

Building Blocks  
For  
Better Living™



**LSB**  
**INDUSTRIES**

2006 Annual Report

Our innovative climate control products are used by millions of people every day in prestigious buildings and homes throughout North America and around the world.

Our technologically advanced and environmentally responsible “green” geothermal heat pumps reduce energy usage and greenhouse gas emissions.

Our chemicals are used to produce dozens of products that benefit people everywhere every day, from clothing and paper products to advanced athletic gear made from high impact polyurethane.

Our industrial chemicals help mine metals and coal vital to meeting the world’s growing demand for energy, and our agricultural chemicals fertilize food crops and pasture land for grazing livestock.

Our engineered products are used for precision metalworking manufacturing throughout industry.

At LSB Industries we make...

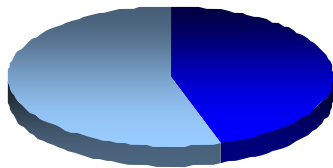
***Building Blocks for Better Living.***

*Cover Photo:  
LSB’s climate control  
products heat and cool  
the Statue of Liberty.*

# Profile

LSB Industries, Inc. (AMEX: LXU) is a manufacturing, marketing, and engineering company with activities on a world wide basis. LSB's principal business activities consist of the manufacture and sale of commercial and residential climate control products, the manufacture and sale of chemical products for the mining, agricultural and industrial markets, the provision of specialized engineering services, and other activities.

## Climate Control



2006 Sales \$221.2 million

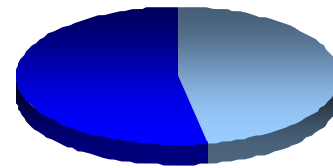
### Key Products

- Geothermal Heat Pumps
- Water Source Heat Pumps
- Hydronic Fan Coils
- Large Custom Air Handlers
- Modular Water Chillers
- Tube-in-Fin Heat Exchange Coils
- Coaxial Heat Exchange Coils
- Contracting Services

### Highlights

- Leading U.S. market share for geothermal heat pumps and water source heat pumps
- Leading U.S. market share for hydronic fan coils
- Products marketed to residential, commercial and institutional new construction, renovation, and replacement

## Chemical



2006 Sales \$260.6 million

### Key Products

- Concentrated Nitric Acid
- Nitric Acid Blends
- Sulfuric Acid
- Mixed Acids
- Ammonium Nitrate Solutions
- E2 High Density Ammonium Nitrate Prills
- Low Density Ammonium Nitrate Prills
- Anhydrous Ammonia

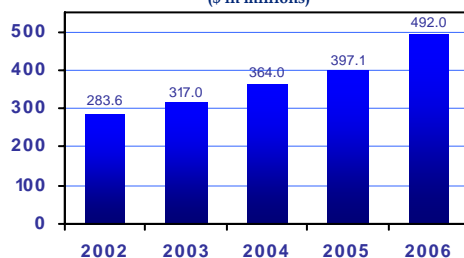
### Highlights

- Leading U. S. marketer of nitric acid and nitric acid blends
- Leading marketer of ammonium nitrate fertilizer in the central southeast U.S.
- Diversified industrial and agricultural customer base

## Performance

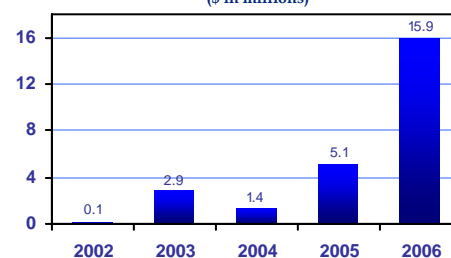
### Revenues

(\$ in millions)



### Net Income

(\$ in millions)



# Letter To Our Shareholders

By all measures, 2006 was an excellent year for LSB Industries. Our two core businesses, Chemical and Climate Control, both achieved record sales and operating income, making the year one of the best ever for LSB Industries and its shareholders. Our balance sheet was substantially strengthened from measures taken to reduce debt and interest expense and to increase net worth. We made, and continue to make, improvements to promote greater efficiency, increase capacity, enhance product quality, and lower costs. Our stronger financials and the momentum achieved in 2006 and early 2007 position LSB for long-term profitable growth.

Consolidated 2006 sales totaled \$492 million, up 24% from 2005. Sales for 2006 by our Climate Control Business rose 41% to \$221 million, while sales by our Chemical Business rose to \$261 million, a 12% improvement. Our total 2006 revenues also include our Engineered Products and Services operation, shown as 'other sales' of \$10 million, compared to \$7 million in 2005.

## **Climate Control Business**

Our Climate Control business consists of a group of companies that are niche market leaders in their respective specialties within the heating, ventilation and air-conditioning (HVAC) industry. Our

core products in this business enjoy leading U.S. market shares. We have a huge installed base of millions of units in thousands of buildings throughout the U.S. and around the world.

The two largest companies in our Climate Control business are **ClimateMaster**, the world's leading manufacturer of geothermal and water source heat pumps and **International Environmental**, the leading U.S. producer of hydronic fan coils. These two companies generated approximately 88% of Climate Control revenues in 2006. ClimateMaster sales increased nearly 58% while International Environmental achieved 11% top line growth.

Over the past several years, but to a greater degree in 2006, our geothermal and water source heat pump product lines have achieved substantial growth. Geothermal heat pumps are used in heating and cooling systems powered by the sun's renewable energy stored in the earth, resulting in utility bills reduced by as much as 60% compared to conventional heating and cooling systems. As an added benefit, geothermal systems can generate "free" domestic hot water. These ultra high efficiency, zero ozone depleting products have estimated life spans of up to three times that of conventional systems and operate virtually noise free.

Geothermal systems make economic sense even without the State and Federal energy efficiency incentives available. Geothermal systems are a truly “green” form of renewable energy and are a win for the environment, a win for cost-savings and a win for foreign oil independence.

In 2006, our sales of residential geothermal units rose 44% over 2005. This top line growth is even more impressive when you consider that overall U.S. factory shipments for conventional residential air conditioners and air source heat pumps declined approximately 18%, as reported by the Air Conditioning and Refrigeration Institute (“ARI”). The potential geothermal market is vast. The total U.S. residential heating and cooling market alone represents an opportunity of some seven million units annually. In addition, geothermal systems can be used in commercial and institutional buildings. As the U.S. market share leader in this product, we believe we are poised to take advantage of this potential.

As we noted earlier, approximately 88% of 2006 Climate Control sales were water source heat pumps, including geothermal, and hydronic fan coils. A majority of these sales are to commercial and institutional buildings, such as hotels, resorts, office buildings, apartments, condominiums, health care and extended care facilities, schools and universities. During 2006 we shipped fan coil

products to several large hotel casinos in Las Vegas, bringing our installed base there in recent years to over 70,000 units.

In addition to our core products, 12% of our Climate Control sales in 2006 were by newer, very promising businesses that have yet to achieve break even results from operations. **ClimateCraft** engineers and produces large custom air handling units for environmentally-sensitive applications, such as semiconductor and pharmaceutical manufacturing facilities and surgical suites, where control of air temperature, humidity and purity are critical. **ClimaCool** produces modular water chillers that are connected to each other forming large capacity chillers used in central air-conditioning systems. Individual chiller modules fit through standard doorways and passenger elevators, avoiding the demolition and expensive installation costs associated with large one-piece chillers. **Trison Construction** offers design, engineering and construction services, specializing in large scale geothermal installations. It has provided geothermal systems to some of the largest military housing privatization projects completed to date.

Within our Climate Control business we have a number of initiatives in place designed to increase both our top and bottom lines. In addition to maintaining our leadership positions in geothermal, water source heat pumps and hydronic fan

coils, we regularly add new products and/or product enhancements that are complementary to our existing product line up and are well suited to our distribution channels.

During 2006 total bookings of new orders for our Climate Control business were up 33% over 2005 and we closed the year with a backlog of \$80.4 million, up 43% over \$56.2 million at year-end 2005. This growth was led by geothermal and water source heat pumps. To accommodate this growth and to prepare for the future, we added a 46,000 square foot warehouse and a 100,000 square foot distribution center to our **ClimateMaster** operation during the first quarter of 2007. This had the effect of almost doubling the floor space available in this operation for manufacturing. Newly installed fabrication equipment, assembly lines, automated line testing and quality assurance systems are increasing production output and will allow us to reduce delivery times. In addition, we have added assembly lines for **International Environmental's** high rise fan coils, doubled the manufacturing floor space at our **ClimateCraft** large custom air handler plant, and are in the process of doubling the capacity of our tube-in-fin heat transfer coil operation.

The pursuit of cost savings is an essential part of our corporate culture and is an ongoing endeavor. We have several important cost reductions initiatives underway at this time.

While we are open to well-priced acquisitions of either entire companies or products that are complementary and/or strategic, there are sufficient internal expansion opportunities within our established and newer ventures upon which to continue to build our Climate Control business. We are optimistic about the future of this business.

### **Chemical Business**

During 2006, our Chemical Business achieved nearly a 12% year-over-year increase in sales, despite a serious drought in the agricultural markets we serve. Strong gains in industrial market sales, where we have cost-plus sales agreements in place, more than offset the impact of the agricultural shortfall during 2006. As we have repeatedly stated, one of the goals of the Chemical Business is to increase sales to large industrial customers, where cost-plus sales agreements are mutually beneficial. These pricing agreements pass through certain key costs including the cost of raw material feedstocks.

When LSB entered the Chemical Business in 1984, most of its sales were to agricultural markets. In 2006, sales of products to the agricultural markets represented only 35% of Chemical Business sales volume and only 18% of LSB's total sales. As we write this letter, anticipated demand for agricultural grade nitrogen fertilizer is stronger than in recent years, in part because of increased corn

planting to use as feedstock for ethanol as an alternative to fossil fuel, in part because of world wide demand for grain, and in part due to better weather conditions in the markets we serve. However, as experience has taught us, these circumstances can easily change. Over time, our goal is to continue to increase our Chemical Business' sales subject to long-term cost-plus agreements with major corporate and industrial customers, up from the 65% currently sold to these sectors. If we are successful in achieving this goal, most of our Chemical Business will be more predictable and less subject to seasonality, weather and natural gas price fluctuations, while still maintaining a foothold in the agricultural markets which generally result in higher than average gross margins.

Our Industrial Chemical Business is the largest merchant marketer of concentrated nitric acid in North America. It is also a large marketer of all grades of nitric acid, which is used to produce various specialty chemicals including polyurethane, flame resistant fibers and carbon fibers. The specialty blends and the mixed acids we produce are used for metal treatment, diesel fuel additives, herbicides, ordnance, and pharmaceuticals. We also produce sulfuric acid which is used for pulp and paper manufacture, water treatment, metals processing, and a variety of other uses. Our industrial grade ammonium nitrate is required for the manufacture of commercial explosives for surface min-

ing of coal, iron and copper as well as road construction and quarrying.

A detailed description of our manufacturing facilities at El Dorado, Arkansas, Cherokee, Alabama, and Baytown, Texas, including their size, output and feedstocks is provided in the 2006 10-K. Our manufacturing strategy is to maximize plant run rates to increase absorption of fixed costs and to increase capacity and sales volume through process optimization. We believe that cost reduction measures undertaken in 2006, including improved energy management systems, will have lasting value. Continued improvements in yield, at all facilities, is an ongoing mission.

During 2006 our El Dorado Chemical Company subsidiary received a unanimous jury verdict in which it was awarded approximately \$9.8 million in damages for the negligence of the defendants, Ingersoll-Rand Co. and DR Holding Corp., as general partners of Dresser Rand Company. The details of the case are documented in the 2006 10-K. Not unexpectedly, an appeal was filed by the defendants in January 2007. As of this date, we have not received nor have we booked the jury award. If the verdict withstands the appeal, we should realize 70% of the net recovery.

#### **Other Business**

In addition to our two core businesses, we have a

small, self-sufficient and profitable Engineered Products and Services business that is classified within “other” in the Segment Reporting section of our 10-K. Within this area, under the trade name “Summit”, we market standard and computer numerical control precision machine tools required in many metalworking manufacturing operations and tool and die shops. We also provide design and construction services for metal manufacturing and chemical facilities.

**Our Balance Sheet Focus:  
Strengthen and Simplify**

Our continued focus on strengthening and simplifying our balance sheet should have lasting benefits and enhance the positive impact of growing sales and profits. The 2006 10-K provides an extensive review of our capital structure including, borrowings, financings, refinancings, debenture conversions, preferred stock exchanges into common stock, and credit agreements. The objective is to replace higher cost borrowings and dividend bearing preferred stock with lower cost capital. In 2006 we reduced total long-term debt and increased shareholders’ equity. As a result of the Exchange of Preferred stock for Common that we completed in 2006 and 2007, we have taken a large bite out of the accrued and unpaid dividends on our preferred shares.

During March 2006 we sold \$18 million 7% Con-

vertible Senior Subordinated Debentures (“Debentures”), which allowed us to purchase or redeem \$13.6 million of a subsidiary’s 10-3/4% senior unsecured notes, plus accrued interest of \$300,000. Since then all of the 7% debentures have been converted into common stock.

In the fourth quarter of 2006 and in February 2007, exchange offers were completed for 410,000 of the 603,000 outstanding shares of the \$3.25 Convertible Exchangeable Class C Preferred Stock, Series 2 (the “Series 2 Preferred”). Holders received 7.4 shares of LSB common stock for each share of Series 2 preferred exchanged. At this time, only 193,000 shares of Class C Preferred remain outstanding and as a result of the exchanges, we reduced the cumulative dividends in arrears by \$9.8 million to a remaining balance of \$4.8--million at March 31, 2007.

We are pursuing opportunities to prepay our \$50 million 11% senior secured loan and replacing it with a less costly and less restrictive lending agreement.

At the start of 2006, our market cap was under \$90 million, and at year end it was just under \$195 million. As we finalized this letter, our market cap was \$320 million. We started 2006 with shareholders’ equity of \$13.5 million and by year-end it increased to \$42.6 million. As of March 30, 2007 our shareholder’s equity was \$----- million.



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## Future Outlook

Our goals for 2007 are consistent with our long-term strategic objectives. We will continue to look for ways to reduce debt and interest expense, while ensuring that we have the capital we need to grow the business. We will continue to move our Chemical Business in the direction of long-term cost-plus type agreements, and we will continue to emphasize energy efficient and environmentally responsible technology such as geothermal as we grow our Climate Control Business.

We are enthusiastic about LSB's prospects. As large LSB shareholders, management's interests are aligned with those of our public shareholders.

Simply put, we look to enhance shareholder value through long-term profitable growth and by strengthening LSB's financial position.

On behalf of the Board of Directors, we thank all of the members of the LSB family. The financial results achieved in 2006, are a result of their performance, their hard work and their dedication. We also appreciate the support and cooperation of our investors, lenders, customers and suppliers.

Sincerely,

Jack E. Golsen  
Chairman of the Board  
and CEO

Barry H. Golsen  
Vice Chairman of the  
Board, President and  
COO

*This letter contains certain forward-looking statements, including, but not limited to, actions taken have placed us on right course for long-term growth, potential geothermal market is vast, opportunities of U.S. residential heating and cooling market, our Climate Control business is poised to take advantage of the Geothermal market, our Climate Control business is working to increase volume of its newer promising business and become profitable, initiatives designed to increase our product lines, optimistic about the future of our Climate Control business, goal of our Chemical business to increase sales to large industrial customers, strategy of our Chemical business, replace our senior secured loan with a less costly and less restrictive lending agreement, goals for 2007 and look for ways to reduce debt and interest expense and enhance shareholder value. Please read "A Special Note Regarding Forward-Looking Statements" contained in the Form 10-K for a discussion of a variety of factors which could cause the future outcome to differ materially from the forward-looking statements contained in this letter.*



# LSB Directors and Officers:

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Professor, University of Kansas

### **JACK E. GOLSEN**

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and Climate Control Business

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Executive Vice President  
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Financial Reporting

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General Counsel and Secretary

### **MIKE TEPPER**

Senior Vice President,  
International Operations

## Subsidiary Executive Officers

### **DAN ELLIS**

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ClimateMaster, Inc.

### **STEVE J. GOLSEN**

Co-Chairman, CEO  
ClimateMaster, Inc. and  
COO Climate Control Business

### **PHIL GOUGH**

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Agrochemical Group

### **BRIAN HAGGART**

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The Climate Control Group, Inc.

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El Dorado Chemical Company  
and Cherokee Nitrogen Company

### **LARRY L. JEWELL**

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International Environmental  
Corporation

### **WALTER P. MECOZZI**

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### **ANNE RENDON**

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El Dorado Nitric Company

### **PAUL RYDLUND**

President,  
LSB Chemical Corporation

### **BRUCE SMITH**

President,  
Summit Machine Tool  
Manufacturing Corporation



# Building Blocks For Better Living™

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## Independent Auditors

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Oklahoma City, Oklahoma

## Security Listing

Common Stock listed on the  
American Stock Exchange  
AMEX Ticker Symbol: LXU

Series 2, \$3.25 Convertible  
Exchangeable Class C Preferred  
Stock (Ticker Symbol: LSBDP)

## Transfer Agent & Registrar

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## Website

[www.lsb-okc.com](http://www.lsb-okc.com)

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operations and policies.