INTERNATIONAL SPECIALTY PRODUCTS INC /NEW/
Form 10-Q
November 14, 2001

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2001

OR

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

COMMISSION FILE NUMBER 000-29764

INTERNATIONAL SPECIALTY PRODUCTS INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

| | |
|---|---|
| DELAWARE<br>(State of Incorporation) | 51-0376469<br>(I. R. S. Employer Identification No.) |
| 300 DELAWARE AVENUE, SUITE 303, WILMINGTON, DELAWARE<br>(Address of principal executive offices) | 19801<br>(Zip Code) |

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE (302) 427-5715

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 such filing requirements for the past 90 days. Yes /X/ No / /

As of November 9, 2001, 65,121,309 shares of International Specialty Products Inc. common stock (par value $.01 per share) were outstanding.

PART I - FINANCIAL INFORMATION
ITEM 1 - FINANCIAL STATEMENTS

INTERNATIONAL SPECIALTY PRODUCTS INC.

CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)
(THOUSANDS, EXCEPT PER SHARE AMOUNTS)

| | THIRD QUARTER ENDED | | NINE MONTHS ENDED | |
|---|---|---|---|---|
| | OCTOBER 1, 2000 | SEPT. 30, 2001 | OCTOBER 1, 2000 | SEPT. 30, 2001 |
| Net sales............................ | $ 195,886 | $ 188,633 | $ 594,084 | $ 595,124 |
| Costs and Expenses: | | | | |
| Cost of products sold............. | 129,680 | 114,896 | 386,080 | 370,491 |
| Selling, general and administrative | 38,268 | 39,177 | 116,618 | 120,485 |
| Goodwill amortization............. | 4,049 | 4,048 | 12,144 | 12,144 |
| Total costs and expenses ....... | 171,997 | 158,121 | 514,842 | 503,120 |
| Operating income.................... | 23,889 | 30,512 | 79,242 | 92,004 |
| Interest expense.................... | (21,810) | (25,052) | (62,725) | (62,780) |
| Gain on contract settlement ......... | - | - | 3,450 | - |
| Other income (expense), net.......... | 39,451 | (8,326) | 48,548 | 3,427 |
| Income (loss) before income taxes.... | 41,530 | (2,866) | 68,515 | 32,651 |
| Income tax (provision) benefit....... | (14,566) | 989 | (24,020) | (11,473) |
| Income (loss) before cumulative effect of accounting change....... | 26,964 | (1,877) | 44,495 | 21,178 |
| Cumulative effect of change in accounting principle, net of income tax benefit of $216........ | - | - | - | (440) |
| Net income (loss)................... | $ 26,964 | $ (1,877) | $ 44,495 | $ 20,738 |

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INTERNATIONAL SPECIALTY PRODUCTS INC.

CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED) - (CONTINUED)
(THOUSANDS, EXCEPT PER SHARE AMOUNTS)

| | THIRD QUARTER ENDED | | NINE MONTHS ENDED | |
|---|---|---|---|---|
| | OCTOBER 1, 2000 | SEPT. 30, 2001 | OCTOBER 1, 2000 | SEPT. 30, 2001 |
| Earnings per common share: | | | | |
| Basic: | | | | |
| Income (loss) before cumulative Effect of accounting change... | $ .40 | $ (.03) | $ .65 | $ .32 |
| Cumulative effect of accounting change....................... | - | - | - | (.01) |
| Net income (loss)............... | $ .40 | $ (.03) | $ .65 | $ .31 |

| | | | | |
|---|---|---|---|---|
| Diluted: | | | | |
| Income (loss) before cumulative of accounting change.......... | $ .40 | $ (.03) | $ .65 | $ .32 |
| Cumulative effect of accounting change....................... | - | - | - | (.01) |
| Net income (loss)............... | $ .40 | $ (.03) | $ .65 | $ .31 |

| | | | | |
|---|---|---|---|---|
| Weighted average number of common and common equivalent shares outstanding: | | | | |
| Basic............................ | 67,951 | 65,641 | 68,518 | 66,050 |
| Diluted.......................... | 67,951 | 65,770 | 68,518 | 66,137 |

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

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INTERNATIONAL SPECIALTY PRODUCTS INC.

CONSOLIDATED BALANCE SHEETS

| | DECEMBER 31, 2001 | SEPTEMBER 30, 2000 (UNAUDITED) |
|---|---|---|
| | (THOUSANDS) | |
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents..................... | $ 18,181 | $ 30,168 |
| Investments in trading securities............. | 303,103 | 26,000 |
| Investments in available-for-sale securities... | 222,327 | 331,189 |
| Other short-term investments.................. | 19,129 | 2,220 |
| Restricted cash............................... | - | 176,519 |
| Accounts receivable, trade, net............... | 89,173 | 89,784 |
| Accounts receivable, other.................... | 19,596 | 27,739 |
| Receivable from related parties, net.......... | 11,624 | 15,698 |
| Inventories................................... | 150,948 | 201,712 |
| Other current assets.......................... | 36,928 | 36,637 |
| Total Current Assets....................... | 871,009 | 937,666 |
| Property, plant and equipment, net.............. | 562,973 | 558,786 |
| Goodwill, net................................... | 494,386 | 488,153 |
| Long-term restricted cash....................... | - | 81,130 |
| Other assets.................................... | 31,916 | 68,733 |
| Total Assets.................................... | $1,960,284 | $2,134,468 |

| | | |
|---|---|---|
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current Liabilities: | | |
| Short-term debt | $ 143,682 | $ 116,645 |
| Current maturities of long-term debt | 224,419 | 182,446 |
| Accounts payable | 58,238 | 51,555 |
| Accrued liabilities | 91,309 | 109,006 |
| Income taxes | 13,610 | 15,567 |
| Total Current Liabilities | 531,258 | 475,219 |
| Long-term debt less current maturities | 524,780 | 912,540 |
| Deferred income taxes | 151,181 | 93,148 |
| Other liabilities | 61,730 | 65,439 |
| Stockholders' Equity: | | |
| Preferred stock, $.01 par value per share; 20,000,000 shares authorized: no shares issued | - | - |
| Common stock, $.01 par value per share; 300,000,000 shares authorized: 69,546,456 shares issued | 695 | 695 |
| Additional paid-in capital | 485,629 | 487,067 |
| Unearned compensation - restricted stock awards | (1,287) | (1,072) |
| Treasury stock, at cost - 3,135,192 and 4,245,947 shares, respectively | (19,631) | (30,668) |
| Retained earnings | 213,928 | 234,666 |
| Accumulated other comprehensive income(loss) | 12,001 | (102,566) |
| Total Stockholders' Equity | 691,335 | 588,122 |
| Total Liabilities and Stockholders' Equity | $1,960,284 | $2,134,468 |

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.



INTERNATIONAL SPECIALTY PRODUCTS INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

| | NINE MONTHS ENDED | |
|---|---|---|
| | OCTOBER 1, 2000 | SEPT. 30, 2001 |
| | (THOUSANDS) | |
| Cash and cash equivalents, beginning of period | $ 23,309 | $ 18,181 |
| Cash provided by operating activities: | | |
| Net income | 44,495 | 20,738 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Cumulative effect of change in accounting principle | - | 440 |
| Depreciation | 38,039 | 39,542 |

| | | |
|---|---|---|
| Goodwill amortization | 12,144 | 12,144 |
| Deferred income taxes | 10,118 | (785) |
| Unrealized (gains) losses on trading securities and other short-term investments | (20,191) | 4,584 |
| Increase in working capital items | (2,819) | (46,949) |
| Purchases of trading securities | (41,740) | (405,621) |
| Proceeds from sales of trading securities | 87,839 | 610,191 |
| Increase in net receivable from related parties | (1,337) | (4,074) |
| Change in cumulative translation adjustment | (12,790) | (953) |
| Other, net | 12,901 | 5,441 |
| Net cash provided by operating activities | 126,659 | 234,698 |
| Cash provided by (used in) investing activities: | | |
| Capital expenditures and acquisitions | (39,380) | (58,716) |
| Purchases of available-for-sale securities | (296,448) | (298,850) |
| Proceeds from sales of available-for-sale securities | 217,388 | 92,456 |
| Proceeds from sales of other short-term investments | - | 12,765 |
| Net cash used in investing activities | (118,440) | (252,345) |
| Cash provided by (used in) financing activities: | | |
| Proceeds (repayments) from sale of accounts receivable | (5,128) | (7,791) |
| Increase (decrease) in short-term debt | 5,766 | (27,037) |
| Proceeds from issuance of debt | - | 527,332 |
| Increase (decrease) in borrowings under revolving credit facilities | 1,800 | (115,400) |
| Repayments of long-term debt | (10,461) | (65,059) |
| Increase in restricted cash | - | (257,649) |
| Financing fees and expenses | - | (13,789) |
| Repurchases of common stock | (8,616) | (12,257) |
| Other, net | 530 | 1,284 |
| Net cash provided by (used in) financing activities | (16,109) | 29,634 |
| Net change in cash and cash equivalents | (7,890) | 11,987 |
| Cash and cash equivalents, end of period | $ 15,419 | $ 30,168 |

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INTERNATIONAL SPECIALTY PRODUCTS INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)-- (CONTINUED)

| | NINE MONTHS ENDED | |
|---|---|---|
| | OCTOBER 1, 2000 | SEPT. 30, 2001 |
| | (THOUSANDS) | |
| Supplemental Cash Flow Information: | | |
| Cash paid during the period for: | | |
| Interest (net of amount capitalized) | $ 59,799 | $ 49,874 |
| Income taxes | 10,212 | 7,114 |

Acquisition of FineTech Ltd.:

| | |
|---|---|
| Fair market value of assets acquired............ | $ 26,547 |
| Purchase price of acquisition................... | 22,450 |
| Liabilities assumed............................. | $ 4,097 |

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The consolidated financial statements for International Specialty Products Inc. (the "Company") reflect, in the opinion of management, all adjustments necessary to present fairly the financial position of the Company at September 30, 2001, and the results of operations and cash flows for the periods ended October 1, 2000 and September 30, 2001. All adjustments are of a normal recurring nature. These financial statements should be read in conjunction with the annual financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2000 (the "Form 10-K").

NOTE 1. FINANCING TRANSACTIONS AND RESTRUCTURING

On June 27, 2001, ISP Chemco Inc.("ISP Chemco"), an indirect wholly-owned subsidiary of the Company, and three wholly-owned subsidiaries of ISP Chemco issued $205.0 million aggregate principal amount of 10 1/4% Senior Subordinated Notes due 2011 (the "2011 Notes"). The net proceeds of $197.3 million, after discount and fees, were placed in an escrow account and were used to retire the Company's 9 3/4% Senior Notes due 2002 (the "2002 Notes") on or prior to October 15, 2001. During the third quarter of 2001, the Company retired $19.9 million of the 2002 Notes, and the remaining $180.0 million of 2002 Notes were retired on or before October 15, 2001. On July 31, 2001, these four subsidiaries issued an additional $100.0 million aggregate principal amount of the 2011 Notes. These notes have the same terms as the 2011 Notes issued in June. The net proceeds were $98.9 million, including $0.9 million of accrued interest from June 27, 2001 to the date of issuance, of which $98.0 million was placed in an escrow account to be used to retire a portion of the Company's 9% Senior Notes due 2003 (the "2003 Notes") on or prior to their maturity. On November 13, 2001, these four subsidiaries issued an additional $100.0 million aggregate principal amount of the 2011 Notes. These notes have the same terms as the 2011 Notes issued in June, except with respect to interest accrual and registration rights. The net proceeds of $101.0 million were placed in an escrow account to be used to retire a portion of the Company's 2003 Notes on or prior to their maturity. During the third quarter of 2001, the Company retired $16.9 million principal amount of the 2003 Notes. All of the 2011 Notes were guaranteed by substantially all of ISP Chemco's other domestic subsidiaries. The 2011 Notes were issued under an indenture which, among other things, places limits on the ability of ISP Chemco and its subsidiaries to incur additional debt, issue preferred stock, incur liens, and pay dividends or make certain other restricted payments and restricted investments.

In a related transaction, ISP Chemco and its three subsidiaries which issued the notes also entered into $450.0 million of new senior secured credit facilities (the "Senior Credit Facilities"), the initial borrowings under which were used to repay amounts outstanding under the Company's previous credit facility. The Senior Credit Facilities are comprised of a $225.0 million term loan with a maturity of seven years and a $225.0 million revolving credit facility which will terminate in five years. The revolving credit facility





includes a borrowing capacity not in excess of $50.0 million for letters of credit. All borrowings under the Senior Credit Facilities will be based on either an alternate base rate (based on the banks' base rate or on the federal funds rate) or on the eurodollar rate plus a margin based on the ratio of ISP Chemco's total consolidated debt to EBITDA (as defined in the Senior Credit Facilities). The Senior Credit Facilities require compliance with various financial covenants, including a total debt leverage maintenance ratio, a senior debt leverage maintenance ratio, an interest coverage ratio and a minimum adjusted net worth. As of September 30, 2001, $80.6 million of borrowings and $5.6 million of letters of credit were outstanding under the revolving credit facility.

In connection with the above transactions, the Company also completed a restructuring of its business in order to separate its investment assets from its specialty chemicals business. As part of the restructuring, ISP Chemco transferred all of its investment assets to a newly formed subsidiary of the Company, Newco Holdings Inc., which is a parent company of ISP Chemco. Newco Holdings, in turn, transferred those assets to its newly formed subsidiary, ISP Investco LLC. As a result of the restructuring, ISP Chemco's assets consist solely of those related to the Company's specialty chemicals business.

NOTE 2. ACQUISITION

On June 7, 2001, the Company completed the acquisition of FineTech Ltd. ("FineTech"), a pharmaceutical research company based in Haifa, Israel. FineTech specializes in the design of proprietary synthetic routes and methodologies used in the production of highly complex and valuable organic compounds for the pharmaceutical industry. The acquisition was accounted for under the purchase method of accounting. Accordingly, the purchase price was allocated to the estimated fair value of the identifiable net assets acquired, and the excess was recorded as goodwill. The results of FineTech are included in the Company's results from the date of acquisition and are not expected to be material to the

Company's results of operations for the year 2001. FineTech recorded revenues of $3.5 million in the year 2000.

NOTE 3. CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE

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." SFAS No. 133 establishes accounting and reporting standards requiring that every derivative instrument be recorded in the balance sheet as either an asset





or liability measured at its fair value. SFAS No. 133 requires that changes in a derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met. Special accounting for qualifying hedges allows a derivative's gains and losses to offset related results on the hedged item in the income statement.

The Company adopted SFAS No. 133 as of January 1, 2001. Accounting for interest rate swaps and foreign exchange forward contracts held by the Company is affected by implementation of this standard. The earnings impact of the transition adjustments related to the initial adoption of the standard was an after-tax loss of $0.4 million, which was recorded in the first quarter of 2001 as the cumulative effect of a change in accounting principle.

NOTE 4. HEDGING AND DERIVATIVES

As discussed in Note 1, in June 2001, ISP Chemco entered into the $450.0 million Senior Credit Facilities, which include a $225.0 million term loan. Borrowings against this term loan will be based on either an alternate base rate or on the eurodollar rate plus a margin based on the ratio of ISP Chemco's total consolidated debt to EBITDA. The Company has designated interest rate swaps, with a notional amount of $100 million, as a hedge of its exposure to changes in the eurodollar rate. The interest rate swaps are structured to receive interest based on the eurodollar rate and pay interest on a fixed rate basis. A cash flow hedging relationship has been established whereby the interest rate swaps hedge the risk of changes in the eurodollar rate related to forecasted borrowings against the term loan. The interest rate swaps hedge forecasted exposure to changes in the eurodollar rate through July 2002.

During the first nine months of 2001, a $1.0 million charge related to the reduction in the fair market value of the interest rate swaps was reclassified and charged against interest expense, of which $0.2 million represents hedge ineffectiveness. As of September 30, 2001, the reclassification charge to earnings related to interest accruals over the next twelve months is estimated to be $2.1 million.

Derivatives held by the Company not designated as hedging instruments include total return equity swaps and forward foreign exchange instruments. The total return equity swaps are held for investment income purposes. Foreign exchange forward contracts are held to offset exposure to changes in exchange rates affecting intercompany loans.

NOTE 5. COMPREHENSIVE INCOME

| | Third Quarter Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | October 1, 2000 | Sept 30, 2001 | October 1, 2000 | Sept 30, 2001 |
| | (Thousands) | | | |
| Net income (loss)........................... | $ 26,964 | $(1,877) | $ 44,495 | $ 20,738 |
| Other comprehensive income (loss), net of tax: | | | | |
| Change in unrealized gains (losses) on available-for-sale securities: | | | | |
| Unrealized holding gains (losses) arising during the period, net of income tax (provision) benefit of $(26,933), $17,154, $(44,297) and $58,890.................... | 54,748 | (33,478) | 90,644 | (114,365) |
| Less: reclassification adjustment for losses included in net income, net of income tax benefit of $(13,228), $1,223, $(2,583) and $1,534............... | 24,390 | (1,526) | 20,675 | (2,100) |
| Total change for the period................ | 30,358 | (31,952) | 69,969 | (112,265) |
| Change in unrealized losses on derivative hedging instruments - cash flow hedges: | | | | |
| Net derivative losses, net of tax effect of $443 and $1,070....................... | - | (819) | - | (1,979) |
| Less: reclassification adjustment for losses included in net income, net of tax effect of $151 and $341.............. | - | (280) | - | (630) |
| Total change for the period................ | - | (539) | - | (1,349) |
| Foreign currency translation adjustment....... | (6,081) | 8,023 | (12,790) | (953) |
| Total other comprehensive income (loss)....... | 24,277 | (24,468) | 57,179 | (114,567) |
| Comprehensive income (loss).................. | $ 51,241 | $(26,345) | $101,674 | $(93,829) |

Changes in the components of "Accumulated other comprehensive income (loss)" for the nine months ended September 30, 2001 are as follows:

| | Unrealized Gains (Losses) on Available-for-Sale Securities | Unrealized Losses on Derivative Hedging Instruments | Cumulative Foreign Currency Translation Adjustment | Accumulated Other Comprehensive Income (Loss) |
|---|---|---|---|---|
| | (Thousands) | | | |
| Balance, December 31, 2000.. | $ 34,020 | $ - | $ (22,019) | $ 12,001 |
| Change for the period....... | (112,265) | (1,349) | (953) | (114,567) |

| | | | | |
|---|---|---|---|---|
| Balance, September 30, 2001. | $ (78,245) | $ (1,349) | $ (22,972) | $(102,566) |
| | ============ | ========== | ========= | ========= |



NOTE 6. BUSINESS SEGMENT INFORMATION

| | Third Quarter Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | October 1, 2000 | Sept. 30, 2001 | October 1, 2000 | Sept. 30, 2001 |
| | (Thousands) | | | |
| Net sales: | | | | |
| Personal Care............................ | $ 44,532 | $ 45,454 | $ 139,999 | $ 150,509 |
| Pharmaceutical, Food and Beverage......... | 55,616 | 59,635 | 174,589 | 175,452 |
| Performance Chemicals, Fine Chemicals and Industrial............................. | 75,530 | 59,754 | 222,551 | 205,351 |
| Total Specialty Chemicals............... | 175,678 | 164,843 | 537,139 | 531,312 |
| Mineral Products (1)..................... | 20,208 | 23,790 | 56,945 | 63,812 |
| Net sales................................. | $ 195,886 | $ 188,633 | $ 594,084 | $ 595,124 |
| Operating income(2): | | | | |
| Personal Care............................ | $ 7,314 | $ 5,746 | $ 22,824 | $ 27,003 |
| Pharmaceutical, Food and Beverage......... | 12,191 | 12,146 | 37,341 | 38,779 |
| Performance Chemicals, Fine Chemicals and Industrial............................. | 726 | 7,603 | 10,184 | 17,505 |
| Total Specialty Chemicals.............. | 20,231 | 25,495 | 70,349 | 83,287 |
| Mineral Products......................... | 3,358 | 5,078 | 8,661 | 8,434 |
| Total segment operating income........... | 23,589 | 30,573 | 79,010 | 91,721 |
| Unallocated corporate office.............. | 300 | (61) | 232 | 283 |
| Total operating income..................... | 23,889 | 30,512 | 79,242 | 92,004 |
| Interest expense and other, net............ | 17,641 | (33,378) | (10,727) | (59,353) |
| Income (loss) before income taxes.......... | $ 41,530 | $ (2,866) | $ 68,515 | $ 32,651 |

(1) Includes sales to Building Materials Corporation of America, an affiliate, and its subsidiaries, of $15.7 and $18.7 million for the third quarter of 2000 and 2001, respectively, and $47.6 and $50.5 million for the first nine months of 2000 and 2001, respectively.

(2) Operating income for the third quarter and first nine months of 2000 for the three Specialty Chemicals business segments have been reclassified to conform to the 2001 presentation, based on a reallocation of certain manufacturing costs.

NOTE 7. INVENTORIES

Inventories comprise the following:

| | December 31, 2000 | September 30, 2001 |
|---|---|---|
| | (Thousands) | |
| Finished goods................ | $ 93,356 | $ 127,489 |
| Work-in-process............... | 29,022 | 41,131 |
| Raw materials and supplies.... | 28,570 | 33,092 |
| Inventories................... | $150,948 | $ 201,712 |

At December 31, 2000 and September 30, 2001, $38.7 and $62.7 million, respectively, of domestic inventories were valued using the LIFO method. If the FIFO inventory method had been used for these inventories, they would have been $0.1 million lower at December 31, 2000 and $4.9 million higher at September 30, 2001.

NOTE 8. RESTRUCTURING RESERVES

In December 2000, the Company shut down its Seadrift, Texas butanediol manufacturing facility and shut down production of butanediol at its Texas City, Texas manufacturing facility in the first quarter of 2001. Accordingly, the Company recorded a one-time restructuring charge against operating income in 2000 of $2.5 million, including an accrual of $2.1 million for cash costs to be incurred in 2001 for severance and for decommissioning and remediation costs. During the first nine months of 2001, $2.0 million of such costs were charged against this reserve, leaving a reserve balance of $0.1 million as of the end of the third quarter of 2001.

In connection with the relocation of certain of the Company's production lines for Personal Care products to the Company's Freetown, Massachusetts facility, the Company shut down its manufacturing operation in Belleville, New Jersey in the first quarter of 2001. Accordingly, the Company recorded a restructuring charge against operating income in 2000 of $11.9 million, which included a $10.4 million write-off of production assets. The total charge included an accrual of $1.5 million for cash costs to be incurred in 2001, mainly for severance and other shutdown-related costs. During the first nine months of 2001, $1.1 million of costs were charged against this reserve, leaving a reserve balance of $0.4 million as of the end of the third quarter of 2001, primarily for remaining severance costs.

NOTE 9. SALE OF ACCOUNTS RECEIVABLE

In October 2001, the Company entered into a new agreement for the sale of its domestic receivables. This agreement replaces a previous agreement which terminated in October 2001. The agreement has a termination date of October 2004 and provides for up to $40.0 million in cash to be made available to the Company based on eligible domestic receivables outstanding from time to time.



NOTE 10. CONTINGENCIES

Environmental Litigation

The Company, together with other companies, is a party to a variety of proceedings and lawsuits involving environmental matters ("Environmental Claims") under the Comprehensive Environmental Response Compensation and Liability Act, Resource Conservation and Recovery Act and similar state laws, in which recovery is sought for the cost of cleanup of contaminated sites or remedial obligations are imposed, a number of which Environmental Claims are in the early stages or have been dormant for protracted periods.

In the opinion of the Company's management, the resolution of the Environmental Claims should not be material to the business, liquidity, results of operations, cash flows or financial position of the Company. However, adverse decisions or events, particularly as to increases in remedial costs, discovery of new contamination, assertion of natural resource damages and the liability and the financial responsibility of the Company's insurers and of the other parties involved at each site and their insurers, could cause the Company to increase its estimate of its liability in respect of such matters. It is not currently possible to estimate the amount or range of any additional liability.

For further information regarding environmental matters, reference is made to Note 19 to Consolidated Financial Statements contained in the Form 10-K.

Tax Claim Against G-I Holdings Inc.

The Company and certain of its subsidiaries were members of the consolidated group (the "G-I Holdings Group") for Federal income tax purposes that included G-I Holdings Inc. ("G-I Holdings") in certain prior years and, accordingly, would be severally liable for any tax liability of the G-I Holdings Group in respect of those prior years. Effective as of January 1, 1997, neither the Company nor any of its subsidiaries are members of the G-I Holdings Group.

On September 15, 1997, G-I Holdings received a notice from the Internal Revenue Service (the "IRS") of a deficiency in the amount of $84.4 million

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NOTE 10. CONTINGENCIES - (CONTINUED)

(after taking into account the use of net operating losses and foreign tax credits otherwise available for use in later years) in connection with the formation in 1990 of Rhone-Poulenc Surfactants and Specialties, L.P. (the "surfactants partnership"), a partnership in which G-I Holdings held an interest. G-I Holdings has advised the Company that it believes that it will prevail in the tax matter arising out of the surfactants partnership, although there can be no assurance in this regard. The Company believes that the ultimate disposition of this matter will not have a material adverse effect on its business, financial position or results of operations. On September 21, 2001, the IRS filed a proof of claim with respect to such deficiency against G-I Holdings in the G-I Holdings bankruptcy. If such proof of claim is sustained, the Company and/or some of the Company's subsidiaries, together with G-I Holdings and several current and former subsidiaries of G-I Holdings, would be severally liable for such taxes and interest in the amount of approximately $250.0 million should G-I Holdings be unable to satisfy such liability. In January 2001, G-I Holdings filed a voluntary petition for reorganization under Chapter 11 of the U.S. Bankruptcy Code due to its asbestos-related bodily injury claims relating to the inhalation of asbestos fiber. For additional information relating to G-I Holdings, reference is made to Notes 8, 16 and 19 to Consolidated Financial Statements contained in the Form 10-K.

NOTE 11. NEW ACCOUNTING STANDARDS

On June 30, 2001, the FASB issued SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets". SFAS No. 141 requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method of accounting and eliminates the pooling method of accounting. SFAS No. 141 will not have an impact on the Company's business since the Company has historically accounted for all business combinations using the purchase method of accounting. With the adoption of SFAS No. 142, effective January 1, 2002, goodwill will no longer be subject to amortization over its estimated useful life. However, goodwill will be subject to at least an annual assessment for impairment and more frequently if circumstances indicate a possible impairment. Companies must perform a fair-value-based goodwill impairment test. In addition, under SFAS No. 142, an acquired intangible asset should be separately recognized if the benefit of the intangible is obtained through contractual or other legal rights, or if the intangible asset can be sold, transferred, licensed, rented, or exchanged. Intangible assets will be amortized over their useful lives. Early adoption of SFAS No. 142 is not permitted. On an annualized basis, effective January 1, 2002, the Company's net income will increase by approximately $16.2 million ($.24 diluted earnings per share), unless any impairment charges are necessary.



## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### RESULTS OF OPERATIONS - THIRD QUARTER 2001 COMPARED WITH THIRD QUARTER 2000

The Company recorded a third quarter 2001 net loss of $1.9 million ($.03 diluted earnings per share) compared with net income of $27.0 million ($.40 diluted earnings per share) in the third quarter of 2000. The results were attributable to investment losses in the quarter and higher interest expense partially offset by higher operating income.

Net sales for the third quarter of 2001 were $188.6 million compared with $195.9 million for the same period in 2000. The decrease in sales resulted primarily from lower volumes in the Industrial, Performance Chemicals and Fine Chemicals businesses, partially offset by higher volumes in the Pharmaceutical and Mineral Products businesses and improved pricing in the Industrial business. Volumes in the Industrial business were lower than last year's quarter due to the impact of discontinuing butanediol production at the Company's Texas City, Texas plant in March 2001.

Operating income for the third quarter of 2001 improved 28% to $30.5 million compared with $23.9 million for the third quarter of 2000. The increase was attributable to improvements in operating profits in the Industrial, Pharmaceutical, Fine Chemicals and Mineral Products businesses, reflecting higher gross margins in each business as a result of favorable manufacturing costs, improved pricing in the Industrial business, the effect of favorable volume in the Pharmaceutical business and the favorable impact of the acquisition of FineTech Ltd. which was completed in the second quarter of 2001 (see Note 2 to Consolidated Financial Statements). These improved results were partially offset by unfavorable volumes in the Industrial and Performance Chemicals businesses, higher manufacturing costs in the Alginates business and lower margins in the Personal Care business segment.

Interest expense for the third quarter of 2001 was $25.1 million versus $21.8 million for the same period last year. The increase was due to higher average borrowings, primarily reflecting the issuance of $305 million aggregate principal amount of 10 1/4% Senior Subordinated Notes in June and July 2001. Other expense, net, for the quarter was $8.3 million compared with other income of $39.5 million in last year's third quarter. The decrease was attributable to investment losses in the third quarter of 2001 of $7.3 million compared with investment income of $43.9 million in the third quarter of 2000, which reflected a net gain of $36.8 million from the sale of the Company's investments in Dexter Corporation and Life Technologies, Inc.



Business Segment Review

A discussion of operating results for each of the Company's business segments follows. The Company operates its Specialty Chemicals business through three reportable business segments, in addition to the Mineral Products segment.

Personal Care

Sales in the third quarter of 2001 were $45.5 million compared with $44.5 million for the same period last year, while operating income for the third quarter of 2001 decreased to $5.7 million from $7.3 million in last year's quarter. The increase in sales resulted primarily from higher volumes in the North America hair care markets, reflecting strong mass market sales of hair gels and styling aids, partially offset by the lower volumes in the North America and Asia skin care markets. The $1.6 million decrease in operating income mainly reflected an unfavorable product mix in the North America hair care markets and higher operating expenses, partially offset by the effect of favorable volumes.

Pharmaceutical, Food and Beverage ("PFB")

Sales for the PFB segment were $59.6 million for the third quarter of 2001 compared with $55.6 million for the third quarter of 2000, while operating income was $12.1 million versus $12.2 million in last year's quarter. Sales for the Pharmaceutical and Beverage business increased by 12% in the third quarter of 2001, reflecting higher volumes in both Pharmaceutical (excipients markets) and Beverage. Sales for the Alginates business decreased by 6% due to lower volumes in the industrial markets.

Operating income for the Pharmaceutical and Beverage business increased 37% in the third quarter of 2001 compared with the same period in 2000, while the operating margin improved from 21.4% in the third quarter of 2000 to 26.2% in this year's quarter. The improvement reflected the higher volumes. Operating income for the Alginates business decreased in the third quarter of 2001 due to the lower volumes and unfavorable manufacturing costs related to lower production volumes.

Performance Chemicals, Fine Chemicals and Industrial

Sales in the third quarter of 2001 were $59.8 million compared with $75.5 million in the third quarter of 2000. The 21% lower sales reflected lower volumes in each of the three businesses, partially offset by improved pricing in the Industrial business. Lower volumes in the Performance Chemicals business primarily reflected declines in the specialty coatings market. Lower Fine Chemicals volumes were related to contract sales to Polaroid. The lower contract sales were partially offset by sales of $1.2 million for the FineTech business which was was acquired in the second quarter.

Operating income for the Performance Chemicals, Fine Chemicals and Industrial segment improved in the third quarter of 2001 to $7.6 million versus

$0.7 million for the same period last year, primarily reflecting higher Industrial operating income due to improved pricing and favorable manufacturing costs resulting from lower raw material and energy costs. Higher operating income for the Fine Chemicals business was attributable to an improved gross margin due to favorable manufacturing costs and the favorable impact of the FineTech acquisition. The Performance Chemicals business experienced a loss in the third quarter of 2001 as a result of the lower volumes and an unfavorable product mix.



On October 12, 2001, Polaroid filed for protection under Chapter 11 of the U.S. Bankruptcy Code. As a result, Polaroid may choose to either assume or reject the supply agreement it has with the Company. Polaroid has stated that it is reviewing this contract and will determine some time in the future whether it will elect to assume it or propose certain modifications to the contract. If it rejects that contract and no longer purchases product from the Company, or the Company accepts modifications to the contract, which would reduce the amounts to be paid by Polaroid, the Company's Performance Chemicals, Fine Chemicals and Industrial business segment could experience a reduction in sales and operating income which could be material to that business segment's results.

Mineral Products

Sales for the Mineral Products segment for the third quarter of 2001 were $23.8 million compared with $20.2 million for the third quarter of 2000. The 18% higher sales were attributable to a $3.0 million (19%) increase in sales to Building Materials Corporation of America, an affiliate, and a 13% increase in trade sales, both due to higher volumes. Operating income for the third quarter of 2001 was $5.1 million compared with $3.4 million for the third quarter of 2000, reflecting a higher gross margin due to favorable manufacturing costs, partially offset by an unfavorable product mix.

RESULTS OF OPERATIONS - FIRST NINE MONTHS 2001 COMPARED WITH FIRST NINE MONTHS 2000

For the first nine months of 2001, the Company recorded net income of $20.7 million ($.31 diluted earnings per share) compared with $44.5 million ($.65 diluted earnings per share) in the first nine months of 2000. The results for the first nine months of 2001 include an after-tax charge of $0.4 million ($.01 diluted earnings per share), representing the cumulative effect of adopting Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities." Excluding the effect of such charge and a one-time gain of $3.5 million in the first nine months of 2000 from a contract settlement, net income for the first nine months of 2001 was $21.1 million ($.32 diluted earnings per share) versus $42.3 million ($.62 diluted earnings per share) in the same period last year. On a comparable basis, the lower results were attributable to lower investment income, partially offset by improved operating income.

Net sales for the first nine months of 2001 were $595.1 million compared with $594.1 million for the same period in 2000. The increase in sales resulted from higher volumes in the Personal Care, Pharmaceutical and Mineral Products businesses and improved pricing in the Industrial business, partially offset by lower volumes in the Industrial, Alginates and Fine Chemicals businesses and by the adverse effect of the stronger U.S. dollar in Europe.

Operating income for the first nine months of 2001 was $92.0 million compared with $79.2 million for the first nine months of 2000. The 16% increase in operating income was attributable to improvements in operating profits in all Specialty Chemicals business segments, primarily resulting from higher volumes and favorable manufacturing costs in the Personal Care and Pharmaceutical businesses and improved pricing in the Industrial business. These gains were partially offset by lower volumes in the Industrial and Performance Chemicals businesses, unfavorable manufacturing costs in the Alginates business and by the adverse effect of the stronger U.S. dollar in Europe.

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Interest expense for the first nine months of 2001 was $62.8 million versus $62.7 million for the same period last year, as the effect of higher average borrowings reflecting the issuance of $305 million aggregate principal amount of 10 1/4% Senior Subordinated Notes in June and July 2001 was offset by lower average interest rates. Other income, net, for the first nine months of 2001 was $3.4 million compared with $48.5 million for the same period last year, with the decrease due to lower investment income. Investment income in the first nine months of 2001 was $13.5 million compared with $56.1 million in the first nine months of 2000, which included the net gain of $36.8 million from the sale of the Company's investments in Dexter Corporation and Life Technologies, Inc.

Business Segment Review

A discussion of operating results for each of the Company's business segments follows. The Company operates its Specialty Chemicals business through three reportable business segments, in addition to the Mineral Products segment.

Personal Care

Sales in the first nine months of 2001 were $150.5 million compared with $140.0 million for the same period last year, while operating income for the first nine months of 2001 increased to $27.0 million from $22.8 million in the same period last year. The 7.5% increase in sales resulted principally from higher volumes in the North American and European hair care markets, reflecting strong mass market sales of hair gels and styling aids, partially offset by the adverse effect ($3.3 million) of the stronger U.S. dollar in Europe. Operating profits improved 18% as a result of the higher volumes and a higher gross margin which was attributable to favorable manufacturing costs.

Pharmaceutical, Food and Beverage ("PFB")

Sales for the PFB segment were $175.5 million for the first nine months of 2001 compared with $174.6 million for the first nine months of 2000, while operating income increased to $38.8 million versus $37.3 million last year. Sales for the Pharmaceutical and Beverage business increased by 7.5% in the first nine months of 2001, primarily reflecting higher Pharmaceutical volumes in the excipients market and, to a lesser extent, higher Beverage volumes. Sales for the Alginates business decreased by 17% due to lower volumes across all regions and markets.

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Operating income for the Pharmaceutical and Beverage business increased 29% in the first nine months of 2001 compared with the same period in 2000, while the operating margin improved from 23% in the first nine months of 2000 to 28% for the same period this year. The improvement reflected the higher unit volumes and higher gross margins as a result of favorable manufacturing costs, partially offset by the adverse effect of the stronger U.S. dollar in Europe. Operating income for the Alginates business decreased in the first nine months of 2001 due to the lower volumes and unfavorable manufacturing costs related to lower production volumes.

Performance Chemicals, Fine Chemicals and Industrial

Sales in the first nine months of 2001 were $205.4 million compared with $222.6 million in the first nine months of 2000. The lower sales were primarily attributable to an 11% sales decline in the Industrial business due to lower volumes and the unfavorable impact ($4.0 million) of the stronger U.S. dollar in Europe, partially offset by improved pricing. Sales for the Fine Chemicals business decreased by 9%, reflecting unit volume decreases related to contract sales to Polaroid (see discussion relating to Polaroid in "Results of Operations - Third Quarter 2001 Compared With Third Quarter 2000 - Performance Chemicals, Fine Chemicals and Industrial"). The lower contract sales were partially offset by sales of $1.6 million for the FineTech business which was acquired in the second quarter. Sales for the Performance Chemicals business decreased slightly, as small volume gains and favorable pricing were offset by the adverse effect ($1.4 million) of the stronger U.S. dollar in Europe.

Operating income for the Performance Chemicals, Fine Chemicals and Industrial segment increased 72% for the first nine months of 2001 to $17.5 million compared with $10.2 million for the same period last year. The improved results were primarily attributable to higher Industrial operating income due to improved pricing. In addition, operating income for the Fine Chemicals business improved by 80% due to favorable manufacturing costs and the favorable impact of the FineTech acquisition, partially offset by increased operating expenses. Offsetting these improved results was an 84% decline in operating income for the Performance Chemicals business as a result of an unfavorable product mix and higher operating expenses.

Mineral Products

Sales for the Mineral Products segment for the first nine months of 2001 were $63.8 million compared with $56.9 million for the first nine months of 2000. The higher sales were attributable to a $3.9 million (42%) increase in trade sales and a 6% increase in sales to Building Materials Corporation of America, an affiliate, due primarily to higher volumes. Operating income for the first nine months of 2001 was $8.4 million compared with $8.7 million for the first nine months of 2000, reflecting an unfavorable product mix and also higher operating expenses due mainly to an increased provision for doubtful accounts.

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LIQUIDITY AND FINANCIAL CONDITION

During the first nine months of 2001, the Company's net cash outflow before financing activities was $17.6 million, including $234.7 million of cash generated from operations, the reinvestment of $58.7 million for capital programs and the acquisition of FineTech Ltd. (see Note 2 to Consolidated Financial Statements) and the use of $193.6 million of cash for net purchases of available-for-sale securities and other short-term investments.

Cash generated from operations in the first nine months of 2001 reflected a $204.6 million net cash inflow related to net sales of trading securities. Excluding this cash flow, cash provided from operations totaled $30.1 million. Cash invested in additional working capital totaled $46.9 million during the first nine months of 2001, primarily reflecting a $50.7 million increase in inventories, mainly due to higher production levels in line with increased sales, partially offset by a $2.5 million net increase in payables and accrued liabilities.

Net cash provided by financing activities during the first nine months of 2001 totaled $29.6 million, reflecting the debt financing transactions discussed below, financing fees and expenses of $13.8 million related to the financing transactions, repayments of long-term debt totaling $65.1 million and a $27.0 million decrease in short-term borrowings. In addition, financing activities included a $12.3 million cash outlay for repurchases of 1,296,900 shares of the Company's common stock pursuant to the Company's repurchase program. On May 15, 2001, the Company's Board of Directors approved the repurchase of an additional 2.5 million shares of its common stock pursuant to its share repurchase program. At September 30, 2001, 1,589,962 shares of common stock remained to be purchased under the Company's repurchase program.

On June 27, 2001, ISP Chemco Inc.("ISP Chemco"), an indirect wholly-owned subsidiary of the Company, and three wholly-owned subsidiaries of -ISP Chemco issued $205.0 million aggregate principal amount of 10 1/4% Senior Subordinated Notes due 2011 (the "2011 Notes"). The net proceeds of $197.3 million, after discount and fees, were placed in an escrow account and were used to retire the Company's 9 3/4% Senior Notes due 2002 (the "2002 Notes") on or prior to October 15, 2001. During the third quarter of 2001, the Company retired $19.9 million of the 2002 Notes, and the remaining $180.0 million of 2002 Notes were retired on or before October 15, 2001. On July 31, 2001, these four subsidiaries issued an additional $100.0 million aggregate principal amount of the 2011 Notes. These notes have the same terms as the 2011 Notes issued in June. The net proceeds were $98.9 million, including $0.9 million of accrued interest from June 27, 2001 to the date of issuance, of which $98.0 million was placed in an escrow account to be used to retire a portion of the Company's 9% Senior Notes due 2003 (the "2003 Notes") on or prior to their maturity. On November 13, 2001, these four subsidiaries issued an additional $100.0 million aggregate principal amount of the 2011 Notes. These notes have the same terms as the 2011 Notes issued in June, except with respect to interest accrual and registration rights. The net proceeds of $101.0 million were placed in an escrow account to be used to retire a portion of the Company's 2003 Notes on or prior to their maturity. During the third quarter of 2001, the Company retired $16.9 million principal amount of the 2003 Notes. All of the 2011 Notes were guaranteed by substantially all of ISP Chemco's other domestic subsidiaries. The 2011 Notes were issued under an indenture which, among other things, places limits on the ability of ISP Chemco and its subsidiaries to incur additional debt, issue preferred stock, incur liens, and pay dividends or make certain other restricted payments and restricted investments.

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In a related transaction, ISP Chemco and its three subsidiaries which issued the notes also entered into $450.0 million of new senior secured credit facilities (the "Senior Credit Facilities"), the initial borrowings under which were used to repay amounts outstanding under the Company's previous credit facility. The Senior Credit Facilities are comprised of a $225.0 million term loan with a maturity of seven years and a $225.0 million revolving credit facility which will terminate in five years. The revolving credit facility includes a borrowing capacity not in excess of $50.0 million for letters of credit. All borrowings under the Senior Credit Facilities will be based on either an alternate base rate (based on the banks' base rate or on the federal funds rate) or on the eurodollar rate plus a margin based on the ratio of ISP Chemco's total consolidated debt to EBITDA (as defined in the Senior Credit Facilities). The Senior Credit Facilities require compliance with various financial covenants, including a total debt leverage maintenance ratio, a senior debt leverage maintenance ratio, an interest coverage ratio and a minimum adjusted net worth. As of September 30, 2001, $80.6 million of borrowings and $5.6 million of letters of credit were outstanding under the revolving credit facility.

As a result of the foregoing factors, cash and cash equivalents increased by $12.0 million during the first nine months of 2001 to $30.2 million, excluding $359.4 million of trading and available-for-sale securities and other short-term investments.

In December 2000, the Company shut down its Seadrift, Texas butanediol manufacturing facility and shut down production of butanediol at its Texas City, Texas manufacturing facility in the first quarter of 2001. Accordingly, the Company recorded a one-time restructuring charge against operating income in 2000 of $2.5 million, including an accrual of $2.1 million for cash costs to be incurred in 2001 for severance and for decommissioning and remediation costs. During the first nine months of 2001, $2.0 million of costs were charged against this reserve, leaving a reserve balance of $0.1 million as of the end of the third quarter of 2001.

In connection with the relocation of certain of the Company's production lines for Personal Care products to the Company's Freetown, Massachusetts facility, the Company shut down its manufacturing operation in Belleville, New Jersey in the first quarter of 2001. Accordingly, the Company recorded a restructuring charge against operating income in 2000 of $11.9 million, which included a $10.4 million write-off of production assets. The total charge included an accrual of $1.5 million for cash costs to be incurred in 2001, mainly for severance and other shutdown-related costs. During the first nine months of 2001, $1.1 million of costs were charged against this reserve, leaving a reserve balance of $0.4 million as of the end of the third quarter of 2001.

See Note 10 to Consolidated Financial Statements for information regarding contingencies.

* * *



FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains both historical and forward-looking statements. All statements other than statements of historical fact are, or may be deemed to be, forward-looking statements within the meaning of section 27A of the Securities Act of 1933 and section 21E of the Securities Exchange Act of 1934. These forward-looking statements are only predictions 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. The Company's operations are subject to certain risks and uncertainties that could cause actual results to differ materially from those contemplated by the relevant forward-looking statement. The forward-looking statements included herein are made only as of the date of this Quarterly Report on Form 10-Q and the Company undertakes no obligation to publicly update such forward-looking statements to reflect subsequent events or circumstances. No assurances can be given that projected results or events will be achieved.

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## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Reference is made to Management's Discussion and Analysis of Financial Condition and Results of Operations in the Form 10-K for a discussion of "Market-Sensitive Instruments and Risk Management." As of December 31, 2000, equity-related financial instruments employed by the Company to reduce market risk included long contracts valued at $40.1 million. At September 30, 2001, the value of long contracts was $57.4 million. Such instruments are marked-to-market each month, with unrealized gains and losses included in the results of operations. As such, there is no economic cost to the Company at July 1, 2001 to terminate these instruments and therefore the fair market value is zero.

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## PART II

## OTHER INFORMATION

### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) No reports on Form 8-K were filed during the quarter ended September 30, 2001.

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## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

INTERNATIONAL SPECIALTY PRODUCTS INC.

DATE: November 14, 2001

BY: /s/ Susan B. Yoss

Susan B. Yoss
Executive Vice President - Finance
and Treasurer
(Principal Financial Officer)

DATE: November 14, 2001

BY: /s/ Jon W. Rushatz

Jon W. Rushatz
Vice President - Finance
(Principal Accounting Officer)