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RECOMMENDATION: Buy

FUNDAMENTALS			
LXU Price (10/23/05) ¹	\$5.84	LSBDP Price (10/23/05) ¹	\$48.00
Target Price	\$9.00	ROE ¹	38.49%
Market Cap. ¹	\$80.29 M	ROA ¹	2.54%
EV	\$219.44 M	EPS ¹	\$0.10
P/S	0.21	Shares Outstanding	13.74 M

Highlights:

- LSB Industries is a holding company with two main business segments: climate control and chemical.
- The climate control business segment is in a well-positioned niche market and according to our discount cash flow model, it has room to grow.
- LSB is in arrears of \$14.47 million for dividends payable from three of the four types of preferred stock.
- Using a discount rate of 12%, our discounted cash flow analysis returned a target price of \$9.00. Under the assumptions of an growing demand for their climate control products due to increasing housing/ business development.

Introduction

LSB Industries is a manufacturing, engineering, and marketing company that operates on a global basis. The company is involved in two different businesses through its subsidiaries. The Climate Control segment of LSB manufactures and sells a wide range of water source and geothermal heat pumps, hydronic fan coils and other heating and air conditioning products for commercial and residential use. The company sells these products

mainly to original equipment manufacturers (OEMs), mechanical contractors and independent sellers across the globe. According to LSB's last 10-K, the climate control segment had an operating profit of almost \$13 million. The other main segment of LSB is the company's chemical segment. The company makes and sells chemicals for use in mining, quarry, and construction, agricultural and industrial acid markets. The majority of the company's chemical products are made with ammonia or ammonium nitrate. The chemical segment is much less profitable than the climate control segment. The chemical segment's had a profit of about two million fiscal year 2004.

The business strategy of LSB's climate control segment is to establish leadership positions in niche markets by offering large and customizable product lines and by creating proprietary technology. The strategy of the company's chemical business is to focus on specific geographic areas in order to gain a strong regional presence. The company plans to do this by creating distribution advantages, building customer loyalty and creating and selling high margin products.

	12/31/04 (mil\$)
Secured Revolving Credit Facility	27.49
Senior Unsecured Notes due 2007	13.30
Senior Secured Loan Due 2009	50.00
Other	15.72
Total	106.51
Current Portion of LTD	4.83
LTD due After One Year	101.68

(All values from LSB 10-K)²

Capital Structure and Total Enterprise Value

The capital structure of LSB is interesting because it is a diversified holding company. The company's climate control segment has a large amount of debt. ThermaClima, a wholly-owned subsidiary of LSB, has a \$50 million Senior Secured Loan due in 2009, a \$50 million Working Capital Revolver renewed through April 2009, and \$13.3 million in Senior Unsecured Notes due in 2007. The company also has other long-term debt dealing with machinery, equipment, and real estate. The table below summarizes the company's long-term debt situation.²

LSB's capital structure has a lot of equity. Currently, the company has different types of preferred stock. The Series B and D preferred stock are cumulative and convertible. The Series 2 preferred stock

is just convertible. There are about 1.64 million shares of preferred stock issued. Of this amount, fifteen thousand of the Series 2 stock are held in treasury. LSB also has about 13.74 million shares of common stock outstanding according to the company's most recent quarterly report. The company holds about 3.21 million shares of common stock as treasury stock.⁴

LSB's market capitalization is about \$80 million. The company currently has about 13.74 million shares outstanding. The share price has been trading at about \$5.80 recently. LSB's total enterprise value is approximately \$218.78 million. This number was calculated by summing market capitalization, debt and the value of preferred stock. The company's long-term debt is about \$105.26 million and the book value of preferred stock is about \$33.52 million.

Preferred Stock

LSB Industries has four different types of preferred stock: \$3.25 Convertible Exchangeable Class C Preferred Stock, Series 2 ("Series 2 Preferred"), Series D Cumulative Convertible Class C Preferred Stock ("Series D Preferred"), Convertible Non Cumulative Preferred Stock ("Non Cumulative Preferred Stock"), and Series B 12% Convertible, Cumulative Preferred Stock ("Series B Preferred"). Series 2 Preferred is entitled to receive an annual dividend of \$3.25 per share. This dividend is paid quarterly. Series D Preferred pays an annual dividend of \$0.06 per share payable on October 9. Non cumulative Preferred Stock can receive a dividend of \$10 per share, payable on April 1. Finally, Series B Preferred is entitled to a \$12 dividend per share, which is payable to the shareholders on January 1. All of the preferred stock are cumulative, expected for the Convertible Non Cumulative Preferred Stock. The company is currently not paying dividends on any of the company's preferred or common stock. June 15, 1999 was the last time that the company paid dividends on the outstanding \$3.25 Convertible Exchangeable Class C Preferred Stock, Series 2. 1999 was also the last time that the company paid dividends on the Series B 12% Convertible, Cumulative Preferred Stock. LSB is not excepting to resume paying dividends in the near future due to the company's previous operating losses and limited ability to borrow².

The current market value of the \$3.25 Convertible Exchangeable Class C Preferred Stock, Series 2 is approximately \$29.93 million. The book value was \$31.18 million at the end of 2004². The market value is less than the book value by roughly \$1.25 million for the \$3.25 Convertible Exchangeable Class C Preferred Stock, Series 2.

The company has quite a bit of dividends that have not been paid because of the lack of cash. This has lead to LSB having \$14.47 million in arrears since the dividends are cumulative for three of the four types of preferred stock. Over 87% of the \$14.47 million is from the Series 2 Preferred that has 623,500 shares outstanding.

Dividend Value Arrears

In Million	Value in Arrears (\$) ²
Series 2 Preferred	12.67
Series D Preferred	0.36
Series B Preferred	1.44
Total	14.47

LSB would want to call the preferred shares when 4.3 shares of the common stock are worth more than \$70. The investor would want to convert to common from preferred when the 4.3 common shares are worth more than one share of the preferred stock.

Risks

There are many risks associated with LSB Industries Inc. For a more detailed overview please refer to LSB's most recent 10-k. The risks we feel are the most notable are as follows. Concerning the future financial state of LSB, we feel that there are four main risks. First, the loss of significant customers or increased competition is reason for concern; LSB's revenue is linked to limited consumers, therefore, it will be important for LSB to maintain good customer relations and product superiority over its competition in order to maintain revenue growth and profitability. Secondly, the risks associated with changes in environmental regulations, particularly air emissions, are also important. LSB's chemical business contributed 59% of consolidated net sales in fiscal 2004. There have been growing concerns about ammonium nitrate and other nitrogen fertilizers which are used in LSB's chemical business. This has lead to new laws and regulations pertaining to ammonium nitrate and other nitrogen

fertilizers that could have a dramatic effect on LSB's bottom line.

Thirdly, LSB is currently in numerous lawsuits, mainly concerning environmental matters and breaches of contract. Some of the more notable include: Trade Mechanical Contractor, Inc vs. Trison Construction, Inc. (A subsidiary of LSB) and Nelson Brothers, LLC vs. Cherokee Nitrogen (a LSB Subsidiary). The Trison lawsuit involves LSB's climate control division in where the plaintiff (Trade Mechanical Contractor) is alleging \$306 thousand in damages in relation to a breach of contract. The Cherokee Nitrogen lawsuit involves LSB's chemical division in where the plaintiff (Nelson Brothers) has sued Cherokee for an undisclosed amount due to a breach of contract involving overcharging Nelson Brothers for ammonium nitrate. Cherokee Nitrogen in response has filled a counter claim against Dynegy Marketing for overcharging for natural gas, which resulted in the increased price of ammonium nitrate. And finally, what we feel the most significant risk is the increasing cost of natural gas. The cost of natural gas is a primary and vital component of LSB's chemical division's operating revenues. Over the past 52 weeks prices for natural gas, according to the AMEX natural gas index, have risen almost 14%. Current trends show natural gas prices are declining, but worries of decreased supply are reasons for concern.¹

Using the risk assumptions mentioned above, we have in our Discounted Cash Flow Analysis, increased our fiscal 2005 estimate of operating expenses, as percent of revenue, to 15%, up 2.9% from fiscal 2004. And have decreased our fiscal 2005 estimate of revenue growth by 3% from fiscal 2004.

Discounted Cash Flow Analysis

Despite our pessimistic estimates regarding LSB's fiscal 2005 performance, we believe that natural gas prices will become more reasonable when refinery plants begin to reopen and supply gradually increases to levels seen before Hurricanes Katrina and Rita. Also, we feel that the needed reconstruction of the areas hit under the recent hurricanes will provide a boost in traditional revenue growth and gross margins for roughly half a decade following 2005.

LSB - DCF Derived Fair Market Value Matrix
(in Thousands \$)

FCF Growth Rate	1%	2%	3%
PV of FCF (2004)	4,593	4,593	4,593
PV of FCF ('05E-'10E)	55,143	55,143	55,143
PV or Terminal Value	153,339	170,343	191,126
Aggregate Value	106,715	123,719	144,502
Aggregate value per share	7.76	9.00	10.51

We have set our discount rate at 12% which derived a target price of \$9.00 assuming a long term growth rate of 2%. Based on our Discounted Cash Flow assumptions and assuming LSB's Chemical Division's fair market value is \$100M, we found LSB's Climate Division's fair market value to be approximately \$24M or \$1.73/share. In conclusion, we calculated LSB's total fair market value to be about \$124M, which lead us to the target price of \$9.00 and our undervalued rating.

References

1. Yahoo Finance, Accessed 10/23/05 at 5:00 p.m., WEBSITE
2. LSB SEC 2005 10-K Filing, Filed 03/28/05, <http://www.sec.gov/Archives/edgar/data/60714/000006071405000014/lbs10k2004.htm>
3. KU Applied Portfolio Management Website, Accessed 10/23/05 at 5:30 p.m., <http://www2.business.ku.edu/apm/portfolio/portfoliotyped.shtml>
4. LSB SEC 2005 10-Q Filing, Filed 08/05/05, <http://www.sec.gov/Archives/edgar/data/60714/000006071405000033/0000060714-05-000033-index.htm>

LSB Industries Inc. - Discounted Cash Flow Model (in thousands)

Income Statement Projections	Years Ended December 31,									
	2003	2004	2005Q1	2005Q2	2005E	2006E	2007E	2008E	2009E	2010E
Total Revenues	312,802	353,555	86,681	109,508	388,911	447,247	536,696	644,036	740,641	740,641
COGS	268,270	306,911	72,132	91,788	330,574	366,743	429,357	502,348	555,481	555,481
Gross Profits	44,532	46,644	14,549	17,720	58,337	80,504	107,339	141,688	185,160	185,160
Sales and Marketing	38,021	42,645	12,468	13,685	58,337	76,032	107,339	128,807	111,096	111,096
Total Operating Expenses	38,021	42,645	12,468	13,685	58,337	76,032	107,339	128,807	111,096	111,096
Operating Income	6,511	3,999	2,081	4,035	0	4,472	0	12,881	74,064	74,064
Interest Expense	5,559	6,784	2,535	3,293	-	-	-	-	-	-
EBITDA	22,382	20,977	7,528	10,391	-	-	-	-	-	-
Dep.& Amortization	10,312	10,194	2912	3063	1,500	1,500	1,000	1,000	1,000	1,000
Taxes	0	0	0	0	0	0	0	0	0	0
Capital Expenditures	7,177	9,600	2,156	4,641	10,000	10,000	10,000	10,000	10,000	10,000
Free Cash Flow	9,646	4,593	2,837	2,457	-8,500	-4,028	-9,000	3,881	65,064	65,064
PV of Free Cash Flow					-7,589	-3,211	-6,406	2,466	36,919	32,964
PV of Terminal Value										170,343

PV of Chemical Division	\$100,000
PV of FCFs	\$59,736
PV of Terminal Value	\$170,343
Total Value	\$230,079
Less:	
Total Debt	\$109,230
Plus:	
Cash	\$2,870
Total Fair Market Value	\$123,719
Diluted Shares Outstanding	\$13,750
Fair Market Value/Share	\$9.00
Fair Market Value(Climate Division)/Share	\$1.73

WACC	12.0%
Long Term Growth Rate	2.0%

DCF Derived Fair Market Value Matrix

WACC v. LT Growth Rate			
	1%	2%	3%
10.5%	\$12.16	\$14.11	\$16.58
11.0%	\$10.51	\$12.18	\$14.26
11.5%	\$9.05	\$10.49	\$12.26
12.0%	\$7.76	\$9.00	\$10.51
12.5%	\$6.61	\$7.68	\$8.98
13.0%	\$5.57	\$6.51	\$7.63
13.5%	\$4.64	\$5.46	\$6.43

Operating Assumptions

	2003	2004	2005E	2006E	2007E	2008E	2009E	2010E
Revenue Growth		13.0%	10.0%	15.0%	20.0%	20.0%	15.0%	0.0%
Gross Margins	14.2%	13.2%	15.0%	18.0%	20.0%	22.0%	25.0%	25.0%
Operating Expenses as % of Rev.	12.2%	12.1%	15.0%	17.0%	20.0%	20.0%	15.0%	15.0%