

AIR PRODUCTS & CHEMICALS INC /DE/
Form DFAN14A
September 07, 2010

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

SCHEDULE 14A
(Rule 14a-101)

INFORMATION REQUIRED IN PROXY STATEMENT

SCHEDULE 14A INFORMATION

Proxy Statement Pursuant to Section 14(a) of the
Securities Exchange Act of 1934 (Amendment No. __)

Filed by the Registrant

Filed by a Party other than the Registrant

Check appropriate box:

- Preliminary Proxy Statement
- Confidential, For Use of the Commission Only (as permitted by Rule 14a-6(e)(2))
- Definitive Proxy Statement
- Definitive Additional Materials
- Soliciting Material under Rule 14a-12

Airgas, Inc.

(Name of Registrant as Specified in Its Charter)

Air Products Distribution, Inc.

Air Products and Chemicals, Inc.

(Name of Persons Filing Proxy Statement, if Other than Registrant)

Payment of filing fee (Check the appropriate box):

- No fee required.
- Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (Set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

(5) Total fee paid:

- Fee paid previously with preliminary materials.
- Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

Air Products Offer for Airgas
September 2010

Investor Presentation
Forward-Looking Statements

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All statements included or incorporated by reference in this communication other than statements or characterizations of historical fact, are forward-looking statements. These forward-looking statements are based on our current expectations, estimates and projections about our business and industry, management's beliefs, and certain assumptions made by us, all of which are subject to change. Forward-looking statements can often be identified by words such as "anticipates", "expects", "intends", "plans", "predicts", "believes", "seeks", "estimates", "may", "will", "should", "would", "could", "potential", "continue", "ongoing", similar expressions, and variations or negatives of these words. These forward-looking statements are not guarantees of future results and are subject to risks, uncertainties and assumptions that could cause our actual results to differ materially and adversely from those expressed in any forward-looking statement. Important risk factors that could contribute to such differences or otherwise affect our business, results of operations and financial condition include the possibility that Air Products will not pursue a transaction with Airgas and the risk factors discussed in our Annual Report on Form 10-K, subsequent Quarterly Reports on Form 10-Q, recent Current Reports on Form 8-K, and other SEC filings. The forward-looking statements in this release speak only as of the date of this filing. We undertake no obligation to revise or update publicly any forward-looking statement, except as required by law.

Investor Presentation

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ADDITIONAL INFORMATION

On February 11, 2010, Air Products Distribution, Inc. (“Purchaser”), a wholly owned subsidiary of Air Products and Chemicals, Inc. (“Air Products”), commenced a cash tender offer for all the outstanding shares of common stock of Airgas, Inc. (“Airgas”) not already owned by Air Products, subject to the terms and conditions set forth in the Offer to Purchase dated as of February 11, 2010 (the “Offer to Purchase”). The purchase price to be paid upon the successful closing of the cash tender offer is \$65.50 per share in cash, without interest and less any required withholding tax, subject to the terms and conditions set forth in the Offer to Purchase, as amended. The offer is scheduled to expire at midnight, New York City time, on Friday, October 29, 2010, unless further extended in the manner set forth in the Offer to Purchase.

This communication does not constitute an offer to buy or solicitation of an offer to sell any securities. The tender offer is being made pursuant to a tender offer statement on Schedule TO (including the Offer to Purchase, a related letter of transmittal and other offer

materials) filed by Air Products with the U.S. Securities and Exchange Commission (“SEC”) on February 11, 2010. INVESTORS AND

SECURITY HOLDERS OF AIRGAS ARE URGED TO READ THESE AND OTHER DOCUMENTS FILED WITH THE SEC CAREFULLY IN THEIR ENTIRETY

BECAUSE THEY CONTAIN IMPORTANT INFORMATION ABOUT THE PROPOSED TRANSACTION.

Investors and security holders can obtain

free copies of these documents and other documents filed with the SEC by Air Products through the web site maintained by the SEC

at <http://www.sec.gov>. The Offer to Purchase and related materials may also be obtained for free by contacting the Information

Agent for the tender offer, MacKenzie Partners, Inc., at 212-929-5500 or toll-free at 800-322-2885.

Air Products has filed a definitive proxy statement on Schedule 14A dated July 29, 2010 with the SEC in connection with the

solicitation of proxies for the 2010 annual meeting of Airgas stockholders. The definitive proxy statement has been mailed to

shareholders of Airgas. INVESTORS AND SECURITY HOLDERS OF AIRGAS ARE URGED TO READ THE PROXY STATEMENT AND OTHER

DOCUMENTS RELATED TO THE SOLICITATION AND FILED WITH THE SEC CAREFULLY IN THEIR ENTIRETY AS THEY BECOME AVAILABLE

BECAUSE THEY WILL CONTAIN IMPORTANT INFORMATION. Investors and security holders will be able to obtain free copies of these

documents (if and when available) and other documents filed with the SEC by Air Products through the web site maintained by the

SEC at <http://www.sec.gov>. These materials may also be obtained for free by contacting Air Products’ proxy solicitor for the 2010

Airgas annual meeting, MacKenzie Partners, Inc., at 212-929-5500 or toll-free at 800-322-2885.

CERTAIN INFORMATION REGARDING PARTICIPANTS

Air Products, Purchaser, and certain of their respective directors and executive officers and the Air Products nominees may be

deemed to be participants in the proposed transaction under the rules of the SEC. Security holders may obtain

information regarding
the names, affiliations and interests of Air Products' directors and executive officers in Air Products' Annual Report on
Form 10-K for
the year ended September 30, 2009, which was filed with the SEC on November 25, 2009, and its proxy statement for
the 2010 Annual
Meeting, which was filed with the SEC on December 10, 2009; and of Purchaser's directors and executive officers in
the Offer to
Purchase. Information about the Air Products nominees is included in the definitive proxy statement Air Products
filed with the SEC on
July 29, 2010 relating to the 2010 annual meeting of Airgas stockholders. These documents can be obtained free of
charge from the
sources indicated above. Additional information regarding the interests of these participants in the proxy solicitation
and a
description of their direct and indirect interests, by security holdings or otherwise, is also included in the definitive
proxy statement
filed by Air Products with the SEC.

Investor Presentation
Situation overview

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Investor Presentation

Our offer for Airgas

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- Consideration • \$65.50 per share, all-cash
 - Premium • 50% premium to Airgas unaffected price on 02/04/10 of \$43.53
 - Financing • Fully-committed through J.P. Morgan
 - Regulatory • Reached agreement with FTC on terms of a Consent Decree - announced August 16th
 - Approval • No other regulatory hurdles to close transaction
 - Closing • Q4 2010
- Premium Price, Certain Value, Fast Closing
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Investor Presentation

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- Airgas refuses to engage despite our efforts
10/15/2009: McGlade and McCausland meet; McGlade indicates Air Products' interest in pursuing a business combination
11/20/2009: Air Products sends letter to Airgas, offering to acquire the Company for \$60 per share in stock
12/08/2009: Airgas responds to Air Products' letter, rejecting proposal and indicating that Airgas will not engage with Air Products
12/17/2009: Air Products responds to Airgas' 12/8/2009 letter, increasing its offer to \$62 share, with up to half in cash, and indicating the possibility of a higher price if Airgas can demonstrate incremental value
01/04/2010: Airgas responds to Air Products' letter, again rejecting proposal and indicating that Airgas will not engage with Air Products
02/05/2010: Air Products announces its offer to acquire Airgas for \$60.00 per share in cash, a premium of 38% to Airgas' closing price of \$43.53 on 02/04/10
02/22/2010: Airgas Board rejects tender offer from Air Products through 14D-9; says offer is "grossly inadequate," refuses to discuss offer with Air Products
06/16/2010: Air Products files preliminary proxy, nominating John P. Clancey, Robert L. Lumpkins and Ted B. Miller, Jr. to the Board of Directors and includes three additional proposals
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06/21/2010: Airgas files preliminary proxy, urges shareholders to vote for three incumbent directors
07/08/2010: Air Products increases its offer to \$63.50
07/21/2010: Airgas rejects increased offer; says offer grossly undervalues Airgas; refuses to discuss offer with Air Products
08/16/2010: Air Products announces that it has reached agreement with the FTC on terms of the Consent Decree; Air Products extends tender offer to October 29, 2010
08/26/2010: Airgas submits letter to Delaware Chancery Court indicating intent to seek invalidation of any majority vote of shareholders on bylaw amending 2011 annual meeting date
08/27/2010: Airgas publicly states its refusal to discuss offer with Air Products, says offer price is "not close to a sensible starting point for negotiations"
08/30/2010: Airgas commits to hold special meeting of stockholders on June 21, 2011 if Airgas stockholders reject Air Products' by-law amendment proposal and reiterates that Airgas

would seek to invalidate any majority vote of shareholders to hold
2011 annual meeting in January 2011

09/06/2010: Air Products increases its offer to \$65.50

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Air Products stands ready to execute a transaction

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Investor Presentation

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Airgas' delay tactics not in shareholder interests

- Airgas' first action in response to our public offer was to pursue litigation
- Airgas has refused to discuss any aspect of our offers despite our clearly stated flexibility regarding price and form of consideration
- Airgas has refused to form an independent Board committee despite possibility of founder, Chairman and CEO's interests not being aligned with other shareholders
- Airgas amended bylaws on April 7, 2010, in order to delay its 2010 annual meeting date

Airgas continues to deprive shareholders of their right to decide

- Refused to rescind "poison pill" shareholder rights plan
 - Rejected Air Products' request to hold 2010 annual meeting no later than August 18, 2010 (one year anniversary of 2009 annual meeting)
 - Rejected Air Products' request that director nominees not elected by shareholders at 2010 annual meeting not be reappointed for at least three years
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Investor Presentation

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And Airgas continues to delay and act against
shareholder interests

Airgas' refusal to engage ignores the will of the shareholders

- On August 26, 2010, Airgas submitted a letter to the Delaware Chancery Court stating that it intends to seek to **INVALIDATE ANY AFFIRMATIVE DECISION BY A MAJORITY OF AIRGAS SHAREHOLDERS** to approve adoption of a new bylaw at the September annual meeting requiring Airgas to hold its next annual meeting in January 2011
 - And most recently Airgas continues its delay campaign by announcing on August 30 that it would hold a 2011 special meeting in June rather than hold an annual meeting in January 2011 and reiterated that it would seek to **INVALIDATE ANY VOTE BY A MAJORITY OF AIRGAS SHAREHOLDERS** to hold the annual meeting in January 2011
-

Investor Presentation

Airgas is not strategic to other industrial gas players

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Quotes

Source

Date

“[Airgas] is really not that strategic to us.”	James Sawyer (CFO), Morgan Stanley Global	August 31, 2010
“Don’t see much growth in U.S. packaged gases.”	Industrials Unplugged Conference	
“When we look at our project pipeline in Gases, you can easily see that the focus is on the emerging markets.”	Georg Denoke (CFO), Full Year 2009 Earnings Conference Call	March 17, 2010
“[Airgas is] an American operation. Our strategy is growth. We see growth in emerging markets and that’s where we will invest our resources.”	Benoît Potier (CEO), Full Year 2009 Earnings Conference Call	February 15, 2010

Investor Presentation
Overview of Offer for Airgas
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Investor Presentation
Compelling valuation multiple

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Source: Airgas filings

Notes: Airgas unaffected date as of 02/04/2010; LTM EBITDA and balance sheet information as of 12/31/2009

Current offer announced on 09/06/2010; LTM EBITDA and balance sheet information as of 06/30/2010

Airgas implied firm value and multiples
(\$ in millions, except per share amounts)

Unaffected	
Airgas	
Air Products'	
current offer	
Share price	
\$43.53	
\$65.50	
Diluted shares outstanding (mm)	
84.5	
86.7	
Equity value	
\$3,679	
\$5,676	
Add: Net debt	
\$1,849	
\$1,663	
Firm value	
\$5,528	
\$7,339	
LTM EBITDA	
\$672	
\$691	
Firm value / LTM EBITDA	
8.2x	
10.6x	

Investor Presentation
Compelling valuation multiple relative to
precedent transactions

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Source: Company filings, equity research, press releases, investor presentations

Note: Airgas transaction value based on \$65.50 offer price (increased on 09/06/2010); LTM EBITDA and balance sheet information as of 06/30/2010, the most recent date for which public

filings were available at the time of announcement

Precedent transaction values and multiples

01/08/07

Air Products

BOC Gazy Sp Industrial Gas

\$0.5

9.7x

01/24/06

Linde

BOC Group PLC

16.4

10.9x

10/07/04

Praxair

Air Liquide SA-Industrial Gas

0.6

8.0x

01/20/04

Air Liquide

Messer Griesheim-gas oper.

3.3

10.1x

08/16/99

Linde

AGA

4.5

10.4x

High

10.9x

Median

10.1x

Low

8.0x

02/05/10

Air Products

Airgas

\$7.3

10.6x

Ann. date

Acquiror

Target (Parent)

Transaction value

(\$bn)

Transaction value/
LTM EBITDA

Investor Presentation

\$53.61

\$46.00

\$42.11

\$51.00

\$26.29

\$43.53

\$65.50

Current offer

Pre-announcement

stock price -

02/04/2010

Pre-announcement

52 week low -

03/06/2009

Pre-announcement

52 week high -

10/19/2009

Pre-announcement

1 year VWAP

Recent analyst

estimates of

standalone value

PV of consensus 1

year price target

(pre-

announcement)¹

Source: FactSet as of 08/27/10, Bloomberg

Note: VWAP based on closing stock price and total daily volume traded

Compelling premium to every metric

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Current Offer Premium:

50% 149% 28% 56% 42% 22%

¹ 1 year Bloomberg consensus price target of \$55.40 (as of 02/01/10) discounted from 12/31/10 at 10% cost of equity

Investor Presentation

Premium is significantly higher than precedents

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Source: Dealogic Analytics

Rank eligible deals with value greater than \$10mm

Note: Includes public deals where initial stake is <50% and final stake is >51%, includes only deals for which Dealogic data is available; data represents median of all deals for YTD through

June 30th, 2010

50%

28%

30%

16%

28%

26%

17%

25%

Current offer

U.S. all deals

U.S. all-cash
deals

U.S. all-stock
deals

U.S. all friendly
deals

U.S. all
unsolicited deals

Global all friendly
deals

Global all
unsolicited deals

Investor Presentation
Premium compelling even after reflecting change
in peer share prices since initial offer

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Source: FactSet

Note: Market data as of 08/27/10; red bar reflects unaffected premium based upon \$65.50 offer and unaffected price of \$43.53

From February 4, 2010 to August 27, 2010

50%

14%

17%

14%

12%

Current offer

Peer average

Praxair

Air Liquide

Linde

Investor Presentation

Growth from emerging markets is driving peer performance while Airgas is a U.S business

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Airgas

Praxair

Europe

57%

ME & Africa

2%

North America

55%

Europe

15%

S. America

19%

Asia

10%

Western Europe

42%

Americas

22%

Asia &

Eastern Europe

20%

South Pacific &

Africa

16%

FY 2009 Sales2

FY 2009 Sales

1H10 vs. 1H09 (% growth)

FY 2009 Sales

1H10 vs. 1H09 (% growth)

2Q10 vs. 2Q09 (% growth)

US

98%

Rest of World

2%

FY 20101 Sales

FY1Q11 vs. FY1Q10 (% growth)

7%

Total

12%

11%

26%

Asia

North

America

Total

10%

10%
 25%
 Asia
 Pacific
 Americas
 Total
 6%
 7%
 13%
 Asia &
 Eastern
 Europe
 Americas
 Total

Source: Company filings, company earnings releases, investor presentations

Note: Year over year sales growth excludes items that effect comparability such as currency effects, natural gas pricing, cost-pass through, acquisitions, etc; Air Liquide sales growth relates to Gas VALIGN="bottom">

Foreign currency translation adjustments, net of tax of \$0

7,020 (28,717) (6,025) (4,797)

Reclassification of loss on interest rate swap, net of tax of \$0

0 0 0 1,073

Increase in unrealized loss of interest rate swaps, net of tax of \$0

(9) (1,018) (143) (921)

Unrealized gain (loss) of net investment hedge, net of tax of \$0

(1,155) 0 648 0

Other comprehensive income (loss), net of tax

5,856 (29,735) (5,520) (4,645)

Total comprehensive income (loss)

\$(9,643) \$13,358 \$7,741 \$107,302

See Notes to Condensed Consolidated Financial Statements

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)****(In thousands)**

	Nine months ended September 30,	
	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 13,261	\$ 111,947
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	47,843	46,919
Amortization of debt premium	(72)	0
Amortization of debt issuance costs	2,235	6,067
Loss on property, plant, and equipment	415	28
Impairment of long-lived assets	5,434	0
Loss on extinguishment of debt	0	2,985
(Earnings) loss from unconsolidated joint venture, net of dividends received	(33)	660
Deferred income tax expense (benefit)	(6,172)	4,585
Share-based compensation	5,245	4,196
<i>Decrease (increase) in:</i>		
Accounts receivable	(23,059)	(42,637)
Inventories of products, materials and supplies	53,056	(108,423)
Other assets	(721)	(1,337)
<i>Increase (decrease) in:</i>		
Accounts payable-trade	7,909	(2,941)
Other payables and accruals	(8,768)	(8,417)
Other long-term liabilities	(1,554)	(4,081)
Due to related party	7,169	(6,001)
Net cash provided by operating activities	102,188	3,550
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of property, plant, and equipment, net of proceeds from sales	(42,436)	(46,720)
Purchase of software	(1,789)	(2,968)
Settlement of net investment hedge	1,648	0
Net cash used in investing activities	(42,577)	(49,688)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from debt	101,250	400,000
Repayments of debt	(45,626)	(391,285)
Proceeds from the exercise of stock options	820	8,271
Proceeds from insurance note payable	0	4,734
Repayments of insurance note payable	0	(4,734)
Debt issuance costs	(3,156)	(15,231)
Net cash provided by financing activities	53,288	1,755
Effect of exchange rate differences on cash	793	(2,819)

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Net increase (decrease) in cash and cash equivalents	113,692	(47,202)
Cash and cash equivalents, beginning of period	88,579	92,750
Cash and cash equivalents, end of period	\$ 202,271	\$ 45,548
Supplemental disclosures:		
Cash paid during the period for income taxes, net of refunds received	\$ 12,695	\$ 6,043
Cash paid during the period for interest, net of capitalized interest	\$ 23,854	\$ 21,611

See Notes to Condensed Consolidated Financial Statements

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KRATON PERFORMANCE POLYMERS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. General

Description of our Business. We are a leading global producer of styrenic block copolymers (SBCs) and other engineered polymers. We market our products under the Kraton[®], Cariflex[™], and NEXAR[™] brands. SBCs are highly-engineered synthetic elastomers, which we invented and commercialized almost 50 years ago, that enhance the performance of numerous end use products by imparting greater flexibility, resilience, strength, durability, and processability. Our polymers are typically formulated or compounded with other products to achieve improved, customer-specific performance characteristics in a variety of applications. Our SBC products are found in many everyday applications, including personal care products such as disposable diapers and the rubberized grips of toothbrushes, razor blades, and power tools. Our products are also used to impart tack and shear properties in a wide variety of adhesive products and to impart characteristics such as flexibility and durability in sealants and corrosion resistance in coatings. Our paving and roofing applications provide durability, extending road and roof life. We also produce Cariflex isoprene rubber and isoprene rubber latex. Our Cariflex products are highly-engineered, non-SBC synthetic substitutes for natural rubber latex. Our Cariflex products, which have not been found to contain the proteins present in natural rubber latex and are, therefore, not known to cause allergies, are used in applications such as surgical gloves and condoms. We believe the versatility of Cariflex provides opportunities for new, high-margin applications. In addition to Cariflex, we have a portfolio of innovations at various stages of development and commercialization, including polyvinyl chloride (PVC) alternatives for wire, cable, medical applications, polymers used in slush molding for automotive applications, and our Nexar[™] family of membrane polymers for water filtration, breathable fabrics, and synthetic cement formulations for use in oilfield applications. We manufacture our polymers at five manufacturing facilities globally, including our flagship facility in Belpre, Ohio, as well as facilities in Germany, France, Brazil, and Japan. The facility in Japan is operated by an unconsolidated manufacturing joint venture.

Basis of Presentation. The accompanying unaudited condensed consolidated financial statements we present in this report are for Kraton Performance Polymers, Inc. and its consolidated subsidiaries, each of which is a wholly-owned subsidiary. These interim financial statements should be read in conjunction with the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2011, as subsequently amended on March 8, 2012, and reflect all normal recurring adjustments that are, in the opinion of management, necessary to fairly present our results of operations and financial position. Amounts reported in our Condensed Consolidated Statements of Operations are not necessarily indicative of amounts expected for the respective annual periods or any other interim period, in particular due to the effect of seasonal changes and weather conditions that typically affect our sales into our Paving and Roofing end use market.

Our significant accounting policies have been disclosed in Note 1 *Description of Business, Basis of Presentation and Significant Accounting Policies* in our most recent Annual Report on Form 10-K, as amended. There have been no changes to the policies disclosed therein. The accompanying unaudited condensed consolidated financial statements we present in this report have been prepared in accordance with those policies.

Use of Estimates. The preparation of condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant items subject to such estimates and assumptions include the useful lives of fixed assets; allowances for doubtful accounts and sales returns; the valuation of derivatives, deferred tax assets, property, plant, and equipment, inventory, investments and share-based compensation; and liabilities for employee benefit obligations, asset retirement obligations, income tax uncertainties, and other contingencies.

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Reclassifications. Certain amounts reported in the condensed consolidated financial statements for prior periods have been reclassified to conform to the current reporting presentation.

Income Tax in Interim Periods. Our business operations are global in nature and we are subject to taxes in numerous jurisdictions. Tax laws and tax rates vary substantially in these jurisdictions and are subject to change based on the political and economic climate in those countries. We file our tax returns in accordance with our interpretations of each jurisdiction's tax laws. We record our tax provision or benefit on an interim basis using the estimated annual effective tax rate. This rate is applied to the current period ordinary income or loss to determine the income tax provision or benefit allocated to the interim period.

Losses from jurisdictions for which no benefit can be realized and the income tax effects of unusual and infrequent items are excluded from the estimated annual effective tax rate. Valuation allowances are provided against the future tax benefits that arise from the losses in jurisdictions for which no benefit can be realized. The effects of unusual and infrequent items are recognized in the impacted interim period as discrete items.

The estimated annual effective tax rate may be significantly affected by nondeductible expenses and by our projected earnings mix by tax jurisdiction. Adjustments to the estimated annual effective income tax rate are recognized in the period during which such estimates are revised.

We have established valuation allowances against a variety of deferred tax assets, including net operating loss carryforwards, foreign tax credits and other income tax credits. Valuation allowances take into consideration our ability to realize these deferred tax assets and reduce the value of such assets to the amount that is deemed more likely than not to be recoverable. Our ability to realize these deferred tax assets is dependent on achieving our forecast of future taxable operating income over an extended period of time. We review our forecast in relation to actual results and expected trends on a quarterly basis. Failure to achieve our operating income targets may change our assessment regarding the recoverability of our net deferred tax assets and such change could result in a valuation allowance being recorded against some or all of our net deferred tax assets. A change in our valuation allowance would impact our income tax expense/benefit and our stockholders' equity and could have a significant impact on our results of operations or financial condition in future periods.

2. New Accounting Pronouncements

Adoption of Accounting Standards

We have implemented all new accounting pronouncements that are in effect and that management believes would materially impact our financial statements. Management does not believe that there are any other new accounting pronouncements that have been issued that may have a material impact on our financial position or results of operations.

3. Share-Based Compensation

We account for share-based awards under the provisions of ASC 718, *Compensation Stock Compensation*, which established the accounting for share-based awards exchanged for employee services. Accordingly, share-based compensation cost is measured at the grant date based on the fair value of the award and we expense these costs using the straight-line method over the requisite service period. Share-based compensation expense was approximately \$1.5 million and \$1.2 million for the three months ended September 30, 2012 and 2011, respectively, and \$5.2 million and \$4.2 million for the nine months ended September 30, 2012 and 2011, respectively. We record these costs in selling, general, and administrative expenses.

4. Restructuring and Restructuring-related Costs

There were no restructuring and restructuring-related expenses incurred in the three and nine months ended September 30, 2012. In the three and nine months ended September 30, 2011, restructuring and restructuring-

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related expenses amounted to approximately \$0.3 million and \$1.3 million, respectively, and were comprised of charges related to consulting fees, severance expenses and other costs primarily associated with the restructuring of our European organization, which were recorded as selling, general, and administrative expenses.

5. Detail of Certain Balance Sheet Accounts

	September 30, 2012	December 31, 2011
	(in thousands)	
<i>Inventories of products:</i>		
Finished products	\$ 258,929	\$ 289,921
Work in progress	4,466	5,048
Raw materials	75,686	99,827
	\$ 339,081	\$ 394,796
<i>Other payables and accruals:</i>		
Employee related	\$ 13,883	\$ 11,639
Income taxes payable	3,882	12,254
Other	20,897	27,360
	\$ 38,662	\$ 51,253
<i>Other long-term liabilities:</i>		
Pension	\$ 72,978	\$ 74,304
Other	15,916	9,354
	\$ 88,894	\$ 83,658
<i>Accumulated other comprehensive loss:</i>		
Foreign currency translation adjustments	\$ 23,525	\$ 29,550
Net unrealized loss on interest rate swaps	(952)	(809)
Net unrealized gain on net investment hedge	1,547	899
Pension liability	(47,258)	(47,258)
	\$ (23,138)	\$ (17,618)

6. Earnings Per Share (EPS)

Basic EPS is computed by dividing net income by the weighted-average number of shares outstanding during the period.

Diluted EPS is computed by dividing net income by the diluted weighted-average number of shares outstanding during the period and, accordingly, reflects the potential dilution that could occur if securities or other agreements to issue common stock, such as stock options, were exercised, settled or converted into common stock and were dilutive. The diluted weighted-average number of shares used in our diluted EPS calculation is determined using the treasury stock method.

Unvested awards of share-based payments with rights to receive dividends or dividend equivalents, such as our restricted stock awards are considered to be participating securities, and therefore, the two-class method is used for purposes of calculating EPS. Under the two-class method, a portion of net income is allocated to these participating securities and is excluded from the calculation of EPS allocated to common stock. Our restricted stock awards are subject to forfeiture and restrictions on transfer until vested and have identical voting, income and distribution rights to the unrestricted common shares outstanding.

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The computation of diluted EPS excludes the effect of the potential exercise of stock options that are anti-dilutive. The number of stock options excluded from the computation was 757,687 and 398,008 for the three months ended September 30, 2012 and 2011, respectively, and 737,033 and 368,008 for the nine months ended September 30, 2012 and 2011, respectively.

The effects of share-based compensation awards on our diluted weighted-average number of shares outstanding used in calculating our diluted EPS are as follows:

	Three months ended September 30, 2012			Three months ended September 30, 2011		
	Net Income (Loss) (In thousands, except per share data)	Weighted Average Shares Outstanding	Earnings (Loss) Per Share	Net Income (Loss) (In thousands, except per share data)	Weighted Average Shares Outstanding	Earnings Per Share
<i>Basic:</i>						
As reported	\$ (15,499)	32,251		\$ 43,093	32,077	
Less: amounts allocated to unvested restricted shares	148	(308)		(265)	(197)	
Amounts available to common stockholders	(15,351)	31,943	\$ (0.48)	42,828	31,880	\$ 1.34
<i>Diluted:</i>						
Add: amounts allocated to unvested restricted shares	(148)	308		265	197	
Restricted share units non participating	0	0		0	29	
Stock options added under the treasury stock method	0	0		0	306	
Less: amounts reallocated to unvested restricted shares	148	(308)		(262)	(197)	
Amounts available to stockholders and assumed conversions	\$ (15,351)	31,943	\$ (0.48)	\$ 42,831	32,215	\$ 1.33

	Nine months ended September 30, 2012			Nine months ended September 30, 2011		
	Net Income (Loss) (In thousands, except per share data)	Weighted Average Shares Outstanding	Earnings Per Share	Net Income (Loss) (In thousands, except per share data)	Weighted Average Shares Outstanding	Earnings Per Share
<i>Basic:</i>						
As reported	\$ 13,261	32,210		\$ 111,947	31,911	
Less: amounts allocated to unvested restricted shares	(117)	(283)		(567)	(161)	
Amounts available to common stockholders	13,144	31,927	\$ 0.41	111,380	31,750	\$ 3.51
<i>Diluted:</i>						
Add: amounts allocated to unvested restricted shares	117	283		567	161	
Restricted share units non participating	0	29		0	32	
Stock options added under the treasury stock method	0	246		0	471	
Less: amounts reallocated to unvested restricted shares	(116)	(283)		(558)	(161)	
Amounts available to stockholders and assumed conversions	\$ 13,145	32,202	\$ 0.41	\$ 111,389	32,253	\$ 3.45

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In March 2012, we completed a public offering of \$100.0 million principal amount of our 6.75% senior notes due 2019 at an issue price of 101.25%. The notes constitute a further issuance of, and are fungible with, the \$250.0 million aggregate principal amount of 6.75% senior notes due 2019 that we issued on February 11, 2011. The additional notes form a single series of debt securities with the existing notes.

Concurrently with the \$100.0 million senior note offering, we entered into an amendment to our 2011 senior secured credit agreement to, among other things, facilitate our ability to pursue a new manufacturing facility by providing for an additional \$50.0 million in investment capacity for certain investments and a \$75.0 million increase to the capital expenditures basket under certain circumstances. Additionally, the amendment provides for certain modifications to the consolidated net leverage ratio we are required to maintain and provides that certain guarantees by us or any of our domestic subsidiaries not to exceed \$100.0 million shall not constitute indebtedness for purposes of compliance with certain financial covenants.

Our senior secured credit agreement provides for financing consisting of a \$200.0 million senior secured revolving credit facility, a \$150.0 million senior secured term loan facility and an option to raise up to \$125.0 million of incremental term loans or incremental revolving credit commitments. The senior secured credit agreement has a maturity date of February 11, 2016. In these notes to the condensed consolidated financial statements, the loans made under the revolving credit facility are referred to as revolving loans and the loans made under the term loan facility are referred to as term loans.

Long-term debt consists of the following:

	September 30, 2012	December 31, 2011
	(in thousands)	
Term loans	\$ 96,875	\$ 142,500
6.75% senior notes due 2019	351,178	250,000
Total debt	448,053	392,500
Less current portion of long-term debt	0	7,500
Total long-term debt	\$ 448,053	\$ 385,000

Senior Secured Credit Agreement. Kraton Polymers LLC is the borrower under our senior secured credit agreement, which is unconditionally guaranteed by Kraton Performance Polymers, Inc. and the wholly-owned domestic subsidiaries of Kraton Polymers LLC, and is required to be guaranteed by all future direct and indirect material domestic subsidiaries. Revolving loans bear interest at a rate per annum equal to, at our option, either (a) a base rate determined by reference to the higher of (1) the federal funds rate plus 0.50% and (2) the prime rate of Bank of America, N.A., in each case plus a margin of 1.75% to 2.25% depending on a consolidated net leverage ratio, or (b) a LIBOR rate determined by reference to the costs of funds for U.S. dollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs plus a margin of 2.75% to 3.25% depending on a consolidated net leverage ratio.

Our term loans bear interest at a rate per annum equal to, at our option, either (a) a base rate determined by reference to the higher of (1) the federal funds rate plus 0.50% and (2) the prime rate of Bank of America, N.A., in each case plus a margin of 2.00% per annum, or (b) a LIBOR rate determined by reference to the costs of funds for U.S. dollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs plus a margin of 3.00% per annum. The average effective interest rates, including debt issuance costs, on the term loans for the three months ended September 30, 2012 and 2011 were 3.7% and 3.6%, respectively. The average effective interest rates, including debt issuance costs, on the term loans for the nine months ended September 30, 2012 and 2011 were 3.7% and 6.6% (which would have been 3.7% excluding charges aggregating \$3.4 million associated with the debt refinancing in the first quarter of 2011).

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Under the terms of our senior secured credit agreement, we are subject to certain financial covenants, which include the maintenance of a maximum consolidated net leverage ratio, a minimum consolidated net interest coverage ratio and maximum capital expenditures. We are required to maintain a fiscal quarter end maximum consolidated net leverage ratio not to exceed 4.00:1.00 through December 31, 2012; not to exceed 3.50:1.00 beginning March 31, 2013 through December 31, 2013; not to exceed 3.25:1.00 beginning March 31, 2014 through December 31, 2014; not to exceed 3.00:1.00 beginning March 31, 2015 and continuing thereafter. In addition, we are required to maintain a minimum consolidated net interest coverage ratio as of the end of any fiscal quarter of at least 3.00:1.00. In light of the negative impact of the spread between FIFO and ECRC of \$56.9 million on the earnings that are used to calculate the consolidated net leverage ratio in the trailing twelve month period ended September 30, 2012, we made a \$40.0 million voluntary prepayment of outstanding indebtedness under our term loans in September 2012. At September 30, 2012, the consolidated net leverage ratio was 3.60 to 1.00, which was below the 4.00 to 1.00 maximum allowed under the senior secured credit agreement. See *Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations* for further discussion of available liquidity.

In addition to paying interest on outstanding principal under revolving loans and term loans, we are required to pay a commitment fee ranging from 0.50% to 0.75%, depending on our consolidated net leverage ratio, related to the unutilized commitments under revolving loans, as well as pay customary letter of credit fees and agency fees.

6.75% Senior Notes due 2019. Kraton Polymers LLC and its wholly-owned financing subsidiary Kraton Polymers Capital Corporation issued \$350.0 million aggregate principal amount of 6.75% senior notes that mature on March 1, 2019 pursuant to an indenture, dated as of February 11, 2011 (\$250.0 million senior notes) and supplemental indenture thereto dated as of March 20, 2012 (\$100.0 million senior notes). The indenture provides that the notes are general unsecured, senior obligations and will be unconditionally guaranteed on a senior unsecured basis. We will pay interest on the notes at 6.75% per annum, semi-annually in arrears on March 1 and September 1 of each year.

Debt Maturities. The remaining principal payments on our outstanding total debt as of September 30, 2012, are as follows:

	Principal Payments (in thousands)
December 31:	
2015	96,875
Thereafter(1)	350,000
 Total debt	 \$ 446,875

- (1) Excludes a \$1.2 million premium associated with our issuance of \$100.0 million principal amount of our 6.75% senior notes in March 2012.
See Note 9 *Fair Value Measurements, Financial Instruments, and Credit Risk* for fair value information related to our long-term debt.

8. Debt Issuance Costs

We capitalize the debt issuance costs related to issuing long-term debt and amortize these costs using the effective interest method, except for costs related to revolving debt, which are amortized using the straight-line method. We had debt issuance costs of \$14.7 million and \$13.7 million (of which \$3.1 million and \$2.6 million were included in other current assets) as of September 30, 2012 and December 31, 2011, respectively. In connection with our March 2012 offering, we capitalized \$3.2 million of debt issuance costs related to the

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issuance of an additional \$100.0 million principal amount of our 6.75% senior notes and an amendment to our 2011 senior secured credit agreement. Debt issuance costs for the nine months ended September 30, 2012 consisted of the following:

	Debt Issuance Costs (in thousands)
Debt issuance costs at December 31, 2011	\$ 13,747
Capitalization of financing fees and other costs	3,156
Amortization expense	(2,235)
 Debt issuance costs at September 30, 2012	 \$ 14,668

9. Fair Value Measurements, Financial Instruments, and Credit Risk

ASC 820, *Fair Value Measurements and Disclosures* defines fair value, establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. ASC 820 requires entities to, among other things, maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

ASC 820 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

ASC 820 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our market assumptions.

In accordance with ASC 820, these two types of inputs have created the following fair value hierarchy:

Level 1 Inputs that are quoted prices (unadjusted) for identical assets or liabilities in active markets;

Level 2 Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the asset or liability, including:

Quoted prices for similar assets or liabilities in active markets

Quoted prices for identical or similar assets or liabilities in markets that are not active

Inputs other than quoted prices that are observable for the asset or liability

Inputs that are derived principally from or corroborated by observable market data by correlation or other means; and

Level 3 Inputs that are unobservable and reflect our assumptions used in pricing the asset or liability based on the best information available under the circumstances (e.g., internally derived assumptions surrounding the timing and amount of expected cash flows).

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Recurring Fair Value Measurements. The following tables set forth by level within the fair value hierarchy our financial assets and liabilities that were accounted for at fair value on a recurring basis as of September 30, 2012 and December 31, 2011, respectively. These financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Our assessment of the significance of a particular input to the fair value measurement requires judgment, and may affect the valuation of their fair value and their placement within the fair value hierarchy levels.

Balance Sheet Location		September 30, 2012	Fair Value Measurements at Reporting Date Using Quoted Prices in Active Markets for Identical Assets (Level 1)			Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
			(in thousands)				
Derivative asset	current	Other current assets	\$ 76	\$ 0	\$ 76	\$ 0	
Derivative liability	current	Other payables and accruals	(575)	0	(575)	0	
Derivative liability	noncurrent	Other long-term liabilities	(376)	0	(376)	0	
Total			\$ (875)	\$ 0	\$ (875)	\$ 0	

Balance Sheet Location		December 31, 2011	Fair Value Measurements at Reporting Date Using Quoted Prices in Active Markets for Identical Assets (Level 1)			Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
			(in thousands)				
Derivative liability	2011 Interest rate swap	Other payables and accruals	\$ 434	\$ 0	\$ 434	\$ 0	
Derivative liability	2011 Interest rate swap	Other long-term liabilities	375	0	375	0	
Total			\$ 809	\$ 0	\$ 809	\$ 0	

The use of derivatives creates exposure to credit risk relating to potential losses that could be recognized in the event that the counterparties to these instruments fail to perform their obligations under the contracts. We seek to minimize this risk by limiting our counterparties to major financial institutions with acceptable credit ratings and monitoring the total value of positions with individual counterparties. In the event of a default by one of our counterparties, we may not receive payments provided for under the terms of our derivatives.

Nonrecurring Fair Value Measurements. Our long-lived assets, such as property, plant, and equipment, and purchased intangible assets subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that their carrying value may not be recoverable. When impairment has occurred, such long-lived assets are written down to fair value.

The following table sets forth by level within the fair value hierarchy our fair value measurements with respect to non-financial assets that are measured at fair value on a nonrecurring basis. Our assessment of the significance of a particular input to the fair value measurement requires judgment, and may affect the valuation of their fair value and their placement within the fair value hierarchy levels.

	Fair Value Measurements as of Reporting Date			September 30, 2012	Total Impairment Charges
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3) (in thousands)		
Long-lived assets	\$ 0	\$ 0	\$ 12,719	\$ 12,719	\$ 5,434
Total	\$ 0	\$ 0	\$ 12,719	\$ 12,719	\$ 5,434

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During the three months ended September 30, 2012, a group of long-lived assets were written down to their fair value of \$12.7 million, resulting in pre-tax impairment charges of \$5.4 million. See Note 10 *Impairment Charges*, for further discussion.

The following table presents the carrying values and approximate fair values of our long-term debt as of September 30, 2012 and December 31, 2011:

	September 30, 2012		December 31, 2011	
	Carrying Value	Fair Value	Carrying Value	Fair Value
	(in thousands)			
Term Loans	\$ 96,875	\$ 96,875	\$ 142,500	\$ 142,500
6.75% unsecured notes	\$ 351,178	\$ 364,000	\$ 250,000	\$ 234,063

The term loans are variable interest rate instruments, and as such, the fair value approximates their carrying value.

Financial Instruments

Interest Rate Swap Agreements. Periodically, we enter into interest rate swap agreements to hedge or otherwise protect against interest rate fluctuations on a portion of our variable rate debt. These interest rate swap agreements are designated as cash flow hedges on our exposure to the variability of future cash flows.

In June 2011, we entered into a \$75.0 million notional amount interest rate swap agreement with respect to a portion of our outstanding term loans. This agreement was effective as of July 15, 2011 and matures on June 15, 2014. The interest rate swap agreement provides for a fixed interest rate of 1.0%; therefore, including the current 3.0% margin on our term loans, our current hedged fixed interest rate is 4.0%. We recorded an unrealized loss of \$1.0 million in accumulated other comprehensive loss related to the effective portion of this interest rate swap agreement as of September 30, 2012.

In June 2010, we entered into a \$215.0 million notional amount interest rate swap agreement. This agreement was effective on January 3, 2011 and was set to expire on January 3, 2012. However, on February 10, 2011, in connection with the refinancing of our previously existing indebtedness, we terminated and settled the interest rate swap agreement, and as a result, recognized \$1.0 million of interest expense.

Fair Value Hedges. In April 2012, we entered into a series of non-deliverable forward contracts to reduce our exposure to fluctuations in the Canadian dollar (CAD) against the U.S. dollar associated with the funding of certain capital expenditures, for the notional amounts of CAD \$1.6 million, CAD \$3.3 million, CAD \$3.3 million, CAD \$2.5 million, CAD \$2.5 million, and CAD \$1.6 million with settlement dates of May 14, 2012, August 16, 2012, September 27, 2012, December 20, 2012, July 11, 2013, and August 1, 2013, respectively. These non-deliverable forward contracts qualified for hedge accounting and were designated as fair value hedges in accordance with ASC 815-25 *Fair Value Hedges*. For the effective portion of these hedges, we recorded an aggregate \$0.1 million gain, which offset the \$0.1 million loss on the exposure to the CAD for the three months ended September 30, 2012, and an aggregate \$0.1 million loss, which offset the \$0.1 million gain for the nine months ended September 30, 2012.

We settled our ineffective portion of the hedge, with a notional amount of CAD \$3.3 million and settlement date of September 27, 2012, on September 21, 2012, prior to the contract's fixing date, due to an adjustment in the underlying payment schedule, and recorded a \$0.1 million gain for the ineffective portion. We then entered into a new derivative agreement for CAD \$3.8 million with a settlement date of December 20, 2012, based on the modified payment schedule.

Net Investment Hedges. During 2012, we entered into a series of non-deliverable forward and foreign currency option contracts to protect our net investment in our European subsidiaries against adverse changes in

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exchange rates by fixing the U.S. dollar/Euro exchange rate. The notional amounts of these contracts ranged from 50.0 million to 100.0 million with all contracts expiring after a 30-day duration. These contracts qualify for hedge accounting and were designated as net investment hedges in accordance with ASC 815-35 *Net Investment Hedges*. We recorded an aggregate \$0.6 million gain in accumulated other comprehensive loss related to the settlement of the effective portion of the contracts during the nine months ended September 30, 2012.

Foreign Currency Hedges. Periodically, we enter into foreign currency agreements to hedge or otherwise protect against fluctuations in foreign currency exchange rates. These agreements typically do not qualify for hedge accounting and gains/losses resulting from both the up-front premiums and/or settlement of the hedges at expiration of the agreements are recognized in the period in which they are incurred. During the nine months ended September 30, 2012, we entered into a series of foreign currency option and forward contracts to reduce our exposure to exchange rate volatility. The contracts were structured such that the underlying foreign currency exchange gains/losses would be offset by the mark-to-market impact of the hedging instruments and reduce the impact of foreign currency exchange movements throughout the period. The contracts entered into during the nine months ended September 30, 2012 did not qualify for hedge accounting. In the three and nine months ended September 30, 2012, we settled these hedges and recorded an aggregate gain of \$0.1 million and \$1.2 million, respectively, which offset the underlying foreign currency exchange losses and were recorded in cost of goods sold.

Credit Risk

Our customers are diversified by industry and geography with more than 800 customers in over 60 countries. We analyze the counterparties financial condition prior to extending credit and we establish credit limits and monitor the appropriateness of those limits on an ongoing basis. We also obtain cash, letters of credit or other acceptable forms of security from customers to provide credit support, where appropriate, based on our financial analysis of the customer and the contractual terms and conditions applicable to each transaction.

10. Impairment Charges

On September 30, 2012, our framework agreement with Formosa Petrochemical Corporation (FPCC) expired and we opted not to extend the agreement. The expired agreement had governed the formation of a proposed 50/50 joint venture to build, own and operate a 30-kiloton hydrogenated styrenic block copolymer (HSBC) plant at FPCC s petrochemical site in Mailiao, Taiwan. Due to the expiration of the agreement, we concluded that the long-lived assets related to the HSBC facility should be evaluated for impairment. In addition, we also evaluated our other long-lived assets for impairment. Based on these evaluations, we determined we had impaired long-lived assets for these groups and recorded pre-tax impairment charges aggregating \$5.4 million, for the three months ended September 30, 2012, of which \$3.4 million related to the long-lived assets associated with the HSBC facility and \$2.0 million related to other long-lived assets. The \$16.1 million carrying value of the long-lived assets attributable to the HSBC facility was reduced to fair market value of \$12.7 million and the \$2.0 million carrying value of the other long-lived assets was reduced to fair market value of \$0.0 million. We used internally developed assumptions in determining the fair value of these long-lived assets, which are classified within level 3 of the fair value hierarchy.

11. Income Taxes

Our income tax provision was a \$1.6 million benefit and a \$3.4 million expense for the three months ended September 30, 2012 and 2011, respectively. For the nine months ended September 30, 2012 and 2011, our income tax expense was \$4.4 million and \$10.1 million, respectively. Our effective tax rate was a 9.6% benefit, and a 7.4% expense for the three months ended September 30, 2012 and 2011, and a 24.7% expense and an 8.3% expense for the nine months ended September 30, 2012 and 2011, respectively. Our effective tax rates differed from the U.S. corporate statutory tax rate of 35.0%, primarily due to the mix of pre-tax income or loss earned in certain jurisdictions and our expected ability to utilize net operating loss carryforwards in certain jurisdictions, primarily in the United States.

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We record a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. As of September 30, 2012 and 2011, a valuation allowance of \$63.8 million and \$46.6 million, respectively, has been provided for net operating loss carryforwards and other deferred tax assets. For the three months ended September 30, 2012 and 2011, we increased our valuation allowance on deferred tax assets by \$9.8 million and reduced our valuation allowance on deferred tax assets by \$11.0 million, respectively. For the nine months ended September 30, 2012 and 2011, we increased our valuation allowance on deferred tax assets by \$9.6 million and reduced our valuation allowance on deferred tax assets by \$19.8 million, respectively. Excluding the change in our valuation allowance, our effective tax rate would have been a 66.4% benefit and a 25.6% expense for the three months ended September 30, 2012 and 2011, and a 29.1% benefit and a 22.1% expense for the nine months ended September 30, 2012 and 2011, respectively.

As of September 30, 2012 and 2011, we had total unrecognized tax benefits of \$4.4 million and \$1.8 million, respectively, related to uncertain foreign tax positions, all of which, if recognized, would impact our effective tax rate. During the three months ended September 30, 2012 and 2011, we had an increase in uncertain tax positions of \$0.4 million and \$0.3 million, respectively, primarily related to uncertain tax positions in Europe. During the nine months ended September 30, 2012 and 2011, we had an increase in uncertain tax positions of \$1.5 million and a decrease of \$2.1 million, respectively, primarily related to uncertain tax positions in Europe. We recorded interest and penalties related to unrecognized tax benefits within the provision for income taxes. We believe that no current tax positions that have resulted in unrecognized tax benefits will significantly increase or decrease within one year.

We file income tax returns in the U.S. federal jurisdiction and in various state and foreign jurisdictions. For our U.S. federal income tax returns, the statute of limitations has expired through the tax year ended December 31, 2003. As a result of net operating loss carryforwards from 2004, the statute of limitations remains open for all years subsequent to 2003. In addition, open tax years for state and foreign jurisdictions remain subject to examination.

The Internal Revenue Service has completed its review of our 2009 U.S. federal income tax return. We do not expect the final resolution of this matter to have a material impact on our financial position or results of operations.

12. Commitments and Contingencies

Legal Proceedings. We received notice from the tax authorities in Brazil assessing \$2.3 million in connection with tax credits that were generated from the purchase of certain goods. The credits were subsequently applied against taxes owed. The tax authorities assert that the goods purchased were not eligible to earn a credit. We have appealed this assessment and contend that the tax credits were earned. While the outcome of this proceeding cannot be predicted with certainty, we do not expect this matter to have a material adverse effect upon our financial position, results of operations or cash flows.

In 2011, we were notified by the tax authorities in France that we owed an additional 6.9 million of property taxes related to the 2009 tax year.

The tax authorities claimed that we did not timely file forms that serve to cap property taxes for 2009. We believe that all such forms were timely filed and that we were otherwise in compliance with the related applicable filing requirements. In March 2012, the tax authorities advised us of their final ruling in this matter and assessed us a final amount of 4.7 million, including penalties of 0.4 million. For the nine months ended September 30, 2012, we recorded charges of approximately \$5.6 million and \$0.6 million, on a pre-tax basis, to cost of goods sold and selling, general, and administrative expenses, respectively, associated with this ruling.

Kraton was a party to an arbitration proceeding with LyondellBasell regarding the ongoing effect of a multi-year term sheet that had been reached between the parties and put into effect in January 2009, covering certain terms and conditions applicable to operations and butadiene sales by LyondellBasell (for and to Kraton) at Berre, France and Wesseling, Germany. The parties had been dealing with one another in accordance with the term sheet from January 2009 until LyondellBasell notified Kraton on September 9, 2010 that LyondellBasell would

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no longer be governed by the term sheet. Following receipt of the September 9, 2010 notice, Kraton paid an increased net amount to LyondellBasell on a monthly basis (under protest) to reflect the pre-term sheet arrangements between the parties. On March 13, 2012, Kraton and LyondellBasell reached a settlement regarding the matter, and in connection therewith entered into a series of commercial agreements and amendments to existing commercial agreements. For the nine months ended September 30, 2012, we recorded a benefit of approximately \$6.8 million, on a pre-tax basis, to cost of goods sold for a refund received in the settlement of net increased payments we had been making to LyondellBasell.

We and certain of our subsidiaries, from time to time, are parties to various other legal proceedings, claims, and disputes that have arisen in the ordinary course of business. These claims may involve significant amounts, some of which would not be covered by insurance. A substantial settlement payment or judgment in excess of our accruals could have a material adverse effect on our financial position, results of operations or cash flows. While the outcome of these proceedings cannot be predicted with certainty, our management does not expect any of these other existing matters, individually or in the aggregate, to have a material adverse effect upon our financial position, results of operations or cash flows.

Asset Retirement Obligations. The changes in the aggregate carrying amount of our ARO liability are as follows:

	ARO Liability Balance (in thousands)
Balance at December 31, 2011	\$ 8,978
Accretion expense	432
Obligations settled	(588)
Revisions in estimated cash flows	843
Balance at September 30, 2012	\$ 9,665

There have been no other material changes to our Commitments and Contingencies disclosed in our most recently filed Annual Report on Form 10-K, as subsequently amended on March 8, 2012.

13. Employee Benefits

Retirement Plans. The components of net periodic benefit cost related to U.S. pension benefits are as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
	(in thousands)		(in thousands)	
Service cost	\$ 795	\$ 660	\$ 2,385	\$ 1,980
Interest cost	1,394	1,303	4,185	3,903
Expected return on plan assets	(1,464)	(1,310)	(4,455)	(3,930)
Amortization of prior service cost	683	252	2,048	746
Net periodic benefit cost	\$ 1,408	\$ 905	\$ 4,163	\$ 2,699

We made contributions of \$6.8 million and \$6.1 million to our pension plan in the nine months ended September 30, 2012 and 2011, respectively. Our total pension plan contributions in 2012 will be \$8.0 million as compared to \$7.4 million in 2011.

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The components of net periodic benefit cost related to other post-retirement benefits are as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
	(in thousands)		(in thousands)	
Service cost	\$ 127	\$ 104	\$ 383	\$ 324
Interest cost	305	310	915	925
Amortization of prior service cost	150	102	450	300
Net periodic benefit cost	\$ 582	\$ 516	\$ 1,748	\$ 1,549

14. Industry Segment and Foreign Operations

We operate in one segment for the manufacturing and marketing of engineered polymers. In accordance with the provisions of ASC 280, *Segment Reporting*, our chief operating decision-maker has been identified as the President and Chief Executive Officer, who reviews operating results to make decisions about allocating resources and assessing performance for the entire company. Since we operate in one segment and in one group of similar products, all financial segment and product line information required by ASC 280 can be found in the condensed consolidated financial statements.

We manufacture our products along the following primary product lines based upon polymer chemistry and process technologies:

unhydrogenated SBCs (USBCs);

hydrogenated SBCs (HSBCs);

Cariflex isoprene rubber and isoprene rubber latex; and

compounds.

Sales revenue for our four primary product lines are as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
	(in thousands)		(in thousands)	
USBCs	\$ 208,119	\$ 235,180	\$ 670,219	\$ 677,051
HSBCs	103,400	132,289	353,921	361,923
Cariflex	24,193	27,639	76,643	73,728
Compounds	6,685	6,885	23,799	20,547
Other	238	0	2,122	0
	\$ 342,635	\$ 401,993	\$ 1,126,704	\$ 1,133,249

For geographic reporting, sales revenue is attributed to the geographic location in which the customers' facilities are located. Long-lived assets consist primarily of property, plant, and equipment, which are attributed to the geographic location in which they are located and are presented at historical cost.

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Sales revenue and long-lived assets by geographic region are as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
	(in thousands)		(in thousands)	
Sales revenue:				
United States	\$ 103,114	\$ 142,745	\$ 375,453	\$ 389,524
Germany	52,078	58,162	152,277	167,990
Japan	23,561	22,561	64,757	64,766
China	19,324	16,269	59,241	45,964
France	12,361	12,680	39,188	37,214
Brazil	11,807	14,936	37,627	39,247
Belgium	10,745	14,201	36,340	33,516
Italy	10,445	10,661	34,945	39,732
Thailand	10,750	8,206	32,382	24,660
United Kingdom	7,411	11,450	30,499	33,684
The Netherlands	6,076	11,082	26,867	31,765
Turkey	5,293	6,741	24,071	20,831
Poland	6,758	7,580	16,879	14,293
Taiwan	4,744	3,863	14,784	14,098
Canada	4,170	5,471	14,769	18,780
Austria	4,467	6,446	14,622	16,895
Sweden	5,361	4,179	14,067	12,565
Australia	4,348	4,523	13,128	9,036
Malaysia	2,673	5,827	12,789	12,200
South Korea	4,068	3,307	12,457	11,434
Argentina	3,371	3,372	11,144	10,182
Mexico	3,443	2,379	9,891	8,353
All other countries	26,267	25,352	78,527	76,520
	\$ 342,635	\$ 401,993	\$ 1,126,704	\$ 1,133,249

	September 30,	December 31,
	2012	2011
	(in thousands)	
Long-lived assets:		
United States	\$ 412,287	\$ 387,022
France	116,997	115,169
Brazil	78,526	81,021
Germany	50,624	47,125
The Netherlands	14,142	13,355
China	5,448	4,394
Japan	1,955	1,893
All other countries	4,324	4,436
	\$ 684,303	\$ 654,415

Table of Contents**15. Related Party Transactions**

We own a 50% equity investment in an SBC manufacturing joint venture located in Kashima, Japan.

The aggregate amounts of related-party transactions were as follows:

	Three months ended		Nine months ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
	(in thousands)		(in thousands)	
Purchases from related party	\$ 8,518	\$ 6,706	\$ 39,188	\$ 24,445

The due to related party is solely related to our commercial arrangement associated with this joint venture, which requires payment within 150 days of invoice.

16. Supplemental Guarantor Information

Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, (the Issuers), are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Performance Polymers, Inc. and Elastomers Holdings LLC, a U.S. holding company and wholly-owned subsidiary of Kraton Polymers LLC, collectively, (the Guarantors), fully and unconditionally guarantee on a joint and several basis, the Issuers obligations under the 6.75% senior notes. Our remaining subsidiaries are not guarantors of the 6.75% senior notes. We do not believe that separate financial statements and other disclosures concerning the guarantor subsidiaries would provide any additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING BALANCE SHEET**

September 30, 2012

(Unaudited)

(In thousands, except par value)

	Kraton	Kraton Polymers LLC (1)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
ASSETS						
Current assets:						
Cash and cash equivalents	\$ 0	\$ 0	\$ 74,187	\$ 128,084	\$ 0	\$ 202,271
Receivables, net of allowances of \$496	0	429	53,021	111,100	0	164,550
Inventories of products	0	0	194,267	144,814	0	339,081
Inventories of materials and supplies	0	0	7,925	2,268	0	10,193
Deferred income taxes	0	0	8,199	1,440	0	9,639
Other current assets	0	4,953	600	22,330	0	27,883
Total current assets	0	5,382	338,199	410,036	0	753,617
Property, plant, and equipment, less accumulated depreciation of \$318,755	0	58,994	209,413	97,141	0	365,548
Identifiable intangible assets, less accumulated amortization of \$65,273	0	42,768	18,925	0	0	61,693
Investment in consolidated subsidiaries	554,738	1,275,730	0	0	(1,830,468)	0
Investment in unconsolidated joint venture	0	813	0	12,480	0	13,293
Debt issuance costs	0	11,624	0	0	0	11,624
Deferred income taxes	0	0	2,823	4,314	0	7,137
Other long-term assets	0	634	466,782	50,787	(493,517)	24,686
Total assets	\$ 554,738	\$ 1,395,945	\$ 1,036,142	\$ 574,758	\$ (2,323,985)	\$ 1,237,598
LIABILITIES AND STOCKHOLDERS AND MEMBER S EQUITY						
Current liabilities:						
Accounts payable-trade	0	1,212	33,191	60,977	0	95,380
Other payables and accruals	0	4,215	17,345	17,102	0	38,662
Due to related party	0	0	0	21,514	0	21,514
Deferred income taxes	0	68	4	537	0	609
Total current liabilities	0	5,495	50,540	100,130	0	156,165
Long-term debt, net of current portion	0	448,053	0	0	0	448,053
Deferred income taxes	0	12,886	0	0	0	12,886
Other long-term liabilities	0	373,537	79,279	129,595	(493,517)	88,894
Total liabilities	0	839,971	129,819	229,725	(493,517)	705,998
Commitments and contingencies (note 12)						
Stockholders and member s equity:						
Preferred stock, \$0.01 par value; 100,000 shares authorized; none issued	0	0	0	0	0	0
Common stock, \$0.01 par value; 500,000 shares authorized; 32,276 shares issued and outstanding	323	0	0	0	0	323
Additional paid in capital	353,518	0	0	0	0	353,518
Member s equity	0	554,738	947,322	328,408	(1,830,468)	0

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Retained earnings	200,897	0	0	0	0	200,897
Accumulated other comprehensive income (loss)	0	1,236	(40,999)	16,625	0	(23,138)
Total stockholders and member s equity	554,738	555,974	906,323	345,033	(1,830,468)	531,600
Total liabilities and stockholders and member s equity	\$ 554,738	\$ 1,395,945	\$ 1,036,142	\$ 574,758	\$ (2,323,985)	\$ 1,237,598

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING BALANCE SHEET****December 31, 2011****(In thousands, except par value)**

	Kraton	Kraton Polymers LLC (1)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
ASSETS						
Current assets:						
Cash and cash equivalents	\$ 0	\$ 0	\$ 6,030	\$ 82,549	\$ 0	\$ 88,579
Receivables, net of allowances of \$549	0	0	54,905	87,791	0	142,696
Inventories of products	0	0	222,783	172,013	0	394,796
Inventories of materials and supplies	0	0	7,654	2,342	0	9,996
Deferred income taxes	0	0	1,881	259	0	2,140
Other current assets	0	3,365	344	23,619	0	27,328
Total current assets	0	3,365	293,597	368,573	0	665,535
Property, plant, and equipment, less accumulated depreciation of \$281,442	0	66,095	205,562	101,316	0	372,973
Identifiable intangible assets, less accumulated amortization of \$58,530	0	47,961	18,223	0	0	66,184
Investment in consolidated subsidiaries	535,412	1,218,793	0	0	(1,754,205)	0
Investment in unconsolidated joint venture	0	813	0	12,537	0	13,350
Debt issuance costs	0	11,106	0	0	0	11,106
Other long-term assets	0	5,451	511,452	121,961	(614,256)	24,608
Total assets	\$ 535,412	\$ 1,353,584	\$ 1,028,834	\$ 604,387	\$ (2,368,461)	\$ 1,153,756
LIABILITIES AND STOCKHOLDERS AND MEMBER S EQUITY						
Current liabilities:						
Current portion of long-term debt	\$ 0	\$ 7,500	\$ 0	\$ 0	\$ 0	\$ 7,500
Accounts payable-trade	0	841	42,252	44,933	0	88,026
Other payables and accruals	0	7,832	14,125	29,296	0	51,253
Due to related party	0	0	0	14,311	0	14,311
Total current liabilities	0	16,173	56,377	88,540	0	161,090
Long-term debt, net of current portion	0	385,000	0	0	0	385,000
Deferred income taxes	0	14,505	(7,330)	(961)	0	6,214
Other long-term liabilities	0	401,573	78,754	217,587	(614,256)	83,658
Total liabilities	0	817,251	127,801	305,166	(614,256)	635,962
Commitments and contingencies (note 12)						
Stockholders and member s equity:						
Preferred stock, \$0.01 par value; 100,000 shares authorized; none issued	0	0	0	0	0	0
Common stock, \$0.01 par value; 500,000 shares authorized; 32,092 shares issued and outstanding	321	0	0	0	0	321
Additional paid in capital	347,455	0	0	0	0	347,455
Member s equity	0	535,412	942,032	276,761	(1,754,205)	0
Retained earnings	187,636	0	0	0	0	187,636
Accumulated other comprehensive income (loss)	0	921	(40,999)	22,460	0	(17,618)

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Total stockholders and member s equity	535,412	536,333	901,033	299,221	(1,754,205)	517,794
Total liabilities and stockholders and member s equity	\$ 535,412	\$ 1,353,584	\$ 1,028,834	\$ 604,387	\$ (2,368,461)	\$ 1,153,756

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS****Three months ended September 30, 2012****(Unaudited)****(In thousands)**

	Kraton	Kraton Polymers LLC (1)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Sales revenue	\$ 0	\$ 0	\$ 163,070	\$ 218,801	\$ (39,236)	\$ 342,635
Cost of goods sold	0	(210)	147,891	191,437	(39,236)	299,882
Gross profit	0	210	15,179	27,364	0	42,753
Operating expenses						
Research and development	0	0	4,770	2,631	0	7,401
Selling, general, and administrative	0	11	16,151	7,285	0	23,447
Depreciation and amortization	0	4,079	8,715	3,315	0	16,109
Impairment of long-lived assets	0	0	5,434	0	0	5,434
Total operating expenses	0	4,090	35,070	13,231	0	52,391
Earnings (loss) in consolidated subsidiaries	(15,499)	(3,041)	0	0	18,540	0
Earnings of unconsolidated joint venture	0	0	0	133	0	133
Interest expense (income), net	0	9,696	(3,632)	1,570	0	7,634
Income (loss) before income taxes	(15,499)	(16,617)	(16,259)	12,696	18,540	(17,139)
Income tax expense (benefit)	0	(1,118)	(661)	139	0	(1,640)
Net income (loss)	\$ (15,499)	\$ (15,499)	\$ (15,598)	\$ 12,557	\$ 18,540	\$ (15,499)

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS****Three months ended September 30, 2011****(Unaudited)****(In thousands)**

	Kraton	Kraton Polymers LLC (1)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Sales revenue	\$ 0	\$ 0	\$ 200,299	\$ 239,055	\$ (37,361)	\$ 401,993
Cost of goods sold	0	0	139,165	198,735	(37,361)	300,539
Gross profit	0	0	61,134	40,320	0	101,454
Operating expenses						
Research and development	0	0	4,251	2,452	0	6,703
Selling, general, and administrative	0	0	18,076	7,762	0	25,838
Depreciation and amortization	0	4,085	9,037	3,567	0	16,689
Total operating expenses	0	4,085	31,364	13,781	0	49,230
Earnings in consolidated subsidiaries	43,093	56,118	0	0	(99,211)	0
Earnings of unconsolidated joint venture	0	0	0	595	0	595
Interest expense (income), net	0	8,983	(3,761)	1,066	0	6,288
Income before income taxes	43,093	43,050	33,531	26,068	(99,211)	46,531
Income tax expense (benefit)	0	(43)	0	3,481	0	3,438
Net income	\$ 43,093	\$ 43,093	\$ 33,531	\$ 22,587	\$ (99,211)	\$ 43,093

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS**

Nine months ended September 30, 2012

(Unaudited)

(In thousands)

	Kraton	Kraton Polymers LLC (1)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Sales revenue	\$ 0	\$ 0	\$ 558,547	\$ 685,969	\$ (117,812)	\$ 1,126,704
Cost of goods sold	0	(1,295)	473,510	580,549	(117,812)	934,952
Gross profit	0	1,295	85,037	105,420	0	191,752
Operating expenses						
Research and development	0	0	14,483	8,474	0	22,957
Selling, general, and administrative	0	11	52,124	24,088	0	76,223
Depreciation and amortization	0	12,238	25,874	9,731	0	47,843
Impairment of long-lived assets	0	0	5,434	0	0	5,434
Total operating expenses	0	12,249	97,915	42,293	0	152,457
Earnings in consolidated subsidiaries	13,261	51,692	0	0	(64,953)	0
Earnings of unconsolidated joint venture	0	0	0	433	0	433
Interest expense (income), net	0	29,028	(11,145)	4,223	0	22,106
Income (loss) before income taxes	13,261	11,710	(1,733)	59,337	(64,953)	17,622
Income tax expense (benefit)	0	(1,551)	(1,778)	7,690	0	4,361
Net income	\$ 13,261	\$ 13,261	\$ 45	\$ 51,647	\$ (64,953)	\$ 13,261

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS**

Nine months ended September 30, 2011

(Unaudited)

(In thousands)

	Kraton	Kraton Polymers LLC (1)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Sales revenue	\$ 0	\$ 0	\$ 569,947	\$ 677,786	\$ (114,484)	\$ 1,133,249
Cost of goods sold	0	(120)	401,475	549,678	(114,484)	836,549
Gross profit	0	120	168,472	128,108	0	296,700
Operating expenses						
Research and development	0	0	12,625	7,646	0	20,271
Selling, general, and administrative	0	(180)	56,735	24,366	0	80,921
Depreciation and amortization	0	12,321	24,489	10,109	0	46,919
Total operating expenses	0	12,141	93,849	42,121	0	148,111
Loss on extinguishment of debt	0	2,985	0	0	0	2,985
Earnings in consolidated subsidiaries	111,947	159,120	0	0	(271,067)	0
Loss of unconsolidated joint venture	0	0	0	(144)	0	(144)
Interest expense (income), net	0	32,075	(11,474)	2,783	0	23,384
Income before income taxes	111,947	112,039	86,097	83,060	(271,067)	122,076
Income tax expense	0	92	0	10,037	0	10,129
Net income	\$ 111,947	\$ 111,947	\$ 86,097	\$ 73,023	\$ (271,067)	\$ 111,947

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS**

Nine months ended September 30, 2012

(Unaudited)

(In thousands)

	Kraton	Kraton Polymers LLC (1)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Cash flows provided by (used in) operating activities	\$ 0	\$ (69,068)	\$ 136,814	\$ 34,442	\$ 0	\$ 102,188
Cash flows provided by (used in) investing activities:						
Payments on intercompany loans	0	14,132	0	0	(14,132)	0
Purchase of property, plant, and equipment, net of proceeds from sales	0	0	(33,094)	(9,342)	0	(42,436)
Purchase of software	0	0	(1,842)	53	0	(1,789)
Settlement of net investment hedge	0	1,648	0	0	0	1,648
Net cash provided by (used in) investing activities	0	15,780	(34,936)	(9,289)	(14,132)	(42,577)
Cash flows provided by (used in) financing activities:						
Proceeds from debt	0	101,250	0	0	0	101,250
Repayments of debt	0	(45,626)	0	0	0	(45,626)
Cash contributions from member	0	820	0	0	(820)	0
Cash distributions to member	(820)	0	0	0	820	0
Proceeds from the exercise of stock options	820	0	0	0	0	820
Debt issuance costs	0	(3,156)	0	0	0	(3,156)
Proceeds from (repayments of) intercompany loans	0	0	(33,722)	19,590	14,132	0
Net cash provided by (used in) financing activities	0	53,288	(33,722)	19,590	14,132	53,288
Effect of exchange rate differences on cash	0	0	0	793	0	793
Net increase in cash and cash equivalents	0	0	68,156	45,536	0	113,692
Cash and cash equivalents, beginning of period	0	0	6,030	82,549	0	88,579
Cash and cash equivalents, end of period	\$ 0	\$ 0	\$ 74,186	\$ 128,085	\$ 0	\$ 202,271

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS**

Nine months ended September 30, 2011

(Unaudited)

(In thousands)

	Kraton	Kraton Polymers LLC (1)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Cash flows provided by (used in) operating activities	\$ 0	\$ (24,639)	\$ 11,702	\$ 16,487	\$ 0	\$ 3,550
Cash flows provided by (used in) investing activities:						
Proceeds from intercompany loans	0	22,884	0	0	(22,884)	0
Purchase of property, plant, and equipment, net of proceeds from sales	0	0	(34,395)	(12,325)	0	(46,720)
Purchase of software	0	0	(2,968)	0	0	(2,968)
Net cash provided by (used in) investing activities	0	22,884	(37,363)	(12,325)	(22,884)	(49,688)
Cash flows provided by (used in) financing activities:						
Proceeds from debt	0	400,000	0	0	0	400,000
Repayments of debt	0	(391,285)	0	0	0	(391,285)
Cash contributions from member	0	8,271	0	0	(8,271)	0
Cash distributions to member	(8,271)	0	0	0	8,271	0
Proceeds from the exercise of stock options	8,271	0	0	0	0	8,271
Proceeds from insurance note payable	0	4,734	0	0	0	4,734
Repayments of insurance note payable	0	(4,734)	0	0	0	(4,734)
Debt issuance costs	0	(15,231)	0	0	0	(15,231)
Proceeds from (repayments of) intercompany loans	0	0	19,116	(42,000)	22,884	0
Net cash provided by (used in) financing activities	0	1,755	19,116	(42,000)	22,884	1,755
Effect of exchange rate differences on cash	0	0	0	(2,819)	0	(2,819)
Net decrease in cash and cash equivalents	0	0	(6,545)	(40,657)	0	(47,202)
Cash and cash equivalents, beginning of period	0	0	31,421	61,329	0	92,750
Cash and cash equivalents, end of period	\$ 0	\$ 0	\$ 24,876	\$ 20,672	\$ 0	\$ 45,548

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

17. Subsequent Events

We have evaluated significant events and transactions that occurred after the balance sheet date and determined that there were no events or transactions other than those disclosed above that would require recognition or disclosure in our condensed consolidated financial statements for the period ended September 30, 2012.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

INTRODUCTION

You should read the following discussion of our financial condition and results of operations with our audited consolidated financial statements and related notes thereto included in our Annual Report on Form 10-K as of and for the year ended December 31, 2011, as subsequently amended on March 8, 2012. This discussion contains forward-looking statements and involves numerous risks and uncertainties, including, but not limited to, the risk factors discussed in the Risk Factors section of our most recent Form 10-K and subsequent quarterly reports on Form 10-Q, as well as in Factors Affecting Our Results of Operations and elsewhere in this Form 10-Q. Actual results may differ materially from those contained in any forward-looking statements.

OVERVIEW

We are a leading global producer of styrenic block copolymers (SBCs) and other engineered polymers. We market our products under the Kraton[®], Cariflex[™], and NEXAR[™] brands. SBCs are highly-engineered synthetic elastomers, which we invented and commercialized almost 50 years ago, that enhance the performance of numerous end use products by imparting greater flexibility, resilience, strength, durability, and processability. Our polymers are typically formulated or compounded with other products to achieve improved, customer-specific performance characteristics in a variety of applications. Our SBC products are found in many everyday applications, including personal care products such as disposable diapers and the rubberized grips of toothbrushes, razor blades, and power tools. Our products are also used to impart tack and shear properties in a wide variety of adhesive products and to impart characteristics such as, flexibility and durability in sealants and corrosion resistance in coatings. Our paving and roofing applications provide durability, extending road and roof life. We also produce Cariflex isoprene rubber and isoprene rubber latex. Our Cariflex products are highly-engineered, non-SBC synthetic substitutes for natural rubber latex. Our Cariflex products, which have not been found to contain the proteins present in natural rubber latex and are, therefore, not known to cause allergies, are used in applications such as surgical gloves and condoms. We believe the versatility of Cariflex provides opportunities for new, high margin applications. In addition to Cariflex, we have a portfolio of innovations at various stages of development and commercialization, including polyvinyl chloride (PVC) alternatives for wire, cable, medical applications, polymers used in slush molding for automotive applications, and our NEXAR family of membrane polymers for water filtration, breathable fabrics, and synthetic cement formulations for use in oilfield applications.

We offer our customers a broad portfolio of products and manufacture our products along the following primary product lines based upon polymer chemistry and process technologies:

unhydrogenated SBCs (USBCs);

hydrogenated SBCs (HSBCs);

Cariflex isoprene rubber (IR) and isoprene rubber latex (IRL); and

compounds.

The majority of worldwide SBC production is dedicated to USBCs, which are primarily used in paving and roofing, in adhesives, sealants and coatings, and in footwear applications. HSBCs, which are significantly more complex and capital-intensive to manufacture than USBCs, are primarily used in more differentiated applications, such as soft touch and flexible materials, personal hygiene products, medical products, automotive components, and certain adhesives and sealant applications. We sometimes refer to complex or specialized polymers as being differentiated, as they generally yield higher margins than less differentiated products.

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Product Line Sales Revenue:	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
USBCs	60.7%	58.5%	59.5%	59.8%
HSBCs	30.2%	32.9%	31.4%	31.9%
Cariflex	7.1%	6.9%	6.8%	6.5%
Compounds	1.9%	1.7%	2.1%	1.8%
Other	0.1%	0.0%	0.2%	0.0%

End Use Markets Sales Revenue Mix (1)	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Advanced Materials	27.3%	25.4%	26.8%	28.2%
Adhesives, Sealants and Coatings	34.0%	35.3%	35.6%	34.1%
Paving and Roofing	31.5%	32.4%	30.6%	31.0%
Cariflex	7.1%	6.9%	6.8%	6.5%
Other	0.1%	0.0%	0.2%	0.2%

- (1) We realigned our core end use markets in the fourth quarter of 2011. The Emerging Businesses end use, which previously was comprised primarily of IR and IRL sales, has been renamed Cariflex, and IR sales previously reported in our Advanced Materials, and in our Adhesives, Sealants and Coatings end use markets are now reported in the Cariflex end use. Additionally, sales of lubricant additives, which were previously not included in our four core end uses, are now reported in our Adhesives, Sealants and Coatings end use. Sales revenue data in the table above and other data for our core end use markets are reported on this realigned basis for the three and nine months ended September 30, 2012, as well as for prior periods.

2012 Third Quarter Financial Overview

Sales volume was 79.3 kilotons in the third quarter of 2012 compared to 77.6 kilotons in the third quarter of 2011, an increase of 2.2%.

Sales revenue decreased \$59.4 million in the third quarter of 2012 compared to the third quarter of 2011, primarily due to decreases in average selling prices of \$36.2 million related to declines in raw material costs, primarily butadiene, and a \$25.0 million negative impact from changes in foreign currency exchange rates.

Gross profit was \$42.8 million in the third quarter of 2012 compared to \$101.5 million in the third quarter of 2011. Included in the period-over-period decline of \$58.7 million, is a \$69.7 million negative impact associated with the spread between the first-in, first-out (FIFO) basis of accounting and estimated current replacement cost (ECRC). Net of the impact of this spread, gross profit at ECRC was \$80.4 million in the third quarter of 2012 compared to \$69.4 million in the third quarter of 2011.

Adjusted EBITDA was \$13.2 million in the third quarter of 2012 compared to \$71.1 million in the third quarter of 2011. Included in the period-over-period decline of \$57.9 million, is a \$69.7 million negative impact associated with the spread between FIFO and ECRC. Net of the impact of the spread, Adjusted EBITDA at ECRC was \$50.8 million in the third quarter of 2012 compared to \$39.0 million in the third quarter of 2011.

Net income declined \$58.6 million to a net loss of \$15.5 million or \$0.48 per diluted share in the third quarter of 2012 compared to net income of \$43.1 million or \$1.33 per diluted share in the third quarter of 2011.

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Cash provided by operating activities increased \$44.2 million to \$33.5 million in the third quarter of 2012 compared to cash used in operating activities of \$10.7 million in the third quarter of 2011.

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RESULTS OF OPERATIONS

Factors Affecting Our Results of Operations

Raw Materials and Product Mix. Our results of operations are directly affected by the cost of raw materials. We use butadiene, styrene, and isoprene as our primary raw materials in manufacturing our products. These monomers together represented approximately 64.0% and 62.2% of our total cost of goods sold for the three months ended September 30, 2012 and 2011, respectively, and 62.6% and 57.3% of our total cost of goods sold for the nine months ended September 30, 2012 and 2011 respectively. Since the cost of our three primary raw materials comprise a significant amount of our total cost of goods sold, our selling prices for our products and therefore our total sales revenue is impacted by movements in our raw material costs, as well as the cost of other inputs. For example, in the third quarter of 2012, our global product sales prices decreased primarily due to the decline in average raw material purchase prices. In addition, product mix can have an impact on our overall unit selling prices, since we provide an extensive product offering and therefore experience a wide range of unit selling prices.

The cost of these monomers has generally correlated with changes in energy prices, supply and demand factors, and prices for natural and synthetic rubber. Average purchase prices for all three monomers decreased during the three months ended September 30, 2012 compared to the three months ended June 30, 2012, with a more significant decrease in butadiene and modest decreases in both isoprene and styrene prices. Average butadiene and styrene purchase prices were lower during the three and nine months ended September 30, 2012 compared to the same periods in 2011, with a more significant decline in butadiene prices. Average isoprene purchase prices were higher during the three and nine months ended September 30, 2012 compared to the same periods in 2011.

We use the FIFO basis of accounting for inventory and cost of goods sold, and therefore gross profit. In periods of raw material price volatility, reported results under FIFO will differ from what the results would have been if cost of goods sold were based on ECRC. Specifically, in periods of rising raw material costs, reported gross profit will be higher under FIFO than under ECRC. Conversely, in periods of declining raw material costs, reported gross profit will be lower under FIFO than under ECRC. In recognition of the fact that the cost of raw materials affects our results of operations and the comparability of our results of operations we provide the spread between FIFO and ECRC.

In the three and nine months ended September 30, 2012, reported results under FIFO were lower than results would have been on an ECRC basis by \$37.6 million and \$20.3 million, respectively; and

In the three and nine months ended September 30, 2011, reported results under FIFO were higher than results would have been on an ECRC basis by \$32.1 million and \$102.9 million, respectively.

Our current view is that average monomer costs may decline slightly through year end driven by lower butadiene prices. As such, we currently anticipate that our gross profit will be negatively impacted by the spread between FIFO and ECRC of approximately \$5.0 million to \$10.0 million in the fourth quarter of 2012. This estimate is based on numerous complex and interrelated assumptions with respect to monomer costs, and ending inventory levels in the fourth quarter and the actual charge may be significantly different based on fourth quarter results.

International Operations and Currency Fluctuations. We operate a geographically diverse business, serving customers in over 60 countries from five manufacturing facilities on four continents. Although we sell and manufacture our products in many countries, our sales and production costs are mainly denominated in U.S. dollars, Euro, Japanese Yen and Brazilian Real. From time to time, we use hedging strategies to reduce our exposure to currency fluctuations.

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We generated our sales revenue from customers located in the Americas, Europe, and the Asia Pacific regions.

Revenue by Geography:	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Americas	36.9%	42.5%	40.3%	41.4%
Europe, Middle East, and Africa	41.5%	39.9%	39.9%	40.7%
Asia Pacific	21.6%	17.6%	19.8%	17.9%

Our financial results are subject to gains and losses on currency translations, which occur when the financial statements of our foreign operations are translated into U.S. dollars. The financial statements of operations outside the United States where the local currency is considered to be the functional currency are translated into U.S. dollars using the exchange rate at each balance sheet date for assets and liabilities and the average exchange rate for each period for revenues, expenses, gains and losses and cash flows. The effect of translating the balance sheet into U.S. dollars is included as a component of accumulated other comprehensive loss in our Condensed Consolidated Balance Sheets. Any appreciation of the functional currencies against the U.S. dollar will increase the U.S. dollar equivalent of amounts of revenues, expenses, gains and losses and cash flows, and any depreciation of the functional currencies will decrease the U.S. dollar amounts reported. Our results of operations are also subject to currency transaction risk. We incur currency transaction risk when we enter into either a purchase or sale transaction using a currency other than the local currency of the transacting entity. The estimated impact from currency fluctuations amounted to pre-tax losses of \$2.1 million and \$4.9 million for the three and nine months ended September 30, 2012 and pre-tax losses of \$0.4 million and \$0.9 million for the three and nine months ended September 30, 2011. The primary driver for the increase in our pre-tax losses for the periods presented was the change in foreign currency exchange rates between the Euro and U.S. dollar.

Seasonality. Seasonal changes and weather conditions typically affect the Paving and Roofing end use market generally resulting in higher sales volumes into this end use market in the second and third quarters of the calendar year versus the first and fourth quarters of the calendar year. However, sales volumes into this end use market were lower in the second and third quarter of 2012 than in the first quarter of 2012, during which demand was higher than normal, particularly in Europe and North America paving. Our other end use markets tend to show relatively little seasonality.

Recent Developments

Plans to Expand Hydrogenated Styrenic Block Copolymer (HSBC) Capacity in Asia. We recently opted not to extend our previously announced framework agreement with Formosa Petrochemical Corporation (FPCC) which expired, in accordance with its terms, on September 30, 2012. The expired agreement had governed the formation of a proposed 50/50 joint venture to build, own and operate a 30 kiloton HSBC plant at FPCC's petrochemical site in Mailiao, Taiwan. Progress on the HSBC joint venture project had been significantly delayed while FPCC waited initially for environmental permit approval, and subsequently while FPCC sought resolution regarding conditions on which the permit was finally approved in July, 2012. FPCC considered the conditions to be too restrictive and limiting on its overall operation in Mailiao, Taiwan.

We are moving forward with a stand-alone HSBC expansion project in the Asia Pacific region. Locations in the region, including those in China, which were identified during our site selection process conducted in 2010 and early 2011, will be the primary areas of focus. We believe a significant amount of the engineering and design work conducted to date will be applicable to the alternate location. Presently, however, it is not possible to estimate with certainty either the project cost or the time-line for completion at an alternate stand-alone location. However, the options under consideration are within existing industrial sites where we should have access to existing infrastructure and utilities, thus helping to control overall project expenditure. In the third quarter 2012, we incurred a pre-tax impairment charge of \$3.4 million associated with the write-off of a portion of project costs associated with our joint venture efforts in Mailiao, Taiwan.

Table of Contents***Three Months Ended September 30, 2012 Compared to Three Months Ended September 30, 2011****Sales Revenue*

Sales revenue decreased \$59.4 million or 14.8% to \$342.6 million for the three months ended September 30, 2012 from \$402.0 million for the three months ended September 30, 2011. The decrease was largely due to global product sales price decreases of \$36.2 million associated with the decline in monomer costs and changes in foreign currency exchange rates of \$25.0 million, partially offset by increased sales volumes of \$1.6 million. Sales volumes were 79.3 kilotons and 77.6 kilotons for the three months ended September 30, 2012 and 2011, an increase of 2.2%.

The following factors influenced our sales revenue in each of our core end use markets:

Advanced Materials. Sales revenue decreased \$8.6 million or 8.4% to \$93.7 million for the three months ended September 30, 2012 from \$102.3 million for the three months ended September 30, 2011. Changes in foreign currency exchange rates represented \$4.0 million of the \$8.6 million decline in sales revenue. The balance of the decline in sales revenue was due to lower average selling prices associated with declines in raw material costs, primarily butadiene, which were partially offset by improved sales volume in more differentiated products, including innovation grades for PVC alternatives.

Adhesives, Sealants and Coatings. Sales revenue decreased \$25.3 million or 17.8% to \$116.5 million for the three months ended September 30, 2012 from \$141.8 million for the three months ended September 30, 2011. Changes in foreign currency exchange rates accounted for \$7.9 million of the \$25.3 million decline in sales revenue. The balance of the decline in sales revenue was due to lower sales volume and, to a lesser extent, lower average selling prices associated with declines in raw material costs, primarily butadiene. The decline in sales volume was due to the timing of sales of lubricant additives, as sales volume for other applications in this end use increased compared to the third quarter of 2011. Within the innovation portfolio, third quarter 2012 sales volume increased compared to the third quarter 2011, primarily for printing plate applications.

Paving and Roofing. Sales revenue decreased \$22.2 million or 17.0% to \$108.1 million for the three months ended September 30, 2012 from \$130.3 million for the three months ended September 30, 2011. Changes in foreign currency exchange rates accounted for \$10.9 million of the \$22.2 million decline in sales revenue. The balance of the decline in sales revenue was the result of lower average selling prices associated with declines in raw material costs, primarily butadiene, which were partially offset by increased sales volume. Sales volume increased in all markets with the exception of North America, in which paving and, to a lesser extent, roofing sales volume declined year-on-year. A portion of the growth in paving volume was in target growth markets in Asia and the Middle East. Sales of our innovative highly modified asphalt (HiMA) volume increased in the third quarter of 2012 compared to the third quarter of 2011.

Cariflex™. Sales revenue decreased \$3.4 million or 12.3% to \$24.2 million for the three months ended September 30, 2012 from \$27.6 million for the three months ended September 30, 2011. Changes in foreign currency exchange rates accounted for \$2.2 million of the \$3.4 million decline in sales revenue. The remaining \$1.2 million decline was the result of lower sales volume, largely due to the timing of buying patterns by our customers, partially offset by higher average selling prices.

Cost of Goods Sold

Cost of goods sold decreased \$0.7 million or 0.2% to \$299.9 million for the three months ended September 30, 2012 from \$300.5 million for the three months ended September 30, 2011. The change in cost of goods sold was driven largely by a \$20.3 million decline from changes in foreign currency exchange rates, largely offset by increased monomer costs of \$14.3 million, which includes the period-over-period \$69.7 million negative impact associated with the spread between the FIFO and ECRC basis, and increased sales volumes of \$4.3 million.

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Gross Profit

Gross profit decreased \$58.7 million or 57.9% to \$42.8 million for the three months ended September 30, 2012 from \$101.5 million for the three months ended September 30, 2011. For the three months ended September 30, 2012, our reported gross profit under FIFO was lower than what it would have been under ECRC by approximately \$37.6 million and for the three months ended September 30, 2011 was higher by \$32.1 million.

See *Factors Affecting Our Results of Operations Cost of Raw Materials* above.

Operating Expenses

Research and Development. Research and development expenses increased \$0.7 million or 10.4% primarily due to an increase in employee related costs commensurate with additions to staffing levels among our scientists and increased lease expense for our research and development facilities, partially offset by lower maintenance and operational costs. Research and development expenses were 2.2% and 1.7% of sales revenue for the three months ended September 30, 2012 and 2011, respectively.

Selling, General, and Administrative. Selling, general, and administrative expenses decreased \$2.4 million or 9.3%. The decrease was primarily due to a \$1.2 million decrease in costs associated with the proposed joint venture with FPCC, and \$0.8 million from changes in foreign currency exchange rates. Selling, general, and administrative expenses were 6.8% and 6.4% of sales revenue for the three months ended September 30, 2012 and 2011, respectively.

Depreciation and Amortization. Depreciation and amortization decreased \$0.6 million to \$16.1 million for the three months ended September 30, 2012 from \$16.7 million for the three months ended September 30, 2011 primarily due to changes in foreign currency exchange rates of \$0.5 million.

Impairment of long-lived assets. We recorded a pre-tax charge of \$5.4 million in the aggregate for the impairment of long-lived assets, of which \$3.4 million was related to the HSBC facility in Mailiao, Taiwan and \$2.0 million related to other long-lived assets.

Interest expense, net

Interest expense, net increased \$1.3 million or 21.4% to \$7.6 million for the three months ended September 30, 2012 from \$6.3 million for the three months ended September 30, 2011. The increase was primarily due to an increased average debt balance.

Income tax expense (benefit)

Our income tax provision was a \$1.6 million benefit and a \$3.4 million expense for the three months ended September 30, 2012 and September 30, 2011, respectively. Our effective tax rate was a 9.6% benefit and a 7.4% expense for the three months ended September 30, 2012 and 2011, respectively. Our effective tax rates differed from the U.S. corporate statutory tax rate of 35.0%, primarily due to the mix of pre-tax income or loss earned in certain jurisdictions and our expected ability to utilize net operating loss carryforwards in certain jurisdictions, primarily in the United States.

We record a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. As of September 30, 2012 and 2011, a valuation allowance of \$63.8 million and \$46.6 million, respectively, has been provided for net operating loss carryforwards and other deferred tax assets. For the three months ended September 30, 2012 and 2011, we increased our valuation allowance on deferred tax assets by \$9.8 million and reduced our valuation allowance on deferred tax assets by \$11.0 million, respectively. Excluding the change in our valuation allowance, our effective tax rate would have been a 66.4% benefit and a 25.6% expense for the three months ended September 30, 2012 and 2011, respectively.

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Our pre-tax income is generated in a number of jurisdictions and is subject to a number of different effective tax rates that are significantly lower than the U.S. corporate statutory tax rate of 35.0%. For the three months ended September 30, 2012, we earned \$13.2 million of pre-tax income in jurisdictions with an expected full year effective tax rate of 10.2%. For the three months ended September 30, 2011, we earned \$23.2 million of pre-tax income in jurisdictions with an expected full year effective tax rate of 10.5%.

Net income (loss)

Net loss was \$15.5 million or \$0.48 per diluted share for the three months ended September 30, 2012, a decrease of \$58.6 million compared to net income of \$43.1 million or \$1.33 per diluted share in the same period in 2011. Net loss included charges for the impairment of long-lived assets of approximately \$3.5 million, net of tax, partially offset by a reduction to our storm related charges of \$0.2 million, net of tax. These items, net of tax, decreased our diluted earnings per share by \$0.10 for the three months ended September 30, 2012. The impact of the change in our valuation allowance decreased our diluted earnings per share by \$0.30 for the three months ended September 30, 2012 and increased our diluted earnings per share by \$0.34 for the three months ended September 30, 2011.

*Nine Months Ended September 30, 2012 Compared to Nine Months Ended September 30, 2011**Sales Revenue*

Sales revenue decreased \$6.5 million or 0.6% to \$1,126.7 million for the nine months ended September 30, 2012 from \$1,133.2 million for the nine months ended September 30, 2011. The decrease was largely due to changes in foreign currency exchange rates of \$58.2 million, partially offset by global product sales price increases of \$34.0 million and increased sales volumes of \$15.5 million. Sales volumes were 246.1 kilotons and 241.1 kilotons for the nine months ended September 30, 2012 and 2011, an increase of 2.1%.

The following factors influenced our sales revenue in each of our core end use markets:

Advanced Materials. Sales revenue decreased \$17.7 million or 5.5% to \$301.4 million for the nine months ended September 30, 2012 from \$319.2 million for the nine months ended September 30, 2011. Changes in foreign currency exchange rates accounted for \$9.0 million of the \$17.7 million decline in sales revenue. Sales volume was lower in 2012 compared to 2011, with a significant portion of the decline coming from sales of less differentiated products, partially offset by an increase in average selling prices. Sales of innovation grades for PVC alternatives in medical applications increased compared to the first nine months of 2011.

Adhesives, Sealants and Coatings. Sales revenue increased \$14.4 million or 3.7% to \$401.3 million for the nine months ended September 30, 2012 from \$386.9 million for the nine months ended September 30, 2011, despite a negative impact from foreign currency exchange rates of \$20.0 million. Average selling prices and sales volumes improved in 2012 compared to 2011. Sales volume was up broadly, including increased sales of lubricant additive applications. Sales volume increased in 2012 compared to 2011 for our innovation grades in printing plate and oil field applications.

Paving and Roofing. Sales revenue decreased \$6.3 million or 1.8% to \$345.2 million for the nine months ended September 30, 2012 from \$351.5 million for the nine months ended September 30, 2011. Excluding the \$24.1 million negative impact from changes in foreign currency exchange rates, revenue for the Paving and Roofing end use increased \$17.8 million year-on-year due to higher global sales volumes excluding North America, where both the paving and roofing sales volumes were lower than 2011. Outside North America, growth in sales volume was largely in European paving markets and in target markets of the Middle East and South America.

Cariflex™. Sales revenue increased \$3.0 million or 4.1% to \$76.6 million for the nine months ended September 30, 2012 from \$73.6 million for the nine months ended September 30, 2011. Excluding the \$5.1 million negative impact from changes in foreign currency exchange rates, Cariflex revenue

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improved \$8.1 million or 11.0%. The revenue increase reflects increased sales volume, mainly in surgical glove applications, and an increase in average selling prices across the Cariflex portfolio.

Cost of Goods Sold

Cost of goods sold increased \$98.4 million or 11.8% to \$935.0 million for the nine months ended September 30, 2012 from \$836.5 million for the nine months ended September 30, 2011. The increase was driven largely by increased monomer costs in the amount of \$125.7 million, which includes the period-over-period \$123.2 million negative impact associated with the spread between the FIFO and ECRC basis, increased sales volumes in the amount of \$12.8 million, a \$5.6 million charge associated with the resolution of a property tax dispute in France, storm related charges of \$2.5 million and restructuring and related charges of \$1.3 million, partially offset by a \$48.3 million decrease from changes in foreign currency exchange rates, and a \$6.8 million benefit associated with a refund received in settlement of a matter with LyondellBasell (the LBI settlement).

Gross Profit

Gross profit decreased \$104.9 million or 35.4% to \$191.8 million for the nine months ended September 30, 2012 from \$296.7 million for the nine months ended September 30, 2011. For the nine months ended September 30, 2012, our reported gross profit under FIFO was lower than what it would have been under ECRC by approximately \$20.3 million and for the nine months ended September 30, 2011 was higher by \$102.9 million. See *Factors Affecting Our Results of Operations Cost of Raw Materials* above.

Operating Expenses

Research and Development. Research and development expenses increased \$2.7 million or 13.3% primarily due to an increase in employee related costs commensurate with additions to staffing levels among our scientists and increased lease expense for our research and development facilities, partially offset by lower maintenance and operational costs. Research and development expenses were 2.0% and 1.8% of sales revenue for the nine months ended September 30, 2012 and 2011, respectively.

Selling, General, and Administrative. Selling, general, and administrative expenses decreased \$4.7 million or 5.8%. The decrease was primarily due to \$1.8 million from changes in foreign currency exchange rates, \$1.6 million in lower information technology costs, and \$1.3 million of lower employee related costs. Selling, general, and administrative expenses were 6.8% and 7.1% of sales revenue for the nine months ended September 30, 2012 and 2011, respectively.

Depreciation and Amortization. Depreciation and amortization increased \$0.9 million or 2.0% primarily due to increased levels of capital expenditures and depreciation of our asset retirement obligations.

Impairment of long-lived assets. We recorded a pre-tax charge of \$5.4 million in the aggregate for the impairment of long-lived assets, of which \$3.4 million was related to the HSBC facility in Mailiao, Taiwan and \$2.0 million related to other long-lived assets.

Loss on Extinguishment of Debt

In connection with the refinancing of our indebtedness in the first quarter of 2011, we incurred a \$3.0 million loss on the extinguishment of debt.

Interest expense, net

Interest expense, net decreased \$1.3 million or 5.5% to \$22.1 million for the nine months ended September 30, 2012 from \$23.4 million for the nine months ended September 30, 2011. The decrease was

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primarily due to charges aggregating \$5.2 million associated with the debt refinancing in the first quarter of 2011, partially offset by increased average debt balances.

Income tax expense (benefit)

Our income tax expense was \$4.4 million and \$10.1 million for the nine months ended September 30, 2012 and 2011, respectively. Our effective tax rate was a 24.7% expense and an 8.3% expense for the nine months ended September 30, 2012 and 2011, respectively. Our effective tax rates differed from the U.S. corporate statutory tax rate of 35.0%, primarily due to the mix of pre-tax income or loss earned in certain jurisdictions and our expected ability to utilize net operating loss carryforwards in certain jurisdictions, primarily in the United States.

We record a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. As of September 30, 2012 and 2011, a valuation allowance of \$63.8 million and \$46.6 million, respectively, has been provided for net operating loss carryforwards and other deferred tax assets. For the nine months ended September 30, 2012 and 2011, we increased our valuation allowance on deferred tax assets by \$9.6 million and reduced our valuation allowance on deferred tax assets by \$19.8 million, respectively. Excluding the change in our valuation allowance, our effective tax rate would have been a 29.1% benefit and a 22.1% expense for the nine months ended September 30, 2012 and 2011, respectively.

Our pre-tax income is generated in a number of jurisdictions and is subject to a number of different effective tax rates that are significantly lower than the U.S. corporate statutory tax rate of 35.0%. For the nine months ended September 30, 2012, we earned \$55.8 million of pre-tax income in jurisdictions with an expected full year effective tax rate of 10.2%. For the nine months ended September 30, 2011, we earned \$69.4 million of pre-tax income in jurisdictions with an expected full year effective tax rate of 10.5%.

Net income

Net income was \$13.3 million or \$0.41 per diluted share for the nine months ended September 30, 2012, a decrease of \$98.7 million compared to net income of \$111.9 million or \$3.45 per diluted share in the same period in 2011. Net income for the nine months ended September 30, 2012 included charges of approximately \$12.2 million, net of tax, associated with a property tax dispute in France, impairment related charges, storm related charges, restructuring and related charges, and costs associated with our March 2012 offering, partially offset by \$6.9 million, net of tax, associated with the LBI settlement. These items, net of tax, decreased our diluted earnings per share by \$0.16 for the nine months ended September 30, 2012. Net income for the nine months ended September 30, 2011 included charges of approximately \$9.8 million, net of tax, or \$0.30 per diluted share associated with restructuring and related charges, costs associated with debt refinancing, costs associated with a secondary public offering of our common stock and charges associated with evaluating acquisition transactions. The impact of the change in our valuation allowance decreased our diluted earnings per share by \$0.29 for the nine months ended September 30, 2012 and increased our diluted earnings per share by \$0.61 for the nine months ended September 30, 2011.

Critical Accounting Policies

For a discussion of our critical accounting policies and estimates that require the use of significant estimates and judgments, see Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies in our Annual Report on Form 10-K for the year ended December 31, 2011, subsequently amended on March 8, 2012.

Table of Contents***EBITDA, Adjusted EBITDA, Adjusted EBITDA at ECRC and Gross Profit at ECRC***

We consider EBITDA, Adjusted EBITDA, Adjusted EBITDA at ECRC and Gross Profit at ECRC to be important supplemental measures of our performance and believe they are frequently used by investors, securities analysts, and other interested parties in the evaluation of our performance. In addition, management uses these measures to evaluate operating performance, and our executive compensation plan bases incentive compensation payments on our Adjusted EBITDA performance, along with other factors. EBITDA, Adjusted EBITDA, Adjusted EBITDA at ECRC and Gross Profit at ECRC have limitations as analytical tools and in some cases can vary substantially from other measures of our performance. You should not consider any of them in isolation, or as substitutes for analysis of our results under generally accepted accounting principles in the United States (US GAAP).

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
	(in thousands)		(in thousands)	
EBITDA (1)	\$ 6,604	\$ 69,508	\$ 87,571	\$ 192,379
Adjusted EBITDA (2)	\$ 13,210	\$ 71,063	\$ 101,185	\$ 201,280
Adjusted EBITDA at ECRC (3)	\$ 50,846	\$ 38,975	\$ 121,482	\$ 98,337
Gross Profit at ECRC (4)	\$ 80,389	\$ 69,366	\$ 212,049	\$ 193,757

- (1) EBITDA represents net income before interest, taxes, depreciation and amortization.

Some of the limitations for EBITDA as an analytical tool are:

EBITDA does not reflect our cash expenditures, or future requirements for capital expenditures or contractual commitments;

EBITDA does not reflect changes in, or cash requirements for, our working capital needs;

EBITDA does not reflect the significant interest expense, or the cash requirements necessary to service interest or principal payments, on our debt;

although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future, and EBITDA does not reflect any cash requirements for such replacements;

EBITDA calculations under the terms of our debt agreements may vary from EBITDA presented herein, and our presentation of EBITDA herein is not for purposes of assessing compliance or non-compliance with financial covenants under our credit agreement;

other companies in our industry may calculate EBITDA differently than we do, limiting its usefulness as a comparative measure; and

EBITDA is not a measure of discretionary cash available to us to invest in the growth of our business

- (2) We present Adjusted EBITDA as a further supplemental measure of our performance and because we believe these additional adjustments provide helpful information to investors, securities analysts and other interested parties in the evaluation of our performance. We prepare Adjusted EBITDA by adjusting EBITDA to eliminate the impact of a number of items we do not consider indicative of our ongoing

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operating performance. We explain how each adjustment is derived and why we believe it is helpful and appropriate in the reconciliation below. You are encouraged to evaluate each adjustment and the reasons we consider it appropriate for supplemental analysis. As an analytical tool, Adjusted EBITDA is subject to all the limitations applicable to EBITDA. In addition, in evaluating Adjusted EBITDA, you should be aware that in the future we may incur expenses similar to the adjustments in this presentation. Our presentation of Adjusted EBITDA should not be construed as an inference that our future results will be unaffected by unusual or non-recurring items.

- (3) Adjusted EBITDA at estimated current replacement cost (ECRC) is Adjusted EBITDA net of the impact of the spread between the FIFO basis of accounting and ECRC. Although we report our financial results using

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the FIFO basis of accounting, as part of our pricing strategy, we measure our business performance using the estimated current replacement cost of our inventory and cost of goods sold. In addition, volatility in the cost of raw materials affects our results of operations and the period-over-period comparability of our results of operations. Therefore, we provide the spread between FIFO and ECRC, and we present Adjusted EBITDA at ECRC as another supplemental measure of our performance. We believe this additional adjustment provides helpful information to investors, securities analysts and other interested parties in evaluating period-over-period comparisons of our performance. As an analytical tool, Adjusted EBITDA at ECRC is subject to all the limitations applicable to EBITDA, as well as the following limitations:

due to volatility in raw material prices, Adjusted EBITDA at ECRC may, and often does, vary substantially from EBITDA, net income and other performance measures, including net income calculated in accordance with US GAAP; and

Adjusted EBITDA at ECRC may, and often will, vary significantly from EBITDA calculations under the terms of our debt agreements and should not be used for assessing compliance or non-compliance with financial covenants under our credit agreement. Our presentation of Adjusted EBITDA at ECRC should not be construed as an inference that our future results will be unaffected by unusual or non-recurring items.

- (4) Gross Profit at ECRC is gross profit net of the impact of the spread between the FIFO basis of accounting and ECRC. Although we report our financial results using the FIFO basis of accounting, as part of our pricing strategy, we measure our business performance using the estimated current replacement cost of our inventory and cost of goods sold. In addition, volatility in the cost of raw materials affects our results of operations and the period-over-period comparability of our results of operations. Therefore, we provide Gross Profit at ECRC as another supplemental measure of our performance. We believe this adjustment provides helpful information to investors, securities analysts and other interested parties in the evaluating period-over-period comparisons of our performance. As a measure of our performance, Gross Profit at ECRC is limited because it often varies substantially from gross profit calculated in accordance with US GAAP because of volatility in raw material prices.

We compensate for these limitations by relying primarily on our GAAP results and using EBITDA, Adjusted EBITDA, Adjusted EBITDA at ECRC and Gross Profit at ECRC only as supplemental measures.

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We reconcile net income (loss) to EBITDA, Adjusted EBITDA and Adjusted EBITDA at ECRC as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
	(in thousands)		(in thousands)	
Net income (loss)	\$ (15,499)	\$ 43,093	\$ 13,261	\$ 111,947
<i>Add:</i>				
Interest expense, net	7,634	6,288	22,106	23,384
Income tax expense (benefit)	(1,640)	3,438	4,361	10,129
Depreciation and amortization expenses	16,109	16,689	47,843	46,919
 EBITDA	 \$ 6,604	 \$ 69,508	 \$ 87,571	 \$ 192,379
<i>Add (deduct):</i>				
Settlement gain (a)	0	0	(6,819)	0
Property tax dispute (b)	0	0	6,211	0
Storm related charges (c)	(336)	0	2,481	0
Restructuring and related costs (d)	0	308	1,062	1,720
Non-cash compensation expense	1,508	1,247	5,245	4,196
Impairment of long-lived assets (e)	5,434	0	5,434	0
Loss on extinguishment of debt (f)	0	0	0	2,985
 Adjusted EBITDA	 13,210	 71,063	 101,185	 201,280
<i>Add (deduct):</i>				
Spread between FIFO and ECRC	37,636	(32,088)	20,297	(102,943)
 Adjusted EBITDA at ECRC (g)	 \$ 50,846	 \$ 38,975	 \$ 121,482	 \$ 98,337

- (a) Reflects the benefit of the LBI settlement, which is recorded in cost of goods sold.
- (b) Reflects the charge associated with the resolution of the property tax dispute in France, of which \$5,646 is recorded in cost of goods sold and \$565 is recorded in selling, general, and administrative expenses.
- (c) Reflects the storm related charge at our Belpre, Ohio facility, which is recorded in cost of goods sold.
- (d) Includes charges related to severance expenses, fees associated with the public offering of our senior notes, secondary public offering of our common stock, consulting fees, and charges associated with evaluating acquisition transactions.
- (e) Reflects the impairment of long-lived assets, of which \$3.4 million and \$2.0 million were associated with the HSBC facility and other long-term assets, respectively.
- (f) Reflects the loss on extinguishment of debt arising from the 2011 refinancing.
- (g) Adjusted EBITDA at estimated current replacement cost (ECRC) is Adjusted EBITDA net of the impact of the spread between the FIFO basis of accounting and ECRC. Although we report our financial results using the FIFO basis of accounting, as part of our pricing strategy, we measure our business performance using the estimated current replacement cost of our inventory and cost of goods sold. In addition, volatility in the cost of raw materials affects our results of operations and the period-over-period comparability of our results of operations. Therefore, we provide the spread between FIFO and ECRC, and we present Adjusted EBITDA at ECRC as another supplemental measure of our performance. We believe this additional adjustment provides helpful information to investors, securities analysts and other interested parties in evaluating period-over-period comparisons of our performance.

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We reconcile Gross Profit to Gross Profit at ECRC as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
	(in thousands)		(in thousands)	
Gross profit	\$ 42,753	\$ 101,454	\$ 191,752	\$ 296,700
<i>Add (deduct):</i>				
Spread between FIFO and ECRC	37,636	(32,088)	20,297	(102,943)
Gross profit at ECRC (a)	\$ 80,389	\$ 69,366	\$ 212,049	\$ 193,757

- (a) Gross Profit at ECRC is gross profit net of the impact of the spread between the FIFO basis of accounting and ECRC. Although we report our financial results using the FIFO basis of accounting, as part of our pricing strategy, we measure our business performance using the estimated current replacement cost of our inventory and cost of goods sold. In addition, volatility in the cost of raw materials affects our results of operations and the comparability of our results of operations. Therefore, we provide Gross Profit at ECRC as another supplemental measure of our performance. We believe this adjustment provides helpful information to investors, securities analysts and other interested parties in the evaluating period-over-period comparisons of our performance. As a measure of our performance, Gross Profit at ECRC is limited because it often varies substantially from gross profit calculated in accordance with US GAAP because of volatility in raw material prices.

LIQUIDITY AND CAPITAL RESOURCES

Known Trends and Uncertainties

Kraton Performance Polymers, Inc. is a holding company without any operations or assets other than the operations of its subsidiaries.

Based upon current and anticipated levels of operations, we believe that cash flows from operations of our subsidiaries, cash on hand, and borrowings available to us will be sufficient to fund our working capital requirements, our plan to expand HSBC capacity on a stand-alone basis, scheduled debt payments, interest payments, capital expenditures, benefit plan contributions, and income tax obligations. However, these cash flows are subject to a number of factors, including, but not limited to, earnings, sensitivities to the cost of raw materials, seasonality and fluctuations in foreign currency exchange rates. Because feedstock costs generally represent a substantial portion of our cost of goods sold, in periods of rising feedstock costs, we generally consume cash in operating activities due to increases in accounts receivable and inventory costs, partially offset by increased value of accounts payable. Conversely, during periods in which feedstock costs are declining, we generate cash flow from decreases in working capital.

Going forward there can be no assurance that our business will generate sufficient cash flow from operations or that future borrowings will be available under the senior secured credit facility to fund liquidity needs and enable us to service our indebtedness. At September 30, 2012, we had \$202.3 million of cash and cash equivalents. Our available cash and cash equivalents are held in accounts managed by third-party financial institutions and consist of cash invested in interest bearing funds and operating accounts. To date, we have not experienced any losses or lack of access to our invested cash or cash equivalents; however, we cannot provide any assurance that adverse conditions in the financial markets will not impact access to our invested cash and cash equivalents.

We have in place a \$350.0 million senior secured credit agreement that provides for a \$200.0 million senior secured revolving credit facility, a \$150.0 million senior secured term loan facility and an option to raise up to \$125.0 million of incremental term loans or incremental revolving credit commitments. We can voluntarily prepay these loans at par without premium or penalty.

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Under the terms of our senior secured credit agreement, we are subject to certain financial covenants, which include the maintenance of a maximum consolidated net leverage ratio, a minimum consolidated net interest coverage ratio and maximum capital expenditures. We are required to maintain a fiscal quarter end maximum consolidated net leverage ratio not to exceed 4.00:1.00 through December 31, 2012; not to exceed 3.50:1.00 beginning March 31, 2013 through December 31, 2013; not to exceed 3.25:1.00 beginning March 31, 2014 through December 31, 2014; and not to exceed 3.00:1.00 beginning March 31, 2015 and continuing thereafter. In addition, we are required to maintain a minimum consolidated net interest coverage ratio as of the end of any fiscal quarter of at least 3.00:1.00. Our failure to comply with any of these financial covenants would give rise to a default under the senior secured credit facility. The maintenance of these financial ratios is based primarily on our level of profitability and the amount of our outstanding debt obligations. If factors arise that negatively impact our profitability, we may not be able to satisfy our covenants. If we are unable to satisfy such covenants or other provisions at any future time we would need to seek an amendment or waiver of such financial covenants or other provisions. The respective lenders under the senior secured credit facility may not consent to any amendment or waiver requests that we may make in the future, and, if they do consent, they may do so on terms that are not favorable to us. In the event that we were unable to obtain any such waiver or amendment and we were not able to refinance or repay our senior secured credit facility, our inability to meet the financial covenants or other provisions of the senior secured credit facility would constitute an event of default under our senior secured credit facility, which would permit the bank lenders to accelerate the senior secured credit facility. Such acceleration may in turn constitute an event of default under our senior notes or other debt instruments. In light of the negative impact of the spread between FIFO and ECRC of \$56.9 million on the earnings that are used to calculate the consolidated net leverage ratio in the trailing twelve month period ended September 30, 2012, we made a \$40.0 million voluntary prepayment of outstanding indebtedness under our term loans in September 2012. At September 30, 2012, the consolidated net leverage ratio was 3.60 to 1.00, which was below the 4.00 to 1.00 maximum allowed under the senior secured credit agreement. As of September 30, 2012, and as of the date of the filing of this report, we have no outstanding draws under the revolving portion of our senior secured credit facility. Due to the consolidated net leverage ratio of 3.60 to 1.00, the amount available under the revolving portion of our senior secured credit facility was limited to \$44.1 million, and our liquidity amounted to \$246.4 million at September 30, 2012. However, as of the date of this filing, because we were in compliance with the applicable financial ratios and the other covenants in our senior secured credit agreement at September 30, 2012, we have available to us \$200.0 million under such revolving portion. We were also in compliance with the indenture governing our 6.75% senior notes as of September 30, 2012. We have borrowed all of the available commitments under the term loan portion of our credit facility. While we expect to meet the conditions required to provide us full access to the revolving portion of the senior secured credit facility, we cannot guarantee that all of the counterparties contractually committed to fund a revolving credit draw request will actually fund future requests, although we currently believe that each of the counterparties would meet their funding requirements. The term loan and revolving portions of the facility mature in February 2016. For additional information regarding our credit agreement, see *Senior Secured Credit Agreement* in Note 7 *Long-Term Debt* to the condensed consolidated financial statements, which is incorporated herein by reference.

We made contributions of \$6.8 million and \$6.1 million to our pension plan in the nine months ended September 30, 2012 and 2011, respectively. In July 2012, federal legislation was signed into law providing pension funding relief by effectively increasing the interest rates used to value the liability. We elected to apply the provisions of this law, which reduced our total 2012 pension contributions to \$8.0 million from \$10.2 million. Our total pension contributions in 2011 were \$7.4 million. Our pension plan obligations are predicated on a number of factors, the primary ones being the return on our pension plan assets and the discount rate used in deriving our pension obligations. If the investment return on our pension plan assets does not meet or exceed expectations during 2012, and the discount rate decreases from the prior year, higher levels of contributions could be required in 2013 and beyond.

As of September 30, 2012, we had \$128.1 million of cash and short-term investments related to foreign operations that management asserts are permanently reinvested. As a result of certain net operating loss carryforwards, management estimates approximately \$2.6 million of additional cash tax expense would be incurred if this cash were repatriated.

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Turbulence in U.S. and international markets and economies may adversely affect our liquidity and financial condition, the liquidity and financial condition of our customers, and our ability to timely replace maturing liabilities and access the capital markets to meet liquidity needs, resulting in adverse effects on our financial condition and results of operations. However, to date we have been able to access borrowings available to us in amounts sufficient to fund liquidity needs. Total receivables, net of allowances, for customers located in Italy, Spain, Portugal, Greece, and Ireland aggregated approximately \$9.6 million at September 30, 2012. We have not incurred to date, nor do we currently expect to incur any material losses associated with these trade receivables.

Our ability to pay principal and interest on our indebtedness, fund working capital, make anticipated capital expenditures, and expand HSBC capacity on a stand-alone basis depends on our future performance, which is subject to general economic conditions and other factors, some of which are beyond our control. See Part I, Item 1A. Risk Factors in our annual report on Form 10-K for the year ended December 31, 2011, as subsequently amended on March 8, 2012, for further discussion.

Operating Cash Flows and Liquidity

Net cash provided by operating activities totaled \$102.2 million and \$3.6 million for the nine months ended September 30, 2012 and 2011, respectively. This represents a net increase of \$98.6 million which was driven primarily by changes in working capital, partially offset by a decrease in net income, as follows:

a \$161.5 million decrease in inventories of products, materials and supplies, largely due to lower cost and to a lesser extent lower quantities;

a \$19.6 million decrease in accounts receivable primarily related to lower sales revenue and improved days sales outstanding;

a \$10.9 million increase in trade accounts payable primarily due to the timing of payments; and

a \$13.2 million increase in related party payables associated with purchases and timing of payments to our joint venture in Japan; partially offset by

an \$98.7 million decrease in net income.

Investing Cash Flows

Net cash used in investing activities totaled \$42.6 million and \$49.7 million for the nine months ended September 30, 2012 and 2011, respectively.

Expected Capital Expenditures. We currently expect 2012 capital expenditures will be approximately \$60.0 million to \$65.0 million. Included in our 2012 capital expenditure estimate is approximately \$18.2 million related to our semi-works facility and health, safety and environmental infrastructure and maintenance projects which typically range from \$16.0 million to \$22.0 million. The remaining anticipated 2012 capital expenditures are primarily associated with projects to optimize production capabilities of our manufacturing assets. We anticipate funding our 2012 capital expenditures with available liquidity.

Financing Cash Flows

Our consolidated capital structure as of September 30, 2012 was approximately 54% equity and 46% debt compared to approximately 59% equity and 41% debt as of September 30, 2011.

Net cash provided by financing activities totaled \$53.3 million and \$1.8 million for the nine months ended September 30, 2012 and 2011, respectively. The \$51.5 million increase was driven primarily by:

a \$391.3 million repayment of debt primarily related to the refinancing in February 2011, compared to a \$40.0 million voluntary prepayment on the term loan portion of the senior secured credit facility in September 2012;

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a \$12.1 million decrease in debt issuance costs paid; partially offset by

a \$298.8 million decrease in proceeds from debt, primarily related to \$150.0 million term debt and \$250.0 million senior notes in February 2011, partially offset by \$101.3 million from the issuance of senior notes in March 2012; and

a \$7.5 million decrease in proceeds from the exercise of employee stock options.

Description of Certain Indebtedness

In March 2012, we completed an offering of \$100.0 million principal amount of our unsecured 6.75% senior notes due in 2019 at an issue price of 101.250%. The notes constitute a further issuance of, and are fungible with the \$250.0 million aggregate principal amount of our 6.75% senior notes due 2019 issued in February 2011. Prior to March 1, 2015, we may redeem all or a part of the senior notes, at a redemption price equal to 100.00% of the principal amount of the senior notes redeemed plus the applicable premium as of, plus accrued and unpaid interest, if any, to the applicable redemption date. After March 1, 2015, we may redeem all or a part of the senior notes for 103.375%, 101.688%, and 100.000% of the principal amount in 2015, 2016 and 2017 and thereafter, respectively.

Concurrently with the \$100.0 million senior note offering, we entered into an amendment to our senior secured credit facility to, among other things, facilitate our ability to pursue a new manufacturing facility by providing for an additional \$50.0 million in investment capacity for certain investments and a \$75.0 million increase to the capital expenditures basket under certain circumstances. Additionally, the amendment provides for certain modifications to the consolidated net leverage ratio we are required to maintain and provides that certain guarantees by us or any of our subsidiaries not to exceed \$100.0 million shall not constitute indebtedness for purposes of compliance with certain financial covenants. See Note 7 *Long-Term Debt*, for further discussion.

Contractual Commitments

Our contractual obligations are summarized in *Part II, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations*, in our annual report on Form 10-K for the period ended December 31, 2011, as subsequently amended on March 8, 2012. Other than the \$40.0 million voluntary prepayment of outstanding indebtedness under the term loans and the offering of \$100.0 million principal amount of our 6.75% senior notes in March 2012, there have been no other material changes to the contractual obligation amounts disclosed in our annual report on Form 10-K for the year ended December 31, 2011. See Note 7 *Long-Term Debt* for further discussion.

Off-Balance Sheet Arrangements

We are not involved in any material off-balance sheet arrangements as of September 30, 2012.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

For quantitative and qualitative disclosures about market risk, see *Part II, Item 7A, Quantitative and Qualitative Disclosures About Market Risk*, in our annual report on Form 10-K for the year ended December 31, 2011, as subsequently amended on March 8, 2012. There have been no material changes to the quantitative and qualitative disclosures about market risk disclosed in our annual report on Form 10-K for the year ended December 31, 2011. See Note 9 *Fair Value Measurements, Financial Instruments, and Credit Risk* for further discussion.

Item 4. Controls and Procedures.

An evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15 under the Securities Exchange Act of 1934) was carried out under the supervision and

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with the participation of our management, including our Chief Executive Officer and Chief Financial Officer. As of September 30, 2012, based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective.

There has been no change in our internal control over financial reporting that occurred during the three months ended September 30, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

For information regarding legal proceedings, see Note 12 *Commitments and Contingencies*, to our condensed consolidated financial statements.

Item 1A. Risk Factors.

Readers of this Quarterly Report on Form 10-Q should carefully consider the risks described in our other reports filed with or furnished to the SEC, including our prior and subsequent reports on Forms 10-K, 10-Q and 8-K, in connection with any evaluation of our financial position, results of operations and cash flows.

Significant fluctuations in raw material costs may result in volatility in our quarterly operating results and impact the market price of our common stock.

We use the first-in, first-out (FIFO) basis of accounting for inventory and cost of goods sold, and therefore gross profit. In periods of raw material price volatility, reported results under FIFO will differ from what the results would have been if cost of goods sold were based on estimated current replacement cost (ECRC). Specifically, in periods of declining raw material costs, reported gross profit will be lower under FIFO than under ECRC, and in periods of rising raw material costs, gross profit will be higher under FIFO than under ECRC. However, because monomer costs are difficult to predict, we cannot accurately anticipate fluctuations in monomer costs with precision, or effectively or economically hedge against the effects of any such change. If monomer costs fluctuate in a quarter, our earnings will be affected, the magnitude of which could be significant, which could cause our earnings to depart from the periodic expectations of financial analysts or investors and, therefore, the market price of our common stock may be volatile as a result.

Our planned stand-alone HSBC manufacturing facility in Asia is subject to risks and uncertainties.

We are currently exploring our options to construct a 30-kiloton HSBC facility at a site to be determined in Asia. Locations in the region, including those in China, which were identified during our site selection process conducted in 2010 and early 2011, will be the primary areas of focus. This project is in its initial phase and remains subject to numerous known and unknown contingencies. We cannot be certain that we will be able to identify and acquire a suitable site for construction of the facility, or if such site is obtained, if we will be able to obtain all necessary permitting or other approvals for the construction of the facility in a timely fashion, if at all, or that the facility will be successfully constructed and operated within our expected timeframe or budget or yield expected results. If any of these risks materialize, our prospects in Asia and as a result, our ability to meet demand for HSBC products could be materially adversely affected.

The risks and uncertainties in our most recent Annual Report on Form 10-K, as subsequently amended on March 8, 2012, are not the only ones facing us. Additional risks and uncertainties not presently known or those that are currently deemed immaterial may also affect our operations. Any of the risks, uncertainties, events or circumstances described therein could cause our future financial condition, results of operations or cash flows to be adversely affected.

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Item 5. Other Information.

Our Deferred Compensation and Restoration Plan, as adopted in 2002 and then amended and restated in 2008 (the Prior Plan), was intended to restore certain benefits that may not be provided under our tax-qualified 401(k) savings plan (our 401(k) Plan) due to limitations placed on participation in 401(k) plans under the Internal Revenue Code (the Code). In order to separate the benefits restoration and compensation deferral features of the Prior Plan and to make certain design changes, as described below to the benefits restoration feature, while continuing to comply with existing tax requirements, on October 31, 2012, we approved an amendment and restatement of our Deferred Compensation and Restoration Plan, renamed the Benefits Restoration Plan (the Benefits Restoration Plan), to be effective January 1, 2013.

The key features of the Benefits Restoration Plan are as follows. Our key management employees, including our named executive officers for whom compensation information will be provided in our proxy statement, who are selected to participate in the Benefits Restoration Plan will have the opportunity to elect to defer a portion of their base compensation (including all amounts paid by the company for services rendered, but excluding any amounts paid for overtime, commissions, severance payments, bonus compensation or the value of any stock options granted) in excess of the compensation limit under Section 401(a)(17) of the Code (currently \$250,000) up to the percentage of compensation that is matched under our 401(k) Plan (currently, 3% or 6% of base compensation, depending on years of service) . Therefore, the principle feature of the Benefits Restoration Plan is that participants are able to receive the applicable employer matching contributions on the amounts deferred into the Benefits Restoration Plan, which would have otherwise been lost due to the compensation limit under Section 401(a)(17) of the Code.

The new Benefits Restoration Plan differs from the Prior Plan in several ways. For instance, under the Prior Plan, participants were able to elect to contribute up to 100% of their base compensation that could not be contributed to our 401(k) Plan due to the application of any Code limitation on tax-qualified 401(k) plans. Under the new Benefits Restoration Plan, participants' deferral contributions are limited to the matched contribution percentage of their base compensation, and then only when in excess of the Section 401(a)(17) compensation limit. Also, under the Prior Plan, employer contributions for a plan year began when a participant was no longer able to participate in our 401(k) Plan due to the applicability of any Code limitation (rather than only due to the Section 401(a)(17) compensation limit as provided under the Benefits Restoration Plan). Under the new Benefits Restoration Plan, participants will have the opportunity to receive non-elective employer contributions based on the enhanced employer contribution formula under our 401(k) Plan based on their base compensation only when in excess of the Section 401(a)(17) compensation limit. A participant's entire account balance under the Benefits Restoration Plan for plan years beginning on and after January 1, 2013 will be paid to him in a lump sum cash payment 183 days after the participant's separation from service date. Under the Prior Plan, participants could elect to receive their benefits in a lump sum payment or annual installment payments

To make deferral contributions, a participant must complete a deferral election prior to January 1st of the plan year during which the deferrals will be made. Deferrals and employer contributions are credited to a bookkeeping account and notionally invested in accordance with the participant's investment elections in the investment options selected for the plan.

The Benefits Restoration Plan is unfunded and benefits are paid from our general assets. However, we intend to fund the benefits payable under the Benefits Restoration Plan through the purchase of corporate-owned life insurance on the lives of some of the participants. The life insurance policies will be owned by the Company. In order to secure a participant's consent to be insured, we will agree to pay the participant's estate a death benefit of \$50,000 if he or she is employed with us, or fully retired based on our defined benefit definition, on his date of death.

We do not anticipate that the adoption of the new Benefits Restoration Plan to replace the Prior Plan will have a material effect on our compensation expense.

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Item 6. Exhibits.

**Exhibit
Number**

10.1*	Kraton Polymers US LLC Benefits Restoration Plan, as amended and restated effective as of January 1, 2013
31.1*	Certification of Chief Executive Officer under Section 302 of Sarbanes Oxley Act of 2002
31.2*	Certification of Chief Financial Officer under Section 302 of Sarbanes Oxley Act of 2002
32.1*	Certification Pursuant to Section 906 of Sarbanes Oxley Act of 2002
101**	The following materials from Kraton Performance Polymers, Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets as of September 30, 2012 and December 31, 2011 (Unaudited), (ii) Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2012 and 2011 (Unaudited), (iii) Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2012 and 2011 (iv) Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2012 and 2011 (Unaudited), and (v) Notes to Condensed Consolidated Financial Statements (Unaudited).**

* Filed herewith.

** Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files in Exhibit 101 hereto are not deemed filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are not deemed filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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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.

KRATON PERFORMANCE POLYMERS, INC.

Date: November 1, 2012

/s/ KEVIN M. FOGARTY
Kevin M. Fogarty

President and Chief Executive Officer

Date: November 1, 2012

/s/ STEPHEN E. TREMBLAY
Stephen E. Tremblay

Vice President and Chief Financial Officer