

OM GROUP INC
Form 10-Q
June 10, 2005

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2004
Commission File Number 001-12515

OM GROUP, INC.

(exact name of registrant as specified in its charter)

Delaware
(state or other jurisdiction of
incorporation or organization)

52-1736882
(I.R.S., Employer
Identification Number)

127 Public Square
1500 Key Tower
Cleveland, Ohio 44114-1221
(Address of principal executive offices)
(zip code)

(216) 781-0083
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934)

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of September 30, 2004:
Common Stock, \$.01 Par Value 27,470,073 shares

INDEX
OM GROUP, INC.

Part I. Financial Information

Item 1. Financial Statements (Unaudited)

Condensed consolidated balance sheets September 30, 2004 and December 31, 2003

Condensed statements of consolidated operations Three months ended September 30, 2004 and 2003; Nine months ended September 30, 2004 and 2003

Condensed statements of consolidated cash flows Nine months ended September 30, 2004 and 2003

Notes to condensed consolidated financial statements September 30, 2004

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Item 4. Controls and Procedures

Part II. Other Information

Item 1. Legal Proceedings

Item 2. Changes in Securities - Not applicable

Item 3. Defaults upon Senior Securities

Item 4. Submission of Matters to a Vote of Security Holders Not applicable

Item 5. Other information - Not applicable

Item 6. Exhibits

EXHIBIT 12 COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES

EXHIBIT 31.1 CERTIFICATION

EXHIBIT 31.2 CERTIFICATION

EXHIBIT 32 CERTIFICATION

Table of Contents**Part I Financial Information****Item I Financial Statements****OM GROUP, INC.**

CONDENSED CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except per share data)
(Unaudited)

	September 30, 2004	December 31, 2003
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 52,834	\$ 54,719
Accounts receivable, less allowances	159,222	136,700
Inventories	407,807	269,201
Advances to suppliers	22,266	19,400
Other	47,608	45,669
<i>Total current assets</i>	689,737	525,689
PROPERTY, PLANT AND EQUIPMENT, AT COST		
Land	4,994	5,511
Buildings and improvements	161,521	157,738
Machinery and equipment	484,523	470,435
Furniture and fixtures	17,309	16,287
	668,347	649,971
Less accumulated depreciation	277,723	238,611
	390,624	411,360
OTHER ASSETS		
Goodwill	179,165	178,678
Receivables from joint venture partners	29,378	51,187
Other	51,555	44,524
TOTAL ASSETS	\$ 1,340,459	\$ 1,211,438
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Long-term debt in default	\$ 400,000	\$
Accounts payable	147,136	136,190
Retained liabilities of businesses sold	21,674	41,654
Accrued income taxes	21,031	4,114
Accrued interest	12,465	1,896
Shareholder litigation accrual	92,000	

Edgar Filing: OM GROUP INC - Form 10-Q

Other	59,530	61,272
<i>Total Current Liabilities</i>	753,836	245,126
LONG-TERM LIABILITIES		
Long-term debt	31,002	430,466
Deferred income taxes	33,266	29,042
Shareholder litigation accrual		84,500
Minority interest	45,892	42,726
Other	29,775	29,126
STOCKHOLDERS EQUITY		
Preferred stock, \$.01 par value:		
Authorized 2,000,000 shares, no shares issued or outstanding		
Common stock, \$.01 par value:		
Authorized 60,000,000 shares; issued 28,484,098 shares in 2004 and 2003		
Capital in excess of par value	285	285
	497,668	495,107
Retained deficit	(65,001)	(160,724)
Treasury stock (14,025 shares in 2004 and 2003, at cost)	(710)	(710)
Accumulated other comprehensive income	14,593	17,086
Unearned compensation	(147)	(592)
<i>Total Stockholders Equity</i>	446,688	350,452
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	\$ 1,340,459	\$ 1,211,438

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**Part I Financial Information****Item I Financial Statements****OM GROUP, INC.****CONDENSED STATEMENTS OF CONSOLIDATED OPERATIONS****(Amounts in thousands, except per share data)****(Unaudited)**

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2004	2003	2004	2003
Net sales	\$ 311,902	\$ 238,506	\$ 992,270	\$ 653,776
Cost of products sold	234,606	187,597	732,326	534,179
	77,296	50,909	259,944	119,597
Selling, general and administrative expenses	27,321	33,485	93,843	78,709
INCOME FROM OPERATIONS	49,975	17,424	166,101	40,888
OTHER INCOME (EXPENSE)				
Interest expense	(9,766)	(14,614)	(30,100)	(32,553)
Foreign exchange loss	(2,967)	(1,839)	(6,802)	(2,028)
Investment income and other, net	1,803	10,369	5,867	11,723
	(10,930)	(6,084)	(31,035)	(22,858)
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES AND MINORITY INTEREST	39,045	11,340	135,066	18,030
Income tax expense	8,062	3,868	36,177	6,149
Minority interest	1,193	212	3,166	(1,155)
INCOME FROM CONTINUING OPERATIONS	29,790	7,260	95,723	13,036
DISCONTINUED OPERATIONS				
Income from operations, net of tax		15,808		10,022
Gain on the sale of Precious Metal Group, net of tax		131,748		131,748
		147,556		141,770
NET INCOME	\$ 29,790	\$ 154,816	\$ 95,723	\$ 154,806
Net income per common share - basic				
Continuing operations	\$ 1.05	\$ 0.26	\$ 3.36	\$ 0.46

Edgar Filing: OM GROUP INC - Form 10-Q

Discontinued operations		5.20		5.00
Net income	\$ 1.05	\$ 5.46	\$ 3.36	\$ 5.46
Net income per common share - assuming dilution				
Continuing operations	\$ 1.04	\$ 0.26	\$ 3.35	\$ 0.46
Discontinued operations		5.20		5.00
Net income	\$ 1.04	\$ 5.46	\$ 3.35	\$ 5.46
Weighted average shares outstanding				
Basic	28,470	28,359	28,470	28,344
Assuming dilution	28,642	28,364	28,613	28,347

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**Part I Financial Information****Item I Financial Statements****OM GROUP, INC.**

CONDENSED STATEMENTS OF CONSOLIDATED CASH FLOWS
(Amounts in thousands, except per share data)
(Unaudited)

	Nine Months Ended	
	September 30,	
	2004	2003
OPERATING ACTIVITIES		
Income from continuing operations	\$ 95,723	\$ 13,036
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	37,856	44,262
Foreign exchange loss	6,802	2,028
Minority interest	3,166	(1,155)
Other non-cash items	16,317	(2,817)
Changes in operating assets and liabilities	(142,627)	(5,532)
NET CASH PROVIDED BY OPERATING ACTIVITIES	17,237	49,822
INVESTING ACTIVITIES		
Expenditures for property, plant and equipment	(11,909)	(6,910)
Acquisition of business	(6,715)	(3,724)
Proceeds from sale of businesses		871,281
NET CASH (USED IN) PROVIDED BY INVESTING ACTIVITIES	(18,624)	860,647
FINANCING ACTIVITIES		
Payments of long-term debt		(794,400)
NET CASH USED IN FINANCING ACTIVITIES		(794,400)
Effect of exchange rate changes on cash and cash equivalents	(498)	4,450
CASH (USED IN) PROVIDED BY CONTINUING OPERATIONS	(1,885)	120,519
CASH USED IN DISCONTINUED OPERATIONS		(70,860)
(Decrease) increase in cash and cash equivalents	(1,885)	49,659
Cash and cash equivalents at beginning of period	54,719	12,470
Cash and cash equivalents at end of period	\$ 52,834	\$ 62,129

Table of Contents

Part I Financial Information

Item 1 Financial Statements

OM GROUP, INC.

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2004

(Thousands of dollars, except as noted and per share amounts)

Note A Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals for 2004 and 2003 and restatement adjustments for 2003 see Note B for further discussion) considered necessary for a fair financial presentation have been included. Past operating results are not necessarily indicative of the results which may occur in future periods, and the interim period results are not necessarily indicative of the results to be expected for the full year. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003.

During 2003, the Company changed its method of accounting for certain inventories of its continuing operations from the last-in, first-out (LIFO) method to the first-in, first-out (FIFO) method. As a result, all unaudited financial information presented herein is on a FIFO basis (See Note C for further discussion).

Note B Restatement

The 2003 Form 10-K includes restated consolidated financial statements for 2002 and 2001 and adjustments to financial information for the first three quarters of 2003 to restate amounts originally reported on Form 10-Q or 10-Q/A. The restatement initially arose from an independent investigation conducted by the audit committee of the Company's Board of Directors related to certain inventory accounting issues. The investigation, which commenced in December 2003, was conducted with the assistance of outside legal counsel and forensic accountants, and involved an extensive examination of the Company's systems and procedures for valuing and reporting assets, liabilities and results of operations in the consolidated financial statements. The investigation included the review of accounting records, supporting documentation and e-mail communications, as well as interviews with numerous current and former employees.

A primary focus of the investigation was adjustments made by or directed to be made by certain former Corporate accounting personnel as part of the financial statement close process, after financial results were submitted to Corporate from the operating units (top-side adjustments). As a result of the investigation, the Company has concluded that many of these top-side adjustments were not appropriate. The restatement adjustments include correction of these entries. The Company is cooperating with the SEC's Division of Enforcement in its review of the findings of the audit committee with respect to evidence of accounting irregularities by former employees. The audit committee investigation concluded there was no evidence of wrongdoing by current employees.

Edgar Filing: OM GROUP INC - Form 10-Q

In connection with the restatement process, including expanded audit procedures at a number of locations worldwide, additional adjustments were identified and have been recorded in the restated financial statements.

Table of Contents

Further, in late 2003 and throughout the first nine months of 2004, the Company addressed comments from the SEC's Division of Corporation Finance on periodic reports previously filed with the SEC. One of these comments challenged the Company's methodology used to compute the lower of cost or market value of its inventory. As a result of this process, the Company revised its methodology to base its lower of cost or market computations on end of period market prices (as opposed to projected market prices), resulting in adjustments to amounts previously reported.

The overall impact of the restatement adjustments on the Company's previously issued condensed statement of consolidated operations for the three and nine months ended September 30, 2003 follows. Amounts presented are before the Company's change from the LIFO to the FIFO method of valuing certain inventory as described in Note C.

	Three Months Ended September 30, 2003	Nine Months Ended September 30, 2003
Net income, as originally reported	\$ 62,022	\$ 57,553
Effect of the restatement adjustments	94,062	111,266
Net income, as restated	\$ 156,084	\$ 168,819
Net income per common share – basic and diluted:		
Net income, as originally reported	\$ 2.19	\$ 2.04
Effect of restatement adjustments	3.31	3.91
Net income, as restated	\$ 5.50	\$ 5.95

Note C Inventories and Change in Accounting Principle

Inventories consist of the following:

	September 30, 2004	December 31, 2003
Raw materials and supplies	\$ 224,847	\$ 158,112
Work in process	42,535	43,109
Finished goods	140,425	67,980
	\$ 407,807	\$ 269,201

Table of Contents

Previously, substantially all of the Company's inventories were accounted for under the LIFO method of accounting. During the fourth quarter 2003, the Company changed its method of accounting for certain inventories from the LIFO method to the FIFO method for its continuing operations. The effect of the change on restated income from continuing operations and per share amounts is as follows:

	Three Months Ended September 30, 2003	Nine Months Ended September 30, 2003
Income from continuing operations, as restated using the LIFO method	\$ 8,527	\$ 27,048
Effect of change in accounting method to the FIFO method, applied retroactively	(1,267)	(14,012)
Income from continuing operations, as adjusted using the FIFO method	\$ 7,260	\$ 13,036
Income from continuing operations per common share - diluted:		
Income from continuing operations per common share, as restated using the LIFO method	\$ 0.30	\$ 0.95
Effect of change in accounting method to the FIFO method, applied retroactively	(0.04)	(0.49)
Income from continuing operations per common share, as adjusted using the FIFO method	\$ 0.26	\$ 0.46

Table of Contents

The effect of the change on restated net income and per share amounts is as follows:

	Three Months Ended September 30, 2003	Nine Months Ended September 30, 2003
Net income, as restated using the LIFO method	\$ 156,083	\$ 168,818
Effect of change in accounting method to the FIFO method, applied retroactively	(1,267)	(14,012)
Net income, as adjusted using the FIFO method	\$ 154,816	\$ 154,806
Net income per common share - diluted:		
Net income per common share, as restated using the LIFO method	\$ 5.50	\$ 5.95
Effect of change in accounting method to the FIFO method, applied retroactively	(0.04)	(0.49)
Net income per common share, as adjusted using the FIFO method	\$ 5.46	\$ 5.46

The Company used the LIFO method of accounting at its principal manufacturing locations since its initial public offering in 1993. However, since that time, the Company has experienced a high degree of volatility in the reference/published prices of its primary raw materials—cobalt and nickel. The prices of these raw materials are not significantly impacted by inflation but rather by supply and demand dynamics and the impact of traders speculating in the market. This volatility resulted in debit LIFO reserves at each fiscal year end from 1998 to 2002, due to cumulative deflation in the Company's inventory since its adoption of LIFO. The Company believes that this volatility in metal prices will continue, and the change to FIFO will result in a more meaningful measure of inventory stated at current cost. Further, the change to FIFO will result in an improvement to reporting interim results by eliminating the fluctuations caused by the need to estimate year-end pricing and quantities during the year in a volatile market. Finally, the change to FIFO will conform all of the Company's inventory accounting to the FIFO method and will align the Company's accounting method with many of its peer companies.

Note D Divestitures of Precious Metals and SCM Metal Products, Inc.

On July 31, 2003, the Company completed the sale of its Precious Metals Group (PMG) to Umicore N.A. for approximately \$814 million. After transaction costs and expenses, the Company recorded a gain on the disposal of this business of \$145.9 million (\$131.7 million after-tax). This business was comprised of the Company's Precious Metal Chemistry and Metal Management reportable segments, which were acquired by the Company in August 2001. PMG is classified as a discontinued operation. The net proceeds were used to repay all of the Company's indebtedness outstanding under its then-existing senior credit facilities.

On April 1, 2003, the Company completed the sale of its copper powders business—SCM Metal Products, Inc. (SCM)—for \$63.7 million. The net proceeds were used to repay a portion of the Company's indebtedness outstanding under its then-existing senior credit facilities. There was no gain or loss recorded as this business was written-down by \$2.6 million to its fair value in 2002. SCM is classified as a discontinued operation.

Table of Contents

Operating results of discontinued operations are summarized as follows:

	Three Months Ended September 30, 2003	Nine Months Ended September 30, 2003
Net sales	\$ 342,857	\$ 2,415,945
Operating income	9,245	49,185
Interest expense	(4,094)	(37,819)
Income tax benefit	6,537	4,880
Income from discontinued operations	\$ 15,808	\$ 10,022

The operating results summarized above include restructuring charges of \$5.6 million. The results also include an allocation of consolidated interest expense, based on the estimated proceeds from the sales of the PMG business and SCM that were required to be used to repay indebtedness outstanding under the Company's then-existing senior credit facilities.

Note E Acquisitions

In April 2000, the Company acquired Outokumpu Nickel Oy (ONO) for a cash purchase price on the acquisition date of \$188.1 million. For the nine months ended September 30, 2004 and 2003, the Company made additional payments to the seller in the amount of \$6.7 million and \$3.7 million, respectively, under a contingent price participation clause of the original purchase agreement, whereby the seller is entitled to receive such payment based on a formula when the London Metal Exchange nickel price is above \$3.50 per pound. Such price participation clause was in place through May 2004, at which time this original contract provision was renegotiated. As a result of this renegotiation, price participation payments made after May 2004 were charged to cost of products sold rather than accounted for as acquisition cost. The ultimate aggregate purchase price for the ONO acquisition was \$206.0 million, including price participation payments of \$6.7 million in 2004. These price participation payments reduce negative goodwill as calculated in the initial purchase price allocation. In accordance with the provisions of APB 16, *Business Combinations*, such negative goodwill was recorded in the opening balance sheet as a reduction of acquired long-lived assets (primarily property, plant and equipment). The price participation payments are accounted for as a reduction of negative goodwill as initially calculated, resulting in an increase to long-lived assets as these payments are made. Depreciation expense on the increase in long-lived assets has been calculated and recorded on a prospective basis over the estimated remaining useful life of the acquired assets.

Note F Restructuring and Other Charges

The Company's worldwide restructuring program announced in 2002 was completed by the end of 2003, and therefore there were no restructuring charges in 2004. During the three and nine months ended September 30, 2003, the Company recorded restructuring and other charges related to its continuing operations of \$15.7 million and \$20.9 million, respectively. For the three months ended September 30, 2003, the amounts are recorded in cost of products sold (\$5.8 million) and selling, general and administrative expenses (\$9.9 million). For the nine-month period ended September 30, 2003, the amounts are recorded in cost of products sold (\$5.8 million) and selling, general and administrative expenses (\$15.1 million). A summary of the charges, which have a cash component of approximately \$9.7 million for the nine months

Edgar Filing: OM GROUP INC - Form 10-Q

ended September 30, 2003, is as follows:

	Three Months Ended September 30, 2003	Nine Months Ended September 30, 2003
Exit of facilities	\$ 11,365	\$ 11,365
Workforce reductions	1,815	3,855
Asset write-downs		1,242
Other	2,500	4,415
	\$ 15,680	\$ 20,877

Charges for the exit of facilities include amounts related to the shut-down of the manufacturing operations of the electroless nickel business in Newark, New Jersey (\$4.1 million); the shut-down of the manufacturing facility in Thailand (\$3.5 million); relocation of the corporate headquarters and shut-down of an administrative facility in Cleveland, Ohio (\$3.7 million). The Other charge is contract termination payments on the disposal of one of the Company's corporate aircraft.

An analysis of restructuring activity for the Company's continuing operations is summarized below:

	Workforce Reductions	Exit of Facilities and Other	Total
Balance at December 31, 2003	\$ 3,109	\$ 1,436	\$ 4,545
Utilized in first quarter of 2004	(1,233)	(1,131)	(2,364)
Utilized in second quarter of 2004	(543)	(33)	(576)
Utilized in third quarter of 2004	(181)	(13)	(194)
Balance at September 30, 2004	\$ 1,152	\$ 259	\$ 1,411

During the nine months ended September 30, 2003, the Company also recorded restructuring charges of

Table of Contents

\$5.6 million included in discontinued operations.

Note G Contingent Matters

In November 2002, the Company received notice that shareholder class action lawsuits were filed against the Company related to the decline in the Company's stock price after the third quarter 2002 earnings announcement. The lawsuits allege virtually identical claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 against the Company, certain executive officers and the members of the Board of Directors. Plaintiffs seek damages in an unspecified amount to compensate persons who purchased the Company's stock between November 2001 and October 2002 at allegedly inflated market prices. In July 2004, these lawsuits were amended to include the entire restatement period back to and including 1999, and to add the Company's independent auditors, Ernst & Young LLP, as a defendant.

In November 2002, the Company also received notice that shareholder derivative lawsuits had been filed against the members of the Company's Board of Directors. Derivative plaintiffs allege the directors breached their fiduciary duties to the Company in connection with a decline in the Company's stock price after its third quarter 2002 earnings announcement by failing to institute sufficient financial controls to ensure that the Company and its employees complied with generally accepted accounting principles by writing down the value of the Company's cobalt inventory on or before December 31, 2001. Derivative plaintiffs seek a number of changes to the Company's accounting, financial and management structures and unspecified damages from the directors to compensate the Company for costs incurred in, among other things, defending the aforementioned securities lawsuits. In July 2004, the derivative plaintiffs amended these lawsuits to include conduct allegedly related to the Company's decision to restate its earnings back to and including 1999.

The Company has been engaged in mediation sessions with the plaintiffs regarding the shareholder class action and shareholder derivative lawsuits. The Company anticipates these lawsuits will be resolved during 2005. The Company and the lead plaintiff of the shareholder class action lawsuits have entered into an Agreement to Settle Class Action (Agreement) dated March 7, 2005, which is an agreement in principle that outlines the general terms of a proposed settlement of these lawsuits subject to the satisfaction of various conditions and execution of a definitive agreement. Based on the Agreement and the Company's consideration of the shareholder derivative lawsuits described above, during the fourth quarter of 2003, the Company recorded a charge to administrative expense of \$84.5 million related to the lawsuits and during the first quarter of 2004, the Company recorded an additional charge to administrative expense of \$7.5 million. At September 30, 2004 and December 31, 2003, the Company had an accrual of \$92.0 million and \$84.5 million, respectively, for these lawsuits.

The settlements are expected to be payable \$74.0 million in cash and \$18.0 million in common stock. In April 2005, the Company paid \$74.0 million into an escrow account as required by the Agreement. Insurance proceeds are expected to be available for contribution to the resolution of the cases but the Company does not expect these lawsuits to be resolved within the limits of applicable insurance. Insurance proceeds of approximately \$15 million have been received and utilized in 2003, 2004 and 2005 to cover legal expenses related to these lawsuits. Potential remaining insurance proceeds of up to approximately \$30 million may be available and will be recognized when received.

The Company is a party to various other legal proceedings incidental to its business and is subject to a variety of environmental and pollution control laws and regulations in the jurisdictions in which it operates.

As is the case with other companies in similar industries, the Company faces exposure from actual or potential claims and legal proceedings involving environmental matters.

A number of factors affect the cost of environmental remediation, including the determination of the extent of contamination, the length of time the remediation may require, the complexity of environmental regulations, and the continuing improvements in remediation techniques. Taking these factors into consideration, the Company has estimated the undiscounted costs of remediation, which will be incurred over several years. The Company accrues an amount consistent with the estimates of these costs when it is probable that a liability has been incurred. At September 30, 2004 and December 31, 2003, the Company has recorded environmental liabilities of \$11.6 million and \$14.2 million, respectively, primarily related to remediation and decommissioning at the Company's closed manufacturing sites in St. George, Utah, Newark, New Jersey, and Vasset, France. These amounts are included in Other long-term liabilities.

Although it is difficult to quantify the potential impact of compliance with or liability under environmental protection laws, the Company believes that any amount it may be required to pay in connection with

Table of Contents

environmental matters, as well as other legal proceedings arising out of operations in the normal course of business, is not reasonably likely to exceed amounts accrued by an amount that would have a material adverse effect upon its financial condition, results of operations, or cash flows.

Note H Pension and Other Postretirement Benefits

The components of the Company's net periodic benefit expense (income) for its defined benefit pension plan and other postretirement benefits are shown below:

	Three months ended September 30,			
	Defined Benefit Pension Plan		Other Postretirement Benefits	
	2004	2003	2004	2003
Service cost	\$	\$	\$	\$ 42
Interest cost	216	217	50	81
Expected return on plan assets	(243)	(258)		
Other	8	44	(8)	(5)
Net periodic benefit (income) expense	\$ (19)	\$ 3	\$ 42	\$ 118

	Nine months ended September 30,			
	Defined Benefit Pension Plan		Other Postretirement Benefits	
	2004	2003	2004	2003
Service cost	\$	\$	\$	\$ 126
Interest cost	648	651	150	243
Expected return on plan assets	(729)	(774)		
Curtailement gain				(1,812)
Other	24	132	(24)	(15)
Net periodic benefit (income) expense	\$ (57)	\$ 9	\$ 126	\$ (1,458)

The Medicare Prescription Drug, Improvement and Modernization Act (Act) was enacted on December 8, 2003. The Act introduces a prescription drug benefit under Medicare Part D, in addition to a federal subsidy to sponsors of postretirement benefit plans that provide a prescription drug benefit that is at least actuarially equivalent to Medicare Part D. In May 2004, the Financial Accounting Standards Board issued FSP No. 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*, which requires measures of the accumulated postretirement benefit obligation and net periodic postretirement benefit (income) expense to reflect the effects of the Act and supersedes FSP No. 106-1. FSP No. 106-2 is effective for interim or annual periods beginning after June 15, 2004. The adoption of FSP No. 106-2 did not have a material impact on the Company's results of operations or financial position.

Table of Contents**Note I Computation of Net Income per Common Share**

The following table sets forth the computation of basic and dilutive income per share from continuing operations:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Income from continuing operations	\$ 29,790	\$ 7,260	\$ 95,723	\$ 13,036
Weighted average shares outstanding	28,470	28,359	28,470	28,344
Dilutive effect of stock options and restricted stock	172	5	143	3
Weighted average shares outstanding assuming dilution	28,642	28,364	28,613	28,347
Basic income per common share from continuing operations	\$ 1.05	\$ 0.26	\$ 3.36	\$ 0.46
Dilutive income per common share from continuing operations	\$ 1.04	\$ 0.26	\$ 3.35	\$ 0.46

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net income	\$ 29,790	\$ 154,816	\$ 95,723	\$ 154,806
Weighted average shares outstanding	28,470	28,359	28,470	28,344
Dilutive effect of stock options and restricted stock	172	5	143	3
Weighted average shares outstanding assuming dilution	28,642	28,364	28,613	28,347
Basic net income per common share	\$ 1.05	\$ 5.46	\$ 3.36	\$ 5.46
Dilutive net income per common share	\$ 1.04	\$ 5.46	\$ 3.35	\$ 5.46

Note J Comprehensive Income

During the three months ended September 30, 2004 and 2003, total comprehensive income was \$33.2 million and \$80.8 million, respectively. Total comprehensive income for the nine months ended September 30, 2004 and 2003 was \$93.2 million and \$137.3 million, respectively. Comprehensive income consists of net income, foreign currency translation adjustments and unrealized gains and losses on commodity hedging activity, net of income taxes.

Table of Contents**Note K Income Taxes**

The effective income tax rate for the three months ended September 30, 2004 was 20.6% versus 34.1% for the comparable period in 2003. The effective income tax rate for the nine months ended September 30, 2004 was 26.8% versus 34.1% for the comparable period in 2003. The effective tax rate in 2004 was lower than the statutory rate in the United States due primarily to a higher proportion of earnings in jurisdictions having lower statutory tax rates and a tax holiday from income taxes in Malaysia, both offset by losses in the United States with no corresponding tax benefit. The rate for the third quarter of 2004 also includes a benefit of \$1.7 million as a result of adjusting deferred taxes in Finland for a rate change from 29% to 26% and a benefit of \$1.7 million related to Malaysian income taxes to be refunded.

Note L Debt and Other Financial Instruments

Debt consists of the following:

	September 30, 2004	December 31, 2003
Senior Subordinated Notes	\$ 400,000	\$ 400,000
Note payable - bank	22,919	22,919
Deferred gain on termination of cash flow hedges	6,881	7,377
Fair value of interest rate swaps (fair value hedges)	1,202	170
	431,002	430,466
Current: Long-term debt in default	400,000	
Total long-term debt	\$ 31,002	\$ 430,466

The Senior Subordinated Notes (the Notes) bear interest at 9.25% and mature on December 15, 2011. The delay in filing required periodic reports with the SEC during 2004 caused events of default under the indenture governing these Notes. The Company obtained waivers from the events of default from the noteholders under the indenture governing the Notes, but such waivers expired on October 31, 2004. The Company paid \$1.0 million to the noteholders for the waivers of the events of default. The noteholders, or the indenture trustee at the direction of the noteholders, have the right, but are not obligated, to accelerate the payment of the Notes. If acceleration were to occur, the Company would seek to finance such obligation through other borrowings. On March 31, 2004, the Company reclassified the Notes from long-term to short-term as the Company failed to file its 2003 Form 10-K by such date.

In August 2003, the Company entered into a \$150 million Senior Secured Revolving Credit Facility with a group of lending institutions. The facility bears interest at a rate of LIBOR plus 2.00% to 3.00% or PRIME plus 0.25% to 1.25% and matures in August 2006. There was no borrowing under this facility at September 30, 2004. Because of the delay by the Company in filing required periodic reports with the SEC during 2004, the Company failed to comply with specific covenants in the related credit agreement and events of default occurred under the credit agreement. The Company has obtained temporary waivers from the lenders under the credit agreement that will be in effect as long as there are no additional defaults under the credit agreement, there is no acceleration of the Company's public debt (the Notes described above), and the Company makes appropriate deliveries of delayed financial information under the credit agreement and

the indenture governing its public debt by specific dates, the latest of which is July 22, 2005. Until such time, the aggregate of borrowings available under the credit facility is limited to \$75 million and borrowings are subject to conditions relating to, among other things, the Company's available cash and intended use of the borrowed proceeds. The Company paid approximately \$0.2 million to the lenders for the temporary waivers of the events of default.

During December 2003, the Company borrowed \$22.9 million from a Belgium bank. This loan bears interest at a rate of LIBOR plus 2.75% and matures in December 2008. In November 2004, the Company refinanced this loan with a Finland bank. The refinanced loan has an interest rate of LIBOR plus 1.25% and is payable in 48 equal installments beginning in January 2005 and ending December 2008. Simultaneous to the initial borrowing, the proceeds were loaned by the Company to one of its Congo smelter joint venture partners. The loan receivable is recorded in Receivables from joint venture partners, bears interest at LIBOR plus 2.75% and matures in December 2008.

Table of Contents

Note M Receivables from Joint Venture Partners

In 2001 and prior years, the Company financed the capital contribution for the 20% minority shareholder in its joint venture in the Democratic Republic of Congo (DRC). At December 31, 2003, the receivable from this partner was \$21.8 million and such amount was repaid by September 30, 2004.

In 2001 and subsequent years, the Company refinanced the capital contribution for the 25% minority shareholder in its joint venture in the DRC. At September 30, 2004 and December 31, 2003, the receivables from this partner were \$29.4 million. The receivables bear interest at 3.7% and are secured by the partner's interest in the joint venture and are due in full on December 31, 2008 (\$22.9 million) and December 31, 2010 (\$6.5 million). Dividends paid by the joint venture, if any, first serve to reduce the Company's receivable before any amounts are remitted to the joint venture partner.

Note N Recently Issued Accounting Standards

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

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised), Share-Based Payments (SFAS 123R). SFAS 123R is a revision of Statement of Financial Accounting Standards No. 123, Accounting for Stock Issued to Employees (APB 25). SFAS 123R requires that the cost of transactions involving share-based payments be recognized in the financial statements based on a fair-value-based measurement. SFAS 123R is effective for fiscal periods beginning after June 15, 2005. The adoption of SFAS 123R will not have a material impact on the Company's results of operations or financial position.

The American Jobs Creation Act of 2004 (AJCA) was enacted on October 22, 2004. The AJCA repeals an export incentive, creates a new deduction for qualified domestic manufacturing activities, and includes a special one-time deduction of 85 percent of certain foreign earnings repatriated to the U.S. In December 2004, the Financial Accounting Standards Board issued Staff Position No. FAS 109-1, Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004 (FSP FAS 109-1). In accordance with FSP FAS 109-1, the Company will treat the deduction for qualified domestic manufacturing as a special deduction in future years as realized. The deduction for qualified domestic manufacturing activities did not impact the Company's consolidated financial statements in 2004. The Company has not yet completed its evaluation of the deduction for qualified domestic manufacturing activities on the Company's future effective tax rate. The phase-out of the export incentive is not expected to have a material impact on the Company's effective tax rate in the future. In December 2004, the Financial Accounting Standards Board issued Staff Position No. FAS 109-2, Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision with the American Jobs Creation Act of 2004, allowing companies additional time to evaluate the effect of the AJCA on plans for reinvestment or repatriation of foreign earnings. The Company is in the process of evaluating the effects of the repatriation provision; however, the Company does not expect the impact of repatriation of foreign earnings, if any, to have a material impact on the Company's results of operations or financial position.

Note O Business Segment Information

The Company operates in two business segments - Cobalt and Nickel. The Cobalt segment includes products manufactured using cobalt and other metals including copper, zinc, manganese and calcium. The Nickel segment includes nickel-based products. The Company's products are essential components in numerous complex chemical and industrial processes, and are used in many end markets, such as rechargeable batteries, coatings, custom catalysts, liquid detergents, lubricants and fuel additives, plastic stabilizers, polyester promoters and adhesion promoters for rubber tires, colorants, petroleum additives, magnetic media, metal finishing agents, cemented carbides for mining and machine tools, diamond tools used in construction, stainless steel, alloy and plating applications. The Company's products are sold in various forms such as solutions, crystals, powders, cathodes and briquettes.

While the primary manufacturing sites are in Finland, the Company also has manufacturing and other facilities in Australia, North America, Europe and Asia-Pacific, and the Company markets its products worldwide. Further, approximately 25% of the Company's investment in property, plant and equipment is located in the Democratic Republic of Congo where the Company operates a smelter through a 55% owned joint venture.

These segments correspond to management's approach to aggregating products and business units, making operating decisions and assessing performance. The following table reflects the results of the segments.

Table of Contents

OM GROUP, INC.
SEGMENT DATA UNAUDITED
(Thousands of dollars)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2004	2003	2004	2003
Net sales				
Cobalt	\$ 163,281	\$ 98,701	\$ 492,389	\$ 280,175
Nickel	170,479	147,480	559,652	397,446
Intercompany sales between segments	(21,858)	(7,675)	(59,771)	(23,845)
 Total net sales	 \$ 311,902	 \$ 238,506	 \$ 992,270	 \$ 653,776
 Operating profit				
Cobalt	\$ 39,125	\$ 23,827	\$ 129,466	\$ 40,767
Nickel	21,056	8,850	79,516	31,581
Corporate	(10,206)	(15,253)	(42,881)	(31,460)
 Total operating profit	 \$ 49,975	 \$ 17,424	 \$ 166,101	 \$ 40,888
Interest expense	(9,766)	(14,614)	(30,100)	(32,553)
Foreign exchange loss	(2,967)	(1,839)	(6,802)	(2,028)
Investment income and other, net	1,803	10,369	5,867	11,723
 Income from continuing operations before income taxes and minority interest	 \$ 39,045	 \$ 11,340	 \$ 135,066	 \$ 18,030

Corporate expenses for the nine months ended September 30, 2004 include a \$7.5 million charge for the shareholder derivative lawsuits (see Note G).

There were no restructuring charges recorded by the Cobalt or Nickel segment for the three months or nine months ended September 30, 2004. Operating profit for the Cobalt and Nickel segment for the three months ended September 30, 2003 includes restructuring charges of \$6.5 million and \$4.1 million, respectively. Operating profit for the Cobalt and Nickel segment for the nine months ended September 30, 2003 includes restructuring charges of \$10.4 million and \$4.1 million, respectively. Corporate expenses for the three months and nine months ended September 30, 2003 include restructuring charges of \$5.0 million and \$6.4 million, respectively.

Note P Guarantor and Non-Guarantor Subsidiary Information

In December 2001, the Company issued \$400 million in aggregate principal amount of 9.25% Senior Subordinated Notes due 2011. These Notes are guaranteed by the Company's wholly-owned domestic subsidiaries. The guarantees are full, unconditional and joint and several.

The Company's foreign subsidiaries are not guarantors of these Notes. The Company, as presented below, represents OM Group, Inc. exclusive of its guarantor subsidiaries and its non-guarantor subsidiaries. Condensed consolidating financial information for the Company, the guarantor subsidiaries, and the non-guarantor subsidiaries is as follows:

Table of Contents

Balance Sheet Data	September 30, 2004				
	The Company	Combined Guarantor Subsidiaries	Combined Non-guarantor Subsidiaries	Eliminations	Total
Current assets:					
Cash and cash equivalents	\$ 16,188	\$ 1,059	\$ 35,587	\$	\$ 52,834
Accounts receivable	459,023	67,788	444,835	(812,424)	159,222
Inventories		51,707	356,100		407,807
Other assets	718	4,540	64,616		69,874
Total current assets	475,929	125,094	901,138	(812,424)	689,737
Property, plant and equipment - net		36,182	354,442		390,624
Goodwill	75,830	68,908	34,427		179,165
Intercompany receivables	306,271		963,828	(1,270,099)	
Investment in subsidiaries	114,179	(49)	2,160,526	(2,274,656)	
Other assets	11,431	12,642	56,860		80,933
Total assets	\$ 983,640	\$ 242,777	\$ 4,471,221	\$ (4,357,179)	\$ 1,340,459
Current liabilities:					
Long-term debt in default	\$ 400,000	\$	\$	\$	\$ 400,000
Accounts payable	(5,547)	99,965	461,462	(408,744)	147,136
Other accrued expenses	126,632	21,313	58,755		206,700
Total current liabilities	521,085	121,278	520,217	(408,744)	753,836
Long term debt	8,083		22,919		31,002
Deferred income taxes			33,266		33,266
Other long-term liabilities	7,784	12,398	55,485		75,667
Intercompany payables		461,756	1,200,932	(1,662,688)	
Stockholders equity	446,688	(352,655)	2,638,402	(2,285,747)	446,688
Total liabilities and stockholders equity	\$ 983,640	\$ 242,777	\$ 4,471,221	\$ (4,357,179)	\$ 1,340,459

Balance Sheet Data	December 31, 2003				
	The Company	Combined Guarantor Subsidiaries	Combined Non-guarantor Subsidiaries	Eliminations	Total
Current assets:					
Cash and cash equivalents	\$ 8,839	\$ 4,553	\$ 41,327	\$	\$ 54,719

Edgar Filing: OM GROUP INC - Form 10-Q

Accounts receivable	424,455	45,979	511,343	(845,077)	136,700
Inventories		33,151	236,050		269,201
Other assets	166	4,712	60,191		65,069
Total current assets	433,460	88,395	848,911	(845,077)	525,689
Property, plant and equipment - net		37,606	373,754		411,360
Goodwill	75,830	68,908	33,940		178,678
Intercompany receivables	287,620		1,027,343	(1,314,963)	
Investment in subsidiaries	55,124		2,160,526	(2,215,650)	
Other assets	11,711	9,804	74,196		95,711
Total assets	\$ 863,745	\$ 204,713	\$ 4,518,670	\$ (4,375,690)	\$ 1,211,438
Current liabilities:					
Accounts payable	\$ (5,290)	\$ 76,677	\$ 571,427	\$ (506,624)	\$ 136,190
Other accrued expenses	14,513	28,303	66,120		108,936
Total current liabilities	9,223	104,980	637,547	(506,624)	245,126
Long-term debt	407,547		22,919		430,466
Deferred income taxes	5,265		23,777		29,042
Other long-term liabilities and minority interest	91,258	15,415	49,679		156,352
Intercompany payables		419,566	1,220,445	(1,640,011)	
Stockholder s equity	350,452	(335,248)	2,564,303	(2,229,055)	350,452
Total liabilities & stockholder s equity	\$ 863,745	\$ 204,713	\$ 4,518,670	\$ (4,375,690)	\$ 1,211,438

Table of Contents

	Three months ended September 30, 2004				
		Combined Guarantor	Combined Non-guarantor	Eliminations	Total
Income Statement Data	The Company	Subsidiaries	Subsidiaries	Eliminations	Total
Net sales	\$	\$ 53,391	\$ 400,555	\$ (142,044)	\$ 311,902
Cost of products sold		34,584	342,066	(142,044)	234,606
		18,807	58,489		77,296
Selling, general and administrative expense		17,302	10,019		27,321
Income (loss) from operations		1,505	48,470		49,975
Interest expense	(9,367)	(1,311)	(12,853)	13,765	(9,766)
Investment and other income, net	1,620	314	13,634	(13,765)	1,803
Foreign exchange loss	(129)	17	(2,855)		(2,967)
Income (loss) before income taxes and minority interest	(7,876)	525	46,396		39,045
Income tax expense			8,062		8,062
Minority interest			1,193		1,193
Net income (loss)	\$ (7,876)	\$ 525	\$ 37,141		\$ 29,790

	Three months ended September 30, 2003				
		Combined Guarantor	Combined Non-guarantor	Eliminations	Total
Income Statement	The Company	Subsidiaries	Subsidiaries	Eliminations	Total
Net sales	\$	\$ 40,316	\$ 271,033	\$ (72,843)	\$ 238,506
Cost of products sold		32,409	228,031	(72,843)	187,597
		7,907	43,002		50,909
Selling, general and administrative expenses		19,736	13,749		33,485
Income (loss) from operations		(11,829)	29,253		17,424
Interest expense	(14,463)	(2,363)	(14,823)	17,035	(14,614)
Investment and other income, net	2,276	6,150	18,978	(17,035)	10,369
Foreign exchange gain (loss)	79	(20)	(1,898)		(1,839)
Income (loss) before income taxes and minority interest	(12,108)	(8,062)	31,510		11,340
Income tax expense			3,868		3,868
Minority interest			212		212
Income (loss) from continuing operations	(12,108)	(8,062)	27,430		7,260
	120,058	(46,150)	73,648		147,556

Edgar Filing: OM GROUP INC - Form 10-Q

Income (loss) from discontinued operations, net of tax

Net income (loss) \$ 107,950 \$ (54,212) \$ 101,078 \$ 154,816

Income Statement Data	Nine months ended September 30, 2004				
		Combined Guarantor	Combined Non-guarantor		Total
	The Company	Subsidiaries	Subsidiaries	Eliminations	
Net sales	\$	\$ 161,963	\$ 1,266,244	\$ (435,937)	\$ 992,270
Cost of products sold		118,097	1,050,166	(435,937)	732,326
		43,866	216,078		259,944
Selling, general and administrative expense		62,290	31,553		93,843
Income (loss) from operations		(18,424)	184,525		166,101
Interest expense	(28,496)	(4,333)	(42,679)	45,408	(30,100)
Investment and other income, net	5,260	528	45,487	(45,408)	5,867
Foreign exchange loss	(375)	9	(6,436)		(6,802)
Income (loss) before income taxes and minority interest	(23,611)	(22,220)	180,897		135,066
Income tax expense			36,177		36,177
Minority interest			3,166		3,166
Net income (loss)	\$ (23,611)	\$ (22,220)	\$ 141,554		\$ 95,723

Income Statement	Nine months ended September 30, 2003				
		Combined Guarantor	Combined Non-guarantor		Total
	The Company	Subsidiaries	Subsidiaries	Eliminations	
Net sales	\$	\$ 126,516	\$ 714,707	\$ (187,447)	\$ 653,776
Cost of products sold		97,637	623,989	(187,447)	534,179
		28,879	90,718		119,597
Selling, general and administrative expenses		50,142	28,567		78,709
Income (loss) from operations		(21,263)	62,151		40,888
Interest expense	(60,324)	(10,558)	(17,667)	55,996	(32,553)
Investment and other income, net	12,568	6,522	48,629	(55,996)	11,723
Foreign exchange gain (loss)	603	22	(2,653)		(2,028)
Income (loss) before income taxes and minority interest	(47,153)	(25,277)	90,460		18,030
Income tax expense			6,149		6,149
Minority interest			(1,155)		(1,155)

Edgar Filing: OM GROUP INC - Form 10-Q

Income (loss) from continuing operations	(47,153)	(25,277)	85,466	13,036
Income (loss) from discontinued operations, net of tax	120,042	(45,332)	67,060	141,770
Net income (loss)	\$ 72,889	\$ (70,609)	\$ 152,526	\$ 154,806

Table of Contents

Cash Flow Data	The Company	Nine months ended September 30, 2004			Total
		Combined Guarantor Subsidiaries	Combined Non-guarantor Subsidiaries	Eliminations	
Net cash provided by (used in) operating activities	\$ 14,064	\$ (1,486)	\$ 4,659	\$	\$ 17,237
Investing activities:					
Expenditures for property plant and equipment - net		(2,008)	(9,901)		(11,909)
Acquisition of business	(6,715)				(6,715)
Net cash used in investing activities	(6,715)	(2,008)	(9,901)		(18,624)
Effect of exchange rate changes on cash and cash equivalents			(498)		(498)
Increase (decrease) in cash and cash equivalents	7,349	(3,494)	(5,740)		(1,885)
Cash and cash equivalents at beginning of period	8,839	4,553	41,327		54,719
Cash and cash equivalents at end of period	\$ 16,188	\$ 1,059	\$ 35,587	\$	\$ 52,834

Cash Flow Data	The Company	Nine months ended September 30, 2003			Total
		Combined Guarantor Subsidiaries	Combined Non-guarantor Subsidiaries	Eliminations	
Net cash provided by (used in) operating activities	\$ (66,127)	\$ 5,857	\$ 110,092	\$	\$ 49,822
Investing activities:					
Expenditures for property plant and equipment - net		(3,952)	(2,958)		(6,910)
Acquisition of business	(3,724)				(3,724)
Proceeds from the sale of businesses	871,281				871,281
Net cash provided by (used in) investing activities	867,557	(3,952)	(2,958)		860,647
Financing activities:					
Payments of long-term debt	(794,400)				(794,400)
Net cash used in financing activities	(794,400)		4,450		(794,400)
					4,450

Effect of exchange rate changes on cash and cash equivalents

Cash provided by continuing operations	7,030	1,905	111,584	120,519
Cash used in discontinuing operations			(70,860)	(70,860)
Increase in cash and cash equivalents	7,030	1,905	40,724	49,659
Cash and cash equivalents at beginning of period	667	1,708	10,095	12,470
Cash and cash equivalents at end of period	\$ 7,697	\$ 3,613	\$ 50,819	\$ 62,129

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

The Company is a leading, vertically integrated international producer and marketer of value-added, metal-based specialty chemicals and related materials, primarily from cobalt and nickel. The Company applies proprietary technology to unrefined cobalt and nickel raw materials to market more than 1,500 product offerings to approximately 3,300 customers in over 30 industries. The Company operates in two business segments—Cobalt and Nickel. The Company's business is critically connected to both the price and availability of raw materials, primarily cobalt and nickel. Since the Company has manufacturing and other facilities in Africa, North America, Europe and Asia-Pacific, and markets its products worldwide, fluctuations in currency prices may affect the Company's operating results. These factors are discussed in more detail in Management's Discussion and Analysis of Financial Condition and Results of Operations contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2003.

Three Months Ended September 30, 2004 Compared to Three Months Ended September 30, 2003

Net sales for the three months ended September 30, 2004 were \$311.9 million, an increase of 30.8% compared to the same period in 2003. The increase in sales is primarily a result of higher metal prices for both cobalt and nickel (\$128 million), partially offset by lower sales volumes (\$54 million). The average price of cobalt for the third quarter of 2004 was \$23.18 compared to \$9.75 for the third quarter of 2003. The average price of nickel for the third quarter of 2004 was \$6.35 compared to \$4.23 for the third quarter of 2003.

Gross profit increased to \$77.3 million for the three-months ended September 30, 2004, compared to \$50.9 million for the same period in 2003. The increase in gross profit was principally due to increased selling prices of the Company's products as a result of the higher metal prices. The overall margin improvement was partially offset by the negative impact of currency effects resulting from the strong euro compared to the U.S. dollar. The 2003 amount included \$5.8 million of restructuring charges.

Table of Contents

Selling, general and administrative (SG&A) expenses decreased as a percentage of sales to 8.8% in 2004 compared to 14.0% in the 2003 period. The 2003 period included restructuring charges of \$9.9 million primarily related to exit of facilities (see Note F for further discussion). SG&A expenses increased after the restructuring costs in 2003 due primarily to costs associated with the restatement process.

Other expense net was \$10.9 million for the three months ended September 30, 2004, compared to \$6.1 million for the same period in 2003. The 2003 amount includes a gain related to the sale of the PVC operations of \$4.5 million and interest income of \$6.2 million from one of the Company's joint venture partners. The 2004 amount has higher foreign exchange losses compared to 2003 of \$1.2 million.

The effective income tax rate for the three months ended September 30, 2004 was 20.6% compared to 34.1% for the comparable period in 2003. The effective tax rate in 2004 was lower than the statutory rate in the United States due primarily to a higher proportion of earnings in jurisdictions having lower statutory tax rates and a tax holiday from income taxes in Malaysia, both offset by losses in the United States with no corresponding tax benefit. The rate for the third quarter of 2004 also includes a benefit of \$1.7 million as a result of adjusting deferred taxes in Finland for a rate change from 29% to 26% and a benefit of \$1.7 million related to Malaysian income taxes to be refunded.

Income from continuing operations was \$29.8 million for the three months ended September 30, 2004 compared to \$7.3 million for the same period in 2003, due primarily to the aforementioned factors.

There were no discontinued operations in 2004. Income from discontinued operations was \$147.6 million in the third quarter of 2003, due primarily to the PMG gain.

Net income was \$29.8 million for the three months ended September 30, 2004 compared to \$154.8 million for the same period in 2003, due primarily to the aforementioned factors.

Cobalt

Net sales for the three months ended September 30, 2004 were \$163.3 million compared to \$98.7 million for the same period in 2003. Operating profit for the three months ended September 30, 2004 was \$39.1 million compared to \$23.8 million in the 2003 period. Sales increased due primarily to higher prices on cobalt related products due to the increase in the price of cobalt from the prior year. The overall volume of products sold by the cobalt group decreased 13% versus the prior year due principally to the sale of the PVC operations that occurred in the third quarter of 2003 and decreases of sales to the battery, coatings and inks market as customers adjusted inventory levels due to higher prices of cobalt related products.

The increase in operating profit was principally due to the higher cobalt metal prices that resulted in increased selling prices on the Company's products. Operating profit for the three months ended September 30, 2003 includes restructuring charges of \$6.5 million.

Nickel

Net sales for the three months ended September 30, 2004 were \$170.5 million compared to \$147.5 million for the same period in 2003, due primarily to higher metal market prices for nickel, resulting in higher selling prices for the Company's products. This increase was partially offset by a 17% decline in volume due to the availability of raw material feedstocks. Operating profit for the three months ended September 30, 2004 was \$21.1 million compared to \$8.9 million in the 2003 period. These results were attributable primarily to higher market prices for nickel, resulting in higher selling prices for the Company's products. Operating profit for the

three months ended September 30, 2003 includes restructuring charges of \$4.1 million.

On July 2, 2004, the OMG Cawse facility in Australia incurred a mechanical failure in the main production autoclave requiring that operations there be suspended for four weeks. While there were no injuries, the Company did have to replace raw material feed with other market sources. The decrease in the operating profit in the three months ended September 30, 2004 due to the mechanical failure was approximately

Table of Contents

\$3.9 million.

Corporate expenses

Corporate expenses for the three months ended September 30, 2004 were \$10.2 million compared to \$15.3 million for the same period in 2003. The 2003 amount included restructuring charges of \$5.0 million.

Nine Months Ended September 30, 2004 Compared to Nine Months Ended September 30, 2003

Net sales for the nine months ended September 30, 2004 were \$992.3 million, an increase of 51.8% compared to the same period in 2003. The increase in sales resulted principally from higher metal prices in 2004 compared to 2003 (\$432 million) and was offset partially by lower volumes of products sold due to the continued low availability of nickel feed stocks and the sale of the PVC operations in the third quarter of 2003.

Gross profit increased to \$259.9 million for the nine months ended September 30, 2004, compared to \$119.6 million for the same period in 2003. The increase was due primarily to an increase in selling prices on the Company's products as a result of the increase in metal prices, primarily in the first quarter in the Cobalt group. Margins benefited from using raw materials that were purchased before the overall increases in metal prices. The margin improvement was partially offset by the negative impact of currency effects resulting from the strong euro compared to the U.S. dollar.

Selling, general and administrative expenses decreased as a percentage of sales to 9.5% in 2004 compared to

12.0% in 2003. The SG&A expenses increase was due principally to a \$7.5 million charge related to the derivative lawsuit, higher legal and professional fees associated with the restatement, forensic investigation and Sarbanes-Oxley Act (SOX) requirements of \$7.5 million, and executive compensation awards of \$4.9 million, which includes \$3.4 million related to the departure of the Company's former chief financial officer.

Other expense net was \$31.0 million for the nine months ended September 30, 2004, compared to \$22.9 million for the same period in 2003. The increase is due primarily to waiver fees of \$1.2 million associated with the delay in filing periodic reports with the SEC (see Note L for further discussion), and higher foreign exchange losses in 2004 compared to 2003, partially offset by a 2003 gain related to the sale of the PVC operations of \$4.5 million and interest income of \$6.2 million from one of the Company's joint venture partners in 2003.

The effective income tax rate for the nine months ended September 30, 2004 was 26.8% compared to 34.1% for the same period in 2003. The effective tax rate in 2004 was lower than the statutory rate in the United States due primarily to a higher proportion of earnings in jurisdictions having lower statutory tax rates and a tax holiday from income taxes in Malaysia, both offset by losses in the United States with no corresponding tax benefit. The rate for the third quarter of 2004 also includes a benefit of \$1.7 million as a result of adjusting deferred taxes in Finland for a rate change from 29% to 26% and a benefit of \$1.7 million related to Malaysian income taxes to be refunded.

Income from continuing operations was \$95.7 million for the nine months ended September 30, 2004 compared to \$13.0 million for the same period in 2003, due primarily to the aforementioned factors.

There were no discontinued operations in 2004. Income from discontinued operations was \$141.8 million for the nine months ended September 30, 2003, due primarily to a gain of \$131.7 million on the sale of Precious Metal Group.

Net income was \$95.7 million for the nine months ended September 30, 2004 compared to \$154.8 million for the same period in 2003, due primarily to the aforementioned factors.

Cobalt Group

Net sales for the nine months ended September 30, 2004 were \$492.4 million compared to \$280.2 million for the same period in 2003, due primarily to higher metal market prices for

Table of Contents

cobalt, resulting in higher selling prices for the Company's products. This increase was also helped by a shift in sales due to increased demand in the battery sector during the first half of 2004.

Operating profit for the nine months ended September 30, 2004 was \$129.5 million compared to operating profit of \$40.8 million in the 2003 period. The increase in operating profit was principally due to the increased selling prices on the Company's products as a result of higher cobalt metal prices, partially offset by a weaker U.S. dollar against the euro. Operating profit for the Cobalt segment for the nine months ended September 30, 2003 includes restructuring charges of \$10.4 million.

Nickel Group

Net sales for the nine months ended September 30, 2004 were \$559.7 million compared to \$397.4 million for the same period in 2003, due primarily to higher metal market prices for nickel which resulted in higher selling prices for the Company's products and increase in volumes of value-added products, partially offset by lower volumes of nickel metal products.

Operating profit for the nine months ended was \$79.5 million compared to \$31.6 million in the 2003. The increase is due primarily to increased metal prices and higher volume of value-added products sold in 2004, partially offset by weaker U.S. dollar against both the euro and Australian dollar. Operating profit for the Nickel segment for the nine months ended September 30, 2003 includes restructuring charges of \$4.1 million.

Corporate expenses

Corporate expenses for the nine months ended September 30, 2004 were \$42.9 million compared to \$31.5 million for the same period in 2003. The increase was due principally to a \$7.5 million charge related to the derivative lawsuit, higher legal and professional fees of \$7.5 million associated with the restatement, forensic investigation, Sarbanes-Oxley compliance and shareholder lawsuits, as well as executive compensation awards of \$5.3 million which includes \$3.4 million related to the departure of the Company's former chief financial officer. The 2003 amount includes restructuring charges of \$6.4 million.

Liquidity and Capital Resources

Operating activities generated positive cash flow of \$17.2 million during the nine months ended September 30, 2004 compared to operations providing cash of \$49.8 million for the same period in 2003. Income from continuing operations for the nine months ended September 30, 2004 was \$95.7 million which represents an increase of \$82.7 million compared the same period in 2003. Accounts receivable at September 30, 2004 increased \$22.5 million compared to December 31, 2003 as a result of higher sales due to higher metal prices in the third quarter of 2004 compared to the fourth quarter of 2003. Inventories at September 30, 2004 increased \$138.6 million compared to December 31, 2003 due to higher raw material costs as a result of higher metal prices and a build of inventory due to the planned shutdown of the smelter in the Democratic Republic of Congo in January of 2005. The shutdown of the smelter was completed and fully operational in May of 2005. Accrued income taxes increased \$16.9 million compared to December 31, 2003 based on income generated in 2004. Accrued interest increased by \$10.6 million associated with the \$400 million of 9.25% Senior Subordinated Notes due 2011 for which interest payments are due June 15 and December 15. Retained liabilities of businesses sold decreased by \$20.0 million compared to December 31, 2003 due to payment of employee bonuses and taxes as required as part of the sale of PMG to Umicore in July 2003.

Capital expenditures for the nine months ended September 30, 2004 and 2003 were \$11.9 million and \$6.9 million, respectively, primarily related to ongoing projects to maintain current operating levels.

In August 2003, the Company entered into a \$150 million Senior Secured Revolving Credit Facility with a group of lending institutions. The facility bears interest at a rate of LIBOR plus 2.00% to 3.00% or PRIME plus 0.25% to 1.25% and matures in August

Table of Contents

2006. There was no borrowing under this facility at September 30, 2004. Because of the delay by the Company in filing required periodic reports with the SEC during 2004, the Company failed to comply with specific covenants in the related credit agreement and events of default occurred under the credit agreement. The Company has obtained temporary waivers from the lenders under the credit agreement that will be in effect as long as there are no additional defaults under the credit agreement, there is no acceleration of the Company's public debt (described immediately below), and the Company makes appropriate deliveries of delayed financial information under the credit agreement and the indenture governing its public debt by specific dates, the latest which is July 22, 2005. Until such time, the aggregate of borrowings available under the credit facility is limited to \$75 million and borrowings are subject to conditions relating to, among other things, the Company's available cash and intended use of the borrowed proceeds. The Company paid approximately \$0.2 million to the lenders for the temporary waivers of the events of default.

The majority of the Company's debt at September 30, 2004 was \$400 million of 9.25% Senior Subordinated Notes due 2011. The delay in filing required SEC reports during 2004 caused events of default under the indenture governing these notes. The Company obtained waivers of the events of default from the noteholders, but such waivers expired on October 31, 2004. The Company paid \$1.0 million to the noteholders for the waivers of the events of default. The noteholders, or the indenture trustee at the direction of the noteholders, have the right, but are not obligated, to accelerate the payment of these notes. Although the noteholders have not taken any action to accelerate this debt since the waivers expired, the Company cannot predict whether they will do so in the future. If acceleration were to occur, the Company would seek to finance such obligation through other borrowings. There is no assurance the Company would be able to obtain such other borrowings if necessary.

During December 2003, the Company borrowed \$22.9 million from a Belgium bank. This loan bears interest at a rate of LIBOR plus 2.75% and matures in December 2008. In November 2004, the Company refinanced this loan with a Finland bank. The refinanced loan has an interest rate of LIBOR plus 1.25% and is payable in 48 equal installments beginning in January 2005 and ending December 2008. Simultaneous to the initial borrowing, the proceeds were loaned by the Company to one of its Congo smelter joint venture partners. The loan receivable is recorded in Receivables from joint venture partners, bears interest at LIBOR plus 2.75% and matures in December 2008.

The Company generated sufficient cash from operations during 2004 to provide for its working capital, debt service and capital expenditure requirements. The Company believes that it will have sufficient cash generated by operations and available from its credit facility to provide for its working capital, debt service, litigation settlement and capital expenditure requirements in 2005.

As a result of the delay in filing required SEC reports, there currently are limitations upon the Company's ability to incur additional indebtedness. However, the Company anticipates that it will resolve the existing defaults under the credit facility and the indenture for the notes outstanding in a manner that will permit it to borrow under the credit facility without such limitations in the future.

The Company is a defendant in shareholder class action and derivative lawsuits alleging securities law violations relating to the decline in the Company's stock price following the third quarter 2002 earnings announcement. The status of such lawsuits is described in Note G to the condensed consolidated financial statements included in this quarterly report.

Critical Accounting Policies

Edgar Filing: OM GROUP INC - Form 10-Q

The consolidated financial statements include the accounts of the company and all majority-owned subsidiaries. The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions in certain circumstances that affect amounts reported in the accompanying condensed consolidated financial statements and related footnotes. In preparing these condensed consolidated financial statements, management has made its

Table of Contents

best estimates and judgments of certain amounts included in the condensed consolidated financial statements, giving due consideration to materiality. Application of these accounting policies involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, actual results could differ from these estimates. During the first nine months of 2004, there was no change in the Company's critical accounting policies as disclosed in its Form 10-K filed for the year ended December 31, 2003.

Cautionary Statement for Safe Harbor Purposes

The Company is making this statement in order to satisfy the safe harbor provisions contained in the Private Securities Litigation Reform Act of 1995. This report contains statements that the Company believes may be forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934. These forward-looking statements are not historical facts and generally can be identified by use of statements that include phrases such as believe, expect, anticipate, intend, plan, foresee or other words or phrases of similar import. Similarly, statements that describe the Company's objectives, plans or goals also are forward-looking statements. These forward-looking statements are subject to risks and uncertainties that are difficult to predict, may be beyond the Company's control and could cause actual results to differ materially from those currently anticipated.

Important factors that may affect the Company's expectations, estimates or projections include:

the completion of the settlement of the shareholder class action lawsuits filed against the Company and certain of its executives in a manner that is consistent with the agreement in principle reached with the lead plaintiffs in such lawsuits;

the ultimate impact upon the Company of the shareholder derivative lawsuits filed against the Company's Board of Directors;

the speed and sustainability of price changes in cobalt and nickel;

the availability of competitively priced supplies of raw materials, particularly cobalt and nickel;

the effect of the Company's inability to meet the SEC and NYSE filing obligations on a timely basis upon funding availability under the Company's credit facilities or upon debt obligations outstanding;

the effect of the Company not completing the testing of its internal control over financial reporting systems such that management of the Company and its independent registered public accounting firm are unable to report as to such internal control over financial reporting in a timely fashion for the year 2004;

the risk that new or modified internal controls, implemented in response to an investigation by the audit committee of the Company's board of directors and the Company's examination of its internal control over financial reporting systems pursuant to Section 404 of the Sarbanes-Oxley Act, are not effective and need to be improved, resulting in additional expense;

the demand for metal-based specialty chemicals and products in the Company's markets;

the effect of fluctuations in currency exchange rates on the Company's international operations;

the effect of non-currency risks of investing and conducting operations in foreign countries, including political, social, economic and regulatory factors;

the outcome of the previously announced SEC Division of Enforcement's review of the investigation conducted by the Company's audit committee; and

the general level of global economic activity and demand for the Company's products.

The Company does not assume any obligation to update these forward-looking statements.

Item 3 Quantitative and Qualitative Disclosures About Market Risk

A discussion of market risk exposures is included in Part II, Item 7a, **Qualitative and Quantitative Disclosure About Market Risk**, of the Company's 2003 Annual Report on

Table of Contents

Form 10-K. The Company's exposure to market risk did not change materially between December 31, 2003 and September 30, 2004.

Item 4 Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

The Company carried out an evaluation under the supervision and with the participation of the Company's management, including the Company's interim chief executive officer and chief financial officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of September 30, 2004.

As disclosed in Note B to the condensed consolidated financial statements contained in this quarterly report, the Company's audit committee of the board of directors conducted an independent investigation commencing in December 2003 which ultimately concluded that previously issued financial statements contained material errors. The investigation and subsequent audits of the restated financial statements included in the Form 10-K for the year ended December 31, 2003 have identified significant internal control weaknesses and deficiencies that existed in prior periods and were not identified or corrected as of September 30, 2004. In connection with the audit of its consolidated financial statements for the year ended December 31, 2003 and its restated consolidated financial statements for the years ended December 31, 2002 and 2001, the Company received two material weakness letters from its independent auditors dated February 28, 2005 (see the 2003 Form 10-K for further information) and March 31, 2005 (see the March 31, 2004 Form 10-Q for further information).

Based on their evaluation, the interim chief executive officer and the chief financial officer have concluded that the Company's disclosure controls and procedures were not effective as of September 30, 2004 in timely alerting them to material information relating to the Company and its subsidiaries that is required to be included in the Company's SEC filings.

(b) Changes in Internal Controls in 2004 and 2005

As a result of the issues underlying the investigation referenced in (a) above, and as part of the Company's continuing activities pursuant to the provisions of Section 404 of the Sarbanes-Oxley Act, the Company has made many changes that improve its internal control environment. Changes that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting, are summarized below:

The Company has changed its financial management to improve the quality of the team. Some of these changes include: (1) chief financial officer, (2) corporate controller, (3) group controllers for cobalt and nickel, (4) treasurer, (5) tax manager, (6) director of internal audit, and (7) elimination of the information technologies team, replacing them with an outsourced, professionally managed company.

The Company is in the process of shifting all original accounting from corporate to the operating units. Two group controllers manage these operating unit accounting personnel and are primarily responsible for consolidated group accounting results. Corporate accounting is now a part of the oversight, review and consultation process. The shifting of the original accounting to the operating unit level has resulted in improved communication and interaction among the unit controllers, group controllers and corporate accounting.

The Company has implemented improved internal controls and efficiencies with respect to

Table of Contents

its monthly, quarterly and year-end financial statement close processes. Two key controls implemented are as follows: (1) formal quarterly meetings among the chief executive officer, chief financial officer, group vice presidents, corporate controller and group controllers are held to discuss all significant and/or judgmental issues, facts and circumstances as well as accounting treatment of each issue, and a summary of the issues and conclusions is then shared with the chairman of the audit committee and the Company's independent auditors; and (2) the group vice presidents and corporate and group controllers sign an internal representation letter each quarter regarding their respective results, which cascade up to the chief executive officer and chief financial officer certifications pursuant to Sections 302 and 906 of the Sarbanes-Oxley Act.

The Company has made improvements to its consolidation process, including enhanced operating unit reporting, improved chart of accounts, better use of the system for financial analysis, budget to actual variance analysis, tighter system security and placing responsibility with the unit controllers to reconcile intercompany accounts. With these changes in place, more tools are available for management's financial analysis.

A formal monthly financial calendar is in place and communicated to the controller group to establish responsibilities and due dates. The goal is a more consistent, timely closing process at the operating units, which will allow more time for analysis by the group controllers and corporate accounting.

The Company has developed revised monthly management reporting to communicate more timely and relevant financial information to the entire management group (including operating units). The Company has made many improvements in this area during the last half of 2004, including continually challenging the specific content included in the report based on input from users, as well as involving unit controllers in validating their information provided.

The Company has made significant improvements to its information systems, the controls surrounding these systems and the users understanding of how they can be used to improve business processes. Daily transactional accuracy and thoroughness has improved significantly resulting in far less month end corrections and customer/vendor errors.

The Company created a worldwide whistleblower program managed by human resources, completely independent of its operating units and corporate.

The people, process and technology enhancements outlined above significantly overlap with continuing activities pursuant to the provisions of Section 404 of the Sarbanes-Oxley Act. During the fourth quarter of 2003, the Company engaged external assistance to work with management to identify internal control deficiencies and suggest remediation. Although this process is not yet completed, through the fourth quarter of 2004, the Company has spent approximately \$2 million on this external assistance. This has resulted in more formalized, company-wide financial policies and procedures to standardize and improve processes and controls; improved procedures related to reconciliation of key accounts; improved segregation of duties; enhanced oversight and review by management; and access restrictions to critical systems.

By implementing the above actions, the Company believes that issues raised by the audit committee investigation and by the material weakness letters have been or are in the process of being remediated.

Part II Other Information

Item 1 Legal Proceedings

The Company is a party to certain shareholder class action and derivative lawsuits related to the decline in the Company's stock price after the third quarter of 2002 earnings announcement. A description of this litigation,

including material developments occurring

Table of Contents

during the period covered by this report, is included in Note G to the condensed consolidated financial statements.

Item 3 Defaults Upon Senior Securities

The delay in filing required SEC reports during 2004 caused events of default under the indenture governing the Company's \$400 million of 9.25% Senior Subordinated Notes due in 2011. A description of this matter is included in this quarterly report under Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources.

Item 6 Exhibits

(12) Computation of Ratio of Earnings to Fixed Charges

(31.1) Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

(31.2) Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

(32) Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Table of Contents

SIGNATURE

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.

June 9, 2005

OM GROUP, INC.

/s/ R. Louis Schneeberger

R. Louis Schneeberger
Chief Financial Officer
(Duly authorized signatory of OM Group, Inc.)