LSB INDUSTRIES INC
Form 10-Q
May 04, 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 March 31, 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 23,865,518 shares as of April 28, 2016.

FORM 10-Q OF LSB INDUSTRIES, INC.

TABLE OF CONTENTS

PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

LSB INDUSTRIES, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Information at March 31, 2016 is unaudited)

	March 31, 2016	December 31, 2015
	(In Thousands)	
Assets		
Current assets:		
Cash and cash equivalents	$39,529	$127,314
Accounts receivable, net	87,496	92,602
Inventories:		
Finished goods	26,433	24,383
Work in progress	1,893	2,042
Raw materials	20,313	26,812
Total inventories	48,639	53,237
Supplies, prepaid items and other:		
Prepaid insurance	7,959	10,563
Precious metals	12,669	12,918
Supplies	20,003	18,681
Prepaid and refundable income taxes	5,954	6,811
Other	4,445	5,797
Total supplies, prepaid items and other	51,030	54,770
Deferred income taxes	4,588	4,774
Total current assets	231,282	332,697
Property, plant and equipment, net	1,087,954	1,005,488
Intangible and other, net	24,060	23,642
	$1,343,296	$1,361,827

(Continued on following page)

LSB INDUSTRIES, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (continued)

(Information at March 31, 2016 is unaudited)

	March 31, 2016	December 31, 2015
	(In Thousands)	
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$106,853	$108,002
Short-term financing	6,399	9,119
Accrued and other liabilities	42,049	52,331
Current portion of long-term debt	16,836	22,468
Total current liabilities	172,137	191,920
Long-term debt, net	511,678	497,954
Noncurrent accrued and other liabilities	23,754	20,922
Deferred income taxes	50,715	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 $219,637,000 ($212,287,000 at December 31, 2015)	186,865	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, 27,137,599 shares issued (27,131,724 shares at December 31, 2015)	2,714	2,713
Capital in excess of par value	190,378	192,249
Retained earnings	223,616	248,150
	419,708	446,112

Less treasury stock, at cost:		
Common stock, 3,283,081 shares (3,735,503 shares at December 31, 2015)	21,561	24,532
Total stockholders' equity	398,147	421,580
	$1,343,296	$1,361,827

See accompanying notes.

LSB INDUSTRIES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended March 31, 2016	2015
	(In Thousands, Except Per Share Amounts)	
Net sales	$165,599	$198,798
Cost of sales	150,590	158,037
Gross profit	15,009	40,761
Selling, general and administrative expense	26,862	26,615
Other expense (income), net	390	(77)
Operating income (loss)	(12,243)	14,223
Interest expense, net	1,350	3,398
Non-operating other expense (income), net	1,956	(35)
Income (loss) from continuing operations before provision (benefit) for income taxes	(15,549)	10,860
Provision (benefit) for income taxes	(610)	4,181
Income (loss) from continuing operations	(14,939)	6,679
Net loss from discontinued operations	2	30
Net income (loss)	(14,941)	6,649
Dividends on convertible preferred stocks	75	300
Dividend on Series E redeemable preferred stock	7,350	—
Accretion of Series E redeemable preferred stock	2,243	—
Net income (loss) attributable to common stockholders	$(24,609)	$6,349
Income (loss) per common share:		
Basic and diluted:		
Income (loss) from continuing operations	$(1.08)	$0.28
Net loss from discontinued operations	—	—
Net income (loss)	$(1.08)	$0.28

See accompanying notes.

LSB INDUSTRIES, INC.

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

(Unaudited)

Three Months Ended March 31, 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 loss					(14,941)		(14,941)
Dividend accrued on redeemable preferred stock					(7,350)		(7,350)
Accretion of redeemable preferred stock					(2,243)		(2,243)
Stock-based compensation				1,103			1,103
Exercise of stock options	6		1	48			49
Restricted stock granted from treasury stock				(2,971)		2,971	—
Excess income tax detriment associated with stock-based compensation				(51)			(51)
Balance at March 31, 2016	27,138	$ 3,000	$ 2,714	$ 190,378	$ 223,616	$ (21,561)	$ 398,147

See accompanying notes.

6

LSB INDUSTRIES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Three Months Ended March 31, 2016	2015
	(In Thousands)	
Cash flows from continuing operating activities		
Net income (loss)	$(14,941)	$6,649
Adjustments to reconcile net income (loss) to net cash provided by continuing operating activities:		
Deferred income taxes	(1,329)	3,176
Depreciation, depletion and amortization of property, plant and equipment	11,679	9,001
Other	2,271	(795)
Cash provided (used) by changes in assets and liabilities (net of effects of discontinued operations):		
Accounts receivable	(1,910)	(2,348)
Inventories	7,051	(1,477)
Prepaid insurance	2,604	3,744
Prepaid and accrued income taxes	858	4,640
Other supplies, prepaid items and other	342	932
Accounts payable	10,843	1,629
Accrued interest	(8,078)	(8,086)
Customer deposits	1,022	(3,003)
Other current and noncurrent liabilities	3,681	(1,459)
Net cash provided by continuing operating activities	14,093	12,603
Cash flows from continuing investing activities		
Expenditures for property, plant and equipment	(104,290)	(66,837)
Purchases of short-term investments	—	(10,000)
Proceeds from noncurrent restricted cash and cash equivalents	—	45,969
Other investing activities	(514)	(1,080)
Net cash used by continuing investing activities	(104,804)	(31,948)
Cash flows from continuing financing activities		
Proceeds from revolving debt facility	25,000	—
Payments on revolving debt facility	(25,000)	—
Proceeds from other long-term debt, net of fees	9,951	—
Payments on other long-term debt	(3,014)	(2,881)
Payments of debt issuance costs	(476)	—
Payments of issuance costs relating to preferred stocks and warrants	(785)	—
Payments on short-term financing	(2,720)	(3,566)
Proceeds from exercises of stock options	49	742
Excess income tax benefit associated with stock-based compensation	—	129

Dividends paid on convertible preferred stocks	—	(300)
Net cash provided (used) by continuing financing activities	3,005	(5,876)
Cash flows of discontinued operations:		
Operating cash flows	(79)	(32)
Net decrease in cash and cash equivalents	(87,785)	(25,253)
Cash and cash equivalents at beginning of period	127,314	186,811
Cash and cash equivalents at end of period	$39,529	$161,558

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 consolidated financial statements. We are involved in manufacturing and marketing operations. We are primarily engaged in the manufacture and sale of chemical products (the "Chemical Business") and the manufacture and sale of water source and geothermal heat pumps and air handling products (the "Climate Control Business"). LSB is a holding company with no significant operations or assets other than cash, cash equivalents, and investments in its subsidiaries. Our Chemical Business' 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.

In our opinion, the unaudited condensed consolidated financial statements of the Company as of March 31, 2016 and for the three month period ended March 31, 2016 and 2015 include all adjustments and accruals, consisting of normal, recurring accrual adjustments, which are necessary for a fair presentation of the results for the interim periods. These interim results are not necessarily indicative of results for a full year due, in part, to the seasonality of our sales of agricultural products and the timing of performing our major plant maintenance activities. Our selling seasons for agricultural products are primarily during the spring and fall planting seasons, which typically extend from March through June and from September through November.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with United States ("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.

Redeemable Preferred Stocks - Our redeemable preferred stocks that are redeemable outside of our control 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.

Equity Awards - Equity award transactions with employees are measured based on the estimated fair value of the equity awards issued. For equity awards with only service conditions that have a graded vesting period, we recognize compensation cost on a straight-line basis over the requisite service period for the entire award. In addition, historically we issue new shares of common stock upon the exercise of stock options but treasury shares may be used.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 1: Summary of Significant Accounting Policies (continued)

During the three months ended March 31, 2016, the compensation committee of our Board of Directors (the "Board") approved the grants under the 2008 Incentive Stock Plan of 452,422 shares of restricted stock ("2016 Restricted Stock") to certain employees. The 2016 Restricted Stock carry dividend and voting rights. Sales of these shares are restricted prior to the date of vesting. Most of the 2016 Restricted Stock vest 100% at the end of three years. Pursuant to the terms of the 2016 Restricted Stock agreements, unvested restricted shares will immediately vest upon the occurrence of certain events (such as a change in control), as defined by the agreements.

In addition, certain employees surrendered a total of 280,000 shares of stock options previously granted under the 2008 Incentive Stock Plan. These employees were also granted shares of restricted stock. For financial reporting purposes, these transactions were accounted for as modifications of stock awards. The total incremental fair value of these modified awards (additional compensation cost) will be recognized on a straight-line basis over the requisite service period of three years, but the recognition of these costs could be accelerated if the unvested restricted shares immediately vest.

For the three months ended March 31, 2016 and 2015, the total stock-based compensation expense was $1.1 million and $0.6 million, respectively.

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"). The Series E Redeemable Preferred 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. As a result, 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.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 1: Summary of Significant Accounting Policies (continued)

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 but earlier application is permitted as of the beginning of an interim or annual reporting period. The amendments in this ASU may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented. We currently do not expect a significant impact from adopting this ASU.

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, 2017 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.

In March 2016, the FASB issues ASU No. 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net) which amends the guidance in ASU 2014-09 discussed above on assessing whether an entity is a principal or an agent in a revenue transaction. This conclusion impacts whether an entity reports revenue on a gross or net basis. This ASU has the same effective date and transition requirements as ASU 2014-09.

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 but early adoption will be permitted in any interim or annual period, with any adjustments reflected as of the beginning of the fiscal year of adoption. We are currently evaluating the impact of this guidance, if any, on our consolidated financial statements and related disclosures.

Previously Reported Correction and Reclassification – 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 Business. 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 months ended March 31, 2015 to conform to the current presentation as summarized in the table below.

	Condensed Consolidated Statement of Operations		
	Three Months Ended March 31, 2015		
	As Previously Reported	Adjustments / Reclassifications	As Adjusted
	(In Thousands)		
Net sales	$193,858	$ 4,940	$198,798
Cost of sales	$151,499	$ 6,538	$158,037
Gross profit	$42,359	$ (1,598)	$40,761
Selling, general and administrative expense	$28,191	$ (1,576)	$26,615
Provision for losses on accounts receivable	$22	$ (22)	$—

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 2: Income (Loss) Per Common Share

	Three Months Ended March 31, 2016	2015
	(Dollars In Thousands, Except Per Share Amounts)	
Numerator:		
Net (loss) income:	$ (14,941)	$ 6,649
Dividend requirements on Series E Redeemable Preferred	(7,350)	—
Dividend and dividend requirements on Series B Preferred	(60)	(240)
Dividend and dividend requirements on Series D Preferred	(15)	(60)
Accretion of Series E Redeemable Preferred	(2,243)	—
Total dividends, dividend requirements and accretion on preferred stocks	(9,668)	(300)
Numerator for basic net income (loss) per common share - net income (loss) attributable to common stockholders	(24,609)	6,349
Dividends on convertible preferred stocks assumed to be converted, if dilutive	—	60
Numerator for diluted net income (loss) per common share	$ (24,609)	$ 6,409
Denominator:		
Denominator for basic net income (loss) per common share - weighted- average shares (1)	22,868,307	22,674,739
Effect of dilutive securities:		

Convertible preferred stocks	—	250,000
Stock options	—	121,763
Dilutive potential common shares	—	371,763
Denominator for dilutive net income (loss) per common share - adjusted weighted-average shares and assumed conversions	22,868,307	23,046,502
Basic and diluted net income (loss) per common share	$ (1.08)	$ 0.28

(1) Excludes the weighted-average shares of unvested restricted stock that are contingently returnable during the first quarter of 2016.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 2: 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 March 31,	
	2016	2015
Convertible preferred stocks	916,666	666,666
Stock options	559,167	700,388
Warrants	4,103,746	—
Restricted stock	833,642	—
Series E Redeemable Preferred - embedded derivative	456,225	—
	6,869,446	1,367,054

Note 3: Inventories

At March 31, 2016 and December 31, 2015, inventory reserves for certain slow-moving inventory items (Climate Control Business products) were $2,158,000 and $1,968,000, respectively. In addition, because costs exceeded the net realizable value, inventory adjustments for certain nitrogen-based inventories provided by our Chemical Business were $189,000 and $2,832,000 at March 31, 2016 and December 31, 2015, respectively.

Note 4: Current and Noncurrent Accrued and Other Liabilities

	March 31, 2016	December 31, 2015
	(In Thousands)	
Accrued warranty costs	$ 10,766	$ 10,551
Accrued payroll and benefits	10,110	7,027
Deferred revenue on extended warranty contracts	8,282	8,217
Accrued interest	6,705	14,784

Series E Redeemable Preferred - embedded derivative	5,817	3,308
Customer deposits	3,231	2,209
Other	20,892	27,157
	65,803	73,253
Less noncurrent portion	23,754	20,922
Current portion of accrued and other liabilities	$42,049	$ 52,331

Note 5: Accrued Warranty Costs

Our Climate Control Business sells equipment that has an expected life, under normal circumstances and use, which extends over several years. As such, we provide warranties after equipment shipment/start-up covering defects in materials and workmanship. Generally, for commercial/institutional products, the base warranty coverage for most of the manufactured equipment in the Climate Control Business is limited to eighteen months from the date of shipment or twelve months from the date of start-up, whichever is shorter, and to ninety days for spare parts. For residential products, the base warranty coverage for manufactured equipment in the Climate Control Business is limited to ten years from the date of shipment for material and to five years from the date of shipment for labor associated with the repair. The warranty provides that most equipment is required to be returned to the factory or an authorized representative, and the warranty is limited to the repair and replacement of the defective product, with a maximum warranty of the refund of the purchase price. Furthermore, companies within the Climate Control Business generally disclaim and exclude warranties related to merchantability or fitness for any particular purpose and disclaim and exclude any liability for consequential or incidental damages. In some cases, the customer may purchase, or a specific product may be sold with, an extended warranty. The above discussion is generally applicable to such extended warranties, but variations do occur depending upon specific contractual obligations, certain system components, and local laws.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 5: Accrued Warranty Costs (continued)

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

	Three Months Ended March 31,	
	2016	2015
	(In Thousands)	
Balance at beginning of period	$10,551	$8,817
Amounts charged to SG&A	2,405	2,099
Costs incurred	(2,190)	(1,882)
Balance at end of period	$10,766	$9,034

Note 6: Asset Retirement Obligations

Currently, we have various legal requirements related to operations of our Chemical Business facilities, including the disposal of wastewater generated at certain of these facilities. Additionally, we have certain facilities in our Chemical Business that contain asbestos insulation around certain piping and heated surfaces, which we plan to maintain or replace, as needed, with non-asbestos insulation through our standard repair and maintenance activities to prevent deterioration. Currently, there is insufficient information to estimate the fair value for most of our asset retirement obligations ("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, our Chemical Business owns working interests in certain natural gas properties. We recognized AROs associated with the obligation to plug and abandon wells when the natural gas reserves in the wells are depleted. At March 31, 2016 and December 31, 2015, our accrued liability for AROs was $284,000 and $281,000, respectively.

Note 7:Long-Term Debt

Our long-term debt consists of the following:

	March 31, 2016	December 31, 2015
	(In Thousands)	
Working Capital Revolver Loan, with a current interest rate of 4.00% (A)	$—	$ —
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 2016, with a current interest rate of 3.63% (C)	14,090	15,856
Secured Promissory Note due 2019, with a current interest rate of 5.73% (D)	9,917	—
Secured Promissory Note due 2021, with a current interest rate of 5.25% (E)	16,189	16,189
Secured Promissory Note due 2023, with a current interest rate of 4.44% (F)	15,000	15,000
Other, with a current weighted-average interest rate of 4.43%, most of which is secured primarily by machinery and equipment	6,584	7,103
Unamortized discount and debt issuance costs	(8,266)	(8,726)
	528,514	520,422
Less current portion of long-term debt	16,836	22,468
Long-term debt due after one year, net	$511,678	$ 497,954

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 7:Long-Term Debt (continued)

(A) The Working Capital Revolver Loan, which matures on April 13, 2018, provides advances up to $100.0 million, based on specific percentages of eligible accounts receivable and inventories and up to $15.0 million of letters of credit, the outstanding amount of which reduces the available for borrowing under the Working Capital Revolver Loan. As of March 31, 2016, the amount available for borrowing under the Working Capital Revolver Loan was approximately $69.3 million.

(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. LSB does not have independent assets or operations.

(C) See discussion under Secured Promissory Note Amendment in Note 15-Subsequent Events.

(D) On February 5, 2016, El Dorado Chemical Company ("EDC"), a subsidiary within our Chemical Business, entered into a secured promissory note (the "Secured Promissory Note due 2019") for an original principal amount of $10.0 million. This note 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 requires 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.

(F) On September 16, 2015, El Dorado Ammonia L.L.C. ("EDA"), a subsidiary within our Chemical Business, 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. The remainder of the funding under this note is expected to be drawn upon completion of the ammonia storage tank, but in any event by May 2016 (the "Loan Conversion Date"). Up to the Loan Conversion Date, the note requires monthly interest payments on the outstanding principal borrowed.

On the Loan Conversion Date, the outstanding principal balance will be converted to a seven year secured term loan requiring equal monthly principal and interest payments. In addition, a final balloon payment equal to the remaining outstanding principal (or 30% of the outstanding principal balance on the Loan Conversion Date) is required on the maturity date. The Secured Promissory Note due 2023 bears interest at a rate that is based on the monthly LIBOR rate plus 4.0% and matures in May 2023. The Secured Promissory Note due 2023 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 – A subsidiary within our Chemical Business, Pryor Chemical Company (“PCC”), is 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, which termination will be effective as of May 31, 2016. Under the Koch Purchase Agreement, Koch had the exclusive right to purchase substantially all of the UAN produced at the Pryor Facility and the limited first right to purchase additional amounts. PCC did not incur any early termination penalties in connection with the termination of the Koch Purchase Agreement. PCC elected to terminate the Koch Purchase Agreement to pursue alternative marketing arrangements for the UAN produced at the Pryor Facility.

New UAN supply agreement – On March 3, 2016, PCC entered into a UAN Purchase and Sale Agreement with Coffeyville Resources Nitrogen Fertilizers, LLC (“CVR”), which is effective as of June 1, 2016 (the “CVR Purchase Agreement”).

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 8: Commitments and Contingencies (continued)

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 our commitments relating to derivative contracts and carbon credits (accounted for on a mark-to-market basis). At March 31, 2016, our natural gas contracts, which are exempt from mark-to-market accounting, included the firm purchase commitments of approximately 5.4 million MMBtu of natural gas. These contracts extend through December 2016 at a weighted-average cost of $2.68 per MMBtu ($14.4 million) and a weighted-average market value of $2.29 per MMBtu ($12.3 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 by our Chemical Business are 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 Chemical Business' 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.

Historically, significant expenditures have been incurred by subsidiaries within our Chemical Business in order to comply with the Environmental and Health Laws, and significant 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 Chemical Business 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, with our Chemical Business being responsible for its proportionate share of the costs involved. As of March 31, 2016, our accrued liabilities for environmental matters totaled $372,000 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.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 8: Commitments and Contingencies (continued)

1. Discharge Water Matters

Each of our chemical 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 chemical 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 March 31, 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 March 31, 2016, in connection with this matter.

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 March 31, 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.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 8: Commitments and Contingencies (continued)

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 civil penalty has been paid. As a result, the penalty relating to the emergency response equipment is included in our accrued liabilities for environmental matters discussed above.

In 2002, two subsidiaries within our Chemical Business 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 agreements 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 quarter 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 March 31, 2016, no liability reserve has been established in connection with this matter, except for the unpaid portion of the settlement agreement discussed above, 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 March 31, 2016.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

Note 8: Commitments and Contingencies (continued)

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.

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.

We are also involved in various other claims and legal actions including claims for damages resulting from water leaks related to our Climate Control Business products and other product liability occurrences. Most of the product liability claims are covered by our general liability insurance, which includes a deductible of $250,000 or $500,000 per claim, depending on the policy period. For any claims or legal actions that we have assessed the likelihood of our liability as probable, we have recognized our estimated liability. At March 31, 2016, our accrued general liability insurance claims were $636,000 and are included in accrued and other liabilities. It is possible that the actual future development of claims could be different from our estimates but, after consultation with legal counsel, we believe that changes in our estimates will not have a material effect on our business, financial condition, results of operations or cash flows.

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 used to estimate fair values.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

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

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 March 31, 2016 the valuations of contracts classified as Level 2 related to certain futures/forward natural gas contracts, a foreign exchange contract, and an embedded derivative. 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 March 31, 2016, the valuation inputs included the contractual weighted-average cost of $1.99 per MMBtu and the estimated weighted-average market value of $1.96 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 March 31, 2016, the valuation inputs included the total contractual exchange rate of 1.12 and the total estimated market exchange rate of 1.14 (U.S. Dollar/Euro). For the embedded derivative, the derivative is valued using the underlying number of shares as defined in the terms of the Series E Redeemable Preferred and the market price of our common stock. At March 31, 2016, the valuation inputs included the market price of our common stock, which was $12.75 per share. No valuation input adjustments were considered necessary relating to nonperformance risk for the contracts as discussed above.

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 March 31, 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 March 31, 2016, the valuation was based on a recent price offered 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. In addition, no valuation input adjustments were considered necessary relating to nonperformance risk for the carbon credits or the associated contractual obligations.

Commodities Contracts

Raw materials for use in our manufacturing processes include copper used by our Climate Control Business and natural gas used by our Chemical Business. As part of our raw material price risk management, we periodically enter into futures/forward contracts for these materials, which contracts may be required to be accounted for on a mark-to-market basis. At March 31, 2016 and December 31, 2015, we did not have any futures/forward copper contracts. At March 31, 2016, our futures/forward natural gas contracts included 611,000 MMBtu of natural gas, extend through December 2016 (includes contractual costs indexed to future NYMEX prices) at a weighted-average cost of $1.99 per MMBtu. 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 business operations purchases industrial machinery and related components from vendors outside of the United States. As part of our foreign currency risk management, we periodically enter into foreign exchange contracts, which set the U.S. Dollar/Euro exchange rates. At March 31, 2016 and December 31, 2015, our foreign exchange contract was for the receipt of approximately 228,000 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

As part of our interest rate risk management, we periodically purchase and/or enter into various 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 through March 31, 2016. This contract was a free-standing derivative and was accounted for on a mark-to-market basis. During the three months ended March 31, 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.

LSB INDUSTRIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Unaudited)

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

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 the 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 March 31, 2016 and December 31, 2015, we had approximately 516,000 and 495,000 carbon credits, respectively, 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.

Embedded Derivative

The embedded derivative, which includes the participation rights value, relating to the redemption of the Series E Redeemable Preferred has been bifurcated from the Series E Redeemable Preferred and recorded as a liability. At March 31, 2016 and December 31, 2015 the fair value of the embedded derivative was based on the equivalent of 456,225 shares of our commons stock at $12.75 and $7.25 per share, respectively.

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

		Fair Value Measurements at March 31, 2016 Using			
Description	Total Fair Value at March 31, 2016	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Fair Value at December 31, 2015

		(Level 1)			
	(In Thousands)				
Assets - Supplies, prepaid items and other:					
Commodities contracts (1)	$320	$—	$ 320	$ —	$ 195
Carbon credits	1,214	—	—	1,214	1,154
Foreign exchange contracts	7	—	7	—	—
Total	$1,541	$—	$ 327	$ 1,214	$ 1,349
Liabilities - Current and noncurrent accrued and other liabilities:					
Commodities contracts (1)	$(320)	$—	$ (320)	$ —	$ (202)
Contractual obligations - carbon credits	(1,214)	—	—	(1,214)	(1,154)
Embedded derivative	(5,817)	—	(5,817)	—	(3,308)
Interest rate contracts	—	—	—	—	(126)
Foreign exchange contracts	—	—	—	—	(6)
Total	$(7,351)	$—	$ (6,137)	$ (1,214)	$ (4,796)

(1) At March 31, 2016 and December 31, 2015, $320,000 and $195,000, respectively, are subject to an agreement that allows net settlement of contracts; however, we have chosen to present the fair values of our commodities contracts under master netting agreements using a gross fair value presentation.

LSB INDUSTRIES, INC.

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. 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 Three Months Ended March 31,		Liabilities Three Months Ended March 31,	
	2016	2015	2016	2015
	(In Thousands)			
Beginning balance	$1,154	$2,779	$(1,154)	$(2,779)
Transfers into Level 3	—	—	—	—
Transfers out of Level 3	—	—	—	—
Total realized and unrealized gains (losses) included in operating results	60	(30)	(60)	30
Purchases	—	—	—	—
Issuances	—	—	—	—
Sales	—	(33)	—	—
Settlements	—	—	—	33
Ending balance	$1,214	$2,716	$(1,214)	$(2,716)
Total gains (losses) for the period included in operating results attributed to the change in unrealized gains or losses on assets and liabilities still held at the reporting date	$60	$—	$(60)	$—

Net gains (losses) included in operating results and the statement of operations classifications are as follows:

Three Months Ended

	March 31, 2016	2015
	(In Thousands)	
Total net gains (losses) included in operating results:		
Cost of sales - Undesignated commodities contracts	$(17)	$(1,978)
Cost of sales - Undesignated foreign exchange contracts	13	(93)
Other income - Carbon credits	60	(30)
Other expense - Contractual obligations relating to carbon credits	(60)	30
Non-operating other expense - embedded derivative	(2,509)	—
Interest expense - Undesignated interest rate contracts	—	(31)
Total net losses included in operating results	$(2,513)	$(2,102)

At March 31, 2016 and December 31, 2015, we did not have any financial instruments with fair values significantly different from their carrying amounts, except for the 7.75% Senior Secured Notes as shown below.

	March 31, 2016		December 31, 2015	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
	(In Millions)			
7.75% Senior Secured Notes (1)	$425			