

AIRGAS INC
Form 10-Q
November 13, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended: **September 30, 2003**

Commission file number: 1-9344

AIRGAS, INC.

(Exact name of registrant as specified in its charter)

Delaware

56-0732648

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer
Identification No.)

259 North Radnor-Chester Road, Suite 100
Radnor, PA

19087-5283

(Address of principal executive offices)

(ZIP code)

(610) 687-5253

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes NO

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities and Exchange Act of 1934).
Yes NO

Common Stock outstanding at November 10, 2003: 73,909,843 shares

AIRGAS, INC.

FORM 10-Q
September 30, 2003

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

AIRGAS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF EARNINGS

(Unaudited)

(In thousands, except per share amounts)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2003	2002	2003	2002
Net sales	\$460,452	\$451,053	\$921,508	\$908,721
Costs and expenses				
Cost of products sold (excluding depreciation)	220,361	214,087	441,494	436,353
Selling, distribution and administrative expenses	178,175	174,737	356,636	351,036
Depreciation	19,824	18,169	39,115	36,628
Amortization	1,331	1,636	2,842	3,376
Special charges				2,694
Total costs and expenses	<u>419,691</u>	<u>408,629</u>	<u>840,087</u>	<u>830,087</u>
Operating income	40,761	42,424	81,421	78,634
Interest expense, net	(10,295)	(12,040)	(20,730)	(25,161)
Discount on securitization of trade receivables	(801)	(899)	(1,669)	(1,750)
Other income (expense), net	(185)	(129)	(358)	(252)
Equity in earnings of unconsolidated affiliates	1,347	1,364	2,047	2,296
Earnings before income taxes	<u>30,827</u>	<u>30,720</u>	<u>60,711</u>	<u>53,767</u>
Income taxes	11,714	11,520	23,070	20,523
Net earnings	<u>\$ 19,113</u>	<u>\$ 19,200</u>	<u>\$ 37,641</u>	<u>\$ 33,244</u>
Basic earnings per share	<u>\$ 0.26</u>	<u>\$ 0.27</u>	<u>\$ 0.52</u>	<u>\$ 0.47</u>
Diluted earnings per share	<u>\$ 0.26</u>	<u>\$ 0.27</u>	<u>\$ 0.51</u>	<u>\$ 0.46</u>
Weighted average shares outstanding:				
Basic	<u>72,600</u>	<u>70,400</u>	<u>72,200</u>	<u>70,100</u>
Diluted	<u>74,400</u>	<u>71,900</u>	<u>74,100</u>	<u>72,000</u>
Comprehensive income	<u>\$ 19,588</u>	<u>\$ 19,294</u>	<u>\$ 38,888</u>	<u>\$ 34,214</u>

See accompanying notes to consolidated financial statements.

AIRGAS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands, except per share amounts)

	(Unaudited) September 30, 2003	March 31, 2003
ASSETS		
Current Assets		
Trade receivables, less allowances for doubtful accounts of \$8,845 at September 30, 2003 and \$8,514 at March 31, 2003	\$ 82,009	\$ 71,346
Inventories, net	158,663	151,405
Deferred income tax asset, net	18,058	17,688
Prepaid expenses and other current assets	29,198	30,143
Total current assets	287,928	270,582
Plant and equipment, at cost	1,424,614	1,345,783
Less accumulated depreciation	(523,349)	(476,291)
Plant and equipment, net	901,265	869,492
Goodwill	439,886	437,709
Other intangible assets, net	18,214	19,832
Investments in unconsolidated affiliates	66,906	65,957
Other non-current assets	35,956	36,671
Total assets	\$1,750,155	\$1,700,243
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts payable, trade	\$ 78,008	\$ 85,375
Accrued expenses and other current liabilities	104,721	121,292
Current portion of long-term debt	580	2,229
Total current liabilities	183,309	208,896
Long-term debt	684,017	658,031
Deferred income taxes, net	221,359	209,140
Other non-current liabilities	15,798	27,243
Commitments and contingencies		
Stockholders Equity		
Preferred stock, no par value, 20,000 shares authorized, no shares issued or outstanding at September 30, 2003 and March 31, 2003		
Common stock, par value \$.01 per share, 200,000 shares authorized, 77,085 and 76,373 shares issued at September 30, 2003 and March 31, 2003, respectively	771	764
Capital in excess of par value	227,847	216,275
Retained earnings	445,061	413,286
Accumulated other comprehensive loss	(2,055)	(3,302)
Treasury stock, 547 common shares at cost at September 30, 2003 and March 31, 2003	(4,289)	(4,289)
Employee benefits trust, 2,873 and 3,421 common shares at cost at September 30, 2003 and March 31, 2003, respectively	(21,663)	(25,801)
Total stockholders equity	645,672	596,933

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Total liabilities and stockholders equity	\$1,750,155	\$1,700,243
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See accompanying notes to consolidated financial statements.

AIRGAS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

(In thousands)	Six Months Ended September 30, 2003	Six Months Ended September 30, 2002
CASH FLOWS FROM OPERATING ACTIVITIES		
Net earnings	\$ 37,641	\$ 33,244
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	39,115	36,628
Amortization	2,842	3,376
Deferred income taxes	10,600	(3,006)
Equity in earnings of unconsolidated affiliates	(2,047)	(2,296)
Loss on divestitures		241
Loss (gain) on sales of plant and equipment	217	(85)
Stock issued for employee stock purchase plan	4,384	4,502
Changes in assets and liabilities, excluding effects of business acquisitions and divestitures:		
Securitization of trade receivables	(6,200)	20,500
Trade receivables, net	(3,404)	(20,589)
Inventories, net	(6,569)	6,264
Prepaid expenses and other current assets	575	18,533
Accounts payable, trade	(7,384)	1,437
Accrued expenses and other current liabilities	(4,241)	(12,131)
Other assets	76	(1,755)
Other liabilities	2,340	(2,989)
	<u>67,945</u>	<u>81,874</u>
Net cash provided by operating activities		
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(42,151)	(34,271)
Proceeds from sales of plant and equipment	3,133	2,748
Proceeds from divestitures		3,167
Business acquisitions, holdbacks and other settlements of acquisition related liabilities	(5,852)	(4,816)
Dividends and fees from unconsolidated affiliates	1,098	1,402
Other, net	(1,728)	(686)
	<u>(45,500)</u>	<u>(32,456)</u>
Net cash used in investing activities		
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from borrowings	136,461	167,229
Repayment of debt	(151,871)	(224,157)
Dividends paid to stockholders	(5,866)	
Exercise of stock options	7,353	4,998
Cash overdraft	(8,522)	2,512
	<u>(22,445)</u>	<u>(49,418)</u>
Net cash used in financing activities		
Change in cash	\$	\$
Cash Beginning of period		
	<u> </u>	<u> </u>
Cash End of period	\$	\$
	<u> </u>	<u> </u>
Cash paid during the period for:		
Interest	\$ 23,108	\$ 32,528
Income taxes, net of refunds	\$ 12,047	\$ 7,660

See accompanying notes to consolidated financial statements.

AIRGAS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(1) BASIS OF PRESENTATION

The consolidated financial statements include the accounts of Airgas, Inc. and its subsidiaries (the Company). Intercompany accounts and transactions are eliminated in consolidation. The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. These statements do not include all disclosures required for annual financial statements. These financial statements should be read in conjunction with the more complete disclosures contained in the Company's audited consolidated financial statements for the fiscal year ended March 31, 2003.

The consolidated financial statements reflect, in the opinion of management, all adjustments necessary to present fairly the Company's financial position, results of operations and cash flows for the periods presented. Such adjustments are of a normal, recurring nature except for the special charges, which are discussed in these notes to the consolidated financial statements. The interim operating results are not necessarily indicative of the results to be expected for an entire year.

Certain reclassifications have been made to prior period financial statements to conform to the current presentation.

(2) NEW ACCOUNTING PRONOUNCEMENTS AND ACCOUNTING CHANGES

FASB Financial Interpretation No. 46

In January 2003, the Financial Accounting Standards Board (FASB) issued Financial Interpretation of Accounting Research Bulletin No. 51 (ARB 51) entitled, *Consolidation of Variable Interest Entities* (FIN 46). The interpretation was originally effective for the first interim period beginning after June 15, 2003. However, as a result of implementation issues, the FASB issued FASB Staff Position No. 46-6 (FSP 46-6), which deferred the effective date for applying the provisions of FIN 46 to variable interest entities existing prior to February 1, 2003 until the end of the first interim period ending after December 15, 2003, with early adoption permitted.

FIN 46 addresses consolidation by a business enterprise of variable interest entities. Variable interest entities are defined as corporations, partnerships, trusts, or any other legal structure used for business purposes, and by design, the holders of equity instruments in those entities lack one of the characteristics of a financial controlling interest. FIN 46 changes previous accounting practice by introducing the concept of a Primary Beneficiary and requiring variable interest entities to be consolidated by the party deemed to be the Primary Beneficiary (i.e., the party that is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both). Under previous accounting practice, entities generally were not consolidated unless the entity was controlled through voting interests.

The Company participates in a joint venture with National Welders Supply Company, Inc. (National Welders). The Company is the only common stockholder of the joint venture, but has a 50% / 50% voting interest shared with National Welders' preferred stockholders. The Company believes that its National Welders joint venture is a variable interest entity as defined by FIN 46. Further, the Company, as the only common stockholder, believes it is the Primary Beneficiary of the joint venture. Accordingly, the Company believes that the joint venture should be consolidated for financial reporting purposes. However, due to the complexity in the application of FIN 46 to the consolidation of the joint venture, the Company elected to defer adoption of FIN 46 as permitted under FSP 46-6. In accordance with FSP 46-6, the Company expects to consolidate the joint venture effective December 31, 2003. The Company will apply FIN 46 prospectively for the joint venture and does not anticipate a cumulative-effect adjustment upon adoption. See Note 11 for more information regarding the National Welders joint venture as well as the financial impact of the consolidation of the joint venture.

AIRGAS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(2) NEW ACCOUNTING PRONOUNCEMENTS AND ACCOUNTING CHANGES (Continued)

Since October 1999, the Company has leased certain real estate and equipment from a grantor trust (the Trust) established by a commercial bank under a sale-leaseback arrangement. The Trust was not previously consolidated for financial reporting purposes. The Company has determined the Trust to be a variable interest entity as defined by FIN 46. In addition, the Company is the Primary Beneficiary of the sale-leaseback arrangement. The implementation issues noted with respect to the National Welders joint venture were not applicable to the Trust. Therefore, effective July 1, 2003, the Company elected to early adopt FIN 46 and to consolidate the Trust. As permitted by FIN 46, the Company has applied FIN 46 prospectively from the date of adoption. The cumulative effect of the accounting change was not material. See Note 12 for more information, including the financial impact of the consolidation of the Trust.

SFAS 143

In July 2001, the FASB issued Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations*. SFAS 143 requires the recognition of a liability for an asset retirement obligation in the period in which it is incurred. A retirement obligation is defined as one in which a legal obligation exists in the future resulting from existing laws, statutes or contracts. The Company adopted SFAS 143 on April 1, 2003, as required. The adoption of SFAS 143 did not have a material impact on its results of operations, financial position or liquidity.

SFAS 149

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. SFAS 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*. SFAS 149 requires, among other things, that contracts with comparable characteristics be accounted for similarly and clarifies the circumstances under which a contract with an initial net investment meets the characteristic of a derivative and when a derivative contains a financing component that warrants special reporting in the statement of cash flows. The Company adopted SFAS 149 on July 1, 2003, as required. The adoption of SFAS 149 did not have a material impact on its results of operations, financial position or liquidity.

SFAS 150

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity in the statement of financial position. The Standard requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those financial instruments were previously classified as equity. The Company adopted SFAS 150 on July 1, 2003, as required. The adoption of SFAS 150 did not have a material impact on its results of operations, financial position or liquidity.

AIRGAS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(3) ACQUISITIONS & DIVESTITURES

(a) Acquisitions

The Company acquired a manufacturer and distributor of dry ice on April 14, 2003 and a distributor of safety products on May 1, 2003. The dry ice business generates annual revenues of approximately \$2 million and is included in the Gas Operations segment. The dry ice business was acquired to expand the Company's market reach into certain southern U.S. states. The distributor of safety products generates annual revenues of approximately \$10 million and is included in the Distribution segment. The safety products distributor business was acquired to complement the Company's existing packaged gas distribution operations in the western U.S. The acquired businesses are not expected to generate significant operating income during fiscal 2004.

The Company paid cash of \$5.9 million for businesses acquired and certain holdback settlements during the six months ended September 30, 2003. Costs in excess of net assets acquired (goodwill) related to the acquisitions totaled approximately \$800 thousand. The final purchase price allocation to net assets, identified intangibles and goodwill acquired has not been completed pending the performance of asset appraisals and intangible valuations. The Company does not expect that the final purchase price allocation will have a material impact on the Company's financial position.

(b) Divestitures

In May 2002, the Company completed the sale of Kendeco for cash proceeds of \$3.2 million. Kendeco's fiscal 2003 operating results were insignificant. During the quarter ended June 30, 2002, the Company also resolved an indemnity claim related to a prior period divestiture. Other income (expense), net, for the six months ended September 30, 2002 included a \$241 thousand net loss from these first quarter divestiture-related transactions.

(4) SPECIAL CHARGES

In June 2002, the Company recorded special charges of \$2.7 million consisting of a restructuring charge related to the integration of the business acquired from Air Products and Chemicals, Inc. (Air Products) during the fourth quarter of fiscal 2002 and costs related to the consolidation of certain hardgoods procurement functions. The special charges include facility exit costs associated with the closure of certain facilities and employee severance. The facilities exited and the affected employees were part of the Company's existing operations prior to the acquisition of the Air Products business.

AIRGAS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(5) EARNINGS PER SHARE

Basic earnings per share is calculated by dividing net earnings by the weighted average number of shares of the Company's common stock outstanding during the period. Outstanding shares consist of issued shares less treasury stock and common stock held by the Employee Benefits Trust. Diluted earnings per share is calculated by dividing net earnings by the weighted average common shares outstanding adjusted for the dilutive effect of common stock equivalents related to stock options and warrants.

The table below reconciles basic weighted average common shares outstanding to diluted weighted average common shares outstanding for the three and six months ended September 30, 2003 and 2002:

(In thousands)	Three Months Ended September 30,		Six Months Ended September 30,	
	2003	2002	2003	2002
Weighted average common shares outstanding:				
Basic	72,600	70,400	72,200	70,100
Stock options and warrants	1,800	1,500	1,900	1,900
Diluted	74,400	71,900	74,100	72,000

Pursuant to a joint venture agreement between the Company and the holders of the preferred stock of National Welders, between June 30, 2006 and June 30, 2009, the preferred shareholders have the option to exchange their 3.2 million preferred shares of National Welders either for cash at a price of \$17.78 per share or to tender them to the joint venture in exchange for approximately 2.38 million shares of Airgas common stock (see Note 11). If Airgas common stock has a market value of approximately \$24.00 per share, the stock and cash redemption options are equivalent. For all periods presented, there were no contingently issuable shares included in the diluted weighted average common shares calculation (the diluted computation) associated with the joint venture agreement.

Outstanding stock options and warrants, with an exercise price above market, are excluded from the Company's diluted computation as their effect would be anti-dilutive. There were approximately 1.7 million and 3.4 million outstanding stock options and warrants with an exercise price above the average market price for the three months ended September 30, 2003 and September 30, 2002, respectively. For the six months ended September 30, 2003 and 2002, there were 1.7 million and 2 million outstanding stock options and warrants with an exercise price above the average market price, respectively. If the market value of the Company's stock increases above the respective exercise prices of the options and warrants, they will be included in the diluted computation as common stock equivalents.

AIRGAS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(6) TRADE RECEIVABLES SECURITIZATION

The Company participates in a securitization agreement with two commercial banks to sell up to \$175 million of qualifying trade receivables. The agreement will expire in December 2005, but is subject to renewal provisions contained in the agreement. During the six months ended September 30, 2003, the Company sold, net of its retained interest, \$818 million of trade receivables and remitted to bank conduits, pursuant to a servicing agreement, \$824 million in collections on those receivables. The amount of outstanding receivables under the agreement was \$152.7 million at September 30, 2003 and \$158.9 million at March 31, 2003.

The transaction has been accounted for as a sale under the provisions of SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Under the securitization agreement, eligible trade receivables are sold to bank conduits through a bankruptcy-remote special purpose entity, which is consolidated for financial reporting purposes. The difference between the proceeds from the sale and the carrying value of the receivables is recognized as *Discount on securitization of trade receivables* in the accompanying Consolidated Statements of Earnings and varies on a monthly basis depending on the amount of receivables sold and market rates. The Company retains a subordinated interest in the receivables sold, which is recorded at the receivables' previous carrying value. A subordinated retained interest of approximately \$47 million and \$45 million are included in *Trade receivables* in the accompanying Consolidated Balance Sheets at September 30, 2003 and March 31, 2003, respectively. The Company's retained interest is generally collected within 60 days. On a monthly basis, management measures the fair value of the retained interest at management's best estimate of the undiscounted expected future cash collections on the transferred receivables. Changes in the fair value are recognized as bad debt expense. Actual cash collections may differ from these estimates and would directly affect the fair value of the retained interest. In accordance with a servicing agreement, the Company continues to service, administer and collect the trade receivables on behalf of the bank conduits. The servicing fees charged to the bank conduits approximate the costs of collections.

(7) INVENTORIES, NET

Inventories, net, consist of:

(In thousands)	(Unaudited) September 30, 2003	March 31, 2003
Hardgoods	\$ 142,653	\$ 136,347
Gases	16,010	15,058
	\$ 158,663	\$ 151,405

Net inventories determined by the LIFO inventory method totaled \$16.2 million and \$15.7 million at September 30, 2003 and March 31, 2003, respectively. If the FIFO inventory method had been used for these inventories, the carrying value would have been increased \$1.5 million and \$1.4 million at September 30, 2003 and March 31, 2003, respectively. Substantially all of the inventories are finished goods.

AIRGAS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(8) ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

Accrued expenses and other current liabilities include:

(In thousands)	(Unaudited) September, 2003	March 31, 2003
Accrued payroll and employee benefits	\$ 28,678	\$ 33,548
Business insurance reserves	19,808	15,272
Health insurance reserves	9,365	9,828
Taxes other than income taxes	13,708	12,972
Accrued interest expense	11,625	12,000
Other accrued expenses and current liabilities	21,537	37,672
	<u>\$ 104,721</u>	<u>\$ 121,292</u>

Business insurance reserves increased primarily due to two fires sustained by the Company during the quarter ended September 30, 2003. The fire incidents resulted in the Company recognizing losses of \$2.8 million associated with its self-insurance retention and property insurance deductibles.

(9) DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

The Company's involvement with derivative instruments is limited to highly effective fixed and variable interest rate swap agreements used to manage well-defined interest rate risk exposures. Interest rate swap agreements are not entered into for trading purposes.

At September 30, 2003, the Company had a notional amount of \$90 million in fixed interest rate swap agreements that effectively convert a corresponding amount of variable interest rate operating leases and the revolving credit facilities to fixed interest rate instruments. During the six months ended September 30, 2003, the Company recorded a net decrease in the fair value of the fixed interest rate swap agreements of \$765 thousand as a reduction of Accumulated Other Comprehensive Loss.

At September 30, 2003, the Company also had a notional amount of \$155 million in variable interest rate swap agreements that effectively convert a corresponding amount of fixed rate medium-term and senior subordinated notes to variable rate debt. The fair value of these variable interest rate swap agreements and the increased carrying value of the hedged portions of the medium-term and senior subordinated notes at September 30, 2003 was \$15.9 million. The changes in the fair value of the swap agreements are offset by changes in the fair value of the hedged portions of the medium-term and senior subordinated notes.

The effect of these interest rate swap agreements was to adjust the Company's ratio of fixed to variable interest rates to 42% fixed and 58% variable.

AIRGAS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(10) GOODWILL AND OTHER INTANGIBLE ASSETS

Changes in the net carrying amount of goodwill for the six months ended September 30, 2003 were as follows:

(In thousands)	Distribution Segment	Gas Operations Segment	Total
Balance at March 31, 2003	\$ 362,400	\$ 75,309	\$ 437,709
Acquisitions	661	563	1,224
Other adjustments	877	76	953
Balance at September 30, 2003	<u>\$ 363,938</u>	<u>\$ 75,948</u>	<u>\$ 439,886</u>

Other intangible assets amounted to \$18.2 million and \$19.8 million (net of accumulated amortization of \$88.2 million and \$87.8 million) at September 30, 2003 and March 31, 2003, respectively. These intangible assets primarily consist of acquired customer lists amortized over 11 years and non-compete agreements entered into in connection with business combinations amortized over the term of the agreements, principally five years. There are no expected residual values related to these intangible assets. Estimated remaining fiscal year amortization expense in millions is as follows: remainder of 2004 - \$3.0; 2005 - \$5.8; 2006 - \$3.2; 2007 - \$2.6 million; 2008 - \$1.9 million, and \$1.7 million thereafter.

(11) JOINT VENTURE WITH NATIONAL WELDERS

The Company has an investment totaling approximately \$60 million and \$59 million at September 30, 2003 and March 31, 2003, respectively, in its National Welders joint venture. The Company currently accounts for its investment under the equity method of accounting. National Welders, which is reported in the Distribution segment, is a producer and distributor of industrial gases based in Charlotte, North Carolina. National Welders owns and operates 46 branch stores, two acetylene plants, a specialty gas lab, and three air separation plants that produce all of the joint venture's oxygen and nitrogen and approximately 50% of its argon requirements. The joint venture also distributes medical and specialty gases, processed chemicals and welding equipment and supplies.

Ownership interests in the National Welders joint venture consists of voting common stock and voting redeemable preferred stock with a 5% annual dividend. The Company owns 100% of the joint venture's common stock, which represents a 50% voting interest. A family holds approximately 3.2 million shares of redeemable preferred stock and controls the balance of the voting interest. Between June 30, 2006 and June 30, 2009, the preferred shareholders have the option to redeem their preferred shares for cash at a price of \$17.78 per share or to tender them to the joint venture in exchange for approximately 2.38 million shares of Airgas common stock. If Airgas common stock has a market value of approximately \$24.00 per share, the common stock and cash redemption options are equivalent. If the preferred shareholders elect to exchange their shares for Airgas common stock, the Company is obligated to provide the necessary shares to the joint venture by capital contribution or other means the Company reasonably deems appropriate. The Company may purchase shares on the open market or may issue new or treasury shares to meet its exchange obligation. Following such redemption or exchange, the Company would be the sole owner of National Welders and the net earnings available to the Company (i.e., the common stockholder) would be expected to increase by the amount of the annual preferred dividend, or \$2.9 million per year. Following a cash redemption, the additional income related to the preferred dividend savings would be partially offset by higher interest expense on the additional debt incurred to finance the redemption. The preferred shareholders may also elect to retain their interest in the preferred stock beyond June 30, 2009.

AIRGAS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(11) JOINT VENTURE WITH NATIONAL WELDERS (Continued)

As disclosed in Note 2, the Company believes that its National Welders joint venture is a variable interest entity as defined by FIN 46 and that the Company is its Primary Beneficiary. Accordingly, the Company anticipates consolidating the joint venture for financial reporting purposes effective December 31, 2003. When the joint venture is consolidated, the Company will record assets on its balance sheet of approximately \$172 million, liabilities of approximately \$115 million and a minority interest liability of \$57 million. The Company's consolidated statement of earnings for the period beginning January 1, 2004 would also reflect the consolidation of the joint venture's results of operations. In fiscal 2003, the joint venture generated annual revenues of \$142 million and operating income of \$12 million. The Company's net earnings would not be affected by the consolidation of the joint venture.

(12) SALE-LEASEBACK TRANSACTION WITH GRANTOR TRUST

The Company leases real estate and certain equipment from a grantor trust (the Trust) established by a commercial bank. The operating leases are structured as a sale-leaseback transaction in which the Trust holds title to the properties and equipment included in the leases. The rental payments are based on LIBOR plus an applicable margin and the amount of proceeds received by the Company from the real estate and equipment sold to the Trust. The non-cancelable lease obligation of the real estate and equipment leases totaled approximately \$42 million at September 30, 2003 and March 31, 2003. The lease terms expire in October 2004. The Company has guaranteed a residual value of the real estate and equipment at the end of the lease terms of approximately \$30 million.

Effective July 1, 2003, the Company elected to early adopt FIN 46 in relation to the Trust (see Note 2). FIN 46 required the Company to consolidate the Trust for financial reporting purposes. The Company recorded on its balance sheet approximately \$29 million of real estate and equipment and debt of \$42 million, while eliminating a deferred gain of \$13 million that was previously carried as a liability. The consolidation of the Trust applied prospectively from the date of adoption resulted in the Company recognizing an additional \$300 thousand in interest expense and \$300 thousand in depreciation expense during the current quarter, which had previously been recognized as rent expense to the Trust. Consolidation of the Trust did not have a material impact on the net earnings or liquidity of the Company.

AIRGAS, INC. AND SUBSIDIARIES
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(Unaudited)

(13) STOCKHOLDERS' EQUITY

Changes in stockholders' equity were as follows:

(In thousands of shares)	Shares of Common Stock \$.01 Par Value	Treasury Stock	Employee Benefits Trust
Balance March 31, 2003	76,373	547	3,421
Common stock issuance (a)	712		
Reissuance of stock from Trust (b)			(548)
Balance September 30, 2003	77,085	547	2,873

(In thousands of dollars)	Common Stock	Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Employee Benefits Trust	Compre- hensive Income
Balance March 31, 2003	\$ 764	\$ 216,275	\$ 413,286	\$ (3,302)	\$ (4,289)	\$ (25,801)	\$
Net earnings			37,641				37,641
Common stock issuance (a)	7	6,173				1,172	
Dividends paid on common stock (\$0.04 per share)			(5,866)				
Foreign currency translation adjustments				1,170			1,170
Net change in fair value of interest rate swap agreements				765			765
Reissuance of common stock from Trust (b)		1,418				2,966	
Tax benefit from stock option exercises		3,981					
Net tax expense on other comprehensive income items				(688)			(688)
Balance September 30, 2003	\$ 771	\$ 227,847	\$ 445,061	\$ (2,055)	\$ (4,289)	\$ (21,663)	\$ 38,888

(a) Issuance of common stock for stock option exercises.

(b) Reissuance of common stock from the Employee Benefits Trust for employee benefit programs.
2003 Employee Stock Purchase Plan

On July 29, 2003, the Company's stockholders approved the 2003 Employee Stock Purchase Plan (the "2003 Plan"). The 2003 Plan is designed to encourage and assist employees of the Company to acquire an equity interest in the Company through the purchase of shares of Airgas common stock at a discount. The 2003 Plan is authorized to issue up to 1.5 million shares of common stock for purchase by employees. Eligible employees may elect to have up to 15% of their annual gross earnings withheld to purchase common stock at 85% of the market value. Market value under the 2003 Plan is defined as either the closing share price on the New York Stock Exchange as of the employees' enrollment date or the closing price on the first business day of the fiscal quarter when the shares are purchased, whichever is lower. An employee may lock-in a

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purchase price for up to 12 months. The 2003 Plan is designed to comply with the requirements of Sections 421 and 423 of the Internal Revenue Code. The 2003 Plan replaced the previous 2001 Employee Stock Purchase Plan.

AIRGAS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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(14) STOCK-BASED COMPENSATION

The Company has elected to continue to account for its stock-based compensation plans in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, as permitted by SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148. Accordingly, no compensation expense has been recognized for its stock option and employee stock purchase plans. The following table illustrates the effect on net income and earnings per share for the three and six months ended September 30, 2003 and 2002 as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based compensation.

(In thousands, except per share amounts)	Three Months Ended September 30,		Six Months Ended September 30,	
	2003	2002	2003	2002
Net earnings, as reported	\$ 19,113	\$ 19,200	\$ 37,641	\$ 33,244
Deduct: Total stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects	(1,452)	(1,942)	(2,723)	(3,938)
Pro forma net earnings	\$ 17,661	\$ 17,258	\$ 34,918	\$ 29,306
Net earnings per share:				
Basic as reported	\$ 0.26	\$ 0.27	\$ 0.52	\$ 0.47
Basic pro forma	\$ 0.24	\$ 0.25	\$ 0.48	\$ 0.42
Diluted as reported	\$ 0.26	\$ 0.27	\$ 0.51	\$ 0.46
Diluted pro forma	\$ 0.24	\$ 0.24	\$ 0.47	\$ 0.41

(15) COMMITMENTS AND CONTINGENCIES*Litigation*

The Company is involved in various legal and regulatory proceedings that have arisen in the ordinary course of its business and have not been fully adjudicated. These actions, when ultimately concluded and determined, will not, in the opinion of management, have a material adverse effect upon the Company's consolidated financial position, results of operations or liquidity.

AIRGAS, INC. AND SUBSIDIARIES
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(16) SUMMARY BY BUSINESS SEGMENT

Information related to the Company's operations by business segment for the three and six months ended September 30, 2003 and 2002 is as follows:

(In thousands)	Three Months Ended September 30, 2003				Three Months Ended September 30, 2002			
	Distribution	Gas Operations	Elim.	Combined	Distribution	Gas Operations	Elim.	Combined
Gas and rent	\$217,481	\$52,154	\$(10,026)	\$259,609	\$214,905	\$49,700	\$(9,817)	\$254,788
Hardgoods	200,215	1,318	(690)	200,843	195,424	1,342	(501)	196,265
Total net sales	417,696	53,472	(10,716)	460,452	410,329	51,042	(10,318)	451,053
Cost of products sold, excl. deprec. expense	207,195	23,882	(10,716)	220,361	201,549	22,856	(10,318)	214,087
Selling, distribution and administrative expenses	161,289	16,886		178,175	158,858	15,879		174,737
Depreciation expense	16,645	3,179		19,824	15,325	2,844		18,169
Amortization expense	1,189	142		1,331	1,518	118		1,636
Operating income	31,378	9,383		40,761	33,079	9,345		42,424

(In thousands)	Six Months Ended September 30, 2003				Six Months Ended September 30, 2002			
	Distribution	Gas Operations	Elim.	Combined	Distribution	Gas Operations	Elim.	Combined
Gas and rent	\$437,888	\$100,226	\$(19,624)	\$518,490	\$431,862	\$93,367	\$(18,657)	\$506,572
Hardgoods	401,663	2,667	(1,312)	403,018	400,522	2,641	(1,014)	402,149
Total net sales	839,551	102,893	(20,936)	921,508	832,384	96,008	(19,671)	908,721
Cost of products sold, excl. deprec. expense	416,344	46,086	(20,936)	441,494	412,998	43,026	(19,671)	436,353
Selling, distribution and administrative expenses	323,239	33,397		356,636	319,471	31,565		351,036
Depreciation expense	32,815	6,300		39,115	31,001	5,627		36,628
Amortization expense	2,546	296		2,842	3,135	241		3,376
Special charges					2,694			2,694

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Operating income	64,607	16,814	81,421	63,085	15,549	78,634
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AIRGAS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(17) SUPPLEMENTARY CONDENSED CONSOLIDATING FINANCIAL INFORMATION OF SUBSIDIARY GUARANTORS

The obligations of the Company under its senior subordinated notes (the Notes) are guaranteed by the Company s domestic subsidiaries (the Guarantors). The Company s joint venture operations, foreign holdings and bankruptcy remote special purpose entity (the Non-guarantors) are not guarantors of the Notes. The guarantees are made on a joint and several basis. The claims of creditors of Non-guarantor subsidiaries have priority over the rights of the Company to receive dividends or distributions from such subsidiaries. Presented below is supplementary condensed consolidating financial information for the Company, the Guarantors and the Non-guarantors as of September 30, 2003 and March 31, 2003 and for the six-month periods ended September 30, 2003 and 2002.

AIRGAS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Condensed Consolidating Balance Sheet
September 30, 2003

(In thousands)	Parent	Guarantors	Non-Guarantors	Elimination Entries	Consolidated
ASSETS					
Current Assets					
Trade receivables, net	\$	\$ 4,437	\$77,572	\$	\$ 82,009
Intercompany receivable/(payable)		(7,250)	7,250		
Inventories, net		154,739	3,924		158,663
Deferred income tax asset, net	10,671	7,387			18,058
Prepaid expenses and other current assets	10,067	18,428	703		29,198
		<u> </u>	<u> </u>	-	<u> </u>
Total current assets	20,738	177,741	89,449		287,928
Plant and equipment, net	17,146	859,593	24,526		901,265
Goodwill		427,701	12,185		439,886
Other intangible assets, net					