

OM GROUP INC  
Form 10-Q  
November 03, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

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

**For the quarterly period ended September 30, 2006**

**OR**

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

**Commission file number 001-12515**

**OM GROUP, INC.**

**(Exact name of Registrant as specified in its charter)**

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**52-1736882**

(I.R.S. Employer  
Identification No.)

**127 Public Square,  
1500 Key Tower,  
Cleveland, Ohio**

(Address of principal executive offices)

**44114-1221**

(Zip Code)

**216-781-0083**

Registrant's telephone number, including area code

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No   
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of Act). Yes  No   
As of October 31, 2006 there were 29,369,258 shares of Common Stock, par value \$.01 per share, outstanding.

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**OM Group, Inc. and Subsidiaries**  
**Unaudited Condensed Consolidated Balance Sheets**

	<b>September 30, 2006</b>	<b>December 31, 2005</b>
<i>(In thousands, except share data)</i>		
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 224,791	\$ 114,618
Accounts receivable, less allowances	184,795	128,278
Inventories	349,003	304,557
Advances to suppliers	15,761	5,503
Other current assets	82,585	52,152
<b>Total current assets</b>	<b>856,935</b>	<b>605,108</b>
<b>Property, plant and equipment, net</b>	<b>361,526</b>	<b>369,129</b>
<b>Goodwill</b>	<b>183,042</b>	<b>179,123</b>
<b>Notes receivable from non-consolidated joint ventures</b>	<b>7,749</b>	<b>354</b>
<b>Notes receivable from joint venture partner, less allowances</b>	<b>24,179</b>	<b>25,179</b>
<b>Other non-current assets</b>	<b>44,186</b>	<b>41,380</b>
<b>Total assets</b>	<b>\$ 1,477,617</b>	<b>\$ 1,220,273</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current liabilities</b>		
Current portion of long-term debt	\$	\$ 5,750
Accounts payable	167,277	103,397
Accrued employee costs	24,872	21,100
Retained liabilities of businesses sold	5,615	6,020
Other current liabilities	65,099	31,772
<b>Total current liabilities</b>	<b>262,863</b>	<b>168,039</b>
<b>Long-term debt</b>	<b>404,284</b>	<b>416,096</b>
<b>Deferred income taxes</b>	<b>24,028</b>	<b>21,461</b>
<b>Minority interest</b>	<b>40,468</b>	<b>36,994</b>
<b>Other non-current liabilities</b>	<b>40,754</b>	<b>41,150</b>
<b>Stockholders equity:</b>		
Preferred stock, \$.01 par value:		
Authorized 2,000,000 shares, no shares issued or outstanding		
Common stock, \$.01 par value:		
Authorized 60,000,000 shares; issued 29,414,817 in 2006 and 29,368,519 shares in 2005	<b>293</b>	<b>293</b>

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Capital in excess of par value	<b>521,345</b>	516,510
Retained earnings	<b>164,533</b>	6,811
Treasury stock (61,541 shares in 2006 and 61,235 shares in 2005, at cost)	<b>(2,239)</b>	(2,226)
Accumulated other comprehensive income	<b>21,288</b>	15,145
<b>Total stockholders equity</b>	<b>705,220</b>	536,533
<b>Total liabilities and stockholders equity</b>	<b>\$ 1,477,617</b>	<b>\$ 1,220,273</b>

*See accompanying notes to unaudited condensed consolidated financial statements.*

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**OM Group, Inc. and Subsidiaries**  
**Unaudited Condensed Statements of Consolidated Income**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	<b>2006</b>	2005	<b>2006</b>	2005
<i>(In thousands, except per share data)</i>				
<b>Net sales</b>	<b>\$ 375,772</b>	\$ 306,586	<b>\$ 1,000,545</b>	\$ 973,227
<b>Cost of products sold</b>	<b>230,455</b>	274,442	<b>710,101</b>	844,659
<b>Gross profit</b>	<b>145,317</b>	32,144	<b>290,444</b>	128,568
<b>Selling, general and administrative expenses</b>	<b>27,691</b>	20,562	<b>85,132</b>	76,301
<b>Income from operations</b>	<b>117,626</b>	11,582	<b>205,312</b>	52,267
<b>Other income (expense):</b>				
Interest expense	<b>(9,774)</b>	(10,159)	<b>(29,506)</b>	(30,411)
Foreign exchange gain (loss)	<b>997</b>	545	<b>2,574</b>	(2,267)
Gain on sale of investments in equity securities			<b>12,223</b>	2,359
Other income, net	<b>3,599</b>	1,246	<b>7,643</b>	4,740
	<b>(5,178)</b>	(8,368)	<b>(7,066)</b>	(25,579)
<b>Income from continuing operations before income taxes, minority interest and cumulative effect of change in accounting principle</b>	<b>112,448</b>	3,214	<b>198,246</b>	26,688
Income tax expense	<b>(22,845)</b>	(1,190)	<b>(36,333)</b>	(6,981)
Minority interest share of (income) loss	<b>(2,838)</b>	1,204	<b>(3,474)</b>	5,775
<b>Income from continuing operations before cumulative effect of change in accounting principle</b>	<b>86,765</b>	3,228	<b>158,439</b>	25,482
<b>Discontinued operations:</b>				
Income from discontinued operations, net of tax	<b>1,243</b>	139	<b>570</b>	1,764
<b>Income before cumulative effect of change in accounting principle</b>	<b>88,008</b>	3,367	<b>159,009</b>	27,246
Cumulative effect of change in accounting principle			<b>287</b>	
<b>Net income</b>	<b>\$ 88,008</b>	\$ 3,367	<b>\$ 159,296</b>	\$ 27,246
<b>Net income per common share basic:</b>				
Continuing operations	<b>\$ 2.96</b>	\$ 0.11	<b>\$ 5.40</b>	\$ 0.89
Discontinued operations	<b>0.04</b>	0.01	<b>0.02</b>	0.06
Cumulative effect of change in accounting principle			<b>0.01</b>	

<b>Net income</b>	\$	<b>3.00</b>	\$	0.12	\$	<b>5.43</b>	\$	0.95
<b>Net income per common share assuming dilution:</b>								
Continuing operations	\$	<b>2.93</b>	\$	0.11	\$	<b>5.37</b>	\$	0.89
Discontinued operations		<b>0.04</b>		0.01		<b>0.02</b>		0.06
Cumulative effect of change in accounting principle						<b>0.01</b>		
<b>Net income</b>	\$	<b>2.97</b>	\$	0.12	\$	<b>5.40</b>	\$	0.95
<b>Weighted average shares outstanding</b>								
<b>Basic</b>		<b>29,336</b>		28,591		<b>29,322</b>		28,530
<b>Assuming dilution</b>		<b>29,635</b>		28,615		<b>29,486</b>		28,593

*See accompanying notes to unaudited condensed consolidated financial statements.*

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**OM Group, Inc. and Subsidiaries**  
**Unaudited Condensed Statements of Consolidated Cash Flows**

	Nine Months Ended September 30, 2005 Revised	
<i>(In thousands)</i>	<b>2006</b>	-
		See Note 1
<b>Operating activities</b>		
Net income	\$ 159,296	\$ 27,246
Adjustments to reconcile net income to net cash provided by operating activities:		
Income from discontinued operations	(570)	(1,764)
Income from cumulative effect of change in accounting principle	(287)	
Depreciation and amortization	36,937	37,036
Foreign exchange (gain) loss	(2,574)	2,267
Payment for termination of swap agreement	(2,877)	
Gain on sale of investments in equity securities	(12,223)	(2,359)
Gain on collection of notes receivable previously reserved		(2,500)
Provision for receivables from joint venture partner	1,000	
Minority interest share of income (loss)	3,474	(5,775)
Equity income from investment	(2,404)	(3,876)
Other non-cash items	2,248	(81)
Changes in operating assets and liabilities		
Accounts receivable	(52,446)	(7,507)
Inventories	(42,634)	107,182
Advances to suppliers	(10,258)	22,516
Accounts payable	61,144	(42,138)
Shareholder litigation accrual		(74,000)
Other, net	8,960	(935)
<b>Net cash provided by operating activities</b>	<b>146,786</b>	<b>55,312</b>
<b>Investing activities</b>		
Expenditures for property, plant and equipment	(21,443)	(18,489)
Proceeds from sale of investments in equity securities	12,223	4,534
Gain on collection of notes receivable previously reserved		2,500
Proceeds from MPI note receivable		3,035
Loans to non-consolidated joint ventures	(7,170)	
Acquisition of business, net of cash acquired	(5,417)	
<b>Net cash used for investing activities</b>	<b>(21,807)</b>	<b>(8,420)</b>
<b>Financing activities</b>		
Payments of long-term debt	(17,250)	(4,313)
Payments of revolving line of credit		(49,872)
Proceeds from revolving line of credit		49,872
Proceeds from exercise of stock options	897	117



<b>Net cash used for financing activities</b>	<b>(16,353)</b>	<b>(4,196)</b>
Effect of exchange rate changes on cash	<b>3,287</b>	<b>(4,432)</b>
<b>Cash and cash equivalents</b>		
Increase from continuing operations	<b>111,913</b>	38,264
Discontinued operations net cash used for operating activities	<b>(1,740)</b>	(5,175)
Balance at the beginning of the period	<b>114,618</b>	26,779
<b>Balance at the end of the period</b>	<b>\$ 224,791</b>	<b>\$ 59,868</b>

*See accompanying notes to unaudited condensed consolidated financial statements*

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**OM Group, Inc. and Subsidiaries**  
**Unaudited Condensed Statements of Consolidated Stockholders Equity**

	Nine Months Ended September 30,	
<i>(In thousands)</i>	<b>2006</b>	2005
<b>Common Stock Shares Outstanding, net of Treasury Shares)</b>		
Beginning balance	<b>29,307</b>	28,480
Shares issued under share-based compensation plans	<b>46</b>	40
Shares issued for settlement of shareholder litigation		407
	<b>29,353</b>	28,927
<b>Common Stock Dollars</b>		
Beginning balance	<b>\$ 293</b>	\$ 285
Shares issued under share-based compensation plans		4
Shares issued for settlement of shareholder litigation		
	<b>293</b>	289
<b>Capital in Excess of Par Value</b>		
Beginning balance	<b>516,510</b>	498,250
Shares issued under share-based compensation plans	<b>897</b>	846
Settlement of shareholder litigation		8,495
Share-based compensation	<b>3,938</b>	1,909
	<b>521,345</b>	509,500
<b>Retained Earnings (Deficit)</b>		
Beginning balance, as originally reported	<b>6,811</b>	(32,080)
Adoption of EITF No. 04-6	<b>(1,574)</b>	
Beginning balance, as adjusted for the adoption of EITF 04-6	<b>5,237</b>	(32,080)
Net income	<b>159,296</b>	27,246
	<b>164,533</b>	(4,834)
<b>Treasury Stock</b>		
Beginning balance	<b>(2,226)</b>	(710)
Reacquired shares	<b>(13)</b>	(1,516)
	<b>(2,239)</b>	(2,226)
<b>Accumulated Other Comprehensive Income</b>		
Beginning balance	<b>15,145</b>	21,287
Foreign currency translation	<b>4,062</b>	(3,206)
Reclassification of hedging activities into earnings	<b>(954)</b>	(3,475)
Unrealized gain (loss) on cash flow hedges, net of tax expense (benefit) of \$(3,541) in 2006 and \$286 in 2005	<b>7,780</b>	(813)

Reclassification of realized gain on available-for-sale securities into earnings	(4,745)	(930)
	<b>21,288</b>	12,863
<b>Total Stockholders Equity</b>	<b>\$ 705,220</b>	<b>\$ 515,592</b>

*See accompanying notes to unaudited condensed consolidated financial statements*

**Table of Contents****Notes to Condensed Consolidated Financial Statements****OM Group, Inc. and Subsidiaries***(In thousands, except as noted and per share amounts)***Note 1 Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements include the accounts of OM Group, Inc. and its subsidiaries (the Company). These financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair financial presentation of the financial position of the Company at September 30, 2006 and the results of its operations for the three and nine months ended September 30, 2006 and 2005 and its cash flows and changes in stockholders' equity for the nine months ended September 30, 2006 and 2005 have been included. The balance sheet at December 31, 2005 has been derived from the audited consolidated financial statements at that date but does not include all of the information or notes required by U.S. generally accepted accounting principles for complete financial statements. Past operating results are not necessarily indicative of the results which may occur in future periods, and the interim period results are not necessarily indicative of the results to be expected for the full year. These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

Unless otherwise indicated, all disclosures and amounts in the Notes to Condensed Consolidated Financial Statements relate to the Company's continuing operations.

Certain prior period amounts have been reclassified to conform to the current period's presentation. Cash flows associated with liabilities of business sold for the first nine months of 2005, which had previously been included in the operating section of the cash flow statement, have been reclassified and are now included with cash flows attributable to discontinued operations.

**Note 2 Recently Issued Accounting Standards***Accounting Standards adopted in 2006:*

**SFAS No. 123R:** In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123 (revised), Share-Based Payments (SFAS No. 123R). SFAS No. 123R is a revision of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123) and supersedes Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees. SFAS No. 123R requires that the cost of transactions involving share-based payments be recognized in the financial statements based on a fair-value-based measurement. The Company adopted SFAS No. 123R on January 1, 2006 using the modified prospective method. The Company has selected the Black-Scholes option-pricing model and will recognize compensation expense on a straight-line method over the awards' vesting period. Previously, the Company expensed share-based payments under the provisions of SFAS No. 123.

SFAS No. 123R requires the Company to estimate forfeitures in calculating the expense relating to share-based compensation while SFAS No. 123 had permitted the Company to recognize forfeitures as an expense reduction upon occurrence. The adjustment to apply estimated forfeitures to previously recognized share-based compensation was accounted for as a cumulative effect of a change in accounting principle at January 1, 2006 and increased net income by \$0.3 million, or \$0.01 per basic and diluted share, for the nine months ended September 30, 2006. The income tax expense related to the cumulative effect was offset by a corresponding change in deferred tax assets and valuation allowance; thus, there was no net tax impact upon adoption of SFAS 123R.

The Company's 2002 Stock Incentive Plan authorizes the grant of options and restricted stock to employees and outside directors of up to 1,400,000 shares, with a limit of 200,000 shares to a single individual in any year. The Plan also limits the total number of shares subject to the Plan that may be granted in the form of restricted stock. The Company's 1998 Long-Term Incentive Compensation Plan authorizes the annual grant of options to employees and outside directors of up to one and one-half percent of the number of outstanding shares of common stock of the Company on the prior December 31, plus unused shares and shares relating to terminated awards from prior years,

subject to an overall annual maximum of 2% of common stock outstanding. This plan also limits awards to a single individual to 200,000 shares in any year. All options granted under both plans have 10-year terms. Options have an exercise

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price equal to the market price at the date of grant except for the options granted to the current CEO in June 2005, some of which have exercise prices set above the grant date market price. See further discussion of these options below.

The unaudited condensed statements of consolidated income include share-based compensation expense of \$1.4 million and \$0.7 million for the three months ended September 30, 2006 and 2005, respectively, and \$4.2 million and \$1.9 million for the nine months ended September 30, 2006 and 2005, respectively. At September 30, 2006, there was \$8.8 million of total unrecognized compensation expense related to nonvested share-based awards. That cost is expected to be recognized as follows: \$1.4 million in the fourth quarter of 2006, \$4.7 million in 2007, \$2.4 million in 2008 and \$0.3 million in 2009. Unearned compensation expense is recognized over the vesting period for the particular grant as a component of Selling, general and administrative expenses within the unaudited condensed statements of consolidated income. The Company currently provides a full valuation allowance for net U.S. deferred tax assets, and accordingly, a valuation allowance is also provided for any tax effects of share-based compensation expense pursuant to SFAS 123R.

In connection with the exercise of stock options previously granted, the Company received cash payments of \$0.6 million and \$0.9 million for the three and nine months ended September 30, 2006, respectively. The Company issues new shares to satisfy stock option exercises and restricted stock awards. The Company does not settle share-based payment obligations for cash.

**Stock Options**

Options granted prior to 2003 generally vested and became fully exercisable at the end of the next fiscal year following the year of grant. Options granted subsequent to January 1, 2003 generally vest equally over three years. The Company accounts for options that vest over more than one year as one award and recognizes expense related to those awards on a straight-line basis over the vesting period. During the first nine months of 2006, the Company granted 144,700 stock options. Upon any change in control of the Company, as defined in the agreement, the stock options become 100% vested and exercisable. For options granted subsequent to May 1, 2006, a pro rata number of options vest in the event of death or disability prior to the stated vesting date.

In June 2005, as an inducement to join the Company, the Chief Executive Officer (the CEO) was granted options to purchase 254,996 shares of common stock, of which options for 80,001 shares vested on May 31, 2006, options for 85,050 shares vest on May 31, 2007 and options for 89,945 shares vest on May 31, 2008, subject to the CEO remaining employed by the Company on those dates. The options that vested in 2006 have an exercise price equal to the market price of the Company's common stock on the date of grant (\$24.89). The options that vest on May 31, 2007 and 2008 have exercise prices set above the grant date market price of the Company's common stock (\$28.67 and \$33.67, respectively).

The fair value of options was estimated at the date of grant using a Black-Scholes options pricing model with the following weighted-average assumptions:

	Nine Months Ended September 30,	
	2006	2005
Risk-free interest rate	4.9%	3.9%
Dividend yield		
Volatility factor of Company common stock	0.47	0.44
Weighted-average expected option life (years)	6.1	5.0
Weighted-average grant-date fair value	\$14.97	\$9.55

The risk-free interest rate assumption is based upon the U.S. Treasury yield curve appropriate for the term of the options being valued. The dividend yield assumption is zero, as the Company intends to continue to retain earnings for use in the operation of the business and does not anticipate paying dividends in the foreseeable future. Expected volatilities are based on historical volatility of the Company's common stock. The expected term of options granted is determined using the shortcut method allowed by SAB No. 107. Under this approach, the expected term is presumed to be the mid-point between the vesting date and the end of the contractual term.



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A summary of the Company's stock option activity for the nine months ended September 30, 2006 is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2006	1,252,817	\$ 30.71		
Granted	144,700	28.83		
Exercised	(48,215)	20.23		
Expired unexercised	(35,000)	31.29		
Forfeited	(2,500)	27.00		
Outstanding at September 30, 2006	1,311,802	\$ 30.88	7.22	\$ 18,789,137
Vested or expected to vest at September 30, 2006	1,293,686	\$ 30.88	7.20	\$ 18,556,402
Exercisable at September 30, 2006	633,527	\$ 34.60	5.73	\$ 7,581,151

The total intrinsic value of options exercised during the nine months ended September 30, 2006 was \$0.6 million.

**Restricted Stock Performance-Based Awards**

During the first nine months of 2006, the Company granted 99,520 shares of performance-based restricted stock which vest subject to the Company's financial performance. The total number of shares of restricted stock that ultimately vest is based upon the Company's achievement of specific measurable performance criteria. A recipient of performance-based restricted stock may earn a total award ranging from 0% to 100% of the initial grant. The ultimate satisfaction of the performance criteria will be determined based on the three-year performance period ending December 31, 2008. The market value of the performance-based restricted stock award was valued based upon the market price of an unrestricted share of the Company's common stock at the date of grant. The Company recognizes expense related to performance-based restricted stock ratably over the requisite service period based upon the number of shares which are anticipated to vest. The number of shares anticipated to vest will be evaluated quarterly and compensation cost will be adjusted accordingly. Upon any change in control of the Company, as defined in the agreement, the shares become 100% vested. In the event of death or disability, a pro rata number of shares shall remain eligible for vesting at the end of the performance period.

A summary of the Company's performance-based restricted stock awards for the nine months ended September 30, 2006 is as follows:

	Shares	Weighted Average Grant Date Fair Value \$
Outstanding at January 1, 2006		
Granted	99,520	28.93
Outstanding at September 30, 2006	99,520	\$ 28.93
Expected to vest at September 30, 2006	47,740	

**Restricted Stock Time-Based Awards**

During the first nine months of 2006, the Company granted 23,300 shares of time-based restricted stock that vest three years from the date of grant subject to the respective employee recipient remaining employed by the Company on that date. The market value of the restricted stock awards, based upon the market price of an unrestricted share of the Company's common stock at the date of grant, was \$0.7 million. The expense is being recognized ratably over the vesting period. Upon any change in control of the Company, as defined in the agreement, the shares become 100% vested. A pro rata number of shares will vest in the event of death or disability prior to the stated vesting date.



In June 2005, the Company granted 166,194 shares of restricted stock to its CEO in connection with his hiring. The restricted shares vest on May 31, 2008 subject to the CEO remaining employed by the Company on that date. During the second quarter of 2006, the

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Company amended the restricted stock agreement to provide for pro rata vesting of the shares covered by the restricted stock agreement in the event the CEO becomes disabled or dies prior to the May 31, 2008, vesting date. The market value of the restricted stock award based upon the market price (\$24.89) of an unrestricted share of the Company's common stock at the date of grant was \$4.1 million and the expense is being recognized ratably over the vesting period.

A summary of the Company's time-based restricted stock awards for the nine months ended September 30, 2006 is as follows:

	Shares	Weighted Average Grant Date Fair Value
Outstanding at January 1, 2006	<b>166,194</b>	<b>\$ 24.89</b>
Granted	<b>23,300</b>	<b>29.10</b>
Outstanding at September 30, 2006	<b>189,494</b>	<b>\$ 25.41</b>
Expected to vest at September 30, 2006	<b>188,594</b>	

**EITF No. 04-6:** In June 2005, the FASB ratified modifications to Emerging Issues Task Force ( EITF ) No. 04-6, Accounting for Stripping Costs Incurred during Production in the Mining Industry. EITF No. 04-6, which was required to be adopted in the first reporting period beginning after December 15, 2005, clarifies that stripping costs incurred during the production phase of a mine are variable production costs that should be included in the costs of the inventory produced during the period that the stripping costs are incurred. The Company adopted EITF No. 04-6 on January 1, 2006. In accordance with EITF 04-6, stripping costs incurred during the production phase of a mine will be included in the cost of inventory produced. Previously, the Company capitalized and deferred stripping costs when developing a new pit or expanding an existing pit until that pit reached full production. Upon adoption of EITF No. 04-6, the Company wrote off the amount of deferred stripping costs that were incurred after production commenced at each pit. The transition provisions require that adoption be accounted for in a manner similar to a cumulative effect adjustment with any adjustment recognized in the opening balance of retained earnings in the year of adoption. The effect of adoption was a \$1.6 million reduction to Other non-current assets and beginning retained earnings, including the additional valuation allowance to offset the resulting tax benefit.

**SFAS No. 154:** In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections, which replaces APB Opinion No. 20, Accounting Changes, and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements, and provides guidance on the accounting for and reporting of accounting changes and error corrections. SFAS No. 154 applies to all voluntary changes in accounting principle and requires retrospective application (a term defined by the statement) to prior periods' financial statements, unless it is impracticable to determine the effect of a change. It also applies to changes required by an accounting pronouncement that does not include specific transition provisions. In addition, SFAS No. 154 redefines restatement as the revising of previously issued financial statements to reflect the correction of an error. The statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company adopted SFAS No. 154 on January 1, 2006 and will apply SFAS No. 154 in future periods, when applicable. The adoption did not impact the Company's results of operations and financial position.

**SFAS No. 151:** In November 2004, the FASB issued SFAS No. 151, Inventory Costs. An amendment of ARB No. 43. SFAS No. 151 clarifies that abnormal amounts of idle facility expense, freight, handling costs and spoilage should be expensed as incurred and not included in overhead. Further, SFAS No. 151 requires that allocation of fixed production overheads to conversion costs should be based on normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Companies must apply the standard prospectively. The adoption of SFAS No. 151 did not and is not expected to impact the Company's results of operations or financial position.

*Accounting Standards Not Yet Adopted*

**SFAS No. 155:** In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Instruments, which is an amendment of SFAS No. 133 and 140 and allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. Companies must apply the standard prospectively. The adoption of SFAS No. 155 is not expected to have a material impact on the Company's results of operations or financial position.

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**SFAS No. 156:** In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets*, which requires all separately recognized servicing assets and servicing liabilities be initially measured at fair value. SFAS No. 156 permits, but does not require, the subsequent measurement of servicing assets and servicing liabilities at fair value. Adoption is required as of the beginning of the first fiscal year that begins after September 15, 2006. Early adoption is permitted. The adoption of SFAS No. 156 is not expected to have a material impact on the Company's results of operations or financial position.

**SFAS No. 157:** In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company has not determined the effect, if any, the adoption of this statement will have on its results of operations or financial position.

**SFAS No. 158:** In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*—an amendment of FASB Statements No. 87, 88, 106 and 132(R). This standard requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur as a component of comprehensive income. The standard also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position.

The requirement to recognize the funded status of a defined benefit postretirement plan as an asset or liability in the statement of financial position is effective as of the end of the fiscal year ending after December 15, 2006. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for the fiscal years ending after December 15, 2008. The Company has not determined the effect, if any, the adoption of this statement will have on its results of operations or financial position.

**FIN No. 48:** In July 2006, the FASB issued Financial Accounting Standards Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN No. 48 prescribes a recognition threshold and measurement attributable for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transitions. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently analyzing the effects of the adoption of FIN No. 48.

**EITF No. 06-3:** In June 2006, the FASB ratified the consensus of EITF No. 06-03, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)*. EITF No. 06-03 indicates that the income statement presentation of taxes within the scope of the Issue on either a gross basis or a net basis is an accounting policy decision that should be disclosed pursuant to APB No. 22. EITF No. 06-03 is effective for fiscal years beginning after December 15, 2006. The adoption of EITF No. 06-3 is not expected to have a material impact on the Company's results of operations or financial position.

**EITF No. 06-4:** In June 2006, the EITF reached a consensus on EITF No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*, which requires the application of the provisions of SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* to endorsement split-dollar life insurance arrangements. SFAS No. 106 would require the Company to recognize a liability for the discounted future benefit obligation that the Company will have to pay upon the death of the underlying insured employee. An endorsement-type arrangement generally exists when the Company owns and controls all incidents of ownership of the underlying policies. EITF No. 06-4 is effective for fiscal years beginning after December 15, 2006. The Company may have certain policies subject to the provisions of this new pronouncement and is currently determining the effect the adoption of EITF No. 06-4 will have on its financial statements.

**SAB No. 108:** In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which provides interpretive guidance on the consideration of the effects of prior year

misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB No. 108 is effective for companies with fiscal years ending on or after November 15, 2006. The adoption of SAB No. 108 is not expected to have a material impact on the Company's results of operations or financial position.

**Table of Contents****Note 3 Inventories**

Inventories consist of the following:

	<b>September 30, 2006</b>	December 31, 2005
Raw materials and supplies	\$ 189,288	\$ 192,739
Work-in-process	40,842	21,781
Finished goods	118,873	90,037
	<b>\$ 349,003</b>	<b>\$ 304,557</b>

**Note 4 Acquisition and Investments**

On March 21, 2006, the Company completed the acquisition of Plaschem Specialty Products Pte Ltd. and its subsidiaries ( Plaschem ). Plaschem develops and produces specialty chemicals for printed circuit board chemistries, semiconductor chemistries and general metal finishing with a manufacturing facility in Singapore and an integrated manufacturing, research and technical support facility in the Shanghai area of China. Plaschem had sales of approximately \$11.0 million in 2005. In connection with the acquisition, the Company paid \$5.2 million in cash, net of cash acquired and issued a \$0.5 million note that is payable in March 2007. The Company incurred fees of approximately \$0.2 million associated with this transaction. Additional contingent consideration, up to a maximum of \$2.0 million, is due to the seller if certain specified financial performance targets of the acquired business are met over the three-year period following the acquisition. Goodwill of \$1.3 million was recognized as a result of this acquisition. Plaschem is included in the Specialties segment results of operations since the date of acquisition.

The Company has an approximately 5% equity interest (\$1.3 million at September 30, 2006) in Talvivaara Mining Company, Ltd. ( Talvivaara ). During the fourth quarter of 2005, the Company entered into a convertible loan agreement with Talvivaara pursuant to which it loaned a total of 2.0 million Euros (\$2.5 million at September 30, 2006), of which 0.3 million Euros was advanced in 2005 and 1.7 million Euros was advanced in the first nine months of 2006. The loan is convertible into Talvivaara shares at the Company's option. If the entire outstanding loan was converted into Talvivaara shares, the Company would have an approximately 11% equity interest in Talvivaara. The loan is included in notes receivable from non-consolidated joint ventures in the unaudited condensed consolidated balance sheets.

The Company has a 20% interest in MPI Nickel, an Australian nickel company, that is accounted for by the equity method. The \$13.9 million and \$11.8 million investment at September 30, 2006 and December 30, 2005, respectively, is included in other non-current assets in the unaudited condensed consolidated balance sheets. Equity income (loss) is included in Other income, net in the unaudited condensed statements of consolidated income. During the first nine months of 2006, the Company loaned \$5.2 million to MPI Nickel, with no stated repayment date. The loan is included in notes receivable from non-consolidated joint ventures in the unaudited condensed consolidated balance sheet. Interest on this loan accrues at LIBOR plus 1% and is payable quarterly.

During the first nine months of 2006, the Company sold the common shares it held in Weda Bay Minerals, Inc. ( Weda Bay ) and received cash proceeds of \$12.2 million. The Company recognized a \$12.0 million gain, net of \$0.2 million tax expense, upon completion of the sale as the net book value of the investment was zero due to a permanent impairment charge recorded in prior years. The gain is included in Gain on sale of investments in equity securities in the unaudited condensed statements of consolidated income.

**Table of Contents****Note 5 Income Taxes**

The income tax provision is based on the application of an estimated annual effective income tax rate applied to the current quarter's year-to-date pre-tax income. In determining the estimated annual effective income tax rate, the Company analyzes various factors, including projections of the Company's annual earnings, taxing jurisdictions in which the earnings will be generated, the Company's ability to use tax credits and net operating loss carryforwards, and available tax planning alternatives. The tax effects of discrete items, including the effect of changes in tax laws, tax rates, certain circumstances with respect to valuation allowances or other unusual or non-recurring items, including the Weda Bay gain discussed below, are reflected in the period in which they occur as an addition to, or reduction from, the income tax provision, rather than included in the estimated annual effective income tax rate. Income (loss) from continuing operations before income taxes, minority interest and cumulative effect of change in accounting principle consists of the following:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
United States	\$ (17,945)	\$ (15,496)	\$ (47,207)	\$ (51,292)
Outside the United States	130,393	18,710	245,453	77,980
	\$ 112,448	\$ 3,214	\$ 198,246	\$ 26,688

The Company's effective tax rates are as follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Effective income tax rate	20.3%	37.0%	18.3%	26.2%

The effective income tax rate is lower than the United States statutory rate primarily due to a higher proportion of earnings in jurisdictions having lower statutory tax rates (primarily in Finland at 26%), a tax holiday from income taxes in Malaysia and the recognition of previously unrecognized tax benefits of NOL carryovers in Australia which were partially offset by losses in the United States with no corresponding tax benefit. In addition, the Company's statutory tax liability is calculated and payable in Euros but is remeasured to the U.S. dollar functional currency for preparation of consolidated financial statements; therefore, changes in the exchange rates impact the effective income tax rate.

The estimated annual effective income tax rate for the nine months ended September 30, 2006 includes the \$0.2 million tax impact of the \$12.2 million gain on the sale of the Company's investment in Weda Bay. The estimated annual effective income tax rate for the third quarter of 2005 includes a \$0.7 million charge related to the liquidation of an entity in Thailand.

As discussed in the Company's 2005 Form 10-K, the Malaysian tax holiday expires on December 31, 2006. The Malaysian tax holiday reduced income tax expense by \$4.9 million and \$3.6 million in the nine months ended September 30, 2006 and 2005, respectively, and \$1.8 million and \$1.3 million in the three months ended September 30, 2006 and 2005, respectively.

**Note 6 Pension and Other Postretirement Benefit Plans**

The Company sponsors a defined contribution plan covering all eligible U.S. employees. To be eligible for the plan, an employee must be a full-time associate for at least six months and at least 21 years of age. Company contributions are determined by the board of directors annually and are computed based upon a percentage of individual participant compensation. The Company also sponsors a non-contributory, nonqualified supplemental executive retirement plan for certain employees, providing benefits beyond those covered in the defined contribution plan.

The Company has a funded non-contributory defined benefit pension plan for certain retired employees in the United States related to the Company's divested SCM business. The Company also has an unfunded supplemental executive

retirement plan ( SERP ) that was executed as of January 1, 2004 for the former Chief Executive Officer and other unfunded postretirement benefit plans, primarily



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health care and life insurance for certain employees and non-employees in the United States. The Company uses an October 31 measurement date for both its pension and postretirement benefit plans.

Set forth below is a detail of the net periodic pension expense for the defined benefit plans for the three and nine months ended September 30, 2006 and 2005:

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>Pension Benefits</b>				
Interest cost	\$ 306	\$ 305	\$ 918	\$ 915
Amortization of unrecognized net loss	67	54	201	162
Expected return on plan assets	(228)	(236)	(684)	(708)
FAS 88 curtailment loss				4,728
Total expense	\$ 145	\$ 123	\$ 435	\$ 5,097
<b>Other Postretirement Benefits</b>				
Service cost	\$ 33	\$ 17	\$ 98	\$ 51
Interest cost	60	63	181	189
Amortization of unrecognized prior service cost	10	10	30	30
Total expense	\$ 103	\$ 90	\$ 309	\$ 270

During the first nine months of 2005, the Company recorded a \$4.7 million curtailment loss related to the SERP for the former Chief Executive Officer.

**Note 7 Earnings Per Share**

The following table sets forth the computation of basic and diluted income per common share from continuing operations before cumulative effect of change in accounting principle:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Income from continuing operations before cumulative effect of change in accounting principle	\$ 86,765	\$ 3,228	\$ 158,439	\$ 25,482
Weighted average shares outstanding	29,336	28,591	29,322	28,530
Dilutive effect of stock options and restricted stock	299	24	164	63
Weighted average shares outstanding assuming dilution	29,635	28,615	29,486	28,593
Income from continuing operations before cumulative effect of change in accounting principle per common share basic	\$ 2.96	\$ 0.11	\$ 5.40	\$ 0.89
Income from continuing operations before cumulative effect of change in accounting principle per common	\$ 2.93	\$ 0.11	\$ 5.37	\$ 0.89

share assuming dilution

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

	Three Months Ended		Nine Months Ended	
	September 30, 2006	2005	September 30, 2006	2005
Net income	\$ 88,008	\$ 3,367	\$ 159,296	\$ 27,246
Weighted average shares outstanding	29,336	28,591	29,322	28,530
Dilutive effect of stock options and restricted stock	299	24	164	63
Weighted average shares outstanding assuming dilution	29,635	28,615	29,486	28,593
Net income per common share basic	\$ 3.00	\$ 0.12	\$ 5.43	\$ 0.95
Net income per common share assuming dilution	\$ 2.97	\$ 0.12	\$ 5.40	\$ 0.95

**Note 8 Comprehensive Income**

Comprehensive income, net of related tax effects, for the three months ended September 30, 2006 and 2005 was \$91.9 million and \$0.5 million, respectively. Comprehensive income, net of related tax effects, for the nine months ended September 30, 2006 and 2005 was \$165.4 million and \$18.8 million, respectively.

**Note 9 Commitments and Contingencies**

James P. Mooney ceased to be employed as the Company's Chief Executive Officer in January 2005. The Company is currently engaged in pending litigation with Mr. Mooney in federal court in Florida. The Company brought suit against Mr. Mooney seeking disgorgement of certain bonuses and profits he received during his tenure as Chief Executive Officer and has filed a declaratory judgment asking the court to determine if Mr. Mooney's termination should be considered "with cause" such that he would not be entitled to any severance benefits. Mr. Mooney has asserted a counterclaim against the Company seeking damages based on additional bonuses he alleges he is owed and other additional payments he claims he is entitled to under his employment agreement and for the release of shares of stock which the Company has held pending the resolution of its claims.

In addition, Mr. Mooney filed suit against the Company in Delaware state court seeking advancement and reimbursement of his attorney's fees in connection with the pending Florida litigation and other related matters. In the first quarter of 2006, this matter was settled, and the Company is now paying Mr. Mooney's attorney's fees on an ongoing basis.

The SEC's Division of Enforcement is conducting an informal investigation resulting from the self reporting by the Company of the internal investigation conducted in 2004 by the audit committee of the Company's board of directors in connection with the previously filed restatement of the Company's financial results for periods prior to December 31, 2003. The Company is cooperating fully with the SEC informal investigation.

During 2005, the Company reversed a \$5.5 million tax contingency accrual that was originally established in July 2003 upon the sale of the Company's Precious Metals Group (PMG) as the liability is no longer probable. Such amount had previously been included in Retained Liabilities of Businesses Sold in the Consolidated Balance Sheets. The contingency relates to a tax matter in Brazil for which the Company has indemnified the PMG buyer under terms of the PMG sale agreement. Although the contingency is no longer probable, the likelihood of an unfavorable outcome of this contingency is reasonably possible based on the length of time expected before the matter is closed and the inherent risk of changes in the political or legal situation in Brazil.

The Company is a party to various other legal proceedings incidental to its business and is subject to a variety of environmental and pollution control laws and regulations in the jurisdictions in which it operates. As is the case with other companies in similar industries, the Company faces exposure from actual or potential claims and legal

proceedings involving environmental matters. A number of factors affect the cost of environmental remediation, including the determination of the extent of contamination, the length of time the remediation may require, the complexity of environmental regulations, and the continuing improvements in remediation

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techniques. Taking these factors into consideration, the Company has estimated the undiscounted costs of remediation, which will be incurred over several years. The Company accrues an amount consistent with the estimates of these costs when it is probable that a liability has been incurred. At September 30, 2006 and December 31, 2005 the Company has recorded environmental liabilities of \$4.6 million and \$8.8 million, respectively, primarily related to remediation and decommissioning at the Company's closed manufacturing sites in Newark, New Jersey; St. George, Utah and Vasset, France. The Company has recorded \$4.0 million in other current liabilities and \$0.6 million in Other non-current liabilities as of September 30, 2006.

Although it is difficult to quantify the potential impact of compliance with or liability under environmental protection laws, the Company believes that any amount it may be required to pay in connection with environmental matters, as well as other legal proceedings arising out of operations in the normal course of business, is not reasonably likely to exceed amounts accrued by an amount that would have a material adverse effect upon its financial condition, results of operations or cash flows.

**Note 10 Debt**

Debt consists of the following

	September 30, 2006	December 31, 2005
Senior Subordinated Notes	\$ 400,000	\$ 400,000
Note payable banks	1,684	17,250
Deferred gain on termination of fair value hedges	5,394	5,984
Deferred loss on termination of fair value hedges	(2,794)	
Fair value of interest rate swaps (fair value hedges)		(1,388)
	404,284	421,846
Less: Current portion of long-term debt		5,750
Total long-term debt	\$ 404,284	\$ 416,096

During the third quarter of 2006, the Company completed the termination of, and settled for cash, two interest rate swap agreements expiring in 2011. These swap agreements converted \$100 million of the fixed 9.25% Senior Subordinated Notes (the "Notes") to a floating rate. The combined pretax loss on the termination of the swaps of \$2.9 million was deferred and is being amortized to interest expense through the date on which the swaps were originally scheduled to mature.

In November 2004, the Company entered into a note payable with a Finnish bank with principal a balance of \$23.0 million which was payable in 48 equal installments beginning in January 2005 and ending December 2008. The balance of this loan was \$17.3 million at December 31, 2005. The Company repaid the balance outstanding of \$14.4 million in May 2006.

**Note 11 Metals Financial Instruments**

The Company enters into forward contracts to hedge the sale and purchase price of nickel and the sale price of copper transactions. These contracts are designated as cash flow hedges. Therefore, realized gains and losses on these forward contracts are included as a component of net sales or cost of products sold, and are recognized when the related product is sold. Unrealized gains and losses are recorded in Accumulated Other Comprehensive Income. In the first nine months of 2006 and 2005, there was no impact on earnings resulting from hedge ineffectiveness. At September 30, 2006 and December 31, 2005, the notional value of the open contracts approximated \$19.5 million and \$40.7 million, respectively. The fair value of open contracts, based on settlement prices at September 30, 2006 and 2005, generated unrealized gains of approximately \$11.3 million and unrealized losses of \$1.1 million, respectively, which is included in Accumulated other comprehensive income. The related receivables are recorded in Other current assets in the unaudited condensed consolidated balance sheets. All open contracts at September 30, 2006 mature no later than December 2007. In addition, the Company enters into hedging positions on a daily basis to protect its net

sale/purchase nickel position. The underlying contracts for these financial instruments do not qualify as cash flow hedges under SFAS No. No. 133, and therefore they are marked-to-market with the related gains or losses recognized immediately in the unaudited condensed statements of consolidated income as a component of cost of products sold. The amounts recorded in the unaudited condensed statements of consolidated income for metals financial instruments are gains of \$10.9 million and \$26.5 million in the three and nine months ended September 30, 2006, respectively. The amounts recorded in the unaudited condensed statements of consolidated income for metals financial instruments are losses of \$2.1 million and \$0.2 million in the three and nine months ended September 30, 2005.

**Table of Contents****Note 12 Special Charges and DRC Smelter Shut-down**

In years prior to 2005, the Company refinanced the capital contribution for the 25% minority shareholder in its joint venture in the Democratic Republic of Congo ( DRC ). At December 31, 2005 the receivables from this partner were \$25.2 million, net of a \$4.2 million valuation allowance. During the first nine months of 2006, the Company recorded an additional \$1.0 million valuation allowance. At September 30, 2006, the receivables from this partner were \$24.2 million, net of a \$5.2 million valuation allowance. The receivables are due in full on December 31, 2008 (\$22.9 million) and December 31, 2010 (\$6.5 million).

On January 11, 2005, James P. Mooney's employment with the Company was terminated and he ceased to be its Chief Executive Officer. On that date, the Company recorded a charge of \$8.7 million related to his termination in accordance with Mr. Mooney's employment agreement and a SERP. Such amount includes termination benefits based on salary, estimated bonus (as calculated per the provisions in the agreement) and certain benefits to be paid over the remaining term of the agreement, as well as the actuarially-determined present value of amounts to be paid under a SERP (See Note 9). The Company is examining its alternatives for recovery against Mr. Mooney and is seeking disgorgement under the Sarbanes-Oxley Act of 2002 of certain bonuses and profits he received during his tenure as Chief Executive Officer. Any such claims would be recognized when settled.

During the first half of 2005, the Company's joint venture in the DRC shut-down its smelter for approximately four months for regularly scheduled maintenance and production improvements. The impact of the shut-down reduced the Company's operating profit by approximately \$9.4 million for the nine months ended September 30, 2005. Income from continuing operations, representing the Company's 55% share in the joint venture, was reduced by approximately \$5.2 million for the nine months ended September 30, 2005. The smelter resumed operations in May 2005.

**Note 13 Reportable Segments**

SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, establishes standards for reporting information about operating segments in financial statements. Operating segments are defined as components of an enterprise that are evaluated regularly by the Company's chief operating decision maker in deciding how to allocate resources and in assessing performance. The Company's chief operating decision maker is the chief executive officer.

The Company has two reportable operating segments—Specialties and Nickel. The Company realigned management responsibilities effective for the first quarter of 2006. As a result, the former Cobalt segment was renamed the Specialties segment and the Electronic Chemicals business unit, formerly a component within the Nickel reportable segment, was realigned to the Specialties reportable segment. Because the Company changed the structure of its internal organization in a manner that caused the composition of its reportable segments to change, the corresponding information for prior periods has been reclassified to conform to the current year reportable segment presentation. The Specialties segment includes three business units: Advanced Organics, which produces products for the tire, coatings and inks, additive and chemicals markets; Inorganics, which produces products for the powder metallurgy, battery, ceramic and chemical markets; and Electronic Chemicals, which produces products for the semiconductor finishing, memory disk, general metal finishing and printed circuit board finishing markets. The Nickel segment includes nickel-based products. The Company's products are essential components in numerous complex chemical and industrial processes, and are used in many end markets, such as rechargeable batteries, coatings, custom catalysts, liquid detergents, lubricants and fuel additives, plastic stabilizers, polyester promoters, adhesion promoters for rubber tires, colorants, petroleum additives, magnetic media, metal finishing agents, cemented carbides for mining and machine tools, diamond tools used in construction, stainless steel, alloy and plating applications. The Company's products are sold in various forms such as solutions, crystals, powders, cathodes and briquettes. Intersegment sales are accounted for at the same prices as if the sales were made to third parties. The Company's Corporate segment is comprised of general and administrative expenses and share-based compensation not allocated to the segments. While its primary manufacturing sites are in Finland, the Company also has manufacturing and other facilities in Australia, Canada, the United States, Europe and Asia-Pacific, and the Company markets its products worldwide. Further, approximately 24% of the Company's investment in property, plant and equipment is located in the DRC, where the Company operates a smelter through a 55% owned joint venture.





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The following table reflects the results of the segments:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
<b>Business Segment Information</b>				
Net Sales				
Specialties	\$ 171,621	\$ 145,961	\$ 491,130	\$ 466,832
Nickel	229,334	177,947	570,548	554,738
Intercompany sales between segments:				
Specialties	(1,201)	(347)	(3,107)	(831)
Nickel	(23,982)	(16,975)	(58,026)	(47,512)
	\$ 375,772	\$ 306,586	\$ 1,000,545	\$ 973,227
Income (loss) from operations				
Specialties	\$ 38,579	\$ 10,799	\$ 90,925	\$ 32,291
Nickel	88,589	8,132	142,297	44,608
Corporate (a)	(9,542)	(7,349)	(27,910)	(24,632)
	\$ 117,626	\$ 11,582	\$ 205,312	\$ 52,267
Interest expense	\$ (9,774)	\$ (10,159)	\$ (29,506)	\$ (30,411)
Foreign exchange gain (loss)	997	545	2,574	(2,267)
Gain on sale of investments in equity securities			12,223	2,359
Other income, net	3,599	1,246	7,643	4,740
	\$ (5,178)	\$ (8,368)	\$ (7,066)	\$ (25,579)
Income from continuing operations before income taxes, minority interest and cumulative effect of change in accounting principle	\$ 112,448	\$ 3,214	\$ 198,246	\$ 26,688
Expenditures for property, plant & equipment				
Specialties	\$ 3,588	\$ 4,382	\$ 8,876	\$ 9,152
Nickel	6,157	5,372	12,567	9,337
	\$ 9,745	\$ 9,754	\$ 21,443	\$ 18,489
Depreciation and amortization				
Specialties	\$ 7,770	\$ 7,533	\$ 23,133	\$ 23,089

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Nickel	<b>4,409</b>	4,423	<b>12,788</b>	12,472
Corporate	<b>331</b>	441	<b>1,016</b>	1,475
	<b>\$ 12,510</b>	\$ 12,397	<b>\$ 36,937</b>	\$ 37,036

	<b>September 30, 2006</b>	December 31, 2005
Total assets		
Specialties	<b>\$ 770,453</b>	\$ 739,332
Nickel	<b>629,455</b>	440,564
Corporate	<b>77,709</b>	40,377
	<b>\$ 1,477,617</b>	\$ 1,220,273

(a) In the nine months ended September 30, 2005, Corporate expenses include an \$8.7 million charge related to the departure of the Company's former CEO. In the nine months ended September 30, 2005, corporate expenses are reduced by \$8.5 million of insurance proceeds related to the shareholder class action litigation and \$1.9 million of income related to the mark-to-market adjustment for 380,000 shares of common stock issued in the fourth quarter of 2005.



**Table of Contents****Note 14 Guarantor and Non-Guarantor Subsidiary Information**

In December 2001, the Company issued \$400 million in aggregate principal amount of 9.25% Senior Subordinated Notes due 2011. These notes are guaranteed by the Company's wholly-owned domestic subsidiaries. The guarantees are full, unconditional and joint and several. The Company's foreign subsidiaries are not guarantors of these Notes. Corporate as presented below represents OM Group, Inc. exclusive of its guarantor subsidiaries and its non-guarantor subsidiaries. Condensed consolidating financial information for Corporate, the guarantor subsidiaries, and the non-guarantor subsidiaries is as follows:

	September 30, 2006				
	Corporate	Combined Guarantor Subsidiaries	Combined Non-guarantor Subsidiaries	Eliminations	Total
<b>Balance Sheet Data</b>					
Current assets:					
Cash and cash equivalents	\$ 51,492	\$ (2,739)	\$ 176,038	\$	\$ 224,791
Accounts receivable, less allowances	525,154	109,924	318,008	(768,291)	184,795
Inventories		45,055	303,948		349,003
Other current assets	1,981	4,441	91,924		98,346
Total current assets	578,627	156,681	889,918	(768,291)	856,935
Property, plant and equipment, net					
		37,057	324,469		361,526
Goodwill	75,830	68,908	38,304		183,042
Intercompany receivables	386,206		863,311	(1,249,517)	
Investment in subsidiaries	98,580		2,160,526	(2,259,106)	
Note receivable from joint venture partner, less allowances			24,179		24,179
Other non-current assets	5,550	13,852	32,533		51,935
Total assets	\$ 1,144,793	\$ 276,498	\$ 4,333,240	\$ (4,276,914)	\$ 1,477,617
Current liabilities:					
Accounts payable	\$ 4,000	\$ 445,372	\$ 369,392	\$ (651,487)	\$ 167,277
Other current liabilities	18,056	16,654	60,876		95,586
Total current liabilities	22,056	462,026	430,268	(651,487)	262,863
Long-term debt					
	402,599		1,685		404,284
Deferred income taxes			24,028		24,028
Other non-current liabilities and minority interest	14,696	15,048	51,478		81,222
Intercompany payables	222	181,285	1,184,595	(1,366,102)	
Stockholders' equity	705,220	(381,861)	2,641,186	(2,259,325)	705,220

Total liabilities and stockholders equity	\$ 1,144,793	\$ 276,498	\$ 4,333,240	\$ (4,276,914)	\$ 1,477,617
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	<b>December 31, 2005</b>				
	<b>Corporate</b>	<b>Combined Guarantor Subsidiaries</b>	<b>Combined Non-guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Total</b>
<b>Balance Sheet Data</b>					
Current assets:					
Cash and cash equivalents	\$ 14,286	\$ 729	\$ 99,603	\$	\$ 114,618
Accounts receivable, less allowances	521,724	104,655	330,721	(828,822)	128,278
Inventories		46,953	257,604		304,557
Other current assets	2,813	6,925	47,917		57,655
Total current assets	538,823	159,262	735,845	(828,822)	605,108
Property, plant and equipment, net					
Goodwill	75,830	35,212	333,917		369,129
Intercompany receivables	255,830	68,908	34,385		179,123
Investment in subsidiaries	92,347		1,013,751	(1,269,581)	
Note receivable from joint venture partner, less allowances			2,160,527	(2,252,874)	
Other non-current assets	6,541	11,571	25,179		25,179
			23,622		41,734
Total assets	\$ 969,371	\$ 274,953	\$ 4,327,226	\$ (4,351,277)	\$ 1,220,273
Current liabilities:					
Current portion of long-term debt	\$	\$	\$ 5,750	\$	\$ 5,750
Accounts payable	4,000	90,040	392,289	(382,932)	103,397
Other current liabilities	8,658	19,522	30,712		58,892
Total current liabilities	12,658	109,562	428,751	(382,932)	168,039
Long-term debt	404,596		11,500		416,096
Deferred income taxes			21,461		21,461
Other non-current liabilities and minority interest	15,584	15,195	47,365		78,144
Intercompany payables		530,435	1,185,238	(1,715,673)	
Stockholders equity	536,533	(380,239)	2,632,911	(2,252,672)	536,533
Total liabilities and stockholders equity	\$ 969,371	\$ 274,953	\$ 4,327,226	\$ (4,351,277)	\$ 1,220,273



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	<b>Three Months Ended September 30, 2006</b>				
	<b>Corporate</b>	<b>Combined Guarantor Subsidiaries</b>	<b>Combined Non-guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Total</b>
<b>Income Statement Data</b>					
Net sales	\$	\$ 55,773	\$ 482,714	\$ (162,715)	\$ 375,772
Cost of products sold		41,968	351,202	(162,715)	230,455
Gross profit		13,805	131,512		145,317
Selling, general and administrative expenses		13,210	14,481		27,691
Income from operations		595	117,031		117,626
Interest expense	(9,610)	(3,115)	(14,517)	17,468	(9,774)
Foreign exchange gain			997		997
Other income, net	3,711	596	16,760	(17,468)	3,599
Income (loss) from continuing operations before income taxes and minority interest	(5,899)	(1,924)	120,271		112,448
Income tax expense			(22,845)		(22,845)
Minority interest share of (income) loss			(2,838)		(2,838)
Income (loss) from continuing operations	(5,899)	(1,924)	94,588		86,765
Income from discontinued operations, net of tax	941	302			1,243
Net income (loss)	\$ (4,958)	\$ (1,622)	\$ 94,588	\$	\$ 88,008

	<b>Three Months Ended September 30, 2005</b>				
	<b>Corporate</b>	<b>Combined Guarantor Subsidiaries</b>	<b>Combined Non-guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Total</b>
<b>Income Statement Data</b>					
Net sales	\$	\$ 51,577	\$ 345,305	\$ (90,296)	\$ 306,586
Cost of products sold		42,461	322,277	(90,296)	274,442
Gross profit		9,116	23,028		32,144
Selling, general and administrative expenses		9,116	11,446		20,562
Income from operations			11,582		11,582
Interest expense	(9,800)	(2,297)	(12,420)	14,358	(10,159)



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Foreign exchange gain		4	541		545
Other income, net	186	327	15,091	(14,358)	1,246
Income (loss) from continuing operations before income taxes and minority interest	(9,614)	(1,966)	14,794		3,214
Income tax expense			(1,190)		(1,190)
Minority interest share of (income) loss			1,204		1,204
Income (loss) from continuing operations	(9,614)	(1,966)	14,808		3,228
Income from discontinued operations, net of tax of tax	139				139
Net income (loss)	\$ (9,475)	\$ (1,966)	\$ 14,808	\$	\$ 3,367

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	<b>Nine Months Ended September 30, 2006</b>				
	<b>Corporate</b>	<b>Combined Guarantor Subsidiaries</b>	<b>Combined Non-guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Total</b>
<b>Income Statement Data</b>					
Net sales	\$	\$ 164,068	\$ 1,217,882	\$ (381,405)	\$ 1,000,545
Cost of products sold		123,229	968,277	(381,405)	710,101
Gross profit		40,839	249,605		290,444
Selling, general and administrative expenses		42,946	42,186		85,132
Income (loss) from operations		(2,107)	207,419		205,312
Interest expense	(28,642)	(9,231)	(42,442)	50,809	(29,506)
Foreign exchange gain (loss)	107	(13)	2,480		2,574
Gain on sale of investment in equity securities			12,223		12,223
Other income, net	10,820	1,619	46,013	(50,809)	7,643
Income (loss) from continuing operations before income taxes, minority interest and cumulative effect of change in accounting principle	(17,715)	(9,732)	225,693		198,246
Income tax expense			(36,333)		(36,333)
Minority interest share of (income) loss			(3,474)		(3,474)
Income (loss) from continuing operations before cumulative effect of change in accounting principle	(17,715)	(9,732)	185,886		158,439
Income (loss) from discontinued operations, net of tax	(445)	1,015			570
Income (loss) before cumulative effect of change in accounting principle	(18,160)	(8,717)	185,886		159,009
Cumulative effect of change in accounting principle	287				287
Net income (loss)	\$ (17,873)	\$ (8,717)	\$ 185,886	\$	\$ 159,296

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	<b>Nine Months Ended September 30, 2005</b>				
	<b>Corporate</b>	<b>Combined Guarantor Subsidiaries</b>	<b>Combined Non-guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Total</b>
<b>Income Statement Data</b>					
Net sales	\$	\$ 165,518	\$ 1,120,668	\$ (312,959)	\$ 973,227
Cost of products sold		137,341	1,020,277	(312,959)	844,659
Gross profit		28,177	100,391		128,568
Selling, general and administrative expenses		36,921	39,380		76,301
Income (loss) from operations		(8,744)	61,011		52,267
Interest expense	(29,205)	(6,541)	(38,659)	43,994	(30,411)
Foreign exchange loss		(27)	(2,240)		(2,267)
Gain on sale of investment in equity securities			2,359		2,359
Other income, net	4,984	850	42,900	(43,994)	4,740
Income (loss) from continuing operations before income taxes and minority interest	(24,221)	(14,462)	65,371		26,688
Income tax expense			(6,981)		(6,981)
Minority interest share of (income) loss			5,775		5,775
Income (loss) from continuing operations	(24,221)	(14,462)	64,165		25,482
Income from discontinued operations, net of tax	1,764				1,764
Net income (loss)	\$ (22,457)	\$ (14,462)	\$ 64,165	\$	\$ 27,246

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	<b>Nine Months Ended September 30, 2006</b>				<b>Total</b>
	<b>Corporate</b>	<b>Combined Guarantor Subsidiaries</b>	<b>Combined Non-guarantor Subsidiaries</b>	<b>Eliminations</b>	
<b>Cash Flow Data</b>					
Net cash provided by (used for) operating activities operating activities	\$ 38,049	\$ (737)	\$ 109,474	\$	\$ 146,786
Investing activities:					
Expenditures for property plant and equipment		(2,731)	(18,712)		(21,443)
Proceeds from sale of investment in equity securities			12,223		12,223
Loans to non-consolidated joint venture			(7,170)		(7,170)
Acquisition of business, net of cash acquired			(5,417)		(5,417)
Net cash used for investing activities		(2,731)	(19,076)		(21,807)
Financing activities:					
Payments of long-term debt			(17,250)		(17,250)
Proceeds from exercise of stock options	897				897
Net cash used for financing activities	897		(17,250)		(16,353)
Effect of exchange rate changes on cash			3,287		3,287
Cash and cash equivalents:					
Increase (decrease) from continuing operations	38,946	(3,468)	76,435		111,913
Discontinued operations net cash used for operating activities	(1,740)				(1,740)
Balance at the beginning of the period	14,286	729	99,603		114,618
Balance at the end of the period	\$ 51,492	\$ (2,739)	\$ 176,038	\$	\$ 224,791

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	<b>Nine Months Ended September 30, 2005 (Revised - See Note 1)</b>				
	<b>Corporate</b>	<b>Combined Guarantor Subsidiaries</b>	<b>Combined Non-guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Total</b>
<b>Cash Flow Data</b>					
Net cash provided by operating activities	\$ 11,573	\$ 1,528	\$ 42,211	\$	\$ 55,312
Investing activities:					
Expenditures for property plant and equipment		(1,939)	(16,550)		(18,489)
Proceeds from MPI note receivable			3,035		3,035
Proceeds from Weda Bay note receivable	2,500				2,500
Proceeds from sale of investments in equity securities			4,534		4,534
Net cash provided by (used for) investing activities	2,500	(1,939)	(8,981)		(8,420)
Financing activities:					
Payments of long-term debt			(4,313)		(4,313)
Payments of revolving line of credit	(49,872)				(49,872)
Proceeds from revolving line of credit	49,872				49,872
Proceeds from exercise of stock options	117				117
Net cash provided by (used for) financing activities	117		(4,313)		(4,196)
Effect of exchange rate changes on cash			(4,432)		(4,432)
Cash and cash equivalents:					
Increase (decrease) from continuing operations	14,190	(411)	24,485		38,264
Discontinued operations net cash used for operating activities	(5,175)				(5,175)
Balance at the beginning of the period	8,533	1,197	17,049		26,779
Balance at the end of the period	\$ 17,548	\$ 786	\$ 41,534	\$	\$ 59,868

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations***Overview*

The Company is a leading, vertically integrated international producer and marketer of value-added, metal-based specialty chemicals and related materials, primarily from cobalt and nickel. The Company applies proprietary technology to unrefined cobalt, nickel and other raw materials to market more than 825 different product offerings to approximately 2,100 customers in over 30 industries. The Company operates in two business segments—Specialties and Nickel.

The Company's business is critically connected to both the price and availability of raw materials. The primary raw materials used by the Company are unrefined cobalt and nickel. Cobalt raw materials include ore, concentrates, slag and scrap. Nickel raw materials include concentrates, ore, intermediates, secondaries, scrap and matte. The cost of the Company's raw materials fluctuates due to actual or perceived changes in supply and demand, changes in cobalt and nickel reference/market prices and changes in availability from suppliers. The Company attempts to mitigate changes in availability by maintaining adequate inventory levels and long-term supply relationships with a variety of producers. Fluctuations in the prices of cobalt and nickel have been significant in the past and the Company believes that cobalt and nickel price fluctuations are likely to continue in the future. The Company attempts to pass through to its customers increases in raw material prices by increasing the prices of its products. The Company's profitability is largely dependent on the Company's ability to maintain the differential between its product prices and product costs. Certain sales contracts and raw material purchase contracts contain variable pricing that adjusts based on changes in the price of cobalt and nickel. During periods of rapidly changing metal prices, however, there may be price lags that can impact the short-term profitability and cash flow from operations of the Company both positively and negatively. Reductions in the price of raw materials or declines in the selling prices of the Company's finished goods could also result in the Company's inventory carrying value being written down to a lower market value.

The Company has manufacturing and other facilities in North America, Africa, Europe and Asia-Pacific, and markets its products worldwide. Although most of the Company's raw material purchases and product sales are based on the U.S. dollar, prices of certain raw materials, non-U.S. operating expenses and income taxes are denominated in local currencies. As such, results of operations are subject to the variability that arises from exchange rate movements (particularly the Euro and the Australian dollar). In addition, fluctuations in exchange rates may affect product demand and profitability in U.S. dollars of products provided by the Company in foreign markets in cases where payments for its products and the majority of operating and selling, general and administrative expenses are made in local currency. Accordingly, fluctuations in currency prices affect the Company's operating results.

**Critical Accounting Policies and Estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires the Company's management to make estimates and assumptions in certain circumstances that affect amounts reported in the accompanying unaudited condensed consolidated financial statements. In preparing these financial statements, management has made its best estimates and judgments of certain amounts included in the unaudited condensed consolidated financial statements, giving due consideration to materiality. The application of these accounting policies involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, actual results could differ from these estimates. In addition, other companies may utilize different estimates, which may impact the comparability of the Company's results of operations to similar businesses. There have been no changes to our critical accounting policies as stated in our Annual Report on Form 10-K for the year ended December 31, 2005 other than the adoption of SFAS No. 123R, as discussed in Note 2 to the Condensed Consolidated Financial Statements in this Form 10-Q.

**Results of Operations**

Consolidated results of operations are set forth below and are followed by a more detailed discussion of each business segment, as well as a detailed discussion of corporate expenses.

**Table of Contents****Third Quarter of 2006 Compared With Third Quarter of 2005  
Consolidated Results of Operations**

<i>(thousands of dollars &amp; percent of net sales)</i>	<b>Three Months Ended September 30,</b>			
	<b>2006</b>		<b>2005</b>	
Net sales	<b>\$ 375,772</b>		\$ 306,586	
Cost of products sold	<b>230,455</b>		274,442	
Gross profit	<b>145,317</b>	<b>38.7%</b>	32,144	10.5%
Selling, general and administrative expenses	<b>27,691</b>	<b>7.4%</b>	20,562	6.7%
Income from operations	<b>117,626</b>	<b>31.3%</b>	11,582	3.8%
Other expense, net (including interest expense)	<b>(5,178)</b>		(8,368)	
Income tax expense	<b>(22,845)</b>		(1,190)	
Minority interest share of (income) loss	<b>(2,838)</b>		1,204	
Income from continuing operations	<b>86,765</b>		3,228	
Income from discontinued operations, net of tax	<b>1,243</b>		139	
Net income	<b>\$ 88,008</b>		\$ 3,367	

Net sales increased \$69.2 million, or 22.6%, to \$375.8 million for the quarter ended September 30, 2006 compared with \$306.6 million for the quarter ended September 30, 2005. In the Nickel segment, higher average nickel product sales price, caused by the higher nickel metal market price, and revenue related to increased toll refining activity were partially offset by lower nickel sales volumes in the third quarter of 2006 compared with the third quarter of 2005. The Company has entered into two nickel toll refining agreements: one that began in September of 2005 and one that began in July of 2006. In the Specialties segment, an increase in the price of copper resulted in higher by-product sales. Specialties net sales were also impacted by increased sales volumes and favorable selling prices in the inorganics and electronic chemicals business units.

Gross profit increased \$113.2 million to \$145.3 million in the third quarter of 2006, compared with \$32.1 million in the third quarter of 2005 primarily due to higher average nickel metal market prices and the favorable impact related to nickel hedging transactions partially offset by decreased nickel sales volumes. In addition, higher copper and cobalt metal prices and increased sales volumes in the Specialties segment contributed to the increase in gross margin in the third quarter of 2006 compared with the third quarter of 2005. In addition, the third quarter of 2005 included a \$3.8 million lower of cost or market charge due to a decline in the nickel market price during 2005.

Selling, general and administrative expenses increased to \$27.7 million in the third quarter of 2006 compared with \$20.6 million in the third quarter of 2005. The increase was primarily due to income in the third quarter of 2005 of \$2.5 million related to the collection of a note receivable that had been fully reserved in 2002 and \$1.8 million related to the mark-to-market adjustment for 380,000 shares of common stock that were issued in the fourth quarter of 2005 in connection with the shareholder derivative litigation. In addition, employee incentive compensation expense was higher in the third quarter of 2006 compared with the third quarter of 2005. The increase in employee incentive compensation is primarily due to higher anticipated payouts under compensation programs that are tied to Company performance and increased share-based compensation expense.

Other expense, net decreased to \$5.2 million in the third quarter of 2006 compared with \$8.4 million in the third quarter of 2005 primarily due to a \$2.0 million increase in interest income in the third quarter of 2006 compared with the third quarter of 2005 due to the higher average cash balance. Equity income from the Company's investment in MPI Nickel was \$1.8 million in the third quarter of 2006 compared with \$1.0 million in the third quarter of 2005, which also contributed to the decrease in Other expense, net.

Minority interest share of (income) loss relates to the Company's smelter joint venture in the DRC. The losses in 2005 were attributable to the scheduled extended maintenance shutdown of the smelter which resulted in decreased production and delayed shipments in the third quarter of 2005. The income in the third quarter of 2006 was the result of increased production and higher metal prices.



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The income from discontinued operations results from the reversal of \$0.9 million due to a reduction in the estimate of tax liabilities related to the former Precious Metals business and a \$0.3 million gain on the sale of assets.

**Segment Results and Corporate Expenses****Specialties**

The following table summarizes the average quarterly reference price of 99.3% cobalt:

	<b>2006</b>	2005	Change
Third quarter	<b>\$15.59</b>	\$13.41	\$2.18

Specialties net sales increased to \$171.6 million in the third quarter of 2006 from \$146.0 million in the third quarter of 2005, primarily due to an increase in the price of copper resulting in higher by-product sales (\$15.4 million), improved sales volumes (\$3.8 million) in the inorganics and electronic chemicals business units and increased Specialties product selling prices (\$4.1 million). The increase in product selling prices was primarily caused by the increase in the nickel metal market price and the resulting impact on the prices of nickel-based specialties products. Operating profit for the third quarter of 2006 was \$38.6 million compared with \$10.8 million in the third quarter of 2005. Operating profit was positively impacted by favorable raw material margins. The third quarter of 2005 cobalt raw material margins were negatively impacted by a decline in cobalt metal prices in 2005 compared with 2004. The average quarterly reference price of cobalt declined from \$20.78 in the second half 2004 to \$15.24 in the first nine months of 2005 compared with an increase from an average price of \$12.96 in the second half of 2005 to \$14.15 in the first nine months of 2006. As a result, cobalt raw material margins in the third quarter of 2006 were favorable compared with the third quarter of 2005 (\$13.5 million). Operating profit was also impacted by favorable copper by-product sales (\$9.0 million), higher volumes (\$3.8 million) and increased margins due to higher cobalt and nickel prices in the third quarter of 2006 (\$3.5 million) compared with the third quarter of 2005.

**Nickel segment**

The following table summarizes the average quarterly London Metal Exchange ( LME ) market price of nickel:

	<b>2006</b>	2005	Change
Third Quarter	<b>\$13.22</b>	\$6.61	\$6.61

Nickel segment net sales increased to \$229.3 million in the third quarter of 2006 compared with \$177.9 million in the third quarter of 2005 primarily due to a higher average nickel sales price (\$88.1 million) and increased revenue from toll refining activities (\$13.2 million) partially offset by a 34 percent decrease in nickel sales volumes (\$54.9 million). Operating profit for the third quarter of 2006 was \$88.6 million compared with \$8.1 million in the third quarter of 2005. The \$80.5 million increase was primarily due to a higher average nickel price (\$39.5 million) and the impact of favorable raw material pricing (\$31.9 million). During the third quarter of 2006, realized and unrealized gains related to nickel hedging transactions increased to a gain of \$12.9 million compared with a loss of \$2.1 million in the third quarter of 2005. In addition, the third quarter of 2005 included a \$3.8 million lower-of-cost or market charge due to decreasing nickel prices. Increased manufacturing costs and the negative impact of lower non-tolling related volumes primarily due to the lack of purchased raw material feed were partially offset by the volume related to the toll refining agreements that began in September 2005 and July 2006 (\$2.2 million).

**Table of Contents****Corporate expenses**

Corporate and other expenses consist of unallocated corporate overhead supporting both segments, including legal, finance, human resources, information technology, strategic development and corporate governance activities, as well as share-based compensation. Corporate expenses for the third quarter of 2006 were \$9.5 million compared with \$7.3 million in the third quarter of 2005. The increase was primarily due to \$1.8 million of income in the third quarter of 2005 related to the mark-to-market adjustment for 380,000 shares of common stock that were issued in the fourth quarter of 2005 in connection with the shareholder derivative litigation and increased employee incentive compensation expense in the third quarter of 2006 (\$1.6 million) related to higher anticipated payouts under compensation programs.

**First Nine Months of 2006 Compared With First Nine Months of 2005****Consolidated Results of Operations**

<i>(thousands of dollars &amp; percent of net sales)</i>	<b>Nine Months Ended September 30,</b>			
	<b>2006</b>		<b>2005</b>	
Net sales	<b>\$ 1,000,545</b>		\$ 973,227	
Cost of products sold	<b>710,101</b>		844,659	
Gross profit	<b>290,444</b>	<b>29.0%</b>	128,568	13.2%
Selling, general and administrative expenses	<b>85,132</b>	<b>8.5%</b>	76,301	7.8%
Income from operations	<b>205,312</b>	<b>20.5%</b>	52,267	5.4%
Other expense, net (including interest expense)	<b>(7,066)</b>		(25,579)	
Income tax expense	<b>(36,333)</b>		(6,981)	
Minority interest share of (income) loss	<b>(3,474)</b>		5,775	
Income from continuing operations before cumulative effect of change in accounting principle	<b>158,439</b>		25,482	
Income from discontinued operations, net of tax	<b>570</b>		1,764	
Income before cumulative effect of change in accounting principle	<b>159,009</b>		27,246	
Cumulative effect of change in accounting principle	<b>287</b>			
Net income	<b>\$ 159,296</b>		\$ 27,246	

Net sales increased 2.8% to \$1.0 billion for the first nine months of 2006 compared with \$973.2 million for the first nine months of 2005. In the Nickel segment, the increase in net sales was primarily due to a higher average nickel product sales price and revenue related to increased toll refining activity partially offset by lower nickel sales volumes resulting from continued raw material feed shortages. Increased copper by-product sales and improved volume were partially offset by lower cobalt metal prices in the Specialties segment.

Gross profit increased to \$290.4 million in the first nine months of 2006, compared with \$128.6 million in the first nine months of 2005. Higher average nickel metal market prices and favorable nickel hedging transactions positively impacted gross profit in the first nine months of 2006. Favorable cobalt raw material margins and copper by-product sales were partially offset by the negative impact of lower cobalt metal prices in the first nine months of 2006 in the Specialties segment. In addition, the first nine months of 2005 included the \$9.4 million impact related to the scheduled maintenance shut-down of the smelter in the DRC and a \$6.1 million lower-of cost or market inventory charge due to decreasing nickel prices during the second and third quarter of 2005.

Selling, general and administrative expenses increased to \$85.1 million in the first nine months of 2006 compared with \$76.3 million in the first nine months of 2005 primarily due to increased administrative expenses as a result of

increased employee incentive compensation expense related to higher anticipated payouts under compensation programs and an additional \$1.0 million reserve provided in the second quarter of 2006 against the note receivable from our joint venture partner in the DRC. In addition, the first nine months of 2005 included income of \$2.5 million related to the collection of a note receivable that had been fully reserved in 2002 and \$1.9 million of income related to the mark-to-market adjustment for 380,000 shares of common stock that were issued in the fourth quarter of 2005 in connection with the shareholder derivative litigation.

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Other expense, net decreased \$18.5 million to \$7.1 million in the first nine months of 2006 compared with \$25.6 million in the first nine months of 2005. The decrease was primarily due to a \$12.2 million gain in 2006 related to the sale of the Company's investment in Weda Bay (See Note 4 to the unaudited condensed consolidated financial statements). Other expense, net in the first nine months of 2005 includes a \$2.4 million gain on the sale of an investment in equity securities. In addition, other expense, net was also impacted by foreign exchange gains of \$2.6 million in the first nine months of 2006 compared with a foreign exchange loss of \$2.3 million in the 2005 period and a \$4.5 million increase in interest income in the first nine months of 2006 compared with the first nine months of 2005 due to the higher average cash balance. Equity income from the Company's investment in MPI Nickel decreased \$1.5 million to \$2.4 million in the first nine months of 2006 compared with \$3.9 million in the first nine months of 2005.

Minority interest share of (income) losses relate to the Company's smelter joint venture in the DRC. The losses in 2005 were attributable to the scheduled extended maintenance shutdown of the smelter.

The income from discontinued operations results from the reversal of \$0.6 million due to a reduction in estimates of environmental accruals related to the Company's closed manufacturing facility in St. George, Utah, the reversal of \$0.6 million due to a reduction in the estimate of tax liabilities related to the former Precious Metals business and a \$0.3 million gain on the sale of assets. These factors were partially offset by an unfavorable foreign currency translation adjustment from translating Euro denominated liabilities to the U.S. dollar.

Net income in the first nine months of 2006 includes \$0.3 million of income related to cumulative effect of a change in accounting principle for the adoption of SFAS No. 123R. See further discussion of the adoption of SFAS No. 123R in Note 2 to the unaudited condensed consolidated financial statements in this Form 10-Q.

**Segment Results and Corporate Expenses****Specialties**

The following table summarizes the average reference price of 99.3% cobalt:

	<b>2006</b>	2005	Change
First nine months	<b>\$14.15</b>	\$15.24	\$(1.09)

Specialties net sales increased to \$491.1 million in the first nine months of 2006 from \$466.8 million in the first nine months of 2005. Increased copper by-product sales (\$32.3 million), increased sales volumes in the inorganics business unit (\$15.3 million), increased volume in the electronic chemicals business unit (\$12.1 million) and sales related to the March 2006 acquisition of Plaschem (\$6.4 million) contributed to the increase in net sales for the first nine months of 2006. The increase in copper by-product sales was primarily due to the increase in the average copper price in 2006 compared with 2005. These increases to net sales were partially offset by lower product selling prices caused primarily by the decrease in cobalt reference prices in 2006 compared with 2005 (\$40.0 million).

Operating profit for the first nine months of 2006 was \$90.9 million compared with \$32.3 million in the first nine months of 2005. The average quarterly reference price of cobalt declined from \$20.78 in the second half 2004 to \$15.24 in the first nine months of 2005 compared with an increase from an average price of \$12.96 in the second half of 2005 to \$14.15 in the first nine months of 2006. As a result, cobalt raw material margins in the first nine months of 2006 were favorable compared with the first nine months of 2005 (\$32.7 million). Operating profit was positively impacted by an increase in copper by-product sales (\$20.5 million) and the impact of increased volume (\$10.2 million). In addition, operating profit in the first nine months of 2005 included the \$9.4 million negative impact of the scheduled maintenance shutdown at the smelter in the DRC. These positive factors were partially offset by the negative impact of the lower price (\$13.5 million) primarily due to lower cobalt metal prices in the first nine months of 2006.

**Nickel segment**

The following table summarizes the average LME market price of nickel:

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	<b>2006</b>	2005	Change
First nine months	<b>\$9.69</b>	\$7.00	\$2.69

Nickel segment net sales increased to \$570.5 million in the first nine months of 2006 compared with \$554.7 million in the first nine months of 2005 primarily due to higher average nickel sales price (\$109.4 million) and increased revenue from toll refining activities (\$30.5 million) partially offset by a 25 percent decrease in nickel sales volumes as a result of lack of raw material feed (\$127.6 million).

Operating profit for the first nine months of 2006 was \$142.3 million compared with \$44.6 million in the first nine months of 2005. The \$97.7 million increase is primarily due to a higher average nickel price (\$50.9 million) and the impact of favorable raw material pricing (\$34.9 million). Favorable raw material pricing was primarily due to the rapid increase in nickel price and the impact of selling inventory purchased at lower prices. In addition, during the first nine months of 2006, realized and unrealized gains related to nickel hedging transactions increased to a gain of \$29.2 million compared with a loss of \$0.2 million in the first nine months of 2005. Increased manufacturing costs and the negative impact of lower non-tolling related volumes due to the lack of purchased raw material feed were partially offset by the volume related to the toll refining agreements that began in September 2005 and July 2006 (\$9.7 million). Operating profit for the first nine months of 2006 was also impacted by lower by-product credits (\$6.2 million) compared with the first nine months of 2005.

**Corporate expenses**

Corporate expenses for the first nine months of 2006 were \$27.9 million compared with \$24.6 million in the first nine months of 2005. The increase in the first nine months of 2006 is primarily due to increased employee incentive compensation expense (\$4.9 million) due to an increase in expected payouts for bonuses and an increase in share-based compensation partially offset by decreased legal expense (\$1.5 million) and decreased corporate aircraft expense (\$1.1 million). Corporate expenses in the first nine months of 2005 included an \$8.7 million charge related to the former Chief Executive Officer's termination which was almost entirely offset by \$8.5 million of income related to the receipt of net insurance proceeds related to the shareholder class action litigation.

**Liquidity and Capital Resources**

The Company's cash flows from operating, investing and financing activities, as reflected in the unaudited condensed statements of consolidated cash flows, are summarized in the following table (in thousands):

	<b>Nine months ended</b>		
	<b>September 30,</b>		
	<b>2006</b>	2005	Change
<b>Cash Flow Summary</b>			
Net cash provided by (used for):			
Operating activities	<b>\$ 146,786</b>	\$ 55,312	\$ 91,474
Investing activities	<b>(21,807)</b>	(8,420)	(13,387)
Financing activities	<b>(16,353)</b>	(4,196)	(12,157)
Effect of exchange rate changes on cash	<b>3,287</b>	(4,432)	7,719
Discontinued operations-net cash used for operating activities	<b>(1,740)</b>	(5,175)	3,435
Net change in cash and cash equivalents	<b>\$ 110,173</b>	\$ 33,089	\$ 77,084

The \$91.5 million increase in cash provided by operating activities was primarily due to the \$132.1 million increase in net income in the first nine months of 2006 compared with the first nine months of 2005. In addition, the first nine months of 2005 include a cash outflow of \$74.0 million for the settlement of the shareholder class action litigation, which was offset by the positive cash flow impact of a \$107.2 million decrease in inventory at September 30, 2005 compared with December 31, 2004. The decrease in inventory was primarily due to working down the build up for the smelter shutdown, lower cobalt metal prices and lower nickel inventory quantities at September 30, 2005 compared with December 31, 2004.

Cash used in investing activities increased \$13.4 million in the first nine months of 2006 compared with the first nine months of 2005 due to the \$5.4 million payment for the Plaschem acquisition, two loans totaling \$5.1 million to MPI Nickel, a \$2.1 million loan to Talvivaara and a \$3.0 million increase in expenditures for property, plant and equipments in the first nine months of 2006 compared with the first nine months of 2005. These cash outflows were partially offset by a \$7.7 million increase in proceeds from the sale

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of investments in equity securities in the first nine months of 2006 compared with the first nine months of 2005. During the first nine months of 2006, the Company sold its investment in Weda Bay and received cash proceeds of \$12.2 million. During the first nine months of 2005, the Company received cash proceeds of \$4.5 million from the sale of an investment in equity securities.

Cash used for financing activities increased \$12.2 million primarily due to the repayment of the \$17.3 million note payable with a Finnish bank in the first nine months of 2006.

The \$3.4 million change in cash used for discontinued operations resulted from higher tax payments in the first nine months of 2005 for retained liabilities of businesses sold.

**Financing Activities**

The Company has a revolving credit agreement (the Revolver) with availability of up to \$100.0 million, including up to the equivalent of \$25.0 million in Euros or other foreign currencies. The Revolver includes an accordion feature under which the Company may increase the availability by \$50.0 million to a maximum of \$150.0 million subject to certain conditions. Obligations under the Revolver are guaranteed by each of the Company's U.S. subsidiaries and are secured by a lien on the assets of the Company and such subsidiaries. The Revolver provides for interest-only payments during its term, with principal due at maturity. The Company has the option to specify that interest be calculated based either on LIBOR, plus a calculated margin amount, or a base rate. The applicable margin for the LIBOR rate ranges from 0.50% to 1.00%. The Revolver also requires the payment of a fee of 0.125% to 0.25% per annum on the unused commitment. The margin and unused commitment fees are subject to quarterly adjustment based on a certain debt to adjusted earnings ratio. The Revolver matures on December 20, 2010 and contains various affirmative and negative covenants. At September 30, 2006, there were no borrowings outstanding under the Revolver, and the Company was in compliance with all covenants.

The Company has outstanding \$400.0 million of 9.25% Senior Subordinated Notes (the Notes) that mature on December 15, 2011. The Notes may be redeemed at the option of the Company beginning December 15, 2006 at prices specified in the indenture. The Company's domestic subsidiaries are the guarantors of the Notes (See Note 14 to the unaudited condensed consolidated financial statements in this Form 10-Q). At September 30, 2006, the fair value of the Notes, based upon the quoted market price, approximated \$417.5 million.

During the third quarter of 2006, the Company completed the termination of, and settled for cash, two interest rate swap agreements expiring in 2011. These swap agreements converted \$100 million of the fixed 9.25% Notes to a floating rate. The combined pre-tax loss on the termination of the swaps of \$2.9 million has been deferred and is being amortized to interest expense through the date on which the swaps were originally scheduled to mature.

In November 2004, the Company obtained a loan with a Finnish bank with principal balance of \$23.0 million payable in 48 equal installments beginning in January 2005 and ending December 2008. The balance of this loan was \$17.3 million at December 31, 2005. The Company repaid the balance outstanding of \$14.4 million in May 2006.

The Company has generated sufficient cash from operations during 2006 to provide for its working capital, debt service and capital expenditure requirements. The Company believes that it will have sufficient cash provided by operations and available from its credit facility to provide for its working capital, debt service and capital expenditure requirements during the balance of 2006.

**Capital Expenditures**

Capital expenditures in the first nine months of 2006 were \$21.4 million, related primarily to a project at the Cawse facility to improve recoveries and ongoing projects to maintain current operating levels, and were funded through cash flows from operations. The Company expects to incur capital spending of approximately \$10 million for the remainder of 2006 primarily for projects at the Kokkola refinery to improve by-product yields and expand capacity in selected product lines, and other fixed asset additions at existing facilities.

**Contractual Obligations**

Since December 31, 2005, there have been no significant changes in the total amount of contractual obligations or the timing of cash flows in accordance with those obligations, as reported in the Company's 10-K for the year ended December 31, 2005 except the repayment of the Finnish bank loan discussed above in Liquidity and Capital Resources, which decreased our debt obligations,





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partially offset by \$1.8 million of debt acquired in the Plaschem acquisition. Total debt obligations decreased from \$417.3 million as of December 31, 2005 to \$401.7 million as of September 30, 2006.

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**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

A discussion of market risk exposures is included in Part II, Item 7a, Quantitative and Qualitative Disclosure About Market Risk, of the Company's 2005 Annual Report on Form 10-K. There have been no material changes from December 31, 2005 to September 30, 2006.

**Item 4. Controls and Procedures**

**EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES**

Management of the Company, under the supervision and with the participation of the Chief Executive Officer and the Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of September 30, 2006. As defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act), disclosure controls and procedures are controls and procedures designed to provide reasonable assurance that information required to be disclosed in reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported on a timely basis, and that such information is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. The Company's disclosure controls and procedures include components of the Company's internal control over financial reporting.

Based upon, and as of the date of this evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were not effective solely because of the material weakness identified as of December 31, 2005 relating to the Company's controls over the Company's joint venture smelter in the Democratic Republic of Congo (DRC), as summarized in the Form 10-K for the year ended December 31, 2005. In light of this material weakness, the Company performed additional analysis and post-closing procedures as deemed necessary to ensure that the accompanying unaudited condensed consolidated financial statements were prepared in accordance with U.S. generally accepted accounting principles for interim financial information and the instructions to Form 10-Q. Accordingly, management believes that the unaudited condensed consolidated financial statements included in this report present fairly, in all material respects, the Company's financial position as of September 30, 2006, and the results of its operations for the three and nine months ended September 30, 2006, and its cash flows and changes in stockholders' equity for the nine months ended September 30, 2006.

**CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

As of December 31, 2005, management identified inadequate controls over the Company's joint venture smelter in the DRC that resulted in several control deficiencies that were individually not material weaknesses but, when aggregated, constituted a material weakness in internal control over financial reporting. Management continues to implement mitigating controls over the DRC joint venture smelter, including timely financial and operational oversight at both a Group and Corporate level, increased frequency of internal audits at the location, quarterly review of cash disbursements made by the location and upgrading finance and management personnel at the location. The additional internal controls put into place during the first nine months of 2006 have not been in place for a period of time sufficient for the Company to evaluate their design and operating effectiveness.

The Company continues to review, revise and improve the effectiveness of its internal controls including the controls discussed above. There were no other changes in the Company's internal controls over financial reporting in connection with the Company's third quarter 2006 evaluation, or subsequent to such evaluation, that would materially affect, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

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**PART II OTHER INFORMATION**

**Item 1A. Risk Factors**

There have been no material changes from the risk factors previously disclosed in the company's Annual Report on Form 10-K for the year ended December 31, 2005.

**ITEM 6. EXHIBITS**

Exhibits are as follow:

- 31.1 Certification by Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification by Chief Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002
- 32 Certification by Chief Executive Officer and Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act (18 U.S.C. Section 1350)

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**Signatures**

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

OM GROUP, INC.

Dated November 3, 2006

By:  
/s/ Kenneth Haber  
Kenneth Haber  
Chief Financial Officer  
(Principal Financial and Accounting Officer  
and  
Duly Authorized Officer)

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