

Kraton Performance Polymers, Inc.
Form 10-Q
August 01, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2013

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

Commission File Number 001-34581

KRATON PERFORMANCE POLYMERS, INC.

(Exact Name of Registrant as Specified in its Charter)

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Delaware
(State or other jurisdiction of
incorporation or organization)

15710 John F. Kennedy Blvd.

Suite 300

Houston, TX 77032
(Address of principal executive offices, including zip code)

20-0411521
(I.R.S. Employer

Identification No.)

281-504-4700
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer:

Accelerated filer:

Non-accelerated filer:

Smaller reporting company:

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). YES NO

Number of shares of Kraton Performance Polymers, Inc. Common Stock, \$0.01 par value, outstanding as of July 26, 2013: 32,528,011.

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on Form 10-Q for

Quarter Ended June 30, 2013

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

Some of the statements in this Quarterly Report on Form 10-Q under the headings "Condensed Consolidated Financial Statements" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. We may also make written or oral forward-looking statements in our periodic reports on Forms 10-K, 10-Q and 8-K, in press releases and other written materials and in oral statements made by our officers, directors or employees to third parties. Statements that are not historical facts, including statements about our beliefs and expectations, are forward-looking statements. Forward-looking statements are often characterized by the use of words such as "believes," "estimates," "expects," "projects," "may," "intends," "plans" or "anticipates," or by discussions of strategy, plans or intentions; anticipated benefits of or performance of our products; beliefs regarding opportunities for new, high-margin applications and other innovations; adequacy of cash flows to fund our working capital requirements; our investment in the joint venture with FPCC; debt payments, interest payments, capital expenditures, benefit plan contributions, and income tax obligations; our anticipated 2013 capital expenditures, compliance with the MACT rule, health, safety and environmental and infrastructure and maintenance projects, projects to optimize the production capabilities of our manufacturing assets and to support our innovation platform; our ability to meet conditions required to ensure full access to our senior secured credit facilities; expectations regarding our counterparties' ability to perform, including with respect to trade receivables; estimates regarding the tax expense of repatriating certain cash and short-term investments related to foreign operations; expectations regarding high-margin applications; our ability to realize certain deferred tax assets and our beliefs with respect to tax positions; expectations regarding our full year effective tax rate; our plans and expectations regarding our Asia expansion project; estimates related to the useful lives of certain assets for tax purposes; expectations regarding our pension contributions for fiscal year 2013; estimates or expectations related to monomer costs, ending inventory levels and related estimated charges; the outcome and financial impact of legal proceedings; expectations regarding the spread between FIFO and ECRC in future periods; and projections regarding environmental costs and capital expenditures and related operational savings. Such forward-looking statements involve known and unknown risks, uncertainties, and other important factors that could cause the actual results, performance or our achievements, or industry results, to differ materially from historical results, any future results, or performance or achievements expressed or implied by such forward-looking statements. There are a number of risks and uncertainties that could cause our actual results to differ materially from the forward-looking statements contained in this report. Further description of these risks and uncertainties and other important factors are set forth in this report, in our latest Annual Report on Form 10-K, including but not limited to Part I, Item 1A. Risk Factors and Part II, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations therein, and in our other filings with the Securities and Exchange Commission, and include, but are not limited to, risks related to:

conditions in the global economy and capital markets;

our reliance on LyondellBasell Industries for the provision of significant operating and other services;

the failure of our raw materials suppliers to perform their obligations under long-term supply agreements, or our inability to replace or renew these agreements when they expire;

limitations in the availability of raw materials we need to produce our products in the amounts or at the prices necessary for us to effectively and profitably operate our business;

significant fluctuations in raw material costs may result in volatility in our quarterly operating results and impact the market price of our common stock;

competition in our end use markets by other producers of styrenic block copolymers and by producers of products that can be substituted for our products;

our ability to produce and commercialize technological innovations;

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our ability to protect our intellectual property, on which our business is substantially dependent;

the possibility that our products infringe upon the intellectual property rights of others;

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seasonality in our business, particularly in our Paving and Roofing end use market;

our substantial indebtedness, which could adversely affect our financial condition and prevent us from fulfilling our obligations under the loan agreement and the senior notes;

financial and operating constraints related to our indebtedness;

the inherently hazardous nature of chemical manufacturing;

product liability claims and other lawsuits arising from environmental damage, personal injuries, other damages associated with chemical manufacturing or our products;

political, economic and local business risks in the various countries in which we operate;

health, safety and environmental laws, including laws that govern our employees' exposure to chemicals deemed harmful to humans;

regulation of our company or our customers, which could affect the demand for our products or result in increased compliance and other costs;

customs, international trade, export control, antitrust, zoning and occupancy and labor and employment laws that could require us to modify our current business practices and incur increased costs;

fluctuations in currency exchange rates;

we may have additional tax liabilities;

our formation of a joint venture to expand HSBC capacity in Asia is subject to risks and uncertainties;

our relationship with our employees;

loss of key personnel or our inability to attract and retain new qualified personnel;

the fact that we generally do not enter into long-term contracts with our customers;

a decrease in the fair value of our pension assets could require us to materially increase future funding requirements of the pension plan;

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domestic or international natural disasters or terrorist attacks may disrupt our operations;

Delaware law and some provisions of our organizational documents that make a takeover of our company more difficult;

our expectation that we will not pay dividends for the foreseeable future; and

we are a holding company with nominal net worth and will depend on dividends and distributions from our subsidiaries to pay any dividends.

There may be other factors of which we are currently unaware or that we deem immaterial that may cause our actual results to differ materially from the expectations we express in our forward-looking statements. Although we believe the assumptions underlying our forward-looking statements are reasonable, any of these assumptions, and, therefore, also the forward-looking statements based on these assumptions could themselves prove to be inaccurate.

Forward-looking statements are based on current plans, estimates, assumptions and projections, and therefore you should not place undue reliance on them. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update them publicly in light of new information or future events.

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Presentation of Financial Statements

The terms Kraton, our company, we, our, ours and us as used in this report refer collectively to Kraton Performance Polymers, Inc. and its consolidated subsidiaries. This Form 10-Q includes financial statements and related notes that present the condensed consolidated financial position, results of operations, comprehensive income, and cash flows of Kraton and its subsidiaries. Kraton is a holding company whose only material asset is its investment in its wholly owned subsidiary, Kraton Polymers LLC. Kraton Polymers LLC and its subsidiaries own all of our consolidated operating assets.

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements.****KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited)****(In thousands, except par value)**

| | June 30, 2013 | December 31, 2012 |
|---|--------------------------|------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 88,669 | \$ 223,166 |
| Receivables, net of allowances of \$502 and \$401 | 163,681 | 124,635 |
| Inventories of products | 336,622 | 340,323 |
| Inventories of materials and supplies | 10,730 | 10,331 |
| Deferred income taxes | 8,117 | 7,869 |
| Other current assets | 27,439 | 28,363 |
| Total current assets | 635,258 | 734,687 |
| Property, plant and equipment, less accumulated depreciation of \$330,881 and \$311,779 | 387,883 | 381,205 |
| Intangible assets, less accumulated amortization of \$73,546 and \$68,531 | 60,222 | 63,393 |
| Investment in unconsolidated joint venture | 13,231 | 13,582 |
| Debt issuance costs | 10,257 | 10,846 |
| Deferred income taxes | 344 | 79 |
| Other long-term assets | 25,339 | 25,397 |
| Total assets | \$ 1,132,534 | \$ 1,229,189 |
| LIABILITIES AND EQUITY | | |
| Current liabilities: | | |
| Current portion of long-term debt | \$ 0 | \$ 15,074 |
| Accounts payable-trade | 97,468 | 99,167 |
| Other payables and accruals | 39,132 | 50,978 |
| Deferred income taxes | 464 | 513 |
| Due to related party | 21,165 | 16,080 |
| Total current liabilities | 158,229 | 181,812 |
| Long-term debt, net of current portion | 351,066 | 432,943 |
| Deferred income taxes | 21,101 | 22,273 |
| Other long-term liabilities | 102,529 | 99,946 |
| Total liabilities | 632,925 | 736,974 |
| Commitments and contingencies (note 10) | | |
| Equity: | | |
| Kraton stockholders' equity: | | |
| Preferred stock, \$0.01 par value; 100,000 shares authorized; none issued | 0 | 0 |

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| | | |
|---|------------------|------------------|
| Common stock, \$0.01 par value; 500,000 shares authorized; 32,528 shares issued and outstanding at June 30, 2013; 32,277 shares issued and outstanding at December 31, 2012 | 325 | 323 |
| Additional paid in capital | 359,795 | 354,957 |
| Retained earnings | 171,526 | 171,445 |
| Accumulated other comprehensive loss | (47,144) | (34,510) |
| Total Kraton stockholders' equity | 484,502 | 492,215 |
| Noncontrolling interest | 15,107 | 0 |
| Total equity | 499,609 | 492,215 |
| Total liabilities and equity | \$ 1,132,534 | \$ 1,229,189 |

See Notes to Condensed Consolidated Financial Statements

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)****(In thousands, except per share data)**

| | Three months ended | | Six months ended | |
|--|---------------------------|------------------|-------------------------|------------------|
| | June 30, | | June 30, | |
| | 2013 | 2012 | 2013 | 2012 |
| Sales revenue | \$ 334,543 | \$ 375,756 | \$ 674,650 | \$ 784,069 |
| Cost of goods sold | 274,682 | 302,276 | 554,878 | 635,070 |
| Gross profit | 59,861 | 73,480 | 119,772 | 148,999 |
| Operating expenses: | | | | |
| Research and development | 8,446 | 7,996 | 16,359 | 15,556 |
| Selling, general and administrative | 25,004 | 26,313 | 51,118 | 52,776 |
| Depreciation and amortization | 15,741 | 15,885 | 30,839 | 31,734 |
| Total operating expenses | 49,191 | 50,194 | 98,316 | 100,066 |
| Earnings of unconsolidated joint venture | 121 | 163 | 255 | 300 |
| Interest expense, net | 5,909 | 7,773 | 19,207 | 14,472 |
| Income before income taxes | 4,882 | 15,676 | 2,504 | 34,761 |
| Income tax expense | 905 | 3,269 | 2,351 | 6,001 |
| Consolidated net income | 3,977 | 12,407 | 153 | 28,760 |
| Net income attributable to noncontrolling interest | 148 | 0 | 72 | 0 |
| Net income attributable to Kraton | \$ 3,829 | \$ 12,407 | \$ 81 | \$ 28,760 |
| Earnings per common share: | | | | |
| Basic | \$ 0.12 | \$ 0.38 | \$ 0.00 | \$ 0.89 |
| Diluted | \$ 0.12 | \$ 0.38 | \$ 0.00 | \$ 0.89 |
| Weighted average common shares outstanding: | | | | |
| Basic | 32,073 | 31,930 | 32,068 | 31,919 |
| Diluted | 32,378 | 32,172 | 32,391 | 32,209 |

See Notes to Condensed Consolidated Financial Statements.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)****(Unaudited)****(In thousands)**

| | Three months ended June 30, | | Six months ended June 30, | |
|--|--|-------------|--------------------------------------|-------------|
| | 2013 | 2012 | 2013 | 2012 |
| Net income attributable to Kraton | \$ 3,829 | \$ 12,407 | \$ 81 | \$ 28,760 |
| Other comprehensive loss: | | | | |
| Foreign currency translation adjustments, net of tax of \$0 | (3,975) | (23,371) | (13,246) | (13,045) |
| (Increase) decrease in unrealized loss of interest rate swaps, net of tax of \$0 | 0 | (17) | 837 | (134) |
| Increase in unrealized gain (loss) of net investment hedge, net of tax of \$0 | 0 | 1,803 | (225) | 1,803 |
| Other comprehensive loss, net of tax | (3,975) | (21,585) | (12,634) | (11,376) |
| Comprehensive income (loss) attributable to Kraton | (146) | (9,178) | (12,553) | 17,384 |
| Comprehensive loss attributable to noncontrolling interest | (291) | 0 | (67) | 0 |
| Consolidated comprehensive income (loss) | \$ (437) | \$ (9,178) | \$ (12,620) | \$ 17,384 |

See Notes to Condensed Consolidated Financial Statements

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY****(Unaudited)****(In thousands)**

| | Common Stock | Additional Paid in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Kraton Stockholders Equity | Noncontrolling Interest | Total Equity |
|--|-------------------------|---|------------------------------|--|---|------------------------------------|-------------------------|
| Balance at December 31, 2011 | \$ 321 | \$ 347,455 | \$ 187,636 | \$ (17,618) | \$ 517,794 | \$ 0 | \$ 517,794 |
| Net income | 0 | 0 | 28,760 | 0 | 28,760 | 0 | 28,760 |
| Other comprehensive loss | 0 | 0 | 0 | (11,376) | (11,376) | 0 | (11,376) |
| Exercise of stock options | 1 | 259 | 0 | 0 | 260 | 0 | 260 |
| Non-cash compensation related to equity awards | 0 | 3,737 | 0 | 0 | 3,737 | 0 | 3,737 |
| Balance at June 30, 2012 | \$ 322 | \$ 351,451 | \$ 216,396 | \$ (28,994) | \$ 539,175 | \$ 0 | \$ 539,175 |
| Balance at December 31, 2012 | \$ 323 | \$ 354,957 | \$ 171,445 | \$ (34,510) | \$ 492,215 | \$ 0 | \$ 492,215 |
| Net income | 0 | 0 | 81 | 0 | 81 | 72 | 153 |
| Other comprehensive loss | 0 | 0 | 0 | (12,634) | (12,634) | (139) | (12,773) |
| Consolidation of variable interest entity | 0 | 0 | 0 | 0 | 0 | 15,174 | 15,174 |
| Exercise of stock options | 2 | 308 | 0 | 0 | 310 | 0 | 310 |
| Non-cash compensation related to equity awards | 0 | 4,530 | 0 | 0 | 4,530 | 0 | 4,530 |
| Balance at June 30, 2013 | \$ 325 | \$ 359,795 | \$ 171,526 | \$ (47,144) | \$ 484,502 | \$ 15,107 | \$ 499,609 |

See Notes to Condensed Consolidated Financial Statements

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)****(In thousands)**

| | Six months ended June 30, | |
|--|--------------------------------------|-------------|
| | 2013 | 2012 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Consolidated net income | \$ 153 | \$ 28,760 |
| Adjustments to reconcile consolidated net income to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 30,839 | 31,734 |
| Amortization of debt premium | (76) | 0 |
| Amortization of debt issuance costs | 6,304 | 1,451 |
| (Gain) loss on property, plant and equipment | (115) | 415 |
| Earnings from unconsolidated joint venture, net of dividends received | 167 | 100 |
| Deferred income tax benefit | (1,531) | (502) |
| Share-based compensation | 4,530 | 3,737 |
| <i>Decrease (increase) in:</i> | | |
| Accounts receivable | (42,338) | (44,466) |
| Inventories of products, materials and supplies | (1,224) | 7,154 |
| Other assets | (1,818) | (848) |
| <i>Increase (decrease) in:</i> | | |
| Accounts payable-trade | (1,836) | 24,763 |
| Other payables and accruals | (8,880) | (1,004) |
| Other long-term liabilities | 3,188 | 622 |
| Due to related party | 8,188 | 16,822 |
| Net cash provided by (used in) operating activities | (4,449) | 68,738 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Purchase of property, plant and equipment | (34,742) | (22,548) |
| Purchase of software | (1,945) | (2,109) |
| Settlement of net investment hedge | (2,225) | 2,854 |
| Net cash used in investing activities | (38,912) | (21,803) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Proceeds from debt | 40,000 | 101,250 |
| Repayments of debt | (136,875) | (3,750) |
| Capital lease payments | (950) | 0 |
| Contribution from noncontrolling interest | 15,174 | 0 |
| Proceeds from the exercise of stock options | 310 | 260 |
| Debt issuance costs | (4,794) | (2,728) |
| Net cash provided by (used in) financing activities | (87,135) | 95,032 |
| Effect of exchange rate differences on cash | (4,001) | (2,584) |
| Net increase (decrease) in cash and cash equivalents | (134,497) | 139,383 |
| Cash and cash equivalents, beginning of period | 223,166 | 88,579 |

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| | | |
|---|-----------|------------|
| Cash and cash equivalents, end of period | \$ 88,669 | \$ 227,962 |
| Supplemental disclosures: | | |
| Cash paid during the period for income taxes, net of refunds received | \$ 5,463 | \$ 10,913 |
| Cash paid during the period for interest, net of capitalized interest | \$ 13,170 | \$ 11,050 |
| Capitalized interest | \$ 1,940 | \$ 1,131 |
| Supplemental non-cash disclosures: | | |
| Capital accruals | \$ 5,298 | \$ 2,842 |
| Capital lease liability included in accounts payable | \$ 1,950 | \$ 0 |

See Notes to Condensed Consolidated Financial Statements

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KRATON PERFORMANCE POLYMERS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. General

Description of our Business. We are a leading global producer of styrenic block copolymers (SBCs) and other engineered polymers. We market our products under the Kraton[®], Cariflex[™] and NEXAR[™] brands. SBCs are highly-engineered synthetic elastomers, which we invented and commercialized almost 50 years ago, that enhance the performance of numerous end use products by imparting greater flexibility, resilience, strength, durability and processability. Our polymers are typically formulated or compounded with other products to achieve improved, customer-specific performance characteristics in a variety of applications. We seek to maximize the value of our product portfolio by emphasizing complex or specialized polymers and innovations that yield higher margins. We sometimes refer to these complex or specialized polymers or innovations as being more differentiated. Our products are found in many everyday applications, including personal care products such as disposable diapers and the rubberized grips of toothbrushes, razor blades and power tools. Our products are also used to impart tack and shear properties in a wide variety of adhesive products and to impart characteristics such as flexibility and durability in sealants and corrosion resistance in coatings. Our paving and roofing applications provide durability, extending road and roof life. We also produce Cariflex isoprene rubber and isoprene rubber latex. Our Cariflex products are highly-engineered, non-SBC synthetic substitutes for natural rubber and natural rubber latex. Our Cariflex products, which have not been found to contain the proteins present in natural rubber latex and are, therefore, not known to cause allergies, are used in applications such as surgical gloves and condoms. We believe the versatility of Cariflex provides opportunities for new, high-margin applications.

In addition to Cariflex, we have a portfolio of innovations at various stages of development and commercialization, including

polyvinyl chloride alternatives for wire, cable and medical applications;

polymers for slush molded automotive and faux leather applications;

our NEXAR family of membrane polymers for water filtration and breathable fabrics; and

synthetic cement formulations and other oilfield applications.

We manufacture our polymers at five manufacturing facilities globally, including our flagship facility in Belpre, Ohio, as well as facilities in Germany, France, Brazil and Japan. The facility in Japan is operated by an unconsolidated manufacturing joint venture. The terms Kraton, our company, we, our, ours and us as used in this report refer collectively to Kraton Performance Polymers, Inc. and its consolidated subsidiaries.

Basis of Presentation. The accompanying unaudited condensed consolidated financial statements presented herein are for us and our consolidated subsidiaries, each of which is a wholly-owned subsidiary, except our 50% investment in our joint venture, Kraton Formosa Polymers Corporation (KFPC), located in Mailiao, Taiwan. KFPC is a variable interest entity for which we have determined that we are the primary beneficiary and, therefore, have consolidated into our financial statements. Our 50% investment in our joint venture located in Kashima, Japan is accounted for under the equity method of accounting. All significant intercompany transactions have been eliminated. These interim financial statements should be read in conjunction with the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2012 and reflect all normal recurring adjustments that are, in the opinion of management, necessary to fairly present our results of operations and financial position. Amounts reported in our Condensed Consolidated Statements of Operations are not necessarily indicative of amounts expected for the respective annual periods or any other interim period, in particular due to the effect of seasonal changes and weather conditions that typically affect our sales into our Paving and Roofing end use market.

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Our significant accounting policies have been disclosed in Note 1 *Description of Business, Basis of Presentation and Significant Accounting Policies* in our most recent Annual Report on Form 10-K. There have been no changes to the policies disclosed therein. The accompanying unaudited condensed consolidated financial statements we present in this report have been prepared in accordance with those policies.

Use of Estimates. The preparation of condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Significant items subject to such estimates and assumptions include

the useful lives of fixed assets;

allowances for doubtful accounts and sales returns;

the valuation of derivatives, deferred tax assets, property, plant and equipment, inventory, investments and share-based compensation; and

liabilities for employee benefit obligations, asset retirement obligations (ARO), income tax uncertainties and other contingencies.

Income Tax in Interim Periods. We conduct operations in separate legal entities in different jurisdictions. As a result, income tax amounts are reflected in these condensed consolidated financial statements for each of those jurisdictions. Tax laws and tax rates vary substantially in these jurisdictions and are subject to change based on the political and economic climate in those countries. We file our tax returns in accordance with our interpretations of each jurisdiction's tax laws. We record our tax provision or benefit on an interim basis using the estimated annual effective tax rate. This rate is applied to the current period ordinary income or loss to determine the income tax provision or benefit allocated to the interim period.

Losses from jurisdictions for which no benefit can be realized and the income tax effects of unusual and infrequent items are excluded from the estimated annual effective tax rate. Valuation allowances are provided against the future tax benefits that arise from the losses in jurisdictions for which no benefit can be realized. The effects of unusual and infrequent items are recognized in the impacted interim period as discrete items.

The estimated annual effective tax rate may be significantly affected by nondeductible expenses and by our projected earnings mix by tax jurisdiction. Adjustments to the estimated annual effective income tax rate are recognized in the period during which such estimates are revised.

We have established valuation allowances against a variety of deferred tax assets, including net operating loss carryforwards, foreign tax credits and other income tax credits. Valuation allowances take into consideration our ability to realize these deferred tax assets and reduce the value of such assets to the amount that is deemed more likely than not to be recoverable. Our ability to realize these deferred tax assets is dependent on achieving our forecast of future taxable operating income over an extended period of time. We review our forecast in relation to actual results and expected trends on a quarterly basis. If we fail to achieve our operating income targets, we may change our assessment regarding the recoverability of our net deferred tax assets and such change could result in a valuation allowance being recorded against some or all of our net deferred tax assets. A change in our valuation allowance would impact our income tax expense/benefit and our stockholders' equity and could have a significant impact on our results of operations or financial condition in future periods.

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We have implemented all new accounting pronouncements that are in effect and that management believes would materially impact our financial statements. Management does not believe that there are any other new accounting pronouncements that have been issued that may have a material impact on our financial position or results of operations.

3. Share-Based Compensation

We account for share-based awards under the provisions of ASC 718, *Compensation Stock Compensation*. Accordingly, share-based compensation cost is measured at the grant date based on the fair value of the award and we expense these costs using the straight-line method over the requisite service period. Share-based compensation expense was \$2.0 million and \$1.9 million for the three months ended June 30, 2013 and 2012, respectively, and \$4.5 million and \$3.7 million for the six months ended June 30, 2013 and 2012, respectively. We have historically recorded these costs in selling, general and administrative expenses; however, beginning in the second quarter of 2013, a portion of these costs were recorded in cost of goods sold and research and development expenses.

4. Detail of Certain Balance Sheet Accounts

| | June 30, 2013 | December 31, 2012 |
|---|--------------------|----------------------|
| | (In thousands) | |
| <i>Inventories of products:</i> | | |
| Finished products | \$ 245,465 | \$ 260,510 |
| Work in progress | 6,818 | 6,759 |
| Raw materials | 84,339 | 73,054 |
| Total inventories of products | \$ 336,622 | \$ 340,323 |
| <i>Other payables and accruals:</i> | | |
| Employee related | \$ 11,836 | \$ 13,423 |
| Income taxes payable | 119 | 3,638 |
| Other | 27,177 | 33,917 |
| Total other payables and accruals | \$ 39,132 | \$ 50,978 |
| <i>Other long-term liabilities:</i> | | |
| Pension and other postretirement benefits | \$ 85,474 | \$ 84,005 |
| Other | 17,055 | 15,941 |
| Total other long-term liabilities | \$ 102,529 | \$ 99,946 |
| <i>Accumulated other comprehensive loss:</i> | | |
| Foreign currency translation adjustments | \$ 13,710 | \$ 26,956 |
| Net unrealized loss on interest rate swaps | 0 | (837) |
| Net unrealized loss on net investment hedge | (1,661) | (1,436) |
| Pension liability | (59,193) | (59,193) |
| Total accumulated other comprehensive loss | \$ (47,144) | \$ (34,510) |

Table of Contents**5. Earnings Per Share (EPS)**

Basic EPS is computed by dividing net income attributable to Kraton by the weighted-average number of shares outstanding during the period.

Diluted EPS is computed by dividing net income attributable to Kraton by the diluted weighted-average number of shares outstanding during the period and, accordingly, reflects the potential dilution that could occur if securities or other agreements to issue common stock, such as stock options, were exercised, settled or converted into common stock and were dilutive. The diluted weighted-average number of shares used in our diluted EPS calculation is determined using the treasury stock method.

Unvested awards of share-based payments with rights to receive dividends or dividend equivalents, such as our restricted stock awards, are considered to be participating securities, and therefore, the two-class method is used for purposes of calculating EPS. Under the two-class method, a portion of net income is allocated to these participating securities and is excluded from the calculation of EPS allocated to common stock. Our restricted stock awards are subject to forfeiture and restrictions on transfer until vested and have identical voting, income and distribution rights to the unrestricted common shares outstanding.

The computation of diluted EPS excludes the effect of the potential exercise of stock options that are anti-dilutive. The number of stock options excluded from the computation was 872,406 and 760,087 for the three months ended June 30, 2013 and 2012, and 851,752 and 723,431 for the six months ended June 30, 2013 and 2012, respectively.

The effects of share-based compensation awards on the diluted weighted-average number of shares outstanding used in calculating diluted EPS are as follows:

| | Three months ended June 30, 2013 | | | Three months ended June 30, 2012 | | |
|---|--|--|--------------------------|--|--|--------------------------|
| | Net Income Attributable to Kraton (In thousands, except per share data) | Weighted Average Shares Outstanding | Earnings Per Share | Net Income Attributable to Kraton (In thousands, except per share data) | Weighted Average Shares Outstanding | Earnings Per Share |
| <i>Basic:</i> | | | | | | |
| As reported | \$ 3,829 | 32,528 | | \$ 12,407 | 32,241 | |
| Amounts allocated to unvested restricted shares | (54) | (455) | | (120) | (311) | |
| Amounts available to common stockholders | 3,775 | 32,073 | \$ 0.12 | 12,287 | 31,930 | \$ 0.38 |
| <i>Diluted:</i> | | | | | | |
| Amounts allocated to unvested restricted shares | 54 | 455 | | 120 | 311 | |
| Non participating share units | 0 | 125 | | 0 | 29 | |
| Stock options added under the treasury stock method | 0 | 180 | | 0 | 213 | |
| Amounts reallocated to unvested restricted shares | (53) | (455) | | (119) | (311) | |
| Amounts available to stockholders and assumed conversions | \$ 3,776 | 32,378 | \$ 0.12 | \$ 12,288 | 32,172 | \$ 0.38 |

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| | Six months ended June 30, 2013 | | | Six months ended June 30, 2012 | | |
|---|--|--|--------------------------|--|--|--------------------------|
| | Net Income Attributable to Kraton (In thousands, except per share data) | Weighted Average Shares Outstanding | Earnings Per Share | Net Income Attributable to Kraton (In thousands, except per share data) | Weighted Average Shares Outstanding | Earnings Per Share |
| <i>Basic:</i> | | | | | | |
| As reported | \$ 81 | 32,443 | | \$ 28,760 | 32,191 | |
| Amounts allocated to unvested restricted shares | (1) | (375) | | (243) | (272) | |
| Amounts available to common stockholders | 80 | 32,068 | \$ 0.00 | 28,517 | 31,919 | \$ 0.89 |
| <i>Diluted:</i> | | | | | | |
| Amounts allocated to unvested restricted shares | 1 | 375 | | 243 | 272 | |
| Non participating share units | 0 | 92 | | 0 | 29 | |
| Stock options added under the treasury stock method | 0 | 231 | | 0 | 261 | |
| Amounts reallocated to unvested restricted shares | (1) | (375) | | (241) | (272) | |
| Amounts available to stockholders and assumed conversions | \$ 80 | 32,391 | \$ 0.00 | \$ 28,519 | 32,209 | \$ 0.89 |

6. Long-Term Debt

Long-term debt consists of the following:

| | June 30, 2013 | December 31, 2012 |
|--|------------------|----------------------|
| | (In thousands) | |
| Term loans | \$ 0 | \$ 96,875 |
| 6.75% unsecured notes | 351,066 | 351,142 |
| Total long-term debt | 351,066 | 448,017 |
| Less current portion of long-term debt | 0 | 15,074 |
| Long-term debt, less current portion | \$ 351,066 | \$ 432,943 |

Senior Secured Credit Facilities. In March 2013, we entered into an asset-based revolving credit facility consisting of a \$150.0 million U.S. senior secured revolving credit facility and a \$100.0 million Dutch senior secured revolving credit facility (the Senior Secured Credit Facilities). The Senior Secured Credit Facilities replaced our then existing senior secured credit facility, and we repaid in full all outstanding amounts payable under the previously existing indebtedness. Borrowing under the Senior Secured Credit Facilities is subject to borrowing base limitations based on the level of receivables and inventory available for security.

We may request up to an aggregate of \$100.0 million of additional revolving facility commitments of which up to an aggregate of \$40.0 million may be additional Dutch revolving facility commitments, provided that we satisfy additional conditions described in the Senior Secured Credit Facilities, and provided further that the U.S. revolver commitment is at least 60% of the commitments after giving effect to such increase.

Kraton Polymers U.S. LLC and Kraton Polymers Nederland B.V. are the borrowers under the Senior Secured Credit Facilities, and Kraton Performance Polymers, Inc., Kraton Polymers LLC, Elastomers Holdings LLC and Kraton Polymers Capital Corporation are guarantors. The Senior Secured Credit Facilities are secured

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by receivables and inventory. The Senior Secured Credit Facilities terminate on March 27, 2018; however, we may from time to time request that the lenders extend the maturity of their commitments. Availability under the Senior Secured Credit Facilities is limited to the lesser of the borrowing base and total commitments (less certain reserves).

U.S. borrowings under the Senior Secured Credit Facilities (other than swingline loans) bear interest at a rate equal to, at the applicable borrower's option, either (a) a base rate determined by reference to the greater of (1) the prime rate of Bank of America, N.A., (2) the federal funds rate plus 0.50% and (3) LIBOR plus 1.0%, or (b) a rate based on LIBOR, in each case plus an applicable margin. U.S. swingline loans shall bear interest at a base rate determined by reference to the greater of (1) the prime rate of Bank of America, N.A., (2) the federal funds rate plus 0.50% or (3) LIBOR plus 1.0%, in each case plus an applicable margin.

Dutch borrowings under the Senior Secured Credit Facilities bear interest at a rate equal to, at the applicable borrower's option, either (a) a fluctuating rate, with respect to Euros, Pounds Sterling and Dollars outside of the U.S. and Canada, equal to the rate announced by the European Central Bank and used as a base rate by the local branch of Bank of America in the jurisdiction in which such currency is funded, or (b) a rate based on LIBOR, in each case plus an applicable margin. The applicable margin is subject to a minimum of 0.5% and a maximum of 1.0% with respect to U.S. base rate loans, and a minimum of 1.5% and maximum of 2.0% for foreign base rate borrowings and LIBOR loans and is subject to adjustment based on the borrower's excess availability of the applicable facility for the most recent fiscal quarter.

In addition to paying interest on outstanding principal amounts under the Senior Secured Credit Facilities, the borrowers will be required to pay a commitment fee in respect of the unutilized commitments at an annual rate of 0.375%.

The Senior Secured Credit Facilities contain a financial covenant that if either (a) excess availability is less than the greater of (i) 12.5% of the lesser of the commitments and the borrowing base and (ii) \$31,250,000 or (b) U.S. availability is less than the greater of (i) 12.5% of the lesser of the U.S. commitments and U.S. borrowing base and (ii) \$18,750,000, then following such event, Kraton and its restricted subsidiaries must maintain a fixed charge coverage ratio of at least 1.0 to 1.0 for four fiscal quarters (or for a shorter duration if certain financial conditions are met). The Senior Secured Credit Facilities contain certain customary events of default, including, without limitation, a failure to make payments under the facility, cross-default and cross-judgment default, certain bankruptcy events and certain change of control events.

As of June 30, 2013, our available borrowing capacity was \$206.2 million of which \$0.0 million was drawn. As of the date of this filing, our available borrowing capacity was \$201.9 million, of which \$0.0 million was drawn.

6.75% Senior Notes due 2019. Kraton Polymers LLC and its wholly-owned financing subsidiary Kraton Polymers Capital Corporation issued \$350.0 million aggregate principal amount of 6.75% senior notes that mature on March 1, 2019 pursuant to an indenture, dated February 11, 2011 (\$250.0 million senior notes) and supplemental indenture thereto dated March 20, 2012 (\$100.0 million senior notes). The indenture provides that the notes are general unsecured, senior obligations and will be unconditionally guaranteed on a senior unsecured basis. We pay interest on the notes at 6.75% per annum, semi-annually in arrears on March 1 and September 1 of each year.

Debt Maturities. The remaining principal payments on our outstanding total debt as of June 30, 2013, are as follows:

| | Principal Payments (In thousands) |
|---------------------|--|
| December 31: | |
| 2019 | 350,000 |
| Total debt | \$ 350,000 |

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See Note 8 *Fair Value Measurements, Financial Instruments and Credit Risk* for fair value information related to our long-term debt.

7. Debt Issuance Costs

We capitalize the debt issuance costs related to issuing long-term debt and amortize these costs using the effective interest method, except for costs related to revolving debt, which are amortized using the straight-line method. We had net debt issuance costs of \$12.4 million and \$13.9 million (of which \$2.2 million and \$3.1 million were included in other current assets) as of June 30, 2013 and December 31, 2012, respectively. In connection with the March 2013 refinancing of our indebtedness, we charged to interest expense \$5.0 million of unamortized debt issuance costs related to our previously existing indebtedness and we capitalized \$4.8 million of debt issuance costs related to our new indebtedness. We amortized \$0.5 million and \$0.8 million of debt issuance costs for the three months ended June 30, 2013 and 2012, respectively, and \$1.3 million (which excludes the \$5.0 million of accelerated amortization) and \$1.5 million of debt issuance costs for the six months ended June 30, 2013 and 2012, respectively.

8. Fair Value Measurements, Financial Instruments and Credit Risk

ASC 820, *Fair Value Measurements and Disclosures* defines fair value, establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. ASC 820 requires entities to, among other things, maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

ASC 820 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

ASC 820 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our market assumptions.

In accordance with ASC 820, these two types of inputs have created the following fair value hierarchy:

Level 1 Inputs that are quoted prices (unadjusted) for identical assets or liabilities in active markets;

Level 2 Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the asset or liability, including:

Quoted prices for similar assets or liabilities in active markets

Quoted prices for identical or similar assets or liabilities in markets that are not active

Inputs other than quoted prices that are observable for the asset or liability

Inputs that are derived principally from or corroborated by observable market data by correlation or other means; and

Level 3 Inputs that are unobservable and reflect our assumptions used in pricing the asset or liability based on the best information available under the circumstances (e.g., internally derived assumptions surrounding the timing and amount of expected cash flows). *Recurring Fair Value Measurements.* The following tables set forth by level within the fair value hierarchy our financial assets and liabilities that were accounted for at fair value on a recurring basis as of June 30, 2013 and December 31, 2012. These financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Our assessment of the significance of a particular input to the fair value measurement requires judgment, which judgment may affect the valuation of their fair value and their

placement within the fair value hierarchy levels.

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| | Balance Sheet Location | June 30, 2013 | Fair Value Measurements at Reporting Date Using Quoted Prices | | |
|----------------------------------|-----------------------------|------------------|---|---|---|
| | | | in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | | | (In thousands) | | |
| Retirement plan asset noncurrent | Other long-term assets | 1,519 | 1,519 | 0 | 0 |
| Derivative liability current | Other payables and accruals | (135) | 0 | (135) | 0 |
| Total | | \$ 1,384 | \$ 1,519 | \$ (135) | \$ 0 |

| | Balance Sheet Location | December 31, 2012 | Fair Value Measurements at Reporting Date Using Quoted Prices | | |
|----------------------------------|-----------------------------|----------------------|---|---|---|
| | | | in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | | | (In thousands) | | |
| Derivative asset current | Other current assets | \$ 34 | \$ 0 | \$ 34 | \$ 0 |
| Retirement plan asset noncurrent | Other long-term assets | 860 | 860 | 0 | 0 |
| Derivative liability current | Other payables and accruals | (578) | 0 | (578) | 0 |
| Derivative liability noncurrent | Other long-term liabilities | (258) | 0 | (258) | 0 |
| Total | | \$ 58 | \$ 860 | \$ (802) | \$ 0 |

The use of derivatives creates exposure to credit risk relating to potential losses that could be recognized in the event that the counterparties to these instruments fail to perform their obligations under the contracts. We seek to minimize this risk by limiting our counterparties to major financial institutions with acceptable credit ratings and monitoring the total value of positions with individual counterparties. In the event of a default by one of our counterparties, we may not receive payments provided for under the terms of our derivatives.

The following table presents the carrying values and approximate fair values of our long-term debt as of June 30, 2013 and December 31, 2012:

| | June 30, 2013 | | December 31, 2012 | |
|-----------------------|----------------|------------|-------------------|------------|
| | Carrying Value | Fair Value | Carrying Value | Fair Value |
| | (In thousands) | | | |
| Term loans | \$ 0 | \$ 0 | \$ 96,875 | \$ 96,875 |
| 6.75% unsecured notes | \$ 351,066 | \$ 353,500 | \$ 351,142 | \$ 364,000 |

The term loans are variable interest rate instruments, and as such, the fair value approximates their carrying value.

Financial Instruments

Interest Rate Swap Agreements. Periodically, we enter into interest rate swap agreements to hedge or otherwise protect against interest rate fluctuations on a portion of our variable rate debt. These interest rate swap agreements are designated as cash flow hedges on our exposure to the variability of future cash flows.

In June 2011, we entered into a \$75.0 million notional amount interest rate swap agreement with respect to a portion of our outstanding term loans. This agreement was effective on July 15, 2011 and was set to expire on June 15, 2014. However, on March 27, 2013, in connection with the refinancing of our credit facility, we terminated and settled the interest rate swap agreement, and as a result, recognized \$0.7 million of

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interest expense for the three months ended March 31, 2013. We recorded an unrealized loss of \$0.1 million in accumulated other comprehensive loss related to the effective portion of this interest rate swap agreement for the three months ended March 31, 2012.

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Fair Value Hedges. In April 2012, we entered into a series of non-deliverable forward contracts to reduce our exposure to fluctuations in the Canadian dollar (CAD) against the U.S. dollar in connection with the funding of certain capital expenditures. These non-deliverable forward contracts qualified for hedge accounting and were designated as fair value hedges in accordance with ASC 815-25 *Fair Value Hedges*. The non-deliverable forward contracts outstanding as of June 30, 2013 had notional amounts of CAD \$2.5 million and CAD \$1.6 million with settlement dates of September 9, 2013 and October 8, 2013, respectively. These hedges were effective in offsetting our exposure to the CAD and therefore the \$0.1 million loss on the hedge was offset by the \$0.1 million gain on the exposure associated with the funding of our semi-works facility for the three and six months ended June 30, 2013, and the \$0.2 million loss on the hedge was offset by the \$0.2 million gain on the exposure to the CAD for the three and six months ended June 30, 2012.

Net Investment Hedges. During 2012, we entered into a series of non-deliverable forward and foreign currency option contracts to protect our net investment in our European subsidiaries against adverse changes in exchange rates by fixing the U.S. dollar/Euro exchange rate. The notional amounts of these contracts ranged from 50.0 million to 100.0 million with all contracts expiring after thirty days. In June 2013, we entered into a 11.6 million notional amount non-deliverable forward contract to protect our net investment in our subsidiary in Taiwan against adverse changes in exchange rates by fixing the TWD/Euro exchange rate. These contracts qualify for hedge accounting and were designated as net investment hedges in accordance with ASC 815-35 *Net Investment Hedges*. We recorded in accumulated other comprehensive loss an aggregate \$0.2 million loss related to the settlement of the effective portion of these contracts during the six months ended June 30, 2013. We recorded in accumulated other comprehensive loss an aggregate \$1.8 million gain related to the settlement of the effective portion of these contracts during the three and six months ended June 30, 2012.

Foreign Currency Hedges. Periodically, we enter into foreign currency agreements to hedge or otherwise protect against fluctuations in foreign currency exchange rates. These agreements typically do not qualify for hedge accounting and gains/losses resulting from both the up-front premiums and/or settlement of the hedges at expiration of the agreements are recognized in the period in which they are incurred. During the six months ended June 30, 2013 and 2012, we entered into a series of foreign currency option and forward contracts to reduce our exposure to exchange rate volatility. The contracts were structured such that the underlying foreign currency exchange gains/losses would be offset by the mark-to-market impact of the hedging instruments and reduce the impact of foreign currency exchange movements throughout the period. These contracts did not qualify for hedge accounting. For the three months ended June 30, 2013 and 2012, we settled these hedges and recorded an aggregate loss of \$0.06 million and a gain of \$0.03 million, respectively. For the six months ended June 30, 2013 and 2012, we recorded an aggregate loss of \$1.8 million and a gain of \$1.1 million, respectively. In all periods, the gains or losses on settlement of these hedges offset the underlying foreign currency exchange gains and losses recorded in cost of goods sold.

Credit Risk

We analyze the counterparties' financial condition prior to extending credit and we establish credit limits and monitor the appropriateness of those limits on an ongoing basis. We also obtain cash, letters of credit or other acceptable forms of security from customers to provide credit support, where appropriate, based on our financial analysis of the customer and the contractual terms and conditions applicable to each transaction.

9. Income Taxes

Our income tax expense was \$0.9 million and \$3.3 million for the three months ended June 30, 2013 and 2012 and \$2.4 million and \$6.0 million for the six months ended June 30, 2013 and 2012, respectively. Our effective tax rate was 18.5%, and 20.9% for the three months ended June 30, 2013 and 2012 and 93.9%, and 17.3% for the six months ended June 30, 2013 and 2012, respectively. Our effective tax rates differed from the U.S. corporate statutory tax rate of 35.0%, primarily due to the mix of pre-tax income or loss earned in certain jurisdictions and the change in our valuation allowance.

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As of June 30, 2013 and December 31, 2012, a valuation allowance of \$94.7 million and \$90.4 million, respectively, has been provided for net operating loss carryforwards and other deferred tax assets. We record a valuation allowance when it is more likely than not that some portion, or all, of the deferred tax assets will not be realized. We decreased our valuation allowance by \$3.1 million and \$0.1 million for the three months ended June 30, 2013 and 2012, respectively, which represents the utilization of net operating losses. We increased our valuation allowance by \$4.3 million for the six months ended June 30, 2013, of which \$4.5 million represents current period net operating losses, partially offset by \$0.2 million that represents changes in other comprehensive income (loss). We decreased our valuation allowance by \$0.2 million for the six months ended June 30, 2012, which represents the utilization of net operating losses. Excluding the change in our valuation allowance, our effective tax rate would have been 81.1% and 21.6% for the three months ended June 30, 2013 and 2012, respectively, and a 88.1% benefit and 18.0% expense for the six months ended June 30, 2013 and 2012, respectively, primarily due to the mix of pre-tax income or loss earned in certain tax jurisdictions.

As of June 30, 2013 and December 31, 2012, we had total unrecognized tax benefits of \$6.2 million and \$5.1 million, respectively, related to uncertain foreign tax positions, all of which, if recognized, would impact our effective tax rate. During the three months ended June 30, 2013 and 2012, we had an increase in uncertain tax positions of \$0.6 million and \$0.3 million, respectively, and \$1.1 million during the six months ended June 30, 2013 and 2012, primarily related to uncertain tax positions in Europe. We recorded interest and penalties related to unrecognized tax benefits within our provision for income taxes. We believe that no current tax positions that have resulted in unrecognized tax benefits will significantly increase or decrease within one year.

We file income tax returns in the U.S. federal jurisdiction and in various state and foreign jurisdictions. For our U.S. federal income tax returns, the statute of limitations has expired through the tax year ended December 31, 2003. As a result of net operating loss carryforwards from 2004, the statute of limitations remains open for all years subsequent to 2003. In addition, open tax years for state and foreign jurisdictions remain subject to examination.

10. Commitments and Contingencies

Legal Proceedings. We received notice from the tax authorities in Brazil assessing R\$ 5.9 million in connection with tax credits that were generated from the purchase of certain goods. The credits were subsequently applied against taxes owed. The tax authorities assert that the goods purchased were not eligible to earn a credit. We have appealed this assessment and contend that the tax credits were earned. While the outcome of this proceeding cannot be predicted with certainty, we do not expect this matter to have a material adverse effect upon our financial position, results of operations or cash flows.

We and certain of our subsidiaries, from time to time, are parties to various other legal proceedings, claims and disputes that have arisen in the ordinary course of business. These claims may involve significant amounts, some of which would not be covered by insurance. A substantial settlement payment or judgment in excess of our accruals could have a material adverse effect on our financial position, results of operations or cash flows. While the outcome of these proceedings cannot be predicted with certainty, our management does not expect any of these existing matters, individually or in the aggregate, to have a material adverse effect upon our financial position, results of operations or cash flows.

Asset Retirement Obligations.

The changes in the aggregate carrying amount of our ARO liability are as follows:

| | ARO Liability (In thousands) |
|------------------------------|---|
| Balance at December 31, 2012 | \$ 9,837 |
| Accretion expense | 251 |
| Foreign currency translation | (63) |
| Balance at June 30, 2013 | \$ 10,025 |

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There have been no other material changes to our Commitments and Contingencies disclosed in our most recently filed Annual Report on Form 10-K.

11. Employee Benefits

Retirement Plans. The components of net periodic benefit cost related to U.S. pension benefits are as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|------------------------------------|--------------------------------|----------|------------------------------|----------|
| | 2013 | 2012 | 2013 | 2012 |
| | (in thousands) | | (in thousands) | |
| Service cost | \$ 762 | \$ 765 | \$ 1,700 | \$ 1,590 |
| Interest cost | 1,385 | 1,438 | 2,795 | 2,791 |
| Expected return on plan assets | (1,650) | (1,493) | (3,305) | (2,991) |
| Amortization of prior service cost | 858 | 735 | 1,865 | 1,365 |
| Net periodic benefit cost | \$ 1,355 | \$ 1,445 | \$ 3,055 | \$ 2,755 |

We made contributions of \$2.6 million and \$3.3 million to our pension plan in the six months ended June 30, 2013 and 2012, respectively.

The components of net periodic benefit cost related to other post-retirement benefits are as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|------------------------------------|--------------------------------|--------|------------------------------|----------|
| | 2013 | 2012 | 2013 | 2012 |
| | (in thousands) | | (in thousands) | |
| Service cost | \$ 145 | \$ 128 | \$ 290 | \$ 256 |
| Interest cost | 293 | 305 | 585 | 610 |
| Amortization of prior service cost | 182 | 150 | 364 | 300 |
| Net periodic benefit cost | \$ 620 | \$ 583 | \$ 1,239 | \$ 1,166 |

12. Industry Segment and Foreign Operations

We operate in one segment for the manufacturing and marketing of engineered polymers. In accordance with the provisions of ASC 280, *Segment Reporting*, our chief operating decision-maker has been identified as the President and Chief Executive Officer, who reviews operating results to make decisions about allocating resources and assessing performance for the entire company. Since we operate in one segment and in one group of similar products, all financial segment and product line information required by ASC 280 can be found in the condensed consolidated financial statements.

We manufacture our products along the following primary product lines based upon polymer chemistry and process technologies:

un-hydrogenated SBCs (USBCs);

hydrogenated SBCs (HSBCs);

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Cariflex isoprene rubber and isoprene rubber latex; and

compounds.

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Sales revenue for our four primary product lines is as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|-----------|--------------------------------|------------|------------------------------|------------|
| | 2013 | 2012 | 2013 | 2012 |
| | (in thousands) | | (in thousands) | |
| USBCs | \$ 192,543 | \$ 218,908 | \$ 389,316 | \$ 462,100 |
| HSBCs | 104,937 | 118,145 | 213,031 | 250,521 |
| Cariflex | 29,244 | 29,805 | 56,273 | 52,450 |
| Compounds | 7,544 | 8,666 | 15,448 | 17,114 |
| Other | 275 | 232 | 582 | 1,884 |
| | \$ 334,543 | \$ 375,756 | \$ 674,650 | \$ 784,069 |

For geographic reporting, sales revenue is attributed to the geographic location in which the customers' facilities are located. Long-lived assets consist primarily of property, plant and equipment, which are attributed to the geographic location in which they are located and are presented at historical cost.

Sales revenue and long-lived assets by geographic region are as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|---------------------|--------------------------------|------------|------------------------------|------------|
| | 2013 | 2012 | 2013 | 2012 |
| | (in thousands) | | (in thousands) | |
| Sales revenue: | | | | |
| United States | \$ 100,929 | \$ 122,089 | \$ 214,237 | \$ 272,339 |
| Germany | 42,304 | 50,583 | 85,685 | 100,200 |
| Japan | 20,080 | 21,834 | 37,131 | 41,196 |
| China | 17,503 | 20,072 | 36,193 | 39,917 |
| Brazil | 12,984 | 11,666 | 26,881 | 25,820 |
| Italy | 10,927 | 10,407 | 23,398 | 24,501 |
| France | 11,361 | 12,792 | 23,195 | 26,827 |
| Belgium | 12,432 | 11,589 | 23,114 | 25,594 |
| United Kingdom | 10,285 | 11,225 | 20,759 | 23,088 |
| Thailand | 10,182 | 13,651 | 20,164 | 21,632 |
| The Netherlands | 6,577 | 7,502 | 16,214 | 20,792 |
| Malaysia | 7,385 | 4,435 | 13,138 | 10,115 |
| Turkey | 5,914 | 9,108 | 11,590 | 18,777 |
| Taiwan | 3,493 | 3,248 | 9,939 | 10,040 |
| Mexico | 4,809 | 3,178 | 9,683 | 6,448 |
| Canada | 4,919 | 5,154 | 9,679 | 10,598 |
| Sweden | 5,499 | 5,396 | 9,572 | 8,706 |
| Argentina | 4,246 | 2,988 | 8,911 | 7,773 |
| South Korea | 3,936 | 3,959 | 7,159 | 8,389 |
| Australia | 4,143 | 5,664 | 6,985 | 8,780 |
| Austria | 4,344 | 5,204 | 6,070 | 10,155 |
| Poland | 2,385 | 7,420 | 3,811 | 10,121 |
| All other countries | 27,906 | 26,592 | 51,142 | 52,261 |
| | \$ 334,543 | \$ 375,756 | \$ 674,650 | \$ 784,069 |

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| | June 30, 2013 | December 31, 2012 |
|-----------------------------|-------------------|----------------------|
| | (In thousands) | |
| Long-lived assets, at cost: | | |
| United States | \$ 418,222 | \$ 411,969 |
| France | 118,955 | 118,275 |
| Brazil | 77,083 | 79,585 |
| Germany | 58,109 | 55,581 |
| Netherlands | 24,063 | 15,255 |
| Taiwan | 9,321 | 0 |
| China | 6,973 | 5,906 |
| Japan | 1,733 | 1,978 |
| All other countries | 4,305 | 4,435 |
| | \$ 718,764 | \$ 692,984 |

13. Related Party Transactions

We own a 50% equity investment in a SBC manufacturing joint venture with JSR Corporation (JSR) under the name of Kraton JSR Elastomers K.K. (KJE) located in Kashima, Japan. We and JSR separately, but with equal rights, participate in distributions in the sales of the thermoplastic rubber produced by KJE.

The aggregate amounts of related-party transactions were as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|------------------------------|--------------------------------|-----------|------------------------------|-----------|
| | 2013 | 2012 | 2013 | 2012 |
| | (in thousands) | | (in thousands) | |
| Purchases from related party | \$ 10,054 | \$ 12,792 | \$ 22,725 | \$ 30,670 |

Our due to related party is solely related to our commercial arrangement associated with KJE, which requires payment by each party within 150 days of invoice.

14. Variable Interest Entity

In February 2013, we executed definitive agreements providing for a 50/50 joint venture with Formosa Petrochemical Corporation (FPCC) to build, own and operate a 30 kiloton HSBC plant at FPCC s petrochemical site in Mailiao, Taiwan. The joint venture company, Kraton Formosa Polymers Corporation (KFPC), is a Taiwan entity with each of Kraton and FPCC having equal representation on the board. Both Kraton and FPCC made an initial investment of approximately \$15.2 million at inception. We have exclusive rights to purchase all production from KFPC. Additionally, we will be obligated to purchase a minimum volume each year, with the minimum obligation increasing over the first three years the plant is operational. As such, we have determined that we are the primary beneficiary of this variable interest entity and, therefore, have consolidated KFPC in our financial statements as of and for the six months ended June 30, 2013 and have reflected FPCC s ownership as a noncontrolling interest.

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The following table summarizes the fair value of KFPC assets and liabilities as of February 27, 2013 recorded upon initial consolidation in our condensed consolidated balance sheet and the carrying amounts of such assets and liabilities as of June 30, 2013, before intercompany eliminations.

| | June 30, 2013 | February 27, 2013 |
|-------------------------------|--------------------------|------------------------------|
| | (In thousands) | |
| Cash and cash equivalents | \$ 21,287 | \$ 30,348 |
| Other current assets | 191 | 0 |
| Property, plant and equipment | 9,318 | 0 |
| Intangible assets | 10,115 | 0 |
| Total assets | \$ 40,911 | \$ 30,348 |
| Current liabilities | 10,698 | 0 |
| Total liabilities | \$ 10,698 | \$ 0 |

15. Supplemental Guarantor Information

Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, (the Issuers), are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Performance Polymers, Inc. and Elastomers Holdings LLC, a U.S. holding company and wholly-owned subsidiary of Kraton Polymers LLC, collectively, (the Guarantors), fully and unconditionally guarantee on a joint and several basis, the Issuers obligations under the 6.75% senior notes. Our remaining subsidiaries are not guarantors of the 6.75% senior notes. We do not believe that separate financial statements and other disclosures concerning the guarantor subsidiaries would provide any additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING BALANCE SHEET****June 30, 2013****(Unaudited)****(In thousands, except par value)**

| | Kraton | Kraton Polymers LLC (1) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|-------------------|-------------------------------|---------------------------|-------------------------------|-----------------------|---------------------|
| ASSETS | | | | | | |
| Current assets: | | | | | | |
| Cash and cash equivalents | \$ 0 | \$ 0 | \$ 19,024 | \$ 69,645 | \$ 0 | \$ 88,669 |
| Receivables, net of allowances of \$502 | 0 | 36 | 54,606 | 109,039 | 0 | 163,681 |
| Inventories of products | 0 | 0 | 198,442 | 138,180 | 0 | 336,622 |
| Inventories of materials and supplies | 0 | 0 | 8,553 | 2,177 | 0 | 10,730 |
| Deferred income taxes | 0 | 0 | 5,768 | 2,349 | 0 | 8,117 |
| Other current assets | 0 | 4,151 | 1,915 | 21,373 | 0 | 27,439 |
| Total current assets | 0 | 4,187 | 288,308 | 342,763 | 0 | 635,258 |
| Property, plant and equipment, less accumulated depreciation of \$330,881 | 0 | 51,892 | 217,904 | 118,087 | 0 | 387,883 |
| Intangible assets, less accumulated amortization of \$73,546 | 0 | 37,631 | 22,516 | 75 | 0 | 60,222 |
| Investment in consolidated subsidiaries | 531,646 | 1,297,788 | 0 | 0 | (1,829,434) | 0 |
| Investment in unconsolidated joint venture | 0 | 813 | 0 | 12,418 | 0 | 13,231 |
| Debt issuance costs | 0 | 6,633 | 2,162 | 1,462 | 0 | 10,257 |
| Deferred income taxes | 0 | 0 | 0 | 344 | 0 | 344 |
| Other long-term assets | 0 | 1,448 | 534,847 | 89,534 | (600,490) | 25,339 |
| Total assets | \$ 531,646 | \$ 1,400,392 | \$ 1,065,737 | \$ 564,683 | \$ (2,429,924) | \$ 1,132,534 |
| LIABILITIES AND STOCKHOLDERS AND MEMBER S EQUITY | | | | | | |
| Current liabilities: | | | | | | |
| Accounts payable-trade | 0 | 940 | 44,886 | 51,642 | 0 | 97,468 |
| Other payables and accruals | 0 | 7,875 | 16,754 | 14,503 | 0 | 39,132 |
| Deferred income taxes | 0 | 0 | 0 | 464 | 0 | 464 |
| Due to related party | 0 | 0 | 0 | 21,165 | 0 | 21,165 |
| Total current liabilities | 0 | 8,815 | 61,640 | 87,774 | 0 | 158,229 |
| Long-term debt, net of current portion | 0 | 351,066 | 0 | 0 | 0 | 351,066 |
| Deferred income taxes | 0 | 11,391 | 5,770 | 3,940 | 0 | 21,101 |
| Other long-term liabilities | 0 | 498,043 | 91,521 | 113,455 | (600,490) | 102,529 |
| Total liabilities | 0 | 869,315 | 158,931 | 205,169 | (600,490) | 632,925 |
| Commitments and contingencies (note 10) | | | | | | |
| Stockholders and member s equity: | | | | | | |
| Preferred stock, \$0.01 par value; 100,000 shares authorized; none issued | 0 | 0 | 0 | 0 | 0 | 0 |
| Common stock, \$0.01 par value; 500,000 shares authorized; 32,528 shares issued and outstanding | 325 | 0 | 0 | 0 | 0 | 325 |
| Additional paid in capital | 359,795 | 0 | 0 | 0 | 0 | 359,795 |
| Member s equity | 0 | 531,646 | 959,893 | 337,895 | (1,829,434) | 0 |
| Retained earnings | 171,526 | 0 | 0 | 0 | 0 | 171,526 |
| Accumulated other comprehensive income (loss) | 0 | (569) | (53,087) | 6,512 | 0 | (47,144) |
| Kraton stockholders and member s equity | 531,646 | 531,077 | 906,806 | 344,407 | (1,829,434) | 484,502 |

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| | | | | | | |
|--|----------------|----------------|----------------|----------------|--------------------|----------------|
| Noncontrolling interest | 0 | 0 | 0 | 15,107 | 0 | 15,107 |
| Total stockholders and member s equity | 531,646 | 531,077 | 906,806 | 359,514 | (1,829,434) | 499,609 |
| Total liabilities and stockholders and member s equity | \$ 531,646 | \$ 1,400,392 | \$ 1,065,737 | \$ 564,683 | \$ (2,429,924) | \$ 1,132,534 |

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING BALANCE SHEET****December 31, 2012****(In thousands, except par value)**

| | Kraton | Kraton Polymers LLC (1) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|-------------------|--|-----------------------------------|---------------------------------------|-----------------------|---------------------|
| ASSETS | | | | | | |
| Current assets: | | | | | | |
| Cash and cash equivalents | \$ 0 | \$ 0 | \$ 80,903 | \$ 142,263 | \$ 0 | \$ 223,166 |
| Receivables, net of allowances of \$401 | 0 | 426 | 44,728 | 79,481 | 0 | 124,635 |
| Inventories of products | 0 | 0 | 180,776 | 159,547 | 0 | 340,323 |
| Inventories of materials and supplies | 0 | 0 | 8,013 | 2,318 | 0 | 10,331 |
| Deferred income taxes | 0 | 0 | 5,768 | 2,101 | 0 | 7,869 |
| Other current assets | 0 | 3,787 | 691 | 23,885 | 0 | 28,363 |
| Total current assets | 0 | 4,213 | 320,879 | 409,595 | 0 | 734,687 |
| Property, plant and equipment, less accumulated depreciation of \$311,779 | 0 | 56,626 | 222,956 | 101,623 | 0 | 381,205 |
| Intangible assets, less accumulated amortization of \$68,531 | 0 | 41,056 | 22,337 | 0 | 0 | 63,393 |
| Investment in consolidated subsidiaries | 526,725 | 1,258,814 | 0 | 0 | (1,785,539) | 0 |
| Investment in unconsolidated joint venture | 0 | 813 | 0 | 12,769 | 0 | 13,582 |
| Debt issuance costs | 0 | 10,846 | 0 | 0 | 0 | 10,846 |
| Deferred income taxes | 0 | 0 | 0 | 79 | 0 | 79 |
| Other long-term assets | 0 | 1,500 | 480,756 | 193,141 | (650,000) | 25,397 |
| Total assets | \$ 526,725 | \$ 1,373,868 | \$ 1,046,928 | \$ 717,207 | \$ (2,435,539) | \$ 1,229,189 |
| LIABILITIES AND STOCKHOLDERS AND MEMBER S EQUITY | | | | | | |
| Current liabilities: | | | | | | |
| Current portion of long-term debt | \$ 0 | \$ 15,074 | \$ 0 | \$ 0 | \$ 0 | \$ 15,074 |
| Accounts payable-trade | 0 | 2,072 | 44,304 | 52,791 | 0 | 99,167 |
| Other payables and accruals | 0 | 8,995 | 21,744 | 20,239 | 0 | 50,978 |
| Due to related party | 0 | 0 | 0 | 16,080 | 0 | 16,080 |
| Deferred income taxes | 0 | 0 | 0 | 513 | 0 | 513 |
| Total current liabilities | 0 | 26,141 | 66,048 | 89,623 | 0 | 181,812 |
| Long-term debt, net of current portion | 0 | 432,943 | 0 | 0 | 0 | 432,943 |
| Deferred income taxes | 0 | 12,206 | 5,768 | 4,299 | 0 | 22,273 |
| Other long-term liabilities | 0 | 377,032 | 89,825 | 283,089 | (650,000) | 99,946 |
| Total liabilities | 0 | 848,322 | 161,641 | 377,011 | (650,000) | 736,974 |
| Commitments and contingencies (note 10) | | | | | | |
| Stockholders and member s equity: | | | | | | |
| Preferred stock, \$0.01 par value; 100,000 shares authorized; none issued | 0 | 0 | 0 | 0 | 0 | 0 |
| Common stock, \$0.01 par value; 500,000 shares authorized; 32,277 shares issued and outstanding | 323 | 0 | 0 | 0 | 0 | 323 |
| Additional paid in capital | 354,957 | 0 | 0 | 0 | 0 | 354,957 |
| Member s equity | 0 | 526,725 | 938,374 | 320,440 | (1,785,539) | 0 |
| Retained earnings | 171,445 | 0 | 0 | 0 | 0 | 171,445 |
| Accumulated other comprehensive income (loss) | 0 | (1,179) | (53,087) | 19,756 | 0 | (34,510) |
| Total stockholders and member s equity | 526,725 | 525,546 | 885,287 | 340,196 | (1,785,539) | 492,215 |

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| | | | | | | |
|---|------------|--------------|--------------|------------|----------------|--------------|
| Total liabilities and stockholders' and member's equity | \$ 526,725 | \$ 1,373,868 | \$ 1,046,928 | \$ 717,207 | \$ (2,435,539) | \$ 1,229,189 |
|---|------------|--------------|--------------|------------|----------------|--------------|

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS**

Three months ended June 30, 2013

(Unaudited)

(In thousands)

| | Kraton | Kraton Polymers LLC (1) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|--|----------|-------------------------------|---------------------------|-------------------------------|--------------|--------------|
| Sales revenue | \$ 0 | \$ 0 | \$ 164,643 | \$ 209,894 | \$ (39,994) | \$ 334,543 |
| Cost of goods sold | 0 | 231 | 124,242 | 190,203 | (39,994) | 274,682 |
| Gross profit (loss) | 0 | (231) | 40,401 | 19,691 | 0 | 59,861 |
| Operating expenses: | | | | | | |
| Research and development | 0 | 0 | 4,437 | 4,009 | 0 | 8,446 |
| Selling, general and administrative | 0 | 146 | 16,601 | 8,257 | 0 | 25,004 |
| Depreciation and amortization | 0 | 4,080 | 8,085 | 3,576 | 0 | 15,741 |
| Total operating expenses | 0 | 4,226 | 29,123 | 15,842 | 0 | 49,191 |
| Earnings in consolidated subsidiaries | 3,977 | 16,758 | 0 | 0 | (20,735) | 0 |
| Earnings of unconsolidated joint venture | 0 | 0 | 0 | 121 | 0 | 121 |
| Interest expense (income), net | 0 | 9,044 | (3,544) | 409 | 0 | 5,909 |
| Income before income taxes | 3,977 | 3,257 | 14,822 | 3,561 | (20,735) | 4,882 |
| Income tax expense (benefit) | 0 | (720) | 10 | 1,615 | 0 | 905 |
| Consolidated net income | 3,977 | 3,977 | 14,812 | 1,946 | (20,735) | 3,977 |
| Net income attributable to noncontrolling interest | 0 | 0 | 0 | 148 | 0 | 148 |
| Net income attributable to Kraton | \$ 3,977 | \$ 3,977 | \$ 14,812 | \$ 1,798 | \$ (20,735) | \$ 3,829 |

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS**

Three months ended June 30, 2012

(Unaudited)

(In thousands)

| | Kraton | Kraton Polymers LLC (1) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|--|-----------|-------------------------------|---------------------------|-------------------------------|--------------|--------------|
| Sales revenue | \$ 0 | \$ 0 | \$ 189,256 | \$ 233,540 | \$ (47,040) | \$ 375,756 |
| Cost of goods sold | 0 | (29) | 155,606 | 193,739 | (47,040) | 302,276 |
| Gross profit | 0 | 29 | 33,650 | 39,801 | 0 | 73,480 |
| Operating expenses: | | | | | | |
| Research and development | 0 | 0 | 4,827 | 3,169 | 0 | 7,996 |
| Selling, general and administrative | 0 | 0 | 17,907 | 8,406 | 0 | 26,313 |
| Depreciation and amortization | 0 | 4,080 | 8,863 | 2,942 | 0 | 15,885 |
| Total operating expenses | 0 | 4,080 | 31,597 | 14,517 | 0 | 50,194 |
| Earnings in consolidated subsidiaries | 12,407 | 25,865 | 0 | 0 | (38,272) | 0 |
| Earnings of unconsolidated joint venture | 0 | 0 | 0 | 163 | 0 | 163 |
| Interest expense (income), net | 0 | 9,673 | (3,457) | 1,557 | 0 | 7,773 |
| Income before income taxes | 12,407 | 12,141 | 5,510 | 23,890 | (38,272) | 15,676 |
| Income tax expense (benefit) | 0 | (266) | (902) | 4,437 | 0 | 3,269 |
| Net income | \$ 12,407 | \$ 12,407 | \$ 6,412 | \$ 19,453 | \$ (38,272) | \$ 12,407 |

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS**

Six months ended June 30, 2013

(Unaudited)

(In thousands)

| | Kraton | Kraton Polymers LLC (1) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|--|--------|-------------------------------|---------------------------|-------------------------------|--------------|--------------|
| Sales revenue | \$ 0 | \$ 0 | \$ 342,225 | \$ 413,445 | \$ (81,020) | \$ 674,650 |
| Cost of goods sold | 0 | 1,964 | 272,361 | 361,573 | (81,020) | 554,878 |
| Gross profit (loss) | 0 | (1,964) | 69,864 | 51,872 | 0 | 119,772 |
| Operating expenses: | | | | | | |
| Research and development | 0 | 0 | 8,780 | 7,579 | 0 | 16,359 |
| Selling, general and administrative | 0 | 148 | 35,572 | 15,398 | 0 | 51,118 |
| Depreciation and amortization | 0 | 8,159 | 15,619 | 7,061 | 0 | 30,839 |
| Total operating expenses | 0 | 8,307 | 59,971 | 30,038 | 0 | 98,316 |
| Earnings in consolidated subsidiaries | 153 | 34,544 | 0 | 0 | (34,697) | 0 |
| Earnings of unconsolidated joint venture | 0 | 0 | 0 | 255 | 0 | 255 |
| Interest expense (income), net | 0 | 24,934 | (7,120) | 1,393 | 0 | 19,207 |
| Income (loss) before income taxes | 153 | (661) | 17,013 | 20,696 | (34,697) | 2,504 |
| Income tax expense (benefit) | 0 | (814) | 21 | 3,144 | 0 | 2,351 |
| Consolidated net income | 153 | 153 | 16,992 | 17,552 | (34,697) | 153 |
| Net income attributable to noncontrolling interest | 0 | 0 | 0 | 72 | 0 | 72 |
| Net income attributable to Kraton | \$ 153 | \$ 153 | \$ 16,992 | \$ 17,480 | \$ (34,697) | \$ 81 |

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS**

Six months ended June 30, 2012

(Unaudited)

(In thousands)

| | Kraton | Kraton Polymers LLC (1) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|--|-----------|-------------------------------|---------------------------|-------------------------------|--------------|--------------|
| Sales revenue | \$ 0 | \$ 0 | \$ 395,477 | \$ 467,168 | \$ (78,576) | \$ 784,069 |
| Cost of goods sold | 0 | (1,085) | 325,619 | 389,112 | (78,576) | 635,070 |
| Gross profit | 0 | 1,085 | 69,858 | 78,056 | 0 | 148,999 |
| Operating expenses: | | | | | | |
| Research and development | 0 | 0 | 9,713 | 5,843 | 0 | 15,556 |
| Selling, general and administrative | 0 | 0 | 35,973 | 16,803 | 0 | 52,776 |
| Depreciation and amortization | 0 | 8,159 | 17,159 | 6,416 | 0 | 31,734 |
| Total operating expenses | 0 | 8,159 | 62,845 | 29,062 | 0 | 100,066 |
| Earnings in consolidated subsidiaries | 28,760 | 54,733 | 0 | 0 | (83,493) | 0 |
| Earnings of unconsolidated joint venture | 0 | 0 | 0 | 300 | 0 | 300 |
| Interest expense (income), net | 0 | 19,332 | (7,513) | 2,653 | 0 | 14,472 |
| Income before income taxes | 28,760 | 28,327 | 14,526 | 46,641 | (83,493) | 34,761 |
| Income tax expense (benefit) | 0 | (433) | (1,117) | 7,551 | 0 | 6,001 |
| Net income | \$ 28,760 | \$ 28,760 | \$ 15,643 | \$ 39,090 | \$ (83,493) | \$ 28,760 |

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING STATEMENT OF COMPREHENSIVE INCOME (LOSS)****Three months ended June 30, 2013****(Unaudited)****(In thousands)**

| | Kraton | Kraton Polymers LLC (1) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---------------|--|-----------------------------------|---------------------------------------|---------------------|---------------------|
| Net income attributable to Kraton | \$ 3,977 | \$ 3,977 | \$ 14,812 | \$ 1,798 | \$ (20,735) | \$ 3,829 |
| Other comprehensive income (loss): | | | | | | |
| Foreign currency translation adjustments, net of tax of \$0 | 0 | 104 | 0 | (4,079) | 0 | (3,975) |
| Other comprehensive income (loss), net of tax | 0 | 104 | 0 | (4,079) | 0 | (3,975) |
| Comprehensive income (loss) attributable to Kraton | 3,977 | 4,081 | 14,812 | (2,281) | (20,735) | (146) |
| Comprehensive loss attributable to noncontrolling interest | 0 | 0 | 0 | (291) | 0 | (291) |
| Consolidated comprehensive income (loss) | \$ 3,977 | \$ 4,081 | \$ 14,812 | \$ (2,572) | \$ (20,735) | \$ (437) |

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING STATEMENT OF COMPREHENSIVE INCOME (LOSS)****Three months ended June 30, 2012****(Unaudited)****(In thousands)**

| | Kraton | Kraton Polymers LLC (1) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|--|---------------|--|-----------------------------------|---------------------------------------|---------------------|---------------------|
| Net income attributable to Kraton | \$ 12,407 | \$ 12,407 | \$ 6,412 | \$ 19,453 | \$ (38,272) | \$ 12,407 |
| Other comprehensive income (loss): | | | | | | |
| Foreign currency translation adjustments, net of tax of \$0 | 0 | (2) | 0 | (23,369) | 0 | (23,371) |
| Increase in unrealized loss on interest rate swaps, net of tax of \$0 | 0 | (17) | 0 | 0 | 0 | (17) |
| Increase in unrealized gain of net investment hedge, net of tax of \$0 | 0 | 1,803 | 0 | 0 | 0 | 1,803 |
| Other comprehensive income (loss), net of tax | 0 | 1,784 | 0 | (23,369) | 0 | (21,585) |
| Consolidated comprehensive income (loss) | \$ 12,407 | \$ 14,191 | \$ 6,412 | \$ (3,916) | \$ (38,272) | \$ (9,178) |

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING STATEMENT OF COMPREHENSIVE INCOME**

Six months ended June 30, 2013

(Unaudited)

(In thousands)

| | Kraton | | | | | |
|--|---------------|-----------------------------|-----------------------------------|---------------------------------------|---------------------|---------------------|
| | Kraton | Polymers LLC (1) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
| Net income attributable to Kraton | \$ 153 | \$ 153 | \$ 16,992 | \$ 17,480 | \$ (34,697) | \$ 81 |
| Other comprehensive income (loss): | | | | | | |
| Foreign currency translation adjustments, net of tax of \$0 | 0 | (2) | 0 | (13,244) | 0 | (13,246) |
| Decrease in unrealized loss on interest rate swaps, net of tax of \$0 | 0 | 837 | 0 | 0 | 0 | 837 |
| Increase in unrealized loss of net investment hedge, net of tax of \$0 | 0 | (225) | 0 | 0 | 0 | (225) |
| Other comprehensive income (loss), net of tax | 0 | 610 | 0 | (13,244) | 0 | (12,634) |
| Comprehensive income attributable to Kraton | 153 | 763 | 16,992 | 4,236 | (34,697) | (12,553) |
| Comprehensive loss attributable to noncontrolling interest | 0 | 0 | 0 | (67) | 0 | (67) |
| Consolidated comprehensive income | \$ 153 | \$ 763 | \$ 16,992 | \$ 4,169 | \$ (34,697) | \$ (12,620) |

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING STATEMENT OF COMPREHENSIVE INCOME**

Six months ended June 30, 2012

(Unaudited)

(In thousands)

| | Kraton | Kraton Polymers LLC (1) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|--|---------------|--|-----------------------------------|---------------------------------------|---------------------|---------------------|
| Net income attributable to Kraton | \$ 28,760 | \$ 28,760 | \$ 15,643 | \$ 39,090 | \$ (83,493) | \$ 28,760 |
| Other comprehensive income (loss): | | | | | | |
| Foreign currency translation adjustments, net of tax of \$0 | 0 | (68) | (1) | (12,976) | 0 | (13,045) |
| Increase in unrealized loss on interest rate swaps, net of tax of \$0 | 0 | (134) | 0 | 0 | 0 | (134) |
| Increase in unrealized gain of net investment hedge, net of tax of \$0 | 0 | 1,803 | 0 | 0 | 0 | 1,803 |
| Other comprehensive income (loss), net of tax | 0 | 1,601 | (1) | (12,976) | 0 | (11,376) |
| Consolidated comprehensive income | \$ 28,760 | \$ 30,361 | \$ 15,642 | \$ 26,114 | \$ (83,493) | \$ 17,384 |

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS**

Six months ended June 30, 2013

(Unaudited)

(In thousands)

| | Kraton | Kraton Polymers LLC (1) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|--|---------------|--|-----------------------------------|---------------------------------------|---------------------|---------------------|
| Cash flows provided by (used in) operating activities | \$ 0 | \$ 2,851 | \$ (63,585) | \$ 56,285 | \$ 0 | \$ (4,449) |
| Cash flows provided by (used in) investing activities: | | | | | | |
| Repayments of intercompany loans | 0 | 80,705 | 0 | 0 | (80,705) | 0 |
| Purchase of property, plant and equipment | 0 | 0 | (9,412) | (25,330) | 0 | (34,742) |
| Purchase of software | 0 | 0 | (1,770) | (175) | 0 | (1,945) |
| Settlement of net investment hedge | 0 | (2,225) | 0 | 0 | 0 | (2,225) |
| Net cash provided by (used in) investing activities | 0 | 78,480 | (11,182) | (25,505) | (80,705) | (38,912) |
| Cash flows provided by (used in) financing activities: | | | | | | |
| Proceeds from debt | 0 | 0 | 40,000 | 0 | 0 | 40,000 |
| Repayments of debt | 0 | (96,875) | (40,000) | 0 | 0 | (136,875) |
| Capital lease payments | 0 | 0 | (950) | 0 | 0 | (950) |
| Cash contributions from member | 0 | 15,544 | 0 | (15,544) | 0 | 0 |
| Cash distributions to member | (310) | 0 | 0 | 310 | 0 | 0 |
| Contribution from noncontrolling interest | 0 | 0 | 0 | 15,174 | 0 | 15,174 |
| Proceeds from the exercise of stock options | 310 | 0 | 0 | 0 | 0 | 310 |
| Debt issuance costs | 0 | 0 | (3,310) | (1,484) | 0 | (4,794) |
| Proceeds from (repayments of) intercompany loans | 0 | 0 | 17,148 | (97,853) | 80,705 | 0 |
| Net cash provided by (used in) financing activities | 0 | (81,331) | 12,888 | (99,397) | 80,705 | (87,135) |
| Effect of exchange rate differences on cash | 0 | 0 | 0 | (4,001) | 0 | (4,001) |
| Net decrease in cash and cash equivalents | 0 | 0 | (61,879) | (72,618) | 0 | (134,497) |
| Cash and cash equivalents, beginning of period | 0 | 0 | 80,903 | 142,263 | 0 | 223,166 |
| Cash and cash equivalents, end of period | \$ 0 | \$ 0 | \$ 19,024 | \$ 69,645 | \$ 0 | \$ 88,669 |

- (1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

Table of Contents**KRATON PERFORMANCE POLYMERS, INC.****CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS**

Six months ended June 30, 2012

(Unaudited)

(In thousands)

| | Kraton | Kraton Polymers LLC (1) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---------------|--|-----------------------------------|---------------------------------------|---------------------|---------------------|
| Cash flows provided by (used in) operating activities | \$ 0 | \$ (17,459) | \$ 25,105 | \$ 61,092 | \$ 0 | \$ 68,738 |
| Cash flows used in investing activities: | | | | | | |
| Proceeds from intercompany loans | 0 | (80,427) | 0 | 0 | 80,427 | 0 |
| Purchase of property, plant and equipment | 0 | 0 | (17,253) | (5,295) | 0 | (22,548) |
| Purchase of software | 0 | 0 | (2,097) | (12) | 0 | (2,109) |
| Settlement of net investment hedge | 0 | 2,854 | 0 | 0 | 0 | 2,854 |
| Net cash used in investing activities | 0 | (77,573) | (19,350) | (5,307) | 80,427 | (21,803) |
| Cash flows provided by financing activities: | | | | | | |
| Proceeds from debt | 0 | 101,250 | 0 | 0 | 0 | 101,250 |
| Repayments of debt | 0 | (3,750) | 0 | 0 | 0 | (3,750) |
| Cash contributions from member | 0 | 260 | 0 | 0 | (260) | 0 |
| Cash distributions to member | (260) | 0 | 0 | 0 | 260 | 0 |
| Proceeds from the exercise of stock options | 260 | 0 | 0 | 0 | 0 | 260 |
| Debt issuance costs | 0 | (2,728) | 0 | 0 | 0 | (2,728) |
| Proceeds from intercompany loans | 0 | 0 | 55,016 | 25,411 | (80,427) | 0 |
| Net cash provided by financing activities | 0 | 95,032 | 55,016 | 25,411 | (80,427) | 95,032 |
| Effect of exchange rate differences on cash | 0 | 0 | 0 | (2,584) | 0 | (2,584) |
| Net increase in cash and cash equivalents | 0 | 0 | 60,771 | 78,612 | 0 | 139,383 |
| Cash and cash equivalents, beginning of period | 0 | 0 | 6,030 | 82,549 | 0 | 88,579 |
| Cash and cash equivalents, end of period | \$ 0 | \$ 0 | \$ 66,801 | \$ 161,161 | \$ 0 | \$ 227,962 |

(1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

16. Subsequent Events

We have evaluated significant events and transactions that occurred after the balance sheet date and determined that there were no events or transactions other than those disclosed above that would require recognition or disclosure in our condensed consolidated financial statements for the period ended June 30, 2013.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

INTRODUCTION

You should read the following discussion of our financial condition and results of operations with our audited consolidated financial statements and related notes thereto included in our Annual Report on Form 10-K as of and for the year ended December 31, 2012. This discussion contains forward-looking statements and involves numerous risks and uncertainties, including, but not limited to, the risk factors discussed in the Risk Factors section of our most recent Form 10-K, as well as in Factors Affecting Our Results of Operations and elsewhere in this Form 10-Q. Actual results may differ materially from those contained in any forward-looking statements.

OVERVIEW

We are a leading global producer of styrenic block copolymers (SBCs) and other engineered polymers. We market our products under the Kraton[®], Cariflex[™] and NEXAR[™] brands. SBCs are highly-engineered synthetic elastomers, which we invented and commercialized almost 50 years ago, that enhance the performance of numerous end use products by imparting greater flexibility, resilience, strength, durability and processability.

Our polymers are typically formulated or compounded with other products to achieve improved, customer-specific performance characteristics in a variety of applications. We seek to maximize the value of our product portfolio by emphasizing complex or specialized polymers and innovations that yield higher margins. We sometimes refer to these complex or specialized polymers or innovations as being more differentiated.

Our products are found in many everyday applications, including personal care products such as disposable diapers and the rubberized grips of toothbrushes, razor blades and power tools. Our products are also used to impart tack and shear properties in a wide variety of adhesive products and to impart characteristics such as, flexibility and durability in sealants and corrosion resistance in coatings. Our paving and roofing applications provide durability, extending road and roof life.

We also produce Cariflex isoprene rubber and isoprene rubber latex. Our Cariflex products are highly-engineered, non-SBC synthetic substitutes for natural rubber and natural rubber latex. Our Cariflex products, which have not been found to contain the proteins present in natural rubber latex and are, therefore, not known to cause allergies, are used in applications such as surgical gloves and condoms. We believe the versatility of Cariflex provides opportunities for new, high margin applications.

In addition to Cariflex, we have a portfolio of innovations at various stages of development and commercialization, including

polyvinyl chloride alternatives for wire, cable and medical applications;

polymers for slush molded automotive and faux leather applications;

our NEXAR family of membrane polymers for water filtration and breathable fabrics; and

synthetic cement formulations and other oilfield applications.

Our products are manufactured along the following primary product lines based upon polymer chemistry and process technologies:

un-hydrogenated SBCs (USBCs);

hydrogenated SBCs (HSBCs);

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Cariflex isoprene rubber (IR) and isoprene rubber latex (IRL); and

compounds.

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The majority of worldwide SBC production is dedicated to USBCs, which are primarily used in paving and roofing, adhesives, sealants and coatings and footwear applications. HSBCs, which are significantly more complex and capital-intensive to manufacture than USBCs, are primarily used in more differentiated applications, such as soft touch and flexible materials, personal hygiene products, medical products, automotive components and certain adhesives and sealant applications.

| Product Line Sales Revenue: | Three months ended June 30, | | Six months ended June 30, | |
|-----------------------------|--------------------------------|-------|------------------------------|-------|
| | 2013 | 2012 | 2013 | 2012 |
| USBCs | 57.5% | 58.3% | 57.7% | 58.9% |
| HSBCs | 31.4% | 31.4% | 31.6% | 32.0% |
| Cariflex | 8.7% | 7.9% | 8.3% | 6.7% |
| Compounds | 2.3% | 2.3% | 2.3% | 2.2% |
| Other | 0.1% | 0.1% | 0.1% | 0.2% |

| End Use Markets | Three months ended June 30, | | Six months ended June 30, | |
|----------------------------------|--------------------------------|-------|------------------------------|-------|
| | 2013 | 2012 | 2013 | 2012 |
| Advanced Materials | 27.2% | 27.2% | 27.8% | 26.6% |
| Adhesives, Sealants and Coatings | 37.7% | 35.9% | 38.2% | 36.3% |
| Paving and Roofing | 26.3% | 28.9% | 25.6% | 30.2% |
| Cariflex | 8.7% | 7.9% | 8.3% | 6.7% |
| Other | 0.1% | 0.1% | 0.1% | 0.2% |

2013 Second Quarter Financial Overview

Sales volume was 77.5 kilotons in the second quarter of 2013 compared to 77.2 kilotons in the second quarter of 2012, an increase of 0.3%.

Sales revenue decreased \$41.2 million in the second quarter of 2013 compared to the second quarter of 2012, primarily due to decreases in global product sales prices associated with lower average raw material costs of \$37.2 million and the negative impact from changes in foreign currency exchange rates of \$2.9 million.

Gross profit was \$59.9 million in the second quarter of 2013 compared to \$73.5 million in the second quarter of 2012. The period-over-period decline of \$13.6 million reflects a \$16.3 million negative impact associated with the spread between the first-in, first-out (FIFO) basis of accounting and estimated current replacement cost (ECRC). Net of the impact of this spread, gross profit at ECRC was \$62.2 million in the second quarter of 2013 compared to \$59.5 million in the second quarter of 2012.

Adjusted EBITDA was \$29.7 million in the second quarter of 2013 compared to \$45.0 million in the second quarter of 2012. The period-over-period decline of \$15.4 million reflects a \$16.3 million negative impact associated with the spread between FIFO and ECRC. Net of the impact of this spread, Adjusted EBITDA at ECRC was \$32.0 million in the second quarter of 2013 compared to \$31.0 million in the second quarter of 2012.

Net income attributable to Kraton was \$3.8 million or \$0.12 per diluted share for the three months ended June 30, 2013 compared to net income of \$12.4 million or \$0.38 per diluted share for the three months ended June 30, 2012. Diluted earnings per share were impacted by items that are discussed further in *Net income attributable to Kraton*.

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Cash provided by operating activities was \$16.3 million in the second quarter of 2013 compared to \$12.7 million in the second quarter of 2012.

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RESULTS OF OPERATIONS

Factors Affecting Our Results of Operations

Raw Materials and Product Mix. Our results of operations are directly affected by the cost of raw materials. We use butadiene, styrene and isoprene as our primary raw materials in manufacturing our products. On a FIFO basis, these monomers together represented approximately \$156.8 million and \$185.8 million or 57.1% and 61.5% of our total cost of goods sold for the three months ended June 30, 2013 and 2012, respectively, and \$319.0 million and \$393.9 million or 57.5% and 62.0% of our total cost of goods sold for the six months ended June 30, 2013 and 2012, respectively. Since the cost of our three primary raw materials comprise a significant amount of our total cost of goods sold, our selling prices for our products and therefore our total sales revenue is impacted by movements in our raw material costs, as well as the cost of other inputs. In addition, product mix can have an impact on our overall unit selling prices, since we provide an extensive product offering and therefore experience a wide range of unit selling prices.

The cost of these monomers has generally correlated with changes in energy prices, supply and demand factors, and prices for natural and synthetic rubber. In aggregate, average purchase prices for these monomers decreased slightly during the three months ended June 30, 2013 compared to the three months ended March 31, 2013. Average purchase prices decreased for butadiene and isoprene during the three months ended June 30, 2013 compared to the same periods in 2012, with a slight increase in average purchase prices for styrene. Average purchase prices decreased for butadiene and isoprene during the six months ended June 30, 2013 compared to the same periods in 2012, with an increase in average purchase prices for styrene.

We use the FIFO basis of accounting for inventory and cost of goods sold, and therefore gross profit. In periods of raw material price volatility, reported results under FIFO will differ from what the results would have been if cost of goods sold were based on ECRC. Specifically, in periods of rising raw material costs, reported gross profit will be higher under FIFO than under ECRC. Conversely, in periods of declining raw material costs, reported gross profit will be lower under FIFO than under ECRC. In recognition of the fact that the cost of raw materials affects our results of operations and the comparability of our results of operations we provide the spread between FIFO and ECRC.

In the three and six months ended June 30, 2013, reported results under FIFO were lower than results would have been on an ECRC basis by \$2.3 million and \$2.8 million, respectively; and

In the three and six months ended June 30, 2012, reported results under FIFO were higher than results would have been on an ECRC basis by \$14.0 million and \$17.3 million, respectively.

We currently anticipate that our results will reflect a negative spread between FIFO and ECRC of approximately \$25.0 million in the third quarter of 2013. This expectation is based on numerous complex and interrelated assumptions with respect to monomer costs and ending inventory levels in the third quarter and the actual results may be significantly different based on third quarter results.

International Operations and Currency Fluctuations. We operate a geographically diverse business, serving customers in over 60 countries from five manufacturing facilities on four continents. Although we sell and manufacture our products in many countries, our sales and production costs are mainly denominated in U.S. dollars, Euro, Japanese Yen and Brazilian Real. From time to time, we use hedging strategies to reduce our exposure to currency fluctuations.

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We generated our sales revenue from customers located in the following regions.

| Revenue by Geography: | Three months ended June 30, | | Six months ended June 30, | |
|--------------------------------|--------------------------------|-------|------------------------------|-------|
| | 2013 | 2012 | 2013 | 2012 |
| Americas | 38.6% | 39.1% | 40.3% | 41.8% |
| Europe, Middle East and Africa | 39.4% | 39.9% | 38.3% | 38.6% |
| Asia Pacific | 22.0% | 21.0% | 21.4% | 19.6% |

Our financial results are subject to gains and losses on currency translations, which occur when the financial statements of our foreign operations are translated into U.S. dollars. The financial statements of operations outside the United States where the local currency is considered to be the functional currency are translated into U.S. dollars using the exchange rate at each balance sheet date for assets and liabilities and the average exchange rate for each period for revenues, expenses, gains and losses and cash flows. The effect of translating the balance sheet into U.S. dollars is included as a component of accumulated other comprehensive income (loss). Any appreciation of the functional currencies against the U.S. dollar will increase the U.S. dollar equivalent of amounts of revenues, expenses, gains and losses and cash flows, and any depreciation of the functional currencies will decrease the U.S. dollar amounts reported. Our results of operations are also subject to currency transaction risk. We incur currency transaction risk when we enter into either a purchase or sale transaction using a currency other than the local currency of the transacting entity. The estimated impact from currency fluctuations amounted to pre-tax losses of \$0.9 million and \$2.0 million for the three months ended June 30, 2013 and 2012, and pre-tax losses of \$1.9 million and \$3.4 million for the six months ended June 30, 2013 and 2012, respectively. The primary driver for the increase in our pre-tax losses for the periods presented was the change in foreign currency exchange rates between the Japanese Yen and U.S. dollar.

Seasonality. Seasonal changes and weather conditions typically affect the Paving and Roofing end use market generally resulting in higher sales volumes into this end use market in the second and third quarters of the calendar year versus the first and fourth quarters of the calendar year. However, sales volumes into this end use market were higher in the first quarter of 2012, during which demand was higher than normal, particularly in Europe and North America paving.

Three Months Ended June 30, 2013 Compared to Three Months Ended June 30, 2012*Sales Revenue*

Sales revenue decreased \$41.2 million or 11.0% to \$334.5 million for the three months ended June 30, 2013 from \$375.8 million for the three months ended June 30, 2012. The decrease was largely due to a reduction in global product sales prices associated with lower average raw material costs, which accounted for \$37.2 million of the revenue decrease, and the negative effect of changes in foreign currency exchange rates of \$2.9 million. Sales volumes were 77.5 kilotons for the three months ended June 30, 2013 compared to 77.2 kilotons for the three months ended June 30, 2012, an increase of 0.3%.

The following factors influenced our sales revenue in each of our end use markets:

Advanced Materials. Sales revenue decreased \$11.1 million or 10.8% to \$91.1 million for the three months ended June 30, 2013 from \$102.2 million for the three months ended June 30, 2012. Excluding the \$1.0 million negative impact from changes in foreign currency exchange rates, sales revenue would have declined \$10.0 million or 9.8%. The decline in sales revenue was driven by lower average selling prices, which reflect the lower average cost of raw materials, primarily butadiene. The revenue decrease associated with lower average raw material costs more than offset the revenue contribution associated with a 3.4% increase in sales volumes. With respect to innovation sales volumes, we experienced growth in personal care and consumer applications, partially offset by lower sales volumes into wire and cable and automotive and industrial applications.

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Adhesives, Sealants and Coatings. Sales revenue decreased \$8.8 million or 6.5% to \$126.0 million for the three months ended June 30, 2013 from \$134.8 million for the three months ended June 30, 2012. Excluding the \$0.9 million negative impact from changes in foreign currency exchange rates, sales revenue would have decreased \$7.9 million or 5.9%. The decline in sales revenue was primarily due to lower average selling prices associated with lower average raw material costs, primarily butadiene and isoprene, and a 1.1% decrease in sales volumes. The decline in sales volumes was largely attributable to pressure sensitive adhesive and elastic nonwoven applications in Europe and the timing of sales into lubricant additive applications.

Paving and Roofing. Sales revenue decreased \$20.8 million or 19.2% to \$87.8 million for the three months ended June 30, 2013 from \$108.6 million for the three months ended June 30, 2012. Excluding a \$0.4 million benefit associated with changes in foreign currency exchange rates, sales revenue would have been down \$21.2 million or 19.5%. The decrease in sales revenue reflects lower average selling prices resulting from lower average raw material costs, primarily butadiene, as sales volumes were essentially unchanged. Innovation sales volumes increased on higher sales of roofing innovation grades in Europe and North America and to a lesser extent, increased sales of paving innovation grades in Europe.

Cariflex™. Sales revenue decreased \$0.6 million or 1.9% to \$29.2 million for the three months ended June 30, 2013 from \$29.8 million for the three months ended June 30, 2012. Excluding the \$1.5 million negative impact from changes in foreign currency exchange rates, sales revenue would have increased \$0.9 million or 3.0%. Although overall sales volumes decreased slightly compared to the second quarter of 2012, sales of innovation grades increased, particularly into isoprene rubber latex applications.

Cost of Goods Sold

Cost of goods sold decreased \$27.6 million or 9.1% to \$274.7 million for the three months ended June 30, 2013 from \$302.3 million for the three months ended June 30, 2012. The decrease was driven largely by a \$28.2 million reduction in raw material costs. In addition, cost of goods sold declined in 2013 as compared to 2012 due to the absence of storm related charges of \$2.8 million, lower restructuring and other charges of \$1.0 million, and \$1.1 million favorable impact from changes in foreign currency exchange rates, which, in the aggregate, were offset by higher manufacturing costs.

Gross Profit

Gross profit decreased \$13.6 million or 18.5% to \$59.9 million for the three months ended June 30, 2013 from \$73.5 million for the three months ended June 30, 2012. Gross profit as a percentage of sales revenue was 17.9% and 19.6% for the three months ended June 30, 2013 and 2012, respectively. The decrease includes a \$16.3 million negative impact associated with the spread between the FIFO basis of accounting and the ECRC basis. Net of the impact of this spread, gross profit at ECRC was \$62.2 million in the second quarter of 2013 compared to \$59.5 million in the second quarter 2012, an increase of \$2.7 million.

Operating Expenses

Research and Development. Research and development expenses increased \$0.5 million or 5.6% primarily due to an increase in employee related and operational costs, partially offset by decreased lease expense for our research and development facilities. Research and development expenses were 2.5% and 2.1% of sales revenue for the three months ended June 30, 2013 and 2012, respectively.

Selling, General and Administrative. Selling, general and administrative expenses decreased \$1.3 million or 5.0%. The decrease was primarily due to a \$2.9 million decrease in employee related costs,

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partially offset by a \$1.1 million increase in restructuring and other costs. Selling, general and administrative expenses were 7.5% and 7.0% of sales revenue for the three months ended June 30, 2013 and 2012, respectively.

Depreciation and Amortization. Depreciation and amortization decreased \$0.1 million or 0.9%, primarily due to the extended compliance deadline for our coal-burning boilers at our Belpre, Ohio, facility, pursuant to the revised MACT rule.

Interest expense, net

Interest expense, net decreased \$1.9 million or 24.0% to \$5.9 million for the three months ended June 30, 2013 from \$7.8 million for the three months ended June 30, 2012. The decrease was primarily due to a lower average debt balance.

Income tax expense

Our income tax expense was \$0.9 million and \$3.3 million for the three months ended June 30, 2013 and 2012, respectively. Our effective tax rate was 18.5% and 20.9% for the three months ended June 30, 2013 and 2012, respectively. Our effective tax rates differed from the U.S. corporate statutory tax rate of 35.0%, primarily due to the mix of pre-tax income or loss earned in certain jurisdictions and the partial release of our valuation allowance.

We record a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. As of June 30, 2013, a valuation allowance of \$94.7 million has been provided for net operating loss carryforwards and other deferred tax assets. We decreased our valuation allowance by \$3.1 million and \$0.1 million for the three months ended June 30, 2013 and 2012, respectively, which represents the utilization of net operating losses. Excluding the change in our valuation allowance, our effective tax rate would have been 81.1% and 21.6% for the three months ended June 30, 2013 and 2012, respectively, primarily due to the mix of pre-tax income or loss earned in certain tax jurisdictions.

Our pre-tax income is generated in a number of jurisdictions and is subject to a number of different effective tax rates that are significantly lower than the U.S. corporate statutory tax rate of 35.0%. For the three months ended June 30, 2013, we generated \$2.6 million of pre-tax loss in jurisdictions with an expected full year effective tax rate of 8.0%. For the three months ended June 30, 2012, we earned \$17.5 million of pre-tax income in jurisdictions with an expected full year effective tax rate of 21.1%.

Net income attributable to Kraton

Net income attributable to Kraton was \$3.8 million or \$0.12 per diluted share for the three months ended June 30, 2013, a decrease of \$8.6 million compared to net income of \$12.4 million or \$0.38 per diluted share for the three months ended June 30, 2012. Net income for the three months ended June 30, 2013 included charges of approximately \$1.1 million, net of tax, or \$0.03 per diluted share related to restructuring and other costs, and \$2.5 million, net of tax, or \$0.08 per diluted share associated with the spread between the FIFO basis of accounting and the ECRC basis. Net income for the three months ended June 30, 2012 included charges of approximately \$2.6 million, net of tax, or \$0.08 per diluted share associated with storm related charges and restructuring and other charges, and a benefit of \$10.5 million, net of tax, or \$0.32 per diluted share associated with the spread between the FIFO basis of accounting and the ECRC basis. The impact of our ability to use net operating loss carryforwards to offset taxes amounted to \$0.09 per diluted share during the three months ended June 30, 2013 and \$0.01 per diluted share during the three months ended June 30, 2012.

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Six Months Ended June 30, 2013 Compared to Six Months Ended June 30, 2012

Sales Revenue

Sales revenue decreased \$109.4 million or 14.0% to \$674.7 million for the six months ended June 30, 2013 from \$784.1 million for the six months ended June 30, 2012. The decrease was largely due to lower sales volumes and mix, which accounted for \$53.0 million of the revenue decrease, global product sales price decreases of \$46.8 million associated with lower raw material costs, and the negative effect of changes in foreign currency exchange rates of \$8.2 million. Sales volumes were 155.7 kilotons for the six months ended June 30, 2013 compared to 166.9 kilotons for the six months ended June 30, 2012, a decrease of 6.7%.

The following factors influenced our sales revenue in each of our end use markets:

Advanced Materials. Sales revenue decreased \$20.0 million or 9.6% to \$187.7 million for the six months ended June 30, 2013 from \$207.7 million for the six months ended June 30, 2012. Excluding the \$2.0 million negative impact from changes in foreign currency exchange rates, the decline in sales revenue would have been \$18.0 million or 8.7%. The decline in sales revenue was primarily driven by lower average selling prices, reflective of lower average raw materials costs, primarily butadiene, partially offset by a 1.4% increase in sales volumes. With respect to innovation sales volumes, we experienced growth in personal care applications, offset by lower sales volumes in wire and cable applications.

Adhesives, Sealants and Coatings. Sales revenue decreased \$27.4 million or 9.6% to \$257.5 million for the six months ended June 30, 2013 from \$284.9 million for the six months ended June 30, 2012. Excluding the \$3.6 million negative impact from changes in foreign currency exchange rates, the decline in sales revenue would have been \$23.8 million or 8.3%. The decline in sales revenue was primarily due to lower average selling prices indicative of lower raw material costs, primarily butadiene and isoprene, and a 4.1% reduction in sales volumes. The decline in sales volumes was due to timing of sales into lubricant additive applications and lower sales into pressure sensitive adhesive and elastic nonwoven applications.

Paving and Roofing. Sales revenue decreased \$64.6 million or 27.2% to \$172.5 million for the six months ended June 30, 2013 from \$237.1 million for the six months ended June 30, 2012. Excluding the \$0.3 million negative impact from changes in foreign currency exchange rates, sales revenue would have declined \$64.3 million or 27.1%. The largest driver of the sales revenue decline was lower sales volumes, which were down 15.1% compared to the prior year, primarily in the North American and European paving markets and to a lesser extent the European roofing market. The decrease in sales revenue also reflects lower average selling prices resulting from lower average raw material costs, primarily butadiene, compared to the prior year. Innovation sales volumes grew on strong performance in roofing applications.

Cariflex™. Sales revenue increased \$3.8 million or 7.3% to \$56.3 million for the six months ended June 30, 2013 from \$52.5 million for the six months ended June 30, 2012. Excluding the \$2.4 million negative impact from changes in foreign currency exchange rates, sales revenue would have increased \$6.2 million or 11.8%. The revenue increase reflects higher sales volumes, mainly in surgical glove, other medical and innovation sales, as well as increased average selling prices across the Cariflex portfolio.

Cost of Goods Sold

Cost of goods sold decreased \$80.2 million or 12.6% to \$554.9 million for the six months ended June 30, 2013 from \$635.1 million for the six months ended June 30, 2012. The decrease was driven largely by a \$43.2 million reduction in raw material costs, \$36.4 million due to lower sales volumes and a \$5.6 million favorable impact from changes in foreign currency exchange rates. In addition, cost of goods sold benefited from the absence of net charges amounting to \$2.6 million recorded in the first half of 2012 related to the property tax

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dispute in France, storm related charges, restructuring and other charges and the LBI settlement. Cost of goods sold increased by \$8.1 million primarily due to higher manufacturing costs, which includes the effect of production issues experienced prior to the second quarter of 2013.

Gross Profit

Gross profit decreased \$29.2 million or 19.6% to \$119.8 million for the six months ended June 30, 2013 from \$149.0 million for the six months ended June 30, 2012. Gross profit as a percentage of sales revenue was 17.8% and 19.0% for the six months ended June 30, 2013 and 2012, respectively. The decrease includes a \$20.1 million negative impact associated with the spread between the FIFO basis of accounting and the ECRC basis. Net of the impact of this spread, gross profit at ECRC was \$122.6 million in the six months ended June 30, 2013 compared to \$131.7 million in the six months ended June 30, 2012, a decrease of \$9.1 million.

Operating Expenses

Research and Development. Research and development expenses increased \$0.8 million or 5.2% primarily due to an increase in employee related and operational costs, partially offset by decreased lease expense for our research and development facilities. Research and development expenses were 2.4% and 2.0% of sales revenue for the six months ended June 30, 2013 and 2012, respectively.

Selling, General and Administrative. Selling, general and administrative expenses decreased \$1.7 million or 3.1%. The decrease was primarily due to a \$2.7 million decrease in employee related costs, a \$0.6 million charge associated with the resolution of a property tax dispute in France during 2012, lower legal expenses of \$0.3 million and a \$0.2 million decrease in lease expense, partially offset by a \$1.2 million increase in restructuring and other costs, a \$0.7 million increase in costs associated with the joint venture with FPCC and a \$0.2 million increase in information technology costs. Selling, general and administrative expenses were 7.6% and 6.7% of sales revenue for the six months ended June 30, 2013 and 2012, respectively.

Depreciation and Amortization. Depreciation and amortization decreased \$0.9 million or 2.8%, primarily due to the extended compliance deadline for our coal-burning boilers at our Belpre, Ohio, facility, pursuant to the revised MACT rule.

Interest expense, net

Interest expense, net increased \$4.7 million or 32.7% to \$19.2 million for the six months ended June 30, 2013 from \$14.5 million for the six months ended June 30, 2012. The increase was primarily due to a \$5.0 million write off of debt issuance costs and a \$0.7 million payment to exit a 2011 interest rate swap agreement associated with replacing and refinancing our previous credit facilities, partially offset by a lower average debt balance.

Income tax expense

Our income tax expense was \$2.4 million and \$6.0 million for the six months ended June 30, 2013 and 2012, respectively. Our effective tax rate was 93.9% and 17.3% for the six months ended June 30, 2013 and 2012, respectively. Our effective tax rates differed from the U.S. corporate statutory tax rate of 35.0%, primarily due to the mix of pre-tax income or loss earned in certain jurisdictions and the change in our valuation allowance.

We record a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. As of June 30, 2013 and December 31, 2012, a valuation allowance of \$94.7 million and \$90.4 million, respectively, has been provided for net operating loss carryforwards and other deferred tax

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assets. We increased our valuation allowance by \$4.3 million for the six months ended June 30, 2013, of which \$4.5 million represents current period net operating losses, partially offset by \$0.2 million which represents changes in other comprehensive income (loss). We decreased our valuation allowance by \$0.2 million for the six months ended June 30, 2012, due to the utilization of net operating losses. Excluding the change in our valuation allowance, our effective tax rate would have been a 88.1% benefit and an 18.0% expense for the six months ended June 30, 2013 and 2012, respectively, primarily due to the mix of pre-tax income or loss earned in certain tax jurisdictions.

Our pre-tax income is generated in a number of jurisdictions and is subject to a number of different effective tax rates that are significantly lower than the U.S. corporate statutory tax rate of 35.0%. For the six months ended June 30, 2013, we earned \$15.9 million of pre-tax income in jurisdictions with an expected full year effective tax rate of 8.0%. For the six months ended June 30, 2012, we earned \$42.6 million of pre-tax income in jurisdictions with an expected full year effective tax rate of 16.5%.

Net income attributable to Kraton

Net income attributable to Kraton was \$0.1 million or \$0.00 per diluted share for the six months ended June 30, 2013, a decrease of \$28.7 million compared to net income of \$28.8 million or \$0.89 per diluted share for the six months ended June 30, 2012. Net income for the six months ended June 30, 2013 included charges of approximately \$7.0 million, net of tax, or \$0.22 per diluted share related to the write-off of debt issuance costs, the settlement of the interest rate swap and restructuring and other costs, and \$3.2 million, net of tax, or \$0.10 per diluted share associated with the spread between the FIFO basis of accounting and the ECRC basis. Net income for the six months ended June 30, 2012 included charges of approximately \$2.0 million, net of tax, or \$0.06 per diluted share associated with the storm related charges, LBI settlement, a property tax dispute in France, restructuring and other charges, costs associated with our March 2012 offering, and a benefit of \$14.5 million, net of tax, or \$0.45 per diluted share associated with the spread between the FIFO basis of accounting and the ECRC basis. The impact of the change in our deferred tax asset valuation allowance decreased our diluted earnings per share by \$0.14 due to our inability to recognize a tax benefit on net operating losses generated during the six months ended June 30, 2013 and increased our diluted earnings per share by \$0.01 during the six months ended June 30, 2012.

Critical Accounting Policies

For a discussion of our critical accounting policies and estimates that require the use of significant estimates and judgments, *see Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies* in our Annual Report on Form 10-K for the year ended December 31, 2012.

Table of Contents***EBITDA, Adjusted EBITDA, Adjusted EBITDA at ECRC and Gross Profit at ECRC***

We consider EBITDA, Adjusted EBITDA, Adjusted EBITDA at ECRC and Gross Profit at ECRC to be important supplemental measures of our performance and believe they are frequently used by investors, securities analysts and other interested parties in the evaluation of our performance including period-to-period comparisons. In addition, management uses these measures to evaluate operating performance, and our executive compensation plan bases incentive compensation payments on our Adjusted EBITDA and Adjusted EBITDA at ECRC performance, along with other factors. EBITDA, Adjusted EBITDA, Adjusted EBITDA at ECRC and Gross Profit at ECRC have limitations as analytical tools and in some cases can vary substantially from other measures of our performance. You should not consider any of them in isolation, or as substitutes for analysis of our results under U.S. generally accepted accounting principles (GAAP).

| | Three months ended June 30, | | Six months ended June 30, | |
|-----------------------------|--------------------------------|-----------|------------------------------|------------|
| | 2013 | 2012 | 2013 | 2012 |
| | (in thousands) | | (in thousands) | |
| EBITDA (1) | \$ 26,532 | \$ 39,334 | \$ 52,550 | \$ 80,967 |
| Adjusted EBITDA (2) | \$ 29,663 | \$ 45,014 | \$ 58,340 | \$ 87,975 |
| Adjusted EBITDA at ECRC (3) | \$ 31,967 | \$ 31,048 | \$ 61,151 | \$ 70,637 |
| Gross Profit at ECRC (4) | \$ 62,165 | \$ 59,514 | \$ 122,583 | \$ 131,661 |

(1) EBITDA represents net income before interest, taxes, depreciation and amortization. Limitations for EBITDA as an analytical tool include the following:

EBITDA does not reflect our cash expenditures, or future requirements for capital expenditures or contractual commitments;

EBITDA does not reflect changes in, or cash requirements for, our working capital needs;

EBITDA does not reflect the significant interest expense, or the cash requirements necessary to service interest payments, on our debt;

although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future and EBITDA does not reflect any cash requirements for such replacements;

EBITDA calculation under the terms of our debt agreements may vary from EBITDA presented herein, and our presentation of EBITDA herein is not for purposes of assessing compliance or non-compliance with financial covenants under our debt agreements;

other companies in our industry may calculate EBITDA differently than we do, limiting its usefulness as a comparative measure; and

EBITDA is not a measure of discretionary cash available to us to invest in the growth of our business.

(2) We prepare Adjusted EBITDA by adjusting EBITDA to eliminate the impact of a number of items we do not consider indicative of our ongoing operating performance. We explain how each adjustment is derived and why we believe it is helpful and appropriate in the reconciliation below. You are encouraged to evaluate each adjustment and the reasons we consider it appropriate for supplemental

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analysis. As an analytical tool, Adjusted EBITDA is subject to the limitations applicable to EBITDA described above. In addition, in evaluating Adjusted EBITDA, you should be aware that in the future we may incur expenses similar to the adjustments in this presentation. Our presentation of Adjusted EBITDA should not be construed as an inference that our future results will be unaffected by unusual or non-recurring items.

- (3) Adjusted EBITDA at estimated current replacement cost (ECRC) is Adjusted EBITDA net of the impact of the spread between the FIFO basis of accounting and ECRC. Although we report our financial results using the FIFO basis of accounting, as part of our pricing strategy, we measure our business performance using the estimated current replacement cost of our inventory and cost of goods sold. We maintain our perpetual

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inventory in our global enterprise resource planning system. The carrying value of our inventory is determined using FIFO. At the beginning of each month, we determine the estimated current cost of our raw materials for that particular month, and using the same perpetual inventory system that we use to manage inventory and therefore costs of goods sold under FIFO, we revalue our ending inventory to reflect the total cost of such inventory as if it was valued using the estimated current replacement cost. The result of this revaluation from FIFO creates the spread between FIFO and ECRC. With inventory valued under FIFO and ECRC, we then have the ability to report cost of goods sold and therefore EBITDA, Adjusted EBITDA, Adjusted EBITDA at ECRC, Gross Profit, and Gross Profit at ECRC under both our FIFO convention and under estimated current replacement cost. As an analytical tool, Adjusted EBITDA at ECRC is subject to the limitations applicable to EBITDA described above, as well as the following limitations:

due to volatility in raw material prices, Adjusted EBITDA at ECRC may, and often does, vary substantially from EBITDA, net income and other performance measures, including net income calculated in accordance with US GAAP; and

Adjusted EBITDA at ECRC may, and often will, vary significantly from EBITDA calculations under the terms of our debt agreements and should not be used for assessing compliance or non-compliance with financial covenants under our debt agreements. Our presentation of Adjusted EBITDA at ECRC should not be construed as an inference that our future results will be unaffected by unusual or non-recurring items.

- (4) Gross Profit at ECRC is gross profit net of the impact of the spread between the FIFO basis of accounting and ECRC. Although we report our financial results using the FIFO basis of accounting, as part of our pricing strategy, we measure our business performance using the estimated current replacement cost of our inventory and cost of goods sold. We maintain our perpetual inventory in our global enterprise resource planning system. The carrying value of our inventory is determined using FIFO. At the beginning of each month, we determine the estimated current cost of our raw materials for that particular month, and using the same perpetual inventory system that we use to manage inventory and therefore costs of goods sold under FIFO, we revalue our ending inventory to reflect the total cost of such inventory as if it was valued using the estimated current replacement cost. The result of this revaluation from FIFO creates the spread between FIFO and ECRC. With inventory valued under FIFO and ECRC, we then have the ability to report cost of goods sold and therefore EBITDA, Adjusted EBITDA, Adjusted EBITDA at ECRC, Gross Profit, and Gross Profit at ECRC under both our FIFO convention and under estimated current replacement cost. As a measure of our performance, Gross Profit at ECRC is limited because it often varies substantially from gross profit calculated in accordance with US GAAP due to volatility in raw material prices.

We compensate for these limitations by relying primarily on our GAAP results and using EBITDA, Adjusted EBITDA, Adjusted EBITDA at ECRC and Gross Profit at ECRC only as supplemental measures.

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We reconcile consolidated net income to EBITDA, Adjusted EBITDA and Adjusted EBITDA at ECRC as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|--|--------------------------------|------------------|------------------------------|------------------|
| | 2013 | 2012 | 2013 | 2012 |
| | (in thousands) | | (in thousands) | |
| Net income attributable to Kraton | \$ 3,829 | \$ 12,407 | \$ 81 | \$ 28,760 |
| Net income attributable to noncontrolling interest | 148 | 0 | 72 | 0 |
| Consolidated net income | 3,977 | 12,407 | 153 | 28,760 |
| <i>Add:</i> | | | | |
| Interest expense, net | 5,909 | 7,773 | 19,207 | 14,472 |
| Income tax expense | 905 | 3,269 | 2,351 | 6,001 |
| Depreciation and amortization expenses | 15,741 | 15,885 | 30,839 | 31,734 |
| EBITDA | 26,532 | 39,334 | 52,550 | 80,967 |
| <i>Add (deduct):</i> | | | | |
| Settlement gain (a) | 0 | 0 | 0 | (6,819) |
| Property tax dispute (b) | 0 | 0 | 0 | 6,211 |
| Storm related charges (c) | 0 | 2,817 | 0 | 2,817 |
| Restructuring and other charges (d) | 1,124 | 1,006 | 1,260 | 1,062 |
| Non-cash compensation expense | 2,007 | 1,857 | 4,530 | 3,737 |
| Adjusted EBITDA | 29,663 | 45,014 | 58,340 | 87,975 |
| <i>Add (deduct):</i> | | | | |
| Spread between FIFO and ECRC | 2,304 | (13,966) | 2,811 | (17,338) |
| Adjusted EBITDA at ECRC | \$ 31,967 | \$ 31,048 | \$ 61,151 | \$ 70,637 |

- (a) Reflects the benefit of the LBI settlement, which is recorded in cost of goods sold.
- (b) Reflects the charge associated with the resolution of the property tax dispute in France, of which \$5,646 is recorded in cost of goods sold and \$565 is recorded in selling, general and administrative expenses.
- (c) Reflects the storm related charge at our Belpre, Ohio facility, which is recorded in cost of goods sold.
- (d) Includes charges related to the evaluation of acquisition transactions, severance expenses and fees associated with the public offering of our senior notes, which are recorded in selling, general and administrative expenses in 2013 and primarily in cost of goods sold in 2012.

We reconcile Gross Profit to Gross Profit at ECRC as follows:

| | Three months ended June 30, | | Six months ended June 30, | |
|------------------------------|--------------------------------|------------------|------------------------------|-------------------|
| | 2013 | 2012 | 2013 | 2012 |
| | (in thousands) | | (in thousands) | |
| Gross profit | \$ 59,861 | \$ 73,480 | \$ 119,772 | \$ 148,999 |
| <i>Add (deduct):</i> | | | | |
| Spread between FIFO and ECRC | 2,304 | (13,966) | 2,811 | (17,338) |
| Gross profit at ECRC | \$ 62,165 | \$ 59,514 | \$ 122,583 | \$ 131,661 |

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LIQUIDITY AND CAPITAL RESOURCES

Known Trends and Uncertainties

Kraton Performance Polymers, Inc. is a holding company without any operations or assets other than the operations of its subsidiaries.

In March 2013, we entered into an asset-based revolving credit facility consisting of a U.S. senior secured revolving credit facility of \$150.0 million and a Dutch senior secured revolving credit facility of \$100.0 million (the Senior Secured Credit Facilities), to replace our then existing senior secured credit facility, and repaid in full all outstanding amounts payable under the previously existing indebtedness. The facilities are secured by receivables and inventory, and borrowing availability under the Senior Secured Credit Facilities is subject to borrowing base limitations based on the level of receivables and inventory available for security. The Senior Secured Credit Facilities include a \$100.0 million uncommitted accordion feature that, subject to borrowing base availability and approval of the bank syndicate, could increase aggregate availability to \$350.0 million. We cannot guarantee that all of the counterparties contractually committed to fund a revolving credit draw request will actually fund future requests, although we currently believe that each of the counterparties would meet their funding requirements.

The Senior Secured Credit Facilities contain a financial covenant and certain customary events of default, including, without limitation, a failure to make payments under the facility, cross-default and cross-judgment default, certain bankruptcy events and certain change of control events. Our failure to comply with the covenants would give rise to a default under the Senior Secured Credit Facilities. If factors arise that negatively impact our profitability, we may not be able to satisfy the covenants. If we are unable to satisfy such covenants or other provisions at any future time we would need to seek an amendment or waiver of such covenants or other provisions. The respective lenders under the Senior Secured Credit Facilities may elect not to consent to any amendment or waiver requests that we may make in the future, and, if they do consent, they may do so on terms that are not favorable to us. In the event that we were unable to obtain any such waiver or amendment and we were not able to refinance or repay our Senior Secured Credit Facilities, our inability to meet the covenants or other provisions of the Senior Secured Credit Facilities would constitute an event of default, which would permit the bank lenders to accelerate the Senior Secured Credit Facilities. Such acceleration may in turn constitute an event of default under our senior notes. At June 30, 2013, we were in compliance with the covenants under the Senior Secured Credit Facilities and the indenture governing our 6.75% senior notes.

The Senior Secured Credit Facilities terminate on March 27, 2018, however we may, from time to time, request that the lenders extend the maturity of their commitments; provided that at no time shall there be more than four maturity dates under the Senior Secured Credit Facilities.

Based upon current and anticipated levels of operations, we believe that cash flows from operations of our subsidiaries, cash on hand, and borrowings available to us will be sufficient to fund our working capital requirements, our investment in the joint venture with FPCC, debt payments, interest payments, capital expenditures, benefit plan contributions and income tax obligations. However, these cash flows are subject to a number of factors, including, but not limited to, earnings, sensitivities to the cost of raw materials, seasonality and fluctuations in foreign currency exchange rates. Because feedstock costs generally represent a substantial portion of our cost of goods sold, in periods of rising feedstock costs, we generally consume cash in operating activities due to increases in accounts receivable and inventory costs, partially offset by increased value of accounts payable. Conversely, during periods in which feedstock costs are declining, we generate cash flow from decreases in working capital.

Going forward there can be no assurance that our business will generate sufficient cash flow from operations or that future borrowings will be available under our senior secured credit facilities to fund liquidity needs and enable us to service our indebtedness. At June 30, 2013, we had \$88.7 million of cash and cash equivalents, which includes \$21.3 million of cash-on-hand at KFPC, the consolidated joint venture in Asia. As of June 30, 2013, our available borrowing capacity was \$206.2 million of which \$0 million was drawn. Excluding

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the \$21.3 million of KFPC cash, our liquidity at June 30, 2013 amounted to \$273.6 million. As of the date of this filing, our available borrowing capacity was \$201.9 million, of which \$0 million was drawn. Our available cash and cash equivalents are held in accounts managed by third-party financial institutions and consist of cash invested in interest bearing funds and operating accounts. To date, we have not experienced any losses or lack of access to our invested cash or cash equivalents; however, we cannot provide any assurance that adverse conditions in the financial markets will not impact access to our invested cash and cash equivalents.

For additional information regarding our Senior Secured Credit Facilities, see *Senior Secured Credit Facilities* in *Note 6 Long-Term Debt* to the condensed consolidated financial statements, which is incorporated herein by reference.

We made contributions of \$2.6 million to our pension plan in the six months ended June 30, 2013 and \$3.3 million for the six months ended June 30, 2012. We expect our total pension plan contributions for the year ended December 31, 2013 to be \$6.2 million. Our pension plan obligations are predicated on a number of factors, the primary ones being the return on our pension plan assets and the discount rate used in deriving our pension obligations. If the investment return on our pension plan assets does not meet or exceed expectations during 2013, and the discount rate decreases from the prior year, higher levels of contributions could be required in 2014 and beyond.

As of June 30, 2013, we had \$69.6 million of cash and short-term investments related to foreign operations that management asserts are permanently reinvested. As a result of net operating loss carryforwards, management estimates that no additional cash tax expense would be incurred if this cash were repatriated.

Turbulence in U.S. and international markets and economies may adversely affect our liquidity and financial condition, the liquidity and financial condition of our customers, and our ability to timely replace maturing liabilities and access the capital markets to meet liquidity needs, resulting in adverse effects on our financial condition and results of operations. However, to date we have been able to access borrowings available to us in amounts sufficient to fund liquidity needs. Total receivables, net of allowances, for customers located in Italy, Spain, Portugal, Greece and Ireland aggregated approximately \$7.5 million at June 30, 2013. We have not incurred to date, nor do we currently expect to incur any material losses associated with these trade receivables.

Our ability to pay principal and interest on our indebtedness, fund working capital, make anticipated capital expenditures and fund our investment in the joint venture with FPCC depends on our future performance, which is subject to general economic conditions and other factors, some of which are beyond our control. See *Part I, Item 1A. Risk Factors* in our annual report on Form 10-K for the year ended December 31, 2012 for further discussion.

Operating Cash Flows and Liquidity

Net cash used in operating activities totaled \$4.4 million for the six months ended June 30, 2013 and net cash provided by operating activities were \$68.7 million for the six months ended June 30, 2012. This represents a net decrease of \$73.2 million, which was driven by a decrease in net income and primarily by changes in working capital, as follows:

\$26.6 million decrease in trade accounts payable primarily due to the cost of raw materials, production volume and the timing of payments;

\$8.6 million decrease in related party payables associated with purchases and timing of payments to our joint venture in Japan;

\$8.4 million increase in inventories of products, materials and supplies, largely due to lower sales volume;

\$7.9 million decrease in other payables and accruals, primarily related to the Asia expansion project and interest; partially offset by

\$2.1 million decrease in accounts receivable primarily related to lower sales revenue.

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Investing Cash Flows

Net cash used in investing activities totaled \$38.9 million for the six months ended June 30, 2013 and \$21.8 million for the six months ended June 30, 2012.

Expected Capital Expenditures. We currently expect 2013 capital expenditures, excluding funding for the joint venture with FPCC, will be approximately \$80.0 million to \$85.0 million. Included in this estimate is approximately \$17.6 million related to the semi-works facility, approximately \$16.4 million to comply with the MACT rule, of which \$2.7 million will be financed with a capital lease, and approximately \$19.0 million to \$22.0 million for health, safety and environmental and infrastructure and maintenance projects. The remaining anticipated 2013 capital expenditures are primarily associated with projects to optimize the production capabilities of our manufacturing assets and to support our innovation platform. In addition, at this time, after completing our initial engineering estimate, we anticipate the total FPCC joint venture project construction cost will be at least \$200.0 million. We and FPCC intend to pursue opportunities to obtain debt financing for project costs at the joint venture level. Based on our current assumptions with respect to final project cost, timing and the extent to which the project can be funded through third-party debt financing, we estimate our share of the funding for the joint venture will be approximately \$50.0 million of which \$15.2 million has been funded during the six months ended June 30, 2013, and approximately \$26.3 million is estimated to be funded in the remainder of 2013. We currently anticipate funding our remaining 2013 contributions with available liquidity.

Financing Cash Flows

Our consolidated capital structure as of June 30, 2013 was approximately 57% equity, 41% debt and 2% noncontrolling interest compared to approximately 52% equity and 48% debt as of June 30, 2012.

Net cash used in financing activities totaled \$87.1 million for the six months ended June 30, 2013 and net cash provided by financing activities were \$95.0 million for the six months ended June 30, 2012. The \$182.2 million decrease was driven primarily by:

a \$96.9 million repayment of the term loans associated with the March 2013 refinancing of our debt structure;

a \$40.0 million repayment of the senior secured credit facilities;

net proceeds from the 2013 refinancing being \$61.3 million less than proceeds from the 2012 issuance of additional 6.75% Senior Notes; partially offset by

a \$15.2 million increase in contribution from noncontrolling interest.

Description of 6.75% Senior Notes due 2019

Kraton Polymers LLC and its wholly-owned financing subsidiary Kraton Polymers Capital Corporation issued \$350.0 million aggregate principal amount of 6.75% senior notes that mature on March 1, 2019. The notes are general unsecured, senior obligations and are unconditionally guaranteed on a senior unsecured basis. We pay interest on the notes at 6.75% per annum, semi-annually in arrears on March 1 and September 1 of each year. Prior to March 1, 2015, we may redeem all or a part of the senior notes, at a redemption price equal to 100.00% of the principal amount of the senior notes redeemed plus the applicable premium as of, plus accrued and unpaid interest, if any, to the applicable redemption date. After March 1, 2015, we may redeem all or a part of the senior notes for 103.375%, 101.688%, and 100.000% of the principal amount in 2015, 2016 and 2017 and thereafter, respectively. See *Note 6 Long-Term Debt*, for further discussion.

Contractual Commitments

Our contractual obligations are summarized in Part II, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, in our annual report on Form 10-K for the period ended December 31, 2012. Other than the refinancing of our indebtedness in March 2013 and our minimum purchase

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obligations required under our KFPC joint venture agreements, there have been no other material changes to the contractual obligation amounts disclosed in our quarterly report on Form 10-Q for the period ended March 31, 2013 and our annual report on Form 10-K for the year ended December 31, 2012.

Off-Balance Sheet Arrangements

We are not involved in any material off-balance sheet arrangements as of June 30, 2013, other than operating leases.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

For quantitative and qualitative disclosures about market risk, see *Part II, Item 7A, Quantitative and Qualitative Disclosures About Market Risk*, in our annual report on Form 10-K for the year ended December 31, 2012. There have been no material changes to the quantitative and qualitative disclosures about market risk disclosed in our annual report on Form 10-K for the year ended December 31, 2012. See Note 8 *Fair Value Measurements, Financial Instruments and Credit Risk* for further discussion.

Item 4. Controls and Procedures.

An evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15 under the Securities Exchange Act of 1934) was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer. As of June 30, 2013, based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective.

There has been no change in our internal control over financial reporting that occurred during the three months ended June 30, 2013 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

For information regarding legal proceedings, see Note 10 *Commitments and Contingencies*, to our condensed consolidated financial statements.

Item 1A. Risk Factors.

Readers of this Quarterly Report on Form 10-Q should carefully consider the risks described in our other reports filed with or furnished to the SEC, including our prior and subsequent reports on Forms 10-K, 10-Q and 8-K, in connection with any evaluation of our financial position, results of operations and cash flows.

The risks and uncertainties in our most recent Annual Report on Form 10-K, are not the only ones facing us. Additional risks and uncertainties not presently known or those that are currently deemed immaterial may also affect our operations. Any of the risks, uncertainties, events or circumstances described therein could cause our future financial condition, results of operations or cash flows to be adversely affected.

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Item 6. Exhibits.

**Exhibit
Number**

| | |
|-------|--|
| 31.1* | Certification of Chief Executive Officer under Section 302 of Sarbanes Oxley Act of 2002 |
| 31.2* | Certification of Chief Financial Officer under Section 302 of Sarbanes Oxley Act of 2002 |
| 32.1* | Certification Pursuant to Section 906 of Sarbanes Oxley Act of 2002 |
| 101** | The following materials from Kraton Performance Polymers, Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 30, 2013, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets as of June 30, 2013 and December 31, 2012 (Unaudited), (ii) Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2013 and 2012 (Unaudited), (iii) Condensed Consolidated Statements of Comprehensive Income (Loss) for the three and six months ended June 30, 2013 and 2012 (Unaudited), (iv) Condensed Consolidated Statements of Changes in Equity for the six months ended June 30, 2013 and 2012 (Unaudited), (v) Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2013 and 2012 (Unaudited) and (vi) Notes to Condensed Consolidated Financial Statements (Unaudited).** |

* Filed herewith.

** Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files in Exhibit 101 hereto are not deemed filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are not deemed filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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SIGNATURES

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

KRATON PERFORMANCE POLYMERS, INC.

Date: August 1, 2013

/s/ KEVIN M. FOGARTY
Kevin M. Fogarty

President and Chief Executive Officer

Date: August 1, 2013

/s/ STEPHEN E. TREMBLAY
Stephen E. Tremblay

Vice President and Chief Financial Officer