LSB INDUSTRIES INC
Form 10-Q
August 08, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

Form 10-Q

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

For the quarterly period ended June 30, 2016

OR

o 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.

x Yes o 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).

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

o Yes x No

The number of shares outstanding of the Registrant's common stock was 27,935,492 shares as of August 1, 2016.

FORM 10-Q OF LSB INDUSTRIES, INC.

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PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

LSB INDUSTRIES, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Information at June 30, 2016 is unaudited)

	June 30, 2016	December 31, 2015
	(In Thousands)	
Assets		
Current assets:		
Cash and cash equivalents	$22,836	$127,195
Accounts receivable, net	43,410	49,601
Inventories:		
Finished goods	15,860	19,029
Raw materials	2,930	5,428
Total inventories, net	18,790	24,457
Supplies, prepaid items and other:		
Prepaid insurance	4,470	10,563
Precious metals	10,617	12,918
Supplies	21,661	18,681
Prepaid and refundable income taxes	7,387	6,811
Other	3,192	4,701
Total supplies, prepaid items and other	47,327	53,674
Deferred income taxes	5,718	4,774
Current assets held for sale	114,468	72,996
Total current assets	252,549	332,697
Property, plant and equipment, net	1,093,609	978,709
Intangible and other, net	15,756	16,640
Noncurrent assets held for sale	—	33,781
	$1,361,914	$1,361,827

(Continued on following page)

LSB INDUSTRIES, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (continued)

(Information at June 30, 2016 is unaudited)

	June 30, 2016	December 31, 2015
	(In Thousands)	
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$72,987	$87,999
Short-term financing	3,666	9,119
Accrued and other liabilities	35,603	39,808
Revolving credit facility	30,907	—
Current portion of long-term debt	15,173	22,468
Current liabilities held for sale	47,289	32,526
Total current liabilities	205,625	191,920
Long-term debt, net	513,505	497,954
Noncurrent accrued and other liabilities	9,223	8,786
Noncurrent liabilities held for sale	—	12,136
Deferred income taxes	31,681	52,179
Commitments and contingencies (Note 8)		
Redeemable preferred stocks:		
Series E 14% cumulative, redeemable Class C preferred stock, no par value, 210,000 shares issued and outstanding; aggregate liquidation preference of $227,266,000 ($212,287,000 at December 31, 2015)	196,735	177,272
Series F redeemable Class C preferred stock, no par value, 1 share issued and outstanding; aggregate liquidation preference of $100	—	—
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, 31,280,685 shares	3,128	2,713

issued (27,131,724 shares at December 31, 2015)		
Capital in excess of par value	192,152	192,249
Retained earnings	228,837	248,150
	427,117	446,112
Less treasury stock, at cost:		
Common stock, 3,317,503 shares (3,735,503 shares at December 31, 2015)	21,972	24,532
Total stockholders' equity	405,145	421,580
	$1,361,914	$1,361,827

See accompanying notes.

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LSB INDUSTRIES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(In Thousands, Except Per Share Amounts)			
Net sales	$109,982	$125,503	$208,954	$259,103
Cost of sales	107,853	112,887	212,989	225,688
Gross profit (loss)	2,129	12,616	(4,035)	33,415
Selling, general and administrative expense	10,874	14,546	21,768	25,746
Other expense (income), net	138	(333)	389	(491)
Operating income (loss)	(8,883)	(1,597)	(26,192)	8,160
Interest expense, net	6,446	2,229	7,796	5,626
Non-operating other income, net	(3,970)	(45)	(2,014)	(80)
Income (loss) from continuing operations before provision (benefit) for income taxes	(11,359)	(3,781)	(31,974)	2,614
Provision (benefit) for income taxes	(3,671)	(907)	(8,521)	1,251
Income (loss) from continuing operations	(7,688)	(2,874)	(23,453)	1,363
Income from discontinued operations, including taxes	22,779	3,291	23,603	5,703
Net income	15,091	417	150	7,066
Dividends on convertible preferred stocks	75	—	150	300
Dividend on Series E redeemable preferred stock	7,629	—	14,979	—
Accretion of Series E redeemable preferred stock	2,241	—	4,484	—
Net income attributable to participating securities	91	—	—	—
Net income (loss) attributable to common stockholders	$5,055	$417	$(19,463)	$6,766
Income (loss) per common share:				
Basic:				
Loss from continuing operations	$(0.70)	$(0.13)	$(1.81)	$0.05
Income from discontinued operations, including taxes	0.90	0.15	0.99	0.25
Net income (loss)	$0.20	$0.02	$(0.82)	$0.30
Diluted:				
Loss from continuing operations	$(0.70)	$(0.13)	$(1.81)	$0.05
Income from discontinued operations, including taxes	0.90	0.15	0.99	0.24
Net income (loss)	$0.20	$0.02	$(0.82)	$0.29

See accompanying notes.

LSB INDUSTRIES, INC.

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

(Unaudited)

Six Months Ended June 30, 2016

	Common Stock Shares	Non-Redeemable Preferred Stock	Common Stock Par Value	Capital in Excess of Par Value	Retained Earnings	Treasury Stock-Common	Total
	(In Thousands)						
Balance at December 31, 2015	27,132	$ 3,000	$ 2,713	$ 192,249	$ 248,150	$ (24,532)	$ 421,580
Net income					150		150
Dividend accrued on redeemable preferred stock					(14,979)		(14,979)
Accretion of redeemable preferred stock					(4,484)		(4,484)
Stock-based compensation				2,921			2,921
Exercise of stock options	45		4	367			371
Exercise of warrants	4,104		411			(411)	—
Restricted stock granted from treasury stock				(2,971)		2,971	—
Excess income tax detriment associated with stock-based compensation				(414)			(414)
Balance at June 30, 2016	31,281	$ 3,000	$ 3,128	$ 192,152	$ 228,837	$ (21,972)	$ 405,145

See accompanying notes.

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LSB INDUSTRIES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Six Months Ended June 30, 2016	2015
	(In Thousands)	
Cash flows from continuing operating activities		
Net income	$150	$7,066
Adjustments to reconcile net income to net cash provided by continuing operating activities:		
Income from discontinued operations, including taxes	(23,603)	(5,703)
Deferred income taxes	(8,633)	2,503
Depreciation, depletion and amortization of property, plant and equipment	24,618	16,711
Other	1,275	540
Cash provided (used) by changes in assets and liabilities (net of effects of discontinued operations):		
Accounts receivable	(4,233)	3,105
Inventories	7,352	2,965
Prepaid insurance	4,566	6,420
Prepaid and accrued income taxes	(576)	4,449
Other supplies, prepaid items and other	(561)	(2,369)
Accounts payable	17,664	(3,292)
Customer deposits	(558)	(3,989)
Other current and noncurrent liabilities	6,783	314
Net cash provided by continuing operating activities	24,244	28,720
Cash flows from continuing investing activities		
Expenditures for property, plant and equipment	(170,057)	(156,981)
Proceeds from short-term investments	—	14,500
Purchases of short-term investments	—	(25,000)
Proceeds from noncurrent restricted cash and cash equivalents	—	45,969
Proceeds from noncurrent restricted investments	—	25,000
Other investing activities	1,058	(566)
Net cash used by continuing investing activities	(168,999)	(97,078)
Cash flows from continuing financing activities		
Proceeds from revolving debt facility	55,907	1,800
Payments on revolving debt facility	(25,000)	(1,800)
Proceeds from other long-term debt, net of fees	14,751	16,047
Payments on other long-term debt	(7,639)	(5,742)
Payments of debt issuance costs	(543)	(109)
Payments of issuance costs relating to preferred stocks and warrants	(785)	—
Payments on short-term financing	(4,783)	(6,324)

Proceeds from exercises of stock options	371	1,638
Excess income tax benefit associated with stock-based compensation	—	80
Dividends paid on convertible preferred stocks	—	(300)
Net cash provided by continuing financing activities	32,279	5,290
Cash flows of discontinued operations:		
Net cash provided by operating activities	10,512	13,436
Net cash used by investing activities	(1,025)	(1,887)
Net cash used by financing activities	(1,370)	(826)
Net cash provided by discontinued operations	8,117	10,723
Net decrease in cash and cash equivalents	(104,359)	(52,345)
Cash and cash equivalents at beginning of period	127,195	184,996
Cash and cash equivalents at end of period	$22,836	$132,651

See accompanying notes.

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, 2015 (“2015 Form 10-K”), filed with the Securities and Exchange Commission (“SEC”) on February 29, 2016.

Basis of Consolidation - LSB Industries, Inc. (“LSB”) and its subsidiaries (the “Company”, “We”, “Us”, or “Our”) are consolidated in the accompanying condensed consolidated financial statements. We are engaged in the manufacture and sale of chemical products. LSB is a holding company with no significant operations or assets other than cash, cash equivalents, and investments in its subsidiaries. Our ownership of working interests in natural gas properties is accounted for as an undivided interest, whereby we reflect our proportionate share of the underlying assets, liabilities, revenues and expenses. Our working interest represents our share of the costs and expenses incurred primarily to develop the underlying leaseholds and to produce natural gas while our net revenue interest represents our share of the revenues from the sale of natural gas. The net revenue interest is less than our working interest as the result of royalty interest due to others. We are not the operator of these natural gas properties. All material intercompany accounts and transactions have been eliminated.

On May 11, 2016, LSB, Consolidated Industries L.L.C., a direct, wholly owned subsidiary of LSB (“Consolidated”), and Climate Control Group, Inc., a direct, wholly owned subsidiary of Consolidated and an indirect subsidiary of LSB (the “Climate Control Group”), entered into a Stock Purchase Agreement (the “Stock Purchase Agreement”) with NIBE Industrier AB (publ), and NIBE Energy Systems Inc., an indirect wholly owned subsidiary of NIBE Industrier AB (together as “NIBE”) pursuant to which LSB, through Consolidated, agreed to sell to NIBE all of the outstanding shares of stock of the Climate Control Group for a total of approximately $364 million, subject to closing and post-closing adjustments which, was completed on July 1, 2016. The Climate Control Group conducts LSB’s Climate Control Business (the “Climate Control Business”). The assets and liabilities of Climate Control Business have been segregated and reported as held for sale as of June 30, 2016. Furthermore, the operating activities of Climate Control Business have been segregated and reported as discontinued operations for all periods presented. Our financial statements and footnotes reflect our results from continuing operations unless otherwise noted. See Note 2-Discontinued Operations. In addition, see Note 15-Subsequent Event for further discussion of this sale.

In our opinion, the unaudited condensed consolidated financial statements of the Company as of June 30, 2016 and for the three and six-month periods ended June 30, 2016 and 2015 include all adjustments and accruals, consisting of normal, recurring accrual adjustments (except otherwise disclosed), 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 (“U.S.”) 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 2015 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.

Concentration of Credit Risks for Cash and Cash Equivalents – Financial instruments relating to cash and cash equivalents potentially subject us to concentrations of credit risk. All of these financial instruments were held by financial institutions within the U.S. and none of these financial instruments were in excess of the federally insured limits.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 1: Summary of Significant Accounting Policies (continued)

Income Taxes – For transactions structured as a sale of assets, the deferred taxes associated with those individual assets and liabilities, as well as any deferred taxes associated with the outside basis difference, would continue to be classified with our other deferred tax assets and liabilities rather than in the assets and liabilities held for sale balance sheet line items as such deferred taxes are not transferred with the sale. For transactions structured as a sale of stock, the deferred taxes associated with outside basis differences are classified with our other deferred tax assets and liabilities as such deferred taxes are not transferred with the sale.

Redeemable Preferred Stocks - Our redeemable preferred stocks contain contingent redemption features that are outside of our control and are classified as temporary/mezzanine equity. The redeemable preferred stocks were recorded at fair value upon issuance, net of issuance costs or discounts. In addition, certain embedded features included in the Series E cumulative, redeemable Class C preferred stock (the “Series E Redeemable Preferred”) required bifurcation and are classified as derivative liabilities. The carrying values of the redeemable preferred stocks are being increased by periodic accretions (including the amount for dividends earned but not yet declared or paid) so that the carrying amount will equal the redemption value as of August 2, 2019, the earliest possible redemption date by the holder. The amount of accretion was recorded to retained earnings. See Note 15-Subsequent Event.

Income (Loss) per Common Share - Net income (loss) attributable to common stockholders is computed by adjusting net income (loss) by the amount of dividends and dividend requirements on preferred stocks and the accretion of redeemable preferred stocks, if applicable. Basic loss per common share is computed by dividing net loss attributable to common stockholders by the weighted average number of common shares outstanding, excluding contingently returnable common shares (unvested restricted stock), if applicable. For periods we earn net income, a proportional share of net income is allocated to participating securities, if applicable, determined by dividing total weighted average participating securities by the sum of the total weighted average common shares and participating securities (the “two-class method”). Certain securities (Series E Redeemable Preferred and restricted stock units) participate in dividends declared on our common stock and are therefore considered to be participating securities. Participating securities have the effect of diluting both basic and diluted income per common share during periods of net income. For periods we incur a net loss, no loss is allocated to participating securities because they have no contractual obligation to share in our losses. Diluted loss per common share is computed after giving consideration to the dilutive effect of our potential common stock instruments that are outstanding during the period, except where such non-participating securities would be anti-dilutive.

Recently Issued Accounting Pronouncements - In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standard Update (“ASU”) 2014-09, Revenue from Contracts with Customers (Topic 606), which will supersede nearly all existing revenue recognition guidance under GAAP. This ASU’s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. We are evaluating our existing revenue recognition policies to determine whether any contracts in the scope of the guidance will be affected by the new requirements. The effects may include identifying performance obligations in existing arrangements, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. In July 2015, the FASB approved a one-year deferral of the effective date of this ASU with the option to early adopt but not before the original effective date. In addition, the FASB has issued various ASUs further amending revenue recognition guidance, which includes ASU 2016-08, 2016-10, 2016-11 and 2016-12. The effective date of this ASU for us is January 1, 2018, with the option to adopt a year earlier. This ASU allows for either "full retrospective" adoption, meaning the standard is applied to all of the periods presented, or "modified retrospective" adoption, meaning the standard is applied only to the most current period presented in the financial statements. We are currently evaluating the transition method that will be elected.

In July 2015, the FASB issued ASU No. 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory. The guidance requires an entity to measure inventory at the lower of cost or net realizable value, which is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation, rather than the lower of cost or market in the previous guidance. This amendment applies to inventory that is measured using first-in, first-out ("FIFO"). This ASU is effective for us on January 1, 2017. A reporting entity should apply the amendments in this ASU prospectively with earlier application permitted as of the beginning of an interim or annual reporting period. We are currently evaluating the impact of this guidance, if any, on our consolidated financial statements and related disclosures.

In November 2015, the FASB issued ASU No. 2015-17, Balance Sheet Classification of Deferred Taxes (Topic 740), which simplifies the presentation of deferred income taxes by eliminating the need for entities to separate deferred income tax liabilities and assets into current and noncurrent amounts in a classified statement of financial position. This ASU is effective for us on January 1, 2017 and will be applied prospectively. We currently do not expect a significant impact from adopting this ASU.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 1: Summary of Significant Accounting Policies (continued)

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), creates Topic 842, Leases, and supersedes the lease requirements in Topic 840, Leases. Topic 842 specifies the accounting for leases. The objective of Topic 842 is to establish the principles that lessees and lessors shall apply to report useful information to users of financial statements about the amount, timing, and uncertainty of cash flows arising from a lease. Extensive quantitative and qualitative disclosures, including significant judgments made by management, will be required to provide greater insight into the extent of revenue and expense recognized and expected to be recognized from existing contracts. This ASU is effective for us on January 1, 2018 but early adoption is permitted. This ASU must be adopted using a modified retrospective transition, and provides for certain practical expedients. Transition will require application of the new guidance at the beginning of the earliest comparative period presented. We are currently evaluating the impact of this guidance on our consolidated financial statements and related disclosures.

The FASB issued ASU No. 2016-09, Compensation—Stock Compensation (Topic 718): Improvements to Employee Share Based Payment Accounting. This ASU includes multiple provisions intended to simplify various aspects of the accounting for share based payments. This ASU is effective for us on January 1, 2017 and adoption will be applied prospectively with any adjustments reflected as of the beginning of the fiscal year. We are currently evaluating the impact of this guidance, if any, on our consolidated financial statements and related disclosures.

Correction and Reclassifications

A previously reported correction and certain reclassifications made to our condensed consolidated statement of operations for the three and six months ended June 30, 2015 are as follows:

	Condensed Consolidated Statement of Operations			
	Three Months Ended June 30, 2015			
	As Previously Reported	Adjustments / Reclassifications (1)	Adjustments / Reclassifications (2)	As Adjusted
	(In Thousands)			
Net sales	$182,659	$ 9,686	$ (66,842)	$ 125,503
Cost of sales	$147,777	$ 11,871	$ (46,761)	$ 112,887

Gross profit	$34,882	$ (2,185)	$ (20,081)	$ 12,616
Selling, general and administrative expense	$32,025	$ (1,699)	$ (15,780)	$ 14,546
Provision for losses on accounts receivable	$491	$ (486)	$ (5)	$ —

	Condensed Consolidated Statement of Operations			
	Six Months Ended June 30, 2015			
	As Previously Reported	Adjustments / Reclassifications (1)	Adjustments / Reclassifications (2)	As Adjusted
	(In Thousands)			
Net sales	$376,517	$ 14,626	$ (132,040)	$ 259,103
Cost of sales	$299,276	$ 18,409	$ (91,997)	$ 225,688
Gross profit	$77,241	$ (3,783)	$ (40,043)	$ 33,415
Selling, general and administrative expense	$60,216	$ (3,267)	$ (31,203)	$ 25,746
Provision for losses on accounts receivable	$513	$ (516)	$ 3	$ —

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LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 1: Summary of Significant Accounting Policies (continued)

(1) Previously Reported Correction and Reclassifications – As discussed in our significant accounting policies note to our audited consolidated financial statements included in the 2015 Form 10-K, in the fourth quarter of 2015, we corrected and reclassified certain shipping and handling costs associated with our Chemical operation. In addition, we reclassified the provision for losses on accounts receivable to selling, general and administrative expenses ("SG&A"). We revised our condensed consolidated statement of operations for the three and six months ended June 30, 2015 to conform to the current presentation as summarized in the table above.

(2) Discontinued Operation Reclassifications – As discussed in Note 2-Discontinued Operations, the Climate Control Business met the criteria to be reported as held for sale during the second quarter of 2016. As a result, the activities of the Climate Control Business have been segregated from continuing operations and reported as discontinued operations for all periods presented. In the table above, we included the reclassifications associated with discontinued operations for the line items impacted by item (1) above.

Note 2: Discontinued Operations

As discussed in Note 1, on May 11, 2016, LSB and Consolidated entered into a definitive agreement with NIBE to sell all of the common stock of the Climate Control Group. Therefore, the assets and liabilities of the Climate Control Group are classified as held for sale at June 30, 2016. See Note 15-Subsequent Event.

The carrying amounts of the assets and liabilities of the Climate Control Group, are as follows:

	June 30, 2016	December 31, 2015
	(In Thousands)	
Cash and cash equivalents	$4,368	$ 119
Accounts receivable, net	50,328	43,001
Inventories, net	25,376	28,780
Other current assets	366	1,096
Property, plant and equipment, net	25,857	26,779

Intangible and other, net	8,173	7,002
Total assets classified as held for sale	114,468	106,777
Less noncurrent assets classified as held for sale	—	33,781
Current assets classified as held for sale	$114,468	$ 72,996
Accounts payable	18,622	20,003
Current and noncurrent accrued and other liabilities	28,667	24,659
Total liabilities classified as held for sale	47,289	44,662
Less noncurrent liabilities classified as held for sale	—	12,136
Current liabilities classified as held for sale	$47,289	$ 32,526

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 2: Discontinued Operations (continued)

Summarized results of discontinued operations are as follows for:

	June 30, Three Months Ended		Six Months Ended	
	2016	2015	2016	2015
	(In Thousands)			
Net sales	$71,982	$66,842	$138,609	$132,040
Cost of sales	47,724	46,761	93,178	91,997
Selling, general and administrative expense	17,301	15,785	32,719	31,200
Transaction costs	1,985	—	2,535	—
Interest expense	—	1	—	2
Other expense (income), net	(25)	138	117	249
Income from operations of discontinued operations	4,997	4,157	10,060	8,592
Provision (benefit) for income taxes (1)	(17,782)	866	(13,543)	2,889
Income from discontinued operations, including taxes	$22,779	$3,291	$23,603	$5,703

(1) The structure of the Climate Control Business sale will allow for additional tax basis to be recovered than was previously recorded as a deferred tax asset. The tax benefit associated with this additional tax basis was recorded in discontinued operations in the second quarter consistent with the period the Climate Control Business subsidiaries were designated as held for sale.

Summarized condensed cash flow information of discontinued operations is as follows:

	June 30,	
	2016	2015
	(In Thousands)	
Deferred income taxes	$(12,809)	$967
Depreciation and amortization of property, plant and equipment	$1,607	$2,325
Stock-based compensation	$573	$643
Expenditures for property, plant and equipment	$273	$426

Software and software development costs	$675	$1,286

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LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 3: Income (Loss) Per Common Share

	Three Months Ended June 30, 2016	Three Months Ended June 30, 2015	Six Months Ended June 30, 2016	Six Months Ended June 30, 2015
	(Dollars In Thousands, Except Per Share Amounts)			
Numerator:				
Net income	$15,091	$417	$150	$7,066
Adjustments for basic net income (loss) per common share:				
Dividend requirements on Series E Redeemable Preferred	(7,629)	—	(14,979)	—
Dividend and dividend requirements on Series B Preferred	(60)	—	(120)	(240)
Dividend and dividend requirements on Series D Preferred	(15)	—	(30)	(60)
Accretion of Series E Redeemable Preferred	(2,241)	—	(4,484)	—
Net income attributable to participating securities	(91)	—	—	—
Numerator for basic net income (loss) per common share - net income (loss) attributable to common stockholders	5,055	417	(19,463)	6,766
Dividends on convertible preferred stocks assumed to be converted, if dilutive	—	—	—	—
Numerator for diluted net income (loss) per common share	$5,055	$417	$(19,463)	$6,766
Denominator:				
Denominator for basic net income (loss) per common share - weighted- average shares (1)	25,240,224	22,747,925	23,822,768	22,711,534
Effect of dilutive securities:				
Stock options	—	—	—	108,151
Dilutive potential common shares	—	—	—	108,151

Denominator for dilutive net income (loss) per common share - adjusted weighted-average shares and assumed conversions	25,240,224	22,747,925	23,822,768	22,819,685
Basic net income (loss) per common share:				
Loss from continuing operations	$(0.70)	$(0.13)	$(1.81)	$0.05
Income from discontinued operations, including taxes	0.90	0.15	0.99	0.25
Net income (loss)	$0.20	$0.02	$(0.82)	$0.30
Diluted net income (loss) per common share:				
Loss from continuing operations	$(0.70)	$(0.13)	$(1.81)	$0.05
Income from discontinued operations, including taxes	0.90	0.15	0.99	0.24
Net income (loss)	$0.20	$0.02	$(0.82)	$0.29

(1) Excludes the weighted-average shares of unvested restricted stock that are contingently returnable during the three and six months ended June 30, 2016.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 3: Income (Loss) Per Common Share (continued)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Convertible preferred stocks	916,666	916,666	916,666	916,666
Stock options	517,273	860,370	538,220	698,561
Restricted stock and stock units	989,484	—	911,563	—
Series E Redeemable Preferred - embedded derivative	456,225	—	456,225	—
	2,879,648	1,777,036	2,822,674	1,615,227

Note 4: Inventories

At June 30, 2016 and December 31, 2015 because costs exceeded the net realizable value, inventory adjustments were $1,146,000 and $2,832,000, respectively.

Note 5: Current and Noncurrent Accrued and Other Liabilities

	June 30, 2016	December 31, 2015
	(In Thousands)	
Accrued interest	$16,498	$ 14,784
Accrued payroll and benefits	7,872	4,521
Series E Redeemable Preferred - embedded derivative	1,865	3,308
Accrued death and other executive benefits	4,251	4,604
Accrued health insurance and worker compensation claims	3,133	2,996
Customer deposits	1,572	2,130
Other	9,635	16,251
	44,826	48,594

Less noncurrent portion	9,223	8,786
Current portion of accrued and other liabilities	$35,603	$ 39,808

Note 6: Asset Retirement Obligations

Currently, we have various legal requirements related to operations of our facilities, including the disposal of waste water generated at certain of these facilities. Additionally, we have certain facilities 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 ("ARO"). 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, a liability for only a minimal amount relating to AROs associated with these facilities has been established. However, we will continue to review these obligations and record a liability when a reasonable estimate of the fair value can be made. In addition, we own working interests in certain natural gas properties. We recognized AROs associated with the obligation to plug and abandon wells when the obligation is incurred which is typically when the well is completed. At June 30, 2016 and December 31, 2015, our accrued liability for AROs was $287,000 and $281,000, respectively.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 7: Long-Term Debt

Our revolving credit facility and long-term debt consists of the following:

	June 30, 2016	December 31, 2015
	(In Thousands)	
Working Capital Revolver Loan, with a current interest rate of 4.00% (A)	$30,907	$ —
7.75% Senior Secured Notes due 2019 (B)	425,000	425,000
12% Senior Secured Notes due 2019 (B)	50,000	50,000
Secured Promissory Note due 2017, with a current interest rate of 3.69% (C)	10,804	15,856
Secured Promissory Note due 2019, with a current interest rate of 5.73% (D)	9,667	—
Secured Promissory Note due 2021, with a current interest rate of 5.25% (E)	15,716	16,189
Secured Promissory Note due 2023, with a current interest rate of 4.72% (F)	19,635	15,000
Other, with a current weighted-average interest rate of 4.50%, most of which is secured primarily by machinery and equipment	5,546	7,103
Unamortized discount and debt issuance costs	(7,690)	(8,726)
	559,585	520,422
Less revolving credit facility and current portion of long-term debt	46,080	22,468
Long-term debt due after one year, net	$513,505	$ 497,954

(A) Our revolving credit facility (the “Working Capital Revolver Loan”), which matures on April 13, 2018, provides advances up to $100 million, based on specific percentages of eligible accounts receivable and inventories and up to $15 million of letters of credit, the outstanding amount of which reduces the available for borrowing under the Working Capital Revolver Loan. See Note 15-Subsequent Event.

(B) The Senior Secured Notes mature on August 1, 2019. Interest is to be paid semiannually on February 1st and August 1st. The Senior Secured Notes are general senior secured obligations of LSB. The Senior Secured Notes are jointly and severally and fully and unconditionally guaranteed by all of LSB's current wholly-owned subsidiaries, with all of the guarantees, except one, being senior secured guarantees and one being a senior unsecured guarantee. The Senior Secured Notes rank equally in right of payment to all of LSB and the guarantors' existing and future senior secured debt, including the Working Capital Revolver Loan discussed above, and are senior in right of payment to all of LSB and the guarantors' future subordinated indebtedness.

(C) On April 1, 2016, Zena Energy L.L.C. ("Zena"), one of our subsidiaries, entered into the second amended and restated note (the "Amended Note") with its original lender. Principal and interest are payable in 20 monthly installments with the first installment made on May 1st. Interest is based on the LIBOR rate plus 300 basis points and the terms of which were not changed by this amendment. The Amended Note matures on December 1, 2017. The Amended Note continues to be secured by certain working interests and related properties and proceeds.

(D) On February 5, 2016, El Dorado Chemical Company ("EDC"), one of our subsidiaries, entered into a secured promissory note (the "Secured Promissory Note due 2019") for an original principal amount of $10 million that matures on June 29, 2019. Principal and interest are payable in 40 equal monthly installments with a final balloon payment of approximately $6.7 million. The Secured Promissory Note due 2019 is secured by the cogeneration facility equipment and is guaranteed by LSB.

(E) EDC's Secured Promissory Note due 2021 matures on March 26, 2021. This note required interest only monthly payments for the first 12 months of the term (through April 2016) and then principal and interest monthly payments through the remaining term. This note is secured by a natural gas pipeline constructed at the El Dorado Facility and is guaranteed by LSB.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 7: Long-Term Debt (continued)

(F) On September 16, 2015, El Dorado Ammonia L.L.C. (“EDA”), one of our subsidiaries, entered into a secured promissory note (the “Secured Promissory Note due 2023”) for the construction financing of an ammonia storage tank and related systems with an initial funding received of $15 million and a maximum principal note amount of $19.8 million. On May 13, 2016 (the “Loan Conversion Date”), the remainder of the funding of $4.8 million was drawn and the outstanding principal balance of $19.8 million was converted to a seven year secured term loan requiring 83 equal monthly principal and interest payments with a final balloon payment of approximately $6.1 million. This Note bears interest at a rate that is based on the monthly LIBOR rate plus 4.25%. The Secured Promissory Note is secured by the ammonia storage tank and related systems and is guaranteed by LSB.

Note 8: Commitments and Contingencies

Termination of UAN supply agreement and new UAN supply agreement – Our subsidiary, Pryor Chemical Company (“PCC”), was party to a contract with Koch Nitrogen Company, LLC (“Koch Nitrogen”) under which Koch Nitrogen agrees to purchase and distribute at market prices substantially all of the urea ammonium nitrate (“UAN”) produced at the Pryor Facility through June 30, 2016 (the “Koch Purchase Agreement”). On March 1, 2016, PCC provided notice of termination under the Koch Purchase Agreement, terminating the agreement effective May 31, 2016. On March 3, 2016, PCC entered into a UAN Purchase and Sale Agreement with Coffeyville Resources Nitrogen Fertilizers, LLC (“CVR”), which became effective June 1, 2016 (the “CVR Purchase Agreement”). Under the CVR Purchase Agreement, CVR will have the exclusive right (but not the obligation) to purchase all the tons of UAN that are produced by PCC in excess of the needs of PCC or its affiliates, which shall be no more than 30,000 tons per year and no more than 10,000 tons in any calendar quarter. If CVR fails to take delivery of certain tons of UAN produced at the PCC and such failure causes PCC’s storage capacity to be more than 75% utilized or the production unit at the PCC to be slowed down, shut-down or idled, PCC may immediately sell such unpurchased product to a third-party without restriction.

The initial term of the CVR Purchase Agreement is for three years and automatically continues for one or more additional one-year terms unless terminated by either party by delivering a notice of termination at least twelve months prior to the end of term in effect. However, CVR may unilaterally terminate the CVR Purchase Agreement upon 180 days’ advance written notice of termination to PCC; provided, however, that each party’s rights and obligations pertaining to UAN that CVR committed to purchase before such advance notice will survive termination. Additionally, PCC can terminate the CVR Purchase agreement upon 90 days’ advance written notice of termination to CVR; provided, however, that each party’s rights and obligations pertaining to UAN that PCC committed to sell prior to such advance notice will survive termination.

Natural Gas Purchase Commitments – See Note 9 – Derivatives, Hedges, Financial Instruments and Carbon Credits for discussion of our commitments relating to derivative contracts and carbon credits (accounted for on a mark-to-market basis). At June 30, 2016, our natural gas contracts, which are exempt from mark-to-market accounting, included the firm purchase commitments of approximately 10.4 million MMBtu of natural gas. These contracts extend through

June 2018 at a weighted-average cost of $2.97 per MMBtu ($30.7 million) and a weighted-average market value of $2.69 per MMBtu ($27.9 million).

Legal Matters - Following is a summary of certain legal matters involving the Company:

A. Environmental Matters

Our facilities and operations are subject to numerous federal, state and local environmental laws and to other laws regarding health and safety matters (collectively, the “Environmental and Health Laws”). In particular, the manufacture, production and distribution of products activities that entail environmental and public health risks and impose obligations under the Environmental and 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 and Health Laws and related enforcement policies have in the past resulted, and could in the future result, in significant compliance expenses, cleanup costs (for our sites or third-party sites where our wastes were disposed of), penalties or other liabilities relating to the handling, manufacture, use, emission, discharge or disposal of hazardous or toxic materials at or from our facilities or the use or disposal of certain of its chemical products. Further, a number of our facilities are dependent on environmental permits to operate, the loss or modification of which could have a material adverse effect on their operations and our financial condition.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 8: Commitments and Contingencies (continued)

Historically, significant capital expenditures have been incurred by our subsidiaries in order to comply with the Environmental and Health Laws, and significant capital expenditures are expected to be incurred in the future. We will also be obligated to manage certain discharge water outlets and monitor groundwater contaminants at our facilities should we discontinue the operations of a facility. We do not operate the natural gas wells where we own a working interest and compliance with Environmental and Health Laws is controlled by others. We are responsible for our working interest proportionate share of the costs involved. As of June 30, 2016, our accrued liabilities for environmental matters totaled $265,000 relating primarily to the matters discussed below. It is reasonably possible that a change in the estimate of our liability could occur in the near term. Also, see discussion in Note 6 - Asset Retirement Obligations.

1. Discharge Water Matters

Each of our manufacturing facilities generates process wastewater, which may include cooling tower and boiler water quality control streams, contact storm water (rain water inside the facility area that may pick 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 various permits generally issued by the respective state environmental agencies as authorized and overseen by the U.S. Environmental Protection Agency (the “EPA”). These permits limit the type and amount of effluents that can be discharged and control the method of such discharge. The following are discharge water matters in relation to the respective state discharge water permits.

Our facility located in Pryor, Oklahoma (the “Pryor Facility”) holds a permit to inject wastewater into an on-site well that is valid until 2018. The Oklahoma Department of Environmental Quality (“ODEQ”) has indicated that the permit may not be renewed and PCC may have to find an alternative means of disposal after the permit expires. PCC is continuing to discuss disposal possibilities both internally and with the ODEQ.

The El Dorado Facility is subject to a state National Pollutant Discharge Elimination System (“NPDES”) discharge water permit issued by the Arkansas Department of Environmental Quality (“ADEQ”). The El Dorado Facility is currently operating under an NPDES discharge water permit, which became effective in 2004. In 2010, a preliminary draft of a discharge water permit renewal for the El Dorado Facility, which contains more restrictive limits, was issued by the ADEQ.

EDC believes that the El Dorado Facility has generally demonstrated its ability to comply with applicable ammonia and nitrate permit levels, but has, from time to time, had difficulty meeting the more restrictive dissolved minerals permit levels, primarily related to storm-water runoff. We do not believe this matter regarding meeting the permit requirements as to the dissolved minerals is a continuing issue for the process wastewater as the result of the El Dorado Facility disposing its wastewater (beginning in September 2013) via a pipeline constructed by the City of El Dorado, Arkansas. We believe that the issue with the storm-water runoff should be resolved if and when the ADEQ issues a new NPDES discharge water permit, which we have been advised that the ADEQ is currently processing.

During 2012, EDC paid a penalty of $100,000 to settle an administrative complaint issued by the EPA, and thereafter handled by the U.S. Department of Justice (“DOJ”), relating to certain alleged violations through 2010 of EDC’s 2004

NPDES discharge water permit. The DOJ advised that action would also be taken for alleged violations occurring after 2010. As of the date of this report, no action has been filed by the DOJ against EDC. As a result, the cost (or range of costs) cannot currently be reasonably estimated regarding this matter. Therefore, no liability has been established at June 30, 2016.

In addition, the El Dorado Facility is currently operating under a consent administrative order (the “CAO”) that recognizes the presence of nitrate contamination in the shallow groundwater. The 2006 CAO required EDC to continue semiannual 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 risk assessment was submitted in August 2007. In February 2015, the ADEQ stated that El Dorado Chemical was meeting the requirements of the CAO and should continue semi-annual monitoring. 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, of which cost (or range of costs) cannot currently be reasonably estimated. Therefore, no liability has been established at June 30, 2016, in connection with this matter.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 8: Commitments and Contingencies (continued)

2. Air Matters

PCC has been advised that the ODEQ is conducting an investigation into whether the Pryor Facility is in compliance with certain rules and regulations of the ODEQ and whether PCC's reports of certain air emissions primarily in 2011 were intentionally reported incorrectly to the ODEQ. PCC has cooperated with the ODEQ in connection with this investigation. As of June 30, 2016, we are not aware of any recommendations made or to be made by the ODEQ with respect to legal action to be taken or recommended as a result of this ongoing investigation.

3. Other Environmental Matters

During 2013, the EPA conducted a risk management inspection of our Cherokee Facility. During 2014, our Cherokee Facility received a notice of violation from the EPA as a result of the inspection, which listed eleven alleged violations. Under the final consent order received in March 2016 approving the settlement agreement, we agreed to pay a penalty in the form of providing approximately $100,000 to purchase emergency response equipment for the local first responders plus a civil penalty to the EPA of approximately $26,000, which both penalties have been paid.

In 2002, two of our subsidiaries sold substantially all of their operating assets relating to a Kansas chemical facility (the "Hallowell Facility") but retained ownership of the real property. 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. 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 develop 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.

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

Our subsidiary and Chevron are pursuing a corrective action strategy relating to the Hallowell Facility with the state of Kansas, including the KDHE. This strategy currently includes long-term surface and groundwater monitoring to track the natural decline in contamination. During 2014, the KDHE approved a corrective action study work plan and will consider and recommend restoration or replacement pursuant to the work plan and/or whether to seek compensation in its evaluation. Currently, it is unknown what remediation and damages the KDHE may require, if any, but it is reasonably possible that certain remediation activities could be required to begin in 2016. The ultimate required remediation, if any, is currently unknown. Our subsidiary and Chevron have retained an environmental consultant to perform the corrective action study work plan as to the appropriate method to remediate the Hallowell Facility. The resulting study was submitted to the KDHE for review. We are advised by our consultant that until the study is completed there is not sufficient information to develop a meaningful and reliable estimate (or range of estimate) as to the cost of the remediation. We accrued our allocable portion of costs primarily for the additional testing, monitoring and risk assessments that could be reasonably estimated, which is included in our accrued liabilities for environmental matters discussed above. The estimated amount is not discounted to its present value. As more information becomes available our estimated accrual will be refined.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 8: Commitments and Contingencies (continued)

B. Other Pending, Threatened or Settled Litigation

In April 2013, an explosion and fire occurred at the West Fertilizer Co. ("West Fertilizer") located in West, Texas, causing death, bodily injury and substantial property damage. West Fertilizer is not owned or controlled by us, but West Fertilizer was a customer of EDC, purchasing AN from EDC from time to time. LSB and EDC received letters from counsel purporting to represent subrogated insurance carriers, personal injury claimants and persons who suffered property damages informing LSB and EDC that their clients are conducting investigations into the cause of the explosion and fire to determine, among other things, whether AN manufactured by EDC and supplied to West Fertilizer was stored at West Fertilizer at the time of the explosion and, if so, whether such AN may have been one of the contributing factors of the explosion. Initial lawsuits filed named West Fertilizer and another supplier of AN as defendants. In 2014, EDC and LSB were named as defendants, together with other AN manufacturers and brokers that arranged the transport and delivery of AN to West Fertilizer, in the case styled City of West, Texas vs. CF Industries, Inc., et al., in the District Court of McLennan County, Texas. The plaintiffs allege, among other things, that LSB and EDC were negligent in the production and marketing of fertilizer products sold to West Fertilizer, resulting in death, personal injury and property damage. EDC retained a firm specializing in cause and origin investigations with particular experience with fertilizer facilities, to assist EDC in its own investigation. LSB and EDC placed its liability insurance carrier on notice, which carrier is handling the defense for LSB and EDC concerning this matter. Our product liability insurance policies have aggregate limits of general liability totaling $100 million, with a self-insured retention of $250,000. In August 2015, the trial court dismissed plaintiff's negligence claims against us and EDC based on a duty to inspect, but allowed the plaintiffs to proceed on claims for design defect and failure to warn. Subsequently, we and EDC have entered into a confidential settlement agreement with several plaintiffs that had claimed wrongful death and bodily injury. A portion of these settlements were paid by the insurer during 2015 and in the first half of 2016. While these settlements resolve the claims of what we believe were the highest risk cases in this matter for us, we continue to be party to litigation related to this explosion by other plaintiffs, in addition to indemnification or defense obligations we may have to other defendants. We intend to continue to defend these lawsuits vigorously and we are unable to estimate a possible range of loss at this time if there is an adverse outcome in this matter as to EDC. As of June 30, 2016, no liability reserve has been established in connection with this matter but we have incurred professional fees up to our self-insured retention amount.

In May 2015, our subsidiary, EDC, was sued in the matter styled BAE Systems Ordinance Systems, Inc. ("BAE"), et al. vs. El Dorado Chemical Company, in the United States District Court, Western District of Arkansas, for an alleged breach of a supply agreement to provide BAE certain products. It is EDC's position, among other things, that its inability to deliver to BAE was due to a force majeure event caused by a fire and explosion at EDC's nitric acid plant, and that a force majeure clause in the supply agreement therefore excuses EDC's performance under the supply agreement. BAE's pre-litigation demand indicated a claim of approximately $18 million. EDC intends to vigorously defend this matter. The cost (or range of costs), if any, EDC would incur relating to this matter cannot currently be reasonably estimated. Therefore, no liability has been established at June 30, 2016.

In September 2015, a case styled Dennis Wilson vs. LSB Industries, Inc., et al., was filed in the United States District Court for the Southern District of New York. The plaintiff purports to represent a class of our shareholders and asserts that we violated federal securities laws by allegedly making material misstatements and omissions about delays and cost overruns at our El Dorado Chemical Company manufacturing facility and about our financial well-being and prospects. The lawsuit, which also names certain current and former officers, seeks an unspecified amount of damages. Given the uncertainty of litigation, the preliminary stage of the case, and the legal standards that must be met for, among other things, class certification and success on the merits, we cannot estimate the reasonably possible loss or range of loss that may result from this action.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 8: Commitments and Contingencies (continued)

In September 2015, we and El Dorado Ammonia L.L.C. (“EDA”) received formal written notice from Global Industrial, Inc. (“Global”) of Global’s intention to assert mechanic liens for labor, service, or materials furnished under certain subcontract agreements for the improvement of the new ammonia plant at our El Dorado Facility. Global is a subcontractor of Leidos Constructors, LLC (“Leidos”), the general contractor for EDA for the construction for the ammonia plant. Leidos terminated the services of Global with respect to their work performed at our El Dorado Facility in July 2015 and Global claims it is entitled to payment for certain work prior to its termination in the sum of approximately $18 million. Leidos reports that it made an estimated $6 million payment to Global on or about September 11, 2015, and EDA paid Leidos approximately $3.5 million relating to work performed by subcontractors of Global. Leidos has not approved certain payments to Global pending the result of on-going audits and investigation undertaken to quantify the financial impact of Global’s work. EDA intends to monitor the Leidos audit, and conduct its own investigation, in an effort to determine whether any additional payment should be released to Global for any work not in dispute. LSB and EDA intend to pursue recovery of any damage or loss caused by Global’s work performed at our El Dorado Facility. In January 2016, El Dorado, Leidos and Global reached an agreement whereby the approximately $3.6 million claims of Leidos’ remaining unpaid subcontracts, vendors and suppliers will be paid (and these suppliers and subcontractors will in turn issue releases of their respective claims and liens). In addition, Global will reduce the value of its claim as against Leidos, and its lien amount as against the Project by a like amount. After all such lower tier supplier and subcontractors are satisfied, the Global claim and lien amount will be reduced to approximately $5 million. In March 2016, EDC and we were served a summons in a case styled Global Industrial, Inc. d/b/a Global Turnaround vs. Leidos Constructors, LLC et al., where in Global seeks damages under breach of contract and other claims. We have requested indemnifications from Leidos under the terms of our contracts and we intend to vigorously defend against the allegation made by Global. No liability has been established in connection with the remaining $5 million claim. In addition, LSB and EDA intend to pursue recovery of any damage or loss caused by Global’s work performed at our El Dorado Facility.

Note 9: Derivatives, Hedges, Financial Instruments and Carbon Credits

Periodically, 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, we are issued climate reserve tonnes (“carbon credits”), of which a certain portion of the carbon credits are to be sold and the proceeds given to Covestro. The assets for carbon credits are accounted for on a fair value basis as discussed below. Also, the contractual obligations to give the related proceeds to Covestro are accounted for on a fair value basis (as discussed below) unless we enter into a firm sales commitment to sell the carbon credits. In addition, certain embedded features (“embedded derivative”) relating to the redemption of the Series E Redeemable Preferred required bifurcation and are being accounted for as derivative instruments and recorded as a liability. 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 are 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 June 30, 2016, the valuations of contracts classified as Level 2 related to certain futures/forward natural gas contracts and a foreign exchange contract. For the natural gas contracts, these contracts are valued using the prices pursuant to the terms of the contracts and using market information for futures/forward natural gas prices. At June 30, 2016, the valuation inputs included the contractual weighted-average cost of $2.97 per MMBtu and the estimated weighted-average market value of $3.05 per MMBtu.

For foreign exchange contracts, these contracts are valued using the foreign currency exchange rates pursuant to the terms of the contract and using market information for foreign currency exchange rates. At June 30, 2016, the valuation inputs included the total contractual exchange rate of 1.12 and the total estimated market exchange rate of 1.11 (U.S. Dollar/Euro). No valuation input adjustments were considered necessary relating to nonperformance risk for the contracts as discussed above.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 9: Derivatives, Hedges, Financial Instruments and Carbon Credits (continued)

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 June 30, 2016 and December 31, 2015, the valuations ($2.35 per carbon credit) of the carbon credits and the contractual obligations associated with these carbon credits are classified as Level 3. At June 30, 2016, the valuation was based on a recent purchase price by one of our customers. 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. At June 30, 2016, the valuation of the embedded derivative is classified as Level 3. This derivative is valued using market information, management's redemption assumptions, the underlying number of shares as defined in the terms of the Series E Redeemable Preferred, and the market price of our common stock. In addition, no valuation input adjustments were considered necessary relating to nonperformance risk for the instruments discussed above.

Commodities Contracts

Raw materials for use in our manufacturing processes include natural gas. As part of our raw material price risk management, we periodically enter into futures/forward contracts for these materials, which contracts may be required to be accounted for on a mark-to-market basis. At June 30, 2016, our futures/forward natural gas contracts subject to mark-to-market accounting were minimal. At December 31, 2015, our futures/forward natural gas contracts included 1,820,000 MMBtu of natural gas, extend through December 2016 (includes contractual costs indexed to future NYMEX prices) at a weighted-average cost of $2.35 per MMBtu. The cash flows relating to these contracts are included in cash flows from continuing operating activities.

Foreign Exchange Contracts

One of our subsidiaries 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. At June 30, 2016 and December 31, 2015, our foreign exchange contract was for the receipt of approximately 100,000 Euros and 280,000 Euros, respectively, through February 2017 at the contractual exchange rate of 1.12 (U.S. Dollar/Euro). These contracts are free-standing derivatives and are accounted for on a mark-to-market basis. The cash flows relating to these contracts are included in cash flows from continuing operating activities.

Interest Rate Contracts

In February 2011, we entered into an interest rate swap at no cost, which set 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 and ended on March 31, 2016. This contract was a free-standing derivative and was accounted for on a mark-to-market basis. During the six months ended June 30, 2016 and 2015, 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

Periodically, we are 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 our agreement with Covestro, 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 Covestro and EDN. We have no obligation to reimburse Covestro 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 assets for 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 sales commitment to sell the carbon credits). At December 31, 2015, we had approximately 495,000 carbon credits (minimal at June 30, 2016), 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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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 9: Derivatives, Hedges, Financial Instruments and Carbon Credits (continued)

Embedded Derivative

The embedded derivatives relating to the redemption of the Series E Redeemable Preferred, which includes certain contingent redemption features and the participation rights value as discussed in Note 11, has been bifurcated from the Series E Redeemable Preferred and recorded as a liability. As the result of entering into the Stock Purchase Agreement relating to the subsequent sale of the Climate Control Business, the fair value of the contingent redemption feature at June 30, 2016 was based on the difference in value between the Series E Redeemable Preferred with and without the feature, considering discounted cash flow models that calculate the present value of future cash flows under probability-weighted redemption scenarios discounted at the estimated current market yield for the Series E Redeemable Preferred. The contingent redemption feature was an asset partially offsetting the liability relating to the participation rights. At June 30, 2016 and December 31, 2015, the fair value of the participation rights was based on the equivalent of 456,225 shares of our common stock at $12.08 and $7.25 per share, respectively.

The following details our assets and liabilities that are measured at fair value on a recurring basis at June 30, 2016 and December 31, 2015:

		Fair Value Measurements at June 30, 2016 Using			
Description	Total Fair Value at June 30, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Fair Value at December 31, 2015
	(In Thousands)				
Assets - Supplies, prepaid items and other:					
Commodities contracts (1)	$36	$—	$ 36	$ —	$ 195
Carbon credits	6	—	—	6	1,154
Foreign exchange contracts	—	—	—	—	—
Total	$42	$—	$ 36	$ 6	$ 1,349
Liabilities - Current and noncurrent accrued and other liabilities:					

Commodities contracts (1)	$(36)	$—	$(36)	$—	$(202)
Contractual obligations - carbon credits	(6)	—	—	(6)	(1,154)
Embedded derivative	(1,865)	—	—	(1,865)	(3,308)
Interest rate contracts	—	—	—	—	(126)
Foreign exchange contracts	—	—	—	—	(6)
Total	$(1,907)	$—	$(36)	$(1,871)	$(4,796)

(1) At June 30, 2016 and December 31, 2015, $36,000 and $195,000, respectively, are subject to an agreement that allows net settlement of contracts related to natural gas commitments; however, we have chosen to present the fair values of our commodities contracts under master netting agreements using a gross fair value presentation.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 9: Derivatives, Hedges, Financial Instruments and Carbon Credits (continued)

None of our assets or liabilities measured at fair value on a recurring basis transferred between Level 1 and Level 2 classifications for the periods presented below. As discussed above under "Embedded Derivative", as the result of entering into the Stock Purchase Agreement relating to the subsequent sale of the Climate Control Business, the valuation of the embedded derivative transferred from Level 2 to Level 3 since the probability increased relating to contingent redemption features requiring the use of significant unobservable inputs. The classification transfer of this derivative was deemed to occur at the beginning of the second quarter of 2016. 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):

	Assets		Liabilities		Assets		Liabilities	
	Three Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015	2016	2015	2016	2015
	(In Thousands)							