AIRGAS SAFETY INC
Form 10-Q
August 09, 2006

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

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

For the quarterly period ended: June 30, 2006

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 þ No o

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

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

Yes o No þ

Shares of common stock outstanding at August 7, 2006: 77,801,186 shares

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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 June 30,	
	2006	**2005**
Net Sales	$ 773,036	$ 678,125
Costs and Expenses:		
Cost of products sold (excluding depreciation)	383,219	334,863
Selling, distribution and administrative expenses	275,977	249,849
Depreciation	33,162	29,110
Amortization	1,772	1,299
Total costs and expenses	694,130	615,121
Operating Income	78,906	63,004
Interest expense, net	(13,676)	(13,944)
Discount on securitization of trade receivables	(3,336)	(1,848)
Other income, net	213	912
Earnings before income taxes and minority interest	62,107	48,124
Income taxes	(22,744)	(18,135)
Minority interest in earnings of consolidated affiliate	(711)	(522)
Income from continuing operations	38,652	29,467
Income from discontinued operations, net of tax		180
Net Earnings	$ 38,652	$ 29,647
Net Earnings Per Common Share		
Basic		
Earnings from continuing operations	$ 0.50	$ 0.39
Earnings from discontinued operations		
Net earnings per share	$ 0.50	$ 0.39

Diluted		
Earnings from continuing operations	$ 0.48	$ 0.38
Earnings from discontinued operations		
Net earnings per share	$ 0.48	$ 0.38
Weighted average shares outstanding:		
Basic	77,557	76,252
Diluted	82,436	77,951
Comprehensive income	$ 40,218	$ 29,468

See accompanying notes to consolidated financial statements.

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

	(Unaudited) June 30, 2006	March 31, 2006
ASSETS		
Current Assets		
Cash	$ 33,118	$ 34,985
Trade receivables, less allowances for doubtful accounts of $16,175 at June 30, 2006 and $14,782 at March 31, 2006	159,696	132,245
Inventories, net	234,603	229,523
Deferred income tax asset, net	24,411	30,141
Prepaid expenses and other current assets	29,125	31,622
Total current assets	480,953	458,516
Plant and equipment at cost	2,250,050	2,191,673
Less accumulated depreciation	(821,713)	(792,916)
Plant and equipment, net	1,428,337	1,398,757
Goodwill	570,625	566,074
Other intangible assets, net	27,721	26,248
Other non-current assets	24,404	24,817
Total assets	$ 2,532,040	$ 2,474,412
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Accounts payable, trade	$ 128,669	$ 143,752
Accrued expenses and other current liabilities	198,484	200,001
Current portion of long-term debt	106,010	131,901
Total current liabilities	433,163	475,654
Long-term debt, excluding current portion	675,825	635,726
Deferred income tax liability, net	338,150	327,818
Other non-current liabilities	35,394	30,864
Minority interest in affiliate	57,191	57,191
Commitments and contingencies		

Stockholders Equity		
Preferred stock, no par value, 20,000 shares authorized, no shares issued or outstanding at June 30, 2006 and March 31, 2006		
Common stock, par value $0.01 per share, 200,000 shares authorized, 78,960 and 78,569 shares issued at June 30, 2006 and March 31, 2006, respectively	790	786
Capital in excess of par value	299,967	289,598
Retained earnings	698,377	665,158
Accumulated other comprehensive income	6,317	4,751
Treasury stock, 1,292 common shares at cost at both June 30, 2006 and March 31, 2006	(13,134)	(13,134)
Total stockholders equity	992,317	947,159
Total liabilities and stockholders equity	$ 2,532,040	$ 2,474,412

See accompanying notes to consolidated financial statements.

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

(In thousands)	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
CASH FLOWS FROM OPERATING ACTIVITIES		
Net earnings	$ 38,652	$ 29,647
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	33,162	29,110
Amortization	1,772	1,299
Deferred income taxes	14,574	11,082
Loss on sales of plant and equipment	128	122
Minority interest in earnings	711	522
Stock-based compensation expense	2,752	
Stock issued for employee stock purchase plan	2,822	2,514
Changes in assets and liabilities, excluding effects of business acquisitions and divestitures:		
Securitization of trade receivables	(9,700)	24,700
Trade receivables, net	(16,222)	(12,938)
Inventories, net	(3,529)	(3,555)
Prepaid expenses and other current assets	2,174	8,954
Accounts payable, trade	(12,444)	(13,883)
Accrued expenses and other current liabilities	(14,177)	(3,944)
Other long-term assets	(1,314)	3,141
Other long-term liabilities	3,643	(272)
Net cash provided by operating activities	43,004	76,499
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(62,704)	(47,265)
Proceeds from sales of plant and equipment	1,263	735
Business acquisitions and holdback settlements	(3,814)	(72,850)
Other, net	492	398
Net cash used in investing activities	(64,763)	(118,982)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from borrowings	166,219	187,008
Repayment of debt	(152,010)	(176,525)
Minority interest in earnings	(711)	(522)
Exercise of stock options	4,799	5,387
Minority stockholder note prepayment		21,000

Dividends paid to stockholders		(5,433)		(4,631)
Cash overdraft		7,028		13,425
Net cash provided by financing activities		19,892		45,142
Change in cash	$	(1,867)	$	2,659
Cash Beginning of period		34,985		32,640
Cash End of period	$	33,118	$	35,299

See accompanying notes to consolidated financial statements.

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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), as well as the Company s consolidated affiliate, National Welders. Intercompany accounts and transactions, including those between the Company and National Welders, 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, 2006.

The preparation of financial statements requires the use of estimates. The consolidated financial statements reflect, in the opinion of management, reasonable estimates and all adjustments necessary to present fairly the Company s financial position, results of operations and cash flows for the periods presented. The interim operating results are not necessarily indicative of the results to be expected for an entire year.

As described in Note 3, the Company divested its subsidiary, Rutland Tool & Supply Co. (Rutland Tool), in December 2005. As a result, Rutland Tool has been reclassified in the Consolidated Statement of Earnings for the three months ended June 30, 2005 as discontinued operations. The Consolidated Statement of Cash Flows for the three months ended June 30, 2005 was not reclassified because the cash flows of Rutland Tool were not significant.

(2) NEW ACCOUNTING PRONOUNCEMENTS

In November 2004, the Financial Accounting Standards Board (FASB) issued SFAS 151, *Inventory Costs,* as an amendment to the guidance provided on *Inventory Pricing* in FASB Accounting Research Bulletin 43. SFAS 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. This statement requires that if the costs associated with the actual level of spoilage or production defects are greater than the normal range of spoilage or defects, the excess costs should be charged to current period expense. The Company adopted SFAS 151 effective April 1, 2006, as required. Since the Company performs limited manufacturing, the adoption of SFAS 151 did not have a material impact on its results of operations, financial position or liquidity.

In December 2004, the FASB issued SFAS 153, *Exchanges of Nonmonetary Assets,* as an amendment to APB Opinion 29, *Accounting for Nonmonetary Transactions.* SFAS 153 requires nonmonetary exchanges to be accounted for at fair value, recognizing any gains or losses, if the fair value is determinable within reasonable limits and the transaction has commercial substance. The Company adopted SFAS 153 effective April 1, 2006, as required. The adoption of SFAS 153 did not have a material impact on its results of operations, financial position or liquidity.

On June 1, 2005, the FASB issued SFAS 154, *Accounting Changes and Error Corrections,* which requires retrospective application to prior periods financial statements of voluntary changes in accounting principle, unless it is impractical to do so. The Company adopted SFAS 154 effective April 1, 2006, as required.

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

(2) NEW ACCOUNTING PRONOUNCEMENTS - (Continued)

Effective April 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment,* (SFAS 123R), which superseded Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees,* (APB 25). SFAS 123R requires that grants of employee stock options, including options to purchase shares under employee stock purchase plans, be recognized as compensation expense based on their fair values. The Company adopted SFAS 123R using the modified prospective method in which compensation cost is recognized from the date of adoption forward for both new awards and the portion of any previously granted awards that vest after the date of adoption. Prior periods are not restated under the modified prospective method of adoption. Prior to April 1, 2006, the Company accounted for its stock-based compensation using the intrinsic value method outlined in APB 25, which provides that compensation expense is recorded on the date of grant only if the current market price of the underlying stock exceeds the exercise price. Accordingly, since the Company does not grant options with exercise prices lower than the market price on the date of grant, no stock-based employee compensation expense was reflected in net earnings prior to the date of adoption. See Note 12 for additional disclosures associated with the adoption of SFAS 123R.

In November 2005, the FASB issued FSP No. FAS 123(R)-3, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards.* This FAS provides an elective alternative simplified method for calculating the pool of excess tax benefits available to absorb tax deficiencies recognized subsequent to the adoption of SFAS 123R and reported in the Consolidated Statements of Cash Flows. Companies may take up to one year from the effective date of the FSP to evaluate the available transition alternatives and make a one-time election as to which method to adopt. Based on the FSP effective date, the Company must decide on its method of adoption no later than the third quarter of fiscal 2007. The Company is currently in the process of evaluating the alternative methods of adoption.

(3) ACQUISITION & DIVESTITURE

(a) Acquisition

During the three months ended June 30, 2006, the Company completed one acquisition with annual sales of approximately $13 million. Costs in excess of net assets acquired (goodwill) related to the acquisition totaled approximately $260 thousand.

(b) Divestiture

On December 1, 2005, the Company sold its Rutland Tool & Supply Co. (Rutland Tool) subsidiary. Rutland Tool distributed metalworking tools, machine tools and MRO supplies from seven locations and had approximately 180 employees. The results of Rutland Tool for the three months ended June 30, 2005 have been reclassified in the Consolidated Statement of Earnings as discontinued operations. The consolidated Statement of Cash Flows was not reclassified to reflect discontinued operations because the cash flows of Rutland Tool were not significant.

The net sales and operating income for the three months ended June 30, 2005, which were segregated and reported as discontinued operations, were $13 million and $304 thousand, respectively.

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AIRGAS, INC. AND SUBSIDIARIES
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(4) 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 the Company s Employee Stock Purchase plan. The calculation of diluted earnings per share also assumes the conversion of National Welders preferred stock to Airgas common stock.

The table below presents the computation of basic and diluted earnings per share for the three months ended June 30, 2006 and 2005:

	Three Months Ended June 30,	
(In thousands, except per share amounts)	**2006**	**2005**
Basic Earnings per Share Computation		
Numerator		
Income from continuing operations	$ 38,652	$ 29,467
Income from discontinued operations		180
Net earnings	$ 38,652	$ 29,647
Denominator		
Basic shares outstanding	77,557	76,252
Basic earnings per share from continuing operations	$ 0.50	$ 0.39
Basic earnings per share from discontinued operations		
Basic net earnings per share	$ 0.50	$ 0.39

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AIRGAS, INC. AND SUBSIDIARIES
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(4) EARNINGS PER SHARE - (Continued)

(In thousands, except per share amounts)	Three Months Ended June 30, 2006	2005
Diluted Earnings per Share Computation		
Numerator		
Income from continuing operations	$ 38,652	$ 29,467
Plus: Preferred stock dividends(1)(2)	711	
Plus: Income taxes on earnings of National Welders(3)	214	
Income from continuing operations assuming preferred stock conversion in 2006	39,577	29,467
Income from discontinued operations		180
Net earnings assuming preferred stock conversion in 2006	$ 39,577	$ 29,647
Denominator		
Basic shares outstanding	77,557	76,252
Incremental shares from assumed conversions		
Stock options and options under the Employee Stock Purchase plan	2,552	1,699
Preferred stock of National Welders(1)	2,327	
Diluted shares outstanding	82,436	77,951
Diluted earnings per share from continuing operations	$ 0.48	$ 0.38
Diluted earnings per share from discontinued operations		
Diluted net earnings per share	$ 0.48	$ 0.38

(1) Pursuant to a joint venture agreement between the Company and the holders of the preferred stock of National Welders, until June 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 2.3 million shares of Airgas common stock. If Airgas common stock has a market value of $24.45 per share, the stock and cash redemption options are equivalent. Since the average market price of Airgas common stock for the three months ended June 30, 2006 was in excess of $24.45 per share, conversion of the preferred stock was assumed. The conversion of the preferred stock was not assumed in the three months ended June 30, 2005 because the average price of Airgas common stock was less than $24.45 per share.

(2) If the preferred stockholders of National Welders convert their preferred stock to Airgas common stock, the 5% preferred stock dividend, recognized as Minority interest in earnings of consolidated affiliate, would no longer be paid to the preferred stockholders, resulting in additional net earnings for Airgas.

(3) The earnings of National Welders for tax purposes are treated as a deemed dividend to Airgas, net of an 80% dividend exclusion. Upon the assumed conversion of National Welders preferred stock to Airgas common stock, National Welders would become a wholly owned subsidiary of Airgas. As a wholly owned subsidiary, the net earnings of National Welders would not be subject to additional tax at the Airgas level.

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AIRGAS, INC. AND SUBSIDIARIES
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(Unaudited)

(5) TRADE RECEIVABLES SECURITIZATION

The Company participates in a securitization agreement with two commercial banks to sell up to $250 million of qualifying trade receivables. The agreement will expire in May 2009, but may be renewed subject to renewal provisions contained in the agreement. During the three months ended June 30, 2006, the Company sold, net of its retained interest, $598 million of trade receivables and remitted to bank conduits, pursuant to a servicing agreement, $608 million in collections on those receivables. The amount of outstanding receivables under the agreement was $234 million at June 30, 2006 and $244 million at March 31, 2006.

The transaction has been accounted for as a sale under the provisions of Statement of Financial Accounting Standards 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. Subordinated retained interests of approximately $70 million and $63 million are included in Trade receivables in the accompanying Consolidated Balance Sheets at June 30, 2006 and March 31, 2006, 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.

(6) INVENTORIES, NET

Inventories, net, consist of:

(In thousands)	**June 30, 2006**	**March 31, 2006**
Hardgoods	$ 208,822	$ 202,894
Gases	25,781	26,629
	$ 234,603	$ 229,523

Net inventories determined by the LIFO inventory method totaled $36 million at June 30, 2006 and $37 million at March 31, 2006. If the FIFO inventory method had been used for these inventories, the carrying value would have been approximately $6 million higher at both June 30, 2006 and March 31, 2006. Substantially all of the inventories are finished goods.

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(7) ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

Accrued expenses and other current liabilities include:

(In thousands)	June 30, 2006	March 31, 2006
Accrued payroll and employee benefits	$ 43,319	$ 57,555
Business insurance reserves	22,936	20,930
Health insurance reserves	10,254	9,734
Accrued interest expense	13,825	14,910
Taxes other than income taxes	16,834	13,590
Cash overdraft	47,183	40,155
Other accrued expenses and current liabilities	44,133	43,127
	$ 198,484	$ 200,001

(8) DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

The Company manages its exposure to changes in market interest rates. The Company s involvement with derivative instruments is limited to highly effective fixed interest rate swap agreements used to manage well-defined interest rate risk exposures. The Company monitors its positions and credit ratings of its counterparties and does not anticipate non-performance by the counterparties. Interest rate swap agreements are not entered into for trading purposes.

At June 30, 2006, the Company had six fixed interest rate swap agreements with a notional amount of $150 million. Two of the swaps effectively convert $50 million of variable interest rate debt associated with the Company s credit facilities to fixed rate debt. The remaining four swaps hedge $100 million of variable cash flow associated with the sale of trade receivables under the Company s trade receivable securitization. At June 30, 2006, these swap agreements required the Company to make fixed interest payments based on a weighted average effective rate of 4.98% and receive variable interest payments from its counterparties based on a weighted average variable rate of 5.08%. The remaining terms of each of these swap agreements are between 2 and 3 years.

National Welders entered into a swap agreement with a major financial institution with a notional principal amount of $27 million. The swap agreement is for 3 years and requires National Welders to make fixed interest payments of 5.36% and receive variable interest payments from its counterparty based on one month LIBOR, which was 5.27% at June 30, 2006.

During the three months ended June 30, 2006, the Company and National Welders recorded a net increase in the fair value of the fixed interest rate swap agreements and a corresponding increase to Accumulated Other Comprehensive Income of approximately $473k. Including the effect of the interest rate swap agreements and the trade receivables securitization, the Company s ratio of fixed to variable interest rates was approximately 65% fixed to 35% variable at June 30, 2006.

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

(9) GOODWILL AND OTHER INTANGIBLE ASSETS

The valuations of goodwill and other intangible assets of recent acquisitions are based on preliminary estimates of fair value and are subject to revision as the Company finalizes appraisals and other analyses. Changes in the net carrying amount of goodwill for the three months ended June 30, 2006 were as follows:

(In thousands)	Distribution Segment	All Other Operations Segment	Total
Balance at March 31, 2006	$ 402,582	$ 163,492	$ 566,074
Acquisitions	1,875	2,158	4,033
Other adjustments	727	(209)	518
Balance at June 30, 2006	$ 405,184	$ 165,441	$ 570,625

Other intangible assets amounted to $27.7 million and $26.2 million (net of accumulated amortization of $45.4 million and $43.8 million) at June 30, 2006 and March 31, 2006, respectively. These intangible assets primarily consist of acquired customer lists amortized over 7 to 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. Intangible assets also include a trade name with an indefinite useful life valued at $1 million acquired in the BOC acquisition. Estimated remaining fiscal year amortization expense in millions is as follows: remainder of 2007 $4.7 million; 2008 $4.2 million; 2009 $3.6 million; 2010 $3.3 million; 2011 $3.0 million; and $7.9 million thereafter.

(10) MINORITY STOCKHOLDER NOTE PREPAYMENT

In June 2005, National Welders entered into an agreement with its preferred stockholders under which the preferred stockholders prepaid their $21 million note receivable owed to National Welders. National Welders used the proceeds from the prepayment of the preferred stockholders note to repay its $21 million Term Loan B, which had been collateralized by the preferred stockholders note.

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AIRGAS, INC. AND SUBSIDIARIES
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(Unaudited)

(11) STOCKHOLDERS EQUITY

Changes in stockholders equity were as follows:

(In thousands of shares)	Shares of Common Stock $0.01 Par Value	Treasury Stock
Balance March 31, 2006	78,569	1,292
Common stock issuance(a)	391	
Balance June 30, 2006	78,960	1,292

(In thousands)	Common Stock	Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Comprehensive Income
Balance March 31, 2006	$ 786	$ 289,598	$ 665,158	$ 4,751	$ (13,134)	
Net earnings			38,652			38,652
Common stock issuance(a)	4	7,617				
Foreign currency translation adjustment				1,258		1,258
Dividends paid on common stock ($0.07 per share)			(5,433)			
Stock-based compensation(b)		2,752				
Net change in fair value of interest rate swap agreements				473		473
Net tax expense of comprehensive income items				(165)		(165)
Balance June 30, 2006	$ 790	$ 299,967	$ 698,377	$ 6,317	$ (13,134)	$ 40,218

(a) Issuance of common stock for purchases through the Employee Stock Purchase Plan and employee stock options exercises.

(b) In accordance with the adoption of SFAS 123R, the Company recognized compensation expense with a corresponding amount recorded to Capital in Excess of Par Value.

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

(12) STOCK-BASED COMPENSATION

The Company adopted SFAS 123R effective April 1, 2006 using the modified prospective method. Under the modified prospective method, stock-based compensation recognized since the date of adoption includes: (a) any share-based payments granted subsequent to the date of adoption; and (b) any portion of share-based payments granted prior to the date of adoption that vests subsequent to the date of adoption. Prior periods have not been restated.

The Company recorded stock-based compensation in the three months ended June 30, 2006 of $2.7 million ($2 million after tax), or $0.02 per diluted share. The pre-tax compensation expense was included in Selling, Distribution and Administrative expenses in the Consolidated Statement of Earnings. The stock-based compensation expense related to stock options and options to purchase common stock under the Employee Stock Purchase Plan.

Prior Period Pro Forma Earnings

The following table presents the effect on net earnings and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123R in the prior year period:

(In thousands, except per share amounts)		**Three Months Ended June 30, 2005**
Net earnings, as reported	$	29,647
Deduct: Total stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects		(2,138)
Pro forma net earnings	$	27,509
Earnings per share:		
Basic as reported	$	0.39
Basic pro forma	$	0.36
Diluted as reported	$	0.38
Diluted pro forma	$	0.35

Stock Option Plans

The Company s 1997 Stock Option Plan (the Employee Plan) provides for the granting of stock options to key employees. Stock options granted under the Employee Plan are granted with an exercise price equal to the closing market price on the date of grant and vest 25% annually on the anniversary of the grant date. Stock options granted prior to April 1, 2006 under the Employee Plan have a maximum term of ten years, while stock options granted subsequent to April 1, 2006 have a maximum term of eight years. Stock options under the Employee Plan are generally granted in May of each year. A total of 927 thousand options were granted during the three months ended June 30, 2006. A total of 11.2 million shares of common stock are reserved for issuance under the Employee Plan upon the exercise of stock options and the issuance of restricted stock, of which 1.1 million remained available at June 30, 2006.

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

(12) STOCK-BASED COMPENSATION - (Continued)

The Company s 1997 Directors Stock Option Plan (the Directors Plan) provides for the granting of stock options to non-employee directors of the Company. Stock options granted under the Directors Plan vest on the date of grant. Stock options granted prior to April 1, 2006 under the Directors Plan have a maximum term of ten years, while stock options to be granted subsequent to April 1, 2006 will have a maximum term of eight years. No stock options were granted under the Directors Plan in the three months ended June 30, 2006. A total of 800 thousand shares of common stock are reserved for issuance under the Directors Plan upon the exercise of stock options, of which 222 thousand remained available at June 30, 2006.

The Company either issues new shares of its common stock to satisfy stock option exercises or issues shares from treasury stock. During the three months ended June 30, 2006, all of the stock option exercises were satisfied with the issuance of new shares of Company common stock.

2006 Equity Incentive Plan

The Company is seeking approval from its stockholders of the 2006 Equity Incentive Plan (the Equity Plan) at the 2006 Annual Meeting of Stockholders. If approved, the Equity Plan shall succeed both the Company s existing Employee Plan and Directors Plan. Outstanding stock options and stock options available for grant under the existing stock option plans will be incorporated into the Equity Plan. Future grants of stock options to employees and directors will then be issued from the Equity Plan. In addition, the number of shares of common stock reserved for issuance under the Equity Plan will be increased by 3.2 million shares.

Fair Value

The Company utilizes the Black-Scholes option pricing model to determine the fair value of stock options under SFAS 123R, which is consistent with that used for pro forma disclosures in prior periods. The weighted-average grant date fair value of stock options granted during the three months ended June 30, 2006 and 2005 was $13.74 and $9.34, respectively. In the three months ended June 30, 2006, the Company recognized stock-based compensation expense associated with stock options of approximately $1.9 million. The following assumptions were used by the Company in valuing the stock option grants issued in the periods presented:

	Three Months Ended June 30,	
	2006	**2005**
Expected volatility	36.2%	35.3%
Expected dividend yield	0.80%	0.83%
Expected term	5.43 years	6.40 years
Risk-free interest rate	5.0%	3.9%

The expected volatility was determined based on anticipated changes in the underlying stock price over the expected term using a weighting of historical and implied volatility. The expected dividend yield was based on the Company s history and expectation of future dividend payouts. The expected term represents the period of time that the options are expected to be outstanding prior to exercise or forfeiture. The expected term was determined based on historical exercise patterns. The risk-free interest rate was based on U.S. Treasury rates in effect at the time of grant commensurate with the expected term.

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(12) STOCK-BASED COMPENSATION - (Continued)

Summary of Stock Option Activity

Employee Plan

The following table summarizes the activity of the Employee Plan during the three months ended June 30, 2006:

	Number of Stock Options (In thousands)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (In thousands)
Outstanding at March 31, 2006	6,472	$ 16.43		
Granted	927	$ 36.17		
Exercised	(248)	$ 19.45		
Forfeited	(28)	$ 22.05		
Outstanding at June 30, 2006	7,123	$ 18.87	5.95	$ 130,921
Exercisable at June 30, 2006	4,728	$ 14.42	5.66	$ 107,940

The aggregate intrinsic value represents the difference between the Company s closing stock price on June 30, 2006 of $37.25 and the weighted-average exercise price multiplied by the number of stock options outstanding as of that date. The total intrinsic value of stock options exercised during the three months ended June 30, 2006 was $4.5 million.

As of June 30, 2006, $24.7 million of total unrecognized compensation expense related to non-vested stock options is expected to be recognized over a weighted-average period of 3 years.

Directors Plan

The following table summarizes the activity of the Directors Plan during the three months ended June 30, 2006:

	Number of Stock Options (In thousands)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (In thousands)
Outstanding at March 31, 2006	522	$ 15.58		
Granted		$		
Exercised	(13)	$ 19.16		
Forfeited		$		
Outstanding at June 30, 2006	509	$ 15.49	5.52	$ 11,076

Exercisable at June 30, 2006	509	$	15.49	5.52	$	11,076

The total intrinsic value of stock options exercised during the three months ended June 30, 2006 was $205 thousand.

Since the stock options granted under the Directors Plan vest immediately upon grant, there were no non-vested stock options and no unrecognized compensation expense at June 30, 2006.

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(12) STOCK-BASED COMPENSATION - (Continued)

Employee Stock Purchase Plan

The Company has an Employee Stock Purchase Plan (the ESPP) to encourage and assist employees in acquiring an equity interest in the Company. The ESPP is authorized to issue up to 1.5 million shares of Company common stock, of which 106 thousand was available for issuance at June 30, 2006. Based on the limited number of shares remaining under the ESPP, the Company is seeking approval from its stockholders at the 2006 Annual Meeting of Stockholders for an amended and restated ESPP. If the amended and restated ESPP is approved, the ESPP will be authorized to issue up to 3.5 million shares of Company common stock.

Under the terms of the ESPP, 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. Employee purchases are limited in any calendar year to an aggregate market value of $25,000. Market value under the ESPP is defined as either the closing share price on the New York Stock Exchange as of an employee s enrollment date or the closing price on the first business day of a fiscal quarter when the shares are purchased, whichever is lower. An employee may lock-in a purchase price for up to 12 months. The ESPP effectively resets at the beginning of each fiscal year at which time employees are re-enrolled in the plan and a new 12-month purchase price is established. The ESPP is designed to comply with the requirements of Sections 421 and 423 of the Internal Revenue Code. During the three months ended June 30, 2006 and 2005, the Company granted 94 thousand and 533 thousand options to purchase common stock under the ESPP, respectively. Should the stockholders approve the amended and restated ESPP, employees will receive a new enrollment date and a new purchase price.

Compensation expense under SFAS 123 is measured based on the fair value of the employees option to purchase shares of common stock at the grant date and is recognized over the future periods in which the related employee service is rendered. The fair value per share of options granted under the ESPP was $8.36 and $5.57 for the three months ended June 30, 2006 and 2005, respectively. In the three months ended June 30, 2006, the Company recognized stock-based compensation expense associated with the ESPP of $785 thousand. The fair value of the employees option to purchase shares of common stock was estimated using the Black-Scholes model. The following assumptions were used by the Company in valuing the employees option to purchase shares of common stock under the ESPP:

	Three Months Ended June 30,	
	2006	**2005**
Expected volatility	29.7%	27.1%
Expected dividend yield	0.59%	0.90%
Expected term	3 months	3 to 12 months
Risk-free interest rate	4.6%	3.1%

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(12) STOCK-BASED COMPENSATION - (Continued)

The following table summarizes the activity of the ESPP during the three months ended June 30, 2006:

(In thousands)	Number of Purchase Options	Exercise Price	Aggregate Intrinsic Value
Outstanding at March 31, 2006	138	$ 20.14	
Granted	94	$ 32.17	
Exercised	(138)	$ 20.14	
Forfeited		$	
Outstanding at June 30, 2006	94	$ 32.17	$ 478

(13) COMMITMENTS, CONTINGENCIES AND UNCERTAINTIES

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.

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(14) SUMMARY BY BUSINESS SEGMENT

As disclosed in Note (1) *Basis of Presentation* and Note (3) *Acquisition and Divestiture,* the Company sold its subsidiary Rutland Tool, which was previously reported in the Distribution segment in December 2005. For the three months ended June 30, 2005, the operating results of Rutland Tool have been reclassified in the Consolidating Statement of Earnings as discontinued operations. Information related to the Company s continuing operations by business segment for the three months ended June 30, 2006 and 2005 is as follows:

	Three Months Ended June 30, 2006				Three Months Ended June 30, 2005			
(In thousands)	**Dist.**	**All Other Ops.**	**Elim**	**Combined**	**Dist.**	**All Other Ops.**	**Elim**	**Combined**
Gas and rent	$ 332,004	$ 117,183	$ (14,486)	$ 434,701	$ 299,857	$ 92,680	$ (13,617)	$ 378,920
Hardgoods	317,249	22,602	(1,516)	338,335	281,661	18,811	(1,267)	299,205
Total net sales	649,253	139,785	(16,002)	773,036	581,518	111,491	(14,884)	678,125
Cost of products sold, excluding deprec. expense	331,595	67,626	(16,002)	383,219	296,958	52,789	(14,884)	334,863
Selling, distribution and administrative expenses	229,883	46,094		275,977	212,084	37,765		249,849
Depreciation expense	25,825	7,337		33,162	22,813	6,297		29,110
Amortization expense	1,309	463		1,772	1,161	138		1,299
Operating income	60,641	18,265		78,906	48,502	14,502		63,004

(15) SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest and income taxes was as follows:

	Three Months Ended June 30,	
(In thousands)	**2006**	**2005**
Interest paid	$ 15,687	$ 15,910
Discount on securitization	3,289	1,801
Income taxes (net of refunds)	2,790	51

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(15) SUPPLEMENTAL CASH FLOW INFORMATION - (Continued)

Cash flows, in excess of a management fee, associated with the Company s consolidated affiliate, National Welders, are not available for the general use of the Company. Rather these cash flows are used by National Welders for operations, capital expenditures, acquisitions, and to satisfy financial obligations, which are non-recourse to the Company. The following reflects the sources and uses of cash associated with National Welders for each period presented:

	Three Months Ended June 30,	
(In thousands)	**2006**	**2005**
Net cash provided by operating activities	$ 7,601	$ 3,638
Net cash used in investing activities	(2,722)	(3,880)
Net cash provided by (used in) financing activities	(4,434)	273
Change in cash	445	31
Management fee paid to the Company, which is eliminated in consolidation	331	298

(16) SUBSEQUENT EVENTS

Debt Refinancing

Effective July 25, 2006, the Company amended and restated its senior credit facility with a syndicate of lenders dated January 15, 2005, (the 2005 Agreement), which would have matured on January 14, 2010 and permitted the Company to borrow up to $430 million. The new $1.6 billion unsecured senior credit facility (the Credit Agreement) consists of a US$966 million and a C$40 million (US$34 million) revolving credit lines and two deferred draw term loans totaling $600 million. The Company intends to use borrowings under the revolving credit lines for working capital, acquisitions and general corporate purposes. A $100 million term loan may only be used to refinance the Company s 7.75% medium-term notes due on September 15, 2006. A $500 million term loan may only be used to finance certain contemplated acquisitions. If the contemplated acqui