KMG CHEMICALS INC
Form 10-Q
June 05, 2007

UNITED STATES

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 April 30, 2007

or

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

For the transition period from to .

Commission file number: 000-29278

KMG CHEMICALS, INC.

(Exact name of registrant as specified in its charter)

Texas	**75-2640529**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
10611 Harwin Drive, Suite 402 **Houston, Texas**	**77036**
(Address of principal executive offices)	(Zip Code)

(713) 600-3800

(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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 o

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

Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY

PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes o No o

APPLICABLE ONLY TO CORPORATE ISSUERS:

As of June 4, 2007, there were 10,581,031 shares of the registrant s common stock outstanding, excluding treasury shares.

Part I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

KMG CHEMICALS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands except for share and per share data)

	April 30, 2007 Unaudited	July 31, 2006
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 7,727	$ 11,168
Accounts receivable:		
Trade, net of allowances of $55 at April 30, 2007 and $35 at July 31, 2006	16,303	8,832
Other	287	264
Inventories	15,713	9,971
Current deferred tax asset	77	57
Prepaid expenses and other current assets	450	712
Total current assets	40,557	31,004
PROPERTY, PLANT AND EQUIPMENT		
Property, plant and equipment	13,892	13,463
Accumulated depreciation and amortization	(5,094)	(4,314)
Net property, plant and equipment	8,798	9,149
DEFERRED TAX ASSET	1,443	656
GOODWILL	3,778	3,778
INTANGIBLE ASSETS, net of accumulated amortization	24,387	26,448
OTHER ASSETS	1,623	1,667
TOTAL	$ 80,586	$ 72,702
LIABILITIES & STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 6,652	$ 5,950
Accrued liabilities	3,706	1,649
Current deferred tax liability	33	33
Current portion of long-term debt	3,717	3,663
Current portion of deferred rent	86	86
Total current liabilities	14,194	11,381
LONG-TERM DEBT, net of current portion	12,685	13,981
DEFERRED RENT, net of current portion	70	134
OTHER LONG-TERM LIABILITIES	345	288
Total liabilities	27,294	25,784
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY		
Preferred stock, $.01 par value, 10,000,000 shares authorized, none issued		
Common stock, $.01 par value, 40,000,000 shares authorized, 10,677,119 shares issued and 10,554,631 shares outstanding at April 30, 2007 and 10,677,119 shares issued and 10,532,856 shares outstanding at July 31, 2006	107	107
Additional paid-in capital	20,395	20,117
Treasury stock, at cost (122,488 shares at April 30, 2007 and 144,263 shares at July 31, 2006)	(612)	(721)
Accumulated other comprehensive income	24	53
Retained earnings	33,378	27,362
Total stockholders equity	53,292	46,918
TOTAL	$ 80,586	$ 72,702

See notes to condensed consolidated financial statements.

2

KMG CHEMICALS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

(in thousands except for per share data)

	Three Months Ended April 30, 2007	2006	Nine Months Ended April 30, 2007	2006
NET SALES	$ 28,036	$ 21,016	$ 64,744	$ 50,934
COST OF SALES	17,723	14,142	41,592	33,476
Gross Profit	10,313	6,874	23,152	17,458
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	4,176	3,640	12,062	11,619
Operating income	6,137	3,234	11,090	5,839
OTHER INCOME (EXPENSE):				
Interest and dividend income	106	36	399	223
Interest expense	(235)	(257)	(715)	(781)
Other	(7)	(10)	(22)	(22)
Total other income (expense)	(136)	(231)	(338)	(580)
INCOME BEFORE INCOME TAXES	6,001	3,003	10,752	5,259
Provision for income taxes	(2,227)	(1,149)	(3,945)	(1,998)
NET INCOME	$ 3,774	$ 1,854	$ 6,807	$ 3,261
EARNINGS PER SHARE:				
Basic	$ 0.36	$ 0.21	$ 0.65	$ 0.37
Diluted	$ 0.34	$ 0.20	$ 0.62	$ 0.35
WEIGHTED AVERAGE SHARES OUTSTANDING:				
Basic	10,555	8,816	10,541	8,799
Diluted	11,079	9,367	11,022	9,327

See notes to condensed consolidated financial statements.

KMG CHEMICALS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(UNAUDITED)

(in thousands)

	Common Stock Shares Issued	**Common Stock Par Value**	**Additional Paid-In Capital**	**Treasury Stock**	**Accumulated Other Comprehensive Income**	**Retained Earnings**	**Total Stockholders Equity**
BALANCE AT JULY 31, 2005	8,956	$ 90	$ 9,353	$ (850)	$ 49	$ 24,246	$ 32,888
Cash dividends						(660)	(660)
Employee stock options exercised	11		38				38
25,737 treasury shares issued			(129)	129			
Shares issued in stock placement	1,710	17	10,891				10,908
Direct costs of stock placement			(426)				(426)
Stock based compensation			359				359
Tax benefit - nonqualified stock options exercised			31				31
Comprehensive income:							
Net income						3,776	3,776
Change in unrealized gain on interest rate swap (net of taxes of $3)					4		4
Total comprehensive income							3,780
BALANCE AT JULY 31, 2006	10,677	107	20,117	(721)	53	27,362	46,918
Cash dividends						(791)	(791)
21,775 treasury shares issued			(109)	109			
Additional costs of stock placement			(5)				(5)
Stock based compensation			392				392
Comprehensive income:							
Net income						6,807	6,807
Change in unrealized value on interest rate swap (net of taxes of $19)					(29)		(29)
Total comprehensive income							6,778
BALANCE AT APRIL 30, 2007	10,677	$ 107	$ 20,395	$ (612)	$ 24	$ 33,378	$ 53,292

See notes to condensed consolidated financial statements.

KMG CHEMICALS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

(in thousands)

	Nine Months Ended April 30, 2007	**2006**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 6,807	$ 3,261
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,863	2,764
Amortization of loan costs included in interest expense	17	
Stock based compensation	392	305
Bad debt expense	20	50
Loss on disposal of property	1	
Deferred rental income	(64)	(16)
Deferred income taxes	(807)	6
Changes in operating assets and liabilities:		
Accounts receivable - trade	(7,491)	(1,518)
Accounts receivable - other	(23)	(55)
Inventories	(5,742)	(3,588)
Prepaid expenses and other assets	262	(300)
Accounts payable	702	3,112
Accrued liabilities and other	2,128	760
Net cash provided by (used in) operating activities	(935)	4,781
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to property, plant and equipment	(469)	(1,376)
Product line purchases		(8,609)
Proceeds from sale of property	2	
Proceeds from insurance claim		18
Additions to other assets	(6)	(60)
Net cash used in investing activities	(473)	(10,027)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Principal payments on borrowings	(1,242)	(1,188)
Proceeds from exercise of stock options		38
Payment of dividends	(791)	(660)
Net cash used in financing activities	(2,033)	(1,810)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(3,441)	(7,056)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	11,168	8,781
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 7,727	$ 1,725
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid during the period for interest	$ 483	$ 464
Cash paid during the period for income taxes	$ 3,028	$ 1,465

See notes to condensed consolidated financial statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

(1) **Basis of Presentation.** The following condensed consolidated balance sheet as of July 31, 2006, which has been derived from audited financial statements, and the unaudited condensed consolidated financial statements included herein, have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) for interim reporting, and in the opinion of management reflect all adjustments, including those of a normal recurring nature, that are necessary for a fair presentation of financial position and results of operations for the interim periods presented. These financial statements include the accounts of KMG Chemicals, Inc. and its subsidiaries (collectively, the Company). All significant intercompany balances and transactions have been eliminated in consolidation. Certain footnotes or other financial information that are normally required by GAAP (accounting principles generally accepted in the United States of America) have been condensed or omitted. The financial statements included herein should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s annual report on Form 10-K for the year ended July 31, 2006. The Company s nine months results may not be indicative of results for its fiscal year ended July 31, 2007.

(2) **Earnings Per Share.** Basic earnings per share have been computed by dividing net income by the weighted average shares outstanding. Diluted earnings per share have been computed by dividing net income by the weighted average shares outstanding plus dilutive potential common shares. The following table presents information necessary to calculate basic and diluted earnings per share for periods indicated:

	Three Months Ended April 30,		**Nine Months Ended April 30,**	
	2007	**2006**	**2007**	**2006**
	(Amounts in thousands, except per share data)			
BASIC EARNINGS PER SHARE:				
Net income	$ 3,774	$ 1,854	$ 6,807	$ 3,261
Weighted average shares outstanding	10,555	8,816	10,541	8,799
Basic earnings per share	$ 0.36	$ 0.21	$ 0.65	$ 0.37
DILUTED EARNINGS PER SHARE:				
Net income	$ 3,774	$ 1,854	$ 6,807	$ 3,261
Weighted average shares outstanding	10,555	8,816	10,541	8,799
Dilutive effect of options and stock awards	524	551	481	528
Weighted average shares outstanding, as adjusted	11,079	9,367	11,022	9,327
Diluted earnings per share	$ 0.34	$ 0.20	$ 0.62	$ 0.35

(3) **Inventories.** Inventories are summarized as follows:

	April 30, 2007	**July 31, 2006**
	(Amounts in thousands)	
Chemical raw materials and supplies	$ 4,392	$ 3,500
Finished chemical products	11,321	6,471
	$ 15,713	$ 9,971

(4) **Stock-based Compensation.** The Company has adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, (FAS 123(R)) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors; including employee stock options, based on estimated fair values. FAS 123(R) supersedes the Company s previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) for periods beginning in fiscal 2006. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107) relating to FAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of FAS 123(R).

The Company adopted FAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of August 1, 2005, the first day of the Company s fiscal year 2006.

A summary of option activity associated with employee compensation for the nine months ended April 30, 2007 is presented below. No options were granted in fiscal year 2007.

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (years)	Aggregate Intrinsic Value ($000)
Stock options on August 1, 2006	774,950	$ 4.17		
Granted	0	$		
Exercised	0	$		
Forfeited/Expired	0	$		
Stock options outstanding on April 30, 2007	774,950	$ 4.17	7.08	$ 5,817
Stock options exercisable on April 30, 2007	655,450	$ 4.16	5.88	$ 4,931

As of April 30, 2007 there was approximately $146,000 of total unrecognized compensation cost related to non-vested employee stock options. That cost is expected to be recognized over a weighted average period of 2.7 years.

Performance based stock awards were granted to certain executives in fiscal 2005 and 2007 under the Company s 2004 Long Term Incentive Plan. The awards were granted as Series 1 and Series 2 awards as follows:

Date of Grant	Series Award	Maximum Award (Shares)	Closing Stock Price on Grant Date	3-Year Measurement Period Ending	Projected Fair Value ($000)
09/02/2005	Series 1	29,040	$ 8.35	07/31/2007	$ 145
09/02/2005	Series 2	19,360	$ 8.35	07/31/2007	$ 110
		48,400			$ 255
02/16/2007	Series 1	23,850	$ 10.16	07/31/2009	$ 242
02/16/2007	Series 2	15,900	$ 10.16	07/31/2009	$ 162
		39,750			$ 404
	Total	88,150			$ 659

The 2005 and 2007 Series 1 awards are subject to a performance requirement composed of certain revenue growth objectives and average annual return on equity objectives measured across a three year period. The revenue growth objectives and average annual return on equity objectives are estimated quarterly using the Company s budget, actual results and long term projections. Based on performance through April 30, 2007, 60% and 100% was projected to be the probable vesting for the 2005 and 2007 Series 1 awards, respectively, at the end of their measurement periods. Therefore, the 2005 Series 1 award was projected to have a fair value of approximately $145,000 to be recognized over the 23 months between the grant date and the vesting date. The 2007 Series 1 award was projected to have a fair value of approximately $242,000 to be recognized over 29.5 months.

The 2005 Series 2 award is subject to a performance requirement that the average annual total shareholder return equal or exceed 10% over a three year measurement period. Total shareholder return is calculated using both stock price appreciation and dividends paid. The fair value for the maximum number of Series 2 shares was $162,000. Using a binomial model, it was determined that there was a 32% probability that the average annual total shareholder return would not exceed 10%. Therefore, the fair value of the Series 2 award was discounted by 32% to approximately $110,000 to be recognized over 23 months. The risk free interest rate used in the binomial model was based on Treasury note interest rates and was 4.0%. The volatility used in the model was 56%. The time to maturity was 1.9 years.

The 2007 Series 2 award is subject to a performance requirement pertaining to the growth rate in the Company s earnings per share over a three year measurement period. The earnings per share growth rate is estimated quarterly using the Company s budget, actual results and long term projections. Based on performance through April 30, 2007, the 2007 Series 2 award was projected to have a fair value of $162,000 to be recognized over 29.5 months.

As of April 30, 2007, no shares have been vested from either the 2005 or 2007 awards, and there was a projected total unrecognized compensation cost related to non-vested share grants of approximately $403,000. This cost will be recognized over the fiscal years 2007 through 2009.

The Company recognized $14,000 in compensation cost relating to the vesting of stock options that were granted in prior fiscal years in the third quarter of fiscal year 2007, and recognized $41,000 in such costs in the first nine months of fiscal year 2007. The Company recognized $33,000 in compensation cost relating to the vesting of the 2005 performance based stock awards and $34,000 relating to the vesting of the 2007 performance based stock awards in the third quarter of fiscal year 2007, and recognized $100,000 and $34,000 in the first nine months of that fiscal year relating to the vesting of the 2005 and 2007 awards, respectively.

(5) **Intangible and Other Assets.** Intangible and other assets are summarized as follows:

	April 30, 2007	**July 31, 2006**
	(Amounts in thousands)	
Intangible assets not subject to amortization:		
Creosote product registrations	$ 6,518	$ 6,518
Other creosote related assets	78	78
Penta product registrations	8,765	8,765
	15,361	15,361
Intangible assets subject to amortization:		
Creosote supply contract	4,000	4,000
Other creosote related assets	131	131
Other penta related assets	7,288	7,288
MSMA product registrations and related assets	48	48
Sodium penta licensing agreement	320	320
Animal health trademarks	364	364
Other animal health related assets	6,165	6,165
Loan costs	124	124
	18,440	18,440
Total intangible assets	33,801	33,801
Less accumulated amortization	(9,414)	(7,353)
	$ 24,387	$ 26,448
Other assets consisted of the following:		
Cash surrender value on key man life insurance policies	$ 1,515	$ 1,515
Other	108	152
	$ 1,623	$ 1,667

Amortization expense was approximately $687,000 and $2.1 million for the three and nine month periods ended April 30, 2007, and $643,000 and $1.9 million for the three and nine month periods ended April 30, 2006.

(6) **Dividends.** Dividends of approximately $396,000 ($0.0375 per share) and approximately $331,000 ($0.0375 per share) were declared and paid in the third quarter of fiscal years 2007 and 2006, respectively. Dividends of approximately $395,000 ($0.0375 per share) and approximately $329,000 ($0.0375 per share) were declared and paid in the first quarter of fiscal years 2007 and 2006, respectively.

(7) **Business Segment Information.** The Company operates four business segments organized around its four product lines: pentachlorophenol (penta) products; creosote; animal health products; and agricultural products.

	Three Months Ended April 30, 2007	**2006**	**Nine Months Ended April 30, 2007**	**2006**
	(Amounts in thousands)			
Revenues				
Penta	$ 7,882	$ 6,502	$ 21,399	$ 20,309
Creosote	11,261	8,966	30,702	23,402
Animal Health	7,556	3,864	10,475	4,778
Agricultural Chemicals	1,337	1,684	2,168	2,445
	$ 28,036	$ 21,016	$ 64,744	$ 50,934
Depreciation and amortization				
Penta	$ 623	$ 601	$ 1,855	$ 1,727
Creosote	74	73	222	220
Animal Health	227	112	672	181
Agricultural Chemicals	25	208	78	615
	$ 949	$ 994	$ 2,827	$ 2,743
Income (loss) from operations				
Penta	$ 2,842	$ 2,171	$ 6,866	$ 6,359
Creosote	2,217	1,686	7,028	2,989
Animal Health	2,773	945	2,604	988
Agricultural Chemicals	(137)	(17)	(654)	(637)
	$ 7,695	$ 4,785	$ 15,844	$ 9,699
Capital expenditures				
Penta	$ 55	$ 272	$ 259	$ 967
Creosote			23	
Animal Health	14	6,233	144	6,233
Agricultural Chemicals		94	2	256
	$ 69	$ 6,599	$ 428	$ 7,456

	April 30, 2007	**July 31, 2006**
	(Amounts in thousands)	
Total assets		
Penta	$ 23,601	$ 25,641
Creosote	18,224	11,115
Animal Health	23,950	17,499
Agricultural Chemicals	3,108	3,564
	$ 68,883	$ 57,819

A reconciliation of total segment information to consolidated amounts is as follows:

	Three Months Ended April 30, 2007 (Amounts in thousands)	2006	Nine Months Ended April 30, 2007	2006
Revenues:				
Total revenues for reportable segments	$ 28,036	$ 21,016	$ 64,744	$ 50,934
Total consolidated revenues	$ 28,036	$ 21,016	$ 64,744	$ 50,934
Profit or Loss:				
Total profit for reportable segments	$ 7,695	$ 4,785	$ 15,844	$ 9,699
Interest income	106	36	399	223
Interest expense	(235)	(257)	(715)	(781)
Other profit or loss	(7)	(10)	(22)	(22)
Other corporate expense	(1,558)	(1,551)	(4,754)	(3,860)
Income before income taxes	$ 6,001	$ 3,003	$ 10,752	$ 5,259

	April 30, 2007 (Amounts in thousands)	July 31, 2006
Assets:		
Total assets for reportable segments	$ 68,883	$ 57,819
Cash and cash equivalents	7,727	11,168
Prepaid expenses and other current assets	627	1,108
Deferred tax assets	1,520	713
Other assets	1,829	1,894
Consolidated total	$ 80,586	$ 72,702

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

Three and Nine Month Periods Ended April 30, 2007 compared with Three and Nine Month Periods Ended April 30, 2006

Segment Data

Segment data is presented for our four segments for the three and nine month periods ended April 30, 2007 and 2006.

	Three Months Ended April 30, 2007 (Amounts in thousands)	2006	Nine Months Ended April 30, 2007	2006
Revenues				
Penta	$ 7,882	$ 6,502	$ 21,399	$ 20,309
Creosote	11,261	8,966	30,702	23,402
Animal Health	7,556	3,864	10,475	4,778
Agricultural Chemicals	1,337	1,684	2,168	2,445
	$ 28,036	$ 21,016	$ 64,744	$ 50,934
Depreciation and amortization				
Penta	$ 623	$ 601	$ 1,855	$ 1,727
Creosote	74	73	222	220
Animal Health	227	112	672	181
Agricultural Chemicals	25	208	78	615
	$ 949	$ 994	$ 2,827	$ 2,743
Income (loss) from operations				
Penta	$ 2,842	$ 2,171	$ 6,866	$ 6,359
Creosote	2,217	1,686	7,028	2,989
Animal Health	2,773	945	2,604	988
Agricultural Chemicals	(137)	(17)	(654)	(637)
	$ 7,695	$ 4,785	$ 15,844	$ 9,699
Capital expenditures				
Penta	$ 55	$ 272	$ 259	$ 967
Creosote			23	
Animal Health	14	6,233	144	6,233
Agricultural Chemicals		94	2	256
	$ 69	$ 6,599	$ 428	$ 7,456

The segment data should be read with our condensed consolidated financial statements and related notes thereto included elsewhere in this report.

Sales Revenue and Gross Profit

Net sales revenue for the third quarter of fiscal year 2007 increased by 33.4% to $28.0 million as compared with $21.0 million in the third quarter of fiscal year 2006. For the third quarter, 18.7% of the increase in net sales revenue was contributed by the penta segment, 31.2% was from the creosote segment and 50.1% was from the animal health segment. Agricultural chemicals sales were down 20.6% in the third quarter as compared with the prior year quarter. Net sales revenue for the first nine months of fiscal year 2007 increased by 27.1% to $64.7 million as compared with $50.9 million in the same period of the prior fiscal year. For the nine month period, the increase came 7.7% from penta, 51.8% from creosote and 40.4% from the animal health segment. Sales of agricultural chemicals were down 11.3% for the nine months comparison.

In the third quarter of fiscal year 2007, penta revenues increased by $1.4 million, or 21.2%, and creosote revenues increased by $2.3 million, or 25.6%. For the first nine months of fiscal year 2007, net sales revenues from penta increased

11

$1.1 million, or about 5.4%, from $20.3 million in fiscal year 2006, and creosote net sales revenues increased $7.3 million, or 31.2%, from $23.4 million in the same period of the prior fiscal year. Demand for penta by utilities has been strong in fiscal year 2007. Penta revenues increased on greater volume in both the third quarter and for the first nine months of fiscal 2007, as compared with the prior year. In the creosote segment, the hurricanes early in fiscal year 2006 disrupted creosote operations, but volume rebounded strongly beginning late in the first quarter of that fiscal year as the Gulf Coast region rebuilt its infrastructure. Creosote volume was down about 22.0% in the third quarter of fiscal year 2007 as compared with the prior year s third quarter, a quarter which had been favorably affected by the Gulf Coast rebuilding effort. The decrease in volume in the third quarter of fiscal year 2007 was also attributable to adverse weather conditions and delayed spring maintenance by major railroads, and volumes in the third quarter were off about 8.3% against average volumes in the two prior quarters. Creosote volume was down about 9.0% over the first nine months as compared with the prior year. The increase in our creosote revenues in the third quarter of fiscal year 2007 and in the first nine months of the fiscal year came from improved pricing. We believe that strong demand from major railroads for crossties treated with creosote will continue through calendar 2007.

Animal health pesticides sales revenues increased by $3.7 million, or by 95.5%, in the third quarter to $7.6 million as compared with $3.9 million in the same period of the prior year. Animal health segment sales revenues increased $5.7 million, or by 119.2%, in the first nine months of fiscal year 2007 to $10.5 million as compared with $4.8 million for that period in fiscal year 2006. Almost all of the increase in the third quarter and in the first nine months of fiscal year 2007 over the prior year periods are attributable to our purchase in February 2006 of certain assets of the animal health pesticide business of Boehringer Ingelheim Vetmedica, Inc., and to the introduction of the Avenger ear tag for livestock that was a part of that purchase. Agricultural chemical sales decreased by $347,000 in the third quarter of fiscal year 2007 as compared to the prior fiscal year period, and segment sales decreased $277,000 over the full nine months. This business was the subject of a $2.4 million impairment charge at the end of fiscal year 2006. Revenue from the animal health pesticides and agricultural chemical segments is seasonal and weighted to the third and fourth quarters. Seasonal usage of animal health pesticides and agricultural chemicals is dependent on varying seasonal patterns, weather conditions and weather-related pressure from pests, as well as customer marketing programs and requirements. Weather patterns can have an impact on our sales, particularly sales of agricultural chemicals. The end users of some of our products, because of weather patterns, may delay or intermittently suspend field work during the planting season which may result in a reduction of the use of some products and therefore reduce our revenues and profitability. The combined revenues from products subject to significant seasonal variations represented approximately 17.6% of our fiscal year 2006 revenues.

Gross profit increased by $3.4 million, or by 50.0%, to $10.3 million in the third quarter of fiscal year 2007 from $6.9 million in the same quarter of the prior year. Gross profit increased by $5.7 million, or by 32.6%, to $23.2 million in the first nine months of fiscal year 2007 from $17.5 million in the same period of the prior year. Gross profit as a percentage of sales was 36.8% for the third quarter of fiscal year 2007 and 32.7% for the same quarter of fiscal year 2006. Gross profit as a percentage of sales was 35.8% for the first nine months of fiscal year 2007 and 34.3% for the same period of the prior fiscal year. For the third quarter, about $345,000 of the increase in gross profit was attributable to increased creosote net sales revenues. Penta segment gross profit in the third quarter was up about $657,000 because of strong demand for penta-treated utility poles. About $2.3 million of the increase in gross profit was attributable to greater animal health product sales, primarily due to the animal health products acquisition in February 2006 and the introduction in January 2007 of the new Avenger ear tag for livestock. For the first nine months of fiscal 2007, creosote gross profit increased $2.7 million on greater net sales revenue for the period. Animal health gross profit increased $3.2 on greater sales primarily attributable to the animal health acquisition, and because we no longer sell these products under the transitional distribution agreement that was in place immediately after our acquisition of that business in February 2006. A decline in penta gross profit of approximately $279,000 in the first nine months of fiscal 2007, as compared with the prior year period, partially offset the increases in creosote and animal health gross profit. The decline in penta gross profits for the nine month period was due to a shift in sales from penta blocks to lower margin penta solutions sales. We believe penta profit will not see any significant relief in fiscal year 2007 from the high penta raw material costs we have been experiencing since fiscal year 2005. We also expect that we will continue to experience high creosote costs due to high costs of coal tar, the product from which creosote is produced. Other companies may include certain of the costs that we record in cost of sales as selling, general and administrative expenses, and may include certain of the costs that we record in selling, general and administrative expenses as a component of cost of sales, resulting in a lack of comparability between our gross profit and that reported by other companies.

Selling, General and Administrative Expenses

Selling, general, and administrative expenses increased $536,000 in the third quarter of fiscal year 2007 to $4.2 million, or 14.9% of net revenue, from $3.6 million, or 17.3% of net revenue, for the same quarter of the prior fiscal year. Selling, general and administrative expenses increased $443,000 in the first nine months of fiscal year 2007 to $12.1 million, or 18.6% of net revenue, from $11.6 million, or 22.8% of net revenue, in fiscal year 2006. Distribution expense declined $66,000 in the third quarter of fiscal year 2007 and $1.7 million in the first nine months of fiscal year 2007 as compared to the prior year, because we shifted to FOB pricing on certain of our products. However, in the first nine months of fiscal 2007, costs related to the animal health product lines acquired in February 2006 increased selling, general and administrative expenses by $1.6 million. Product registration expenses related to agricultural chemicals were also up $215,000 in the first nine months compared to the prior year due to increased regulatory activity.

Interest Expense

Interest expense was $235,000 in the third quarter of fiscal year 2007 as compared with $257,000 in the same quarter of fiscal year 2006, and $715,000 for the full nine months as compared with $781,000 in the prior year. The decrease in this fiscal year was because of principal reductions on outstanding indebtedness.

Income Taxes

Our effective tax rate for the third quarter of fiscal year 2007 was 37.1%, as compared with 38.3% for the same period of the prior year. Our effective tax rate was 36.7% in the first nine months of fiscal year 2007, and 38.0% in the same period of the prior year.

Liquidity and Capital Resources

Cash Flows

Our net cash from operating activities was down approximately $1.0 million for the first nine months of fiscal year 2007. Net income of $6.8 million and depreciation and amortization of $2.9 million were significant contributors to net cash in the first nine months of this fiscal year. Inventory increased $5.7 million in the first nine months of fiscal year 2007, and $4.0 million of that increase was because of the combination of creosote volumes received late in the calendar year and weather related slowing of demand for creosote in the third quarter. Animal health inventories increased about $2.4 million due to the expansion of the segment, but inventories in our other segments were down. Our trade receivables were up $7.5 million, and about $4.6 million of the increase was attributable to the animal health sales cycle. Sales in our animal health and agricultural chemical segments are seasonal, and common industry practice is that sales are made on extended terms. We expect that animal health and agricultural chemical inventories and accounts receivable will decrease significantly in the fourth quarter as these segment sales are collected. In the first nine months of fiscal 2006, net cash from operating activities was $4.8 million on net income of $3.3 million.

Net cash used in investing activities in the first nine months of fiscal year 2007 was $473,000 as compared with $10.0 million in the prior year period. Property and equipment purchased in fiscal year 2007 were for normal upgrades and replacements in the penta and animal health segments. In the prior fiscal year we purchased additional animal health lines and expanded penta production at our Mexico facility.

In the first nine months of fiscal year 2007, we made principal payments of $1.2 million on our borrowings and $791,000 was paid in dividends. It is our policy to pay dividends from available cash after taking into consideration our profitability, capital requirements, financial condition, growth, business opportunities and other factors which our board of directors may deem relevant.

Working Capital

As of May 16, 2007 we entered into a new credit agreement with our lender, Wachovia Bank, National Association. The new credit agreement replaced existing credit facilities, and provided for both a revolving loan facility of up to $8.0 million and a term loan facility of $8.4 million. Advances under the revolving loan facility mature on April 30, 2010, and advances under the term loan facility mature on January 31, 2013. Advances under both the revolving and term loan facilities bear interest at a varying rate of LIBOR plus a margin based on our funded debt to EBITDA:

Ratio of Funded Debt to EBITDA	Margin	
Equal to or greater than 2.5 to 1.0	2.75	%
Equal to or greater than 2.0 to 1.0, but less than 2.5 to 1.0	2.25	%
Equal to or greater than 1.75 to 1.0, but less than 2.0 to 1.0	1.70	%
Equal to or greater than 1.0 to 1.0, but less than 1.75 to 1.0	1.20	%
Less than 1.0 to 1.0	1.00	%

The new credit facility is secured by our assets, including inventory, accounts receivable, equipment, and general intangibles, but excluding real property. The new facility has restrictive covenants including the maintenance of a fixed charge coverage ratio of 1.25 to 1.0 and a ratio of funded debt to the sum of funded debt and owner s equity of not more than 45%.

At April 30, 2007, we had not borrowed under our prior revolving loan facility, and our borrowing base availability under that facility was $5.0 million. Management believes that the new revolving loan facility, combined with cash flows from operations, will adequately provide for our working capital needs for the next twelve months.

Long Term Obligations

Our purchase of certain penta assets from Basic Chemical Company in fiscal 2006 was financed in part by a $10.0 million loan from the seller. The indebtedness is payable in five equal annual installments of $2.0 million plus interest at 4% per annum. The principal balance of that indebtedness was $8.0 million at April 30, 2007. The second installment of principal will be paid in June 2007.

Our purchase of the Rabon animal health products business in fiscal 2003 and our acquisitions in fiscal 2004 were financed in part by two term loans under a senior credit facility with Wachovia Bank. The combined principal balance of those two term loan facilities with Wachovia Bank was approximately $8.4 million at April 30, 2007. Those two term loans have now been combined in the term loan facility entered into with Wachovia Bank as of May 16, 2007. Currently the amount outstanding under the term loan facility bears interest at LIBOR plus 1%. Principal on the term loan is payable in monthly installments of $138,000. For the remainder of fiscal 2007, the interest spread over LIBOR for the term loan is expected to be 1.00%.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements, such as financing or unconsolidated variable interest entities.

New Accounting Standards

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, which permits the choice to measure certain financial assets and liabilities at their fair value at specified election dates. The new standard is effective for the Company on August 1, 2008, unless early adoption is elected. We do not expect the new standard to have any material impact on our financial position and results of operations.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140. SFAS No. 156 requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. The standard permits an entity to subsequently measure each class of servicing assets or servicing liabilities at fair value and report changes in fair value in the statement of income in the period in which the changes occur. We do not expect the new standard to have any material impact on our financial position and results of operations. We will be required to adopt SFAS No. 156 on August 1, 2007.

In September 2006, the FASB issued SFAS No. 157, Accounting for Fair Value Measurements. SFAS No. 157 defines fair value, and establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosure about fair value measurements. SFAS No. 157 is effective for the Company for financial statements issued subsequent to November 15, 2007. We do not expect the new standard to have any material impact on our financial position and results of operations.

In July 2006, the FASB issued FIN No. 48, Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No.109. This interpretation clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. It prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. This interpretation is effective for fiscal years beginning after December 15, 2006. The Company will be required to adopt this interpretation on August 1, 2007. Management is currently evaluating the requirements of FIN No. 48.

In September 2006, the FASB issued FASB Statement No. 158 (SFAS 158), Employers Accounting for Defined Benefit Pension and Other Postretirement Plans . This Statement requires an employer to recognize the over funded or under funded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. SFAS No. 158 will be effective for us as of July 31, 2007. We do not expect that the implementation of SFAS No. 158 will have a material impact on our financial position and results of operations.

Critical Accounting Policies

Our consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the use of estimates, judgments, and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the periods presented. The significant accounting principles that we believe are the most important to aid in fully understanding our financial results are the following:

Revenue Recognition. In general, we recognize revenue of our chemical products sold in the open market when risk of loss and title to the products transfers to our customers, which usually occurs at the time a shipment is made.

Cost of Sales. Cost of sales includes inbound freight charges, purchasing and receiving costs, inspection costs and internal transfer costs. In the case of products we manufacture, direct and indirect manufacturing costs and associated plant administrative expenses are included as well as laid-in cost of raw materials consumed in the manufacturing process.

Allowance for Doubtful Accounts. We provide an allowance for accounts receivable we believe we may not collect in full. A provision for bad debt expense recorded to selling, general and administrative expenses increases the allowance. Accounts receivable that are written off our books decrease the allowance. The amount of bad debt expense recorded each period and the resulting adequacy of the allowance at the end of each period are determined using a customer-by-customer analyses of our accounts receivable balances each period and subjective assessments of our future bad debt exposure. Write-offs of accounts receivable balances have been insignificant historically.

Shipping and Handling Costs. Shipping and handling costs are included as both a cost of sales and as selling, general and administrative expenses. Inbound freight charges and internal transfer costs are included in cost of sales. Product storage and handling costs and the cost of distributing products to the Company s customers (distribution expense) are included in selling, general and administrative expenses. Other companies may record more of their shipping and handling costs in cost of sales, or in selling, general and administrative expenses.

Income Taxes. We have deferred tax assets that are reviewed periodically for recoverability. Valuations related to tax accruals and assets could be impacted by changes to tax codes, changes in the statutory tax rates and our future taxable income levels. We periodically update our estimates used in the preparation of the financial statements based on our latest assessment of the current and projected business and general economic environment.

Inventories. Inventories consist primarily of raw materials and finished goods that we hold for sale in the ordinary course of business. We use the first-in, first-out method to value inventories at the lower of cost or market. Management believes we have not incurred impairments in the carrying value of our inventories.

Goodwill and Other Intangible Assets. The initial recording of goodwill and other intangibles requires estimation of the fair value of assets and liabilities using fair value measurements, which include quoted market price, present value techniques (estimate of future cash flows), and other valuation techniques. Additionally, FASB Statement No. 142, Goodwill and Other Intangibles Assets, requires goodwill and other intangible assets with an indefinite useful life to be reviewed for possible impairment on an annual basis, or if circumstances indicate that impairment may exist. Determining fair value and implied fair value is subjective and often involves the use of estimates and assumptions. These estimates and assumptions could have a significant impact on the recording of intangible assets, whether or not an impairment charge is recognized and also the magnitude of the impairment charge. Our estimates of fair value are primarily determined using present value techniques of projected future cash flows. This approach uses significant assumptions such as multi-year sales projections with associated expenses. We performed impairment analyses on our goodwill and intangible assets of indefinite life which indicated as of July 31, 2006 an impairment charge was not appropriate.

Impairment of Long-lived Assets. We review periodically the carrying value of our long-lived assets held and used and assets to be disposed of at least annually or more frequently when events and circumstances warrant such a review. The carrying value of long-lived assets is evaluated for potential impairment on a product line basis. Except for the impairment charge that was recognized as of the end of fiscal year 2006, we have concluded on the basis of our evaluation that our other long-lived assets are not impaired.

Forward-Looking Statements

We are including the following discussion to inform our existing and potential security holders generally of some of the risks and uncertainties that can affect us and to take advantage of the safe harbor protection for forward-looking statements that applicable federal securities law affords. From time to time, our management, or persons acting on our behalf, makes forward-looking statements to inform existing and potential security holders about our company. These forward-looking statements include information about possible or assumed future results of our operations. All statements, other than statements of historical facts, included or incorporated by reference in this report that address activities, events or developments that we expect or anticipate may occur in the future, including such things as future capital expenditures, business strategy, competitive strengths, goals, growth of our business and operations, plans and references to future successes may be considered forward-looking statements. Also, when we use words such as anticipate, believe, estimate, intend, plan, project, forecast, should, budget, goal, expect, probably or similar expressions, we are making forward-looking statements. Many risks and uncertainties may impact the matters addressed in these forward-looking statements. Our forward-looking statements speak only as of the date made and we will not update forward-looking statements unless the securities laws require us to do so.

Some of the key factors which could cause our future financial results and performance to vary from those expected include:

- decline in demand for creosote-treated railroad crossties from the current upper range of usage, decline in the treatment of utility poles with penta, and other market developments affecting the demand for our products, including the introduction of new competing products;
- availability or increases in the price of our primary raw materials or active ingredients, particularly creosote, chlorine, phenol and co-solvent for our wood treating chemicals;
- our ability to identify, develop or acquire, and market additional product lines and businesses necessary to implement our business strategy and our ability to finance such acquisitions and development;
- the ability to obtain registration and re-registration of our products, particularly our wood treating products, under applicable law;
- the ability to introduce livestock ear tags containing a new use of an active ingredient;
- the loss of primary customers;

- our ability to implement productivity improvements, cost reduction initiatives or facilities expansions;

16

- the timing of planned capital expenditures;

- the condition of the capital markets generally, which will be affected by interest rates, foreign currency fluctuations and general economic conditions;

- cost and other effects of legal and administrative proceedings, settlements, investigations and claims, including environmental liabilities which may not be covered by indemnity or insurance;

- the political and economic climate in the foreign or domestic jurisdictions in which we conduct business; and

- other United States or foreign regulatory or legislative developments which affect the demand for our products generally or increase the environmental compliance cost for our products or impose liabilities on the manufacturers and distributors of such products.

The information contained in this report, including the information set forth under the heading Risk Factors , identifies additional factors that could cause our results or performance to differ materially from those we express in our forward-looking statements. Although we believe that the assumptions underlying our forward-looking statements are reasonable, any of these assumptions and, therefore, the forward-looking statements based on these assumptions, could themselves prove to be inaccurate. In light of the significant uncertainties inherent in the forward-looking statements which are included in this report and the exhibits and other documents incorporated herein by reference, our inclusion of this information is not a representation by us or any other person that our objectives and plans will be achieved.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

We are exposed to certain market risks arising from transactions that are entered into in the ordinary course of business, primarily from changes in foreign exchange rates. We generally do not utilize derivative financial instruments or hedging transactions to manage that risk; however, we did enter into an interest rate swap transaction in February 2003 that effectively fixed the interest rate on one of our term loans at 5.0% for the remainder of the loan s term. An increase or decrease in interest rates would not affect our earnings or cash flow over the life of the term loan because the interest rate swap serves to fix the interest rate at 5.0%. Should the financial market s expectations for interest rates in the future increase, then the value of the swap, recorded as an asset on the consolidated balance sheets, would increase. Conversely, a decrease in the financial market s expectations for future interest rates would cause a decrease in the value of that recorded asset. It is possible that the future expectations for interest rates could decline enough to cause the swap to be recorded no longer as an asset, but as a liability, until the swap expires in December 2007. At April 30, 2007, the market value of the swap was an asset of $37,000.

ITEM 4. CONTROLS AND PROCEDURES

The term disclosure controls and procedures is defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934. This term refers to the controls and procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the SEC. Our management, including our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this quarterly report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report.

There were no changes to our internal control over financial reporting during our last fiscal quarter that has materially affected, or is reasonable likely to materially affect, our internal control over financial reporting.

17

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In the ordinary course of business, we are periodically a party to lawsuits. We do not believe that any resulting liability from existing legal proceedings, individually or in the aggregate, will have a material adverse effect on our business, financial condition and operating results. However, future costs associated with legal proceedings could have a material adverse effect on our business, financial condition and operating results.

ITEM 1A. RISK FACTORS

You should carefully consider the risks described below, together with all of the other information included in this report. We believe the risks and uncertainties described below are the most significant we face. The occurrence of any of the following risks could materially harm our business, financial condition or results of operations. In that case, the trading price of our common stock could decline, and you may lose all or part of your investment. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also impair our operations.

Risks Relating to Our Business

We may experience a reduced demand for our wood preserving chemicals if the demand for the wood products on which those chemicals are used decreases, which may adversely affect our business, results of operations, cash flow and financial condition.

Our wood preserving chemicals, penta and creosote, which represented 82% of our total revenues in fiscal year 2006, are sold into mature markets. The principal consumers of our wood preserving chemicals are industrial wood treating companies who use our products to protect wood utility poles and railroad crossties from insect damage and decay. Although these products are sold into relatively stable markets, the demand for treated wood generally increases or decreases with the financial strength and maintenance budgets of electric utilities and railroad companies.

Penta is used primarily to treat utility poles in the United States. In recent years, utility pole demand has generally declined, as we believe electric utilities in the United States have reduced their maintenance spending due to competitive pressures arising from deregulation. Although utility pole demand has recently increased, deregulation may continue to affect the utility pole market negatively.

The preservation of wood railroad crossties represents the largest market for creosote in the United States. We believe that since January 2001, average annual purchases of wood crossties by United States and Canadian railroads have ranged from approximately 14.0 million to 20.0 million. In fiscal year 2006, purchases were near the high end of this range. If the current purchase rate declines, or if railroads shift significantly to a greater use of non-wood ties, such as those made with concrete or plastic, we will experience a decline in our creosote sales.

A decline in either utility pole or wood crosstie sales could have a material adverse effect on our business, financial condition and results of operations.

Increases in the price of our primary raw materials may decrease our profitability and adversely affect our liquidity and cash flow.

Chlorine is a key component in the manufacture of penta. The price we pay for chlorine has more than quadrupled since fiscal year 2002. Although we have been able to achieve significant price increases for penta since July 2002, these increases have not been sufficient to maintain the previous profitability of this product. High energy prices have increased the competition for creosote, since it can be burned as a fuel in certain markets. Creosote is produced by our suppliers from the distillation of coal tar. Coal tar supplies, particularly in the United States, are in short supply, a situation which we expect will continue indefinitely. Historically, the cost of our creosote has increased each year, and we believe that it will continue to increase.

The prices we pay for our raw materials have increased significantly in the last several years, and we have not always been able to pass those increases through to our customers fully and timely. In the future, we may be unable to pass on increases in our raw material costs fully and timely, and raw material price increases may erode the profitability of our products by reducing our gross margins. Price increases for raw materials also may increase our working capital needs, which could affect our liquidity and cash flow adversely. For these reasons, we cannot assure you that raw material cost increases will not have a material adverse effect on our financial condition and results of operations.

If our products are not re-registered by the EPA or are re-registered subject to new restrictions, our ability to sell our products may be curtailed or significantly limited.

Our creosote, penta and MSMA products, and many of our animal health products, are presently undergoing re-registration review by the EPA under FIFRA. We have submitted and will submit a wide range of scientific data to support our U.S. registrations. In order to be re-registered, we are required to demonstrate, among other things, that our products will not cause unreasonable adverse effects on human health or the environment when used according to approved label directions. The EPA has issued its preliminary risk assessments for creosote and penta, and has identified certain risks to human health and the environment. In August 2006, the EPA issued a preliminary re-registration eligibility decision and concluded that MSMA is not eligible for re-registration. Alone, and with other registrants of these products, we have provided and will provide comments and data on the preliminary risk assessment for creosote and penta, and on the re-registration eligibility decision for MSMA, to show to the EPA that our products do not pose unreasonable risk to human health and the environment when used in accordance with approved label directions. We cannot assure you as to when or if the EPA will issue a final decision concluding that our creosote and penta products, and our animal health pesticides and agricultural chemicals, do not pose an unreasonable risk to human health or the environment when used in accordance with approved label directions. We cannot assure you as to when or if those products will be re-registered by the EPA, or if re-registered, what use or labeling restrictions might be required to obviate or mitigate risks identified by the EPA. Even if our products are re-registered by the EPA, we cannot assure you that our products will not be subject to further data submission requirements, or subject to use or labeling restrictions, that have an adverse effect on our financial position and results of operations. The failure of our current or future-acquired products to be re-registered by the EPA or the imposition of new use, labeling or other restrictions in connection with re-registration would have a material adverse effect on our financial condition and results of operations.

Our products may be rendered obsolete or less attractive by changes in and industry requirements or by supply-chain driven pressures to shift to environmentally preferable alternatives.

Changes in regulatory, legislative and industry requirements, or changes driven by supply-chain pressures, may shift current customers away from products using penta, creosote or certain of our other products and toward alternative products that are believed to have fewer environmental effects. The EPA, foreign and state regulators, local governments, private environmental advocacy organizations and a number of large industrial companies have proposed or adopted policies designed to decrease the use of a variety of chemicals, including penta, creosote and others included in certain of our products. Our ability to anticipate changes in regulatory, legislative, and industry requirements, or changes driven by supply-chain pressures, will be a significant factor in our ability to remain competitive. Further, in the future we may not be able to comply with changed or new regulatory or industrial standards that may be necessary for us to remain competitive.

We cannot assure you that the EPA, foreign and state regulators and local governments will not restrict the uses of penta, creosote or certain of our other products or ban the use of one or more of these products, or that the companies who use our products may decide to reduce significantly or cease the use of our products voluntarily. As a result, our products may become obsolete or less attractive to our customers.

We are dependent on a limited number of suppliers for cosolvent, creosote and one of our animal health pesticides, the loss of any one of which could have a material adverse effect on our financial condition and results of operations.

We depend on two major suppliers for the cosolvent needed to produce the liquid formulation of our penta product. Both of these suppliers produce cosolvent as a byproduct of a process intended to manufacture a higher value product. Changes in that process or in market conditions affecting the higher value product could affect materially the availability or price of cosolvent. Our creosote is supplied primarily by two suppliers. There are no other significant suppliers of creosote for the North American market. We have one major supplier and one minor supplier of the tetrachlorvinphos active ingredient for our Rabon and Ravap products, and only one supplier for each of two other active ingredients in our animal health pesticides, dichlorvos and endosulfan.

If we were to lose any of these suppliers, we might have difficulty securing a replacement supplier at reasonable cost, and no assurance can be given that such loss would not have a material adverse effect on our financial condition and results of operations.

Weather may impact our ability to conduct business adversely.

The supplier of approximately one-half of our creosote is based in Europe. As such, we are dependent on terminals located in coastal areas for the importation of a substantial portion of the creosote we use. These terminals are vulnerable to hurricanes and other adverse weather conditions that have the potential to cause substantial damage to terminal facilities and interrupt our importation of creosote. For example, in 2005 Hurricane Katrina forced us to close our terminal in New Orleans, Louisiana temporarily and locate an interim substitute terminal. We cannot assure you that adverse weather conditions will not affect our importation of creosote in the future, the occurrence of which could have a material adverse effect on our financial condition and results of operations.

If we are unable to identify, fund and execute new acquisitions, we will not be able to execute a key element of our business strategy.

Our strategy is to grow primarily by acquiring additional businesses and product lines. We cannot assure you that we will be able to identify, acquire or profitably manage additional businesses and product lines, or successfully integrate any acquired business or product line without substantial expenses, delays or other operational or financial difficulties. Financing for acquisitions may not be available, or may be available only at a cost or on terms and conditions that are unacceptable to us. Further, acquisitions may involve a number of special risks or effects, including diversion of management s attention, failure to retain key acquired personnel, unanticipated events or circumstances, legal liabilities, impairment of acquired intangible assets and other one-time or ongoing acquisition-related expenses. Some or all of these special risks or effects could have a material adverse effect on our financial and operating results. In addition, we cannot assure you that acquired businesses or product lines, if any, will achieve anticipated revenues and earnings.

The consideration we pay in connection with an acquisition also may affect our financial results. If we were to proceed with one or more significant acquisitions in which the consideration included cash, we could be required to use a substantial portion of our available cash or obtain debt or equity financing. To the extent that we issue shares of our capital stock or other rights to purchase shares of our common stock as consideration for an acquisition or in connection with the financing of an acquisition, including options or other rights, our existing common shareholders may be diluted, and our earnings per share may decrease.

If we are unable to successfully position ourselves in smaller niche markets, our business may be adversely affected.

We are positioned in smaller niche markets that have been or are being abandoned by larger chemical companies. These markets tend not to attract larger chemical companies due to lower volume demand. As a result, larger chemical companies have been divesting themselves of products and businesses that fall into these smaller markets where our acquisition efforts are focused. Larger companies sometimes market and sell newer competing products using other technologies or containing different active ingredients, and their sales efforts may shift demand to these newer products and depress sales of the older products. Thus, we cannot assure you that we will be successful or continue to be successful in niche markets.

The specialty chemical industry is highly competitive, and we may not be able to compete effectively with our competitors, which could adversely impact our results of operations.

The specialty chemical industry is highly competitive. Competition in specialty chemicals is based upon a number of considerations, such as the size of our competitors, competition for raw materials, product innovation, product range and quality, relationships with customers, reliability of delivery, technical support and distribution capability, and price. Among the participants in the specialty chemical industry are some of the world s largest chemical companies and major integrated petroleum companies that have their own raw material resources. Some of these companies may be able to produce products more economically than we can. In addition, some of our competitors have greater financial resources, which may enable them to invest significant capital into their businesses, including expenditures for research and development. If any of our current or future competitors develops proprietary technology that enables them to produce products at a significantly lower cost, our technology could be rendered uneconomical or obsolete. Increased competition in any of our business segments could compel us to reduce the price we receive for our products, which could result in reduced profit margins and/or loss of market share.

Restrictions in our debt agreements could limit our growth and our ability to respond to changing conditions.

Our revolving credit facility and the senior credit facility with Wachovia Bank, N.A. contain a number of significant covenants which affect our ability to take certain actions and restrict our ability to incur additional debt. These include covenants that prohibit acquisitions that are not approved by Wachovia Bank. In addition, our revolving credit facility requires us to maintain certain financial ratios and satisfy certain financial condition tests which may require us to take action to reduce our debt or take some other action to comply with them.

These restrictions could limit our ability to obtain future financings, make needed capital expenditures, withstand a future downturn in our business or the economy in general or otherwise conduct necessary corporate activities. We also may be prevented from taking advantage of business opportunities that arise because of the limitations that these restrictive covenants impose on us.

A breach of any of these covenants would result in a default under the applicable debt agreement. A default, if not waived, could result in acceleration of the debt outstanding under the agreement and in a default with respect to, and acceleration of, the debt outstanding under our other debt agreements. The accelerated debt would become due and payable immediately. If that should occur, we may not be able to pay all such debt or to borrow sufficient funds to refinance it. Even if new financing were then available, it may not be on terms that are acceptable to us.

The distribution and sale of our products is subject to prior governmental approvals and thereafter ongoing governmental regulation.

Our products are subject to laws administered by federal, state and foreign governments, including regulations requiring registration, approval and labeling of our products. The labeling requirements restrict the use and type of application for our products. More stringent restrictions could make our products less desirable which would adversely affect our sales and profitability. All of our products are subject to the EPA s registration and re-registration requirements, and are conditionally registered in accordance with FIFRA. Those registration requirements are based, among other things, on data demonstrating that the product will not cause unreasonable adverse effects on human health or the environment when used according to approved label directions. All states where our products are used also require registration before they can be marketed or used in that state.

Governmental regulatory authorities have required, and may require in the future, that certain scientific testing and data production be provided on our products. We have and are currently furnishing certain required data relative to our products. Under FIFRA, the federal government requires registrants to submit a wide range of scientific data to support U.S. registrations. This requirement increases significantly our operating expenses, and we expect those expenses will continue in the future. Because scientific analyses are improving constantly, we cannot determine with certainty whether or not new or additional tests may be required by regulatory authorities. While Good Laboratory Practice standards specify the minimum practices and procedures which must be followed in order to ensure the quality and integrity of data related to these tests submitted to the EPA, there can be no assurance that the EPA will not request certain tests or studies be repeated. In addition, more stringent legislation or requirements may be imposed in the future. We can provide no assurance that our resources will be adequate to meet the cost of regulatory compliance, or that the cost of such compliance will not affect our profitability adversely.

We are subject to extensive environmental laws and regulations and may incur costs that have a material adverse effect on our financial condition as a result of violations of or liabilities under environmental laws and regulations.

Like other companies involved in environmentally sensitive businesses, our operations and properties are subject to extensive and stringent federal, state, local and foreign environmental laws and regulations, including those concerning, among other things:

- the treatment, storage and disposal of wastes;
- the investigation and remediation of contaminated soil and groundwater;
- the discharge of effluents into waterways;
- the emission of substances into the air; and
- other matters relating to environmental protection and various health and safety matters.

The EPA and other federal and state agencies, as well as comparable agencies in Mexico and in other countries where we sell our products, have the authority to promulgate regulations that could have a material adverse impact on our operations. These environmental laws and regulations may require permits for certain types of operations, require the installation of expensive pollution control equipment, place restrictions upon operations or impose substantial liability for pollution resulting from our operations. We expend substantial funds to minimize the discharge of hazardous materials in the environment and to comply with governmental regulations relating to protection of the environment. Compliance with environmental and health and safety laws and regulations has resulted in ongoing costs for us, and could restrict our ability to modify or expand our facilities or continue production, or require us to install costly pollution control equipment or incur significant expenses, including remediation costs. We have incurred, and expect to continue to incur, significant costs to comply with environmental and health and safety laws. Federal, state and foreign governmental authorities may seek fines and penalties, as well as injunctive relief, for violation of the various laws and governmental regulations, and could, among other things, impose liability on us for cleaning up the damage resulting from a release of pesticides, hazardous materials or other chemicals into the environment.

Our use of hazardous materials exposes us to potential liabilities.

Our manufacturing and distribution of chemical products involve the controlled use of hazardous materials. Our operations, therefore, are subject to various associated risks, including chemical spills, discharges or releases of toxic or hazardous substances or gases, fires, mechanical failure, storage facility leaks and similar events. Our suppliers are subject to similar risks which may impact adversely the availability of raw materials. While we adapt our manufacturing and distribution processes to the environmental control standards of regulatory authorities, we cannot completely eliminate the risk of accidental contamination or injury from hazardous or regulated materials, including injury of our employees, individuals who handle our products or goods treated with our products, or others who claim to have been exposed to our products, nor can we completely eliminate the unanticipated interruption or suspension of operations at our facilities due to such events. We may be held liable for significant damages or fines in the event of contamination or injury, and such assessed damages or fines could have a material adverse effect on our financial performance and results of operations.

Our business success depends significantly on the reliability and sufficiency of our manufacturing facilities.

Our revenues depend significantly on the continued operation of our manufacturing facilities. The operation of our facilities involves risks, including the breakdown, failure, or substandard operation or performance of equipment, power outages, explosions, fires, natural disasters and other unscheduled downtime. The occurrence of material operational problems or the loss or shutdown of our facilities over an extended period of time due to these or other events could have a material adverse effect on our financial performance and operating results.

Our business is subject to many operational risks for which we may not be adequately insured.

We cannot assure you that we will not incur losses beyond the limits of, or outside the coverage of, our insurance policies. From time to time, various types of insurance for companies in the chemical industry have not been available on commercially acceptable terms or, in some cases, have been unavailable. In addition, we cannot assure you that in the future we will be able to maintain existing coverage, or assure you that premiums will not increase substantially.

We maintain limited insurance coverage for sudden and accidental environmental damages. We do not believe that insurance coverage for environmental damages that occur over time is available at a reasonable cost. Also, we do not believe that insurance coverage for the full potential liability that could be caused by sudden and accidental incidences is available at a reasonable cost. Accordingly, we may be subject to an uninsured or under-insured loss in such cases.

We may experience a reduction in demand for creosote if our customers dilute creosote with fuel oil prior to treating.

If creosote begins selling at a premium to fuel oil, it is likely that some of our customers would dilute creosote with fuel oil. The potential for dilution with fuel oil is a limiting factor on our ability to price creosote. If dilution were to occur on a widespread basis, we could see a significant decline in our creosote sales. A decline in creosote sales could have a material adverse effect on our results of operations.

Our business may be adversely affected by cyclical and seasonal effects.

In general, the chemical industry is cyclical and product demand for certain products is seasonal. Many of our products are used in industries that are cyclical in nature. Changes affecting these industries can adversely affect our revenues and margins. Seasonal usage of our chemical products follows varying agricultural seasonal patterns, weather conditions and weather-related pressure from pests, as well as customer marketing programs and requirements. Weather patterns can have an impact on our sales, particularly sales of our agricultural chemicals. The end users of some of our products may, because of weather patterns, delay or intermittently suspend field work during the planting season which may result in a reduction in the use of some products and therefore reduce our revenues and profitability. There can be no assurance that we will adequately address any adverse seasonal effects.

We depend on our senior management team and the loss of any member could adversely affect our operations.

Our success is dependent on the management and leadership skills of our senior management team, including David L. Hatcher, our Chairman, J. Neal Butler, our Chief Executive Officer and President, John V. Sobchak, our Chief Financial Officer, and Roger C. Jackson, our General Counsel. The loss of any member of our senior management team or an inability to attract, retain and maintain additional qualified personnel could prevent us from implementing our business strategy. We cannot assure you that we will be able to retain our existing senior management personnel or attract additional qualified personnel when needed.

If we are unable to successfully negotiate with the labor unions representing our employees, we may experience a material work stoppage.

More than half of our full-time employees who work at our facility in Matamoros, Mexico, where penta and certain other products are produced, are represented under a labor contract that is negotiated annually. We cannot assure you that a new agreement will be reached each year without union action, or that a new agreement will be reached on terms satisfactory to us. An extended work stoppage, slowdown or other action by our employees could disrupt our business significantly. Future labor contracts may be on terms that result in higher labor costs to us, which also could affect our results of operations adversely.

We are subject to possible risk of terrorist attacks which could affect our business adversely.

Since September 11, 2001, there have been increasing concerns that chemical manufacturing facilities and railcars carrying hazardous chemicals may be at an increased risk of future terrorist attacks. Additionally, federal, state and local governments have begun a regulatory process that could lead to new regulations impacting the security of chemical industry facilities and the transportation of hazardous chemicals. Our business could be impacted adversely if a terrorist incident were to occur at any chemical facility or while a railcar or tank truck was transporting chemicals. In addition, our business could be affected due to the cost of complying with new regulations. We are not insured against terrorist attacks, and there can be no assurance that losses that could result from a terrorist attack on one of our facilities, railcars or tank trucks would not have a material adverse effect on our business, results of operations and financial condition.

Additionally, our business depends on the free flow of products and services through the channels of commerce. Recently, in response to terrorist activities and threats aimed at the United States, transportation, mail, financial and other services have been slowed or stopped altogether. Further delays or stoppages in transportation, mail, financial or other services could have a material adverse effect on our business, results of operations and financial condition. Furthermore, we may experience an increase in operating costs, such as costs for transportation, insurance and security as a result of the activities and potential activities. We may also experience delays in receiving payments from payers that have been affected by the terrorist activities and potential activities. The United States economy in general is being affected adversely by the threat of terrorist activities and any economic downturn could impact our results of operations adversely, impair our ability to raise capital or otherwise affect adversely our ability to grow our business.

We are subject to risks inherent in foreign operations, including changes in social, political and economic conditions.

We have facilities in the United States and Mexico, and generate a portion of our sales in foreign countries, primarily in Latin America. In fiscal year 2006, our production facilities in Matamoros, Mexico comprised approximately 34% of our property, plant and equipment, and approximately 3% of our net sales were in foreign countries. Like other companies with foreign operations and sales, we are exposed to market risks relating to fluctuations in interest rates and foreign currency exchange rates. We are also exposed to risks associated with changes in the laws and policies governing foreign investments in Mexico and, to a lesser extent, changes in United States laws and regulations relating to foreign trade and investment. While such changes in laws, regulations and conditions have not had a material adverse effect on our business or financial condition, we cannot assure you as to the future effect of any such changes.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

ITEM 5. OTHER INFORMATION

The Nominating and Corporate Governance Committee will consider recommendations for director made by shareholders for fiscal year 2008, if such recommendations are received in writing, addressed to the chair of the committee, Mr. Urbanowski, in care of the Company, at 10611 Harwin Drive, Suite 402, Houston, Texas 77036 by July 31, 2007.

ITEM 6. EXHIBITS

(a) The following documents are filed as exhibits. Documents marked with an asterisk (*) are management contracts or compensatory plans, and portions of documents marked with a dagger ( ) have been granted confidential treatment or confidential treatment has been requested.

3.1	Restated and Amended Articles of Incorporation filed as Exhibit 3(i) to the company s filed as Exhibit 3(i) to the company s Form 10-QSB12G filed December 6, 1996, incorporated in this report.
3.2	Bylaws filed as Exhibit 3(ii) to the company s Form 10-QSB12G filed December 6, 1996, incorporated in this report.
3.3	Articles of Amendment to Restated and Amended Articles of Incorporation, filed December 11, 1997 filed as Exhibit 3 to the company s second quarter 1998 report on Form 10-QSB filed December 12, 1997, incorporated in this report.
4.1	Form of Common Stock Certificate filed as Exhibit 4.1 to the company s Form 10-QSB12G filed December 6, 1996, incorporated in this report.
10.11	Creosote Supply Agreement dated November 1, 1998 between Rütgers VFT and the company filed as Exhibit 10.20 to the company s second quarter 1999 report on Form 10-QSB filed March 12, 1999, incorporated in this report.
10.12*	1996 Stock Option Plan filed as Exhibit 10.4 to the company s Form 10-QSB12G filed December 6, 1996, incorporated in this report.
10.13*	Stock Option Agreement dated October 17, 1996 with Thomas H. Mitchell filed as Exhibit 10.5 to the company s Form 10-QSB12G filed December 6, 1996, incorporated in this report.
10.14	Warrant for the Purchase of 25,000 Shares of Common Stock dated as of March 6, 2000 between the company and JGIS, Ltd., an assignee of Gilman Financial Corporation, filed as Exhibit 10.24 to the company s 2000 report on Form 10-KSB filed October 25, 2000, incorporated in this report.
10.15*	Employment Agreement with Thomas H. Mitchell dated July 11, 2001 filed as Exhibit 10.25 to the company s 2001 report on Form 10-K filed October 24, 2001, incorporated in this report.
10.16*	Employment Agreement with John V. Sobchak dated June 26, 2001 filed as Exhibit 10.26 to the company s 2001 report on Form 10-K filed October 24, 2001, incorporated in this report.
10.17*	Employment Agreement with Roger C. Jackson dated August 1, 2002 filed as Exhibit 10.31 to the company s 2003 report on Form 10-K filed October 23, 2003, incorporated in this report.
10.18*	Employment Agreement with J. Neal Butler dated March 8, 2004 filed as Exhibit 10.18 to the company s 2004 report on Form 10-K filed October 15, 2004, and incorporated herein by reference.
10.19*	Supplemental Executive Retirement Plan dated effective August 1, 2001 filed as Exhibit 10.27 to the company s 2001 report on Form 10-K filed October 24, 2001, incorporated in this report.
10.20	Direct Stock Purchase Plan filed as Exhibit 99.1 to the company s report on Form 8-K filed February14, 2002, incorporated in this report.
10.21*	2004 Long-Term Incentive Compensation Plan filed as Exhibit 10.21 to the company s report on Form 10-Q filed December 15, 2004, incorporated in this report.
10.22	Securities Purchase Agreement dated April 21, 2005 between the company and Tontine Capital Partners, L.P. and Terrier Partners, L.P. filed as Exhibit 10.22 to the company s report on Form 8-K filed April 22, 2005.

10.23	Registration Rights Agreement dated April 21, 2005 between the company and Tontine Capital Partners, L.P. and Terrier Partners, L.P. filed as Exhibit 10.23 to the company s report on Form 8-K filed April 22, 2005.
10.26	Asset Purchase Agreement dated June 7, 2005 between the company and Basic Chemicals Company, LLC. filed as Exhibit 10.26 to the company s report on Form 8-K filed June 13, 2005.
10.28*	Performance-Based Restricted Stock Agreement, Series 1 dated September 2, 2005 filed as Exhibit 10.28 to the company s report on Form 8-K filed September 7, 2005.
10.29*	Performance-Based Restricted Stock Agreement, Series 2 dated September 2, 2005 filed as Exhibit 10.29 to the company s report on Form 8-K filed September 7, 2005.
10.30	Asset Purchase Agreement dated February 22, 2006 between the company and Boehringer Ingelheim Vetmedica, Inc., filed as Exhibit 10.30 to the company s report on Form 8-K filed February 27, 2006, and incorporated herein by reference.
10.31	Asset Purchase Agreement by and among Wood Protection Products, Inc., KMG-Bernuth, Inc. and James R. Forshaw filed as Exhibit 2.1(v) to the company s report on Form 8-K filed December 19, 2003, and incorporated herein by reference.
10.34	Sales Agreement with Koppers, Inc. dated May 8, 2007, and is incorporated in this report.
10.35	Credit Agreement with Wachovia Bank, National Association dated May 15, 2007, and is incorporated in this report.
31	Certificates under Section 302 the Sarbanes-Oxley Act of 2002 of the President and the Chief Financial Officer.
32	Certificates under Section 906 of the Sarbanes-Oxley Act of 2002 of the President and the Chief Financial Officer.

SIGNATURES

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

KMG Chemicals, Inc.

By:	/s/ J. Neal Butler J. Neal Butler President	Date: June 5, 2007
By:	/s/ John V. Sobchak John V. Sobchak, Chief Financial Officer	Date: June 5, 2007