8.8 million for the first nine months of 2010. The resulting effective tax rate for the first nine months of 2011 was 37% compared to 43% for the same period in 2010. As previously reported, during June 2010, we determined that certain nondeductible expenses had not been properly identified relating to the 2007-2009 provisions for income taxes. As a result, we recorded an additional income tax provision of approximately \$800,000 for the first nine months of 2010.

**Table of Contents****Three Months Ended September 30, 2011 Compared To Three Months Ended September 30, 2010****Climate Control Business**

The following table contains certain information about our net sales, gross profit and operating income in our Climate Control segment for the three months ended September 30,

	<b>2011</b>	<b>2010</b>	<b>Change</b>	<b>Percentage Change</b>
	(Dollars In Thousands)			
Net sales:				
Geothermal and water source heat pumps	\$ 46,458	\$ 44,006	\$ 2,452	5.6%
Hydronic fan coils	15,806	10,506	5,300	50.4%
Other HVAC products	9,540	10,034	(494)	