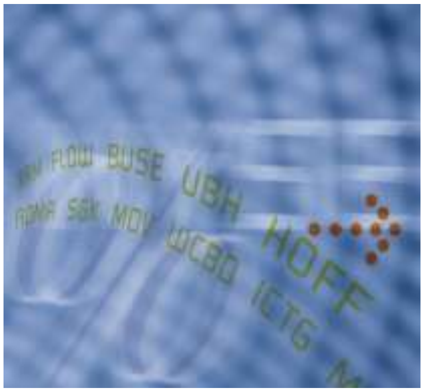

EquityIncentive ANALYTICS

Research Alert ROC

ANALYST: CHAD POTTER, CFA | 04 OCTOBER 2011

Rockwood Holdings Inc.
100 Overlook Center
Princeton, NJ 08540
(609) 514-0300
www.rockwoodspecialties.com

INDUSTRY	*Specialty Chemicals*
PRICE	*$31.79 (10/03/11)*
MARKET CAP	*2.44 billion*
ENT. VALUE	*4.14 billion*
P-E RATIO	*5.96*
EV/REVENUE	*1.18*
DEBT/EBITDA	*2.10*
SHORT INTEREST	*2.1%*
DAYS TO COVER	*1.2*

Equity Incentive Thesis

Gradient is initiating coverage on Rockwood Holdings Inc. (ROC) with a grade of A based on positive behavioral and earnings quality signals and valuation. Chairman/CEO Seifi Ghasemi reported two large-volume exercise-and-hold transactions in September after material declines from the firm's 52-week high. In addition to the apparent positive sentiment suggested by the behavior, we note (1) a material increase in common stock holdings and (2) previously well-timed purchases. From an earnings quality perspective, revenue growth has largely outpaced inventory and accounts receivable in recent quarters. As a result, DSI, DSO, and cash-conversion cycle metrics are well below historical norms. Total and operating accruals have increased, but this appears to be due to strong demand. Finally, the company trades at a discount across most commonly followed valuation metrics relative to peers and historical norms.

EQUITY INCENTIVE GRADE *Scale A – F* **A**

Unusual option-exercise activity may reflect positive sentiment *pg 5*

Chairman/CEO Seifi Ghasemi completed two large-volume exercise-and-hold transactions in September, putting approximately $7.7 million in profits at risk. Data points that suggest the unusual option-exercise activity may have been opportunistic include (1) a 23.1% (40.9%) decline in stock price from its 52-week high at the time of the first (second) exercise, (2) the transaction was Ghasemi's largest exercise-and-hold transaction in terms of volume, (3) a resultant material increase in common stock holdings, and (4) a history of well-timed purchases.

Working-capital improvements drive decline in cash-conversion cycle *pg 9*

Revenue growth has consistently outpaced that of inventory and accounts receivable in recent quarters. This has led to persistent declines in the ratio of inventory and accounts receivable to revenue, days sales in inventory (DSI), and days sales outstanding (DSO). In fact, in the most recent TTM period DSO fell to the lowest level in the last five years, while DSI remains well below historical norms. In addition to decreasing risks of inventory write-downs and uncollectible receivables, ROC's cash-conversion cycle is now at its lowest level since 2007.

Accruals not a concern, while valuation appears attractive *pg 13*

Total and operating accruals increased during the TTM ended 06/30/11 to levels not seen since 2008. However, the increase appears to be driven by rising inventory and capital expenditures to meet strong demand. Further, company disclosures suggest working-capital investments are expected to reverse and benefit cash-flow performance over the next two quarters. On a firm-specific basis, ROC trades below historical norms across four common valuation metrics. In addition, the company trades at a discount to peers according to six of seven metrics.

Company Background, Overview of Recent Results, and Introduction to Gradient's Thesis

COMPANY BACKGROUND

Rockwood is a global developer, manufacturer, and marketer of high-value-added specialty chemicals and advanced materials used for industrial and commercial purposes. ROC operates globally, manufacturing products in 81 facilities in 23 countries and selling products and providing services to more than 60,000 customers, including some of the world's pre-eminent companies. ROC reports results through the following four business segments: (1) Specialty Chemicals (36% of 2010 sales); (2) Performance Additives (23%); (3) Titanium Dioxide Pigments (24%), and (4) Advanced Ceramics (16%).

ROC's products consist primarily of inorganic chemicals and solutions and engineered materials. They are often customized to meet the complex needs of customers and to enhance the value of their end products by improving performance, providing essential product attributes, lowering costs, and/or making them more environmentally friendly. ROC generally competes in niche markets in a wide range of end-use markets, including metal treatment and general industry, chemicals and plastics, automotive, life sciences (including pharmaceutical and medical markets), construction, specialty coatings and electronics and telecommunications. No single end-use market accounted for more than 17% of ROC's 2010 net sales, while no single customer accounted for more than 2% of 2010 net sales.

OVERVIEW OF RECENT RESULTS

Revenue increased 22.9% YOY during the three months ended 06/30/11 (Q2 2011) to $1.0 billion, compared to an increase of 11.4% in the year-ago quarter to $813.7 million (see Table 1, Page 4). Second-quarter revenue increased materially even when adjusted for changes in foreign currency. In this regard, excluding the impact of foreign currency, revenue increased 12.2% YOY in Q2 2011. For the 12 months ended 06/30/11, revenue rose 20.3% YOY to $3.6 billion marking the third consecutive TTM period of double-digit revenue increases (see Table 2, Page 4).

Positive revenue trends were seen across all of ROC's reporting segments in the second quarter. The firm's largest segment, Specialty Chemicals, reported an as-reported (constant-currency) YOY revenue increase of 24.9% (14.6%) in Q2 2011 driven by strong volume growth for the firm's lithium products and surface treatment chemicals (Q2 2011 analyst call). The Performance Additives sector saw a revenue increase of 10.9% YOY (5.7% ex-currency) to $221.2 million as a result of higher selling prices and higher volumes of oilfield applications in the Clay-based additives business (Q2 2011 earnings presentation). Revenue in the Titanium Dioxide Pigments (TiO_2) segment rose 34.6% YOY (18.9% ex-currency) as a result of higher selling prices and benefits from the firm's 2008 joint venture[1] with Kemira (Q2 2011 analyst call). Finally, Advanced Ceramics revenue increased 19.6% YOY (6.9% ex-currency)

[1] http://www.kemira.com/en/media/pressreleases/Pages/1247619_20080901070211.aspx.

to $155.0 million, primarily as a result of higher volumes (Q2 2011 earnings presentation).

The combination of accelerating revenue trends and improvements in pricing and productivity resulted in significant increases in adjusted EBITDA[2] and adjusted EBITDA margin. Adjusted EBITDA increased 43.1% YOY in Q2 2011 to a record $233.6 million. Excluding foreign-currency impacts, adjusted EBITDA increased 30.0% YOY. Relative to revenue, three-month adjusted EBITDA margin increased 330 basis points YOY to 23.4%, which is the highest quarterly adjusted EBITDA margin at ROC. According to the Q2 2011 earnings presentation, higher volumes, price increases, and mix improvements more than offset raw materials and other cost increases. Adjusted EBITDA increased 33.5% YOY to $731.6 million, while adjusted EBITDA margin expanded 203 bps YOY to 20.5% for the TTM period ended 06/30/11.

Diluted EPS improved significantly during Q2 2011, primarily as a result of increases in revenue and adjusted EBITDA. For the three months ended 06/30/11, ROC generated $1.11 in diluted GAAP EPS,[3] compared to $0.59 in Q2 2010. On a TTM basis, diluted GAAP EPS increased 234.5% YOY for the period ended 06/30/11 to $3.75.

Although management does not provide revenue or earnings guidance, sell-side estimates appear to suggest a continuation of recent trends. In the last two months (ROC reported Q2 2011 results on 07/27/11), six analysts raised full-year diluted EPS estimates. As a result, the current median diluted EPS forecast for 2011 is $3.99, or 40.0% above 2010, compared to $3.53 two months prior. Similarly, the sell-side estimate for 2011 revenue of $3.80 billion is expected to increase 18.9% YOY, compared to estimated revenue of $3.71 billion two months ago. In this regard, increases in expected revenue and earnings in 2011 are consistent with the positive sentiment underlying unusual exercise-and-hold decisions reported by ROC's CEO in September 2011.

(See table, **Summary of Recent Operating Performance**, *next page*)

[2] As disclosed in the 2010 10K, adjusted EBITDA = income before the deduction of income taxes of Rockwood Specialties Group Inc. and the Restricted Subsidiaries plus interest expense, depreciation expense, amortization expense, extraordinary losses and nonrecurring charges, noncash charges, losses on asset sales, restructuring charges or reserves, Dynamit Nobel Acquisition expenses, expenses or charges related to issuance of debt or equity securities, fees or expenses related to permitted acquisitions, any deduction for non-controlling interest expense, items arising in connection with CCA litigation, less extraordinary gains and nonrecurring gains, noncash gains, and gains on asset sales.

[3] ROC reported GAAP diluted EPS of $1.11 in Q2 2011. As-reported earnings are adjusted for restructuring and other severance costs, mark-to-market swap losses, impact of tax-related items, systems/organization establishment expenses, loss on early extinguishment/modification of debt, asset write-downs and other, foreign-exchange gain on financing activities, and mark-to-market swap gains.

Table 1. Summary of Recent Operating Performance
($ in millions)

3M Ended:	06/30/11	03/31/11	12/31/10	09/30/10	06/30/10
Revenue	$1,000.0	$914.0	$798.3	$860.9	$813.7
YOY % change	22.9%	17.4%	34.7%	9.5%	11.4%
Adjusted EBITDA	$233.6	$206.6	$122.3	$169.1	$163.2
YOY % change	43.1%	31.7%	59.0%	11.9%	30.2%
Adjusted EBITDA margin	23.4%	22.6%	15.3%	19.6%	20.1%
YOY bps change	330	245	234	42	290
Operating income	$164.4	$140.5	$84.3	$105.1	$100.7
YOY % change	63.3%	54.4%	59.1%	37.6%	92.9%
Operating margin	16.4%	15.4%	10.6%	12.2%	12.4%
YOY bps change	406	368	161	249	523
Net income	$99.5	$73.4	$107.7	$43.5	$48.3
YOY % change	106.0%	128.7%	36,000.0%	353.1%	2515.0%
Net margin	10.0%	8.0%	13.5%	5.1%	5.9%
YOY bps change	401	391	1,354	383	621
Diluted EPS	$1.11	$0.80	$1.32	$0.52	$0.59
YOY % change	88.1%	90.5%	4,669.1%	271.4%	5,800.0%

Table 2. Summary of Recent Operating Performance
($ in millions)

12M Ended:	06/30/11	03/31/11	12/31/10	09/30/10	06/30/10
Revenue	$3,573.2	$3,386.9	$3,251.3	$3,045.5	$2,970.8
YOY % change	20.3%	17.3%	17.4%	4.7%	-1.1%
Adjusted EBITDA	$731.6	$661.2	$611.5	$566.1	$548.1
YOY % change	33.5%	29.6%	32.2%	78.5%	79.6%
Adjusted EBITDA margin	20.5%	19.5%	18.8%	18.6%	18.4%
YOY bps change	203	185	211	2949	2861
Operating income	$494.3	$430.6	$381.1	$349.8	$321.1
YOY % change	53.9%	58.0%	74.3%	56.4%	34.9%
Operating margin	13.8%	12.7%	11.7%	11.5%	10.8%
YOY bps change	303	327	383	380	288
Net income	$324.1	$272.9	$231.6	$123.6	$89.7
YOY % change	261.3%	592.6%	46,220.0%	115.1%	110.8%
Net margin	9.1%	8.1%	7.1%	4.1%	3.0%
YOY bps change	605	669	711	3,213	3,072
Diluted EPS	$3.75	$3.23	$2.85	$1.50	$1.12
YOY % change	234.5%	496.9%	2718.7%	369.1%	834.3%

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INTRODUCTION TO GRADIENT'S THESIS

The combination of executive behavior, earnings quality, and valuation signals underlying our outlook point to an above-average likelihood that ROC shares may outperform over the next six to 12 months. Key points supporting our thesis are summarized below:

- Unusual option-exercise activity reported by ROC Chairman/CEO Ghasemi may reflect a belief that the company can outperform expectations or that shares are otherwise undervalued following two recent share-price corrections. Other data points supporting our belief that the recent exercise may be opportunistic include the fact that (1) Ghasemi delayed the monetization of $7.7 million in certain profits, (2) the 09/08/11 exercise-and-hold transaction was his largest in terms of volume, (3) Ghasemi increased his common stock holdings by 48.3%, and (4) six of seven historical purchases preceded positive six-month returns.

- ROC's cash-conversion cycle (CCC) has consistently declined as a result of improvements in working capital. Specifically, DSI (DSO) decreased YOY in each of the last five (six) TTM periods. Further, DSI is well below its trailing five-year average, while DSO is at its lowest level in at least the last five years. ROC's cash-flow-generating ability has therefore improved with the current TTM CCC at levels not seen since 2007. ROC also improved balance-sheet metrics ahead of peers.

- Total (operating) accruals increased as a percentage of average total (current) assets over the last three (four) TTM periods. However, the primary drivers of the uptick in accruals appear to be increases in inventory and capital expenditures, both of which could be indicative of robust demand. In addition, management disclosures suggest working-capital trends are likely to reverse and lead to higher cash-flow generation in the next two quarters.

ROC trades at a discount to historical valuation multiples and in most metrics when compared to peers. Given the recent exercise-and-hold activity, strengthening balance-sheet metrics, and expected increases in cash flow in future quarters, we believe shares may be positioned to outperform.

Highly Unusual Option-Exercise Activity Could Suggest Continuation of Recent Operating Performance

MULTIPLE LARGE-VOLUME EXERCISE-AND-HOLD TRANSACTIONS PUT SIGNIFICANT PROFITS AT RISK

In September 2011, ROC's Chairman/CEO Seifi Ghasemi exercised (held) a total of 403,862 options (217,649 shares) that had an aggregate market value of $18.2 million (see Table 3, next page). We estimate that Ghasemi incurred exercise expenses of $10.2 million, which includes the cost of exercise ($5.9 million) and ordinary income taxes associated with the conversion of the

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options to shares ($4.3 million).[4] As indicated by Form 4 footnote disclosures, Ghasemi withheld 186,213 shares to satisfy the cost of exercise and income tax obligations[5] associated with his first exercise transaction on 09/08/11.[6] Form 4 filings indicate no shares were withheld in the 09/29/11 exercise, which suggests exercise costs will likely be satisfied out of pocket. More importantly, Ghasemi put $7.7 million in certain profits at risk by not selling the remaining the 217,649 held shares.

Table 3. Summary of Unusual Option-Exercise Activity from Seifi Ghasemi in September 2011

Date	Options Exercised	Shares Held	Market Value	Exercise Cost	Value of Shares Held	Estimated Ordinary Income Taxes
09/08/11	300,000	113,787	$14,367,000	$4,383,000	$5,449,259	$3,494,400
09/29/11	103,862	103,862	$3,805,504	$1,517,424	$2,288,080	$800,828
Totals	**403,862**	**217,649**	**$18,172,504**	**$5,900,424**	**$7,737,339**	**$4,295,228**

MATERIAL SHARE-PRICE DECLINES MAY HAVE MOVED FORWARD TIMING OF EXERCISE-AND-HOLD TRANSACTION

After reaching an intraday 52-week high of $62.03 on 07/27/11, ROC shares fell more than 23% to an intraday low of $47.68 on the date (09/08/11) of Ghasemi's exercise-and-hold transaction (see Chart 1, next page). In this regard, the exercise-and-hold decision may reflect (1) an effort to minimize tax outlays and (2) a belief that ROC shares are undervalued. We estimate that Ghasemi lowered his income tax obligation by as much as $1.5 million as a result of timing his exercise on 09/08/11.[7]

Of additional note, ROC shares appeared to have been hit harder than peers during the summer, as the Dow Jones U.S. Chemicals Index declined just 11.9% from 07/27/11 to 09/08/11 (thus, the index "outperformed" ROC by 9.0% over this period). This may also have partially motivated the CEO's exercise-and-hold decision.

ROC shares have continued to decline since Ghasemi's first exercise-and-hold transaction. Specifically, ROC has declined 33.6% since 09/08/11, compared to a 16.5% decline in the Dow Jones U.S. Chemicals Index over the same period. Material underperformance compared to peers may have motivated Ghasemi's additional exercise-and-hold transaction. Furthermore, multiple exercise-and-

[4] Profit is estimated as the market value of options exercised (number of options exercised multiplied by closing price at date of exercise) less cost of exercise (number of options exercised multiplied by option strike price). We estimate ordinary income tax obligations using a 35% tax rate, which is multiplied by estimated profits.

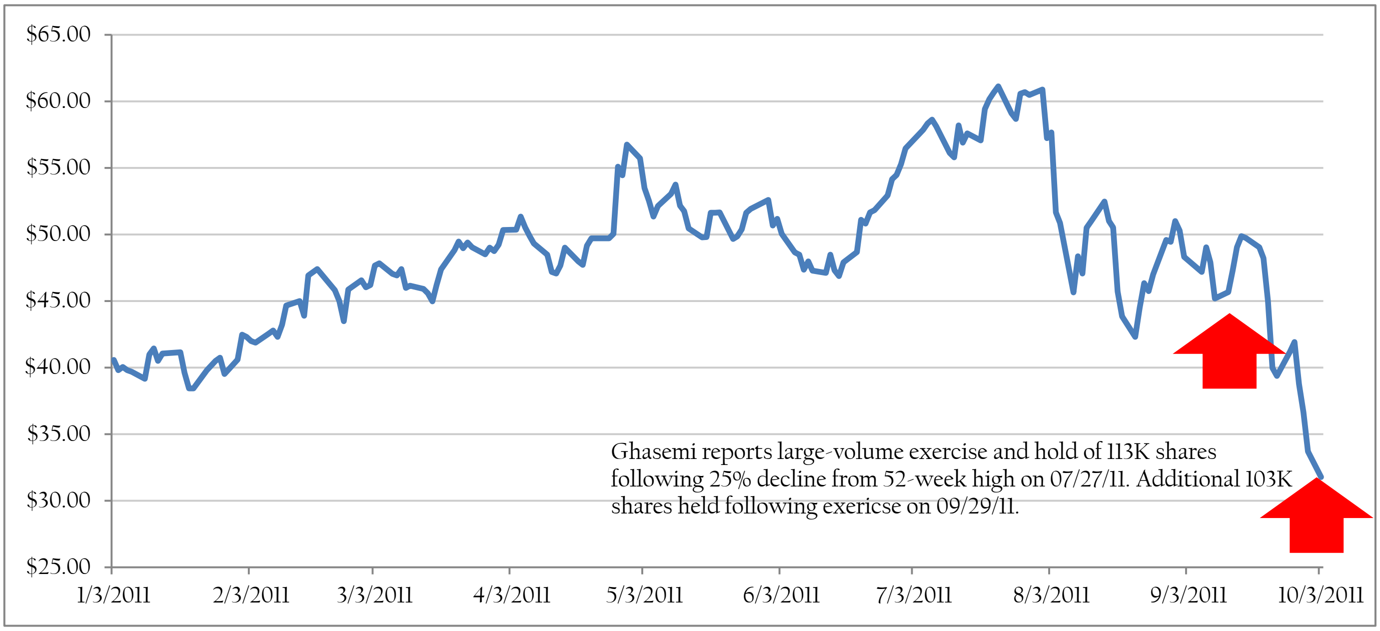
[5] According to the Form 4 filing associated with Ghasemi's 09/08/11 exercise-and-hold, the total of 186,213 shares withheld, "(r)epresents shares delivered to the Issuer to satisfy reporting person's exercise price and tax withholding obligations."

[6] Executives must satisfy exercise and income tax costs either out of pocket or, more commonly, by withholding and/or selling shares acquired through exercise. In this regard, Ghasemi's decision to withhold and sell a total of 186,213 shares does not decrease the strength of the underlying exercise-and-hold signal, in our opinion.

[7] Our estimate assumes an alternative hypothetical exercise price of $62.03, which was the firm's intraday high on 07/27/11 and also the firm's 52-week high (resulting in estimated taxes due of $5.0 million).

hold transactions after significant price corrections may reflect underlying confidence regarding the firm's future performance that is not shared by outsiders. Our expectations regarding Ghasemi's confidence appear to be confirmed by earnings quality and valuation analyses throughout the remainder of our *Alert.*

Chart 1. Overview of Ghasemi's September 2011 Exercise-and-Hold Transactions



OTHER FACTORS TO CONSIDER

We considered a number of additional factors in our evaluation of recent exercise-and-hold activity. These included the increase in Ghasemi's common stock ownership, holding requirements, previously well-timed purchases, and nearing option expiration. Each of these issues is discussed in detail below.

Exercise activity increases common stock ownership by 48.3%: The recent exercise-and-hold decision also materially increased Ghasemi's company holdings. After deducting shares withheld related to the costs of exercise and taxes, the 217,649 shares held represented a 48.3% increase in Ghasemi's common stock holdings. The increase in common stock holdings occurred despite Ghasemi already exceeding the company's executive stock ownership guidelines.[8] According to ROC's most recent proxy filing (03/28/11), Ghasemi held 233,151 direct shares as of 02/28/11. Based on Ghasemi's 2010 salary ($1,150,000) and ROC's closing price on the 03/01/11 date of record ($44.98),

[8] As disclosed in ROC's 03/28/11 proxy filing, "As of January 2011, Mr. Ghasemi's share ownership exceeds the amount required by the guidelines and our other named executive officers fall slightly below such guidelines."

we estimate Ghasemi is required to hold just 153,402 shares.[9] As a result, the decision to increase common stock holdings was not motivated by holding requirements.

Previously well-timed purchases: Consistent and material share-price outperformance following historical purchases by Ghasemi increases the likelihood that recent exercise activity may be opportunistic (see Table 4, next page). Our analysis indicates that Ghasemi purchased a total of 171,000 shares across seven transactions between 2005 and 2009. Six of the seven (85.7%) transactions preceded positive share-price movements over six months. On a weighted-mean basis, ROC shares increased 140.2% six months following the purchases. While the limited sample is insufficient to make reliable statistical inferences regarding an executive's ability to time purchase decisions, we believe that Ghasemi's prior track record should be considered as an important incremental data point that is consistent with the thesis that the firm's top executive may believe that ROC shares are undervalued.

Ghasemi previously reported one exercise-and-hold transaction, on 07/16/08, which involved 19,687 options/shares. The transaction preceded 12-month returns of -55.7%. It is unclear what motivated his decision, although we note the small volume of shares underlying the 07/16/08 transaction compared to his recent exercise (300,000 options). As a result, we do not believe financial motivations (such as minimizing tax outlays and maximizing potential future profits) were a large factor in Ghasemi's July 2008 exercise and hold.

Nearing expiration appears to have been part of the motivation: Options exercised by Ghasemi were scheduled to expire in November 2011. Thus, it appears that nearing option exercise was likely to be a motivating factor behind his decision. Nevertheless, this did not appreciably affect our opinion because (1) the timing of his decision immediately after a significant share-price decline, (2) material (otherwise certain) profits put at risk following the decision, (3) a significant increase in common holdings, and (4) previously well-timed purchases. Taken together, we believe these factors suggest the CEO's confidence in the firm's future performance relative to the exercise price, representing a potentially opportunistic decision.

(See table, **Summary of Historical Purchases by Ghasemi**, *next page*)

[9] Stock ownership guidelines modified in December 2010 (2010 Proxy) indicate the CEO must hold a value of ROC shares that is at least six times base salary (previously five times).

Table 4. Summary of Historical Purchases by Ghasemi

Date	Shares Purchased	Market Value	Forward 6M Return
03/06/09	50,000	$232,030	339.2%
02/27/09	50,000	$341,408	145.3%
09/04/08	15,000	$504,900	-84.2%
08/23/06	5,000	$101,600	38.0%
11/14/05	25,000	$467,500	21.0%
08/24/05	5,000	$100,150	13.0%
08/17/05	21,000	$419,720	11.0%
Total/Mean	**171,000**	**$337,753**	**140.2%**

Working-Capital Improvements Lead to Declining Cash-Conversion Cycle

PERSISTENT DECLINES IN INVENTORY METRICS IN RECENT PERIODS

The growth in inventory outpaced that of revenue for the three months and 12 months ended 06/30/11. On the surface, the resulting increase in inventory metrics on a sequential and YOY basis could be considered a cause for concern. However, as we discuss next, when viewed against historical norms and peers, inventories appear to be at reasonable levels, which may be indicative of high-quality inventory. Furthermore, the large increase in raw-materials inventory may confirm management's expectations of strong demand.

For the three months ended 06/30/11, inventory increased 28.2% YOY, compared to an increase of 22.9% for revenue. Similarly, TTM revenue growth of 20.3% YOY fell short of the 28.2% increase in inventory. As a result, the ratio of inventory to three-month (12-month) revenue rose 254 (106) bps YOY to 61.1% (17.1%) for the period ended 06/30/11. However, the current level of inventory to sales on a three-month (12-month) basis compares favorably to the trailing five-year average of 69.2% (17.6%).

Days sales in inventory (DSI) was flat in Q2 2011, at 82.8 days, compared to the year-ago quarter. However, DSI declined 9.3 days YOY for the 12 months ended 06/30/11 to 83.9 days—marking the fifth consecutive YOY decline on a TTM basis. Three-month and 12-month DSI are well below the trailing five-year average of 91.8 days, which suggests a lower probability of inventory obsolescence and write-downs compared to historical periods.

(See table, **Summary of Quarterly and TTM Inventory Trends**, *next page*)

Table 5. Summary of Quarterly and TTM Inventory Trends ($ in millions)

Period Ended:	06/30/11	03/31/11	12/31/10	09/30/10	06/30/10
Revenue – 3M	$1,000.0	$914.0	$798.3	$860.9	$813.7
% change YOY	22.9%	17.4%	34.7%	9.5%	11.4%
Inventory	$610.9	$576.8	$541.8	$528.6	$476.4
% change YOY	28.2%	12.9%	8.0%	-1.4%	-12.4%
Inventory to sales – 3M	61.1%	63.1%	67.9%	61.4%	58.5%
YOY change in bps	254	-253	-1,681	-676	-1,588
DSI – 3M	82.8	86.1	89.1	78.5	82.8
YOY change in days	0.0	-2.3	-32.0	-10.3	-16.4
Revenue – 12M	$3,573.2	$3,386.9	$3,251.3	$3,045.5	$2,970.8
% change YOY	20.3%	17.3%	17.4%	4.7%	-1.1%
Inventory	$610.9	$576.8	$541.8	$528.6	$476.4
% change YOY	28.2%	12.9%	8.0%	-1.4%	-12.4%
Inventory to sales – 12M	17.1%	17.0%	16.7%	17.4%	16.0%
YOY change in bps	106	-66	-145	-107	-206
DSI – 12M	83.9	84.8	85.0	91.3	93.2
YOY change in days	-9.3	-13.8	-20.7	-11.9	-8.4

Recent trends in inventory metrics also compare favorably to peers.[10] The median increase in inventory-to-revenue on a three-month (12-month) basis in the most recent reporting period was 265 (155) bps YOY, whereas ROC saw a slower increase of 254 (106) bps. Peers had a median YOY increase in three-month (12-month) DSI of 1.6 (0.6) days, while DSI was even (down 9.3 days) at ROC over the same period.

Finally, the increase in raw materials may confirm management disclosures of beneficial supply-and-demand dynamics. The YOY increase in raw materials has outpaced that of total inventory in each of the last three quarters. In Q2 2011, raw materials increased 34.2% YOY, compared to total inventory (up 28.2%), work-in-process inventory (up 26.8%), and finished goods (up 24.9%). As a result, raw materials comprised 34.1% of the company's total inventory balance, representing a 152 bps (216 bps) YOY (sequential) increase.

In the Q2 2011 analyst call, in addition to synergies realized with the 2008 business combination with Kemiera, CEO Seifi Ghasemi indicated higher prices and current supply-and-demand dynamics drove the 35% YOY increase in TiO2 revenue. Further, Ghasemi disclosed expectations that the TiO2 business will continue to achieve superior performance in the foreseeable

[10] The peer group includes Air Products & Chemicals Inc. (APD), Albemarle Corp. (ALB), Cabot Corp. (CBT), Celanese Corp. (CE), Cytec Industries Inc. (CYT), Eastman Chemical Co. (EMN), FMC Corp. (FMC), Nalco Holding Co. (NLC), RPM International Inc. (RPM), Sigma-Aldrich Corp. (SIAL), W.R. Grace & Co. (GRA), and The Valspar Corp. (VAL).

future. While increasing input costs also may have contributed to the YOY increase in raw materials during Q2 2011, we believe strong demand for ROC's products was an additional catalyst, a relationship that would bode well for future revenue growth.

CONSISTENT IMPROVEMENTS IN RECEIVABLES

Accounts-receivable metrics have continued to exhibit positive trends in recent reporting periods, as revenue growth consistently outpaced that of AR (see Table 6, next page). In our view, improvements in accounts receivable could be indicative of higher-quality revenue in the TTM period ended 06/30/11 and may signal that collection risk is lower than in prior periods.

Revenue increased 22.9% YOY in Q2 2011, compared to an increase of 13.3% in accounts receivable. This was the sixth consecutive quarter in which the growth in revenue outpaced that of accounts receivable. On a TTM basis, the YOY growth in revenue (up 20.3%) was also ahead of accounts receivable (up 13.3%) for the period ended 06/30/11. As a result, the ratio of accounts receivable to three-month (12-month) revenue decreased 486 (99) bps YOY during the period ended 06/30/11 to 57.1% (13.3%). Over the prior five-year period, AR to three-month (12-month) revenue averaged 64.8% (16.7%).

Diverging growth rates in revenue and accounts receivable has driven days sales outstanding (DSO) to historic lows. Three-month DSO declined by 5.4 days YOY to 50.7 days in Q2 2011, compared to 56.1 days in the year-ago quarter and the trailing five-year average of 59.4 days. For the 12 months ended 06/30/11, 12-month DSO fell 6.1 days YOY to 52.5 days. Furthermore, the current 12-month DSO (52.5 days) marked the lowest level for any TTM period over the last five years and is well below the trailing five-year average of 60.8 days.

Trends in receivable metrics also appear favorable when compared to peers.[11] On average, the peer set saw a median YOY increase of 140 (76) bps in the ratio of accounts receivable to three-month (12-month) sales, compared to ROC's <u>decline</u> of 486 (99) bps in the most recent period. Three-month (12-month) DSO declined slightly by 0.4 (0.1) days YOY for the peer group, while ROC saw a much larger decline of 5.0 (6.0) in the most recent period. As a result, receivable metrics at ROC have improved markedly to historical lows on a firm-specific basis but also ahead of peers.

(See table, **Summary of Quarterly and TTM Trends in Accounts Receivable**, *next page*)

[11] The peer group includes Air Products & Chemicals Inc. (APD), Albemarle Corp. (ALB), Cabot Corp. (CBT), Celanese Corp. (CE), Cytec Industries Inc. (CYT), Eastman Chemical Co. (EMN), FMC Corp. (FMC), Nalco Holding Co. (NLC), RPM International Inc. (RPM), Sigma-Aldrich Corp. (SIAL), W.R. Grace & Co. (GRA), and The Valspar Corp. (VAL).

Table 6. Summary of Quarterly and TTM Trends in Accounts Receivable ($ in millions)

Period Ended:	06/30/11	03/31/11	12/31/10	09/30/10	06/30/10
Revenue – 3M	$1,000.0	$914.0	$798.3	$860.9	$813.7
% change YOY	22.9%	17.4%	34.7%	9.5%	11.4%
Accounts Receivable	$570.9	$540.4	$436.8	$517.5	$504.1
% change YOY	13.3%	8.9%	3.7%	6.4%	5.9%
AR-to-sales – 3M	57.1%	59.1%	54.7%	60.1%	62.0%
YOY change in bps	-486	-461	-1,639	-174	-322
DSO – 3M	50.7	48.8	54.5	54.1	56.1
YOY change in days	-5.4	-5.0	-15.3	-1.7	-0.2
Revenue – 12M	$3,573.2	$3,386.9	$3,251.3	$3,045.5	$2,970.8
% change YOY	20.3%	17.3%	17.4%	4.7%	-1.1%
Accounts Receivable	$570.9	$540.4	$436.8	$517.5	$504.1
% change YOY	13.3%	8.9%	3.7%	6.4%	5.9%
AR-to-sales – 12M	16.0%	16.0%	13.4%	17.0%	17.0%
YOY change in bps	-99	-123	-178	27	112
DSO – 12M	52.5	53.8	53.3	58.1	58.6
YOY change in days	-6.1	-4.5	-6.6	-3.0	-3.3

Declining Cash-Conversion Cycle

ACCOUNTS RECEIVABLE AND INVENTORY COMBINE TO DRIVE CASH CONVERSION CYCLE LOWER

After rising for six consecutive TTM periods between 12/31/08 and 03/31/10, ROC's cash-conversion cycle (CCC) has fallen in each of the last five TTM periods by an average of 14.9 days YOY, which suggests an improvement in cash-flow-generation (see Table 7, next page). The primary driver behind the CCC shift in recent periods was the material declines in DSO and DSI. As a result, ROC's CCC fell 12.0 days YOY to 100.3 days during the 12 months ended 06/30/11, compared to 112.3 days in the year-ago TTM period. In the context of historical norms, the CCC of 100.3 days is 8.4 days below the trailing five-year average of 108.7 days and at the lowest level since the TTM ended 12/31/07.

Recent trends in the CCC at ROC are similar when compared with peers. The median YOY decline in the CCC for peers between the TTM ended 09/30/09 and 06/30/10 was 2.5 days whereas ROC increased an average of 7.2 days. In contrast, ROC's CCC has fallen in excess of the peer median (average excess of 9.9 days) in each of the last four TTM periods.

(See table, **Summary of TTM Cash-Conversion Cycle**, *next page*)

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Table 7. Summary of TTM Cash-Conversion Cycle
($ in millions)

Period Ended:	06/30/11	03/31/11	12/31/10	09/30/10	06/30/10
Days sales in inventory	83.9	84.8	85.0	91.3	93.2
Days sales outstanding	52.5	53.8	53.3	58.1	58.6
Days payables outstanding	36.1	37.0	37.5	39.3	39.5
Cash-conversion cycle	100.3	101.5	100.8	110.1	112.3
YOY change in days					
Days sales in inventory	-9.3	-13.8	-20.7	-11.9	-8.4
Days sales outstanding	-6.1	-4.5	-6.6	-3.0	-3.3
Days payables outstanding	-3.4	-2.0	-4.1	-1.6	-2.2
Cash-conversion cycle	-12.0	-16.3	-23.3	-13.3	-9.5

Total and Operating Accruals Within Historical Norms

CASH FLOWS AND ACCRUALS APPEAR INFLUENCED BY SURGING DEMAND

For the TTM ended 06/30/11, ROC's net income (EBITDA) increased 255.5% (28.3%) YOY to $335.6 million ($759.9 million) (see Table 8, next page). On the other hand, TTM CFOA increased at a slower rate of 13.0% YOY to $466.3 million, while FCF declined 12.3% YOY to $240.7 million.

As a result of the divergence between cash flows and earnings, total accruals increased 588 bps YOY to 2.0% of average total assets for the 12 months ended 06/30/11, compared to -3.8% a year prior. Similarly, operating accruals to average current assets increased 858 bps YOY to 7.4% for the TTM ended 06/30/11. Despite the recent YOY increase, total (operating) accruals are not far off the trailing five-year average of -1.6% (3.5%) of average total (current) assets.

(See table, **TTM Trends in Accruals and Cash Flows**, *next page*)

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Table 8. TTM Trends in Accruals and Cash Flows[12]
($ in millions)

Period Ended:	06/30/11	03/31/11	12/31/10	09/30/10	06/30/10
EBITDA	$759.9	$689.5	$639.5	$613.0	$592.3
% change YOY	28.3%	25.6%	29.0%	22.7%	16.0%
Adjusted Net Income	$335.6	$284.3	$242.7	$130.2	$94.4
% change YOY	255.5%	585.6%	22874.5%	651.2%	1951.9%
CFOA	$466.3	$465.6	$482.4	$445.7	$412.8
% change YOY	13.0%	21.1%	30.5%	39.4%	33.7%
CAPEX	($225.6)	($198.1)	($178.3)	($148.1)	($138.2)
% change YOY	63.2%	46.4%	24.4%	-13.2%	-26.5%
FCF	$240.7	$267.5	$304.1	$297.6	$274.6
% change YOY	-12.3%	7.3%	34.4%	99.7%	127.3%
Accruals to average total assets	2.0%	0.4%	-1.3%	-3.6%	-3.8%
YOY change in bps	588	472	329	-102	-147
Operating accruals to average total assets	7.4%	2.2%	-2.8%	-1.6%	-1.2%
YOY change in bps	858	437	132	30	-152

Increased demand appears to be affecting the level of total and operating accruals in two aspects. First, absolute increases in working-capital accounts are consuming larger portions of cash flow in the current period. For example, increases in inventory for the 12 months ended 06/30/11 consumed $91.9 million in CFOA (the largest component of CFOA) compared to a source of $22.0 million in cash in the same period last year. However, we believe trends in raw materials indicate ROC is building inventory to meet expected demand. Further, lower-quality cash-flow sources are providing less CFOA in the current TTM period compared to last year's period. In this regard, accrued expenses and other liabilities provided $9.6 million in cash flow during the 12 months ended 06/30/11 versus an average of $67.0 million for the four TTM periods between 06/30/10 and 03/31/11. Also, management expects investments in working capital "to reverse itself" over the next couple of quarters and as a result cash flow performance is also expected to improve (Q2 2011 and Q1 2011 analyst calls).

Second, rising capital expenditures to expand productions adversely affected FCF performance. For the 12 months ended 06/30/11, capital expenditures increased 63.2% YOY to $225.6 million, which represents the largest YOY increase in capital expenditures over the last five years and the highest level of TTM capital expenditures over the same period. According to the Q2 2011 analyst call, the company is investing heavily in the lithium business between $60 million and $70 million per year to increase capacity in order to meet strong demand.

[12] We use two alternative definitions of operating accruals. The preferred definition is EBITDAS minus cash from operations, pre-tax and interest. However, in cases where cash paid for taxes or interest is not available, we use earnings before depreciation, amortization and stock-based compensation. In both cases, operating accruals is scaled by average current assets.

Valuation Appears Attractive

Our analysis of historical and peer-valuation trends finds that ROC trades at a discount on the basis of most commonly followed multiples. As of publication, ROC traded at 15.63x adjusted P/E, 7.67x EV/EBITDA, 1.60x P/TTM sales, and 2.53x P/B. Compared to the trailing five-year averages for adjusted P/E (20.96x), EV/EBITDA (8.94x), P/TTM sales (1.80x), and P/B (3.18x), ROC trades at discounts of 25.4%, 14.3%, 10.6%, and 20.5%, respectively (see Table 9, below).

Relative to peers, ROC trades at a discount on the basis of six metrics, adjusted P/E (10.7%), EV/EBITDA (13.8%), P/CFOA (47.4%), P/FCF (46.7%), P/B (32.7%), and P/TTM sales (10.8%) (see Table 10, next page). However, the company trades at a significant premium on a three-year PEG basis (40.1% above the peer median). While ROC appears overvalued when taking forward earnings growth into account, we believe current consensus growth estimates may underestimate the company's true earnings power. In this regard, ROC has generated diluted EPS (ex-items) growth of 231.9% YOY during the TTM ended 06/30/11 that ranks the highest among the peer set and is significantly above the peer median for diluted EPS growth (ex-items) of 14.6%. The median five-year EPS growth estimate for ROC is 6.0% compared to a peer median of 11.0%. While forward EPS growth rates at ROC trail peers, the preceding analysis of positive exercise-and-hold, fundamental, and earnings quality signals suggest ROC's robust earnings growth may prove to be more persistent than expected.

Table 9. Current vs. Historical Valuation at ROC

	ADJ TTM P/E	TTM EV/EBITDA	P/S	P/B
Five-year average	20.96	8.94	1.80	3.18
Current	15.63	7.67	1.60	2.53
Current vs. Historical	**-25.4%**	**-14.3%**	**-10.6%**	**-20.5%**

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Table 10. Relative Valuation Analysis[13]

	ADJ TTM P/E	TTM EV/EBITDA	3-Yr. PEG	P/CFOA	P/FCF	P/B	P/TTM Sales
ROC	11.19	6.03	1.26	5.23	10.15	1.70	0.69
APD	15.63	8.32	0.94	9.73	41.55	2.53	1.60
ALB	10.72	6.37	0.58	10.42	15.28	2.07	1.36
CBT	7.92	4.33	0.72	5.70	19.03	1.01	0.48
CE	10.19	7.00	0.81	9.00	0.00	3.60	0.78
CYT	12.97	4.76	0.90	8.28	19.74	0.85	0.55
EMN	8.41	4.67	0.81	7.34	17.04	2.52	0.73
FMC	14.58	9.30	0.94	15.17	30.08	3.47	1.48
NLC	22.88	9.34	0.97	22.00	135.21	5.05	1.08
RPM	12.53	7.35	1.06	9.93	11.93	1.86	0.70
SIAL	19.71	10.56	1.65	13.99	17.49	3.27	3.07
GRA	10.87	5.18	0.68	13.44	52.94	22.40	0.80
VAL	14.27	8.42	0.89	14.48	23.54	1.76	0.74
Median	**12.53**	**7.00**	**0.90**	**9.93**	**19.03**	**2.52**	**0.78**
ROC vs. Median	**-10.7%**	**-13.8%**	**40.1%**	**-47.4%**	**-46.7%**	**-32.7%**	**-10.8%**

Conclusion

We observed two large-volume exercise-and-hold transactions by ROC Chairman/ CEO Seifi Ghasemi in September 2011, which followed an average 32.0% decline from the firm's 52-week high. As a result, Ghasemi put approximately $7.7 million in certain profits at risk. Data points supporting the positive sentiment underlying the transaction are the material increase in common stock holdings and previously well-timed purchase transactions that suggest the unusual exercise may be opportunistic in nature.

From an earnings quality perspective, the combination of declining inventory and accounts-receivable metrics has resulted in improvements in the cash-conversion cycle in the last four reporting periods. Recent trends in inventory, accounts receivable, and the cash-conversion cycle also were positive when compared to peers. While total and operating accruals increased in the most recent TTM period as a percentage of total and current assets, respectively, we find that the increase was largely a product of rising inventory and capital expenditures, which could serve as leading indicators of increased demand. Finally, ROC trades at a discount relative to its own historical norms and peers, which is consistent with the positive sentiment reflected in unusual option-exercise activity. Reflective of the above, we are initiating coverage on ROC with a grade of A.

[13] The peer group includes Air Products & Chemicals Inc. (APD), Albemarle Corp. (ALB), Cabot Corp. (CBT), Celanese Corp. (CE), Cytec Industries Inc. (CYT), Eastman Chemical Co. (EMN), FMC Corp. (FMC), Nalco Holding Co. (NLC), RPM International Inc. (RPM), Sigma-Aldrich Corp. (SIAL), W.R. Grace & Co. (GRA), and The Valspar Corp. (VAL).

Risks to Our Thesis

Deterioration in the general economic environment would likely negatively affect revenue for ROC given the company's large exposure to the automotive (Surface Treatment and Specialty Chemicals segments) and construction industries (Performance Additives business). A downturn in the economy could also affect capital markets, which would lower pension-plan returns and potentially require large payments from ROC that could disrupt cash-flow performance. ROC operates in a number of countries, which exposes the company to fluctuations in currency. According to the 2010 10K, 61% of net sales are derived in countries where the local currency is the euro. While no single raw material accounted for more than 3% of total product costs in 2010, raw materials accounted for approximately 46% of total costs for ROC in 2010. As a result, rising raw-materials costs may not be passed on to customers and would affect margin performance.