NAVISITE INC
Form S-3/A
December 17, 2004

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As filed with the Securities and Exchange Commission on December 16, 2004

Registration Statement No. 333-117543

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Amendment No. 1 to

Form S-3

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

NaviSite, Inc.

(Exact name of Registrant as Specified in Its Charter)

Delaware	**52-2137343**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification No.)*

400 Minuteman Road

Andover, Massachusetts 01810
(978) 682-8300
(Address, Including Zip Code, and Telephone Number, Including Area Code, of Registrant s Principal Executive Offices)

Arthur P. Becker
Chief Executive Officer and President
NaviSite, Inc.
400 Minuteman Road
Andover, Massachusetts 01810
(978) 682-8300
(Name, Address, Including Zip Code, and Telephone Number, Including Area Code, of Agent For Service)

Copies to:

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Approximate date of commencement of proposed sale to public: As soon as possible after the Registration Statement becomes effective.

If the only securities being registered on this Form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. o

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. þ

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.
o ______

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.
o ______

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. o

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

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The information in this prospectus is not complete and may be changed. The selling stockholder named in this prospectus may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and the selling stockholder named in this prospectus is not soliciting offers to buy these securities in any jurisdiction where the offer or sale is not permitted.

SUBJECT TO COMPLETION, DATED DECEMBER 16, 2004

PROSPECTUS

NaviSite, Inc.

3,000,000 Shares of Common Stock,

$.01 Par Value Per Share

All of the shares of common stock covered by this prospectus are issued and outstanding shares that may be offered and sold from time to time by the selling stockholder or by its pledgees, donees, transferees or other successors in interest. NaviSite, Inc. will not receive any of the proceeds from the sale of these shares. The prices at which the selling stockholder may sell the shares will be determined by the prevailing market price for the shares or in negotiated transactions.

The shares are being registered to permit the selling stockholder to sell the shares from time to time, subject to certain limitations, in the public market. The selling stockholder may sell the common stock through ordinary broker transactions, directly to market makers of our shares or through other means described in this prospectus.

Investing in our common stock involves a high degree of risk. See Risk Factors beginning on page 4.

We originally issued all of the shares covered by this prospectus in connection with our acquisition of the business of Surebridge, Inc. We are registering the shares pursuant to an agreement between us and the selling stockholder. In addition, the selling stockholder has agreed not to sell, transfer or otherwise dispose of the shares covered by this prospectus prior to June 10, 2005 without the prior written consent of NaviSite.

Our common stock is traded on the Nasdaq SmallCap Market under the symbol NAVI. On December 14, 2004, the last reported sale price for our common stock on the Nasdaq SmallCap Market was $2.25 per share. You are urged to obtain current market quotations for the common stock.

NEITHER THE SECURITIES AND EXCHANGE COMMISSION NOR ANY STATE SECURITIES COMMISSION HAS APPROVED OR DISAPPROVED OF THESE SECURITIES OR DETERMINED IF THIS PROSPECTUS IS TRUTHFUL OR COMPLETE. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

The date of this prospectus is , 2004.

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No person has been authorized to give any information or to make any representations other than those contained in this prospectus in connection with the offering made hereby, and if given or made, such information or representations must not be relied upon as having been authorized by NaviSite, the selling stockholder or by any other person. Neither the delivery of this prospectus nor any sale made hereunder shall, under any circumstances, create any implication that information herein is correct as of any time subsequent to the date hereof. This prospectus does not constitute an offer to sell or a solicitation of an offer to buy any security other than the securities covered by this prospectus, nor does it constitute an offer to or solicitation of any person in any jurisdiction in which such offer or solicitation may not lawfully be made.

PROSPECTUS SUMMARY

This summary highlights important features of this offering and the information included or incorporated by reference in this prospectus. This summary does not contain all of the information that you should consider before investing in our common stock. You should read the entire prospectus carefully, especially the risks of investing in our common stock discussed under Risk Factors.

NaviSite, Inc.

We provide managed application services and a broad range of outsourced hosting services for middle-market organizations, which include mid-sized companies, divisions of large multi-national companies and government agencies. Our service offerings allow our customers to outsource the hosting and management of their information technology infrastructure and applications, such as commerce systems, enterprise software applications and e-mail. We offer services that are designed to focus on the needs of middle-market organizations, where we believe the need for outsourcing is most acute. We believe that by using our services, our customers are able to focus on, and apply resources to, their core business operations by avoiding the significant ongoing investments required to replicate our infrastructure, performance, reliability and expertise.

We support a broad portfolio of outsourced application services including financial management, supply chain management, human resources management and customer relationship management. We provide these services to a range of vertical industries through our direct sales force and channel relationships. The applications we provide include PeopleSoft, Siebel Systems, Progress Software and the Microsoft Business Solutions suite.

We currently operate 14 data centers in the United States and one data center in the United Kingdom. We believe that our data centers and infrastructure have the capacity necessary to expand our business for the foreseeable future. Our services combine our developed infrastructure with established processes and procedures for delivering hosting and application management services. Our high availability infrastructure, high performance monitoring systems, and proactive and collaborative problem resolution and change management processes are designed to identify and address potentially crippling problems before they are able to disrupt our customers operations.

We currently service approximately 1,100 customers, including approximately 148 customers through our sales channel relationships. Our customers typically enter into service agreements with us for a term of one to three years, which provide for monthly payment installments, providing us with a base of recurring revenue.

As of October 31, 2004, we had incurred losses since our incorporation resulting in an accumulated deficit of approximately $446.4 million. During the fiscal year ended July 31, 2004, we had a net loss of approximately $21.4 million. During the fiscal quarter ended October 31, 2004, we had a net loss of approximately $6.6 million. The audit report from KPMG LLP, our independent auditors, relating to our fiscal year 2004 financial statements contains KPMG s opinion that our recurring losses from operations since inception and accumulated deficit, as well as other factors, raise substantial doubt about our ability to continue as a going concern.

We offer a broad range of managed application, infrastructure and messaging services that can be deployed quickly and cost-effectively. Our management expertise allows us to meet an expanding set of needs as our customers applications become more complex. Our experience and capabilities save our customers the time and cost of developing expertise in-house and we increasingly serve as the sole

manager of our customers outsourced applications. All of our service offerings can be customized to meet our customers particular needs. Our services include:

Managed Application Services (A-Services)	Application Hosting Application Management Application Development
Managed Infrastructure Services (I-Services)	Content and Electronic Software Distribution Colocation Bandwidth Security Disaster Recovery
Managed Messaging Services (M-Services)	Managed Messaging

Our service offerings are facilitated by our proprietary Collaborative Application Management platform, or CAM. Our CAM platform enables us, with our customers, to provide highly efficient, effective and customized management of their outsourced enterprise applications and information technology. Comprised of a suite of third-party and proprietary products, CAM provides tools designed specifically to meet the needs of customers who outsource or want to provide on-demand application services.

We believe that the combination of CAM with our physical infrastructure and technical staff gives us a unique ability to provision on-demand application services for software providers for use by their customers. Because this on-demand provisioning capability is not dependent on the individual software application, CAM is application and operating platform neutral. Designed to enable enterprise software applications to be provisioned and used as an on-demand solution, the CAM technology allows us to offer new solutions to our software vendors and new products to our current customers.

Corporate Information

We were formed in 1996 within CMGI, Inc., our former majority stockholder, to support the networks and host Web sites of CMGI, its subsidiaries and several of its affiliated companies. In 1997, we began offering and supplying Web site hosting and management services to companies not affiliated with CMGI. We were incorporated in Delaware in December 1998. In October 1999, we completed our initial public offering of common stock and remained a majority-owned subsidiary of CMGI until September 2002. In September 2002, ClearBlue Technologies, Inc., or CBT, and its subsidiaries became our majority stockholder upon CBT s acquisition from CMGI and Hewlett-Packard Financial Services Company of all of their shares of our common stock then held, warrants to purchase our common stock and convertible promissory notes issued by us in exchange for shares of CBT common stock. In December 2002 and August 2003, CBT transferred shares of our common stock held by it to its stockholders, including the shares of our common stock currently held by Hewlett-Packard Financial Services Company. In connection with CBT s August 2003 transfers to its stockholders of its remaining shares of our common stock, Atlantic Investors, LLC, the indirect majority stockholder of CBT, became our majority stockholder. As of December 6, 2004, Atlantic Investors owned approximately 61% of the issued and outstanding shares of our common stock, allowing it to have significant influence over our management and affairs and the outcome of any corporate action requiring stockholder approval.

Our corporate headquarters are located at 400 Minuteman Road, Andover, Massachusetts, and our telephone number is (978) 682-8300. Our Web site is found at www.navisite.com. The information available on, or that can be accessed through, our Web site is not a part of this prospectus. Our website address is included in this document as an inactive textual reference only. Unless the context otherwise requires, the terms NaviSite, the Company, we, us and our refer to NaviSite, Inc.

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The Offering

Common Stock offered by the selling stockholder	3,000,000 shares
Use of proceeds	NaviSite will not receive any proceeds from the sale of shares in this offering.
Nasdaq SmallCap Market symbol	NAVI

All of the shares being offered by this prospectus are being offered by the selling stockholder listed herein. The selling stockholder identified in this prospectus, or its pledgees, donees, transferees or other successors-in-interest, may offer the shares or interests therein from time to time through public or private transactions at prevailing market prices, at prices related to prevailing market prices or at privately negotiated prices.

Recent Developments

Acquisition of Surebridge

On June 10, 2004, we completed the acquisition of substantially all of the assets and liabilities of Surebridge, Inc., a privately held provider of managed application services for mid-market companies, in exchange for two promissory notes in the aggregate principal amount of approximately $39.3 million, three million shares of our common stock and the assumption of certain liabilities of Surebridge at closing. This acquisition broadens our portfolio of outsourced application services, particularly in the areas of financial management, supply chain management, human resources management and customer relationship management. We now provide these services to a range of vertical industries through our direct sales force as well as channel relationships. The applications we now provide include PeopleSoft, Siebel Systems and the Microsoft Business Solutions suite.

The promissory notes that we issued to Surebridge (now known as Waythere, Inc.) accrue interest on the unpaid balance at an annual rate of 10%, however no interest accrues on any principal paid within nine months of the closing. In the event that we realize net proceeds in excess of $1 million from equity or debt financings or sales of assets, we are obligated to use a significant portion of the proceeds to make payments on the notes. The notes must be paid in full no later than June 10, 2006.

The outstanding principal of and accrued interest on the notes are convertible into shares of NaviSite common stock at a conversion price of $4.642 at the election of the holder:

- at any time following the first anniversary of the closing if the aggregate principal outstanding under the notes at such time is greater than or equal to $20 million;
- at any time following the 18-month anniversary of the closing if the aggregate principal outstanding under the notes at such time is greater than or equal to $10 million;
- at any time following the second anniversary of the closing; and
- at any time following an event of default thereunder.

Waythere may not sell, transfer, assign, convey, encumber, gift, distribute or otherwise dispose of its shares of our common stock or the notes prior to June 10, 2005; provided, however, if we do not make certain payments under the notes or if we otherwise suffer an event of default thereunder, Waythere may sell its shares at any time thereafter.

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RISK FACTORS

You should carefully consider the risks described below before making an investment decision. Our business could be harmed by any of these risks. The trading price of our common stock could decline due to any of these risks, and you may lose all or part of your investment. In assessing these risks, you should also refer to the other information contained or incorporated by reference in this prospectus, including our consolidated financial statements and related notes.

We have a history of losses and may never achieve or sustain profitability and may not continue as a going concern.

We have never been profitable and may never become profitable. Since our incorporation in 1998, we have experienced operating losses and negative operating cash flows for each quarterly and annual period. As of October 31, 2004, we had incurred losses since our incorporation resulting in an accumulated deficit of approximately $446.4 million. During the three months ended October 31, 2004, we had a net loss of approximately $6.6 million. The audit report from KPMG LLP, our independent registered public accounting firm, relating to our fiscal year 2004 financial statements contains KPMG s opinion that our recurring losses from operations since inception and accumulated deficit, as well as other factors, raise substantial doubt about our ability to continue as a going concern. We anticipate that we will continue to incur net losses in the future. We also have significant fixed commitments, including with respect to real estate, bandwidth commitments, machinery and equipment leases. As a result, we can give no assurance that we will achieve profitability or be capable of sustaining profitable operations. If we are unable to reach and sustain profitability, we risk depleting our working capital balances and our business may not continue as a going concern.

We need to obtain additional financing, which may not be available on favorable terms, or at all.

As of October 31, 2004 we had approximately $1.0 million of cash and cash equivalents and a working capital deficit of approximately $37.4 million. Our outstanding balance under our Silicon Valley Bank amended accounts receivable financing agreement as of October 31, 2004 was $20.4 million. We need to raise additional capital and such capital may not be available on favorable terms or at all. On January 22, 2004, we filed with the Securities and Exchange Commission a Registration Statement on Form S-2 to register shares of our common stock to issue and sell in a public offering to raise additional funds. In the event we are not successful in raising capital through this public offering, we will be required to expense $0.7 million of associated offering expenses which are presently included in prepaid expenses and other current assets on our October 31, 2004 Condensed Consolidated Balance Sheet. If we do not raise additional capital, our business may not continue as a going concern.

Our projections for cash usage are based on a number of assumptions, including our ability to:

- retain customers in light of market uncertainties and our uncertain future;
- collect accounts receivables in a timely manner;
- effectively integrate Surebridge and other recent acquisitions and realize forecasted cash savings; and
- achieve other expected cash expense reductions.

Further, our projected use of cash and business results could be affected by continued market uncertainties, including delays or restrictions in information technology spending by customers or potential customers and any merger or acquisition activity.

In recent years, we have generally financed our operations with proceeds from selling shares of our stock and borrowing funds. There can be no assurance that additional financing will be available on favorable terms, or at all. In addition, even if we find outside funding sources, we may be required to issue securities with greater rights than those currently possessed by holders of our common stock. We may also be required to take other actions that may lessen the value of our common stock or dilute our common

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stockholders, including borrowing money on terms that are not favorable to us or issuing additional equity securities. If we experience difficulties raising money in the future, our business and liquidity will be materially adversely affected.

We may not realize all of the anticipated benefits of our recent acquisition of Surebridge.

On June 10, 2004, pursuant to an asset purchase agreement dated May 6, 2004, we completed the acquisition of substantially all of the assets and liabilities of Surebridge for three million shares of our common stock and two promissory notes in the aggregate principal amount of approximately $39.3 million.

The success of the acquisition depends, in part, on our ability to realize the anticipated synergies, cost savings and growth and marketing opportunities from integrating the businesses of Surebridge with the businesses of NaviSite. Our success in realizing these benefits and the timing of this realization depend upon the successful integration of the technology, personnel and operations of Surebridge. The integration of two independent companies is a complex, costly and time-consuming process. The difficulties of combining the operations of the companies include, among others:

retaining key employees;

consolidating corporate and administrative infrastructures;

maintaining customer service levels;

coordinating sales and marketing functions;

preserving the distribution, marketing, promotion and other important internal operations and third-party relationships of Surebridge;

minimizing the diversion of management s attention from our current business;

coordinating geographically disparate organizations and data centers; and

retaining key customers.

There can be no assurance that the integration of Surebridge with NaviSite will result in the realization of the full benefits that we anticipate in a timely manner or at all.

The convertible promissory notes we issued in the Surebridge acquisition may negatively affect our liquidity and our ability to obtain additional financing and operate and manage our business.

On June 10, 2004, in connection with our acquisition of the Surebridge business, we issued two convertible promissory notes in the aggregate principal amount of approximately $39.3 million. We must repay the outstanding principal of the notes with all interest accrued thereon, no later than June 10, 2006. In addition, if we complete certain equity or debt financings, including our proposed public offering, we are obligated to use a significant portion of the proceeds to make payments on the notes. Specifically, if we realize net proceeds in excess of $1.0 million from certain equity or debt financings or sales of assets, we would be obligated to make a payment on the notes equal to 75% of the net proceeds.

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The notes, or the prepayment obligation thereon, may adversely affect our ability to raise or retain additional capital. If we commit an event of default under any of the promissory notes, which may include a default of obligations owed to other third parties, prior to the respective maturity dates of the promissory notes, then the holders of the promissory notes may declare the notes immediately due and payable, which would adversely affect our liquidity and our ability to manage our business. Furthermore, the promissory notes contain certain restrictive covenants, including with respect to our ability to incur indebtedness.

Our common stockholders may suffer significant dilution in the future upon the conversion of outstanding securities and the issuance of additional securities in potential future acquisitions.

The outstanding principal and accrued interest on the two Surebridge promissory notes shall be convertible into shares of our common stock at a conversion price of $4.642, at the election of the holder:

- at any time following the first anniversary of the closing if the aggregate principal outstanding under the notes at such time is greater than or equal to $20.0 million;
- at any time following the 18-month anniversary of the closing if the aggregate principal outstanding under the notes at such time is greater than or equal to $10.0 million;
- at any time following the second anniversary of the closing; and
- at any time following an event of default thereunder.

If the promissory notes are converted into shares of common stock, Surebridge may obtain a significant equity interest in NaviSite and other stockholders may experience significant and immediate dilution. Should Surebridge elect to convert all of the initial principal amount of its two convertible promissory notes into shares of our common stock, Surebridge would own approximately 11,466,000 shares of our common stock, which, based on our capitalization as of December 6, 2004, would be approximately 32% of our outstanding shares of common stock.

In addition, our stockholders will experience further dilution to the extent that additional shares of our common stock are issued in potential future acquisitions.

Our financing agreement with Silicon Valley Bank includes various covenants and restrictions that may negatively affect our liquidity and our ability to operate and manage our business.

As of October 31, 2004, we owed Silicon Valley Bank approximately $20.4 million under our amended accounts receivable financing agreement. The accounts receivable financing agreement generally restricts or limits, among other things, our ability to:

- create or incur indebtedness;
- sell, or permit any lien or security interest in, any of our assets;
- enter into or permit any material transaction with any of our affiliates;
- merge or consolidate with any other party, or acquire all or substantially all of the capital stock or property of another party, unless, among other things, the other party is in the same, or a similar line of business as us;
- relocate our principal executive office or add any new offices or business locations;
- change our state of formation;
- change our legal name;

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- make investments;
- pay dividends or make any distribution or payment or redeem, retire or purchase our capital stock; and
- make or permit any payment on subordinated debt or amend any provision in any document relating to any subordinated debt.

Further, the accounts receivable financing agreement requires that we maintain EBITDA of at least $1.00 for every fiscal quarter. The agreement defines EBITDA as earnings before interest, taxes, depreciation and amortization in accordance with generally accepted accounting principles and excluding acquisition-related costs and one-time extraordinary charges.

If we breach our accounts receivable financing agreement with Silicon Valley Bank, which may be deemed to have occurred upon an event of default under the promissory notes issued in the Surebridge transaction, a default could result. A default, if not waived, could result in, among other things, us not being able to borrow additional amounts from Silicon Valley Bank and all or a portion of our outstanding amounts may become due and payable on an accelerated basis, which would adversely affect our liquidity and our ability to manage our business. A default under the accounts receivable financing agreement could also result in a cross-default under the promissory notes issued in the Surebridge transaction thereby accelerating the repayment obligation on the notes and also allowing the holder to elect to convert the principal and accrued interest thereon into shares of our common stock.

Our limited operating history with our current operating structure makes it difficult for us and our investors to evaluate our past performance and future prospects.

We have completed a number of acquisitions since December 2002. Until a significant period of time elapses, it will be difficult to determine if we correctly valued these acquired businesses or adequately anticipated all of the demands that our growth will impose on our personnel, procedures and structures, including our financing and reporting control systems and management structure. Our limited operating history with our current structure makes it very difficult for you and us to evaluate or predict our ability to, among other things, retain customers, generate and sustain a revenue base sufficient to meet our operating expenses, and achieve and sustain profitability.

A significant portion of our revenue comes from one customer and, if we lost this customer, it would have a significant adverse impact on our business results and cash flows.

The New York State Department of Labor represented approximately 8% of our consolidated revenue for the three months ended October 31, 2004. The New York State Department of Labor has been a long-term customer of ours, but there can be no assurance that we will be able to retain this customer. Further, there can be no assurance that we will be able to maintain the same level of service to this customer or that our revenue from this customer will not decline or suffer a material reduction in future periods. The New York State Department of Labor is not obligated under our agreement to buy a minimum amount of services from us or designate us as its sole supplier of any particular service. This contract with The New York State Department of Labor, and its funding allowance, expires in June 2005. Further, The New York State Department of Labor has the right to terminate this contract at any time by providing us with 60 days notice. If we were to lose this customer or suffer a material reduction in the revenue generated from this customer, it would have a significant adverse impact on our business results and cash flows.

Atlantic Investors may have interests that conflict with the interests of our other stockholders and, as our majority stockholder, can prevent new and existing investors from influencing significant corporate decisions.

Atlantic Investors owns approximately 61% of our outstanding capital stock as of December 6, 2004. In addition, Atlantic Investors holds a note in the principal amount of $3.0 million due upon the earlier to occur of February 1, 2005, and five business days after our receipt of net proceeds from a financing or a

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sale of assets of at least $13.0 million, after satisfying the mandatory prepayment obligations under the promissory notes issued to Surebridge. Atlantic Investors has the power, acting alone, to elect a majority of our Board of Directors and has the ability to control our management and affairs and determine the outcome of any corporate action requiring stockholder approval, regardless of how our other stockholders may vote, including the election of directors, any merger, consolidation or sale of all or substantially all of our assets, and any other significant corporate transaction. Under Delaware law, Atlantic Investors is able to exercise its voting power by written consent, without convening a meeting of the stockholders, which means that Atlantic Investors could effect a sale or merger of us without the consent of our other stockholders. Atlantic Investors ownership of a majority of our outstanding common stock may have the effect of delaying, deterring or preventing a change in control of us or discouraging a potential acquiror from attempting to obtain control of us, which in turn could adversely affect the market price of our common stock.

Members of our management group also have significant interests in Atlantic Investors, which may create conflicts of interest.

Some of the members of our management group also serve as members of the management group of Atlantic Investors and its affiliates. Specifically, Andrew Ruhan, our Chairman of the Board, holds a 10% equity interest in Unicorn Worldwide Holdings Limited, a managing member of Atlantic Investors. Arthur Becker, our President and Chief Executive Officer, is the managing member of Madison Technology LLC, a managing member of Atlantic Investors. As a result, these NaviSite officers and directors may face potential conflicts of interest with each other and with our stockholders. They may be presented with situations in their capacity as our officers or directors that conflict with their fiduciary obligations to Atlantic Investors, which in turn may have interests that conflict with the interests of our other stockholders.

Acquisitions may result in disruptions to our business or distractions of our management due to difficulties in integrating acquired personnel and operations, and these integrations may not proceed as planned.

Since December 2002, we have acquired ClearBlue Technologies Management, Inc., or CBTM (accounted for as an as if pooling), Avasta, Conxion, selected assets of Interliant, all of the shares of ten wholly-owned subsidiaries of ClearBlue Technologies, Inc., or CBT (accounted for as an as if pooling) and substantially all of the assets and liabilities of Surebridge. We intend to continue to expand our business through the acquisition of companies, technologies, products and services. Acquisitions involve a number of special problems and risks, including:

- difficulty integrating acquired technologies, products, services, operations and personnel with the existing businesses;
- difficulty maintaining relationships with important third parties, including those relating to marketing alliances and providing preferred partner status and favorable pricing;
- diversion of management s attention in connection with both negotiating the acquisitions and integrating the businesses;
- strain on managerial and operational resources as management tries to oversee larger operations;
- inability to retain and motivate management and other key personnel of the acquired businesses;
- changes in management and key personnel of acquired businesses may harm relationships with the acquired businesses customers, suppliers and employees;
- exposure to unforeseen liabilities of acquired companies;
- potential costly and time-consuming litigation, including stockholder lawsuits;

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- potential issuance of securities in connection with an acquisition with rights that are superior to the rights of holders of our common stock, or which may have a dilutive effect on our common stockholders;
- the need to incur additional debt or use cash; and
- the requirement to record potentially significant additional future operating costs for the amortization of intangible assets.

As a result of these problems and risks, businesses we acquire may not produce the revenues, earnings or business synergies that we anticipated, and acquired products, services or technologies might not perform as we expected. As a result, we may incur higher costs and realize lower revenues than we had anticipated. We may not be able to successfully address these problems and we cannot assure you that the acquisitions will be successfully identified and completed or that, if acquisitions are completed, the acquired businesses, products, services or technologies will generate sufficient revenue to offset the associated costs or other harmful effects on our business.

A failure to meet customer specifications or expectations could result in lost revenues, increased expenses, negative publicity, claims for damages and harm to our reputation and cause demand for our services to decline.

Our agreements with customers require us to meet specified service levels for the services we provide. In addition, our customers may have additional expectations about our services. Any failure to meet customers specifications or expectations could result in:

- delayed or lost revenue;
- requirements to provide additional services to a customer at reduced charges or no charge;
- negative publicity about us, which could adversely affect our ability to attract or retain customers; and
- claims by customers for substantial damages against us, regardless of our responsibility for such failure, which may not be covered by insurance policies and which may not be limited by contractual terms of our engagement.

Our ability to successfully market our services could be substantially impaired if we are unable to deploy new infrastructure systems and applications or if new infrastructure systems and applications deployed by us prove to be unreliable, defective or incompatible.

We may experience difficulties that could delay or prevent the successful development, introduction or marketing of hosting and application management services in the future. If any newly introduced infrastructure systems and applications suffer from reliability, quality or compatibility problems, market acceptance of our services could be greatly hindered and our ability to attract new customers could be significantly reduced. We cannot assure you that new applications deployed by us will be free from any reliability, quality or compatibility problems. If we incur increased costs or are unable, for technical or other reasons, to host and manage new infrastructure systems and applications or enhancements of existing applications, our ability to successfully market our services could be substantially limited.

Any interruptions in, or degradation of, our private transit Internet connections could result in the loss of customers or hinder our ability to attract new customers.

Our customers rely on our ability to move their digital content as efficiently as possible to the people accessing their Web sites and infrastructure systems and applications. We utilize our direct private transit Internet connections to major network providers, such as Level 3, Internap, WilTel and XO Communications, as a means of avoiding congestion and resulting performance degradation at public Internet exchange points. We rely on these telecommunications network suppliers to maintain the operational integrity of their networks so that our private transit Internet connections operate effectively. If

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our private transit Internet connections are interrupted or degraded, we may face claims by, or lose, customers, and our reputation in the industry may be harmed, which may cause demand for our services to decline.

If we are unable to maintain existing and develop additional relationships with software vendors, the sales and marketing of our service offerings may be unsuccessful.

We believe that to penetrate the market for hosting and application management services we must maintain existing and develop additional relationships with industry-leading software vendors. We license or lease select software applications from software vendors, including IBM, Microsoft, Micromuse and Oracle. Our relationships with Microsoft and PeopleSoft are critical to the operations and success of our recently acquired business from Surebridge. The loss of our ability to continually obtain, utilize or depend on any of these applications or relationships could substantially weaken our ability to provide services to our customers or require us to obtain substitute software applications that may be of lower quality or performance standards or at greater cost. In addition, because we generally license applications on a non-exclusive basis, our competitors may license and utilize the same software applications. In fact, many of the companies with which we have strategic relationships currently have, or could enter into, similar license agreements with our competitors or prospective competitors. We cannot assure you that software applications will continue to be available to us from software vendors on commercially reasonable terms. If we are unable to identify and license software applications that meet our targeted criteria for new application introductions, we may have to discontinue or delay introduction of services relating to these applications.

Our network infrastructure could fail, which would impair our ability to provide guaranteed levels of service and could result in significant operating losses.

To provide our customers with guaranteed levels of service, we must operate our network infrastructure 24 hours a day, seven days a week without interruption. We must, therefore, protect our network infrastructure, equipment and customer files against damage from human error, natural disasters, unexpected equipment failure, power loss or telecommunications failures, terrorism, sabotage or other intentional acts of vandalism. Even if we take precautions, the occurrence of a natural disaster, equipment failure or other unanticipated problem at one or more of our data centers could result in interruptions in the services we provide to our customers. We cannot assure you that our disaster recovery plan will address all, or even most, of the problems we may encounter in the event of a disaster or other unanticipated problem. We have experienced service interruptions in the past, and any future service interruptions could:

- require us to spend substantial amounts of money to replace equipment or facilities;
- entitle customers to claim service credits or seek damages for losses under our service level guarantees;
- cause customers to seek alternate providers; or
- impede our ability to attract new customers, retain current customers or enter into additional strategic relationships.

Our dependence on third parties increases the risk that we will not be able to meet our customers needs for software, systems and services on a timely or cost-effective basis, which could result in the loss of customers.

Our services and infrastructure rely on products and services of third-party providers. We purchase key components of our infrastructure, including networking equipment, from a limited number of suppliers, such as IBM, Cisco Systems and F5 Networks. Our recently acquired business from Surebridge relies on products and services of Microsoft and PeopleSoft. There can be no assurance that we will not experience operational problems attributable to the installation, implementation, integration, performance, features or

functionality of third-party software, systems and services. We cannot assure you that we will have the necessary hardware or parts on hand or that our suppliers will be able to provide them in a timely manner in the event of equipment failure. Our ability to obtain and continue to maintain the necessary hardware or parts on a timely basis could result in sustained equipment failure and a loss of revenue due to customer loss or claims for service credits under our service level guarantees.

We could be subject to increased operating costs, as well as claims, litigation or other potential liability, in connection with risks associated with Internet security and the security of our systems.

A significant barrier to the growth of e-commerce and communications over the Internet has been the need for secure transmission of confidential information. Several of our infrastructure systems and application services utilize encryption and authentication technology licensed from third parties to provide the protections necessary to ensure secure transmission of confidential information. We also rely on security systems designed by third parties and the personnel in our network operations centers to secure those data centers. Any unauthorized access, computer viruses, accidental or intentional actions and other disruptions could result in increased operating costs. For example, we may incur additional significant costs to protect against these interruptions and the threat of security breaches or to alleviate problems caused by such interruptions or breaches. If a third party were able to misappropriate a consumer s personal or proprietary information, including credit card information, during the use of an application solution provided by us, we could be subject to claims, litigation or other potential liability.

Third-party infringement claims against our technology suppliers, customers or us could result in disruptions in service, the loss of customers or costly and time-consuming litigation.

We license or lease most technologies used in the infrastructure systems and application services that we offer. Our technology suppliers may become subject to third-party infringement or other claims and assertions, which could result in their inability or unwillingness to continue to license their technologies to us. We cannot assure you that third parties will not assert claims against us in the future or that these claims will not be successful. Any infringement claim as to our technologies or services, regardless of its merit, could result in delays in service, installation or upgrades, the loss of customers or costly and time-consuming litigation.

We may be subject to legal claims in connection with the information disseminated through our network, which could divert management s attention and require us to expend significant financial resources.

We may face potential direct and indirect liability for claims of defamation, negligence, copyright, patent or trademark infringement and other claims based on the nature and content of the materials disseminated through our network. For example, lawsuits may be brought against us claiming that content distributed by some of our current or future customers may be regulated or banned. In these and other instances, we may be required to engage in protracted and expensive litigation that could have the effect of diverting management s attention from our business and require us to expend significant financial resources. Our general liability insurance may not cover any of these claims or may not be adequate to protect us against all liability that may be imposed. In addition, on a limited number of occasions in the past, businesses, organizations and individuals have sent unsolicited commercial e-mails from servers hosted at our facilities to a number of people, typically to advertise products or services. This practice, known as spamming, can lead to statutory liability as well as complaints against service providers that enable such activities, particularly where recipients view the materials received as offensive. We have in the past received, and may in the future receive, letters from recipients of information transmitted by our customers objecting to such transmission. Although we prohibit our customers by contract from spamming, we cannot assure you that our customers will not engage in this practice, which could subject us to claims for damages.

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If we fail to attract or retain key officers, management and technical personnel, our ability to successfully execute our business strategy or to continue to provide services and technical support to our customers could be adversely affected and we may not be successful in attracting new customers.

We believe that attracting, training, retaining and motivating technical and managerial personnel, including individuals with significant levels of infrastructure systems and application expertise, is a critical component of the future success of our business. Qualified technical personnel are likely to remain a limited resource for the foreseeable future and competition for these personnel is intense. The departure of any of our executive officers, particularly Arthur P. Becker, our Chief Executive Officer and President, or core members of our sales and marketing teams or technical service personnel, would have negative ramifications on our customer relations and operations, including adversely affecting the stability of our infrastructure and our ability to provide the guaranteed service levels our customers expect. Any officer or employee can terminate his or her relationship with us at any time. In addition, we do not carry life insurance on any of our personnel. Over the past two years, we have had significant reductions-in-force due to redundancies and restructurings resulting from the consolidation of our acquired companies. We have also had a number of departures of several members of senior management due primarily to the change of control of NaviSite on September 11, 2002. In the event future reductions or departures of employees occur, our ability to successfully execute our business strategy, or to continue to provide services to our customers or attract new customers, could be adversely affected.

The unpredictability of our quarterly results may cause the trading price of our common stock to fluctuate or decline.

Our quarterly operating results may vary significantly from quarter-to-quarter and period-to-period as a result of a number of factors, many of which are outside of our control and any one of which may cause our stock price to fluctuate. The primary factors that may affect our operating results include the following:

- reduction of market demand and/or acceptance of our services;
- oversupply of data center space in the industry;
- our ability to develop, market and introduce new services on a timely basis;
- the length of the sales cycle for our services;
- the timing and size of sales of our services, which depends on the budgets of our customers;
- downward price adjustments by our competitors;
- changes in the mix of services provided by our competitors;
- technical difficulties or system downtime affecting the Internet or our hosting operations;
- our ability to meet any increased technological demands of our customers; and
- the amount and timing of costs related to our marketing efforts and service introductions.

Due to the above factors, we believe that quarter-to-quarter or period-to-period comparisons of our operating results may not be a good indicator of our future performance. Our operating results for any particular quarter may fall short of our expectations or those of stockholders or securities analysts. In this event, the trading price of our common stock would likely fall.

If we are unsuccessful in pending and potential litigation matters, our financial condition may be adversely affected.

We are currently involved in various pending and potential legal proceedings, including a class action lawsuit related to our initial public offering, a bankruptcy trustee claim, an arbitration matter involving the former stockholders of Avasta and counterclaims by the defendant in a suit in which we are the plaintiff. If we are ultimately unsuccessful in any of these matters, we could be required to pay substantial amounts

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of cash and/or shares of our common stock to the other parties. The amount and timing of any such payments could adversely affect our financial condition.

If the markets for outsourced information technology infrastructure and applications, Internet commerce and communication decline, there may be insufficient demand for our services and, as a result, our business strategy and objectives may fail.

The increased use of the Internet for retrieving, sharing and transferring information among businesses and consumers is developing, and the market for the purchase of products and services over the Internet is still relatively new and emerging. Our industry has experienced periods of rapid growth, followed by a sharp decline in demand for products and services, which related to the failure in the last few years of many companies focused on developing Internet-related businesses. If acceptance and growth of the Internet as a medium for commerce and communication declines, our business strategy and objectives may fail because there may not be sufficient market demand for our hosting and application management services.

If we do not respond to rapid changes in the technology sector, we will lose customers.

The markets for the technology-related services we offer are characterized by rapidly changing technology, evolving industry standards, frequent new service introductions, shifting distribution channels and changing customer demands. We may not be able to adequately adapt our services or to acquire new services that can compete successfully. In addition, we may not be able to establish and maintain effective distribution channels. We risk losing customers to our competitors if we are unable to adapt to this rapidly evolving marketplace.

The market in which we operate is highly competitive and is likely to consolidate, and we may lack the financial and other resources, expertise or capability needed to capture increased market share or maintain market share.

We compete in the hosting and application management services market. This market is rapidly evolving, highly competitive and likely to be characterized by over-capacity and industry consolidation. Our competitors may consolidate with one another or acquire software application vendors or technology providers, enabling them to more effectively compete with us. Many participants in this market have suffered significantly in the last several years. We believe that participants in this market must grow rapidly and achieve a significant presence to compete effectively. This consolidation could affect prices and other competitive factors in ways that would impede our ability to compete successfully in the hosting and application management services market.

Further, our business is not as developed as that of many of our competitors. Many of our competitors have substantially greater financial, technical and market resources, greater name recognition and more established relationships in the industry. Many of our competitors may be able to:

- develop and expand their network infrastructure and service offerings more rapidly;
- adapt to new or emerging technologies and changes in customer requirements more quickly;
- take advantage of acquisitions and other opportunities more readily; or
- devote greater resources to the marketing and sale of their services and adopt more aggressive pricing policies than we can.

We may lack the financial and other resources, expertise or capability needed to maintain or capture increased market share in this environment in the future. Because of these competitive factors and due to our comparatively small size and our lack of financial resources, we may be unable to successfully compete in the hosting and application management services market.

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The emergence and growth of a market for our hosting and managed application services will be impaired if third parties do not continue to develop and improve Internet infrastructure.

The recent growth in the use of the Internet has caused frequent periods of performance degradation, requiring the upgrade of routers and switches, telecommunications links and other components forming the infrastructure of the Internet. Any perceived degradation in the performance of the Internet as a means to transact business and communicate could undermine the benefits and market acceptance of our services. Consequently, the market for our services will be impaired if improvements are not made to the entire Internet infrastructure to alleviate overloading and congestion.

Difficulties presented by international economic, political, legal, accounting and business factors could harm our business in international markets.

We operate a data center in the United Kingdom and revenue from our foreign operations accounted for approximately 5% of our total revenue during the three months ended October 31, 2004. Although we expect to focus most of our growth efforts in the United States, we may enter into joint ventures or outsourcing agreements with third parties, acquire complementary businesses or operations, or establish and maintain new operations outside of the United States. Some risks inherent in conducting business internationally include:

- unexpected changes in regulatory, tax and political environments;
- longer payment cycles and problems collecting accounts receivable;
- geopolitical risks such as political and economic instability and the possibility of hostilities among countries;
- reduced protection of intellectual property rights;
- fluctuations in currency exchange rates;
- our ability to secure and maintain the necessary physical and telecommunications infrastructure;
- challenges in staffing and managing foreign operations;
- employment laws and practices in foreign countries; and
- laws and regulations on content distributed over the Internet that are more restrictive than those currently in place in the United States.

Any one or more of these factors could adversely affect our contemplated future international operations and consequently, our business.

We may become subject to burdensome government regulation and legal uncertainties that could substantially harm our business or expose us to unanticipated liabilities.

It is likely that laws and regulations directly applicable to the Internet or to hosting and managed application service providers may be adopted. These laws may cover a variety of issues, including user privacy and the pricing, characteristics and quality of products and services. The adoption or modification of laws or regulations relating to commerce over the Internet could substantially impair the growth of our business or expose us to unanticipated liabilities. Moreover, the applicability of existing laws to the Internet and hosting and managed application service providers is uncertain. These existing laws could expose us to substantial liability if they are found to be applicable to our business. For example, we provide services over the Internet in many states in the United States and elsewhere and facilitate the activities of our customers in such jurisdictions. As a result, we may be required to qualify to do business, be subject to taxation or be subject to other laws and regulations in these jurisdictions, even if we do not have a physical presence, employees or property in those states.

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The price of our common stock has been volatile, and may continue to experience wide fluctuations.

Since January 1, 2004, our common stock has closed as low as $1.41 per share and as high as $7.30 per share. The trading price of our common stock has been and may continue to be subject to wide fluctuations due to the risk factors discussed in this section and elsewhere in this prospectus. Fluctuations in the market price of our common stock may cause you to lose some or all of your investment. In addition, should the market price of our common stock be below $1.00 per share for an extended period, Nasdaq may delist our common stock, which would have an adverse effect on the trading of our common stock. On June 10, 2002, the listing of our common stock transferred from the Nasdaq National Market to the Nasdaq SmallCap Market because the market price of our common stock had failed to maintain compliance with the Nasdaq National Market s minimum $1.00 per share continued listing requirement. A delisting of our common stock from Nasdaq could materially reduce the liquidity of our common stock and result in a corresponding material reduction in the price of our common stock. In addition, any such delisting could harm our ability to raise capital through alternative financing sources on terms acceptable to us, or at all, and may result in the potential loss of confidence by suppliers, customers and employees.

Anti-takeover provisions in our corporate documents may discourage or prevent a takeover.

Provisions in our certificate of incorporation and our by-laws may have the effect of delaying or preventing an acquisition or merger in which we are acquired or a transaction that changes our Board of Directors. These provisions:

authorize the board to issue preferred stock without stockholder approval;

prohibit cumulative voting in the election of directors;

limit the persons who may call special meetings of stockholders; and

establish advance notice requirements for nominations for the election of directors or for proposing matters that can be acted on by stockholders at stockholder meetings.

SPECIAL NOTE REGARDING FORWARD-LOOKING INFORMATION

This prospectus includes and incorporates forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements, other than statements of historical facts, included or incorporated in this prospectus regarding our strategy, future operations, financial position, future revenues, projected costs, prospects, plans and objectives of management are forward-looking statements. The words anticipates, believes, estimates, expects, intends, may, plans, projects, wi similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain these identifying words. We cannot guarantee that we actually will achieve the plans, intentions or expectations disclosed in our forward-looking statements and you should not place undue reliance on our forward-looking statements. Actual results or events could differ materially from the plans, intentions and expectations disclosed in the forward-looking statements we make. We have included important factors in the cautionary statements included or incorporated in this prospectus, particularly under the heading Risk Factors, that we believe could cause actual results or events to differ materially from the forward-looking statements that we make. Our forward-looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures or investments we may make. Except as otherwise required by law, we do not assume any obligation to update any forward-looking statements.

USE OF PROCEEDS

We will not receive any proceeds from the sale of shares by the selling stockholder. The selling stockholder will pay any underwriting discounts and commissions and expenses incurred by it for brokerage, accounting, tax or legal services or any other expenses incurred by the selling stockholder in disposing of the shares. We will bear all other reasonable costs, fees and expenses incurred in effecting the

registration of the shares covered by this prospectus, including, without limitation, all registration and filing fees, all national securities exchange or automated quotation system application and filing fees, blue sky registration and filing fees, and fees and expenses of our counsel and our accountants.

SELLING STOCKHOLDER

The following table sets forth information with respect to the number of shares of our common stock owned by the selling stockholder named below as of December 15, 2004 and as adjusted to give effect to the sale of the shares offered hereby. This prospectus will also cover any additional shares of our common stock which become issuable in connection with the shares registered for sale hereby by reason of any stock dividend, stock split, recapitalization or other similar transaction effected without the receipt of consideration which results in an increase in the number of NaviSite s outstanding shares of common stock.

The shares being offered by the selling stockholder were acquired in connection with our acquisition of the Surebridge business. At the closing of the acquisition, we issued 3,000,000 shares of common stock and promissory notes totaling approximately $39.3 million to the selling stockholder. The shares of common stock were issued pursuant to the exemption from the registration and prospectus delivery requirements of the Securities Act of 1933 under Section 4(2) thereof. In connection with the asset purchase agreement dated May 6, 2004 by and among NaviSite, Waythere, and Lexington Acquisition Corp., as amended, we entered into a registration rights agreement with Waythere dated as of June 10, 2004. In the registration rights agreement, we undertook to file a registration statement to register the shares of our common stock issued at the closing of the transaction. The registration rights agreement also includes certain indemnification arrangements with Waythere. In addition, Waythere may not sell, transfer, assign, convey, encumber, gift, distribute or otherwise dispose of its shares of our common stock or the notes prior to June 10, 2005; provided, however, if we do not make certain payments under the notes or if we otherwise suffer an event of default thereunder, Surebridge may sell its shares at any time thereafter.

The shares covered by this prospectus may be offered from time to time by the selling stockholder named below:

Name of Selling Stockholder	Number of Shares of Common Stock Beneficially Owned Prior to Offering	Number of Shares of Common Stock Being Offered	Number of Shares of Common Stock Beneficially Owned After Offering(1)	
			Number	Percentage
Waythere, Inc.(2)	3,000,000	3,000,000	0	

(1) The number of shares beneficially owned by the selling stockholder after the offering assumes disposition by such selling stockholder of all the shares of NaviSite common stock being offered.

(2) Formerly Surebridge, Inc.

For a description of the Surebridge acquisition, see Prospectus Summary Recent Developments. Except as set forth therein, the selling stockholder has not held any position or office with, and has not otherwise had a material relationship with, NaviSite or any of our subsidiaries within the past three years.

PLAN OF DISTRIBUTION

The selling securityholders may resell or redistribute the securities listed elsewhere in this prospectus from time to time on any stock exchange or automated interdealer quotation system on which the securities are listed, in the over-the-counter market, in privately negotiated transactions, or in any other legal manner, at fixed prices that may be changed, at market prices prevailing at the time of sale, at prices related to prevailing market prices or at negotiated prices. Persons who are pledgees, donees, transferees, or other successors in interest of the named selling stockholder (including but not limited to persons who receive securities from the named selling stockholder as a gift, distribution or other non-sale-related

transfer after the date of this prospectus) may also use this prospectus and are included when we refer to selling securityholders in this prospectus. Selling securityholders may sell the securities by one or more of the following methods, without limitation:

- block trades (which may include cross trades) in which the broker or dealer so engaged will attempt to sell the securities as agent but may position and resell a portion of the block as principal to facilitate the transaction;
- purchases by a broker or dealer as principal and resale by the broker or dealer for its own account;
- an exchange distribution or secondary distribution in accordance with the rules of any stock exchange on which the securities are listed;
- ordinary brokerage transactions and transactions in which the broker solicits purchases;
- an offering at other than a fixed price on or through the facilities of any stock exchange on which the securities are listed or to or through a market maker other than on that stock exchange;
- privately negotiated transactions, directly or through agents;
- short sales;
- through the writing of options on the securities, whether or the options are listed on an options exchange;
- through the distribution of the securities by any selling securityholder to its partners, members or stockholders;
- one or more underwritten offerings;
- agreements between a broker or dealer and one or more of the selling securityholders to sell a specified number of the securities at a stipulated price per share; and
- any combination of any of these methods of sale or distribution, or any other method permitted by applicable law.

The selling securityholders may also transfer the securities by gift. We do not know of any current arrangements by the selling securityholders for the sale or distribution of any of the securities.

The selling securityholders may engage brokers and dealers, and any brokers or dealers may arrange for other brokers or dealers to participate in effecting sales of the securities. These brokers, dealers or underwriters may act as principals, or as an agent of a selling securityholder. Broker-dealers may agree with a selling securityholder to sell a specified number of the securities at a stipulated price per security. If the broker-dealer is unable to sell securities acting as agent for a selling securityholder, it may purchase as principal any unsold securities at the stipulated price. Broker-dealers who acquire securities as principals may thereafter resell the securities from time to time in transactions in any stock exchange or automated interdealer quotation system on which the securities are then listed, at prices and on terms then prevailing at the time of sale, at prices related to the then-current market price or in negotiated transactions. Broker-dealers may use block transactions and sales to and through broker-dealers, including transactions of the nature described above. The selling securityholders may also sell the securities in accordance with Rule 144 under the Securities Act of 1933, as amended, provided they meet the criteria and conform to the requirements of Rule 144, rather than pursuant to this prospectus, regardless of whether the securities are covered by this prospectus.

From time to time, one or more of the selling securityholders may pledge, hypothecate or grant a security interest in some or all of the securities owned by them. The pledgees, secured parties or persons to whom the securities have been hypothecated will, upon foreclosure in the event of default, be deemed to be selling securityholders. The number of a selling securityholder s securities offered under this prospectus will decrease as and when it takes such actions. The plan of distribution for that selling securityholder s securities will otherwise remain unchanged. In addition, a selling securityholder may, from time to time,

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sell the securities short, andiv>

$
1.71

$
3.44

Weighted average number of basic shares
72.1

74.7

72.5

75.9

Diluted earnings per share:

Net income attributable to W. R. Grace & Co. shareholders
$
0.19

$
0.99

$
1.69

$
3.40

Weighted average number of diluted shares
72.7

75.6

73.1

76.8

The Notes to Consolidated Financial Statements are an integral part of these statements.

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W. R. Grace & Co. and Subsidiaries
Consolidated Statements of Comprehensive (Loss) Income (unaudited)

(In millions)	Three Months Ended September 30, 2015	Three Months Ended September 30, 2014	Nine Months Ended September 30, 2015	Nine Months Ended September 30, 2014
Net income	$14.1	$75.0	$124.4	$262.0
Other comprehensive (loss) income:				
Defined benefit pension and other postretirement plans, net of income taxes	(2.6)	(18.6)	(3.8)	3.2
Currency translation adjustments	(32.8)	(12.7)	(44.3)	(7.5)
(Loss) gain from hedging activities, net of income taxes	(1.4)	0.7	(1.7)	(1.0)
Other than temporary impairment of investment	—	0.8	—	0.8
Gain (loss) on securities available for sale, net of income taxes	—	0.4	—	(0.1)
Total other comprehensive (loss) income attributable to noncontrolling interests	(0.6)	0.7	0.1	0.8
Total other comprehensive loss	(37.4)	(28.7)	(49.7)	(3.8)
Comprehensive (loss) income	(23.3)	46.3	74.7	258.2
Less: comprehensive loss (income) attributable to noncontrolling interests	0.3	(1.2)	(0.6)	(2.0)
Comprehensive (loss) income attributable to W. R. Grace & Co. shareholders	$(23.0)	$45.1	$74.1	$256.2

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W. R. Grace & Co. and Subsidiaries
Consolidated Statements of Cash Flows (unaudited)

(In millions)	Nine Months Ended September 30, 2015	2014
OPERATING ACTIVITIES		
Net income	$124.4	$262.0
Reconciliation to net cash used for operating activities:		
Depreciation and amortization	99.5	102.3
Equity in earnings of unconsolidated affiliate	(12.1)	(13.2)
Dividends received from unconsolidated affiliate	11.8	11.2
Chapter 11 expenses, net	4.3	10.8
Asbestos and bankruptcy related charges, net	(8.7)	6.8
Cash paid for Chapter 11 and asbestos	(493.8)	(1,344.6)
Cash paid to settle deferred payment obligation	—	(632.0)
Provision for income taxes	122.4	66.7
Cash paid for income taxes, net of refunds	(34.2)	(21.7)
Excess tax benefits from stock-based compensation	—	(0.7)
Cash paid for interest on credit arrangements	(55.7)	(19.8)
Defined benefit pension expense	23.9	19.5
Cash paid under defined benefit pension arrangements	(13.2)	(94.1)
Currency and other losses in Venezuela	72.5	1.0
Cash paid for repositioning	(18.6)	—
Cash paid for restructuring	(12.1)	(4.8)
Cash paid for environmental remediation	(8.7)	(9.7)
Changes in assets and liabilities, excluding effect of currency translation:		
Trade accounts receivable	(35.4)	(51.4)
Inventories	(16.4)	(49.9)
Accounts payable	40.0	18.6
All other items, net	129.3	106.6
Net cash used for operating activities	(80.8)	(1,636.4)
INVESTING ACTIVITIES		
Capital expenditures	(112.4)	(121.7)
Transfer from restricted cash and cash equivalents	—	395.4
Other investing activities	(1.7)	5.7
Net cash (used for) provided by investing activities	(114.1)	279.4
FINANCING ACTIVITIES		
Borrowings under credit arrangements	306.3	1,114.4
Repayments under credit arrangements	(85.7)	(750.0)
Proceeds from issuance of bonds	—	1,000.0
Cash paid for debt financing costs	(0.4)	(38.6)
Cash paid for repurchases of common stock	(220.1)	(334.4)
Proceeds from exercise of stock options	24.9	17.6
Excess tax benefits from stock-based compensation	—	0.7
Other financing activities	—	0.2
Net cash provided by financing activities	25.0	1,009.9
Effect of currency exchange rate changes on cash and cash equivalents	(56.5)	(9.7)
Decrease in cash and cash equivalents	(226.4)	(356.8)

Cash and cash equivalents, beginning of period	557.5	964.8
Cash and cash equivalents, end of period	$331.1	$608.0

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W. R. Grace & Co. and Subsidiaries
Consolidated Balance Sheets (unaudited)

(In millions, except par value and shares)	September 30, 2015	December 31, 2014
ASSETS		
Current Assets		
Cash and cash equivalents	$331.1	$557.5
Trade accounts receivable, less allowance of $7.8 (2014—$5.8)	455.2	481.1
Inventories	323.1	332.8
Deferred income taxes	239.6	235.4
Other current assets	77.3	84.1
Total Current Assets	1,426.3	1,690.9
Properties and equipment, net of accumulated depreciation and amortization of $1,747.1 (2014—$1,818.4)	813.9	833.5
Goodwill	439.9	452.9
Technology and other intangible assets, net	265.7	288.0
Deferred income taxes	545.6	612.0
Overfunded defined benefit pension plans	44.7	44.1
Investment in unconsolidated affiliate	112.1	113.1
Other assets	59.3	60.7
Total Assets	$3,707.5	$4,095.2
LIABILITIES AND EQUITY		
Current Liabilities		
Debt payable within one year	$72.0	$96.8
Accounts payable	262.3	255.3
PI warrant liability	—	490.0
Other current liabilities	380.8	340.0
Total Current Liabilities	715.1	1,182.1
Debt payable after one year	2,143.8	1,919.0
Deferred income taxes	17.7	19.3
Income tax contingencies	22.5	24.0
Underfunded and unfunded defined benefit pension plans	440.0	457.5
Other liabilities	111.0	124.3
Total Liabilities	3,450.1	3,726.2
Commitments and Contingencies—Note 8		
Equity		
Common stock issued, par value $0.01; 300,000,000 shares authorized; outstanding: 71,354,446 (2014—72,922,565)	0.8	0.7
Paid-in capital	491.1	526.1
Retained earnings	416.0	292.1
Treasury stock, at cost: shares: 6,102,179 (2014—4,524,688)	(581.3)	(429.2)
Accumulated other comprehensive loss	(73.6)	(23.8)
Total W. R. Grace & Co. Shareholders' Equity	253.0	365.9
Noncontrolling interests	4.4	3.1
Total Equity	257.4	369.0
Total Liabilities and Equity	$3,707.5	$4,095.2

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W. R. Grace & Co. and Subsidiaries
Consolidated Statements of Equity (unaudited)

(In millions)	Common Stock and Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Noncontrolling Interests	Total Equity
Balance, December 31, 2013	$534.2	$15.8	$—	$ 10.6	$10.6	$571.2
Net income	—	260.8	—	—	1.2	262.0
Repurchase of common stock	—	—	(334.4)	—	—	(334.4)
Purchase of noncontrolling interest	—	—	—	—	(0.7)	(0.7)
Stock based compensation	9.9	—	—	—	—	9.9
Exercise of stock options	(7.2)	—	24.8	—	—	17.6
Tax benefit related to stock plans	0.7	—	—	—	—	0.7
Shares issued	1.9	—	—	—	—	1.9
Other comprehensive income (loss)	—	—	—	(4.6)	0.8	(3.8)
Balance, September 30, 2014	$539.5	$276.6	$(309.6)	$ 6.0	$11.9	$524.4
Balance, December 31, 2014	$526.8	$292.1	$(429.2)	$ (23.8)	$3.1	$369.0
Net income	—	123.9	—	—	0.5	124.4
Repurchase of common stock	—	—	(220.1)	—	—	(220.1)
Purchase of noncontrolling interest	(0.7)	—	—	—	0.7	—
Stock based compensation	7.4	—	—	—	—	7.4
Exercise of stock options	(43.1)	—	68.0	—	—	24.9
Tax benefit related to stock plans	0.5	—	—	—	—	0.5
Shares issued	1.0	—	—	—	—	1.0
Other comprehensive income (loss)	—	—	—	(49.8)	0.1	(49.7)
Balance, September 30, 2015	$491.9	$416.0	$(581.3)	$ (73.6)	$4.4	$257.4

The Notes to Consolidated Financial Statements are an integral part of these statements.

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Notes to Consolidated Financial Statements

1. Basis of Presentation and Summary of Significant Accounting and Financial Reporting Policies

W. R. Grace & Co., through its subsidiaries, is engaged in specialty chemicals and specialty materials businesses on a global basis through three operating segments: Grace Catalysts Technologies, which includes catalysts and related products and technologies used in refining, petrochemical and other chemical manufacturing applications; Grace Materials Technologies, which includes packaging technologies and engineered materials used in consumer, industrial, coatings, and pharmaceutical applications; and Grace Construction Products, which includes specialty construction chemicals and specialty building materials used in commercial, infrastructure and residential construction.

W. R. Grace & Co. conducts all of its business through a single wholly owned subsidiary, W. R. Grace & Co.—Conn. ("Grace—Conn."). Grace—Conn. owns all of the assets, properties and rights of W. R. Grace & Co. on a consolidated basis, either directly or through subsidiaries.

As used in these notes, the term "Company" refers to W. R. Grace & Co. The term "Grace" refers to the Company and/or one or more of its subsidiaries and, in certain cases, their respective predecessors.

On February 5, 2015, the Company announced its intent to separate the business, assets and liabilities associated with the Grace Construction Products operating segment and the packaging technologies business (collectively, "GCP") into an independent publicly-traded company. Following the separation, Grace will consist of the Catalysts Technologies and Materials Technologies (excluding the packaging technologies business) operating segments. Grace intends that the separation transaction will be a tax-free spin-off to the Company's stockholders for U.S. federal income tax purposes and expects the transaction to be completed in the 2016 first quarter.

Chapter 11 Proceedings   On April 2, 2001, Grace and 61 of its United States subsidiaries and affiliates filed voluntary petitions for reorganization under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court") in order to resolve outstanding asbestos personal injury and property damage claims, including class-action lawsuits alleging damages from Zonolite® Attic Insulation ("ZAI"), a former Grace attic insulation product. In 2008, Grace and other parties filed a joint plan of reorganization with the Bankruptcy Court (as subsequently amended, the "Joint Plan"). Following the confirmation of the Joint Plan in 2011 by the Bankruptcy Court and in 2012 by a U.S. District Court, and the resolution of all appeals, Grace emerged from bankruptcy on February 3, 2014.

Basis of Presentation   The interim Consolidated Financial Statements presented herein are unaudited and should be read in conjunction with the Consolidated Financial Statements presented in the Company's 2014 Annual Report on Form 10-K. Such interim Consolidated Financial Statements reflect all adjustments that, in the opinion of management, are necessary for a fair statement of the results of the interim periods presented; all such adjustments are of a normal recurring nature except for the impacts of adopting new accounting standards as discussed below. All significant intercompany accounts and transactions have been eliminated.

The results of operations for the nine-month interim period ended September 30, 2015, are not necessarily indicative of the results of operations for the year ending December 31, 2015.

Use of Estimates   The preparation of financial statements in conformity with U.S. generally accepted accounting principles ("U.S. GAAP") requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the Consolidated Financial Statements, and the reported amounts of revenues and expenses for the periods presented. Actual amounts could differ from those estimates, and the differences could be material. Changes in estimates are recorded in the period identified. Grace's accounting measurements that are most affected by management's estimates of future events are:

- Realization values of net deferred tax assets, which depend on projections of future taxable income (see Note 5);
- Pension and postretirement liabilities that depend on assumptions regarding participant life spans, future inflation, discount rates and total returns on invested funds (see Note 6); and

Notes to Consolidated Financial Statements (Continued)

1. Basis of Presentation and Summary of Significant Accounting and Financial Reporting Policies (Continued)

- Contingent liabilities, which depend on an assessment of the probability of loss and an estimate of ultimate obligation, such as litigation (see Note 8), income taxes (see Note 5), and environmental remediation (see Note 8).

Reclassifications Certain amounts in prior years' Consolidated Financial Statements have been reclassified to conform to the current year presentation. Such reclassifications have not materially affected previously reported amounts in the Consolidated Financial Statements.

Venezuela Until September 30, 2015, Grace accounted for its results in Venezuela at the official exchange rate of 6.3 bolivars to U.S. dollar. Based on developments in the 2015 third quarter, including changed expectations about Grace's ability to import raw materials at the official exchange rate in the future and the increase in inflation, Grace determined that it is no longer appropriate to do so. Effective September 30, 2015, Grace is accounting for its results in Venezuela at the SIMADI rate. At September 30, 2015, this rate was 199 bolivars to U.S. dollar. Grace recorded a pre-tax charge of $72.5 million in the 2015 third quarter to reflect the devaluation of monetary assets and the impairment of non-monetary assets, including $40.5 million for cash, $26.7 million for working capital and $5.3 million for properties and equipment. Of this amount, $11.7 million related to inventory was recorded in cost of goods sold, and $60.8 million related to other assets and liabilities was recorded as a separate line in the Consolidated Statement of Operations. Grace will continue to operate in Venezuela; however, the remaining assets and liabilities, as well as future sales, earnings and cash flows of Grace's Venezuelan subsidiary will be immaterial after September 30, 2015. See "Item 2. Management's Discussion and Analysis—Venezuela" for further discussion.

Effect of New Accounting Standards In April 2014, the FASB issued ASU 2014-08 "Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity." This update is intended to change the requirements for reporting discontinued operations and enhance convergence of the FASB’s and the International Accounting Standard Board’s ("IASB") reporting requirements for discontinued operations. Grace adopted this standard in the first quarter, and it did not have a material effect on the Consolidated Financial Statements.

In May 2014, the FASB issued ASU 2014-09 "Revenue from Contracts with Customers." This update is intended to remove inconsistencies and weaknesses in revenue requirements; provide a more robust framework for addressing revenue issues; improve comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets; provide more useful information to users of financial statements through improved disclosure requirements; and simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer. The new requirements were to be effective for fiscal years beginning after December 15, 2016, and for interim periods within those fiscal years, with early adoption not permitted. In August 2015, the FASB issued ASU 2015-14 "Revenue from Contracts with Customers—Deferral of the Effective Date," deferring the effective date by one year but permitting adoption as of the original effective date. The revised standard allows for two methods of adoption: (a) full retrospective adoption, meaning the standard is applied to all periods presented, or (b) modified retrospective adoption, meaning the cumulative effect of applying the new standard is recognized as an adjustment to the opening retained earnings balance. Grace does not intend to adopt the standard early and is in the process of determining the adoption method as well as the effects the adoption will have on the Consolidated Financial Statements.

In April 2015, the FASB issued ASU 2015-03 "Simplifying the Presentation of Debt Issuance Costs." This update is part of the FASB's Simplification Initiative and is also intended to enhance convergence with the IASB's treatment of debt issuance costs. The update requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts.

In August 2015, the FASB issued ASU 2015-15 "Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements." The update clarifies ASU 2015-03, allowing debt issuance costs related to line of credit arrangements to be deferred and presented as an asset and subsequently amortized ratably over

the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. The new requirements are effective for fiscal years beginning after December 15, 2015, and for interim periods within those fiscal years, with early

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Notes to Consolidated Financial Statements (Continued)

1. Basis of Presentation and Summary of Significant Accounting and Financial Reporting Policies (Continued)

adoption permitted. Grace is currently evaluating the effect of these updates on the Consolidated Financial Statements and the timing of adoption. As of September 30, 2015, capitalized financing fees included in other assets in the Consolidated Balance Sheet were $33.4 million.
In July 2015, the FASB issued ASU 2015-11 "Simplifying the Measurement of Inventory." This update is part of the FASB's Simplification Initiative and is also intended to enhance convergence with the IASB's measurement of inventory. The update requires that inventory be measured at the lower of cost or net realizable value for entities using FIFO or average cost methods. The new requirements are effective for fiscal years beginning after December 15, 2016, and for interim periods within those fiscal years, with early adoption permitted. Grace is currently evaluating its effect on the Consolidated Financial Statements and the timing of adoption.
2. Inventories
Inventories are stated at the lower of cost or market, and cost is determined using FIFO. Inventories consisted of the following at September 30, 2015, and December 31, 2014:

(In millions)	September 30, 2015	December 31, 2014
Raw materials	$82.0	$78.8
In process	45.4	47.2
Finished products	167.5	177.7
Other	28.2	29.1
	$323.1	$332.8

3. Debt
Components of Debt

(In millions)	September 30, 2015	December 31, 2014
U.S. dollar term loan, net of unamortized discount of $1.8 at September 30, 2015, and $2.1 at December 31, 2014(1)	$935.8	$692.6
5.125% senior notes due 2021	700.0	700.0
5.625% senior notes due 2024	300.0	300.0
Euro term loan, net of unamortized discount of $0.4 at September 30, 2015, and $0.4 at December 31, 2014(2)	164.7	181.2
Debt payable—unconsolidated affiliate	31.5	31.5
Deferred payment obligation	28.9	28.2
Other borrowings(3)	54.9	82.3
Total debt	2,215.8	2,015.8
Less debt payable within one year	72.0	96.8
Debt payable after one year	$2,143.8	$1,919.0
Weighted average interest rates on total debt	4.1 %	4.3 %

(1) Interest at LIBOR +200 bps with a 75 bps LIBOR floor at September 30, 2015, and LIBOR +225 bps with a 75 bps LIBOR floor at December 31, 2014.
(2) Interest at EURIBOR +225 bps with a 75 bps EURIBOR floor at September 30, 2015, and EURIBOR +250 bps with a 75 bps EURIBOR floor at December 31, 2014.
(3) Represents borrowings under various lines of credit and other borrowings, primarily by non-U.S. subsidiaries.
See Note 4 for a discussion of the fair value of Grace's debt.

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Notes to Consolidated Financial Statements (Continued)

3. Debt (Continued)

The principal maturities of debt outstanding at September 30, 2015, were as follows:

	(In millions)
2015	$31.7
2016	44.7
2017	45.3
2018	16.0
2019	15.3
Thereafter	2,062.8
Total debt	$2,215.8

On January 30, 2015, Grace borrowed on its $250 million term loan facility and used the funds, together with cash on hand, to repurchase the warrant issued to the asbestos personal injury trust for $490 million. (See Note 8 for Chapter 11 information.)

Grace has reviewed the impact of the separation on the credit agreement entered into upon emergence from bankruptcy (the "Credit Agreement"). Grace anticipates that the Credit Agreement will remain with Grace but at the time of the separation will require an amendment to permit the separation. Grace intends to seek such amendment as well as repay a substantial amount of the borrowings under the Credit Agreement in connection with the separation. If an amendment is not granted, Grace will be required to repay all term loan and revolver debt and enter into a new borrowing facility.

Grace has reviewed the impact of the separation on the senior notes. The senior notes will remain obligations of Grace, and Grace does not believe that the separation will have any impact on payment or other terms.

4. Fair Value Measurements and Risk

Certain of Grace's assets and liabilities are reported at fair value on a gross basis. ASC 820 "Fair Value Measurements and Disclosures" defines fair value as the value that would be received at the measurement date in the principal or "most advantageous" market. Grace uses principal market data, whenever available, to value assets and liabilities that are required to be reported at fair value.

Grace has identified the following financial assets and liabilities that are subject to the fair value analysis required by ASC 820:

Fair Value of Debt and Other Financial Instruments

Debt payable is recorded at carrying value as discussed in Note 3. Fair value is determined based on Level 2 inputs, including expected future cash flows (discounted at market interest rates), estimated current market prices and quotes from financial institutions.

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Notes to Consolidated Financial Statements (Continued)

4. Fair Value Measurements and Risk (Continued)

At September 30, 2015, the carrying amounts and fair values of Grace's debt were as follows:

	September 30, 2015		December 31, 2014	
(In millions)	Carrying Amount	Fair Value	Carrying Amount	Fair Value
U.S. dollar term loan(1)	$935.8	$927.1	$692.6	$691.3
5.125% senior notes due 2021	700.0	691.3	700.0	720.9
5.625% senior notes due 2024	300.0	303.0	300.0	312.0
Euro term loan(1)	164.7	164.0	181.2	181.4
Other borrowings	115.3	115.3	142.0	142.0
Total debt	$2,215.8	$2,200.7	$2,015.8	$2,047.6

(1) Carrying amounts are net of unamortized discounts of $1.8 million and $0.4 million as of September 30, 2015, and $2.1 million and $0.4 million as of December 31, 2014, related to the U.S. dollar term loan and euro term loan, respectively.

At September 30, 2015, the recorded values of other financial instruments such as cash equivalents and trade receivables and payables approximated their fair values, based on the short-term maturities and floating rate characteristics of these instruments.

Commodity Derivatives

From time to time, Grace enters into commodity derivatives such as fixed-rate swaps or options with financial institutions to mitigate the risk of volatility of prices of natural gas or other commodities. Under fixed-rate swaps, Grace locks in a fixed rate with a financial institution for future purchases, purchases its commodity from a supplier at the prevailing market rate, and then settles with the bank for any difference in the rates, thereby "swapping" a variable rate for a fixed rate.

The valuation of Grace's fixed-rate natural gas swaps was determined using a market approach, based on natural gas futures trading prices quoted on the New York Mercantile Exchange. Commodity fixed-rate swaps with maturities of not more than 12 months are used and designated as cash flow hedges of forecasted purchases of natural gas. Current open contracts hedge forecasted transactions until December 2015. The effective portion of the gain or loss on the commodity contracts is recorded in "accumulated other comprehensive loss" and reclassified into income in the same period or periods that the underlying commodity purchase affects income. At September 30, 2015, the contract volume, or notional amount, of the commodity contracts was 1.2 million MMBtu (million British thermal units) with a total contract value of $4.3 million.

The valuation of Grace's natural gas call options was determined using a market approach, based on the strike price of the options and the natural gas futures trading prices quoted on the New York Mercantile Exchange. Commodity option contracts with maturities of not more than 24 months are used and designated as cash flow hedges of forecasted purchases of natural gas. The effective portion of the gain or loss on the commodity contracts is recorded in "accumulated other comprehensive loss" and reclassified into income in the same period or periods that the underlying purchases affect income. At September 30, 2015, there are no outstanding commodity option contracts.

The valuation of Grace's fixed-rate aluminum swaps was determined using a market approach, based on aluminum futures trading prices quoted on the London Metal Exchange. Commodity fixed-rate swaps with maturities of not more than 12 months are used and designated as cash flow hedges of forecasted purchases of aluminum. Current open contracts hedge forecasted transactions until August 2016. The effective portion of the gain or loss on the commodity contracts is recorded in "accumulated other comprehensive loss" and reclassified into income in the same period or periods that the underlying commodity purchase affects income. At September 30, 2015, the contract volume, or

notional amount, of the commodity contracts was 1.3 million pounds with a total contract value of $1.1 million.

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Notes to Consolidated Financial Statements (Continued)

4. Fair Value Measurements and Risk (Continued)

Currency Derivatives

Because Grace operates in over 40 countries and does business in more than 50 currencies, results are exposed to fluctuations in currency exchange rates. Grace seeks to minimize exposure to these fluctuations by matching sales in volatile currencies with expenditures in the same currencies, but it is not always possible to do so. From time to time Grace will use financial instruments such as currency forward contracts, options, or combinations of the two to reduce the risk of certain specific transactions. However, Grace does not have a policy of hedging all exposures, because management does not believe that such a level of hedging would be cost-effective.

The valuation of Grace's currency exchange rate forward contracts is determined using both a market approach and an income approach. Inputs used to value currency exchange rate forward contracts consist of: (1) spot rates, which are quoted by various financial institutions; (2) forward points, which are primarily affected by changes in interest rates; and (3) discount rates used to present value future cash flows, which are based on the London Interbank Offered Rate (LIBOR) curve or overnight indexed swap rates.

Debt and Interest Rate Swap Agreements

Grace uses interest rate swaps designated as cash flow hedges to manage fluctuations in interest rates on variable rate debt. The effective portion of gains and losses on these interest rate cash flow hedges is recorded in "accumulated other comprehensive loss" and reclassified into "interest expense and related financing costs" during the hedged interest period.

In connection with its emergence financing, Grace entered into an interest rate swap beginning on February 3, 2015, and maturing on February 3, 2020, fixing the LIBOR component of the interest on $250 million of Grace's term debt at a rate of 2.393%. The valuation of this interest rate swap is determined using both a market approach and an income approach, using prevailing market interest rates and discount rates to present value future cash flows based on the forward LIBOR yield curves.

The following tables present the fair value hierarchy for financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2015, and December 31, 2014:

	Fair Value Measurements at September 30, 2015, Using			
(In millions)	Total	Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Currency derivatives	$1.6	$—	$1.6	$—
Total Assets	$1.6	$—	$1.6	$—
Liabilities				
Interest rate derivatives	$10.4	$—	$10.4	$—
Commodity derivatives	1.2	—	1.2	—
Currency derivatives	0.9	—	0.9	—
Total Liabilities	$12.5	$—	$12.5	$—

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Notes to Consolidated Financial Statements (Continued)

4. Fair Value Measurements and Risk (Continued)

	Fair Value Measurements at December 31, 2014, Using			
(In millions)	Total	Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Currency derivatives	$3.3	$—	$3.3	$—
Total Assets	$3.3	$—	$3.3	$—
Liabilities				
Interest rate derivatives	$5.5	$—	$5.5	$—
Commodity derivatives	2.6	—	2.6	—
Currency derivatives	0.1	—	0.1	—
Total Liabilities	$8.2	$—	$8.2	$—

The following tables present the location and fair values of derivative instruments included in the Consolidated Balance Sheets as of September 30, 2015, and December 31, 2014:

	Asset Derivatives		Liability Derivatives	
September 30, 2015 (In millions)	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments under ASC 815:				
Commodity contracts	Other current assets	$—	Other current liabilities	$1.2
Currency contracts	Other current assets	1.4	Other current liabilities	0.7
Interest rate contracts	Other current assets	—	Other current liabilities	4.2
Currency contracts	Other assets	0.2	Other liabilities	—
Interest rate contracts	Other assets	—	Other liabilities	6.2
Derivatives not designated as hedging instruments under ASC 815:				
Currency contracts	Other current assets	—	Other current liabilities	0.2
Total derivatives		$1.6		$12.5

	Asset Derivatives		Liability Derivatives	
December 31, 2014 (In millions)	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments under ASC 815:				
Commodity contracts	Other current assets	$—	Other current liabilities	$2.6

Currency contracts	Other current assets	0.8	Other current liabilities	—
Interest rate contracts	Other current assets	—	Other current liabilities	2.5
Currency contracts	Other assets	0.9	Other liabilities	—
Interest rate contracts	Other assets	—	Other liabilities	3.0
Derivatives not designated as hedging instruments under ASC 815:				
Currency contracts	Other current assets	1.6	Other current liabilities	0.1
Total derivatives		$3.3		$8.2

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Notes to Consolidated Financial Statements (Continued)

4. Fair Value Measurements and Risk (Continued)

The following tables present the location and amount of gains and losses on derivative instruments included in the Consolidated Statements of Operations or, when applicable, gains and losses initially recognized in other comprehensive income (loss) ("OCI") for the three and nine months ended September 30, 2015 and 2014:

Three Months Ended September 30, 2015 (In millions)	Amount of Gain (Loss) Recognized in OCI on Derivatives (Effective Portion)	Location of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain (Loss) Reclassified from OCI into Income (Effective Portion)
Derivatives in ASC 815 cash flow hedging relationships:			
Interest rate contracts	$(4.1)	Interest expense	$(1.1)
Currency contracts	(0.2)	Other expense	(0.5)
Currency contracts	0.3	Cost of goods sold	—
Commodity contracts	(0.6)	Cost of goods sold	(0.9)
Total derivatives	$(4.6)		$(2.5)

	Location of Gain (Loss) Recognized in Income on Derivatives	Amount of Gain (Loss) Recognized in Income on Derivatives
Derivatives not designated as hedging instruments under ASC 815:		
Currency contracts	Other expense	$0.5

Nine Months Ended September 30, 2015 (In millions)	Amount of Gain (Loss) Recognized in OCI on Derivatives (Effective Portion)	Location of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain (Loss) Reclassified from OCI into Income (Effective Portion)
Derivatives in ASC 815 cash flow hedging relationships:			
Interest rate contracts	$(7.0)	Interest expense	$(2.8)
Currency contracts	5.6	Other expense	5.6
Currency contracts	0.3	Cost of goods sold	—
Commodity contracts	(1.6)	Cost of goods sold	(3.0)
Total derivatives	$(2.7)		$(0.2)

	Location of Gain (Loss) Recognized in Income on Derivatives	Amount of Gain (Loss) Recognized in Income on Derivatives
Derivatives not designated as hedging instruments under ASC 815:		
Currency contracts	Other expense	$0.4

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Notes to Consolidated Financial Statements (Continued)

4. Fair Value Measurements and Risk (Continued)

Three Months Ended September 30, 2014 (In millions)	Amount of Gain (Loss) Recognized in OCI on Derivatives (Effective Portion)	Location of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain (Loss) Reclassified from OCI into Income (Effective Portion)
Derivatives in ASC 815 cash flow hedging relationships:			
Interest rate contracts	$1.1	Interest expense	$—
Currency contracts	0.2	Other expense	0.2
Total derivatives	$1.3		$0.2

	Location of Gain (Loss) Recognized in Income on Derivatives	Amount of Gain (Loss) Recognized in Income on Derivatives
Derivatives not designated as hedging instruments under ASC 815:		
Currency contracts	Other expense	$2.6

Nine Months Ended September 30, 2014 (In millions)	Amount of Gain (Loss) Recognized in OCI on Derivatives (Effective Portion)	Location of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain (Loss) Reclassified from OCI into Income (Effective Portion)
Derivatives in ASC 815 cash flow hedging relationships:			
Interest rate contracts	$(1.8)	Interest expense	$—
Currency contracts	0.1	Other expense	—
Commodity contracts	0.4	Cost of goods sold	0.2
Total derivatives	$(1.3)		$0.2

	Location of Gain (Loss) Recognized in Income on Derivatives	Amount of Gain (Loss) Recognized in Income on Derivatives
Derivatives not designated as hedging instruments under ASC 815:		
Currency contracts	Other expense	$7.4

Net Investment Hedges

Grace uses foreign currency denominated debt as nonderivative hedging instruments in certain net investment hedges. The effective portion of gains and losses attributable to these net investment hedges is recorded to "currency translation adjustments" within "accumulated other comprehensive income." Recognition in earnings of amounts previously recorded to "currency translation adjustments" is limited to circumstances such as complete or substantially complete liquidation of the net investment in the hedged foreign operation. At September 30, 2015, €147.8 million of Grace's term loan principal was designated as a hedging instrument of its net investment in European subsidiaries.

The following tables present the location and amount of gains and losses on nonderivative instruments designated as net investment hedges for the three and nine months ended September 30, 2015 and 2014. There were no reclassifications of the effective portion of net investment hedges out of OCI and into earnings for the period

presented in the table below.

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Notes to Consolidated Financial Statements (Continued)

4. Fair Value Measurements and Risk (Continued)

Three Months Ended September 30, 2015 (In millions)	Amount of Gain (Loss) Recognized in OCI in Currency Translation Adjustments (Effective Portion)
Nonderivatives in ASC 815 net investment hedging relationships:	
Foreign currency denominated debt	$0.1
Total nonderivatives	$0.1

Nine Months Ended September 30, 2015 (In millions)	Amount of Gain (Loss) Recognized in OCI in Currency Translation Adjustments (Effective Portion)
Nonderivatives in ASC 815 net investment hedging relationships:	
Foreign currency denominated debt	$15.3
Total nonderivatives	$15.3

Three Months Ended September 30, 2014 (In millions)	Amount of Gain (Loss) Recognized in OCI in Currency Translation Adjustments (Effective Portion)
Nonderivatives in ASC 815 net investment hedging relationships:	
Foreign currency denominated debt	$13.0
Total nonderivatives	$13.0

Nine Months Ended September 30, 2014 (In millions)	Amount of Gain (Loss) Recognized in OCI in Currency Translation Adjustments (Effective Portion)
Nonderivatives in ASC 815 net investment hedging relationships:	
Foreign currency denominated debt	$14.8
Total nonderivatives	$14.8

Credit Risk

Grace is exposed to credit risk in its trade accounts receivable. Customers in the petroleum refining and construction industries represent the greatest exposure. Grace's credit evaluation policies, relatively short collection terms and history of minimal credit losses mitigate credit risk exposures. Grace does not generally require collateral for its trade accounts receivable but may require a bank letter of credit in certain instances, particularly when selling to customers in cash-restricted countries.

Grace may also be exposed to credit risk in its derivatives contracts. Grace monitors counterparty credit risk and currently does not anticipate nonperformance by counterparties to its derivatives. Grace's derivative contracts are with internationally recognized commercial financial institutions.

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Notes to Consolidated Financial Statements (Continued)

5. Income Taxes

The annualized effective tax rate on 2015 forecasted income is estimated to be 48.3% as of September 30, 2015, compared with 17.1% for the year ended December 31, 2014. The prior year includes a benefit of $59.6 million for the release of reserves for uncertain tax positions while 2015 includes estimated tax costs of $30.1 million to complete the separation transaction and a $24.7 million impact on the effective tax rate from the nondeductible charge related to Venezuela.

Grace generated approximately $1,800 million in U.S. federal tax deductions relating to its emergence from bankruptcy, including approximately $670 million relating to payments made upon emergence, $632 million upon payment of the PI deferred payment obligation, and $490 million upon repurchase of the warrant held by the PI Trust. These deductions generated U.S. federal and state NOLs in 2014 and 2015, which Grace will carry forward and expects to utilize in subsequent years. Under U.S. federal income tax law, a corporation is generally permitted to carry forward NOLs for a 20-year period for deduction against future taxable income. Grace also expects to generate U.S. federal tax deductions of $30 million upon payment of the ZAI PD deferred payment obligation in 2017. The present value of the expected settlement amount has already been recorded as a deferred tax asset for temporary differences. (See Note 8 for Chapter 11 information.)

The following table summarizes the balance of deferred tax assets, net of deferred tax liabilities, at September 30, 2015, of $766.6 million:

	Deferred Tax Asset (Net of Liabilities)(2)	Valuation Allowance	Net Deferred Tax Asset
United States—Federal(1)	$681.2	$(2.2)	$679.0
United States—States(1)	55.4	(4.2)	51.2
Germany	36.4	—	36.4
Other foreign	4.3	(4.3)	—
Total	$777.3	$(10.7)	$766.6

(1) The U.S. federal deductions generated relating to emergence of $670 million, settlement of the PI deferred payment obligation of $632 million, and the $490 million warrant repurchase, plus the $30 million ZAI PD deferred payment obligation, account for a significant portion of the U.S. federal and state deferred tax assets.

(2) Deferred tax assets are net of $5.8 million of income tax contingencies related to these deferred tax assets.

Grace will need to generate approximately $2,000 million of U.S. federal taxable income by 2035 (or approximately $100 million per year during the carryforward period) to fully realize the U.S. federal and a majority of the U.S. state net deferred tax assets.

The following table summarizes expiration dates in jurisdictions where we have, or will have, material tax loss carryforwards:

	Expiration Dates
United States—Federal	2034 - 2035
United States—States	2015 - 2035
Brazil	Unlimited Carryforward

In evaluating Grace's ability to realize its deferred tax assets, Grace considers all reasonably available positive and negative evidence, including recent earnings experience, expectations of future taxable income and the tax character of that income, the period of time over which the temporary differences become deductible and the carryforward and/or carryback periods available to Grace for tax reporting purposes in the related jurisdiction. In estimating future taxable income, Grace relies upon assumptions and estimates about future activities, including the amount of future federal, state and international pretax operating income that Grace will generate; the reversal of temporary differences;

and the implementation of feasible and prudent tax planning strategies. Grace records a valuation allowance to reduce deferred tax assets to the amount that it believes is more likely

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Notes to Consolidated Financial Statements (Continued)

5. Income Taxes (Continued)

than not to be realized. Grace believes it is reasonably possible that in the next 12 months the amount of the liability for unrecognized tax benefits could decrease by approximately $2 million.

As part of the separation plan, Grace is restructuring certain legal entities. The process of analyzing the tax consequences of the legal entity separation and restructuring is ongoing and includes determining the required tax liability to be reported. In the 2015 third quarter, the calculation of the annualized effective tax rate includes approximately $8 million of tax expense associated with the restructuring of foreign subsidiaries.

As of December 31, 2014, Grace had the intent and ability to indefinitely reinvest undistributed earnings of its foreign subsidiaries outside the United States. In the 2015 first quarter, Grace announced its plan to separate into two publicly traded companies and has subsequently reassessed the capital structure and financial requirements of both Grace and GCP. In the 2015 second quarter, Grace determined that it will repatriate approximately $131 million of foreign earnings in advance of the separation. Such amount was determined based on an analysis of each non-U.S. subsidiary's requirements for working capital, debt repayment and strategic initiatives. Grace also considered local country legal and regulatory restrictions. In the 2015 second quarter, Grace included tax expense of approximately $5 million in its annualized effective tax rate for repatriation attributable to current earnings and tax expense of approximately $11 million as a discrete charge for repatriation attributable to prior years' earnings. The tax effect of the repatriation is determined by several variables including the tax rate applicable to the entity making the distribution, the cumulative earnings and associated foreign taxes of the entity and the extent to which those earnings may have already been taxed in the U.S.

Grace and GCP continue to assess their capital structures, financial requirements and ability to repatriate available cash as part of the separation, which may result in additional repatriation prior to the separation. The tax consequences of additional repatriation, as well as other transactions pursuant to the separation, may require recognition of additional tax expense for actual or deemed repatriation of undistributed earnings of our foreign subsidiaries. Grace believes that the separation is a one-time, non-recurring event, and such recognition of deferred taxes of undistributed earnings would not have occurred if not for the separation. Beyond the separation, Grace expects undistributed prior-year earnings of its foreign subsidiaries to remain permanently reinvested except in certain instances where repatriation of such earnings would result in minimal or no tax. Grace bases this assertion on:

(1) the expectation that it will satisfy its U.S. cash obligations in the foreseeable future without requiring the repatriation of prior-year foreign earnings;

(2) plans for significant and continued reinvestment of foreign earnings in organic and inorganic growth initiatives outside the U.S.; and

(3) remittance restrictions imposed by local governments.

Grace will continually analyze and evaluate its cash needs to determine the appropriateness of its indefinite reinvestment assertion.

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Notes to Consolidated Financial Statements (Continued)

6. Pension Plans and Other Postretirement Benefit Plans

Pension Plans The following table presents the funded status of Grace's fully-funded, underfunded, and unfunded pension plans:

(In millions)	September 30, 2015	December 31, 2014
Overfunded defined benefit pension plans	$44.7	$44.1
Underfunded defined benefit pension plans	(81.9)	(79.5)
Unfunded defined benefit pension plans	(358.1)	(378.0)
Total underfunded and unfunded defined benefit pension plans	(440.0)	(457.5)
Pension liabilities included in other current liabilities	(15.2)	(15.6)
Net funded status	$(410.5)	$(429.0)

Fully-funded plans include several advance-funded plans where the fair value of the plan assets exceeds the projected benefit obligation ("PBO"). This group of plans was overfunded by $44.7 million as of September 30, 2015, and the overfunded status is reflected as "overfunded defined benefit pension plans" in the Consolidated Balance Sheets. Underfunded plans include a group of advance-funded plans that are underfunded on a PBO basis. Unfunded plans include several plans that are funded on a pay-as-you-go basis, and therefore, the entire PBO is unfunded. The combined balance of the underfunded and unfunded plans was $455.2 million as of September 30, 2015.

Postretirement Benefits Other Than Pensions Grace has provided postretirement health care and life insurance benefits for retired employees of certain U.S. business units and certain divested business units. The postretirement medical plan provided various levels of benefits to employees hired before 1993 who retired from Grace after age 55 with at least 10 years of service. These plans are unfunded and Grace pays a portion of the costs of benefits under these plans as they are incurred. Grace applies ASC 715 "Compensation—Retirement Benefits" to these plans, which requires that the future costs of postretirement health care and life insurance benefits be accrued over the employees' years of service. Actuarial gains and losses are recognized in the Consolidated Balance Sheets as a component of Shareholders' Equity, with amortization of the net actuarial gains and losses that exceed 10 percent of the accumulated postretirement benefit obligation recognized each quarter in the Consolidated Statements of Operations over the average future service period of active employees.

In June 2014, Grace announced that it would discontinue its postretirement medical plan for all U.S. employees effective October 31, 2014, and eliminate certain postretirement life insurance benefits. As a result of these actions, Grace recognized a gain of $41.9 million in other comprehensive income in the 2014 second quarter. Grace amortized $39.5 million from accumulated other comprehensive income into the Consolidated Statement of Operations during the five-month period from June to October 2014.

The postretirement plan was further remeasured as of September 30, 2015, due to a plan amendment to eliminate certain postretirement life insurance benefits, which resulted in a curtailment gain of $4.5 million.

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Notes to Consolidated Financial Statements (Continued)

6. Pension Plans and Other Postretirement Benefit Plans (Continued)

Components of Net Periodic Benefit Cost (Income)

	Three Months Ended September 30,					
	2015			2014		
	Pension		Other Post	Pension		Other Post
(In millions)	U.S.	Non-U.S.	Retirement	U.S.	Non-U.S.	Retirement
Service cost	$6.4	$3.0	$—	$5.8	$2.7	$—
Interest cost	13.7	4.1	—	15.0	5.7	0.1
Expected return on plan assets	(17.6)	(3.3)	—	(17.4)	(3.9)	—
Amortization of prior service cost (credit)	0.1	—	(0.9)	0.1	—	(0.9)
Amortization of net deferred actuarial loss	—	—	0.2	—	—	0.2
Gain on termination and curtailment of postretirement plans	—	—	(4.5)	—	—	(23.7)
Net periodic benefit cost (income)	$2.6	$3.8	$(5.2)	$3.5	$4.5	$(24.3)

	Nine Months Ended September 30,					
	2015			2014		
	Pension		Other Post	Pension		Other Post
(In millions)	U.S.	Non-U.S.	Retirement	U.S.	Non-U.S.	Retirement
Service cost	$19.3	$8.9	$—	$17.6	$8.2	$0.1
Interest cost	41.3	12.3	0.1	45.1	17.0	1.0
Expected return on plan assets	(52.8)	(10.0)	—	(52.4)	(11.7)	—
Amortization of prior service cost (credit)	0.2	—	(2.8)	0.5	—	(1.4)
Amortization of net deferred actuarial loss (gain)	—	—	0.5	—	—	(0.1)
Mark-to-market adjustment	—	—	—	(3.1)	—	—
Gain on termination and curtailment of postretirement plans	—	—	(4.5)	—	—	(31.6)
Net periodic benefit cost (income)	$8.0	$11.2	$(6.7)	$7.7	$13.5	$(32.0)

At emergence, benefit payments of approximately $27 million were paid from a U.S. nonqualified pension plan in connection with Grace's emergence from bankruptcy. As a result, that plan was remeasured as of March 1, 2014, using a discount rate of 4.43%. The remeasurement resulted in a mark-to-market gain of $3.1 million.

Plan Contributions and Funding   Grace intends to satisfy its funding obligations under the U.S. qualified pension plans and to comply with all of the requirements of the Employee Retirement Income Security Act of 1974 ("ERISA"). For ERISA purposes, funded status is calculated on a different basis than under U.S. GAAP.

Grace intends to fund non-U.S. pension plans based on applicable legal requirements and actuarial and trustee recommendations.

Defined Contribution Retirement Plan   Grace sponsors a defined contribution retirement plan for its employees in the United States. This plan is qualified under section 401(k) of the U.S. tax code. Currently, Grace contributes an amount equal to 100% of employee contributions, up to 6% of an individual employee's salary or wages. Grace's costs related to this benefit plan for the three and nine months ended September 30, 2015, were $3.7 million and $11.6 million compared with $3.6 million and $10.2 million for the corresponding prior-year periods.

Notes to Consolidated Financial Statements (Continued)

7. Other Balance Sheet Accounts

(In millions)	September 30, 2015	December 31, 2014
Other Current Liabilities		
Accrued compensation	$75.5	$77.0
Income tax payable	56.6	34.1
Customer volume rebates	39.2	37.8
Accrued interest	32.2	21.0
Deferred revenue	21.4	19.4
Environmental contingencies	20.7	21.5
Pension liabilities	15.2	15.6
Deferred tax liability	0.9	1.5
Other accrued liabilities	119.1	112.1
	$380.8	$340.0

Accrued compensation in the table above includes salaries and wages as well as estimated current amounts due under the annual and long-term incentive programs.

8. Commitments and Contingent Liabilities

Asbestos-Related Liabilities   Grace emerged from an asbestos-related Chapter 11 bankruptcy on February 3, 2014 (the "Effective Date"). Under its plan of reorganization, all pending and future asbestos-related claims are channeled for resolution to either a personal injury trust (the "PI Trust") or a property damage trust (the "PD Trust"). The trusts are the sole recourse for holders of asbestos-related claims. The channeling injunctions issued by the bankruptcy court prohibit holders of asbestos-related claims from asserting such claims directly against Grace.

Grace has satisfied all of its financial obligations to the PI Trust. Grace has fixed and contingent obligations remaining to the PD Trust. With respect to property damage claims related to Grace’s former attic insulation product installed in the U.S. ("ZAI PD Claims"), the PD Trust was funded with $34.4 million on the Effective Date. Grace is obligated to make a payment of $30 million to the PD Trust in respect of ZAI PD Claims on February 3, 2017, and has recorded a liability of $28.9 million representing the present value of this amount in "debt payable after one year" in the accompanying Consolidated Balance Sheets. Grace is also obligated to make up to 10 contingent deferred payments of $8 million per year to the PD Trust in respect of ZAI PD Claims during the 20-year period beginning on the fifth anniversary of the Effective Date, with each such payment due only if the assets of the PD Trust in respect of ZAI PD Claims fall below $10 million during the preceding year. Grace has not accrued for the 10 additional payments as Grace does not currently believe they are probable. Grace is not obligated to make additional payments to the PD Trust in respect of ZAI PD Claims beyond the payments described above. Grace has satisfied all of its financial obligations with respect to Canadian ZAI PD Claims.

With respect to other asbestos property damage claims ("Other PD Claims"), claims unresolved as of the Effective Date are to be litigated in the bankruptcy court and any future claims are to be litigated in a federal district court, in each case pursuant to procedures to be approved by the bankruptcy court. To the extent any such Other PD Claims are determined to be allowed claims, they are to be paid in cash by the PD Trust. Grace is obligated to make a payment to the PD Trust every six months in the amount of any Other PD Claims allowed during the preceding six months plus interest (if applicable) and the amount of PD Trust expenses for the preceding six months (the "PD Obligation"). The aggregate amount to be paid under the PD Obligation is not capped and Grace may be obligated to make additional payments to the PD Trust in respect of the PD Obligation. Grace has accrued for those unresolved Other PD Claims that it believes are probable and estimable. Grace has not accrued for other unresolved or unasserted Other PD Claims as it does not believe that payment is probable.

All payments to the PD Trust required after the Effective Date are secured by the Company's obligation to issue 77,372,257 shares of Company common stock to the PD Trust in the event of default, subject to customary anti-dilution provisions.

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Notes to Consolidated Financial Statements (Continued)

8. Commitments and Contingent Liabilities (Continued)

This summary of the commitments and contingencies related to the Chapter 11 proceeding does not purport to be complete and is qualified in its entirety by reference to the plan of reorganization and the exhibits and documents related thereto, which have been filed with the SEC.

Environmental Remediation Grace is subject to loss contingencies resulting from extensive and evolving federal, state, local and foreign environmental laws and regulations relating to the generation, storage, handling, discharge, disposition and stewardship of hazardous wastes and other materials. Grace accrues for anticipated costs associated with response efforts where an assessment has indicated that a probable liability has been incurred and the cost can be reasonably estimated. These accruals do not take into account any discounting for the time value of money.

Grace's environmental liabilities are reassessed whenever circumstances become better defined or response efforts and their costs can be better estimated. These liabilities are evaluated based on currently available information, including the progress of remedial investigation at each site, the current status of discussions with regulatory authorities regarding the method and extent of remediation at each site, existing technology, prior experience in contaminated site remediation and the apportionment of costs among potentially responsible parties.

Estimated Investigation and Remediation Costs

At September 30, 2015, Grace's estimated liability for environmental investigation and remediation costs totaled $54.6 million, compared with $61.7 million at December 31, 2014, and was included in "other current liabilities" and "other liabilities" in the Consolidated Balance Sheets. These amounts are based on funding and/or remediation agreements in place and Grace's estimate of costs for sites not subject to a formal remediation plan for which sufficient information is available to estimate response costs. These amounts do not include certain response costs for the Libby vermiculite mine area or certain vermiculite expansion facilities, which may be material but are not currently estimable. Due to these vermiculite-related matters, it is probable that Grace's actual response costs will exceed Grace's current estimates by material amounts. Net cash paid against previously established reserves for the nine months ended September 30, 2015 and 2014, were $8.7 million and $9.7 million, respectively.

Vermiculite-Related Matters

Grace purchased a vermiculite mine in Libby, Montana, in 1963 and operated it until 1990. Vermiculite concentrate from the Libby mine was used in the manufacture of attic insulation and other products. Some of the vermiculite ore contained naturally occurring asbestos. The U.S. Environmental Protection Agency (the "EPA") and Grace are engaged in a remedial investigation of the Libby mine and the surrounding area.

During 2010, the EPA began reinvestigating certain facilities on a list of 105 facilities where vermiculite concentrate from the Libby mine may have been used, stored or processed. Grace is cooperating with the EPA on this reinvestigation and has remediated several of these facilities. It is probable that the EPA will request additional remediation at other facilities.

Grace's total estimated liability for response costs that are currently estimable related to its former vermiculite operations in Libby and vermiculite processing sites outside of Libby at September 30, 2015, and December 31, 2014, was $15.4 million and $19.4 million, respectively. It is probable that Grace's ultimate liability for these vermiculite-related matters will exceed current estimates by material amounts. Grace's current recorded liability will be adjusted as Grace receives new information and amounts become reasonably estimable.

Non-Vermiculite-Related Matters

At September 30, 2015, and December 31, 2014, Grace's estimated liability for response costs at sites not related to its former vermiculite mining and processing activities was $39.2 million and $42.3 million, respectively. This liability relates to Grace's current and former operations, including its share of liability for off-site disposal at facilities where it has been identified as a potentially responsible party. Grace's estimated liability is based upon

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Notes to Consolidated Financial Statements (Continued)

8. Commitments and Contingent Liabilities (Continued)

regulatory requirements and environmental conditions at each site. As Grace receives new information its estimated liability may change materially.

Purchase Commitments   Grace uses purchase commitments to ensure supply and to minimize the volatility of major components of direct manufacturing costs including natural gas, certain metals, rare earths, asphalt, amines and other materials. Such commitments are for quantities that Grace fully expects to use in its normal operations.

Guarantees and Indemnification Obligations   Grace is a party to many contracts containing guarantees and indemnification obligations. These contracts primarily consist of:

- Product warranties with respect to certain products sold to customers in the ordinary course of business. These warranties typically provide that products will conform to specifications. Grace accrues a warranty liability on a transaction-specific basis depending on the individual facts and circumstances related to each sale. Both the liability and annual expense related to product warranties are immaterial to the Consolidated Financial Statements.
- Performance guarantees offered to customers under certain licensing arrangements. Grace has not established a liability for these arrangements based on past performance.
- Licenses of intellectual property by Grace to third parties in which Grace has agreed to indemnify the licensee against third party infringement claims.
- Contracts providing for the sale of a former business unit or product line in which Grace has agreed to indemnify the buyer against liabilities arising prior to the closing of the transaction, including environmental liabilities.
- Guarantees of real property lease obligations of third parties, typically arising out of (a) leases entered into by former subsidiaries of Grace, or (b) the assignment or sublease of a lease by Grace to a third party.

Financial Assurances   Financial assurances have been established for a variety of purposes, including insurance and environmental matters, trade-related commitments and other matters. At September 30, 2015, Grace had gross financial assurances issued and outstanding of $127.5 million, composed of $34.2 million of surety bonds issued by various insurance companies and $93.3 million of standby letters of credit and other financial assurances issued by various banks.

Accounting for Contingencies   Although the outcome of each of the matters discussed above cannot be predicted with certainty, Grace has assessed its risk and has made accounting estimates as required under U.S. GAAP.

9. Restructuring Expenses, Asset Impairments and Repositioning Expenses

Restructuring Expenses and Asset Impairments

In the third quarter, Grace incurred costs from restructuring actions as a result of changes in the business environment and its business structure, which are included in "other expense, net" in the Consolidated Statements of Operations. Grace incurred $4.8 million ($0.5 million in Catalysts Technologies, $0.4 million in Construction Products, $0.3 million in Materials Technologies, and $3.6 million in Corporate) of restructuring expenses during the third quarter, compared with $0.8 million during the prior-year quarter. These costs are not included in segment operating income. Substantially all costs related to the restructuring programs are expected to be paid by September 30, 2016.

During the nine months ended September 30, 2014, Grace incurred asset impairment charges of $14.3 million, of which $9.8 million related to the concrete production management systems product that is part of the Construction Products operating segment and $4.5 million related to an unconsolidated investment.

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Notes to Consolidated Financial Statements (Continued)

9. Restructuring Expenses, Asset Impairments and Repositioning Expenses (Continued)

Restructuring Expenses and Asset Impairments (In millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Restructuring expenses	$4.8	$0.8	$18.7	$3.5
Asset impairments	—	4.6	—	14.3
Total restructuring expenses and asset impairments	$4.8	$5.4	$18.7	$17.8

Restructuring Liability (In millions)	Total
Balance, December 31, 2014	$4.5
Accruals for severance and other costs	18.7
Payments	(12.1)
Currency translation adjustments and other	0.3
Balance, September 30, 2015	$11.4

Repositioning Expenses

In the third quarter and nine months ended September 30, 2015, Grace incurred repositioning expenses of $14.0 million and $34.3 million, respectively, related to its planned separation into two independent companies.

(In millions)	Three Months Ended September 30, 2015	Nine Months Ended September 30, 2015
Professional fees	$10.4	$26.5
Employee-related costs	3.6	7.8
Total	$14.0	$34.3

Substantially all of these costs have been or are expected to be settled in cash.

10. Other Expense, net

Components of other expense, net are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In millions)	2015	2014	2015	2014
Restructuring expenses and asset impairments	$4.8	$5.4	$18.7	$17.8
Asbestos and bankruptcy-related charges, net	—	0.4	(8.7)	6.8
Net loss on sales of investments and disposals of assets	0.1	0.3	2.0	1.0
Provision for environmental remediation, net	4.2	4.2	1.6	8.8
Currency transaction effects	0.5	(1.6)	(0.6)	(0.9)
Interest income	(0.1)	(0.3)	(0.3)	(1.3)
Other miscellaneous expense (income)	1.2	0.6	0.4	(2.3)
Total other expense, net	$10.7	$9.0	$13.1	$29.9

In the 2015 first quarter, Grace finalized its accounting for emergence from bankruptcy and recorded a gain of $9.0 million reflecting the final resolution of certain bankruptcy liabilities.

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Notes to Consolidated Financial Statements (Continued)

11. Other Comprehensive Income (Loss)

The following tables present the pre-tax, tax, and after-tax components of Grace's other comprehensive income (loss) for the three and nine months ended September 30, 2015 and 2014:

Three Months Ended September 30, 2015 (In millions)	Pre-Tax Amount	Tax Benefit/ (Expense)	After-Tax Amount
Defined benefit pension and other postretirement plans:			
Net prior service credit arising during period	$1.1	$(0.4)	$0.7
Net deferred actuarial gain arising during period	0.1	—	0.1
Gain on curtailment of postretirement plans	(4.5)	1.6	(2.9)
Amortization of net prior service credit included in net periodic benefit cost	(0.8)	0.2	(0.6)
Amortization of net deferred actuarial loss included in net periodic benefit cost	0.2	(0.1)	0.1
Benefit plans, net	(3.9)	1.3	(2.6)
Currency translation adjustments	(32.8)	—	(32.8)
Loss from hedging activities	(2.1)	0.7	(1.4)
Other comprehensive loss attributable to W. R. Grace & Co. shareholders	$(38.8)	$2.0	$(36.8)

Nine Months Ended September 30, 2015 (In millions)	Pre-Tax Amount	Tax Benefit/ (Expense)	After-Tax Amount
Defined benefit pension and other postretirement plans:			
Net prior service credit arising during period	$1.1	$(0.4)	$0.7
Net deferred actuarial gain arising during period	0.1	—	0.1
Gain on curtailment of postretirement plans	(4.5)	1.6	(2.9)
Amortization of net prior service credit included in net periodic benefit cost	(2.6)	0.9	(1.7)
Amortization of net deferred actuarial loss included in net periodic benefit cost	0.5	(0.2)	0.3
Other changes in funded status	(0.4)	0.1	(0.3)
Benefit plans, net	(5.8)	2.0	(3.8)
Currency translation adjustments	(44.3)	—	(44.3)
Loss from hedging activities	(2.5)	0.8	(1.7)
Other comprehensive loss attributable to W. R. Grace & Co. shareholders	$(52.6)	$2.8	$(49.8)

Three Months Ended September 30, 2014 (In millions)	Pre-Tax Amount	Tax Benefit/ (Expense)	After-Tax Amount
Defined benefit pension and other postretirement plans:			
Gain on termination of postretirement plans	$(23.7)	$5.5	$(18.2)
Amortization of net prior service credit included in net periodic benefit cost	(0.8)	0.3	(0.5)
Amortization of net deferred actuarial loss included in net periodic benefit cost	0.2	(0.1)	0.1
Benefit plans, net	(24.3)	5.7	(18.6)
Currency translation adjustments	(12.7)	—	(12.7)
Gain from hedging activities	1.1	(0.4)	0.7
Other than temporary impairment of investment	0.8	—	0.8
Gain on securities available for sale	0.7	(0.3)	0.4
Other comprehensive loss attributable to W. R. Grace & Co. shareholders	$(34.4)	$5.0	$(29.4)

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Notes to Consolidated Financial Statements (Continued)

11. Other Comprehensive Income (Loss) (Continued)

Nine Months Ended September 30, 2014 (In millions)	Pre-Tax Amount	Tax Benefit/ (Expense)	After-Tax Amount
Defined benefit pension and other postretirement plans:			
Net gain due to postretirement plan changes	$41.9	$(14.7)	$27.2
Gain on termination of postretirement plans	(31.6)	8.3	(23.3)
Amortization of net prior service credit included in net periodic benefit cost	(0.9)	0.3	(0.6)
Amortization of net deferred actuarial gain included in net periodic benefit cost	(0.1)	—	(0.1)
Benefit plans, net	9.3	(6.1)	3.2
Currency translation adjustments	(7.5)	—	(7.5)
Loss from hedging activities	(1.5)	0.5	(1.0)
Other than temporary impairment of investment	0.8	—	0.8
Loss on securities available for sale	(0.1)	—	(0.1)
Other comprehensive income (loss) attributable to W. R. Grace & Co. shareholders	$1.0	$(5.6)	$(4.6)

The following tables present the changes in accumulated other comprehensive income (loss), net of tax, for the nine months ended September 30, 2015 and 2014:

Nine Months Ended September 30, 2015 (In millions)	Defined Benefit Pension and Other Postretirement Plans	Currency Translation Adjustments	Loss from Hedging Activities	Total
Beginning balance	$4.0	$(22.8)	$(5.0)	$(23.8)
Other comprehensive income (loss) before reclassifications	0.5	(44.3)	(0.9)	(44.7)
Amounts reclassified from accumulated other comprehensive income	(4.3)	—	(0.8)	(5.1)
Net current-period other comprehensive loss	(3.8)	(44.3)	(1.7)	(49.8)
Ending balance	$0.2	$(67.1)	$(6.7)	$(73.6)

Nine Months Ended September 30, 2014 (In millions)	Defined Benefit Pension and Other Postretirement Plans	Currency Translation Adjustments	Loss from Hedging Activities	Unrealized Loss on Investment	Gain (Loss) on Securities Available for Sale	Total
Beginning balance	$6.6	$5.2	$(0.5)	$(0.8)	$0.1	$10.6
Other comprehensive income (loss) before reclassifications	27.2	(7.5)	(0.8)	—	(0.7)	18.2
Amounts reclassified from accumulated other comprehensive income	(24.0)	—	(0.2)	0.8	0.6	(22.8)
	3.2	(7.5)	(1.0)	0.8	(0.1)	(4.6)

Net current-period other comprehensive income (loss)						
Ending balance	$9.8	$(2.3)	$(1.5)	$—	$—	$6.0

Grace is a global enterprise operating in over 40 countries with local currency generally deemed to be the functional currency for accounting purposes. The currency translation amount represents the adjustments necessary to translate the balance sheets valued in local currencies to the U.S. dollar as of the end of each period presented, and to translate revenues and expenses at average exchange rates for each period presented.

See Note 4 for a discussion of hedging activities. See Note 6 for a discussion of pension plans and other postretirement benefit plans.

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Notes to Consolidated Financial Statements (Continued)

12. Earnings Per Share

The following table shows a reconciliation of the numerators and denominators used in calculating basic and diluted earnings per share.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In millions, except per share amounts)	2015	2014	2015	2014
Numerators				
Net income attributable to W. R. Grace & Co. shareholders	$13.8	$74.5	$123.9	$260.8
Denominators				
Weighted average common shares—basic calculation	72.1	74.7	72.5	75.9
Dilutive effect of employee stock options	0.6	0.9	0.6	0.9
Weighted average common shares—diluted calculation	72.7	75.6	73.1	76.8
Basic earnings per share	$0.19	$1.00	$1.71	$3.44
Diluted earnings per share	$0.19	$0.99	$1.69	$3.40

There were approximately 0.6 million and 0.4 million anti-dilutive options outstanding for the three and nine months ended September 30, 2015, respectively. There were approximately 0.4 million and 0.3 million anti-dilutive options outstanding for the three and nine months ended September 30, 2014, respectively.

On February 4, 2014, Grace announced that the Company's Board of Directors had authorized a share repurchase program of up to $500 million expected to be completed over the following 12 to 24 months at the discretion of management. The Company completed this initial share repurchase program on January 15, 2015. On February 5, 2015, the Grace announced that the Company's Board of Directors had authorized an additional share repurchase program of up to $500 million. The timing of the repurchases and the actual amount repurchased will depend on a variety of factors, including the market price of the Company's shares, the strategic deployment of capital, and general market and economic conditions. During the nine months ended September 30, 2015 and 2014, the Company repurchased 2,263,121 shares and 3,489,819 shares of Company common stock for $220.1 million and $334.4 million, respectively, pursuant to the terms of its share repurchase programs.

13. Operating Segment Information

Grace is a global producer of specialty chemicals and specialty materials. Grace manages its business through three operating segments: Grace Catalysts Technologies, Grace Materials Technologies, and Grace Construction Products. Grace Catalysts Technologies includes catalysts and related products and technologies used in refining, petrochemical and other chemical manufacturing applications. Grace's Advanced Refining Technologies (ART) joint venture is managed in this segment. ART is an unconsolidated affiliate, and Grace accounts for ART using the equity method as discussed in Note 14. Grace Materials Technologies includes packaging products and engineered materials, coatings and sealants used in consumer, industrial, and pharmaceutical applications. Grace Construction Products includes specialty construction chemicals and specialty building materials used in commercial, infrastructure and residential construction. Intersegment sales are eliminated in consolidation. The table below presents information related to Grace's operating segments. Only those corporate expenses directly related to the operating segments are allocated for reporting purposes. All remaining corporate items are reported separately and labeled as such.

Grace excludes defined benefit pension expense from the calculation of segment operating income. Grace believes that the exclusion of defined benefit pension expense provides a better indicator of its operating segment performance as defined benefit pension expense is not managed at an operating segment level.

Grace defines Adjusted EBIT (a non-GAAP financial measure) to be net income adjusted for interest income and expense; income taxes; costs related to Chapter 11 and asbestos; restructuring and repositioning expenses and asset impairments; pension costs other than service and interest costs, expected returns on plan assets, and amortization of

prior service costs/credits; income and expense items related to divested businesses, product

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Notes to Consolidated Financial Statements (Continued)

13. Operating Segment Information (Continued)

lines, and certain other investments; gains and losses on sales of businesses, product lines, and certain other investments; and certain other unusual or infrequent items that are not representative of underlying trends.

Operating Segment Data

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In millions)	2015	2014	2015	2014
Net Sales				
Catalysts Technologies	$285.3	$329.3	$855.6	$927.0
Materials Technologies	200.9	229.1	605.4	685.0
Construction Products	303.9	298.0	831.8	826.9
Total	$790.1	$856.4	$2,292.8	$2,438.9
Adjusted EBIT				
Catalysts Technologies segment operating income	$86.4	$100.9	$246.7	$269.6
Materials Technologies segment operating income	46.4	48.7	133.1	143.9
Construction Products segment operating income	67.3	48.9	150.6	119.3
Corporate costs	(22.2)	(23.8)	(65.9)	(69.1)
Gain on termination and curtailment of postretirement plans related to current businesses	1.9	14.2	1.9	18.9
Certain pension costs	(6.4)	(8.0)	(19.2)	(24.3)
Total	$173.4	$180.9	$447.2	$458.3

Corporate costs include corporate support function costs and other corporate costs such as professional fees and insurance premiums.

Reconciliation of Operating Segment Data to Financial Statements

Grace Adjusted EBIT for the three and nine months ended September 30, 2015 and 2014, is reconciled below to income before income taxes presented in the accompanying Consolidated Statements of Operations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In millions)	2015	2014	2015	2014
Grace Adjusted EBIT	$173.4	$180.9	$447.2	$458.3
Currency and other losses in Venezuela	(72.5)	(1.0)	(72.5)	(1.0)
Repositioning expenses	(14.0)	—	(34.3)	—
Restructuring expenses and asset impairments	(4.8)	(5.4)	(18.7)	(17.8)
Pension MTM adjustment and other related costs, net	—	—	(4.7)	4.8
Gain on termination and curtailment of postretirement plans related to divested businesses	2.6	9.5	2.6	12.7
Income and expense items related to divested businesses	0.7	(2.1)	1.0	(6.8)
(Costs) benefit related to Chapter 11 and asbestos, net	(6.1)	(4.7)	0.9	(21.7)
Net income attributable to noncontrolling interests	0.3	0.5	0.5	1.2
Gain on sale of product line	—	—	—	0.2
Interest expense, net	(25.4)	(58.1)	(75.2)	(101.2)
Income before income taxes	$54.2	$119.6	$246.8	$328.7

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Notes to Consolidated Financial Statements (Continued)

13. Operating Segment Information (Continued)

Geographic Area Data

The table below presents information related to the geographic areas in which Grace operates. Sales are attributed to geographic areas based on customer location.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In millions)	2015	2014	2015	2014
Net Sales				
United States	$248.7	$258.5	$712.2	$703.2
Canada and Puerto Rico	15.7	22.2	58.8	60.4
Total North America	264.4	280.7	771.0	763.6
Europe Middle East Africa	246.9	280.8	724.6	845.5
Asia Pacific	172.3	199.5	534.6	554.5
Latin America	106.5	95.4	262.6	275.3
Total	$790.1	$856.4	$2,292.8	$2,438.9

14. Unconsolidated Affiliate

Grace accounts for its 50% ownership interest in ART using the equity method of accounting. Grace's investment in ART amounted to $112.1 million and $113.1 million as of September 30, 2015, and December 31, 2014, respectively, and the amount included in "equity in earnings of unconsolidated affiliate" in the accompanying Consolidated Statements of Operations totaled $3.6 million and $12.1 million for the three and nine months ended September 30, 2015, compared with $6.4 million and $13.2 million for the three and nine months ended September 30, 2014, respectively.

Grace and ART transact business on a regular basis and maintain several agreements in order to operate the joint venture. These agreements are treated as related party activities with an unconsolidated affiliate. The table below presents summary financial data related to transactions between Grace and ART.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In millions)	2015	2014	2015	2014
Grace sales of catalysts to ART	$76.7	$67.8	$194.2	$197.8
Charges for fixed costs, research and development and selling, general and administrative services to ART	6.0	6.1	17.8	20.7

Grace and Chevron provide lines of credit in the amount of $15.0 million each at a commitment fee of 0.1% of the credit amount. These agreements expire on February 26, 2016. No amounts were outstanding at September 30, 2015, and December 31, 2014.

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

We generally refer to the quarter ended September 30, 2015, as the "third quarter," the quarter ended September 30, 2014, as the "prior-year quarter," the quarter ended March 31, 2015, as the "2015 first quarter," the quarter ended June 30, 2015, as the "2015 second quarter," the nine months ended September 30, 2015, as the "nine months," and the nine months ended September 30, 2014, as the "prior-year period." Our references to "advanced economies" and "emerging regions" refer to classifications established by the International Monetary Fund. See Analysis of Operations for a discussion of our non-GAAP performance measures.

Results of Operations

Third Quarter Performance Summary

Following is a summary of our financial performance for the third quarter compared with the prior-year quarter.

- Net sales decreased 7.7% to $790.1 million, and decreased 1.3% on a constant currency basis.
- Adjusted EBIT decreased 4.1% to $173.4 million, and increased 0.4% on a constant currency basis.
- Net income decreased 81.5% to $13.8 million or $0.19 per diluted share. Adjusted EPS was $1.37 per diluted share.
- Net income includes a pre-tax charge of $72.5 million related to our Venezuelan operations.
- Adjusted EBIT Return On Invested Capital was 32.3% on a trailing four quarters basis compared with 29.7% for the 2014 third quarter.

On February 5, 2015, the Company announced its intent to separate the business, assets and liabilities associated with the Grace Construction Products operating segment and the packaging technologies business (collectively, "GCP") into an independent publicly-traded company. Following the separation, Grace will consist of the Catalysts Technologies and Materials Technologies (excluding the packaging technologies business) operating segments. Grace intends that the separation transaction will be a tax-free spin-off to the Company's stockholders for U.S. federal income tax purposes and expects the transaction to be completed in the 2016 first quarter.

Summary Description of Business

We are engaged in specialty chemicals and specialty materials businesses on a worldwide basis through our three operating segments.

Grace Catalysts Technologies produces and sells catalysts and related products and technologies used in refining, petrochemical and other chemical manufacturing applications, as follows:

- Fluid catalytic cracking catalysts, also called FCC catalysts, that help to "crack" the hydrocarbon chain in distilled crude oil to produce transportation fuels, such as gasoline and diesel fuels, and other petroleum-based products; and FCC additives used to reduce sulfur in gasoline, maximize propylene production from refinery FCC units, and reduce emissions of sulfur oxides, nitrogen oxides and carbon monoxide from refinery FCC units.
- Hydroprocessing catalysts (HPC), most of which are marketed through our ART joint venture with Chevron Products Company in which we hold a 50% economic interest, that are used in process reactors to upgrade heavy oils into lighter, more useful products by removing impurities such as nitrogen, sulfur and heavy metals, allowing less expensive feedstocks to be used in the petroleum refining process (ART is not consolidated in our financial statements, so ART's sales are excluded from our sales).
- Polyolefin catalysts and catalyst supports, also called specialty catalysts (SC), for the production of polypropylene and polyethylene thermoplastic resins, which can be customized to enhance the performance of a wide range of industrial and consumer end-use applications including high pressure pipe, geomembranes, food packaging, automotive parts, medical devices, and textiles; chemical

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catalysts used in a variety of industrial, environmental and consumer applications; and gas-phase polypropylene process technology, which provides our licensees with a reliable capability to manufacture polypropylene products for a broad array of end-use applications.

Grace Materials Technologies produces and sells specialty materials, coatings and sealants and related products used in coatings, consumer, industrial, pharmaceutical, and packaging applications, as follows:

- Engineered materials, including silica-based and silica-alumina-based materials, used in:
- Coatings and print media applications, including functional additives that provide matting effects and corrosion protection for industrial and consumer coatings and media and paper products to enhance quality in ink jet coatings.
- Consumer applications, as a free-flow agent, carrier or processing aid in food and personal care products; as a toothpaste abrasive and thickener; and for the processing and stabilization of edible oils and beverages.
- Industrial applications, such as tires and rubber, precision investment casting, refractory, insulating glass windows, adsorbents for use in petrochemical and natural gas processes and biofuels, various functions such as reinforcement, high temperature binding and moisture scavenging.
- Pharmaceutical, life science and related applications including silica-based separation media, excipients and pharmaceutical intermediates; complementary purification products, chromatography consumables, and instruments; and CO_2 absorbents used in anesthesiology and mine safety applications.
- Packaging products, including can and closure sealants used to seal and enhance the shelf life of can and bottle contents; coatings for cans and closures that prevent metal corrosion, protect package contents from the influence of metal and ensure proper adhesion of sealing compounds; and scavenging technologies designed to reduce off-taste and extend the shelf-life of packaged products.

Grace Construction Products produces and sells construction chemicals and building materials, as follows:

- Specialty construction chemicals (SCC) used to improve the performance of portland cement and materials based on portland cement including:
- Concrete admixtures that are sold to ready-mix, precast, and sprayed concrete producers to improve the rheology, workability, quality, durability and other engineering properties of concrete, reduce production costs and provide differentiated product offerings. Certain of our concrete admixtures include polyolefin fibers which are used to improve the strength of concrete and enables the replacement of steel reinforcement, in certain cases.
- Cement additives that are sold to manufacturers of portland cement to improve energy efficiency in cement milling operations and to enhance the characteristics of finished cement. Our additives are also used by cement manufacturers to meet national standards for cement quality at lower production cost and with a reduced environmental footprint, including lower CO_2 emissions.
- Specialty building materials (SBM) used in both new construction and renovation/repair projects including:
- Sheet and liquid membrane systems that protect commercial buildings, residential buildings and infrastructure from above- and below-grade water penetration and above-grade vapor and air penetration and underlayments used to protect sloped roofs from wind and water penetration.

Global Scope

We operate our business on a global scale with approximately 71% of our annual 2014 sales and 69% of our nine months sales outside the United States. We operate in over 40 countries and do business in more than

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50 currencies. We manage our operating segments on a global basis, to serve global markets. Currency fluctuations affect our reported results of operations, cash flows, and financial position.

Analysis of Operations

We have set forth in the table below our key operating statistics with percentage changes for the third quarter compared with the prior-year quarter. Please refer to this Analysis of Operations when reviewing this Management's Discussion and Analysis of Financial Condition and Results of Operations.

We define Adjusted EBIT (a non-GAAP financial measure) to be net income adjusted for interest income and expense; income taxes; costs related to Chapter 11 and asbestos; restructuring and repositioning expenses and asset impairments; pension costs other than service and interest costs, expected returns on plan assets, and amortization of prior service costs/credits; income and expense items related to divested businesses, product lines, and certain other investments; gains and losses on sales of businesses, product lines, and certain other investments; and certain other unusual or infrequent items that are not representative of underlying trends.

We define Adjusted EBITDA (a non-GAAP financial measure) to be Adjusted EBIT adjusted for depreciation and amortization.

We define Adjusted Earnings Per Share (EPS) (a non-GAAP financial measure) to be diluted EPS adjusted for costs related to Chapter 11 and asbestos; restructuring and repositioning expenses and asset impairments; pension costs other than service and interest costs, expected returns on plan assets, and amortization of prior service costs/credits; income and expense items related to divested businesses, product lines, and certain other investments; gains and losses on sales of businesses, product lines and certain other investments; certain other unusual or infrequent items that are not representative of underlying trends; and certain discrete tax items.

We define Adjusted EBIT Return On Invested Capital (a non-GAAP financial measure) to be Adjusted EBIT (on a trailing four quarters basis) divided by the sum of net working capital, properties and equipment and certain other assets and liabilities.

We define Adjusted Gross Margin (a non-GAAP financial measure) to be gross margin adjusted for pension-related costs and loss in Venezuela included in cost of goods sold.

We use Adjusted EBIT as a performance measure in significant business decisions and in determining certain incentive compensation. We use Adjusted EBIT as a performance measure because it provides improved period-to-period comparability for decision making and compensation purposes, and because it better measures the ongoing earnings results of our strategic and operating decisions by excluding the earnings effects of our Chapter 11 proceedings, asbestos liabilities, restructuring and repositioning activities, and divested businesses.

Adjusted EBIT, Adjusted EBITDA, Adjusted EPS, Adjusted EBIT Return On Invested Capital and Adjusted Gross Margin do not purport to represent income measures as defined under U.S. GAAP, and should not be used as alternatives to such measures as an indicator of our performance. These measures are provided to investors and others to improve the period-to-period comparability and peer-to-peer comparability of our financial results, and to ensure that investors understand the information we use to evaluate the performance of our businesses.

Adjusted EBIT has material limitations as an operating performance measure because it excludes costs related to Chapter 11 and asbestos and may exclude income and expenses from restructuring and repositioning activities and divested businesses, which historically have been material components of our net income. Adjusted EBITDA also has material limitations as an operating performance measure because it excludes the impact of depreciation and amortization expense. Our business is substantially dependent on the successful deployment of capital, and depreciation and amortization expense is a necessary element of our costs. We compensate for the limitations of these measurements by using these indicators together with net income as measured under U.S. GAAP to present a complete analysis of our results of operations. Adjusted EBIT and Adjusted EBITDA should be evaluated together with net income measured under U.S. GAAP for a complete understanding of our results of operations.

We have provided in the following tables a reconciliation of these non-GAAP measures to the most directly comparable financial measure calculated and presented in accordance with U.S. GAAP.

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Analysis of Operations (In millions, except per share amounts)	Three Months Ended September 30, 2015	2014	% Change	Nine Months Ended September 30, 2015	2014	% Change
Net sales:						
Catalysts Technologies	$285.3	$329.3	(13.4)%	$855.6	$927.0	(7.7)%
Materials Technologies	200.9	229.1	(12.3)%	605.4	685.0	(11.6)%
Construction Products	303.9	298.0	2.0%	831.8	826.9	0.6%
Total Grace net sales	$790.1	$856.4	(7.7)%	$2,292.8	$2,438.9	(6.0)%
Net sales by region:						
North America	$264.4	$280.7	(5.8)%	$771.0	$763.6	1.0%
Europe Middle East Africa	246.9	280.8	(12.1)%	724.6	845.5	(14.3)%
Asia Pacific	172.3	199.5	(13.6)%	534.6	554.5	(3.6)%
Latin America	106.5	95.4	11.6%	262.6	275.3	(4.6)%
Total net sales by region	$790.1	$856.4	(7.7)%	$2,292.8	$2,438.9	(6.0)%
Profitability performance measures:						
Adjusted EBIT(A):						
Catalysts Technologies segment operating income	$86.4	$100.9	(14.4)%	$246.7	$269.6	(8.5)%
Materials Technologies segment operating income	46.4	48.7	(4.7)%	133.1	143.9	(7.5)%
Construction Products segment operating income	67.3	48.9	37.6%	150.6	119.3	26.2%
Corporate costs	(22.2)	(23.8)	6.7%	(65.9)	(69.1)	4.6%
Gain on termination and curtailment of postretirement plans related to current businesses	1.9	14.2	NM	1.9	18.9	NM
Certain pension costs(B)	(6.4)	(8.0)	20.0%	(19.2)	(24.3)	21.0%
Adjusted EBIT	173.4	180.9	(4.1)%	447.2	458.3	(2.4)%
Currency and other losses in Venezuela	(72.5)	(1.0)		(72.5)	(1.0)	
Repositioning expenses	(14.0)	—		(34.3)	—	
Restructuring expenses and asset impairments	(4.8)	(5.4)		(18.7)	(17.8)	
Pension MTM adjustment and other related costs, net	—	—		(4.7)	4.8	
Gain on termination and curtailment of postretirement plans related to divested businesses	2.6	9.5		2.6	12.7	
Income and expense items related to divested businesses	0.7	(2.1)		1.0	(6.8)	
(Costs) benefit related to Chapter 11 and asbestos, net	(6.1)	(4.7)		0.9	(21.7)	
Gain on sale of product line	—	—		—	0.2	
Interest expense, net	(25.4)	(58.1)	56.3%	(75.2)	(101.2)	25.7%
Provision for income taxes	(40.1)	(44.6)	10.1%	(122.4)	(66.7)	(83.5)%
Net income attributable to W. R. Grace & Co. shareholders	$13.8	$74.5	(81.5)%	$123.9	$260.8	(52.5)%
Diluted EPS (GAAP)	$0.19	$0.99	(80.8)%	$1.69	$3.40	(50.3)%
Adjusted EPS (non-GAAP)	$1.37	$1.07	28.0%	$3.38	$3.06	10.5%

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Analysis of Operations	Three Months Ended September 30,					Nine Months Ended September 30,					
(In millions)	2015		2014		% Change	2015		2014		% Change	
Adjusted profitability performance measures:											
Adjusted Gross Margin:											
Catalysts Technologies	43.4	%	42.5	%	0.9 pts	41.9	%	41.8	%	0.1 pts	
Materials Technologies	38.1	%	35.3	%	2.8 pts	36.8	%	35.1	%	1.7 pts	
Construction Products	41.2	%	36.8	%	4.4 pts	38.8	%	35.9	%	2.9 pts	
Adjusted Gross Margin	41.2	%	38.6	%	2.6 pts	39.4	%	37.9	%	1.5 pts	
Loss in Venezuela in cost of goods sold	(1.5	)%	—	%	NM	(0.5	)%	—	%	NM	
Pension costs in cost of goods sold	(0.2	)%	(0.3	)%	0.1 pts	(0.5	)%	(0.3	)%	(0.2) pts	
Total Grace	39.5	%	38.3	%	1.2 pts	38.4	%	37.6	%	0.8 pts	
Adjusted EBIT:											
Catalysts Technologies	$86.4		$100.9		(14.4)%	$246.7		$269.6		(8.5	)%
Materials Technologies	46.4		48.7		(4.7)%	133.1		143.9		(7.5	)%
Construction Products	67.3		48.9		37.6 %	150.6		119.3		26.2	%
Corporate	(26.7	)	(17.6	)	(51.7)%	(83.2	)	(74.5	)	(11.7	)%
Total Grace	173.4		180.9		(4.1)%	447.2		458.3		(2.4	)%
Depreciation and amortization:											
Catalysts Technologies	$17.1		$16.7		2.4 %	$51.2		$49.7		3.0	%
Materials Technologies	6.9		8.2		(15.9)%	21.7		24.3		(10.7	)%
Construction Products	7.0		7.6		(7.9)%	21.7		23.0		(5.7	)%
Corporate	1.7		1.8		(5.6)%	4.9		5.3		(7.5	)%
Total Grace	32.7		34.3		(4.7)%	99.5		102.3		(2.7	)%
Adjusted EBITDA:											
Catalysts Technologies	$103.5		$117.6		(12.0)%	$297.9		$319.3		(6.7	)%
Materials Technologies	53.3		56.9		(6.3)%	154.8		168.2		(8.0	)%
Construction Products	74.3		56.5		31.5 %	172.3		142.3		21.1	%
Corporate	(25.0	)	(15.8	)	(58.2)%	(78.3	)	(69.2	)	(13.2	)%
Total Grace	206.1		215.2		(4.2)%	546.7		560.6		(2.5	)%
Adjusted EBIT margin:											
Catalysts Technologies	30.3	%	30.6	%	(0.3) pts	28.8	%	29.1	%	(0.3) pts	
Materials Technologies	23.1	%	21.3	%	1.8 pts	22.0	%	21.0	%	1.0 pts	
Construction Products	22.1	%	16.4	%	5.7 pts	18.1	%	14.4	%	3.7 pts	
Total Grace	21.9	%	21.1	%	0.8 pts	19.5	%	18.8	%	0.7 pts	
Adjusted EBITDA margin:											
Catalysts Technologies	36.3	%	35.7	%	0.6 pts	34.8	%	34.4	%	0.4 pts	
Materials Technologies	26.5	%	24.8	%	1.7 pts	25.6	%	24.6	%	1.0 pts	
Construction Products	24.4	%	19.0	%	5.4 pts	20.7	%	17.2	%	3.5 pts	
Total Grace	26.1	%	25.1	%	1.0 pts	23.8	%	23.0	%	0.8 pts	

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Analysis of Operations (In millions)	Four Quarters Ended September 30, 2015	2014
Calculation of Adjusted EBIT Return On Invested Capital (trailing four quarters):		
Adjusted EBIT	$615.1	$596.9
Invested Capital:		
Trade accounts receivable	455.2	527.3
Inventories	323.1	337.3
Accounts payable	(262.3)	(298.5)
	516.0	566.1
Other current assets (excluding income taxes)	65.2	87.4
Properties and equipment, net	813.9	826.4
Goodwill	439.9	460.2
Technology and other intangible assets, net	265.7	296.2
Investment in unconsolidated affiliate	112.1	108.8
Other assets (excluding capitalized financing fees)	25.9	24.3
Other current liabilities (excluding income taxes, environmental remediation related to asbestos and divested businesses, Chapter 11, restructuring, repositioning and accrued interest)	(257.8)	(265.6)
Other liabilities (excluding environmental remediation related to asbestos and divested businesses)	(75.6)	(93.3)
Total invested capital	$1,905.3	$2,010.5
Adjusted EBIT Return On Invested Capital	32.3%	29.7%

Amounts may not add due to rounding.

(A) Grace's segment operating income includes only Grace's share of income of consolidated and unconsolidated joint ventures.

(B) Certain pension costs include only ongoing costs recognized quarterly, which include service and interest costs, expected returns on plan assets, and amortization of prior service costs/credits. Catalysts Technologies, Materials Technologies, and Construction Products segment operating income and corporate costs do not include any amounts for pension expense. Other pension related costs including annual mark-to-market adjustments and actuarial gains and losses are excluded from Adjusted EBIT. These amounts are not used by management to evaluate the performance of Grace's businesses and significantly affect the peer-to-peer and period-to-period comparability of our financial results. Mark-to-market adjustments and actuarial gains and losses relate primarily to changes in financial market values and actuarial assumptions and are not directly related to the operation of Grace's businesses.

NM—Not Meaningful

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Grace Overview

Following is an overview of our financial performance for the third quarter and nine months compared with the corresponding prior-year periods.

Net Sales and Gross Margin

The following tables identify the year-over-year increase or decrease in sales attributable to changes in sales volume and/or mix, product price, and the impact of currency translation.

	Three Months Ended September 30, 2015 as a Percentage Increase (Decrease) from Three Months Ended September 30, 2014			
Net Sales Variance Analysis	Volume	Price	Currency Translation	Total
Catalysts Technologies	(8.2)%	(0.4)%	(4.8)%	(13.4)%
Materials Technologies	(5.1)%	1.6 %	(8.8)%	(12.3)%
Construction Products	4.9 %	3.5 %	(6.4)%	2.0 %
Net sales	(2.8)%	1.5 %	(6.4)%	(7.7)%
By Region:				
North America	(5.1)%	(0.2)%	(0.5)%	(5.8)%
Europe Middle East Africa	1.9 %	0.3 %	(14.3)%	(12.1)%
Asia Pacific	(7.8)%	(1.0)%	(4.8)%	(13.6)%
Latin America	0.5 %	14.9 %	(3.8)%	11.6 %

Sales for the third quarter decreased 7.7% compared with the prior-year quarter. The sales decrease was due to unfavorable currency translation (-6.4%) and lower sales volumes (-2.8%), partially offset by improved pricing (+1.5%). As the dollar remained strong against the euro and other global currencies compared with the prior-year quarter, unfavorable translation impacted all operating segments, primarily in Europe. These impacts were partially offset by improved pricing in Materials Technologies and improved pricing and sales volumes in Construction Products. Construction Products experienced sales volume growth in North America and Emerging Asia (excluding China) and the Middle East. These gains were offset by volume declines in Europe, China and Brazil reflecting weak demand conditions in these markets. Net sales of our Venezuelan subsidiary were $41.5 million compared with $12.3 million for the prior-year quarter. In the third quarter, we were temporarily able to import a significant amount of raw materials into Venezuela, leading to a significant increase in sales and earnings that is not expected to continue. The remaining assets and liabilities, as well as future sales, earnings and cash

flows of our Venezuelan subsidiary will be immaterial after September 30, 2015, based on our actions in the third quarter. See "—Venezuela" below for further discussion.
Adjusted Gross Margin increased 260 basis points to 41.2% for the third quarter from 38.6% for the prior-year quarter primarily due to improved pricing, productivity and lower manufacturing costs.

	Nine Months Ended September 30, 2015 as a Percentage Increase (Decrease) from Nine Months Ended September 30, 2014			
Net Sales Variance Analysis	Volume	Price	Currency Translation	Total
Catalysts Technologies	(2.3)%	(0.1)%	(5.3)%	(7.7)%
Materials Technologies	(3.5)%	1.1%	(9.2)%	(11.6)%
Construction Products	4.8%	2.1%	(6.3)%	0.6%
Net sales	(0.3)%	1.0%	(6.7)%	(6.0)%
By Region:				
North America	1.0%	0.4%	(0.4)%	1.0%
Europe Middle East Africa	0.4%	0.1%	(14.8)%	(14.3)%
Asia Pacific	0.2%	(0.3)%	(3.5)%	(3.6)%
Latin America	(6.1)%	7.7%	(6.2)%	(4.6)%

Sales for the nine months decreased 6.0% overall compared with the prior-year period. The sales decrease was due to unfavorable currency translation (-6.7%) and lower sales volumes (-0.3%) partially offset by improved pricing (+1.0%). Unfavorable currency translation against the dollar, primarily in Europe, impacted all operating segments. Net sales of our Venezuelan subsidiary were $68.6 million compared with $34.4 million for the prior-year period.
Adjusted Gross Margin increased 150 basis points to 39.4% for the nine months from 37.9% for the prior-year period due to lower manufacturing costs, including lower raw material costs which had a positive effect of approximately 70 basis points; improved pricing in Materials Technologies and Construction Products; and improved product mix in Construction Products.
Adjusted EBIT
Adjusted EBIT was $173.4 million for the third quarter, a decrease of 4.1% compared with the prior-year quarter. The prior-year quarter included a gain of $14.2 million related to the termination of certain retiree benefit plans. The third quarter includes unfavorable currency translation, partially offset by improved pricing. Adjusted EBIT for our Venezuelan subsidiary was $22.8 million compared with $4.4 million for the prior-year quarter.

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Adjusted EBIT was $447.2 million for the nine months, a decrease of 2.4% compared with the prior-year period. The decrease was primarily due to unfavorable currency translation in the nine months and a gain related to the termination of certain retiree benefit plans in the prior-year period, partially offset by improved pricing. Adjusted EBIT for our Venezuelan subsidiary was $28.7 million compared with $12.7 million for the prior-year period.

Grace Net Income

Grace net income was $13.8 million for the third quarter, a decrease of 81.5% compared with $74.5 million for the prior-year quarter. The decrease was primarily due to a pre-tax charge of $72.5 million associated with our operations in Venezuela and repositioning expenses, partially offset by lower net interest expense.

Grace net income was $123.9 million for the nine months, a decrease of 52.5% compared with $260.8 million for the prior-year period. The decrease was primarily due to a pre-tax charge of $72.5 million associated with our operations in Venezuela, a higher provision for income taxes, and repositioning expenses, partially offset by lower interest expense.

Adjusted EPS

The following table reconciles our Diluted EPS (GAAP) to our Adjusted EPS (non-GAAP):

	Three Months Ended September 30,							
	2015				2014			
(In millions, except per share amounts)	Pre-Tax	Tax Effect	After-Tax	Per Share	Pre-Tax	Tax Effect	After-Tax	Per Share
Diluted Earnings Per Share (GAAP)								