

PIMCO INCOME STRATEGY FUND
Form N-CSR
October 03, 2013

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

FORM N-CSR

**CERTIFIED SHAREHOLDER REPORT OF REGISTERED
MANAGEMENT INVESTMENT COMPANIES**

Investment Company Act file number 811-21374

PIMCO Income Strategy Fund
(Exact name of registrant as specified in charter)

1633 Broadway, New York, New York
(Address of principal executive offices)

10019
(Zip code)

Lawrence G. Altadonna -1633 Broadway, New York, New York 10019
(Name and address of agent for service)

Registrant's telephone number, including area code: 212-739-3371

Date of fiscal year July 31, 2013
end:

Date of reporting period: July 31, 2013

Item 1. Report to Shareholders

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Letter from Chairman of the Board & President

Dear Shareholder:

The US economy continued to expand during the fiscal twelve-month reporting period ended July 31, 2013. Bond yields rose sharply, while the Federal Reserve's (the Fed's) monetary policy drove stocks to reach record highs on several occasions.

Twelve-Month Period in Review through July 31, 2013

- PIMCO Income Strategy Fund returned 15.65% on net asset value (NAV) and 5.69% on market price.
- PIMCO Income Strategy Fund II returned 15.26% on NAV and 6.80% on market price.

The Barclays US Credit Index, a measure of high quality corporate bond performance, declined 1.12%; the Barclays US High Yield Bond Index, a measure of below investment-grade corporate bond performance, rose 9.49%; and government bonds, as represented by the Barclays Intermediate-Term Treasury Index, fell 1.14% during the reporting period. The Barclays US Aggregate Bond Index, a broad credit market measure of government and corporate securities, decreased 1.91% and mortgage-backed securities, reflected by the Barclays Fixed Rate MBS Index, dropped 2.03%. As for stocks, the Standard & Poor's 500 Index advanced 25.00% during the twelve-month fiscal period ended July 31, 2013.

Gross domestic product (GDP), the value of goods and services produced in the country, the broadest measure of economic activity and the principal indicator of economic performance, grew at an annual pace of 2.8% during the third quarter of 2012. GDP growth decelerated to 0.1% during the fourth quarter of 2012, as private inventory investment and federal government spending moderated. However, GDP growth rose to 1.1% during the first quarter of 2013, partially due to stronger consumer spending. According to an initial estimate from the US Commerce Department, GDP growth improved to a 1.7% annual pace during the second quarter of 2013.

Although US economic data was mixed, there were continuing signs of the long-awaited recovery in the housing market. Unemployment remained elevated, however, the unemployment rate declined from 8.2% in July 2012 to 7.4% in July 2013, as new job growth trended higher. Elsewhere, despite concerns related to higher tax rates, the fiscal cliff and sequestration, consumer spending held up relatively well during the twelve-month period.

Outlook

Market volatility increased sharply during the end of the fiscal reporting period. This was not triggered by economic concerns, but rather uncertainties surrounding the Fed tapering its asset purchases. We expect the Fed's policy stance to remain accommodative, even if it begins to taper its purchase program toward the end of the year. Tapering of the Fed's purchase program is likely to create higher volatility, however we believe the Fed will only raise interest rates if it is confident the economic recovery is on solid footing.

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With respect to the US economy, consumer spending will be an important factor going forward as it comprises in excess of two-thirds of GDP. The US Commerce Department reported that retail sales rose for the fourth consecutive month in July 2013. In addition, there were signs that consumers have their balance sheets in order. While the global financial crisis of 2008-2009 has had a significant impact on consumers' mindset, it appears that as the employment situation improves, consumer confidence will likely rise, with spending to follow. This could help drive the economy during the remainder of the year and into 2014.

For specific information on the Funds and their performance, please review the following pages. If you have any questions regarding the information provided, we encourage you to contact your financial advisor or call the Funds' shareholder servicing agent at (800) 254-5197. In addition, a wide range of information and resources is available on our website, us.allianzgi.com/closedendfunds.

Together with Allianz Global Investors Fund Management LLC, the Funds' investment manager, and Pacific Investment Management Company LLC (PIMCO), the Funds' sub-adviser, we thank you for investing with us.

We remain dedicated to serving your investment needs.

Sincerely,

Hans W. Kertess
Chairman of the Board of Trustees

Brian S. Shlissel
President & Chief Executive Officer

Fund Insights

PIMCO Income Strategy Fund/PIMCO Income Strategy Fund II

July 31, 2013 (unaudited)

For the twelve-months ended July 31, 2013, PIMCO Income Strategy Fund returned 15.65% on net asset value (NAV) and 5.69% on market price.

For the twelve-months ended July 31, 2013, PIMCO Income Strategy Fund II returned 15.26% on NAV and 6.80% on market price.

The unmanaged Barclays US Aggregate Bond Index and Barclays US Credit Index declined 1.91% and 1.12% respectively, during the reporting period. US fixed income market s experienced periods of volatility during the period. This was triggered by a number of factors, including moderating global growth, uncertainties regarding sequestration and the ongoing European sovereign debt crisis. The Federal Reserve (the Fed) and other developed country central banks maintained their accommodative monetary policies during the reporting period. However, following its meeting on June 19, 2013, Fed Chairman Bernanke said "...the Committee currently anticipates that it would be appropriate to moderate the monthly pace of purchases later this year; and if the subsequent data remain broadly aligned with our current expectations for the economy, we would continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around midyear. This triggered a sharp rise in Treasury yields and falling bond prices. The benchmark 10-year Treasury bond began the fiscal period yielding 1.51% and ended the period at 2.60%.

While the fundamentals in the US credit market remained solid overall, it was dragged down by periods of investor risk aversion and rising interest rates. The corporate bond market was supported at times by company profits that often exceeded expectations, corporate balance sheets which were often flush with cash and low defaults. However, these positive developments were more than offset as the corporate bond market sold off toward the end of 2012 as well as in January, May and June 2013.

Sector exposures produce mixed result to the Funds performance

During the reporting period, PIMCO Income Strategy and PIMCO Income Strategy II (the Funds) outperformed the broad US fixed income market (as measured by the Barclays US Aggregate Bond Index) as well as the US credit market (as measured by the Barclays US Credit Index).

An allocation to non-agency mortgage-backed securities was a significant contributor for performance, as these bonds generally outperformed the broader market, supported by overall strong demand. An emphasis on select high quality banking issues aided performance, as bonds also outperformed the broader market. In addition, the Funds overweighting to the Insurance sector was additive to performance as this sector outperformed the broad credit market. An allocation to Build America Bonds was rewarded, as these subsidized taxable municipal securities generally outperformed the broader market.

On the downside, the Funds' long US duration position in the second quarter of 2013 detracted from performance as rates increased sharply during this time period. Long duration positioning in the UK during 2013 was negative, as rates increased. A tactical allocation to the Brazilian real in the second quarter of 2013 was negative, as the currency weakened against the US dollar. Finally, a tactical allocation to emerging market debt in 2013 was negative, as the asset class underperformed the broader credit market.

Performance & Statistics

PIMCO Income Strategy Fund

July 31, 2013 (unaudited)

Total Return(1):		Market Price	NAV	
1 Year		5.69%	15.65%	%
5 Year		9.93%	9.19%	%
Commencement of Operations (8/29/03) to 7/31/13		5.47%	6.01%	%

Market Price/NAV Performance:

Commencement of Operations (8/29/03) to 7/31/13

Market Price/NAV:

Market Price	\$11.83
NAV	\$11.70
Premium to NAV	1.11%
Market Price Yield(2)	9.13%
Leverage Ratio(3)	21.17%

NAV
Market Price

Performance & Statistics

PIMCO Income Strategy Fund II

July 31, 2013 (unaudited)

Total Return(1):		Market Price	NAV
1 Year		6.80%	15.26%
5 Year		8.45%	6.60%
Commencement of Operations (10/29/04) to 7/31/13		3.48%	4.14%

Market Price/NAV Performance:

Commencement of Operations (10/29/04) to 7/31/13

NAV
Market Price

Market Price/NAV:

Market Price	\$10.24
NAV	\$10.29
Discount to NAV	-0.49%
Market Price Yield(2)	9.38%
Leverage Ratio(3)	21.00%

(1) **Past performance is no guarantee of future results.** Total return is calculated by determining the percentage change in NAV or market price (as applicable) in the specified period. The calculation assumes that all dividends and distributions, if any, have been reinvested. Total return does not reflect broker commissions or sales charges in connection with the purchase or sale of Fund shares and includes the effect of any expense reductions. Total return for a period of more than one year represents the average annual total return.

Performance at market price will differ from results at NAV. Although market price returns typically reflect investment results over time, during shorter periods returns at market price can also be influenced by factors such as changing views about the Fund, market conditions, supply and demand for each Fund's shares, or changes in each Fund's dividends.

An investment in each Fund involves risk, including the loss of principal. Total return, market price, market price yield and NAV will fluctuate with changes in market conditions. This data is provided for information purposes only and is not intended for trading purposes. Closed-end funds, unlike open-end funds, are not continuously offered. There is a one time public offering and once issued, shares of closed-end funds are traded in the open market through a stock exchange. NAV is equal to total assets attributable to common shareholders less total liabilities

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divided by the number of common shares outstanding. Holdings are subject to change daily.

(2) Market Price Yield is determined by dividing the annualized current monthly dividend per common share (comprised of net investment income) by the market price per common share at July 31, 2013.

(3) Represents Preferred Shares (Leverage) outstanding, as a percentage of total managed assets. Total managed assets refer to the total assets (including assets attributable to Leverage) minus liabilities (other than liabilities representing Leverage).

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Schedule of Investments

PIMCO Income Strategy Fund

July 31, 2013

Principal
Amount
(000s)

Value

Corporate Bonds & Notes 30.4%**Airlines 2.6%**

	American Airlines Pass-Through Trust (d),	
\$3,614	9.73%, 9/29/14	\$5,060,022
1,861	10.18%, 1/2/13	3,750,508
877	United Air Lines Pass-Through Trust, 10.40%, 5/1/18	997,060
		9,807,590

Banking 17.1%

	Ally Financial, Inc.,	
527	6.00%, 2/15/19-9/15/19	517,344
538	6.05%, 8/15/19-10/15/19	525,936
20	6.10%, 9/15/19	20,003
31	6.125%, 10/15/19	30,266
1,345	6.15%, 8/15/19-10/15/19	1,346,394
22	6.20%, 4/15/19	22,033
1,371	6.25%, 2/15/16	1,373,078
120	6.30%, 8/15/19	120,156
1,468	6.35%, 2/15/16-4/15/19	1,467,044
629	6.40%, 3/15/16-11/15/19	621,440
2,021	6.50%, 2/15/16-5/15/19	2,019,704
383	6.55%, 12/15/19	380,559
24	6.60%, 5/15/18-6/15/19	23,989
71	6.65%, 6/15/18-10/15/18	70,598
197	6.70%, 6/15/18-6/15/19	193,907
1,335	6.75%, 12/1/14-6/15/19	1,402,685

Earnings from operations	14,825	14,059	28,500	27,357
Other expenses (income):				
Interest income	(1)	(69)	(8)	(140)
Interest expense	3	22	6	40
Other, net	(1)	(246)	(10)	(271)
Earnings before income tax expense	14,824	14,352	28,512	27,728
Income tax expense	4,852	4,780	9,272	9,244
Net earnings	\$ 9,972	\$ 9,572	\$ 19,240	\$ 18,484
	\$ 0.34	\$ 0.34	\$ 0.66	\$ 0.65

Net earnings per
common share -
basic

Net earnings per
common share -
diluted

\$ 0.33

\$ 0.32

\$ 0.64

\$ 0.61

See accompanying notes to consolidated financial statements.

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BALCHEM CORPORATION
 Condensed Consolidated Statements of Comprehensive Income
 (Dollars in thousands)
 (unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net earnings	\$9,972	\$9,572	\$19,240	\$18,484
Other comprehensive income (loss), net of tax:				
Net foreign currency translation adjustment	(792)	217	(409)	818
Net change in postretirement benefit plan, net of taxes of \$1 and \$1 for the three months ended June 30, 2012 and 2011, and \$3 and \$1 for the six months ended June 30, 2012 and 2011	(4)	(1)	(12)	(3)
Other comprehensive (loss) income	(796)	216	(421)	815
Comprehensive income	\$9,176	\$9,788	\$18,819	\$19,299

See accompanying notes to consolidated financial statements.

BALCHEM CORPORATION
Condensed Consolidated Statements of Cash Flows
(Dollars in thousands)
(unaudited)

	Six Months Ended June 30,	
	2012	2011
Cash flows from operating activities:		
Net earnings	\$19,240	\$18,484
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	4,806	4,492
Stock compensation expense	1,946	1,934
Shares issued under employee benefit plans	310	293
Deferred income tax expense	(828)	(976)
Foreign currency transaction loss	68	92
Loss on impairment of assets	-	94
Changes in assets and liabilities		
Accounts receivable	(2,784)	(5,783)
Inventories	(1,537)	(2,973)
Prepaid expenses and other current assets	515	955
Accounts payable and accrued expenses	2,632	641
Income taxes	6,753	(354)
Other	102	218
Net cash provided by operating activities	31,223	17,117
Cash flows from investing activities:		
Capital expenditures	(3,198)	(3,210)
Proceeds from sale of property, plant and equipment	-	28
Intangible assets acquired	(10)	(3)
Net cash used in investing activities	(3,208)	(3,185)
Cash flows from financing activities:		
Proceeds from long-term debt	178	-
Principal payments on long-term debt	(695)	(790)
Proceeds from stock options exercised and restricted shares purchased	877	2,314
Excess tax benefits from stock compensation	1,182	1,282
Dividends paid	(5,237)	(4,310)
Purchase of treasury stock	(964)	(108)
Net cash used in financing activities	(4,659)	(1,612)
Effect of exchange rate changes on cash	(77)	169
Increase in cash and cash equivalents	23,279	12,489
Cash and cash equivalents beginning of period	114,781	77,253
Cash and cash equivalents end of period	\$138,060	\$89,742

Supplemental Cash Flow Information - see Note 9

See accompanying notes to consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(All dollar amounts in thousands, except share and per share data)

NOTE 1 - CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The condensed consolidated financial statements presented herein have been prepared by the Company in accordance with the accounting policies described in its December 31, 2011 consolidated financial statements, and should be read in conjunction with the consolidated financial statements and notes, which appear in the Annual Report on Form 10-K for the year ended December 31, 2011. References in this report to the “Company” mean either Balchem Corporation or Balchem Corporation and its subsidiaries, including BCP Ingredients, Inc., Aberco, Inc., Balchem BV, Balchem Trading BV, and Balchem Italia Srl, on a consolidated basis, as the context requires.

In the opinion of management, the unaudited condensed consolidated financial statements furnished in this Form 10-Q include all adjustments necessary for a fair presentation of the financial position, results of operations and cash flows for the interim periods presented. All such adjustments are of a normal recurring nature. The condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP” or “GAAP”) governing interim financial statements and the instructions to Form 10-Q and Article 10 of Regulation S-X under the Securities Exchange Act of 1934 and therefore do not include some information and notes necessary to conform to annual reporting requirements. Certain prior year amounts have been reclassified to conform to current year presentation. The results of operations for the six months ended June 30, 2012 are not necessarily indicative of the operating results expected for the full year or any interim period.

NOTE 2 - STOCKHOLDERS' EQUITY

STOCK-BASED COMPENSATION

The Company records stock-based compensation in accordance with the provisions of ASC 718, “Compensation-Stock Compensation.” The Company’s results for the three and six months ended June 30, 2012 and 2011 reflected the following stock-based compensation cost, and such compensation cost had the following effects on net earnings:

	Increase/(Decrease) for the Three Months Ended June 30,	
	2012	2011
Cost of sales	\$ 145	\$ 146
Operating expenses	827	759
Net earnings	(620)	(564)

	Increase/(Decrease) for the Six Months Ended June 30,	
	2012	2011
Cost of sales	\$ 289	\$ 291
Operating expenses	1,657	1,643
Net earnings	(1,231)	(1,212)

As required by ASC 718, the Company has made an estimate of expected forfeitures based on its historical experience and is recognizing compensation cost only for those stock-based compensation awards expected to vest.

The Company's stock incentive plans allow for the granting of restricted stock awards and options to purchase common stock. Both incentive stock options and nonqualified stock options can be awarded under the plans. No option will be exercisable for longer than ten years after the date of grant. The Company has approved and reserved a number of shares to be issued upon exercise of the outstanding options that is adequate to cover all exercises. As of June 30, 2012, the plans had 4,521,024 shares available for future awards. Compensation expense for stock options and restricted stock awards is recognized on a straight-line basis over the vesting period, generally three years for stock options, four years for employee restricted stock awards, and four to seven years for non-employee director restricted stock awards. Certain awards provide for accelerated vesting if there is a change in control (as defined in the plans) or other qualifying events.

Option activity for the six months ended June 30, 2012 and 2011 is summarized below:

	Shares (000s)	Weighted Average Exercise Price	Aggregate Intrinsic Value (\$000s)	Weighted Average Remaining Contractual Term
For the six months ended June 30, 2012				
Outstanding as of December 31, 2011	2,514	\$ 14.68	\$65,043	
Granted	225	29.11		
Exercised	(92)	9.52		
Forfeited	(5)	28.87		
Outstanding as of June 30, 2012	2,642	\$ 16.06	\$43,855	5.4
Exercisable as of June 30, 2012	2,068	\$ 12.51	\$41,588	4.5

	Shares (000s)	Weighted Average Exercise Price	Aggregate Intrinsic Value (\$000s)	Weighted Average Remaining Contractual Term
For the six months ended June 30, 2011				
Outstanding as of December 31, 2010	2,955	\$14.21	\$57,930	
Granted	14	40.10		
Exercised	(195)	11.85		
Forfeited	(50)	24.47		
Outstanding as of June 30, 2011	2,724	\$14.32	\$80,246	5.9
Exercisable as of June 30, 2011	2,037	\$10.67	\$67,422	5.0

ASC 718 requires companies to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing model with the following weighted average assumptions: dividend yields of 0.5% and 0.5%; expected volatilities of 41% and 36%; risk-free interest rates of 0.8% and 1.4%; and expected lives of 4.6 and 4.5 years, in each case for the six months ended June 30, 2012 and 2011, respectively.

The Company used a projected expected life for each award granted based on historical experience of employees' exercise behavior. Expected volatility is based on the Company's historical volatility levels. Dividend yields are based on the Company's historical dividend yields. Risk-free interest rates are based on the implied yields currently available on U.S. Treasury zero coupon issues with a remaining term equal to the expected life.

Other information pertaining to option activity during the three and six months ended June 30, 2012 and 2011 was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Weighted-average fair value of options granted	\$10.37	\$12.43	\$9.75	\$12.25
Total intrinsic value of stock options exercised (\$000s)	\$411	\$3,187	\$2,590	\$5,129

Non-vested restricted stock activity for the six months ended June 30, 2012 and 2011 is summarized below:

	Shares (000s)	Weighted Average Grant Date Fair Value
Six months ended June 30, 2012		
Non-vested balance as of December 31, 2011	354	\$ 18.77
Granted	44	29.06
Vested	(80)	13.72
Non-vested balance as of June 30, 2012	318	\$ 21.48

	Shares (000s)	Weighted Average Grant Date Fair Value
Six months ended June 30, 2011		
Non-vested balance as of December 31, 2010	363	\$ 17.66
Granted	1	40.88
Vested	(7)	12.41
Forfeited	(17)	19.12
Non-vested balance as of June 30, 2011	340	\$ 17.77

As of June 30, 2012 and 2011, there was \$6,883 and \$6,545 respectively, of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the plans. As of June 30, 2012, the unrecognized compensation cost is expected to be recognized over a weighted-average period of 1.3 years. The Company estimates that share-based compensation expense for the year ended December 31, 2012 will be approximately \$3,900.

REPURCHASE OF COMMON STOCK

The Company has an approved stock repurchase program. The total authorization under this program is 3,763,038 shares. Since the inception of the program in June 1999, a total of 2,033,700 shares have been purchased, none of which remained in treasury at June 30, 2012 or 2011. During the six months ended June 30, 2012, a total of 23,212 shares have been purchased at an average cost of \$41.53 per share. The Company intends to acquire shares from time to time at prevailing market prices if and to the extent it deems it advisable to do so based on its assessment of corporate cash flow, market conditions and other factors.

NOTE 3 - INVENTORIES

Inventories at June 30, 2012 and December 31, 2011 consisted of the following:

	June 30, 2012	December 31, 2011
Raw materials	\$ 8,292	\$ 7,456
Work in progress	1,682	1,344
Finished goods	10,121	9,837
Total inventories	\$ 20,095	\$ 18,637

NOTE 4 - PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment at June 30, 2012 and December 31, 2011 are summarized as follows:

	June 30, 2012	December 31, 2011
Land	\$ 1,933	\$ 1,971
Building	15,647	15,680
Equipment	67,680	66,584
Construction in progress	4,174	2,632
	89,434	86,867
Less: accumulated depreciation	45,105	42,585
Net property, plant and equipment	\$ 44,329	\$ 44,282

NOTE 5 – INTANGIBLE ASSETS

The Company had goodwill in the amount of \$28,515 as of June 31, 2012 and December 31, 2011 subject to the provisions of ASC 350, “Intangibles-Goodwill and Other.”

Identifiable intangible assets with finite lives at June 30, 2012 and December 31, 2011 are summarized as follows:

	Amortization Period (in years)	Gross Carrying Amount at 6/30/12	Accumulated Amortization at 6/30/12	Gross Carrying Amount at 12/31/11	Accumulated Amortization at 12/31/11
Customer lists	10	\$37,142	\$ 19,091	\$37,142	\$ 17,272
Regulatory registration costs	10	1,302	285	1,302	220
Patents & trade secrets	15-17	1,579	723	1,571	681
Trademarks & trade names	17	909	382	907	356
Other	5-10	754	470	754	441
		\$41,686	\$ 20,951	\$41,676	\$ 18,970

Amortization of identifiable intangible assets was approximately \$1,981 for the six months ended June 30, 2012. Assuming no change in the gross carrying value of identifiable intangible assets, the estimated amortization expense for the remainder of 2012 is \$1,979, approximately \$4,000 per annum for 2013 through 2016 and \$1,400 in 2017. At June 30, 2012, there were no identifiable intangible assets with indefinite useful lives as defined by ASC 350. Identifiable intangible assets are reflected in “Intangible assets with finite lives, net” in the Company’s condensed consolidated balance sheets. There were no changes to the useful lives of intangible assets subject to amortization during the six months ended June 30, 2012.

NOTE 6 – NET EARNINGS PER SHARE

The following presents a reconciliation of the net earnings and shares used in calculating basic and diluted net earnings per share:

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	Net Earnings (Numerator)	Number of Shares (Denominator)	Per Share Amount
Three months ended June 30, 2012			
Basic EPS – Net earnings and weighted average common shares outstanding	\$ 9,972	28,956,523	\$.34
Effect of dilutive securities – stock options and restricted stock		1,316,409	
Diluted EPS – Net earnings and weighted average common shares outstanding and effect of stock options and restricted stock	\$ 9,972	30,272,932	\$.33
Three months ended June 30, 2011			
Basic EPS – Net earnings and weighted average common shares outstanding	\$ 9,572	28,544,898	\$.34
Effect of dilutive securities – stock options and restricted stock		1,687,594	
Diluted EPS – Net earnings and weighted average common shares outstanding and effect of stock options and restricted stock	\$ 9,572	30,232,492	\$.32
Six months ended June 30, 2012			
Basic EPS – Net earnings and weighted average common shares outstanding	\$ 19,240	28,940,875	\$.66
Effect of dilutive securities – stock options and restricted stock		1,354,177	
Diluted EPS – Net earnings and weighted average common shares outstanding and effect of stock options and restricted stock	\$ 19,240	30,295,052	\$.64

Six months ended June 30, 2011	Net Earnings (Numerator)	Number of Shares (Denominator)	Per Share Amount
Basic EPS – Net earnings and weighted average common shares outstanding	\$ 18,484	28,488,327	\$.65
Effect of dilutive securities – stock options and restricted stock		1,673,735	
Diluted EPS – Net earnings and weighted average common shares outstanding and effect of stock options and restricted stock	\$ 18,484	30,162,062	\$.61

The Company had stock options covering 519,455 and 283,100 shares at June 30, 2012 and 2011, respectively, that could potentially dilute basic earnings per share in future periods that were not included in diluted earnings per share because their effect on the period presented was anti-dilutive.

The Company has some share-based payment awards that have non-forfeitable dividend rights. These awards are restricted shares and they participate on a one-for-one basis with holders of common stock. These awards have an immaterial impact as participating securities with regard to the calculation using the two-class method for determining earnings per share.

NOTE 7 – INCOME TAXES

The Company accounts for uncertainty in income taxes in accordance with ASC 740-10, “Accounting for Uncertainty in Income Taxes.” ASC 740-10 clarifies whether or not to recognize assets or liabilities for tax positions taken that may be challenged by a tax authority. All of the unrecognized tax benefits, if recognized in future periods, would impact the Company’s effective tax rate. The Company files income tax returns in the U.S. and in various states and foreign countries. As of June 30 2012, in the major jurisdictions where the Company operates, it is generally no longer subject to income tax examinations by tax authorities for years before 2008. During the six months ended June 30, 2012 and 2011, there was no significant change to the amount of unrecognized tax benefits. As of June 30, 2012 and December 31, 2011, the Company had approximately \$2,092 and \$2,021, respectively, of unrecognized tax benefits. The Company does not anticipate any material change in the total amount of unrecognized tax benefits to occur within the next twelve months. The Company includes interest expense or income as well as potential penalties on unrecognized tax positions as a component of income tax expense in the consolidated statements of earnings. The total amount of accrued interest and penalties related to uncertain tax positions at June 30, 2012 and December 31, 2011 was approximately \$582 and \$547, respectively, and is included in other long-term obligations.

NOTE 8 - SEGMENT INFORMATION

The Company's reportable segments are strategic businesses that offer products and services to different markets. Presently, the Company has three segments: Specialty Products; Food, Pharma & Nutrition; and Animal Nutrition & Health.

Business Segment Net Sales:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Specialty Products	\$12,457	\$12,026	\$24,714	\$23,319
Food, Pharma & Nutrition	11,776	10,897	22,513	21,927
Animal Nutrition & Health	54,781	51,764	107,990	102,449
Total	\$79,014	\$74,687	\$155,217	\$147,695

Business Segment Earnings Before Income Taxes:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Specialty Products	\$4,849	\$4,542	\$9,578	\$8,918
Food, Pharma & Nutrition	3,389	2,832	6,098	5,344
Animal Nutrition & Health	6,587	6,685	12,824	13,095
Interest and other income (expense)	(1)	293	12	371
Total	\$14,824	\$14,352	\$28,512	\$27,728

The following table summarizes domestic (U.S.) and foreign sales for the three and six months ended June 30, 2012 and June 30, 2011:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Domestic	\$52,875	\$50,441	\$103,753	\$96,459
Foreign	26,139	24,246	51,464	51,236
Total	\$79,014	\$74,687	\$155,217	\$147,695

NOTE 9 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid during the six months ended June 30, 2012 and 2011 for income taxes and interest is as follows:

	Six Months Ended June 30,	
	2012	2011
Income taxes	\$ 3,510	\$ 9,308
Interest	\$ 5	\$ 35

NOTE 10 – LONG-TERM DEBT AND CREDIT AGREEMENTS

The Company and a bank have a Loan Agreement (the “European Loan Agreement”) providing for an unsecured term loan of \$9,434 (the “European Term Loan”). The European Term Loan is payable in equal monthly installments of principal, each equal to 1/84th of the principal of the European Term Loan, together with accrued interest, with remaining principal and interest payable at maturity. Effective April 30, 2010, the European Term Loan was renewed with a new maturity date of May 1, 2014, and is subject to a monthly interest rate equal to EURIBOR plus 1%. At June 30, 2012, this interest rate was 1.39%. At June 30, 2012, the European Term Loan had an outstanding balance of €554, translated to \$696. The European Loan Agreement also provided for a short-term revolving credit facility of €3,000 (the “European Revolving Facility”). The European Revolving Facility was subject to a monthly interest rate equal to EURIBOR plus 1.45%, and accrued interest was payable monthly. The European Revolving Facility matured on May 31, 2012, and the Company did not renew such facility.

The Company and a bank have a Loan Agreement (the “Loan Agreement”), which provided for a short-term revolving credit facility of \$6,000 (the “Revolving Facility”). The Revolving Facility was subject to a monthly interest rate equal to LIBOR plus 1%, and accrued interest was payable monthly. The Revolving Facility matured on May 31, 2012, and the Company did not renew such facility.

NOTE 11 - EMPLOYEE BENEFIT PLAN

The Company currently provides postretirement benefits in the form of a retirement medical plan under a collective bargaining agreement covering eligible retired employees of its Verona, Missouri facility.

Net periodic benefit cost for such retirement medical plan for the six months ended June 30, 2012 and June 30, 2011 was as follows:

	2012	2011
Service cost	\$ 26	\$ 32
Interest cost	21	32
Amortization of prior service cost	(9)	(9)
Amortization of loss	2	7
Net periodic benefit cost	\$ 40	\$ 62

The amount recorded on the Company’s balance sheet as of June 30, 2012 for this obligation is \$1,125, and it is included in other long-term obligations. The plan is unfunded and approved claims are paid from Company funds. Historical cash payments made under such plan have typically been less than \$100 per year.

NOTE 12 – COMMITMENTS AND CONTINGENCIES

In 2002, the Company entered into a ten (10) year lease for approximately 20,000 square feet of office space. It is the Company’s intention to renew this lease. The office space is now serving as the Company’s general offices and as a laboratory facility. The Company

leases most of its vehicles and office equipment under non-cancelable operating leases, which primarily expire at various times through 2022.

Rent expense charged to operations under such lease agreements for the six months ended June 30, 2012 and 2011 aggregated approximately \$470 and \$600, respectively. Aggregate future minimum rental payments required under all non-cancelable operating leases at June 30, 2012 are as follows:

Year	
July 1, 2012 to December 31, 2012	\$ 380
2013	413
2014	217
2015	169
2016	120
2017	52
Thereafter	184
Total minimum lease payments	\$ 1,535

In 1982, the Company discovered and thereafter removed a number of buried drums containing unidentified waste material from the Company's site in Slate Hill, New York. The Company thereafter entered into a Consent Decree to evaluate the drum site with the New York Department of Environmental Conservation ("NYDEC") and performed a Remedial Investigation/Feasibility Study that was approved by NYDEC in February 1994. Based on NYDEC requirements, the Company cleaned the area and removed additional soil from the drum burial site, which was completed in 1996. The Company continues to be involved in discussions with NYDEC to evaluate test results and determine what, if any, additional actions will be required on the part of the Company to close out the remediation of this site. Additional actions, if any, would likely require the Company to continue monitoring the site. The cost of such monitoring has been less than \$5 per year for the period 2004 to date.

The Company's Verona, Missouri facility, while held by a prior owner, was designated by the EPA as a Superfund site and placed on the National Priorities List in 1983, because of dioxin contamination on portions of the site. Remediation conducted by the prior owner under the oversight of the EPA and the Missouri Department of Natural Resources ("MDNR") included removal of dioxin contaminated soil and equipment, capping of areas of residual contamination in four relatively small areas of the site separate from the manufacturing facilities, and the installation of wells to monitor groundwater and surface water contamination by organic chemicals. No ground water or surface water treatment was required. The Company believes that remediation of the site is complete. In 1998, the EPA certified the work on the contaminated soils to be complete. In February 2000, after the conclusion of two years of monitoring groundwater and surface water, the former owner submitted a draft third party risk assessment report to the EPA and MDNR recommending no further action. The prior owner is awaiting the response of the EPA and MDNR to the draft risk assessment.

While the Company must maintain the integrity of the capped areas in the remediation areas on the site, the prior owner is responsible for completion of any further Superfund remedy. The Company is indemnified by the sellers under its May 2001 asset purchase

agreement covering its acquisition of the Verona, Missouri facility for potential liabilities associated with the Superfund site and one of the sellers, in turn, has the benefit of certain contractual indemnification by the prior owner that is implementing the above-described Superfund remedy.

From time to time, the Company is a party to various litigation, claims and assessments. Management believes that the ultimate outcome of such matters will not have a material effect on the Company's consolidated financial position, results of operations, or liquidity.

NOTE 13 – NEW ACCOUNTING PRONOUNCEMENTS

In December 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-12, "Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05" ("ASU 2011-12"). The amendments to the Codification in ASU No. 2011-12 are effective at the same time as the amendments in ASU No. 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income, so that entities will not be required to comply with the presentation requirements in ASU No. 2011-05 that ASU No. 2011-12 is deferring. In order to defer only those changes in ASU No. 2011-05 that relate to the presentation of reclassification adjustments, the paragraphs in ASU No. 2011-12 supersede certain pending paragraphs in ASU No. 2011-05. The amendments are being made to allow the FASB time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the FASB is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU No. 2011-05. All other requirements in ASU No. 2011-05 are not affected by ASU No. 2011-12, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. Public entities should apply these requirements for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company early adopted the guidance for fiscal year 2011 and implementation did not have a material impact on its financial statements.

In September 2011, the FASB issued ASU No. 2011-08, "Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment" ("ASU 2011-08"). This ASU is intended to simplify how entities, both public and nonpublic, test goodwill for impairment. ASU 2011-08 permits an entity to first assess qualitative factors to determine whether it is "more likely than not" that the fair value of a reporting unit is less than its carrying amount, including goodwill, as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350, Intangibles-Goodwill and Other. The more-likely-than-not threshold is defined as having a likelihood of more than 50%. ASU 2011-08 is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The Company early

adopted the guidance for fiscal year 2011 and implementation did not have a material impact on its financial statements.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (All dollar amounts in thousands)

This Report contains forward-looking statements, within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, which reflect our expectation or belief concerning future events that involve risks and uncertainties. Our actions and performance could differ materially from what is contemplated by the forward-looking statements contained in this Report. Factors that might cause differences from the forward-looking statements include those referred to or identified in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2011 and other factors that may be identified elsewhere in this Report. Reference should be made to such factors and all forward-looking statements are qualified in their entirety by the above cautionary statements.

Overview

We develop, manufacture, distribute and market specialty performance ingredients and products for the food, nutritional, pharmaceutical, animal health and medical device sterilization industries. Our reportable segments are strategic businesses that offer products and services to different markets. We presently have three reportable segments: Specialty Products; Food, Pharma & Nutrition; and Animal Nutrition & Health.

Specialty Products

Our Specialty Products segment operates in industry as ARC Specialty Products.

Ethylene oxide, at the 100% level, is sold as a sterilant gas, primarily for use in the health care industry. It is used to sterilize a wide range of medical devices because of its versatility and effectiveness in treating hard or soft surfaces, composites, metals, tubing and different types of plastics without negatively impacting the performance of the device being sterilized. Contract sterilizers, medical device manufacturers, and medical gas distributors are our principal customers for this product. In addition, we also sell single use canisters with 100% ethylene oxide for use in medical device sterilization. As a fumigant, ethylene oxide blends are highly effective in killing bacteria, fungi, and insects in spices and other seasoning materials.

We sell propylene oxide as a fumigant: to aid in the control of insects and microbiological spoilage; and to reduce bacterial and mold contamination in shell and processed nut meats (except peanuts), processed spices, cacao beans, cocoa powder, raisins, figs and prunes. We also sell propylene oxide to customers seeking smaller (as opposed to bulk) quantities and whose requirements include utilization in various chemical synthesis applications, to make paints more durable and for manufacturing specialty starches and textile coatings.

Food, Pharma & Nutrition

The Food, Pharma & Nutrition (“FPN”) segment provides microencapsulation solutions to a variety of applications in food, pharmaceutical and nutritional ingredients to enhance performance of nutritional fortification, processing, mixing, and packaging applications and shelf-life. Major product applications are baked goods, refrigerated and frozen dough systems, processed meats, seasoning blends, confections, and nutritional supplements. We also market human grade choline nutrient products through this segment for wellness applications. Choline is recognized to play a key role in the development and structural integrity of brain cell membranes in infants, processing dietary fat, reproductive development and neural functions, such as memory and muscle function. The FPN portfolio also includes a novel smooth dissolve excipient technology, primarily used in chewable tablets or stick-pack dosage forms for nutritional and pharmaceutical products.

Animal Nutrition & Health

Our Animal Nutrition & Health (“ANH”) segment provides the animal nutrition market with nutritional products derived from our microencapsulation and chelation technologies in addition to basic choline chloride. Commercial sales of REASHURE® Choline, an encapsulated choline product, NITROSHURE™, an encapsulated urea supplement, and NIASHURE™, our microencapsulated niacin product for dairy cows, boosts health and milk production in transition and lactating dairy cows, delivering nutrient supplements that survive the rumen and are biologically available, providing required nutritional levels. We also market chelated mineral supplements for use in animal feed throughout the world, as our proprietary chelation technology provides enhanced nutrient absorption for various species of production and companion animals. In October 2008, we introduced the first proven rumen-protected lysine for use in dairy rations, AMINOSHURE®-L, which gives nutritionists and dairy producers a precise and consistent source of rumen-protected lysine. ANH also manufactures and supplies basic choline chloride, an essential nutrient for animal health, predominantly to the poultry and swine industries. Choline, which is manufactured and sold in both dry and aqueous forms, plays a vital role in the metabolism of fat. Choline deficiency can result in reduced growth and perosis in poultry; fatty liver, kidney necrosis and general poor health condition in swine. Certain derivatives of choline chloride are also manufactured and sold into industrial applications predominately as a component for hydraulic fracturing of shale natural gas wells. The ANH segment also includes the manufacture and sale of methylamines. Methylamines are a primary building block for the manufacture of choline products and are also used in a wide range of industrial applications.

The Company sells products for all three segments through its own sales force, independent distributors, and sales agents.

The following tables summarize consolidated net sales by segment and business segment earnings from operations for the three and six months ended June 30, 2012 and June 30, 2011:

Business Segment Net Sales:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Specialty Products	\$12,457	\$12,026	\$24,714	\$23,319
Food, Pharma & Nutrition	11,776	10,897	22,513	21,927
Animal Nutrition & Health	54,781	51,764	107,990	102,449
Total	\$79,014	\$74,687	\$155,217	\$147,695

Business Segment Earnings From Operations:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Specialty Products	\$4,849	\$4,542	\$9,578	\$8,918
Food, Pharma & Nutrition	3,389	2,832	6,098	5,344
Animal Nutrition & Health	6,587	6,685	12,824	13,095
Total	\$14,825	\$14,059	\$28,500	\$27,357

RESULTS OF OPERATIONS

Three months ended June 30, 2012 compared to three months ended June 30, 2011.

Net Sales

Net sales for the three months ended June 30, 2012 were \$79,014 as compared with \$74,687 for the three months ended June 30, 2011, an increase of \$4,327 or 5.8%. Net sales for the Specialty Products segment were \$12,457 for the three months ended June 30, 2012, as compared with \$12,026 for the three months ended June 30, 2011, an increase of \$431 or 3.6%. Approximately 59% of this increase in sales was from ethylene oxide products for medical device sterilization, resulting primarily from modest price increases to offset rising raw material costs. The balance of the increased sales is principally a result of higher sales from propylene oxide for use in the fumigation of certain nut meats and spice fumigation. Net sales for the Food, Pharma & Nutrition segment were \$11,776 for the three months ended June 30, 2012 compared with \$10,897 for the three months ended June 30, 2011, an increase of \$879 or 8.1%. This result was primarily due to a \$1,288 increase in sales of human choline products for both food applications and the supplement markets. Partially offsetting this was an 8.2% decrease in sales in the food market, principally due to lower volumes sold of encapsulated ingredients for certain flavor markets. Also offsetting the increased sales was lower sales of calcium products, which were down approximately \$102, a result of our having sold this business in late 2010, but which was still winding down in 2011. Net sales of \$54,781 were realized for the three months ended June 30, 2012 for the Animal Nutrition & Health segment, as compared with \$51,764 for the prior year comparable period, an increase of \$3,017 or 5.8%. The ANH specialty ingredients, largely targeted to the ruminant and companion animal markets, realized 36% sales growth from the prior year comparable period. The improvement was due to volume increases, as some regional improvement in dairy economics supported greater demand, particularly for our rumen

protected choline, lysine, and methionine products. However, during the quarter, the Company announced a decision to suspend sales of its AminoShure®-L, 52% lysine (the "Product"). There were no safety concerns relating to the Product; however, research indicated that the lysine bioavailability of the Product was lower than originally designed and projected, hence found to not meet our internal expectations. The sales credits issued related to this decision were approximately \$1.0 million in the quarter. Global feed grade choline product sales increased by approximately 3% primarily due to modest price increases, implemented globally, to partially offset rising raw material costs. The Company experienced an overall decrease in sales of various choline and choline derivative products used for certain industrial applications, predominantly in Europe. Industrial sales declined 3.5% over the prior year period with the decrease coming from lower volumes, partially offset by increased average selling prices implemented to offset rising raw material costs. Sales for industrial applications comprised approximately 31.6% of the sales in this segment for the three months ended June 30, 2012.

Gross Margin

Gross margin for the three months ended June 30, 2012 increased to \$22,584 compared to \$21,761 for the three months ended June 30, 2011, an increase of 3.8%. This \$823 increase was principally a result of higher sales, partially offset by increased raw material costs and approximately \$800 due to the net effect of the aforementioned Product sales suspension. Gross margin percentage for the three months ended June 30, 2012 decreased to 28.6%, as compared to 29.1% in the prior year comparative period, primarily due to increases in certain key raw material costs and the impact of the Product sales suspension. Gross margin percentage for the Specialty Products segment increased slightly by 0.3% primarily due to a favorable product mix. Gross margin percentage in the Food, Pharma & Nutrition segment increased by 1.1% primarily due to the sale of the non-core calcium carbonate product line in the fourth quarter of 2010, which was still winding down in 2011. Gross margin percentage in the Animal Nutrition & Health segment decreased by 1.0%, principally from increases in the cost of certain petro-chemical raw materials used to manufacture choline and the impact of the Product sales suspension, partially offset by higher overall Animal Nutrition & Health sales volumes.

Operating Expenses

Operating expenses for the three months ended June 30, 2012 were \$7,759, as compared to \$7,702 for the three months ended June 30, 2011, an increase of \$57 or 0.7%. This was principally due to increased outside research of \$173 and costs of \$160 related to the Product sales suspension, partially offset by lower consultancy fees of \$178, primarily incurred to study acquisition opportunities, and decreased advertising of \$65. Operating expenses were 9.8% of sales or 0.5 percentage points less than the operating expenses as a percent of sales in last year's comparable period. During the three months ended June 30, 2012 and 2011, the Company spent \$947 and \$733 respectively, on research and development programs, substantially all of which pertained to the Company's Food, Pharma & Nutrition and Animal Nutrition & Health segments.

Earnings From Operations

Principally as a result of the above-noted details, earnings from operations for the three months ended June 30, 2012 increased to \$14,825 as compared to \$14,059 for the three

months ended June 30, 2011, an increase of \$766 or 5.4%. Earnings from operations as a percentage of sales (“operating margin”) for the three months ended June 30, 2012 remained flat at 18.8% when compared to the three months ended June 30, 2011. The Company is continuing to focus on leveraging its plant capabilities, driving efficiencies from core volume growth, broadening product applications of human and animal health specialty products into both the domestic and international markets, as well as capitalizing logistically on the Company’s varied choline production capabilities. Earnings from operations for the Specialty Products segment were \$4,849, an increase of \$307 or 6.8%, primarily due to the above-noted higher sales of ethylene oxide and propylene oxide and a favorable product mix. Earnings from operations for Food, Pharma & Nutrition were \$3,389, an increase of \$557 or 19.7%, due largely to the above-noted increased sales of human choline products and the sale of the non-core calcium carbonate product line in the fourth quarter of 2010, which was still generating an operating loss in 2011. Partially offsetting this was lower sales volumes in the food market. Earnings from operations for Animal Nutrition & Health decreased by \$98 to \$6,587, a 1.5% decrease from the prior year comparable period, principally due to the aforementioned increases of certain petro-chemical raw materials used to manufacture choline and the impact of the Product sales suspension, partially offset by higher overall Animal Nutrition & Health sales volumes.

Other Expenses (Income)

Interest income for the three months ended June 30, 2012 totaled \$1 as compared to \$69 for the three months ended June 30, 2011. Interest expense was \$3 for the three months ended June 30, 2012 compared to \$22 for the three months ended June 30, 2011. This decrease is primarily attributable to the decrease in average current and long-term debt resulting from normal recurring principal payments. Other income of \$1 for the three months ended June 30, 2012 is primarily the result of favorable fluctuations in foreign currency exchange rates between the U.S. dollar (the reporting currency) and functional foreign currencies. Other income of \$246 for the three months ended June 30, 2011 is primarily the result of a net gain of \$188 related to the sale of a non-core calcium carbonate product line and favorable fluctuations in foreign currency exchange rates between the U.S. dollar (the reporting currency) and functional foreign currencies.

Income Tax Expense

The Company’s effective tax rate for the three months ended June 30, 2012 and 2011 was 32.7% and 33.3%, respectively. This decrease in the effective tax rate is primarily attributable to a change in apportionment relating to state income taxes.

Net Earnings

Principally as a result of the above-noted details, net earnings were \$9,972 for the three months ended June 30, 2012, as compared with \$9,572 for the three months ended June 30, 2011, an increase of 4.2%.

Six months ended June 30, 2012 compared to six months ended June 30, 2011.

Net Sales

Net sales for the six months ended June 30, 2012 were \$155,217 as compared with \$147,695 for the six months ended June 30, 2011, an increase of \$7,522 or 5.1%. Net sales for the Specialty Products segment were \$24,714 for the six months ended June 30, 2012, as compared with \$23,319 for the six months ended June 30, 2011, an increase of \$1,395 or 6.0%. Approximately 73% of this increase in sales was from our ethylene oxide products for medical device sterilization, resulting from modest price increases to partially offset rising raw material costs. The balance of the increased sales is principally a result of higher sales from propylene oxide for use in the fumigation of certain nut meats and spice fumigation. Net sales for the Food, Pharma & Nutrition segment were \$22,513 for the six months ended June 30, 2012 compared with \$21,927 for the six months ended June 30, 2011, an increase of \$586 or 2.7%. This result was primarily due to a \$2,355 increase in sales of human choline products for both food applications and the supplement markets. Partially offsetting this was a 12.9% decrease in sales in the food market, principally due to lower volumes sold of encapsulated ingredients for certain flavor markets. Also offsetting the increased sales was lower sales of calcium products, which were down approximately \$318, a result of our having sold this business in late 2010, but which was still winding down in 2011. Net sales of \$107,990 were realized for the six months ended June 30, 2012 for the Animal Nutrition & Health segment, as compared with \$102,449 for the prior year comparable period, an increase of \$5,541 or 5.4%. The ANH specialty ingredients, largely targeted to the ruminant and companion animal markets, realized 33% sales growth from the prior year comparable period. The improvement was due to volume increases, as some regional improvement in dairy economics supported greater demand, particularly for our rumen protected choline, lysine, and methionine products. However, during the second quarter 2012, the Company announced a decision to suspend sales of its AminoShure®-L, 52% lysine (the "Product"). There were no safety concerns relating to the Product; however, research indicated that the lysine bioavailability of the Product was lower than originally designed and projected, hence found to not meet our internal expectations. The sales credits issued related to this decision were approximately \$1.0 million in the period. Global feed grade choline product sales decreased by approximately 1% due to lower volumes, partially offset by modest price increases, implemented globally, to partially offset rising raw material costs. The Company experienced increased sales of various choline and choline derivative products used for industrial applications, predominantly in North America, including usage in natural gas fracking. Industrial sales grew 1.4% over the prior year period with the increase coming from increased average selling prices, implemented to offset rising raw material costs. Sales for industrial applications comprised approximately 30.2% of the sales in this segment for the six months ended June 30, 2012.

Gross Margin

Gross margin for the six months ended June 30, 2012 increased to \$43,742 compared to \$42,541 for the six months ended June 30, 2011, an increase of 2.8%. This \$1,201 increase was principally a result of higher sales, partially offset by increased raw material costs and approximately \$800 due to the net effect of the aforementioned Product sales suspension. Gross margin percentage for the six months ended June 30, 2012 decreased to 28.2% as compared to 28.8% in the prior year comparative period, primarily due to

increases in certain key raw material costs and the impact of the Product sales suspension. Gross margin percentage for the Specialty Products segment decreased by 0.4% primarily due to higher raw material costs. Gross margin percentage in the Food, Pharma & Nutrition segment increased by 1.7% primarily due to the sale of the non-core calcium carbonate product line in the fourth quarter of 2010, which was still winding down in 2011. Gross margin percentage in the Animal Nutrition and Health segment decreased by 1.1%, principally from increases in the cost of certain petro-chemical raw materials used to manufacture choline and the impact of the Product sales suspension, partially offset by higher overall Animal Nutrition & Health sales volumes.

Operating Expenses

Operating expenses for the six months ended June 30, 2012 were \$15,242, as compared to \$15,184 for the six months ended June 30, 2011, an increase of \$58 or 0.4%. This was principally due to increased outside research of \$228 and costs of \$160 related to the Product sales suspension, partially offset by decreased advertising of \$106 and lower consultancy fees of \$256 primarily incurred to study acquisition opportunities and related to the 2010 Aberco acquisition that were incurred during the six months ended June 30, 2011. Operating expenses were 9.8% of sales or 0.5 percentage points less than the operating expenses as a percent of sales in last year's comparable period. During the six months ended June 30, 2012 and 2011, the Company spent \$1,723 and \$1,609 respectively, on research and development programs, substantially all of which pertained to the Company's Food, Pharma & Nutrition and Animal Nutrition & Health segments.

Earnings From Operations

Principally as a result of the above-noted details, earnings from operations for the six months ended June 30, 2012 increased to \$28,500 as compared to \$27,357 for the six months ended June 30, 2011, an increase of \$1,143 or 4.2%. Earnings from operations as a percentage of sales ("operating margin") for the six months ended June 30, 2012 decreased to 18.4% from 18.5% for the six months ended June 30, 2011. The Company is continuing to focus on leveraging its plant capabilities, driving efficiencies from core volume growth, broadening product applications of human and animal health specialty products into both the domestic and international markets, as well as capitalizing logistically on the Company's varied choline production capabilities. Earnings from operations for the Specialty Products segment were \$9,578, an increase of \$660 or 7.4%, primarily due to the above-noted higher sales of ethylene oxide and propylene oxide, and the exclusion of consulting costs related to the Aberco acquisition that were incurred during the six months ended June 30, 2011. This was partially offset by the aforementioned higher raw material costs. Earnings from operations for Food, Pharma & Nutrition were \$6,098, an increase of \$754 or 14.1%, due largely to the above-noted increased sales of human choline products and the sale of the non-core calcium carbonate product line in the fourth quarter of 2010, which was still generating an operating loss in 2011. Partially offsetting this was lower sales volumes in the food market. Earnings from operations for Animal Nutrition & Health decreased by \$271 to \$12,824, a 2.1% decrease from the prior year comparable period, principally due to the aforementioned increases of certain petro-chemical raw materials used to manufacture choline and the impact of the Product sales suspension, partially offset by higher overall Animal Nutrition & Health sales volumes.

Other Expenses (Income)

Interest income for the six months ended June 30, 2012 totaled \$8 as compared to \$140 for the six months ended June 30, 2011. Interest expense was \$6 for the six months ended June 30, 2012 compared to \$40 for the six months ended June 30, 2011. This decrease is primarily attributable to the decrease in average current and long-term debt resulting from normal recurring principal payments. Other income of \$10 for the six months ended June 30, 2012 is primarily the result of favorable fluctuations in foreign currency exchange rates between the U.S. dollar (the reporting currency) and functional foreign currencies. Other income of \$271 for the six months ended June 30, 2011 is primarily the result of a net gain of \$188 related to the sale of a non-core calcium carbonate product line and favorable fluctuations in foreign currency exchange rates between the U.S. dollar (the reporting currency) and functional foreign currencies.

Income Tax Expense

The Company's effective tax rate for the six months ended June 30, 2012 and 2011 was 32.5% and 33.3%, respectively. This decrease in the effective tax rate is primarily attributable to a change in apportionment relating to state income taxes.

Net Earnings

Principally as a result of the above-noted details, net earnings were \$19,240 for the six months ended June 30, 2012, as compared with \$18,484 for the six months ended June 30, 2011, an increase of 4.1%.

FINANCIAL CONDITION

LIQUIDITY AND CAPITAL RESOURCES

(All amounts in thousands, except share and per share data)

Contractual Obligations

The Company's contractual obligations and commitments principally include obligations associated with future minimum non-cancelable operating lease obligations, long-term debt obligations, interest payment obligations and purchase obligations principally related to open purchase orders for inventory not yet received or recorded on our balance sheet.

The Company knows of no current or pending demands on, or commitments for, its liquid assets that will materially affect its liquidity.

During the six months ended June 30, 2012, there were no material changes outside the ordinary course of business in the specified contractual obligations set forth in our Annual Report on Form 10-K for the year ended December 31, 2011. The Company expects its operations to continue generating sufficient cash flow to fund working capital requirements and necessary capital investments. The Company is actively pursuing additional acquisition candidates. The Company could seek additional bank loans or access to financial markets to fund such acquisitions, its operations, working capital,

necessary capital investments or other cash requirements should it deem it necessary to do so.

Cash

Cash and cash equivalents increased to \$138,060 at June 30, 2012 from \$114,781 at December 31, 2011 primarily resulting from the activity detailed below. At June 30, 2012, the Company had \$1,517 of cash and cash equivalents held by our foreign subsidiaries. It is our intention to permanently reinvest these funds in our foreign operations by continuing to repay acquisition related debt, make additional plant related investments as needed and potentially invest in additional acquisitions; therefore, we do not currently expect to repatriate these funds in order to fund our U.S. operations or obligations. However, if these funds are needed for our operations in the U.S., we could be required to pay additional U.S. taxes to repatriate these funds. Working capital amounted to \$168,291 at June 30, 2012 as compared to \$144,827 at December 31, 2011, an increase of \$23,464.

Operating Activities

Cash flows from operating activities provided \$31,223 for the six months ended June 30, 2012 compared to \$17,117 for the six months ended June 30, 2011. The increase in cash flows from operating activities was primarily due to higher net earnings along with favorable changes in various components of working capital, particularly in accounts receivable, inventories, accounts payable and accrued expenses, and income taxes.

Investing Activities

Capital expenditures were \$3,198 for the six months ended June 30, 2012 compared to \$3,210 for the six months ended June 30, 2011.

Financing Activities

The Company has an approved stock repurchase program. The total authorization under this program is 3,763,038 shares. Since the inception of the program in June 1999, a total of 2,033,700 shares have been purchased, none of which remained in treasury at June 30, 2012 or 2011. During the six months ended June 30, 2012, a total of 23,212 shares have been purchased at an average cost of \$41.53 per share. The Company intends to acquire shares from time to time at prevailing market prices if and to the extent it deems it advisable to do so based on its assessment of corporate cash flow, market conditions and other factors.

The Company and a bank have a Loan Agreement (the "European Loan Agreement") providing for an unsecured term loan of \$9,434 (the "European Term Loan"). The European Term Loan is payable in equal monthly installments of principal, each equal to 1/84th of the principal of the European Term Loan, together with accrued interest, with remaining principal and interest payable at maturity. Effective April 30, 2010, the European Term Loan was renewed with a new maturity date of May 1, 2014, and is subject to a monthly interest rate equal to EURIBOR plus 1%. At June 30, 2012, this interest rate was 1.39%. At June 30, 2012, the European Term Loan had an outstanding

balance of €554, translated to \$696. The European Loan Agreement also provided for a short-term revolving credit facility of €3,000 (the "European Revolving Facility"). The European Revolving Facility was subject to a monthly interest rate equal to EURIBOR plus 1.45%, and accrued interest was payable monthly. The European Revolving Facility matured on May 31, 2012, and the Company did not renew such facility.

The Company and a bank have a Loan Agreement (the "Loan Agreement"), which provided for a short-term revolving credit facility of \$6,000 (the "Revolving Facility"). The Revolving Facility was subject to a monthly interest rate equal to LIBOR plus 1%, and accrued interest was payable monthly. The Revolving Facility matured on May 31, 2012, and the Company did not renew such facility.

Proceeds from stock options exercised and restricted shares purchased totaled \$877 and \$2,314 for the six months ended June 30, 2012 and 2011, respectively. Dividend payments were \$5,237 and \$4,310 for the six months ended June 30, 2012 and 2011, respectively.

Other Matters Impacting Liquidity

The Company currently provides postretirement benefits in the form of a retirement medical plan under a collective bargaining agreement covering eligible retired employees of its Verona, Missouri facility. The amount recorded on the Company's balance sheet as of June 30, 2012 for this obligation is \$1,125. The postretirement plan is not funded. Historical cash payments made under such plan have typically been less than \$100 per year.

Critical Accounting Policies

There were no changes to the Company's Critical Accounting Policies, as described in its December 31, 2011 Annual Report on Form 10-K, during the six months ended June 30, 2012.

Related Party Transactions

The Company was not engaged in related party transactions during the six months ended June 30, 2012.

Item 3.

Quantitative and Qualitative Disclosures about Market Risk

Cash and cash equivalents are held primarily in noninterest-bearing demand deposit accounts, which are currently fully insured by the Federal Deposit Insurance Corporation (“FDIC”). The Company has no derivative financial instruments or derivative commodity instruments, nor does the Company have any financial instruments entered into for trading or hedging purposes. As of June 30, 2012, the Company’s borrowings were under a bank term loan bearing interest at EURIBOR plus 1.00%. A 100 basis point increase or decrease in interest rates, applied to the Company’s borrowings at June 30, 2012, would result in an increase or decrease in annual interest expense and a corresponding reduction or increase in cash flow of approximately \$7. The Company is exposed to market risks for changes in foreign currency rates and has exposure to commodity price risks, including prices of our primary raw materials. Our objective is to seek a reduction in the potential negative earnings impact of changes in foreign exchange rates and raw material pricing arising in our business activities. The Company manages these financial exposures, where possible, through pricing and operational means. Our practices may change as economic conditions change.

Item 4.

Controls and Procedures

(a)Evaluation of Disclosure Controls and Procedures

As required by Rule 13a-15 under the Securities Exchange Act of 1934 (the “Exchange Act”), we carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as of the end of the period covered by this report on Form 10-Q. This evaluation was carried out under the supervision and with the participation of our management, including our President and Chief Executive Officer and our Chief Financial Officer. Based upon that evaluation, management concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is accumulated and communicated to management (including the chief executive officer and chief financial officer) to allow timely decisions regarding required disclosure and that our disclosure controls and procedures are effective to give reasonable assurance that the information required to be disclosed by us in reports that we file under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission.

(b)Changes in Internal Controls

During the most recent fiscal quarter, there has been no significant change in the Company’s internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company’s internal control over financial reporting.

Part II. Other Information

Item 1A. Risk Factors

There have been no material changes in the Risk Factors identified in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

Item 4. Reserved.

Item 6. Exhibits

Exhibit 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a).

Exhibit 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a).

Exhibit 32.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code.

Exhibit 32.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code.

101.INS XBRL Instance Document

101.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LAB XBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

SIGNATURES

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

BALCHEM CORPORATION

By: /s/ Dino A. Rossi
Dino A. Rossi, Chairman, President and
Chief Executive Officer

By: /s/ Francis J. Fitzpatrick
Francis J. Fitzpatrick,
Chief Financial Officer and Treasurer

Date: August 3, 2012

Exhibit Index

Exhibit No. Description

<u>Exhibit</u> <u>31.1</u>	Certification of Chief Executive Officer pursuant to Rule 13a-14(a).
<u>Exhibit</u> <u>31.2</u>	Certification of Chief Financial Officer pursuant to Rule 13a-14(a).
<u>Exhibit</u> <u>32.1</u>	Certification of Chief Executive Officer pursuant to Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code.
<u>Exhibit</u> <u>32.2</u>	Certification of Chief Financial Officer pursuant to Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
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