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LUBRIZOL CORP  
Form 10-Q  
August 09, 2001

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2001

OR

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

For the transition period from ..... to .....

Commission File Number 1-5263

THE LUBRIZOL CORPORATION

(Exact name of registrant as specified in its charter)

Ohio  
(State or other jurisdiction of  
incorporation or organization)

34-0367600  
(I.R.S. Employer  
Identification No.)

29400 Lakeland Boulevard  
Wickliffe, Ohio 44092-2298  
(Address of principal executive offices)  
(Zip Code)

(440) 943-4200  
(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

Number of the registrant's common shares, without par value, outstanding, as of July 31, 2001: 50,942,129.

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PART I. FINANCIAL INFORMATION

Item 1 Financial Statements

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THE LUBRIZOL CORPORATION

CONSOLIDATED BALANCE SHEETS

(In Thousands of Dollars)	June 30 2001	Decemb 2000
<b>ASSETS</b>		
Cash and short-term investments .....	\$ 119,251	\$ 145,251
Receivables .....	333,940	290,000
Inventories:		
Finished products .....	119,143	124,000
Products in process .....	56,252	56,000
Raw materials .....	68,381	61,000
Supplies and engine test parts .....	16,551	16,000
	-----	-----
	260,327	260,000
Other current assets .....	25,899	31,000
	-----	-----
Total current assets .....	739,417	727,000
Property and equipment - net .....	654,426	677,000
Goodwill and intangible assets - net .....	173,152	170,000
Investments in nonconsolidated companies .....	32,976	34,000
Other assets .....	61,644	49,000
	-----	-----
TOTAL .....	\$1,661,615	\$1,659,000
	=====	=====
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Short-term debt and current portion of long-term debt .....	\$ 21,981	\$ 17,000
Accounts payable .....	138,500	141,000
Accrued expenses and other current liabilities .....	114,778	123,000
	-----	-----
Total current liabilities .....	275,259	282,000
Long-term debt .....	385,739	378,000
Postretirement health care obligation .....	100,321	100,000
Noncurrent liabilities .....	51,195	52,000
Deferred income taxes .....	58,436	60,000
	-----	-----
Total liabilities .....	870,950	874,000
Minority interest in consolidated companies .....	32,688	32,000
Contingencies and commitments		
Shareholders' equity:		
Preferred stock without par value - authorized and unissued:		
Serial Preferred Stock - 2,000,000 shares		
Serial Preference Shares - 25,000,000 shares		
Common shares without par value:		
Authorized 120,000,000 shares		
Outstanding - 50,882,185 shares as of June 30,		
2001 after deducting 35,313,709 treasury		
shares, 51,307,688 shares as of December 31,		
2000 after deducting 34,888,206 treasury shares .....	100,996	82,000
Retained earnings .....	759,621	750,000
Accumulated other comprehensive loss .....	(102,640)	(80,000)
	-----	-----

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Total shareholders' equity .....	757,977	752
	-----	-----
TOTAL .....	\$1,661,615	\$1,659
	=====	=====

Amounts shown are unaudited.

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THE LUBRIZOL CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

(In Thousands Except Per Share Data)	Second Quarter Ended June 30		Six Period E
	2001	2000	2001
Net sales .....	\$485,928	\$448,979	\$939,719
Royalties and other revenues .....	1,856	1,212	2,714
	-----	-----	-----
Total revenues .....	487,784	450,191	942,433
Cost of sales .....	350,002	319,131	684,684
Selling and administrative expenses...	44,074	43,366	88,800
Research, testing and development expenses .....	38,876	36,454	77,361
	-----	-----	-----
Total cost and expenses ....	432,952	398,951	850,845
Special credit .....		2,577	
Other income (expense) - net .....	(3,807)	(2,612)	(7,794)
Interest income .....	1,293	1,972	3,332
Interest expense .....	(6,179)	(6,824)	(12,733)
	-----	-----	-----
Income before income taxes .....	46,139	46,353	74,393
Provision for income taxes .....	14,124	14,641	23,872
	-----	-----	-----
Net income .....	\$ 32,015	\$ 31,712	\$ 50,521
	=====	=====	=====
Net income per share .....	\$ 0.63	\$ 0.59	\$ 0.99
	=====	=====	=====
Net income per share, diluted .....	\$ 0.62	\$ 0.59	\$ 0.98
	=====	=====	=====
Dividends per share .....	\$ 0.26	\$ 0.26	\$ 0.52
	=====	=====	=====
Average common shares outstanding ....	51,205	53,547	51,243

Amounts shown are unaudited.

## THE LUBRIZOL CORPORATION

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands of Dollars)	Six Month Period Ended June 30	
	2001	2000
Cash provided from (used for):		
Operating activities:		
Net income .....	\$ 50,521	\$ 61,817
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization .....	49,214	48,469
Deferred income taxes .....	2,110	3,435
Special credit .....		(2,577)
Change in current assets and liabilities:		
Receivables .....	(53,586)	(27,929)
Inventories .....	(5,751)	(14,023)
Accounts payable and accrued expenses .....	13,296	2,244
Other current assets .....	2,941	1,554
Other items - net .....	4,162	(2)
Total operating activities .....	62,907	72,988
Investing activities:		
Capital expenditures .....	(33,627)	(38,381)
Acquisitions and investments in nonconsolidated companies .....	(14,989)	(40,641)
Other - net .....	81	189
Total investing activities .....	(48,535)	(78,833)
Financing activities:		
Short-term repayments .....	6,957	(4,808)
Long-term borrowing .....		18,375
Long-term repayments .....	(2,025)	(24,867)
Dividends paid .....	(26,642)	(28,074)
Common shares purchased .....	(30,039)	(35,883)
Stock options exercised .....	14,438	1,286
Total financing activities .....	(37,311)	(73,971)
Effect of exchange rate changes on cash .....	(3,747)	(1,595)
Net(decrease) in cash and short-term investments .....	(26,686)	(81,411)
Cash and short-term investments at the beginning of period .....	145,937	185,465
Cash and short-term investments at end of period ....	\$119,251	\$104,054

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Amounts shown are unaudited.

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THE LUBRIZOL CORPORATION

Notes to Consolidated Financial Statements

June 30, 2001

1. The accompanying unaudited consolidated financial statements contain all adjustments (consisting only of normal recurring accruals) necessary to present fairly the financial position as of June 30, 2001 and December 31, 2000, and the results of operations and cash flows for the applicable periods ended June 30, 2001 and 2000.
2. Net income per share is computed by dividing net income by average common shares outstanding during the period. Net income per share, diluted, includes the dilution effect resulting from outstanding stock options and stock awards.

Per share amounts are computed as follows:

	Second Quarter Ended June 30		Six Month Period Ended June 30	
	2001	2000	2001	2000
	-----	-----	-----	-----
Numerator:				
Net income available to common shares	\$32,015	\$31,712	\$50,521	\$61,817
	=====	=====	=====	=====
Denominator:				
Weighted average common shares outstanding	51,205	53,547	51,243	53,924
Dilutive effect of stock options and awards	246	107	216	142
	-----	-----	-----	-----
Denominator for net income per share, diluted	51,451	53,654	51,459	54,066
	=====	=====	=====	=====
Net income per share	\$ .63	\$ .59	\$ 0.99	\$ 1.15
	=====	=====	=====	=====
Net income per share, diluted	\$ .62	\$ .59	\$ 0.98	\$ 1.14
	=====	=====	=====	=====

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3. Total comprehensive income for the three- and six-month periods ended June 30, 2001 and 2000 is comprised as follows:

	Second Quarter Ended June 30		Six Month Period End June 30	
	2001	2000	2001	2000
Net income	\$ 32,015	\$31,712	\$ 50,521	\$ 61,712
Foreign currency translation adjustment	(6,746)	(7,338)	(20,344)	(18,338)
Cumulative effect of accounting change			(1,314)	
Net unrealized gains (losses) on derivative contracts	253		(356)	
Total comprehensive income	\$ 25,522	\$24,374	\$ 28,507	\$ 43,374

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THE LUBRIZOL CORPORATION

Notes to Consolidated Financial Statements

June 30, 2001

4. The company aggregates its product lines into two principal operating segments: fluid technologies for transportation and fluid technologies for industry. Fluid technologies for transportation is comprised of additives for lubricating engine oils, such as for gasoline, diesel, marine and stationary gas engines and additive components; additives for driveline oils, such as automatic transmission fluids, gear oils and tractor lubricants; and additives for fuel products and refinery and oil field chemicals. In addition, the company sells additive components and viscosity improvers within its lubricant and fuel additives product lines. The company's fluid technologies for transportation product lines are generally produced in shared manufacturing facilities and sold largely to a common customer base. Fluid technologies for industry includes industrial additives, such as additives for hydraulic fluids, metalworking fluids and compressor lubricants; performance chemicals, such as additives for coatings and inks and process chemicals; and performance systems, comprised principally of fluid metering devices and particulate emission trap devices. The company evaluates performance and allocates resources based on segment contribution income, defined as revenues less expenses directly identifiable to the product lines aggregated within each segment. In addition, the company allocates corporate research, testing, selling and administrative expenses, and excess production capacity costs, in arriving

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at segment operating profit before tax.

The following table presents a summary of the company's reportable segments for the three- and six- months ended June 30, 2001 and 2000 on a basis of segmentation consistent with the previous year-end:

	Quarter Ended June 30		Six Month Per June 30
	2001	2000	2001
Revenue from external customers:			
Fluid technologies for transportation	\$408,143	\$368,385	\$781,180
Fluid technologies for industry	79,641	81,806	161,253
Total revenues	\$487,784	\$450,191	\$942,433
Segment contribution income:			
Fluid technologies for transportation	\$ 80,799	\$ 76,933	\$145,315
Fluid technologies for industry	7,842	11,832	14,457
Total segment contribution income	\$ 88,641	\$ 88,765	\$159,772
Segment operating profit before tax:			
Fluid technologies for transportation	\$ 47,384	\$ 41,137	\$ 78,129
Fluid technologies for industry	3,641	7,491	5,665
Total segment operating profit before tax	51,025	48,628	83,794
Special credit		2,577	
Interest expense - net	(4,886)	(4,852)	(9,401)
Consolidated income before tax	\$ 46,139	\$ 46,353	\$ 74,393

Prior-year amounts have been restated to reflect reclassifications of products between fluid technologies for transportation and fluid technologies for industry operating segments and changes in allocation methodology for corporate expenses.

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### THE LUBRIZOL CORPORATION

#### Notes to Consolidated Financial Statements

June 30, 2001

5. The company had an effective tax rate of 30.6% for the three-month period

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ended June 30, 2001 and 32.1% for the six-month period ended June 30, 2001, compared to 31.6% and 31.5% for the corresponding periods in 2000. The effective tax rate for the second quarter was lower than the effective rate for the six months ended June 30, 2001, due in large part to a non-recurring revaluation of deferred taxes to reflect a statutory tax rate change in India enacted during the second quarter. The effective tax rate for the six months ended June 30, 2001 was higher than the corresponding period in 2000, primarily due to the U.S. tax benefit of a non-recurring charitable contribution made in 2000.

6. In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities". In June 2000, the FASB amended certain provisions of that statement by issuing SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities". These statements require the company to recognize all derivatives on the balance sheet at fair value and establish criteria for designation and effectiveness of hedging relationships. Derivatives that are not hedges must be adjusted to fair value through income. Depending upon the nature of the hedge, changes in fair value of the derivative are offset against the change in fair value of assets, liabilities or firm commitments through earnings, or recognized in other comprehensive income until the hedged item is recognized in earnings. The ineffective portion of a derivative's change in value is immediately recognized in earnings.

Effective January 1, 2001, the company adopted the provisions of these statements. The company uses derivative financial instruments only to manage well-defined interest rate and foreign currency risks. The company does not use derivatives for trading purposes. The adoption of SFAS 133 did not have a material effect on net income as of January 1, 2001, but did result in a \$2.0 million reduction (\$1.3 million net of tax) of other comprehensive income.

### Interest Rate Contracts

The company is exposed to market risk from changes in interest rates. The company's policy is to manage interest costs using a mix of fixed and variable rate debt. To manage this mix, the company may enter into interest rate swaps, in which the company agrees to exchange, at specified intervals, the difference between fixed and variable interest amounts calculated by reference to an agreed upon notional principal amount.

At June 30, 2001, the company had interest rate swap agreements to convert existing fixed rate debt to variable rates. The fair value of these swaps was an unrealized gain of \$8.7 million, they are designated as fair value hedges of underlying fixed rate debt obligations and are recorded as an increase in non-current assets and long-term debt. These interest rate swaps qualify for the short-cut method for assessing hedge effectiveness per SFAS 133. As a result, there was no impact to earnings for the second quarter of 2001 due to hedge ineffectiveness. Future changes in fair value of the interest rate swaps will be offset by the changes in fair value of the underlying debt.



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At June 30, 2001, the company had interest rate swap agreements to convert existing variable rate debt to fixed rates. The fair value of these swaps was an unrealized loss of \$3.7 million, they are designated as cash flow hedges of underlying variable rate debt obligations and are recorded as a noncurrent liability. The adjustment to record the net change in fair value during the second quarter of 2001 of \$.4 million (\$.3 million net of tax) unrealized gain was recorded in other comprehensive income. Ineffectiveness was determined to be immaterial during the second quarter of 2001. The company does not expect any significant portion of these existing losses to be reclassified into earnings within the next 12 months.

### Currency Contracts

The company is exposed to the effect of changes in foreign currency rates on its earnings and cash flow as a result of doing business internationally. In addition to working capital management, pricing and sourcing, the company selectively uses foreign currency forward contracts to lessen the potential effect of currency changes. These contracts are generally in connection with specific transactions having maturities of less than one year.

At June 30, 2001, the company had short-term forward contracts to sell currencies at various dates during 2001 for \$7.1 million. These forward contracts are not designated as hedges. Any unrealized gains or losses on these contracts are recorded in other income. The fair value of these instruments at June 30, 2001 was not material, and the net impact of the related gains and losses on other income was a loss of \$.1 million in the quarter ended June 30, 2001 and no impact on the six months ended June 30, 2001.

7. In July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 141, "Business Combinations" which prohibits the pooling-of-interests method for business combinations completed after June 30, 2001 and includes criteria for recognition of intangible assets separate from goodwill. Any business combinations the company enters into after June 30, 2001 will have to be accounted for under the provisions of this statement.

In July 2001 the FASB also issued SFAS 142, "Goodwill and Other Intangible Assets" which will become effective for the company on January 1, 2002. Under the provisions of SFAS 142 there will be no goodwill amortization for business combinations that occur after June 30, 2001 and amortization of goodwill on pre-June 30, 2001 acquisitions will cease effective January 1, 2002. The adoption of this statement will result in the elimination of approximately \$10 million of annual goodwill amortization expense beginning on January 1, 2002. Goodwill amortization will be replaced with the requirement to test goodwill annually for impairment. The initial impairment test must be completed within six months of adoption of the new standard. The company has not determined the impact, if any, that the requirement to test goodwill for impairment will have on its consolidated financial position or results of operations.

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June 30, 2001

8. Effective July 17, 2001, the company increased its committed revolving credit facilities from \$150 million to \$575 million. This resulted from the addition of \$525 million in new facilities, \$175 million of which expires on July 16, 2002 and \$350 million of which expires on July 16, 2006; and the cancellation of \$100 million in existing facilities that would have expired on June 30, 2003. We currently have no borrowings under these credit facilities.

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### LUBRIZOL CORPORATION

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

##### RESULTS OF OPERATIONS

Our revenues increased in the 2001 second quarter as compared to the 2000 second quarter, largely as a result of record shipment volume during the quarter. Raw material costs declined from the first quarter of 2001 and, combined with lower per-unit manufacturing costs, resulted in improved profitability in the second quarter as compared to the prior two quarters. We had higher operating expenses and currency had an unfavorable impact in the second quarter. After excluding the special credit taken in the second quarter of 2000, net income for the 2001 second quarter increased 7% from net income for the 2000 second quarter. However, the stronger 2001 second quarter did not offset the poor results from the 2001 first quarter, so that net income for the first half of 2001 was 16% below that for the first half of 2000 (after excluding the special credit).

We group our product lines into two operating segments: fluid technologies for transportation and fluid technologies for industry. Fluid technologies for transportation comprised approximately 82% of our consolidated revenues and 85% of our segment pre-tax operating profits for the full year 2000 (83% of revenues and 93% of operating profits for the six months ended June 30, 2001). This discussion and analysis of our financial condition and results of operations is primarily focused upon the company as a whole, since we believe this provides

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the most appropriate understanding of our business. See Note 4 to the financial statements for further financial disclosures by operating segment.

Our consolidated revenues increased \$37.6 million, or 8% (6% excluding acquisitions), for the second quarter of 2001 compared with the second quarter of 2000, and increased \$47.1 million, or 5% (3% excluding acquisitions), for the first half of 2001 compared with the first half of 2000. On a year-to-year comparative basis, fluid technologies for transportation revenues increased \$39.8 million, or 11%, for the second quarter and \$45.7 million, or 6%, for the first half. On a similar basis, fluid technologies for industry revenues decreased \$2.2 million, or 3%, for the second quarter and increased \$1.4 million, or 1%, for the first half.

Our shipment volume increased 9% in the second quarter of 2001 (7% excluding acquisitions) compared to the second quarter of 2000, after increasing only 1% in the first quarter (and decreasing 2% excluding acquisitions). Our shipment volume for the first half of 2001 increased 5% (2% excluding acquisitions) compared with the first half of 2000. Our second quarter 2001 and first half 2001 shipment volume increased in all geographical areas as compared with comparable prior-year periods, as follows:

	Increase	
	2nd Quarter	First Half
North America	8%	6%
Europe, Middle East	12%	5%
Asia-Pacific	11%	4%
Latin America	1%	2%

The increases are primarily due to business gains in our engine oil additives product group in North America and strong shipments to many of our global engine oil customers in Europe. We believe some of the second quarter engine oil shipments in North America represent pipeline-filling and new specification change-over for GF-3, the new passenger car motor

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### THE LUBRIZOL CORPORATION

#### Management's Discussion and Analysis of Financial Condition and Results of Operations

oil standard, that will not recur in subsequent quarters. The increase in Asia-Pacific is primarily due to consolidation of our new China subsidiaries during the fourth quarter of 2000.

Average additive selling price was flat for the 2001 second quarter and increased only 1% for the 2001 first half, as compared with the same periods in 2000. This resulted from 6% higher pricing for the 2001 second quarter and 7% higher product pricing for 2001 first half due to the four price increases initiated since late 1999, offset approximately equally by unfavorable currency impact and product mix for both the second quarter and first half. Sequentially, average selling price decreased 2% from the 2001 first quarter primarily due to the impact of unfavorable currency.

Cost of sales increased 10% for the 2001 second quarter and increased 8% for the 2001 first half, compared to the same periods in 2000, reflecting the increase in shipment levels, higher raw material costs and higher manufacturing expenses. Average raw material cost increased 3% for the 2001 second quarter and 5% for

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the 2001 first half, compared with the same periods in 2000, due to increases in real raw material costs, partially offset by the effect of favorable currency and product mix. This increase in real raw material cost reflected the effect of higher crude oil costs on petrochemical prices and the impact of higher natural gas costs on our butylene-based raw materials. We have started to see these costs decline, as average raw material cost decreased 3% in the second quarter as compared to the first quarter. Current market projections indicate that raw material costs may continue to decline to some extent during the second half of the year. Manufacturing costs were 6% higher for the 2001 second quarter compared with the 2000 second quarter and 3% higher for the 2001 first half compared with the 2000 first half, primarily due to higher utility costs in the U.S. as a result of higher natural gas costs, and acquisitions, partially offset by the effect of favorable currency.

Gross profit (sales less cost of sales) increased \$6.1 million, or 5%, for the second quarter of 2001, and decreased \$2.1 million, or 1%, for the first half of 2001, compared with the same periods in 2000. The second quarter gross profit rose because the effect of the shipment volume increase more than offset higher raw material costs and manufacturing expenses. However, for the first half, the effect of the shipment volume increase did not offset those increased costs. Gross profit for fluid technologies for transportation increased \$8.6 million, or 8%, for the second quarter of 2001, and \$1.8 million, or 1%, for the first half of 2001 compared with the same periods in 2000 due to the factors mentioned above. Gross profit for fluid technologies for industry decreased \$2.5 million, or 9%, for the second quarter of 2001, and \$3.9 million, or 7%, for the first half of 2001 compared with the same periods in 2000, primarily because the weak manufacturing sector in North America adversely affected our metalworking and paints, coatings and inks additive businesses. These factors caused our gross profit percentage (gross profit divided by net sales) to be 28.0% in the 2001 second quarter (as compared to 28.9% in the 2000 second quarter) and 27.1% in the 2001 first half (as compared with 28.8% in the 2000 first half). Sequentially, gross profit increased 14% from the first quarter of 2001 and the gross profit percentage increased from 26.2% in the first quarter of 2001 primarily because of higher volume and lower average raw material cost. However, our current gross profit percentage is still well below our gross profit percentage in late 1999 when raw material costs began to increase.

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### THE LUBRIZOL CORPORATION

#### Management's Discussion and Analysis of Financial Condition and Results of Operations

Selling and administrative expenses increased \$.7 million, or 2%, for the second quarter of 2001 and \$1.9 million, or 2%, for the first half of 2001 compared with the respective 2000 periods, primarily due to the impact of acquisitions.

Our research, testing and development expenses (technology expenses) increased \$2.4 million, or 7%, for the second quarter of 2001 and increased \$6.3 million, or 9%, for the first half of 2001 compared to the same periods of 2000. The increase was due to high levels of testing, primarily in the first quarter, for GF-3, the new U.S. passenger car motor oil technical standard, and increased development spending, primarily in the second quarter, for growth programs and early stage expenses required for the next diesel engine oil specification, PC-9.

The change in other income (expense) negatively affected pre-tax income by \$1.2 million for the second quarter of 2001 and by \$3.4 million for the first half of 2001 compared with the respective 2000 periods. The unfavorable change for the

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second quarter was primarily due to lower equity earnings of our joint ventures in India and Saudi Arabia, higher expense for our joint venture with GE and the accounting effect of consolidating our majority-owned China subsidiaries, partially offset by currency gains. The unfavorable change for the first half of 2001 compared to the first half of 2000 was primarily due to higher expenses for our joint venture with GE and higher goodwill amortization.

Interest income decreased \$.7 million for the 2001 second quarter and \$1.2 million for the 2001 first half, compared to the same periods in 2000, principally because we had a lower level of cash investments in 2001. Interest expense decreased \$.6 million for the 2001 second quarter and \$1.3 million for the 2001 first half, compared to the same periods in 2000, principally because of lower interest rates due to the interest rate swap agreements we entered into during the first half of 2000.

As a result of the above factors, our income before income taxes decreased 1% for the second quarter of 2001 (but increased 5% excluding the 2000 second quarter special charge adjustment) and decreased 18% for the first half of 2001 (15% excluding the 2000 second quarter special charge adjustment) compared to the same periods in 2000. Segment operating profit before tax, which excludes interest expense, for fluid technologies for transportation increased \$6.2 million, or 15%, for the 2001 second quarter and decreased \$3.3 million, or 4%, for the 2001 first half compared to the same periods in 2000 for the same reasons that caused the changes in consolidated gross profit as described above. Segment operating profit before tax for fluid technologies for industry decreased \$3.9 million, or 51%, for the 2001 second quarter and decreased \$10.1 million, or 64%, for the 2001 first half compared to the same periods in 2000 because of weak demand in the manufacturing sector in North America and spending to commercialize PuriNOx(TM) and other products in our performance systems product group.

We had an effective tax rate of 30.6% for the 2001 second quarter and 32.1% for the 2001 first half compared to 31.6% and 31.5% for the corresponding periods in 2000. The effective tax rate for the 2001 second quarter was lower than the effective rate for the 2001 first half, due in large part to a non-recurring revaluation of deferred taxes to reflect a statutory tax rate change in India enacted during the 2001 second quarter. The effective tax rate for the 2001 first half was higher than the

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### THE LUBRIZOL CORPORATION

#### Management's Discussion and Analysis of Financial Condition and Results of Operations

corresponding period in 2000, primarily due to the U.S. tax benefit of a non-recurring charitable contribution made in 2000. We anticipate an effective tax rate of 33.5% for the second half of 2001.

Currency exchange rates in effect during the second quarter and first half of 2001 had an unfavorable effect on net income per share of \$.05 and \$.12 per share, respectively, as compared to exchange rates in effect during the comparable periods in 2000.

Primarily as a result of the above factors, and after excluding the adjustment to the special charge, net income for the 2001 second quarter was \$32.0 million or \$.63 per share, as compared to \$30.0 million or \$.56 per share for the 2000 second quarter. For the first half of 2001, on the same basis, net income was \$50.5 million or \$.99 per share, as compared to \$60.1 million or \$1.12 per share for the first half of 2000.

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### WORKING CAPITAL, LIQUIDITY AND CAPITAL RESOURCES

Cash provided from operating activities was \$62.9 million for the first half of 2001 compared with \$73.0 million for the first half of 2000. The decrease was caused principally by the reduction in net income compared to the first half of 2000.

Our capital expenditures in the first half of 2001 were \$33.6 million compared with \$38.4 million for the same 2000 period. We estimate capital spending for the full year 2001 will be \$75 million to \$80 million as compared with \$85.8 million in 2000.

During the first quarter of 2001 we completed one acquisition for \$15.0 million. The business acquired, ROSS Chem, Inc., produces defoamers and anti-foam agents that expand our product lines in metalworking and paints, coatings and inks.

During the first half of 2001 we repurchased approximately 968,000 of our shares for \$30.0 million. We currently do not anticipate making share repurchases during the third quarter of 2001.

Our net debt to capitalization ratio at June 30, 2001 was 29.7%. Net debt is the total of short- and long-term debt, reduced by cash and short-term investments in excess of an assumed operating cash level of \$40 million and excluding unrealized gains and losses on derivative instruments designated as fair value hedges of fixed rate debt. Capitalization is shareholders' equity plus net debt.

Primarily as a result of these activities and the payment of dividends, our balance of cash and short-term investments decreased \$26.7 million at June 30, 2001 compared with December 31, 2000.

Our financial position remains strong with a ratio of current assets to current liabilities of 2.7 to 1 at June 30, 2001 compared with a ratio of 2.6 to 1 at December 31, 2000. We believe our current credit facilities, internally generated funds and our ability to obtain additional financing will enable us to meet our future spending needs.

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### THE LUBRIZOL CORPORATION

#### Management's Discussion and Analysis of Financial Condition and Results of Operations

Effective July 17, 2001, we increased our committed revolving credit facilities from \$150 million to \$575 million. This resulted from the addition of \$525 million in new facilities (\$175 million of which expires on July 16, 2002 and \$350 million of which expires on July 16, 2006); and the cancellation of \$100 million in existing facilities that would have expired on June 30, 2003. We currently have no borrowings under these credit facilities.

### COST REDUCTION PROGRAMS

We initiated a series of steps in 1998 to reduce costs and improve our worldwide operating structure and executed these steps in two programs over a two-year period, completing the process at December 31, 2000. The first program of this initiative was substantially completed by the end of the third quarter of 1999.

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The second program, which began in the third quarter of 1999 and involved primarily the downsizing of our Painesville, Ohio manufacturing facility, was completed at December 31, 2000. Approximately \$.6 million remains as an accrued liability at June 30, 2001, for severance-related payments for employees separated prior to December 31, 2000 and costs to complete the dismantling of assets that were taken out of service as of December 31, 2000. We expect these expenses to be incurred before the end of the year.

### CAUTIONARY STATEMENT FOR SAFE HARBOR PURPOSES

This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements within the meaning of the federal securities laws. As a general matter, forward-looking statements are those focused upon future plans, objectives or performance as opposed to historical items and include statements of anticipated events or trends and expectations and beliefs relating to matters not historical in nature. Such forward-looking statements are subject to uncertainties and factors relating to our operations and business environment, all of which are difficult to predict and many of which are beyond our control. Such uncertainties and factors could cause our actual results to differ materially from those matters expressed in or implied by such forward-looking statements.

We believe that the following factors, among others, could affect our future performance and cause our actual results to differ materially from those expressed or implied by forward-looking statements made in this quarterly report:

- o the overall demand for lubricant and fuel additives on a worldwide basis, which has a slow growth rate in mature markets such as North America and Europe;
- o the effect on our business resulting from economic and political uncertainty within the Asia-Pacific and Latin American regions;
- o the lubricant additive demand in developing regions such as China and India, which geographic areas are an announced focus of our activities;
- o technology developments that affect longer-term trends for lubricant additives, such as improved equipment design, fuel economy, longer oil drain intervals, alternative fuel-powered engines and emission system compatibility;

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### THE LUBRIZOL CORPORATION

#### Management's Discussion and Analysis of Financial Condition and Results of Operations

- o the extent to which we are successful in expanding our business in new and existing fluid technology markets incorporating chemicals, systems and services for industry and transportation;
- o our success at continuing to develop proprietary technology to meet or exceed new industry performance standards and individual customer and original equipment manufacturers' expectations;

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- o the frequency of change in industry performance standards, which affects the level and timing of our technology costs, the product life cycles and the relative quantity of additives required for new specifications;
- o our ability to continue to reduce complexities and conversion costs and modify our cost structure to maintain and enhance our competitiveness;
- o our success in strengthening relationships and growing business with our largest customers, and retaining the business of these customers over extended time periods;
- o our ability to identify, complete and integrate acquisitions for profitable growth;
- o the potential negative impact on product pricing and volume demand from the consolidation of finished lubricant marketers;
- o the degree of competition resulting from lubricant additive industry over-capacity;
- o the cost, availability and quality of raw materials, including petroleum-based products;
- o the cost and availability of energy, including natural gas and electricity;
- o the effects of fluctuations in currency exchange rates upon our reported results from international operations, together with non-currency risks of investing in and conducting significant operations in foreign countries, including those relating to political, social, economic and regulatory factors;
- o the extent to which we achieve market acceptance of our PuriNOx(TM) low emission, water blend fuel product;
- o significant changes in government regulations affecting environmental compliance.

### THE LUBRIZOL CORPORATION

#### Item 3. Quantitative and Qualitative Disclosures About Market Risk

We operate manufacturing and blending facilities, laboratories and offices around the world and utilize fixed and variable rate debt to finance our global operations. As a result, we are subject to business risks inherent in non-U.S. activities, including political and economic uncertainty, import and export limitations, and market risk related to changes in interest rates and foreign currency exchange rates. We believe the political and economic risks related to our foreign operations are mitigated due to the stability of the countries in which our largest



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foreign operations are located.

In the normal course of business, we use derivative financial instruments including interest rate swaps and foreign currency forward exchange contracts to manage our market risks. Our objective in managing our exposure to changes in interest rates is to limit the impact of such changes on earnings and cash flow and to lower our overall borrowing costs. Our objective in managing our exposure to changes in foreign currency exchange rates is to reduce the economic effect on earnings and cash flow associated with such changes. Our principal currency exposures are in the major European currencies, the Japanese yen and certain Latin American currencies. We do not hold derivatives for trading purposes.

A quantitative and qualitative discussion about our market risk is contained on page 23 of our 2000 Annual Report to our shareholders. There have been no material changes in the market risks faced by us since December 31, 2000.

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### PART II. OTHER INFORMATION

#### Item 2. Changes in Securities and Use of Proceeds

- (c) On May 1, 2001, we issued 602 common shares in private placement transactions exempt from registration under the Securities Act of 1933 pursuant to Section 4(2) of that Act. We issued the shares to two former directors pursuant to a deferred compensation plan for directors.

#### Item 4. Submission of Matters to a Vote of Security Holders

Our Annual Meeting of Shareholders was held April 23, 2001. The following matters were voted on by the shareholders:

1. Election of directors:
  - (a) Gordon D. Harnett. The vote was 45,235,457 shares for and 393,451 shares to withhold authority.
  - (b) Victoria F. Haynes. The vote was 45,226,870 shares for and 402,037 shares to withhold authority.
  - (c) William P. Madar. The vote was 45,235,916 shares for and 392,991 shares to withhold authority.
  - (d) M. Thomas Moore. The vote was 45,215,285 shares for and 413,622 shares to withhold authority.
2. A proposal to confirm the appointment of Deloitte & Touche LLP as independent auditors. The vote was 45,297,317 shares for; 283,268

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shares against; and 48,324 shares abstaining.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

(10) (h) \* The Lubrizol Corporation 1991 Stock Incentive Plan,  
as amended.

\* Indicates management contract or compensatory plan or  
agreement.

(b) Reports on Form 8-K

There were no reports on Form 8-K filed during the quarter ended  
June 30, 2001.

Signatures

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

THE LUBRIZOL CORPORATION

/s/John R. Ahern

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John R. Ahern  
Chief Accounting Officer and  
Duly Authorized Signatory of  
The Lubrizol Corporation

Date: August 9, 2001