

RPM INTERNATIONAL INC/DE/

Form 10-Q

October 10, 2006

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

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended August 31, 2006,

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 No. 1-14187

RPM International Inc.

(Exact name of Registrant as specified in its charter)

DELAWARE

02-0642224

(State or other jurisdiction of incorporation or organization)

(IRS Employer Identification No.)

P.O. BOX 777; 2628 PEARL ROAD; MEDINA, OHIO

44258

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number including area code

(330) 273-5090

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

Yes No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of October 5, 2006

119,331,232 Shares of RPM International Inc. Common Stock were outstanding.

RPM INTERNATIONAL INC. AND SUBSIDIARIES*
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* As used herein, the terms "RPM" and the "Company" refer to RPM International Inc. and its subsidiaries, unless the context indicates otherwise.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
RPM INTERNATIONAL INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands, except per share amounts)

| | August 31, 2006 (Unaudited) | May 31, 2006 |
|--|--|-------------------------|
| ASSETS | | |
| Current Assets | | |
| Cash and short-term investments | \$ 107,970 | \$ 108,616 |
| Trade accounts receivable (less allowances of \$20,870 and \$20,252, respectively) | 600,223 | 650,945 |
| Inventories | 418,243 | 399,014 |
| Deferred income taxes | 41,896 | 48,885 |
| Prepaid expenses and other current assets | 185,163 | 161,758 |
| Total current assets | 1,353,495 | 1,369,218 |
| Property, Plant and Equipment, at Cost | | |
| Allowance for depreciation and amortization | (457,189) | (442,584) |
| Property, plant and equipment, net | 441,139 | 444,692 |
| Other Assets | | |
| Goodwill | 792,353 | 750,635 |
| Other intangible assets, net of amortization | 317,866 | 321,942 |
| Other | 85,557 | 93,731 |
| Total other assets | 1,195,776 | 1,166,308 |
| Total Assets | \$ 2,990,410 | \$ 2,980,218 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current Liabilities | | |
| Accounts payable | \$ 289,340 | \$ 333,684 |
| Current portion of long-term debt | 5,245 | 6,141 |
| Accrued compensation and benefits | 91,955 | 136,384 |
| Accrued loss reserves | 63,174 | 66,678 |
| Asbestos-related liabilities | 58,575 | 58,925 |
| Other accrued liabilities | 132,646 | 111,688 |

| | | |
|--|--------------|--------------|
| Total current liabilities | 640,935 | 713,500 |
| Long-Term Liabilities | | |
| Long-term debt, less current maturities | 926,382 | 870,415 |
| Asbestos-related liabilities | 346,268 | 362,360 |
| Other long-term liabilities | 102,994 | 108,002 |
| Total long-term liabilities | 1,375,644 | 1,340,777 |
| Stockholders' Equity | | |
| Preferred stock, par value \$0.01; authorized 50,000 shares; none issued | | |
| Common stock, par value \$0.01; authorized 300,000 shares; issued and outstanding 118,850 as of August 2006; issued and outstanding 118,743 as of May 2006 | 1,189 | 1,187 |
| Paid-in capital | 547,877 | 545,422 |
| Accumulated other comprehensive income | 32,930 | 29,839 |
| Retained earnings | 391,835 | 349,493 |
| Total stockholders' equity | 973,831 | 925,941 |
| Total Liabilities and Stockholders' Equity | \$ 2,990,410 | \$ 2,980,218 |

The accompanying notes to consolidated financial statements are an integral part of these statements.

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RPM INTERNATIONAL INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME**(Unaudited)***(In thousands, except per share amounts)*

| | Three Months Ended | |
|---|---------------------------|-------------|
| | August 31, | |
| | 2006 | 2005 |
| Net Sales | \$ 844,161 | \$ 747,352 |
| Cost of Sales | 499,088 | 432,333 |
| Gross Profit | 345,073 | 315,019 |
| Selling, General and Administrative Expenses | 237,585 | 213,760 |
| Asbestos Charge | | 15,000 |
| Interest Expense, Net | 13,203 | 8,575 |
| Income Before Income Taxes | 94,285 | 77,684 |
| Provision for Income Taxes | 32,943 | 27,723 |
| Net Income | \$ 61,342 | \$ 49,961 |
| Average Number of Shares of Common Stock Outstanding: | | |
| Basic | 117,467 | 116,542 |
| Diluted | 128,192 | 127,262 |
| Basic earnings per share of common stock | \$ 0.52 | \$ 0.43 |
| Diluted earnings per share of common stock | \$ 0.49 | \$ 0.40 |
| Cash dividends per share of common stock | \$ 0.16 | \$ 0.15 |

The accompanying notes to consolidated financial statements are an integral part of these statements.

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RPM INTERNATIONAL INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)
(In thousands)

| | Three Months Ended | |
|--|--------------------|-----------|
| | August 31, | |
| | 2006 | 2005 |
| Cash Flows From Operating Activities: | | |
| Net income | \$ 61,342 | \$ 49,961 |
| Depreciation and amortization | 19,173 | 16,759 |
| Items not affecting cash and other | 2,379 | 6,420 |
| Changes in operating working capital | (49,320) | (39,049) |
| Changes in asbestos-related liabilities, net of tax | (10,523) | (1,115) |
| | 23,051 | 32,976 |
| Cash Flows From Investing Activities: | | |
| Capital expenditures | (11,246) | (8,514) |
| Acquisition of businesses, net of cash acquired | (39,270) | (135,780) |
| Purchases of marketable securities | (18,214) | (12,340) |
| Proceeds from the sale of marketable securities | 10,996 | 8,552 |
| Other | 286 | (556) |
| | (57,448) | (148,638) |
| Cash Flows From Financing Activities: | | |
| Additions to long-term and short-term debt | 93,372 | 177,231 |
| Reductions of long-term and short-term debt | (41,234) | (150,620) |
| Cash dividends | (18,999) | (17,635) |
| Exercise of stock options | 965 | 1,412 |
| | 34,104 | 10,388 |
| Effect of Exchange Rate Changes on Cash and Short-Term Investments | (353) | (810) |
| (Decrease) in Cash and Short-Term Investments | (646) | (106,084) |
| Cash and Short-Term Investments at Beginning of Period | 108,616 | 184,140 |

| | | |
|--|------------|-----------|
| Cash and Short-Term Investments at End of Period | \$ 107,970 | \$ 78,056 |
|--|------------|-----------|

The accompanying notes to consolidated financial statements are an integral part of these statements.

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RPM INTERNATIONAL INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
AUGUST 31, 2006
(Unaudited)

NOTE A BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and notes required by generally accepted accounting principles (GAAP) in the U.S. for complete financial statements. In the opinion of management, all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation have been included for the three month periods ended August 31, 2006 and 2005. For further information, refer to the Consolidated Financial Statements and Notes included in our Annual Report on Form 10-K for the year ended May 31, 2006. Our business is dependent on external weather factors. Historically, we have experienced strong sales and net income in our first, second and fourth fiscal quarters comprised of the three month periods ending August 31, November 30 and May 31, respectively, with weaker performance in our third fiscal quarter (December through February). Certain reclassifications have been made to prior year amounts to conform to the current year presentation.

NOTE B NEW ACCOUNTING STANDARDS

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). FIN 48, which clarifies the accounting for uncertainty, if any, in income taxes as recognized in financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes, represents a significant change in the accounting and reporting of income taxes. FIN 48 prescribes the accounting for uncertainty in income taxes by providing guidance on the recognition threshold and measurement of a position taken in a tax return or a position expected to be taken in a tax return. Additionally, FIN 48 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The effective date of FIN 48 is for fiscal years beginning after December 15, 2006. Accordingly, FIN 48 becomes effective for our fiscal year ending May 31, 2008. We are currently evaluating the impact of the adoption of FIN 48 on our financial statements.

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements. Statement 157 clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. This statement is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact, if any, the adoption of this statement will have on our financial statements.

In September 2006, the FASB issued Statement No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R). Statement 158 requires an employer to recognize a net liability or asset and an offsetting adjustment to accumulated other comprehensive income to report the funded status of defined benefit pension and other postretirement benefit plans. Statement 158 requires prospective application, and the recognition and disclosure requirements are effective for our fiscal year ending May 31, 2007. Additionally, Statement 158 requires employers to measure plan assets and obligations at their year-end

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RPM INTERNATIONAL INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
AUGUST 31, 2006
(Unaudited)

balance sheet date. This requirement is effective for our fiscal year ending May 31, 2009. We are currently evaluating the impact the adoption of Statement 158 will have on our financial statements.

Effective June 1, 2004, we voluntarily adopted the preferable fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, for our stock-based employee compensation plans by applying the modified prospective method as outlined by SFAS No. 148,

Accounting for Stock-Based Compensation Transition and Disclosure. On December 16, 2004, the FASB issued FASB Statement No. 123 (revised 2004), Share Based Payment, which is a revision of SFAS No. 123. SFAS No. 123(R) also supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and amends FASB Statement No. 95, Statement of Cash Flows. The approach outlined in SFAS No. 123(R) is generally similar to the approach described in SFAS No. 123. However, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values.

Effective June 1, 2006, we adopted the provisions of SFAS No. 123(R), utilizing the modified-prospective method of accounting. Due to our previous adoption of the fair value recognition provisions under SFAS No. 123, and due to the fact that all unvested awards at the time of adoption were being recognized under a fair value approach, our adoption of SFAS No. 123(R) did not impact our operating income, income before income taxes, net income, cash flow from operating activities, cash flow from financing activities, or basic and diluted earnings per share for the three months ended August 31, 2006.

As of August 31, 2006, we had six share-based compensation plans for employees and/or directors of the company, as further described below. Total compensation expense recognized in the consolidated statements of income for share-based compensation arrangements was \$1.5 million for each of the three month periods ended August 31, 2006 and 2005. The total income tax benefit recognized for share-based compensation arrangements was approximately \$0.5 million for each of the three month periods ended August 31, 2006 and 2005. The amount of compensation cost that was capitalized as inventory or fixed assets during the three month periods ended August 31, 2006 and 2005 was zero.

Effective October 10, 2003, the RPM International Inc. 2003 Restricted Stock Plan for Directors (the 2003 Plan) was approved by our stockholders. The plan was established primarily for the purpose of recruiting and retaining directors, and to align the interests of directors with the interests of our stockholders. Only directors who are not employees of RPM International Inc. are eligible to participate. Under the 2003 Plan, up to 500,000 shares of RPM International Inc. may be awarded, with awards vesting over a 3-year period. Nonvested restricted shares of common stock under the 2003 Plan are eligible for dividend payments.

On October 8, 2004, our stockholders approved the RPM International Inc. Omnibus Equity and Incentive Plan (the Omnibus Plan). The Omnibus Plan is intended to be the primary stock-based award program for covered employees. A wide variety of stock and stock-based awards, as well as dollar-denominated performance-based awards, may be granted under the Omnibus Plan. A total of 6,000,000 shares of our common stock may be subject to awards under the Omnibus Plan. Of the

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RPM INTERNATIONAL INC. AND SUBSIDIARIES
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(Unaudited)

6,000,000 shares of common stock issuable under the Omnibus Plan, up to 3,000,000 shares may be subject to full-value awards such as restricted stock, restricted stock unit, performance stock and performance stock unit awards. We also grant stock appreciation rights (SARs) to employees; see the discussion below regarding shares under option for further information. In October 2005, we granted 328,500 shares of restricted stock under the Omnibus Plan at a weighted-average grant price of \$17.65. The restricted stock cliff vests after three years. No restricted stock was issued under this plan during the first quarter ended August 31, 2006. Nonvested restricted shares of common stock under the Omnibus Plan are eligible for dividend payments.

In addition to the restricted shares outstanding under the Omnibus Plan, we have restricted shares outstanding under two equity compensation plans for employees the Performance Accelerated Restricted Stock Plan (the PARS Plan) and the 1997 Restricted Stock Plan (1997 Plan). Under the terms of the PARS plan, up to 1,000,000 shares may be awarded to certain employees, generally subject to forfeiture until the completion of ten years of service or the attainment of certain performance goals. No shares were issued under the PARS Plan in fiscal 2006 or during the quarter ended August 31, 2006. Under the 1997 Plan, up to 1,562,500 shares may be awarded to certain employees, generally subject to forfeiture. The shares vest upon the latter of attainment of age 55 and the fifth anniversary of the May 31st immediately preceding the date of the grant. During the quarter ended August 31, 2006, 38,149 shares were awarded under the 1997 Plan at a weighted average price of \$18.52. Nonvested restricted shares of common stock under each of these plans are eligible for dividend payments.

The following table summarizes nonvested restricted share activity under the Plans as of and for the three month period ended August 31, 2006:

Nonvested Restricted Shares

| <i>(Shares in thousands)</i> | Weighted Average Grant-Date Fair Value | Number of Shares Under Option | Weighted Average Remaining Contractual Term |
|-----------------------------------|---|--|---|
| Nonvested, June 1, 2006 | \$ 14.92 | 1,367 | |
| Granted | \$ 18.52 | 38 | |
| Forfeited/expired | | (7) | |
| Nonvested, August 31, 2006 | \$ 15.01 | 1,398 | 4.49 |

The fair value of the nonvested restricted share awards have been calculated using the market value of the shares on the date of issuance. We anticipate that approximately 1.3 million shares at a weighted-average exercise price of \$14.95 and a weighted-average remaining contractual term of 4.53 years will ultimately vest, based upon the unique terms and participants of each plan. Approximately 10,000 shares of restricted stock were vested at June 1, 2006, with no changes occurring through August 31, 2006. As of August 31, 2006, total unrecognized compensation cost related to nonvested restricted shares of

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RPM INTERNATIONAL INC. AND SUBSIDIARIES
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(Unaudited)

common stock awards granted was \$11.0 million. That cost is expected to be recognized over a weighted-average period of 4.53 years.

We have options outstanding under two stock option plans, the 1989 Stock Option Plan and the 1996 Key Employees Stock Option Plan, the latter of which provides for the granting of options for up to 9,000,000 shares. Stock options are granted to employees and directors at an exercise price equal to the fair market value of RPM International Inc. stock at the date of grant. These options are generally exercisable cumulatively in equal annual installments commencing one year from the grant date, and have expiration dates ranging from October 2006 to October 2014. The total fair value of shares vested during the quarter ended August 31, 2006 was \$23.0 million. Shares of common stock under option are not eligible for dividend payments until the shares are exercised.

We also grant stock appreciation rights (SARs) to employees under the Omnibus Plan. The SARs are issued at fair value at the date of grant, have up to ten-year terms and vest over four years. Currently all SARs outstanding are to be settled with stock. As of August 31, 2006, there were 550,000 SARs outstanding. The fair value of stock options and SARs granted is estimated as of the date of the grant using a Black-Scholes option-pricing model with the following weighted average assumptions for each of the following years ended May 31:

| | 2006 | 2005 | 2004 |
|--------------------------|-------------|-------------|-------------|
| Risk-free interest rate | 4.2% | 3.7% | 3.7% |
| Expected life of option | 6.0 yrs | 6.4 yrs | 7.0 yrs |
| Expected dividend yield | 3.6% | 3.4% | 3.5% |
| Expected volatility rate | 27.7% | 31.0% | 35.9% |

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The expected life of options granted is derived from the output of the option-pricing model and represents the period of time that options granted are expected to be outstanding. Expected volatilities are based on historical volatility of our shares of common stock.

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(Unaudited)

The following table summarizes stock based award activity under the Plans as of and for the three month period ended August 31, 2006:

Shares Under Option

| <i>(Shares in thousands)</i> | Weighted Average Exercise Price | Number of Shares Under Option | Weighted Average Remaining Contractual Term |
|-------------------------------------|--|--|---|
| Outstanding, June 1, 2006 | \$ 14.34 | 6,414 | |
| Granted | | | |
| Canceled/expired | \$ 14.21 | 21 | |
| Exercised | \$ 12.97 | 74 | |
| Outstanding, August 31, 2006 | \$ 14.35 | 6,319 | 4.97 |
| Exercisable, August 31, 2006 | \$ 13.70 | 4,501 | 3.82 |

There have been no options granted during the current or prior fiscal year. The total intrinsic value of options exercised during the three months ended August 31, 2006 and 2005 was \$0.4 million and \$0.7 million, respectively. As of August 31, 2006, the aggregate intrinsic value of both outstanding and exercisable options was \$28.2 million. Cash received from option exercises under all share-based payment arrangements for the three month periods ended August 31, 2006 and 2005 was \$1.0 million and \$1.4 million, respectively. There was no tax benefit realized for the tax deductions from option exercises of the share-based payment for the three months ended August 31, 2006 and 2005, respectively.

The fair value of the nonvested share-based payment awards have been calculated using the market value of the shares on the date of issuance. We anticipate that approximately 1.5 million shares at a weighted-average exercise price of \$4.16 and a weighted-average remaining contractual term of 7.81 years will ultimately vest under these plans. A summary of the status of our nonvested share-based payment awards as of August 31, 2006, and the changes during the three month period then-ended, is incorporated in the following table.

Nonvested Shares Under Option

| <i>(Shares in thousands)</i> | Weighted Average Grant-Date Fair Value | Number of Shares Under Option | Weighted Average Remaining Contractual Term |
|------------------------------|---|--|---|
| Nonvested, June 1, 2006 | \$ 4.16 | 1,829 | |
| Granted | | | |

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| | | | |
|-----------------------------------|---------------|--------------|-------------|
| Forfeited/expired | \$4.18 | (10) | |
| Nonvested, August 31, 2006 | \$4.16 | 1,819 | 7.81 |

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RPM INTERNATIONAL INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
AUGUST 31, 2006
(Unaudited)

NOTE C INVENTORIES

Inventories were composed of the following major classes:

| | August 31, 2006 | May 31, 2006 |
|----------------------------|----------------------------|-------------------------|
| | <i>(In thousands)</i> | |
| Raw materials and supplies | \$ 127,533 | \$ 124,573 |
| Finished goods | 290,710 | 274,441 |
| | \$ 418,243 | \$ 399,014 |

NOTE D COMPREHENSIVE INCOME

Other comprehensive income includes foreign currency translation adjustments, minimum pension liability adjustments and unrealized gains or losses on securities. Total comprehensive income, comprised of net income and other comprehensive income, amounted to \$64.4 million and \$61.2 million for the three month periods ended August 31, 2006 and 2005, respectively.

NOTE E ACQUISITIONS

On August 31, 2005, Tremco, Inc., a wholly-owned subsidiary of RPM, completed its acquisition of privately-owned illbruck Sealant Systems, located in Leverkusen, Germany, for approximately \$136.6 million, plus debt assumption of approximately \$10.3 million, subject to certain post-closing adjustments. illbruck, a leading manufacturer of high-performance sealants and installation systems for pre-fabricated construction elements and for window and door applications, had sales of approximately \$190 million for its fiscal year ended December 31, 2004. The acquisition extends our product line offerings to include joint sealing tapes, flashing tapes, cartridge sealants and adhesives, strips, foils and accessories marketed under brand names such as illbruck, Festix, Perennator and Coco.

The purchase price has been allocated to the underlying assets acquired and liabilities assumed based upon their fair values at the date of acquisition. We have determined the estimated fair values based on independent appraisals, discounted cash flow analyses, quoted market prices and estimates made by management. Goodwill has been recorded to the extent the purchase price exceeded the fair values of the net identifiable tangible and intangible assets acquired. The following table summarizes the fair values of the assets acquired and liabilities assumed at the date of acquisition.

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RPM INTERNATIONAL INC. AND SUBSIDIARIES
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(Unaudited)

| <i>(In thousands)</i> | Amortization Life (In Years) | illbruck |
|-------------------------------|---|-------------------|
| Current assets | | \$ 63,740 |
| Property, plant and equipment | | 32,562 |
| Goodwill | N/A | 53,334 |
| Tradenames indefinitely lived | N/A | 27,190 |
| Tradenames other | 12 - 15 | 1,639 |
| Other intangible assets | 4 - 12 | 21,805 |
| Total Assets Acquired | | \$200,270 |
| Liabilities assumed | | (63,633) |
| Net Assets Acquired | | \$ 136,637 |

Our consolidated financial statements reflect the results of operations of this business as of the date of acquisition.

NOTE F CONTINGENCIES AND LOSS RESERVES

We provide, through our wholly owned insurance subsidiaries, certain insurance coverage, primarily product liability, to our other subsidiaries. Excess coverage is provided by third party insurers. Our reserves provide for these potential losses as well as other uninsured claims. Product warranty expense is recorded within selling, general and administrative expense. As of August 31, 2006, the current portion of these reserves amounted to \$50.0 million as compared with \$53.8 million at May 31, 2006 and \$56.3 million at August 31, 2005, while the total long-term reserves of \$13.2 million at August 31, 2006 compare with \$13.3 million at May 31, 2006 and \$6.8 million a year ago. The changes in the reserve balance have occurred primarily as a result of our continuing evaluation of our liability under a class action lawsuit settlement covering our Dryvit residential exterior insulated finish systems product line (EIFS). Based upon the final court order approving the national class action settlement and Dryvit's claims experience to date, Dryvit determined that an \$11.9 million increase to its existing reserves was necessary and appropriate to fully cover the anticipated costs of the settlement. It is anticipated that \$5.0 million of this reserve increase will be recovered from third party insurance carriers and accordingly, insurance receivables were increased by that amount. Third party excess insurers have historically paid varying shares of Dryvit's defense and settlement costs for individual commercial and residential EIFS lawsuits under various cost-sharing agreements. Dryvit has increasingly assumed a greater share of the costs associated with its EIFS litigation as it seeks funding commitments from our third party excess insurers and will likely continue to do so pending the outcome of coverage litigation involving these same third party insurers. One of our excess insurers filed suit seeking a declaration with respect to its rights and obligations for EIFS related claims under its applicable policies. During last year's fiscal third quarter, the court granted Dryvit's motion to stay the federal filing based on a more complete state court complaint filed against these same insurers and the Company's insurance broker. The coverage case will now proceed in state court.

RPM INTERNATIONAL INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
AUGUST 31, 2006
(Unaudited)

Certain of our wholly-owned subsidiaries, principally Bondex International, Inc. (collectively referred to as the subsidiaries), are defendants in various asbestos-related bodily injury lawsuits filed in various state courts with the vast majority of current claims pending in five states – Illinois, Ohio, Mississippi, Texas and Florida. These cases generally seek unspecified damages for asbestos-related diseases based on alleged exposures to asbestos-containing products previously manufactured by our subsidiaries.

Our subsidiaries vigorously defend these asbestos-related lawsuits and in many cases, the plaintiffs are unable to demonstrate that any injuries they have incurred, in fact, resulted from exposure to one of our subsidiaries' products. In such cases, the subsidiaries are generally dismissed without payment. With respect to those cases where compensable disease, exposure and causation are established with respect to one of our subsidiaries' products, the subsidiaries generally settle for amounts that reflect the confirmed disease, the particular jurisdiction, applicable law, the number and solvency of other parties in the case and various other factors which may influence the settlement value each party assigns to a particular case at the time.

As of August 31, 2006, our subsidiaries had a total of 10,934 active asbestos cases compared to a total of 9,093 cases as of August 31, 2005. For the quarter ended August 31, 2006, our subsidiaries secured dismissals and/or settlements of 232 claims and made total payments of \$16.4 million, which included defense costs paid during the current quarter of \$6.6 million. For the comparable period ended August 31, 2005, dismissals and/or settlements covered 392 claims and total payments were \$16.5 million, which included defense costs paid during the quarter of \$4.5 million. In some jurisdictions, cases may involve more than one individual claimant. As a result, settlement or dismissal statistics on a per case basis are not necessarily reflective of the payment amounts on a per claimant basis and the amounts and rates can vary widely depending on a variety of factors including the mix of malignancy and non-malignancy claims and the amount of defense costs incurred during the period.

The rate at which plaintiffs filed asbestos-related suits against our subsidiaries, particularly Bondex, increased since the fourth fiscal quarter of 2002, influenced by the bankruptcy filings of numerous other defendants in asbestos-related litigation. Based on the significant increase in asbestos claims activity, which in many cases disproportionately increased Bondex's exposure in joint and several liability law states, our third-party insurance was depleted within the first fiscal quarter of 2004. Our third-party insurers historically had been responsible, under various cost-sharing arrangements, for the payment of approximately 90% of the indemnity and defense costs associated with our asbestos litigation. Prior to this sudden precipitous increase in loss rates, the combination of book loss reserves and insurance coverage was expected to adequately cover asbestos claims for the foreseeable future. We have reserved our rights with respect to several of our third-party insurers' claims of exhaustion, and in late calendar 2002 commenced a review of our known insurance policies to determine whether other insurance limits may be available to cover our asbestos liabilities.

As a result of an examination of our subsidiaries' historical insurance and as previously disclosed, certain of our subsidiaries filed a complaint in July 2003 for declaratory judgment, breach of contract and bad faith against various third-party insurers, challenging their assertion that their policies covering asbestos-related claims have been exhausted. The coverage litigation involves, among other matters,

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insurance coverage for claims arising out of alleged exposure to asbestos containing products manufactured by the previous owner of the Bondex tradename before March 1, 1966. On March 1, 1966, Republic Powdered Metals Inc. (as it was known then), purchased the assets and assumed the liabilities of the previous owner of the Bondex tradename. That previous owner subsequently dissolved and was never a subsidiary of Republic Powdered Metals, Bondex, RPM, Inc. or the Company. Because of the earlier assumption of liabilities, however, Bondex has historically and must continue to respond to lawsuits alleging exposure to these asbestos containing products. The Company discovered that the defendant insurance companies in the coverage litigation had wrongfully used cases alleging exposure to these pre-1966 products to erode their aggregate limits. This conduct, apparently known by the insurance industry based on discovery conducted to date, was in breach of the insurers' policy language. While this pending litigation could, in the future, result in third party coverage for a substantial amount of these future asbestos claims, the Company has not considered any such future recovery in determining the scope and amount of its reserve for future unknown asbestos claims. Two of the defendant insurers have filed counterclaims seeking to recoup certain monies should the plaintiffs prevail on their claims. Pursuant to a revised case management order, the parties have substantially completed fact discovery and must complete expert discovery by November 17, 2006. Dispositive motions must be filed no later than December 29, 2006, with trial briefing completed no later than March 16, 2007. A trial date was previously set for January 29, 2007. Because of the briefing schedule, however, the trial will not go forward on that date and the Court will set a new date after ruling on the dispositive motions. It is possible that these dates may be modified as the case progresses.

We are unable at the present time to predict the timing or ultimate outcome of this insurance coverage litigation. Consequently, we are unable to predict whether, or to what extent, any additional insurance may be available to cover a portion of our subsidiaries' asbestos liabilities. We have not included any potential benefits from this litigation either in our financial statements or in calculating our current asbestos reserve. Our wholly-owned captive insurance companies have not provided any insurance or reinsurance coverage for any of our subsidiaries' asbestos-related claims.

Claim filings in Mississippi, Ohio, Texas, Florida and Illinois at the quarter ended August 31, 2006, comprise approximately 75% of the total aggregate claims filed against Bondex. Three of these states (Mississippi, Ohio and Texas) provide for liability to be determined on a proportional cause basis, thereby limiting Bondex's responsibility to only its share of the alleged asbestos exposure. Two of the three previously mentioned states have passed additional legislation impacting medical criteria and product identification in asbestos-related litigation. While there have been some changes in the type of claims filed in certain of these states, the ultimate influence these law changes will have on future claims activity and costs is still developing.

Estimating the future cost of asbestos related contingent liabilities was and continues to be subject to many uncertainties, including (i) the ultimate number of claims filed; (ii) the cost of resolving both current known and future unknown claims; (iii) the amount of insurance, if any, available to cover such claims, including the outcome of coverage litigation against the subsidiaries' third party insurers; (iv) future earnings and cash flow of our subsidiaries; (v) the impact of bankruptcies of other companies whose share of liability may be imposed on our subsidiaries under certain state liability laws; (vi) the

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unpredictable aspects of the litigation process including a changing trial docket and the jurisdictions in which trials are scheduled; (vii) the outcome of any such trials including judgments or jury verdicts, as a result of our more aggressive defense posture which includes taking selective cases to verdict; (viii) the lack of specific information in many cases concerning exposure to the subsidiaries' products and the claimants' diseases; (ix) potential changes in applicable federal and/or state law; and (x) the potential impact of various proposed structured settlement transactions or subsidiary bankruptcies by other companies, some of which are the subject of federal appellate court review, the outcome of which could materially affect any future asbestos-related liability estimates. In addition to the foregoing, ongoing debate in the Senate concerning the establishment of a trust fund to pay future asbestos related claims and remove such cases from federal and state courts with industry and insurers funding the trust continues to be a significant variable that makes it increasingly difficult to predict with certainty the full exposure of future, unknown asbestos-related claims.

As part of our ongoing assessment of our asbestos liability exposure, during last year's third fiscal quarter we considered whether (i) our recent verdict experience, (ii) venue reforms, (iii) medical criteria requirements, and (iv) proportionate share liability and other known tort reforms provided sufficient relevant and reliable information to reasonably estimate our future liability for asbestos-related claims. Accordingly, as previously disclosed, we retained Crawford & Winiarski (C&W), an independent, third-party consulting firm with expertise in the area of asbestos valuation work, to assist us in calculating an estimate of our liability for unasserted potential future asbestos-related claims.

The methodology used by C&W to project our liability for unasserted potential future asbestos-related claims included C&W doing an analysis of (a) widely accepted forecast of the population likely to have been exposed to asbestos; (b) epidemiological studies estimating the number of people likely to develop asbestos-related diseases; (c) historical rate at which mesothelioma incidences resulted in the payment of claims by us; (d) historical settlement averages to value the projected number of future compensable mesothelioma claims; (e) historical ratio of mesothelioma related indemnity payments to non-mesothelioma indemnity payments; and (f) historical defense costs and their relationship with total indemnity payments.

As a result, at the end of fiscal 2006, we increased our reserve for asbestos claims by approximately \$335.0 million, while paying out \$12.9 million for dismissals and/or settlements resulting in our reserve moving from \$99.2 million at February 28, 2006 to \$421.3 million at May 31, 2006. This reserve increase is based upon C&W's analysis of our total estimated liability for pending and unasserted potential future claims through May 31, 2016. This amount was calculated on a pre-tax basis and was not discounted for the time value of money. As of August 31, 2006, total reserves were approximately \$404.8 million. In light of the uncertainties inherent in making long-term projections, we have determined that the ten-year period through 2016 is the most reasonable time period over which reasonably accurate estimates might still be made for projecting asbestos liabilities and defense costs and, accordingly, the reserve does not include asbestos liabilities for any period past 2016.

In determining the amount of our asbestos reserves, we relied on assumptions that are based on currently known facts and projection models. Our actual expenses could be significantly higher or lower than

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those recorded if assumptions used in our or C&W's calculations vary significantly from actual results. Key variables in these assumptions include the period of exposure to asbestos claims, the number and type of new claims to be filed each year, the rate at which mesothelioma incidences result in compensable claims against us, the average cost of disposing of each such new claim, the dismissal rates each year and the related annual defense costs. Furthermore, predictions with respect to these variables are subject to greater uncertainty as the projections period lengthens. A significant upward or downward trend in the number of claims filed, depending on the nature of the alleged injury; the jurisdiction where filed; the average cost of resolving each such claim and the quality of the product identification, could change our estimated liability, as could any substantial adverse verdict at trial. A federal legislative solution, further state tort reform or structured settlement transaction could also change the estimated liability.

Subject to the foregoing variables, based on currently available data and upon the analysis of C&W, we believe that our current asbestos reserves are sufficient to cover asbestos-related cash flow requirements for our known pending and unasserted potential future asbestos-related claims. However, given the uncertainties associated with projecting matters into the future and numerous other factors outside of our control, we believe that it is reasonably possible we may incur asbestos liabilities for the period through 2016 and b