

EASTMAN CHEMICAL CO

Form 10-Q

July 30, 2008

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549  
FORM 10-Q

(Mark  
One)

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

For the quarterly period ended June 30, 2008

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-12626

EASTMAN CHEMICAL COMPANY  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

62-1539359  
(I.R.S. employer  
identification no.)

200 South Wilcox Drive  
Kingsport, Tennessee  
(Address of principal executive offices)

37660  
(Zip Code)

Registrant's telephone number, including area code: (423) 229-2000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class                                    | Number of Shares Outstanding at June 30, 2008 |
|--|---|
| Common Stock, par value \$0.01 per share | 76,392,765                                    |

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UNAUDITED CONSOLIDATED STATEMENTS OF EARNINGS,  
COMPREHENSIVE INCOME AND RETAINED EARNINGS

| (Dollars in millions, except per share amounts)                           | Second Quarter |          | First Six Months |          |
|---|----------------|----------|------------------|----------|
|   | 2008           | 2007     | 2008             | 2007     |
| Sales   | \$ 1,834       | \$ 1,764 | \$ 3,561         | \$ 3,401 |
| Cost of sales   | 1,513          | 1,455    | 2,903            | 2,806    |
| Gross profit  | 321            | 309      | 658              | 595      |
| Selling, general and administrative expenses                              | 107            | 109      | 217              | 207      |
| Research and development expenses   | 39             | 38       | 81               | 72       |
| Asset impairments and restructuring charges, net                          | 3              | 2        | 20               | 2        |
| Operating earnings  | 172            | 160      | 340              | 314      |
| Interest expense, net   | 18             | 14       | 34               | 31       |
| Other (income) charges, net   | 1              | (5)      | --               | (8)      |
| Earnings from continuing operations before income taxes                   | 153            | 151      | 306              | 291      |
| Provision for income taxes from continuing operations                     | 38             | 49       | 76               | 96       |
| Earnings from continuing operations                                       | 115            | 102      | 230              | 195      |
| Earnings (loss) from discontinued operations, net of tax                  | --             | 1        | --               | (2)      |
| Gain (loss) from disposal of discontinued operations, net of tax          | --             | 2        | 18               | (11)     |
| Net earnings  | \$ 115         | \$ 105   | \$ 248           | \$ 182   |
| Basic earnings per share  |                |          |                  |          |
| Earnings from continuing operations                                       | \$ 1.51        | \$ 1.21  | \$ 2.98          | \$ 2.32  |
| Earnings (loss) from discontinued operations                              | --             | 0.03     | 0.23             | (0.16)   |
| Basic earnings per share  | \$ 1.51        | \$ 1.24  | \$ 3.21          | \$ 2.16  |
| Diluted earnings per share  |                |          |                  |          |
| Earnings from continuing operations                                       | \$ 1.48        | \$ 1.19  | \$ 2.94          | \$ 2.29  |
| Earnings (loss) from discontinued operations                              | --             | 0.03     | 0.22             | (0.16)   |
| Diluted earnings per share  | \$ 1.48        | \$ 1.22  | \$ 3.16          | \$ 2.13  |
| Comprehensive Income  |                |          |                  |          |
| Net earnings  | \$ 115         | \$ 105   | \$ 248           | \$ 182   |
| Other comprehensive income (loss)   |                |          |                  |          |
| Change in cumulative translation adjustment, net of tax                   | (4)            | 12       | (41)             | 9        |
| Change in pension liability, net of tax                                   | --             | (6)      | 8                | (4)      |
| Change in unrealized gains (losses) on derivative instruments, net of tax | 29             | (4)      | 3                | 3        |
| Change in unrealized gains (losses) on investments, net of tax            | --             | 2        | --               | 1        |

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|  |          |          |          |          |
|--|----------|----------|----------|----------|
| Total other comprehensive income (loss)  | 25       | 4        | (30)     | 9        |
| Comprehensive income                     | \$ 140   | \$ 109   | \$ 218   | \$ 191   |
| Retained Earnings                        |          |          |          |          |
| Retained earnings at beginning of period | \$ 2,448 | \$ 2,234 | \$ 2,349 | \$ 2,186 |
| Net earnings                             | 115      | 105      | 248      | 182      |
| Cash dividends declared                  | (34)     | (37)     | (68)     | (74)     |
| Adoption of accounting standard          | --       | --       | --       | 8        |
| Retained earnings at end of period       | \$ 2,529 | \$ 2,302 | \$ 2,529 | \$ 2,302 |

The accompanying notes are an integral part of these consolidated financial statements.

## CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

| (Dollars in millions, except per share amounts)  | June 30,<br>2008<br>(Unaudited) | December 31,<br>2007 |
|--|---------------------------------|----------------------|
| <b>Assets</b>  |                                 |                      |
| <b>Current assets</b>  |                                 |                      |
| Cash and cash equivalents  | \$ 562                          | \$ 888               |
| Trade receivables, net of allowance of \$4 and \$6   | 644                             | 546                  |
| Miscellaneous receivables  | 155                             | 112                  |
| Inventories  | 669                             | 539                  |
| Other current assets   | 102                             | 74                   |
| Current assets related to discontinued operations  | --                              | 134                  |
| <b>Total current assets</b>  | <b>2,132</b>                    | <b>2,293</b>         |
| <b>Properties and equipment</b>  |                                 |                      |
| Properties and equipment at cost   | 8,376                           | 8,152                |
| Less: Accumulated depreciation   | 5,341                           | 5,306                |
| <b>Net properties and equipment</b>  | <b>3,035</b>                    | <b>2,846</b>         |
| <b>Goodwill</b>  | <b>328</b>                      | <b>316</b>           |
| <b>Other noncurrent assets</b>   | <b>335</b>                      | <b>313</b>           |
| <b>Noncurrent assets related to discontinued operations</b>  | <b>--</b>                       | <b>241</b>           |
| <b>Total assets</b>  | <b>\$ 5,830</b>                 | <b>\$ 6,009</b>      |
| <b>Liabilities and Stockholders' Equity</b>  |                                 |                      |
| <b>Current liabilities</b>   |                                 |                      |
| Payables and other current liabilities   | \$ 1,107                        | \$ 1,013             |
| Borrowings due within one year   | --                              | 72                   |
| Current liabilities related to discontinued operations   | --                              | 37                   |
| <b>Total current liabilities</b>   | <b>1,107</b>                    | <b>1,122</b>         |
| <b>Long-term borrowings</b>  | <b>1,440</b>                    | <b>1,535</b>         |
| Deferred income tax liabilities  | 286                             | 300                  |
| Post-employment obligations  | 858                             | 852                  |
| Other long-term liabilities  | 127                             | 118                  |
| <b>Total liabilities</b>   | <b>3,818</b>                    | <b>3,927</b>         |
| <b>Stockholders' equity</b>  |                                 |                      |
| Common stock (\$0.01 par value – 350,000,000 shares authorized; shares issued – 94,472,428 and 93,630,292 for 2008 and 2007, respectively) | 1                               | 1                    |
| Additional paid-in capital   | 623                             | 573                  |
| Retained earnings  | 2,529                           | 2,349                |
| Accumulated other comprehensive loss   | (58)                            | (28)                 |
|  | 3,095                           | 2,895                |
| <b>Less: Treasury stock at cost (18,162,337 shares for 2008 and 13,959,951 shares for 2007)</b>  | <b>1,083</b>                    | <b>813</b>           |

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|  |          |          |
|--|----------|----------|
| Total stockholders' equity                 | 2,012    | 2,082    |
| Total liabilities and stockholders' equity | \$ 5,830 | \$ 6,009 |

The accompanying notes are an integral part of these consolidated financial statements.



## UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

| (Dollars in millions)  | First Six Months |        |
|--|------------------|--------|
|  | 2008             | 2007   |
| Cash flows from operating activities   |                  |        |
| Net earnings   | \$ 248           | \$ 182 |
| Adjustments to reconcile net earnings to net cash provided by<br>(used in) operating activities: |                  |        |
| Depreciation and amortization  | 132              | 169    |
| Asset impairments  | 1                | 22     |
| Gains on sale of assets  | (13)             | --     |
| Provision (benefit) for deferred income taxes  | (59)             | (18)   |
| Changes in operating assets and liabilities:   |                  |        |
| (Increase) decrease in receivables   | (88)             | (59)   |
| (Increase) decrease in inventories   | (115)            | (18)   |
| Increase (decrease) in trade payables  | 10               | (63)   |
| Increase (decrease) in liabilities for employee benefits and<br>incentive pay                    | (29)             | (121)  |
| Other items, net   | (8)              | 5      |
| Net cash provided by operating activities  | 79               | 99     |
| Cash flows from investing activities   |                  |        |
| Additions to properties and equipment  | (278)            | (198)  |
| Proceeds from sale of assets and investments   | 329              | 43     |
| Investments in and acquisitions of joint ventures  | (38)             | (13)   |
| Additions to capitalized software  | (6)              | (5)    |
| Other items, net   | (1)              | 27     |
| Net cash provided by (used in) investing activities  | 6                | (146)  |
| Cash flows from financing activities   |                  |        |
| Net increase (decrease) in commercial paper, credit facility and<br>other borrowings             | (40)             | 75     |
| Repayment of borrowings  | (72)             | --     |
| Dividends paid to stockholders   | (69)             | (75)   |
| Treasury stock purchases   | (270)            | (86)   |
| Proceeds from stock option exercises and other items   | 39               | 88     |
| Net cash provided by (used in) financing activities  | (412)            | 2      |
| Effect of exchange rate changes on cash and cash equivalents                                     | 1                | (3)    |
| Net change in cash and cash equivalents  | (326)            | (48)   |
| Cash and cash equivalents at beginning of period   | 888              | 939    |

|  |    |     |    |     |
|--|----|-----|----|-----|
| Cash and cash equivalents at end of period | \$ | 562 | \$ | 891 |
|--|----|-----|----|-----|

The accompanying notes are an integral part of these consolidated financial statements.

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## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## 1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared by Eastman Chemical Company (the "Company" or "Eastman") in accordance and consistent with the accounting policies stated in the Company's 2007 Annual Report on Form 10-K, except as described below with respect to the adoption of Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements," ("SFAS No. 157"), and should be read in conjunction with the consolidated financial statements in Part II, Item 8 of the Company's 2007 Annual Report on Form 10-K. The unaudited consolidated financial statements are prepared in conformity with generally accepted accounting principles ("GAAP") and, of necessity, include some amounts that are based upon management estimates and judgments. Future actual results could differ from such current estimates. The unaudited consolidated financial statements include assets, liabilities, revenues and expenses of all majority-owned subsidiaries and joint ventures. Eastman accounts for other joint ventures and investments in minority-owned companies where it exercises significant influence on the equity basis. Intercompany transactions and balances are eliminated in consolidation.

The Company adopted SFAS No. 157 as of January 1, 2008, with the exception of the application of the statement to non-recurring nonfinancial assets and nonfinancial liabilities, which has been deferred until January 1, 2009. The standard establishes a valuation hierarchy for disclosure of the inputs to the valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based on the Company's assumptions used to measure assets and liabilities at fair value. A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement. The following chart shows the securities valued on a recurring basis.

(Dollars in millions)

## Fair Value Measurements at June 30, 2008

| Description            | June 30, 2008 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|------------------------|---------------|--|---|---|
| Derivative Assets      | \$ 48         | \$ --  | \$ 48   | \$ --                                     |
| Derivative Liabilities | (56)          | --   | (56)  | --  |
|                        | \$ (8)        | \$ --  | \$ (8)  | \$ --                                     |

The Company will be required to measure the assets of its defined benefit pension and post-retirement welfare plans pursuant to SFAS No. 157 at the next measurement date, which will be December 31, 2008.

## 2. DISCONTINUED OPERATIONS

In first quarter 2008, the Company sold its polyethylene terephthalate ("PET") polymers and purified terephthalic acid ("PTA") production facilities in the Netherlands and its PET production facility in the United Kingdom and related businesses for approximately \$340 million, subject to working capital adjustments and retained approximately \$10 million of working capital. The Company recognized a gain of \$18 million, net of tax, related to the sale of these businesses which includes the recognition of deferred currency translation adjustments of approximately \$40 million,

net of tax. In addition, the Company indemnified the buyer against certain liabilities primarily related to taxes, legal matters, environmental matters, and other representations and warranties. As of December 31, 2007, the Company had definitive agreements to sell assets and liabilities related to these businesses, resulting in them being classified as assets held for sale at December 31, 2007. The Company also entered into contracts with the buyer for transition services to supply raw materials for a period of less than one year. During first quarter 2007, the Company recorded asset impairments and restructuring charges of \$21 million for its PET polymers manufacturing facility in Spain, which it sold in second quarter 2007. Net proceeds from the sale of the San Roque site were approximately \$42 million. In addition, the Company indemnified the buyer against certain liabilities primarily related to taxes, legal matters, environmental matters, and other representations and warranties.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The manufacturing facilities in the Netherlands, United Kingdom, and Spain, and related businesses represent the Company's European PET business and qualify as a component of an entity under SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," and accordingly their results are presented as discontinued operations and are not included in the results from continuing operations for all periods presented in the Company's unaudited consolidated financial statements.

In fourth quarter 2007, the Company sold its PET polymers production facilities in Mexico and Argentina and the related businesses. The results related to the Mexico and Argentina facilities are not presented as discontinued operations due to continuing involvement of the Company's Performance Polymers segment in the region including contract polymer intermediates sales under a transition supply agreement to the divested sites.

Operating results of the discontinued operations which were formerly included in the Performance Polymers segment are summarized below:

| (Dollars in millions)                                    | Second Quarter |        | First Six Months |        |
|--|----------------|--------|------------------|--------|
|  | 2008           | 2007   | 2008             | 2007   |
| Sales  | \$ --          | \$ 131 | \$ 169           | \$ 289 |
| Earnings before income taxes                             | --             | 3      | 2                | 1      |
| Earnings (loss) from discontinued operations, net of tax | --             | 1      | --               | (2)    |
| Gain (loss) on disposal, net of tax                      | --             | 2      | 18               | (11)   |

Assets and liabilities of the discontinued operations classified as held for sale as of December 31, 2007 are summarized below:

| (Dollars in millions)                       | December 31,<br>2007 |
|---|----------------------|
| <b>Current assets</b>                       |                      |
| Trade receivables                           | \$ 85                |
| Inventories                                 | 49                   |
| Total current assets held for sale          | 134                  |
| <b>Non-current assets</b>                   |                      |
| Properties and equipment, net               | 236                  |
| Other non-current assets                    | 5                    |
| Total non-current assets held for sale      | 241                  |
| <b>Total assets</b>                         | <b>\$ 375</b>        |
| <b>Current liabilities</b>                  |                      |
| Payables and other current liabilities, net | \$ 37                |
| Total current liabilities held for sale     | 37                   |
| <b>Total liabilities</b>                    | <b>\$ 37</b>         |



## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## 3. INVENTORIES

| (Dollars in millions)                               | June 30,<br>2008 | December 31,<br>2007 |
|---|------------------|----------------------|
| At FIFO or average cost (approximates current cost) |                  |                      |
| Finished goods                                      | \$ 672           | \$ 607               |
| Work in process                                     | 218              | 195                  |
| Raw materials and supplies                          | 329              | 247                  |
| Total inventories                                   | 1,219            | 1,049                |
| LIFO Reserve  | (550)            | (510)                |
| Total inventories                                   | \$ 669           | \$ 539               |

Inventories valued on the LIFO method were approximately 80 percent as of June 30, 2008 and 70 percent as of December 31, 2007 of total inventories.

## 4. ACQUISITION AND DIVESTITURE OF INDUSTRIAL GASIFICATION INTERESTS

In October 2007, the Company entered into an agreement with Green Rock Energy, L.L.C. ("Green Rock") to jointly develop an industrial gasification facility in Beaumont, Texas through TX Energy, L.L.C. ("TX Energy"). In June 2008, the Company acquired Green Rock's 50 percent ownership interest in TX Energy for approximately \$35 million, which is primarily allocated to properties and equipment.

The results of operations of TX Energy for the period subsequent to the acquisition have been included in Eastman's consolidated financial statements for the second quarter of 2008. If TX Energy had been consolidated for the periods prior to the acquisition, the Company's consolidated revenue, net income and earnings per share would not have been materially different than reported. With this acquisition, the Company became the sole owner and developer of the industrial gasification facility in Beaumont, Texas, which is expected to be operational in 2011 and will produce intermediate chemicals, such as hydrogen, methanol, and ammonia from petroleum coke or coal.

Eastman had also begun to participate in an industrial gasification project in St. James Parish, Louisiana sponsored by Faustina Hydrogen Products, L.L.C. ("Faustina"). Through May 2008, the Company had invested approximately \$11 million in Faustina. In June 2008, the Company sold its ownership interest in Faustina for approximately \$11 million and will no longer participate in the project.

## 5. PAYABLES AND OTHER CURRENT LIABILITIES

| (Dollars in millions)   | June 30,<br>2008 | December 31,<br>2007 |
|---|------------------|----------------------|
| Trade creditors   | \$ 620           | \$ 578               |
| Accrued payrolls, vacation, and variable-incentive compensation | 96               | 138                  |
| Accrued taxes   | 51               | 36                   |
| Post-employment obligations                                     | 55               | 60                   |
| Interest payable  | 29               | 31                   |
| Bank overdrafts   | 73               | 6                    |



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|  |    |       |    |       |
|--|----|-------|----|-------|
| Other  |    | 183   |    | 164   |
| Total payables and other current liabilities | \$ | 1,107 | \$ | 1,013 |

The current portion of post-employment obligations is an estimate of current year payments in excess of plan assets.

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## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## 6. PROVISION FOR INCOME TAXES

| (Dollars in millions)      | Second Quarter |       | First Six Months |       |
|----------------------------|----------------|-------|------------------|-------|
|                            | 2008           | 2007  | 2008             | 2007  |
| Provision for income taxes | \$ 38          | \$ 49 | \$ 76            | \$ 96 |
| Effective tax rate         | 25 %           | 33 %  | 25 %             | 33 %  |

The second quarter 2008 effective tax rate reflects an estimated benefit resulting from a federal gasification investment tax credit associated with the Company's expected capital spending in 2008 on the Beaumont, Texas industrial gasification project. Excluding discrete items, the second quarter 2008 and 2007 effective tax rates reflect the Company's expected full year tax rate on reported operating earnings from continuing operations before income tax, of approximately 30 percent and 33 percent, respectively.

Excluding discrete items, the first six months 2008 and 2007 effective tax rates reflect the Company's expected full year rate on reported operating earnings before income tax of approximately 30 percent and 33 percent, respectively.

The Company or one of its subsidiaries files tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2002. It is reasonably possible that within the next 12 months the Company will recognize approximately \$2 million of unrecognized tax benefits as a result of the expiration of the relevant statute of limitations.

## 7. BORROWINGS

| (Dollars in millions)          | June 30,<br>2008 | December 31,<br>2007 |
|--------------------------------|------------------|----------------------|
| Borrowings consisted of:       |                  |                      |
| 3 1/4% notes due 2008          | \$ --            | \$ 72                |
| 7% notes due 2012              | 147              | 148                  |
| 6.30% notes due 2018           | 187              | 188                  |
| 7 1/4% debentures due 2024     | 497              | 497                  |
| 7 5/8% debentures due 2024     | 200              | 200                  |
| 7.60% debentures due 2027      | 298              | 298                  |
| Credit facilities borrowings   | 95               | 188                  |
| Other                          | 16               | 16                   |
| Total borrowings               | 1,440            | 1,607                |
| Borrowings due within one year | --               | (72)                 |
| Long-term borrowings           | \$ 1,440         | \$ 1,535             |

At June 30, 2008, the Company has credit facilities with various U.S. and non-U.S. banks totaling approximately \$800 million. These credit facilities consist of a \$700 million revolving credit facility (the "Credit Facility") and a 60 million euro credit facility. These credit facilities will expire in 2012 and 2013. Borrowings under these credit facilities are subject to interest at varying spreads above quoted market rates. The Credit Facility requires a facility fee on the total commitment. In addition, these credit facilities contain a number of customary covenants and events

of default, including the maintenance of certain financial ratios. The Company was in compliance with all such covenants for all periods presented. At June 30, 2008, the Company's credit facility borrowings totaled \$95 million at an effective interest rate of 4.82 percent. At December 31, 2007, the Company's credit facility borrowings were \$188 million at an effective interest rate of 4.79 percent.

The Credit Facility provides liquidity support for general corporate purposes.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

At June 30, 2008 and December 31, 2007, the Company had outstanding interest rate swaps associated with the entire outstanding principal of the 7% notes due in 2012 and \$150 million of the outstanding principal of the 6.30% notes due in 2018. The average variable interest rate on the 7% notes was 5.65 percent and 7.12 percent for June 30, 2008 and December 31, 2007, respectively. The average variable interest rate on the 6.30% notes was 4.05 percent and 5.52 percent for June 30, 2008 and December 31, 2007, respectively. See the table in Note 1, "Basis of Presentation" for the fair value of the interest rate swaps.

## 8. ASSET IMPAIRMENTS AND RESTRUCTURING CHARGES, NET

In the second quarter and first six months 2008, asset impairments and restructuring charges, net totaled \$3 million and \$20 million, respectively, primarily for severance, pension charges and site closure costs in the Performance Chemicals and Intermediates ("PCI") segment resulting from the decision to close a previously impaired site in the United Kingdom.

In the second quarter and first six months 2007, asset impairments and restructuring charges, net totaled \$2 million, related primarily to the dismantlement charges of a previously closed manufacturing facility.

## Changes in Reserves for Asset Impairments, Restructuring Charges, and Severance Charges

The following table summarizes the beginning reserves, charges to and changes in estimates to the reserves as described above, and the cash and non-cash reductions to the reserves attributable to asset impairments and the cash payments for severance and site closure costs for the full year 2007 and the first six months 2008:

| (Dollars in millions)                            | Balance at<br>January 1,<br>2007 | Provision/<br>Adjustments | Non-cash<br>Reductions | Cash<br>Reductions | Balance at<br>December<br>31, 2007 |
|--|----------------------------------|---------------------------|------------------------|--------------------|------------------------------------|
| Non-cash charges                                 | \$ --                            | \$ 122                    | \$ (122)               | \$ --              | \$ --                              |
| Severance costs                                  | 34                               | (9)                       | --                     | (18)               | 7                                  |
| Site closure and<br>other restructuring<br>costs | 14                               | (1)                       | --                     | (2)                | 11                                 |
| Total  | \$ 48                            | \$ 112                    | \$ (122)               | \$ (20)            | \$ 18                              |

|  | Balance at<br>January 1,<br>2008 | Provision/<br>Adjustments | Non-cash<br>Reductions | Cash<br>Reductions | Balance at<br>June 30,<br>2008 |
|--|----------------------------------|---------------------------|------------------------|--------------------|--------------------------------|
| Non-cash charges                                 | \$ --                            | \$ 9                      | \$ (9)                 | \$ --              | \$ --                          |
| Severance costs                                  | 7                                | 5                         | --                     | (7)                | 5                              |
| Site closure and<br>other restructuring<br>costs | 11                               | 6                         | --                     | (9)                | 8                              |
| Total  | \$ 18                            | \$ 20                     | \$ (9)                 | \$ (16)            | \$ 13                          |

A majority of the remaining severance and site closure costs is expected to be applied to the reserves within one year.



## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## 9. RETIREMENT PLANS

## DEFINED BENEFIT PENSION PLANS

Eastman maintains defined benefit pension plans that provide eligible employees hired prior to January 1, 2007, with retirement benefits. Costs recognized for these benefits are recorded using estimated amounts, which may change as actual costs derived for the year are determined.

Below is a summary of the components of net periodic benefit cost recognized for Eastman's significant defined benefit pension plans:

## Summary of Components of Net Periodic Benefit Costs

| (Dollars in millions)     | Second Quarter |       | First Six Months |       |
|---------------------------|----------------|-------|------------------|-------|
|                           | 2008           | 2007  | 2008             | 2007  |
| Service cost              | \$ 11          | \$ 13 | \$ 23            | \$ 24 |
| Interest cost             | 23             | 24    | 44               | 45    |
| Expected return on assets | (27)           | (27)  | (53)             | (52)  |
| Curtailment charge        | --             | --    | 9                | --    |
| Amortization of:          |                |       |                  |       |
| Prior service credit      | (4)            | (2)   | (7)              | (4)   |
| Actuarial loss            | 8              | 8     | 14               | 17    |
| Net periodic benefit cost | \$ 11          | \$ 16 | \$ 30            | \$ 30 |

The Company contributed \$100 million to its U.S. defined benefit pension plan in first quarter 2007.

The curtailment charge is primarily related to the decision to close a previously impaired site in the United Kingdom.

## POSTRETIREMENT WELFARE PLANS

Eastman provides a subsidy toward life insurance and health care and dental benefits for eligible retirees hired prior to January 1, 2007, and a subsidy toward health care benefits for retirees' eligible survivors. In general, Eastman provides those benefits to retirees eligible under the Company's U.S. plans. Similar benefits are also made available to retirees of Holston Defense Corporation, a wholly-owned subsidiary of the Company that, prior to January 1, 1999, operated a government-owned ammunitions plant.

Employees hired on or after January 1, 2007 will have access to post-retirement health care benefits only, but Eastman will not provide a subsidy toward the premium cost of post-retirement benefits for those employees.

A few of the Company's non-U.S. operations have supplemental health benefit plans for certain retirees, the cost of which is not significant to the Company. Costs recognized for benefits for eligible retirees hired prior to January 1, 2007 are recorded using estimated amounts, which may change as actual costs derived for the year are determined. Below is a summary of the components of net periodic benefit cost recognized for the Company's U.S. plans:

## Summary of Components of Net Periodic Benefit

## Costs

| (Dollars in millions)     | Second Quarter |       | First Six Months |       |
|---------------------------|----------------|-------|------------------|-------|
|                           | 2008           | 2007  | 2008             | 2007  |
| Service cost              | \$ 1           | \$ 2  | \$ 3             | \$ 4  |
| Interest cost             | 11             | 10    | 22               | 21    |
| Expected return on assets | (1)            | --    | (2)              | (1)   |
| Amortization of:          |                |       |                  |       |
| Prior service credit      | (5)            | (5)   | (11)             | (11)  |
| Actuarial loss            | 3              | 3     | 5                | 6     |
| Net periodic benefit cost | \$ 9           | \$ 10 | \$ 17            | \$ 19 |

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

10. ENVIRONMENTAL MATTERS

Certain Eastman manufacturing sites generate hazardous and nonhazardous wastes, the treatment, storage, transportation, and disposal of which are regulated by various governmental agencies. In connection with the cleanup of various hazardous waste sites, the Company, along with many other entities, has been designated a potentially responsible party ("PRP"), by the U.S. Environmental Protection Agency under the Comprehensive Environmental Response, Compensation and Liability Act, which potentially subjects PRPs to joint and several liability for such cleanup costs. In addition, the Company will be required to incur costs for environmental remediation and closure and postclosure under the federal Resource Conservation and Recovery Act. Reserves for environmental contingencies have been established in accordance with Eastman's policies described in Note 1, "Significant Accounting Policies", to the consolidated financial statements in Part II, Item 8 of the Company's 2007 Annual Report on Form 10-K. Because of expected sharing of costs, the availability of legal defenses, and the Company's preliminary assessment of actions that may be required, management does not believe that the Company's liability for these environmental matters, individually or in the aggregate, will be material to the Company's consolidated financial position, results of operations or cash flows. The Company's reserve for environmental contingencies was \$40 million and \$42 million at June 30, 2008 and December 31, 2007, respectively, representing the minimum or best estimate for remediation costs and the best estimate accrued to date over the facilities' estimated useful lives for asset retirement obligation costs. Estimated future environmental expenditures for remediation costs range from the minimum or best estimate of \$11 million to the maximum of \$16 million at June 30, 2008 and \$13 million to the maximum of \$17 million at December 31, 2007.

11. COMMITMENTS

Purchasing Obligations and Lease Commitments

At June 30, 2008, the Company had various purchase obligations totaling approximately \$2.1 billion over a period of approximately 15 years for materials, supplies, and energy incident to the ordinary conduct of business. The Company also had various lease commitments for property and equipment under cancelable, non-cancelable, and month-to-month operating leases totaling approximately \$125 million over a period of several years. Of the total lease commitments, approximately 15 percent relate to machinery and equipment, including computer and communications equipment and production equipment; approximately 35 percent relate to real property, including office space, storage facilities and land; and approximately 50 percent relate to vehicles, primarily railcars.

Accounts Receivable Securitization Program

In 1999, the Company entered into an agreement that allows the Company to sell certain domestic accounts receivable under a planned continuous sale program to a third party. The agreement permits the sale of undivided interests in domestic trade accounts receivable. Receivables sold to the third party totaled \$200 million at June 30, 2008 and December 31, 2007. Undivided interests in designated receivable pools were sold to the purchaser with recourse limited to the purchased interest in the receivable pools. Average monthly proceeds from collections reinvested in the continuous sale program were approximately \$341 million and \$312 million in the second quarter 2008 and 2007, respectively, and \$335 million and \$302 million for the first six months of 2008 and 2007, respectively.

Guarantees

Financial Accounting Standards Board, ("FASB") Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others", clarifies the requirements of SFAS No. 5, "Accounting for Contingencies," relating to the guarantor's accounting for, and disclosure of, the issuance



of certain types of guarantees. If certain operating leases are terminated by the Company, it guarantees a portion of the residual value loss, if any, incurred by the lessors in disposing of the related assets. Under these operating leases, the residual value guarantees at June 30, 2008 totaled \$152 million and consisted primarily of leases for railcars, aircraft, and other equipment. Leases with guarantee amounts totaling \$2 million, \$11 million, and \$139 million will expire in 2008, 2011, and 2012, respectively. The Company believes, based on current facts and circumstances, that the likelihood of a material payment pursuant to such guarantees is remote.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## Variable Interest Entities

The Company has evaluated its material contractual relationships and has concluded that the entities involved in these relationships are not Variable Interest Entities ("VIEs") or, in the case of Primester, a joint venture that manufactures cellulose acetate at the Company's Kingsport, Tennessee plant, the Company is not the primary beneficiary of the VIE. As such, in accordance with FASB Interpretation Number 46, "Consolidation of Variable Interest Entities", the Company is not required to consolidate these entities. In addition, the Company has evaluated long-term purchase obligations with an entity that may be a VIE at June 30, 2008. This potential VIE is a joint venture from which the Company has purchased raw materials and utilities for several years and purchases approximately \$60 million of raw materials and utilities on an annual basis. The Company has no equity interest in this entity and has confirmed that one party to this joint venture does consolidate the potential VIE. However, due to competitive and other reasons, the Company has not been able to obtain the necessary financial information to determine whether the entity is a VIE, and whether or not the Company is the primary beneficiary.

## 12. FAIR VALUE OF FINANCIAL INSTRUMENTS

## Hedging Programs

The Company is exposed to market risk, such as changes in currency exchange rates, raw material and energy costs and interest rates. The Company uses various derivative financial instruments pursuant to the Company's hedging policies to mitigate these market risk factors and their effect on the cash flows of the underlying transactions. Designation is performed on a specific exposure basis to support hedge accounting. The changes in fair value of these hedging instruments are offset in part or in whole by corresponding changes in the cash flows of the underlying exposures being hedged. The Company does not hold or issue derivative financial instruments for trading purposes. For further information, see Note 10 to the consolidated financial statements in Part II, Item 8 of the Company's 2007 Annual Report on Form 10-K.

At June 30, 2008, net mark-to-market gains from raw material and energy, currency and certain interest rate hedges that were included in accumulated other comprehensive income totaled less than \$1 million. If realized, approximately \$10 million in gains will be reclassified into earnings during the next 12 months. The mark-to-market gains or losses on non-qualifying, excluded and ineffective portions of hedges are immediately recognized in cost of sales or other income and charges. Such amounts did not have a material impact on earnings during the second quarter of 2008.

## 13. STOCKHOLDERS' EQUITY

A reconciliation of the changes in stockholders' equity for the first six months 2008 is provided below:

|                              | Common<br>Stock at<br>Par Value | Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Treasury<br>Stock at<br>Cost | Total<br>Stockholders'<br>Equity |
|------------------------------|---------------------------------|--------------------|----------------------|--|------------------------------|----------------------------------|
| (Dollars in millions)        | \$                              | \$                 | \$                   | \$   | \$                           | \$                               |
| Balance at December 31, 2007 | 1                               | 573                | 2,349                | (28)   | (813)                        | 2,082                            |
| Net Earnings                 | --                              | --                 | 248                  | --   | --                           | 248                              |
| Cash Dividends Declared (1)  | --                              | --                 | (68)                 | --   | --                           | (68)                             |

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|   |    |     |       |      |         |       |
|---|----|-----|-------|------|---------|-------|
| Other Comprehensive Income                      | -- | --  | --    | (30) | --      | (30)  |
| Stock-Based Compensation and Other Items (2)(3) | -- | 50  | --    | --   | --      | 50    |
| Share Repurchases                               | -- | --  | --    | --   | (270)   | (270) |
| Balance at June 30, 2008                        | 1  | 623 | 2,529 | (58) | (1,083) | 2,012 |

(1) Includes dividends declared but unpaid.

- (2) The tax benefits relating to the difference between the amounts deductible for federal income taxes over the amounts charged to income for book value purposes have been credited to paid-in capital.
- (3) Includes the fair value of equity share-based awards recognized under SFAS No. 123 Revised December 2004 , "Share-Based Payment".

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX

| (Dollars in millions)                                   | Cumulative<br>Translation<br>Adjustment<br>\$ | Unfunded<br>Additional<br>Minimum<br>Pension<br>Liability<br>\$ | Unrecognized<br>Loss and Prior<br>Service Cost<br>\$ | Unrealized<br>Gains (Losses)<br>on Derivative<br>Instruments<br>\$ | Unrealized<br>Gains<br>(Losses) on<br>Investments<br>\$ | Accumulated<br>Other<br>Comprehensive<br>Income (Loss)<br>\$ |
|---|---|---|--|--|---|--|
| Pre-SFAS No. 158 (1)<br>balance at December 31,<br>2006 | 121   | (207)   | --   | (6)  | (1)   | (93)   |
| Adjustments to apply SFAS<br>No. 158                    | --  | 207   | (288)  | --   | --  | (81)   |
| Balance at December 31,<br>2006                         | 121   | --  | (288)  | (6)  | (1)   | (174)  |
| Period change   | 36  | --  | 106  | 3  | 1   | 146  |
| Balance at December 31,<br>2007                         | 157   | --  | (182)  | (3)  | --  | (28)   |
| Period change   | (41)  | --  | 8  | 3  | --  | (30)   |
| Balance at June 30, 2008                                | 116   | --  | (174)  | --   | --  | (58)   |

(1) SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" ("SFAS No. 158")

Amounts of other comprehensive income (loss) are presented net of applicable taxes. The Company records deferred income taxes on the cumulative translation adjustment related to branch operations and other entities included in the Company's consolidated U.S. tax return. No deferred income taxes are provided on the cumulative translation adjustment of subsidiaries outside the United States, as such cumulative translation adjustment is considered to be a component of permanently invested, unremitted earnings of these foreign subsidiaries.

## 14. EARNINGS AND DIVIDENDS PER SHARE

|   | Second Quarter |      | First Six Months |      |
|---|----------------|------|------------------|------|
|   | 2008           | 2007 | 2008             | 2007 |
| Shares used for earnings per share calculation (in millions): |                |      |                  |      |
| Basic   | 76.1           | 84.2 | 77.1             | 84.1 |
| Diluted   | 77.4           | 85.5 | 78.3             | 85.3 |

In second quarter and the first six months 2008, common shares underlying options to purchase 171,500 shares of common stock and 237,050 shares of common stock, respectively, were excluded from the computation of diluted earnings per share, because the total market value of option exercises for these awards was less than the total proceeds that would be received for these awards. Additionally, the basic and diluted shares were reduced in second quarter and the first six months 2008 as a result of the Company's share repurchase programs. For second quarter and the first six months 2008, a total of 383,600 shares and 4,198,178 shares, respectively, were repurchased under the current

\$700 million share repurchase authorization.

In second quarter and the first six months 2007, common shares underlying options to purchase 674,134 shares of common stock and 673,593 shares of common stock, respectively, were excluded from the computation of diluted earnings per share, because the total market value of option exercises for these awards was less than the total proceeds that would be received for these awards. Additionally, the basic and diluted shares were reduced in second quarter and the first six months 2007 as a result of the Company's share repurchase programs. For the second quarter and first six months 2007, a total of 810,000 shares and 1,370,100 shares, respectively were repurchased under a prior \$300 million share repurchase authorization.

The Company declared cash dividends of \$0.44 per share in second quarters 2008 and 2007 and \$0.88 per share in the first six months 2008 and 2007.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## 15. SHARE-BASED COMPENSATION AWARDS

The Company utilizes share-based awards under employee and non-employee director compensation programs. These share-based awards may include restricted and unrestricted stock grants, restricted stock units, stock options and performance shares. In the second quarter 2008 and 2007, approximately \$5 million and \$7 million, respectively, of compensation expense before tax were recognized in selling, general and administrative expense in the earnings statement for all share-based awards. The impact on second quarter 2008 and 2007 net earnings of \$3 million and \$4 million, respectively, is net of deferred tax expense related to share-based award compensation for each period. In the first six months 2008 and 2007, approximately \$13 million for each period of compensation expense before tax were recognized in selling, general and administrative expense in the earnings statement for all share-based awards. The impact on first six months 2008 and 2007 net earnings of \$8 million for each period is net of deferred tax expense related to share-based award compensation for each period.

Additional information regarding share-based compensation plans and awards may be found in Note 16 to the consolidated financial statements in Part II, Item 8 of the Company's 2007 Annual Report on Form 10-K.

## 16. SEGMENT INFORMATION

The Company's products and operations are managed and reported in five reportable operating segments, consisting of the Coatings, Adhesives, Specialty Polymers, and Inks ("CASPI") segment, the Fibers segment, the PCI segment, the Performance Polymers segment, and the Specialty Plastics ("SP") segment. For additional information concerning the Company's segments' businesses and products, refer to Note 23 to the consolidated financial statements in Part II, Item 8 of the Company's 2007 Annual Report on Form 10-K.

Research and development and other expenses not identifiable to an operating segment are not included in segment operating results for either of the periods presented and are shown in the tables below as "other" operating losses.

| (Dollars in millions) | Second Quarter |          |
|-----------------------|----------------|----------|
|                       | 2008           | 2007     |
| Sales by Segment      |                |          |
| CASPI                 | \$ 414         | \$ 376   |
| Fibers                | 260            | 239      |
| PCI                   | 618            | 552      |
| Performance Polymers  | 289            | 382      |
| SP                    | 253            | 215      |
| Total Sales           | \$ 1,834       | \$ 1,764 |

| (Dollars in millions) | First Six Months |          |
|-----------------------|------------------|----------|
|                       | 2008             | 2007     |
| Sales by Segment      |                  |          |
| CASPI                 | \$ 803           | \$ 721   |
| Fibers                | 514              | 473      |
| PCI                   | 1,174            | 1,050    |
| Performance Polymers  | 593              | 730      |
| SP                    | 477              | 427      |
| Total Sales           | \$ 3,561         | \$ 3,401 |



## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

| (Dollars in millions)               | Second Quarter |               |
|-------------------------------------|----------------|---------------|
|                                     | 2008           | 2007          |
| Operating Earnings (Loss)           |                |               |
| CASPI (1)                           | \$ 53          | \$ 66         |
| Fibers                              | 62             | 51            |
| PCI (2)                             | 54             | 57            |
| Performance Polymers (3)            | 2              | (21)          |
| SP (4)                              | 13             | 18            |
| Total Operating Earnings by Segment | 184            | 171           |
| Other                               | (12)           | (11)          |
| <b>Total Operating Earnings</b>     | <b>\$ 172</b>  | <b>\$ 160</b> |

- (1) CASPI includes \$2 million in second quarter 2008 gains for an adjustment to a reserve for asset impairments and restructuring costs for the first quarter divestiture of certain product lines.
- (2) PCI includes \$1 million and \$7 million in second quarter 2008 and second quarter 2007, respectively, in accelerated depreciation costs related to cracking units at the Company's Longview, Texas facility and \$3 million in second quarter 2008 in asset impairments and restructuring charges, net, primarily related to severance and pension costs from the decision to close a previously impaired site in the United Kingdom.
- (3) Performance Polymers includes \$2 million and \$6 million in second quarter 2008 and second quarter 2007, respectively, in accelerated depreciation costs related to assets in Columbia, South Carolina and asset impairments and restructuring charges, net of \$2 million in second quarter 2008 related to restructuring at the South Carolina facility using IntegRex™ technology and \$1 million in second quarter 2007 primarily related to the divested PET manufacturing facilities in Mexico and Argentina.
- (4) SP includes \$1 million in second quarter 2007 in accelerated depreciation costs related to assets in Columbia, South Carolina and \$1 million in second quarter 2007 in asset impairments and restructuring charges, net related to the discontinued production of cyclohexane dimethanol ("CHDM") at the San Roque, Spain facility.

| (Dollars in millions)               | First Six Months |               |
|-------------------------------------|------------------|---------------|
|                                     | 2008             | 2007          |
| Operating Earnings (Loss)           |                  |               |
| CASPI(1)                            | \$ 112           | \$ 131        |
| Fibers                              | 130              | 110           |
| PCI (2)                             | 98               | 111           |
| Performance Polymers (3)            | (4)              | (53)          |
| SP (4)                              | 30               | 36            |
| Total Operating Earnings by Segment | 366              | 335           |
| Other                               | (26)             | (21)          |
| <b>Total Operating Earnings</b>     | <b>\$ 340</b>    | <b>\$ 314</b> |

- (1) CASPI includes \$2 million in the first six months 2008 gains for an adjustment to a reserve for asset impairments and restructuring costs for the first quarter divestiture of certain product lines.
- (2)



PCI includes \$2 million and \$14 million in the first six months 2008 and the first six months 2007, respectively, in accelerated depreciation costs related to cracking units at the Company's Longview, Texas facility and \$19 million in the first six months 2008 in asset impairments and restructuring charges, net, primarily related to severance and pension costs from the decision to close a previously impaired site in the United Kingdom.

- (3) Performance Polymers includes \$3 million and \$13 million in the first six months 2008 and the first six months 2007, respectively, in accelerated depreciation costs related to assets in Columbia, South Carolina and asset impairments and restructuring charges, net of \$3 million in the first six months 2008 related to restructuring at the South Carolina facility using IntegRex™ technology and \$1 million in the first six months 2007 primarily related to the divested PET manufacturing facilities in Mexico and Argentina.
- (4) SP includes \$1 million in the first six months 2007 in accelerated depreciation costs related to assets in Columbia, South Carolina and \$1 million in the first six months 2007 in asset impairments and restructuring charges, net related to the discontinued production of CHDM at the San Roque, Spain facility.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

| (Dollars in millions)  | June 30,<br>2008 | December<br>31,<br>2007 |
|--|------------------|-------------------------|
| Assets by Segment (1)  |                  |                         |
| CASPI  | \$ 1,247         | \$ 1,114                |
| Fibers   | 778              | 692                     |
| PCI  | 969              | 1,062                   |
| Performance Polymers   | 659              | 727                     |
| SP   | 807              | 622                     |
| Total Assets by Segment  | 4,460            | 4,217                   |
| Corporate Assets   | 1,370            | 1,417                   |
| Total Assets Before Assets Related to Discontinued<br>Operations | 5,830            | 5,634                   |
| Assets Related to Discontinued Operations (2)                    | --               | 375                     |
| Total Assets   | \$ 5,830         | \$ 6,009                |

(1) Assets managed by segment are accounts receivable, inventory, fixed assets, and goodwill.

(2) For more information regarding assets related to discontinued operations, see [Note 2](#), "Discontinued Operations".

## 17. LEGAL MATTERS

## General

From time to time, the Company and its operations are parties to, or targets of, lawsuits, claims, investigations and proceedings, including product liability, personal injury, asbestos, patent and intellectual property, commercial, contract, environmental, antitrust, health and safety, and employment matters, which are being handled and defended in the ordinary course of business. While the Company is unable to predict the outcome of these matters, it does not believe, based upon currently available facts, that the ultimate resolution of any such pending matters, including the asbestos litigation described below, will have a material adverse effect on its overall financial condition, results of operations or cash flows. However, adverse developments could negatively impact earnings or cash flows in a particular future period.

## Asbestos Litigation

Over the years, Eastman has been named as a defendant, along with numerous other defendants, in lawsuits in various state courts in which plaintiffs have alleged injury due to exposure to asbestos at Eastman's manufacturing sites. More recently, certain plaintiffs have claimed exposure to an asbestos-containing plastic, which Eastman manufactured in limited amounts between the mid-1960's and the early 1970's.

To date, the Company has obtained dismissals or settlements of its asbestos-related lawsuits with no material effect on its financial condition, results of operations or cash flows, and over the past several years, has substantially reduced its

number of pending asbestos-related claims. The Company has also obtained insurance coverage that applies to a portion of certain of the Company's defense costs and payments of settlements or judgments in connection with asbestos-related lawsuits.

Based on an ongoing evaluation, the Company believes that the resolution of its pending asbestos claims will not have a material impact on the Company's financial condition, results of operations, or cash flows, although these matters could result in the Company being subject to monetary damages, costs or expenses, and charges against earnings in particular periods.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

18. RECENTLY ISSUED ACCOUNTING STANDARDS

Effective first quarter 2008, the Company adopted SFAS No. 157, except as it applies to those nonfinancial assets and nonfinancial liabilities addressed in FASB Staff Position FAS 157-2 ("FSP FAS 157-2"). The FASB issued FSP FAS 157-2 which delays the effective date of SFAS No. 157 to fiscal years beginning after November 15, 2008 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The Company is currently evaluating the effect FSP FAS 157-2 will have on its consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007) "Business Combinations" ("SFAS No. 141R") which replaces SFAS No. 141 "Business Combinations" ("SFAS No. 141"). SFAS No. 141R retains the fundamental requirements of SFAS No. 141 that the acquisition method of accounting be used for all business combinations. However, SFAS No. 141R provides for the following changes from SFAS No. 141: an acquirer will record 100% of assets and liabilities of acquired business, including goodwill, at fair value, regardless of the level of interest acquired; certain contingent assets and liabilities will be recognized at fair value at the acquisition date; contingent consideration will be recognized at fair value on the acquisition date with changes in fair value to be recognized in earnings upon settlement; acquisition-related transaction and restructuring costs will be expensed as incurred; reversals of valuation allowances related to acquired deferred tax assets and changes to acquired income tax uncertainties will be recognized in earnings; and when making adjustments to finalize preliminary accounting, acquirers will revise any previously issued post-acquisition financial information in future financial statements to reflect any adjustments as if they occurred on the acquisition date. SFAS No. 141R applies prospectively to business combinations for which the acquisition date is on or after January 1, 2009. SFAS No. 141R will not have an impact on the Company's consolidated financial statements when effective, but the nature and magnitude of the specific effects will depend upon the nature, terms, and size of the acquisitions consummated after the effective date.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51" ("SFAS No. 160"), which establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS No. 160 provides that accounting and reporting for minority interests be recharacterized as noncontrolling interests and classified as a component of equity. This Statement also establishes reporting requirements that provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 applies to all entities that prepare consolidated financial statements but will affect only those entities that have an outstanding noncontrolling interest in one or more subsidiaries or that deconsolidate a subsidiary. This Statement is effective as of the beginning of an entity's first fiscal year beginning after December 15, 2008. The Company has concluded that SFAS No. 160 will not have a material impact on the Company's consolidated financial statements.

In March 2008, the FASB issued SFAS Statement No. 161 "Disclosures about Derivative Instruments and Hedging Activities" ("SFAS No. 161"). The new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The new standard also improves transparency about the location and amounts of derivative instruments in an entity's financial statements; how derivative instruments and related hedged items are accounted for under SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities"; and how derivative instruments and related hedged items affect its financial position, financial performance, and cash flows. The Company has concluded that SFAS No.

161 will not have a material impact on the Company's consolidated financial statements.

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

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This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with Eastman Chemical Company's (the "Company" or "Eastman") audited consolidated financial statements, including related notes, and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in the Company's 2007 Annual Report on Form 10-K, and the Company's unaudited consolidated financial statements, including related notes, included elsewhere in this report. All references to earnings per share contained in this report are diluted earnings per share unless otherwise noted.

As described below in "Strategic Actions and Related Presentation of Non-GAAP Financial Measures", the Company sold its polyethylene terephthalate ("PET") manufacturing facility in Spain in the second quarter 2007 and sold its PET polymers and purified terephthalic acid ("PTA") manufacturing facilities in the Netherlands and its PET manufacturing facility in the United Kingdom and the related businesses in first quarter 2008. Because the Company has exited the PET business in the European region, results from sales of PET products manufactured at the Spain, the Netherlands, and the United Kingdom sites, including impairments and restructuring charges of those operations, and gains and losses from disposal of those assets and businesses, are presented as discontinued operations for all periods presented and are therefore not included in results from continuing operations under generally accepted accounting principles ("GAAP"). For additional information, see Note 2, "Discontinued Operations", to the Company's unaudited consolidated financial statements in Part I, Item 1 of this quarterly report on Form 10-Q. Also in 2007, the Company sold its Mexico and Argentina PET manufacturing sites. Sales and results from these sites are not presented as discontinued operations due to the Performance Polymers segment's continuing involvement in the Latin American region and polymer intermediates sales to the divested facilities.



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CRITICAL ACCOUNTING ESTIMATES

In preparing the consolidated financial statements in conformity with GAAP in the United States, the Company's management must make decisions which impact the reported amounts and the related disclosures. Such decisions include the selection of the appropriate accounting principles to be applied and assumptions on which to base estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, the Company evaluates its estimates, including those related to impairment of assets, environmental costs, U.S. pension and other post-employment benefits, litigation and contingent liabilities, and income taxes. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The Company's management believes the critical accounting estimates listed and described in Part II, Item 7 of the Company's 2007 Annual Report on Form 10-K are the most important to the fair presentation of the Company's financial condition and results. These estimates require management's most significant judgments in the preparation of the Company's consolidated financial statements.

STRATEGIC ACTIONS AND RELATED PRESENTATION OF NON-GAAP FINANCIAL MEASURES

During 2007 and 2008, the Company took strategic actions in its Performance Polymers segment to address its underperforming PET manufacturing facilities outside the United States. In second quarter 2007, the Company completed the sale of its PET manufacturing facility in Spain and in first quarter 2008, the Company completed the sale of its PET polymers and PTA manufacturing facilities in the Netherlands and the PET manufacturing facility in the United Kingdom and related businesses. Results from, charges related to, and gains and losses from disposal of the Spain, the Netherlands, and the United Kingdom assets and businesses are presented as discontinued operations. In fourth quarter 2007, the Company completed the sale of its Mexico and Argentina manufacturing facilities. As part of this divestiture, the Company entered into transition supply agreements for polymer intermediates. In order to provide a better understanding of the impact on Performance Polymers segment results of the divested Latin American PET assets, this Management's Discussion and Analysis includes certain financial measures with and without sales and operating results in Latin America from PET manufacturing facilities and related businesses in Mexico and Argentina and with and without contract polymer intermediates sales.

In fourth quarter 2006, the Company sold its polyethylene ("PE") and Epolene™ polymer businesses and related assets of the Performance Polymers and Coatings, Adhesives, Specialty Polymers, and Inks ("CASPI") segments. As part of the PE divestiture, the Company entered into a transition supply agreement for contract ethylene sales, from which sales revenue and operating earnings are included in the Performance Chemicals and Intermediates ("PCI") segment results in 2008 and 2007.

Also in the fourth quarter 2006, the Company made strategic decisions relating to the scheduled shutdown of cracking units in Longview, Texas and a planned shutdown of higher cost PET assets in Columbia, South Carolina. Accelerated depreciation costs resulting from these decisions were \$3 million and \$14 million in second quarter 2008 and second quarter 2007, respectively, and \$5 million and \$28 million in the first six months 2008 and first six months 2007, respectively. For more information on accelerated depreciation costs, see "Gross Profit" in the "Results of Operations" section of this Management's Discussion and Analysis.



This Management's Discussion and Analysis includes the following non-GAAP financial measures and accompanying reconciliations to the most directly comparable GAAP financial measures:

- Company sales and segment sales and results from continuing operations excluding sales revenue and results from continuing operations from sales in Latin America of PET products manufactured at the divested Mexico and Argentina PET manufacturing sites;
- Company and segment sales excluding contract ethylene sales under a transition agreement related to the divestiture of the PE product lines;
- Company and segment sales excluding contract polymer intermediates sales under a transition supply agreement related to the divestiture of the PET manufacturing facilities and related businesses in Mexico and Argentina;

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- Company and segment gross profit, operating earnings and earnings from continuing operations excluding accelerated depreciation costs and asset impairments and restructuring charges; and
- Company earnings from continuing operations excluding net deferred tax benefits related to the previous divestiture of businesses.

Eastman's management believes that contract ethylene sales under the transition agreement related to the divestiture of the PE product lines and the contract polymer intermediates sales under the transition supply agreement related to the divestiture of the PET manufacturing facilities and related businesses in Mexico and Argentina do not reflect the continuing and expected future business of the PCI and Performance Polymers segments. In addition, for evaluation and analysis of ongoing business results and of the impact on the Company and segments of strategic decisions and actions to reduce costs and to improve the profitability of the Company, management believes that Company and segment earnings from continuing operations should be considered both with and without accelerated depreciation costs, asset impairments and restructuring charges, and deferred tax benefits related to the previous divestiture of businesses, and that Company and segment sales and results from continuing operations should be considered both with and without sales revenue and results from continuing operations from sales in Latin America of PET products manufactured at the divested Mexico and Argentina manufacturing facilities. Management believes that investors can better evaluate and analyze historical and future business trends if they also consider the reported Company and segment results, respectively, without the identified items. Management utilizes Company and segment results including and excluding the identified items in the measures it uses to evaluate business performance and in determining certain performance-based compensation. These measures, excluding the identified items, are not recognized in accordance with GAAP and should not be viewed as alternatives to the GAAP measures of performance.

#### OVERVIEW

The Company generated sales revenue of \$1.8 billion for both the second quarter 2008 and the second quarter 2007. Excluding the results of contract ethylene sales, contract polymer intermediates sales, and sales from divested PET facilities in Mexico and Argentina, sales revenue increased by 8 percent. The Company generated sales revenue of \$3.6 billion for the first six months 2008 compared to \$3.4 billion for the first six months 2007. Excluding the results of contract ethylene sales, contract polymer intermediates sales, and sales from divested PET facilities in Mexico and Argentina, sales revenue increased by 9 percent. Sales revenue increases for both second quarter and first six months 2008 compared to comparable periods 2007 were due to increased selling prices in response to higher raw material and energy costs more than offsetting lower sales volume.

Operating earnings were \$172 million in second quarter 2008, an 8 percent increase compared with second quarter 2007. Excluding accelerated depreciation costs and asset impairments and restructuring charges from both the second quarter 2008 and 2007, operating earnings were \$178 million in second quarter 2008 compared with \$176 million in second quarter 2007. Operating earnings were \$340 million in first six months 2008, an 8 percent increase compared with first six months 2007. Excluding accelerated depreciation costs and asset impairments and restructuring charges from both the first six months 2008 and 2007, operating earnings were \$365 million in the first six months 2008 compared with \$344 million in the first six months 2007. The Company's broad base of businesses continues to have strong results, despite the difficulty to fully offset increased raw material and energy costs. The Performance Polymers segment had significant improvement due primarily to improved operation of the South Carolina PET facility based on the IntegRex™ technology.

Primarily as a result of strategic decisions related to the Performance Polymers and PCI segments, operating earnings in second quarter 2008 were negatively impacted by \$3 million of accelerated depreciation costs and \$3 million in asset impairments and restructuring charges. Operating earnings in second quarter 2007 were negatively impacted by \$14 million of accelerated depreciation costs and \$2 million in asset impairments and restructuring charges. Operating earnings in first six months 2008 were negatively impacted by \$5 million of accelerated depreciation costs and \$20 million in asset impairments and restructuring charges. Operating earnings in first six months 2007 were negatively impacted by \$28 million of accelerated depreciation costs and \$2 million in asset impairments and restructuring charges.

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Earnings from continuing operations increased by \$13 million for second quarter 2008 as compared to second quarter 2007. Excluding accelerated depreciation costs and asset impairments and restructuring charges, net, earnings from continuing operations were \$119 million and \$111 million, respectively. Earnings from continuing operations increased by \$35 million for the first six months 2008 compared to the first six months 2007. Excluding accelerated depreciation costs, asset impairments and restructuring charges, net, and net deferred tax benefits related to the previous divestiture of businesses, earnings from continuing operations were \$236 million and \$214 million, respectively. Earnings from continuing operations for second quarter and first six months 2008 compared to second quarter and first six months 2007 included a reduction in the provision for income taxes resulting from an estimated benefit from a federal gasification investment tax credit associated with the Company's expected capital spending in 2008 on the Beaumont, Texas industrial gasification project.

The Company generated \$79 million in cash from operating activities during the first six months 2008 compared to \$99 million provided by operating activities in the first six months 2007. The difference was primarily due to a greater increase in working capital in 2008 largely resulting from an increase in inventory attributable to higher raw material costs, which was partially offset by lower pension contributions. In first six months 2007, the Company contributed \$100 million to its U.S. defined benefit pension plan and does not plan to make any contributions in 2008. In first six months 2008, the Company received proceeds from sales of assets and investments of \$329 million, repurchased shares totaling \$270 million, and repaid \$175 million of borrowings.

In addition to the completion of the sale of its PET polymers and PTA manufacturing facilities in the Netherlands and the PET manufacturing facility in the United Kingdom in first quarter 2008, Eastman continued to progress on its overall growth objectives including the industrial gasification project in the U.S. Gulf Coast and actions to improve the performance of its Performance Polymers segment including the transformation at the South Carolina facility. In June 2008, the Company acquired the remaining ownership interest in TX Energy, LLC ("TX Energy") for approximately \$35 million. With this acquisition, the Company became the sole owner and developer of the industrial gasification facility in Beaumont, Texas, which is expected to be operational in 2011. Additionally, the Company sold its ownership interest in the St. James Parish, Louisiana industrial gasification project for approximately \$11 million and will no longer participate in the project.

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## RESULTS OF OPERATIONS

| (Dollars in millions)   | Second Quarter |          |        | Volume<br>Effect | Price<br>Effect | Product<br>Mix<br>Effect | Exchange<br>Rate<br>Effect |
|---|----------------|----------|--------|------------------|-----------------|--------------------------|----------------------------|
|   | 2008           | 2007     | Change |                  |                 |                          |                            |
| Sales   | \$ 1,834       | \$ 1,764 | 4 %    | (9) %            | 11 %            | 1 %                      | 1 %                        |
| Sales from Mexico and<br>Argentina PET<br>manufacturing<br>facilities (1) | --             | 110      |        |                  |                 |                          |                            |
| Sales - contract<br>polymer intermediates<br>sales (2)                    | 26             | --       |        |                  |                 |                          |                            |
| Sales - contract<br>ethylene sales (3)                                    | 102            | 74       |        |                  |                 |                          |                            |
| Sales – excluding listed<br>items   | 1,706          | 1,580    | 8 %    | (4) %            | 10 %            | 1 %                      | 1 %                        |

| (Dollars in millions)   | First Six Months |          |        | Volume<br>Effect | Price<br>Effect | Product<br>Mix<br>Effect | Exchange<br>Rate<br>Effect |
|---|------------------|----------|--------|------------------|-----------------|--------------------------|----------------------------|
|   | 2008             | 2007     | Change |                  |                 |                          |                            |
| Sales   | \$ 3,561         | \$ 3,401 | 5 %    | (8) %            | 11 %            | 1 %                      | 1 %                        |
| Sales from Mexico and<br>Argentina PET<br>manufacturing<br>facilities (1) | --               | 235      |        |                  |                 |                          |                            |
| Sales - contract<br>polymer intermediates<br>sales (2)                    | 82               | --       |        |                  |                 |                          |                            |
| Sales - contract<br>ethylene sales (3)                                    | 194              | 144      |        |                  |                 |                          |                            |
| Sales – excluding listed<br>items   | 3,285            | 3,022    | 9 %    | (3) %            | 10 %            | 1 %                      | 1 %                        |

(1) Sales revenue for 2007 include sales revenue from PET manufacturing facilities and related businesses in Cosoleacaque, Mexico and Zarate, Argentina divested in fourth quarter 2007.

(2) Included in 2008 sales revenue are contract polymer intermediates sales under the transition supply agreement related to the divestiture of the PET manufacturing facilities and related businesses in Mexico and Argentina in fourth quarter 2007.

(3) Included in 2008 and 2007 sales revenue are contract ethylene sales under the transition supply agreement related to the divestiture of the PE businesses.



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Sales revenue in second quarter and first six months 2008 compared to second quarter and first six months 2007 increased \$70 million and \$160 million, respectively. Excluding revenue from the contract ethylene and polymer intermediates sales and the sales from Mexico and Argentina PET manufacturing facilities, sales revenues increased \$126 million and \$263 million for second quarter and first six months 2008 compared to second quarter and first six months 2007, respectively. The increase was primarily due to higher selling prices in all segments in response to higher raw material and energy costs partially offset by lower sales volume. Lower sales volume for the PCI and Performance Polymers segments was partially offset by higher sales volume in the Specialty Plastics ("SP") segment.

| (Dollars in millions)   | Second Quarter |        |        | First Six Months |        |        |
|---|----------------|--------|--------|------------------|--------|--------|
|   | 2008           | 2007   | Change | 2008             | 2007   | Change |
| Gross Profit  | \$ 321         | \$ 309 | 4 %    | \$ 658           | \$ 595 | 11 %   |
| As a percentage of sales                                      | 18 %           | 18 %   |        | 18 %             | 17 %   |        |
| Accelerated depreciation costs included in cost of goods sold | 3              | 14     |        | 5                | 28     |        |
| Gross Profit excluding accelerated depreciation costs         | 324            | 323    | -- %   | 663              | 623    | 6 %    |
| As a percentage of sales                                      | 18 %           | 18 %   |        | 19 %             | 18 %   |        |

Gross profit for second quarter 2008 increased compared to second quarter 2007 as higher selling prices were partially offset by higher raw material and energy costs. Second quarter 2008 and 2007 included accelerated depreciation costs of \$3 million and \$14 million, respectively, resulting from the previously reported shutdown of the cracking units in Longview, Texas and of higher cost PET polymer assets in Columbia, South Carolina. The Company's second quarter 2008 raw material and energy costs increased by approximately \$200 million compared with second quarter 2007.

Gross profit and gross profit as a percentage of sales for the first six months 2008 increased compared to the first six months 2007 primarily in the Performance Polymers and Fibers segments. In addition, the first six months 2008 and 2007 included accelerated depreciation costs of \$5 million and \$28 million, respectively, resulting from the previously reported shutdown of the cracking units in Longview, Texas and of higher cost PET polymer assets in Columbia, South Carolina. The Company's first six months 2008 raw material and energy costs increased by approximately \$350 million compared with first six months 2007.

| (Dollars in millions)                        | Second Quarter |        |        | First Six Months |        |        |
|--|----------------|--------|--------|------------------|--------|--------|
|  | 2008           | 2007   | Change | 2008             | 2007   | Change |
| Selling, General and Administrative Expenses | \$ 107         | \$ 109 | (2) %  | \$ 217           | \$ 207 | 5 %    |
| Research and Development Expenses            | 39             | 38     | 3 %    | 81               | 72     | 13 %   |
|  | \$ 146         | \$ 147 | (1) %  | \$ 298           | \$ 279 | 7 %    |

|                          |     |     |     |     |
|--------------------------|-----|-----|-----|-----|
| As a percentage of sales | 8 % | 8 % | 8 % | 8 % |
|--------------------------|-----|-----|-----|-----|

Selling, general and administrative ("SG&A") expenses for second quarter 2008 decreased compared to second quarter 2007 primarily due to lower compensation expenses in second quarter 2008. SG&A costs for first six months 2008 increased compared to first six months 2007 primarily due to higher compensation expense and higher expenses related to corporate initiatives.

Research and development ("R&D") expenses increased \$1 million and \$9 million in second quarter 2008 compared to second quarter 2007 and first six months 2008 compared to first six months 2007, respectively. This increase is primarily due to higher expenses related to corporate initiatives.



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### Asset Impairments and Restructuring Charges, Net

Asset impairments and restructuring charges, net, totaled \$3 million and \$20 million for second quarter and first six months 2008, respectively, compared to \$2 million for second quarter and first six months 2007. For more information regarding asset impairments and restructuring charges, net see the CASPI, PCI, Performance Polymers, and SP segment discussions and Note 8, "Asset Impairments and Restructuring Charges, Net" to the Company's unaudited consolidated financial statements.

### Operating Earnings

| (Dollars in millions)  | Second Quarter |        |        | First Six Months |        |        |
|--|----------------|--------|--------|------------------|--------|--------|
|  | 2008           | 2007   | Change | 2008             | 2007   | Change |
| Operating earnings   | \$ 172         | \$ 160 | 8 %    | \$ 340           | \$ 314 | 8 %    |
| Accelerated depreciation costs included in cost of goods sold  | 3              | 14     |        | 5                | 28     |        |
| Asset impairments and restructuring charges, net   | 3              | 2      |        | 20               | 2      |        |
| Operating earnings excluding accelerated depreciation costs and asset impairments and restructuring charges, net | \$ 178         | \$ 176 | 1 %    | \$ 365           | \$ 344 | 6 %    |

### Interest Expense, Net

| (Dollars in millions)      | Second Quarter |       |        | First Six Months |       |        |
|----------------------------|----------------|-------|--------|------------------|-------|--------|
|                            | 2008           | 2007  | Change | 2008             | 2007  | Change |
| Gross interest costs       | \$ 28          | \$ 28 |        | \$ 54            | \$ 56 |        |
| Less: Capitalized interest | 3              | 4     |        | 4                | 5     |        |
| Interest expense           | 25             | 24    | 4 %    | 50               | 51    | (2) %  |
| Interest income            | 7              | 10    |        | 16               | 20    |        |
| Interest expense, net      | \$ 18          | \$ 14 | 29 %   | \$ 34            | \$ 31 | 10 %   |

Interest income for second quarter and first six months 2008 was lower compared to second quarter and first six months 2007 due to lower average interest rates and lower average cash balances. Gross interest costs for first six months 2008 were lower compared to first six months 2007 due to lower average interest rates.

For 2008, the Company expects net interest expense to increase compared with 2007 primarily due to lower interest income, driven by lower average interest rates and lower average invested cash balances.

### Other (Income) Charges, Net

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| (Dollars in millions)       | Second Quarter |        | First Six Months |         |
|-----------------------------|----------------|--------|------------------|---------|
|                             | 2008           | 2007   | 2008             | 2007    |
| Other (income)              | \$ (2)         | \$ (6) | \$ (11)          | \$ (13) |
| Other charges               | 3              | 1      | 11               | 5       |
| Other (income) charges, net | \$ 1           | \$ (5) | \$ --            | \$ (8)  |

Included in other income are gains from the sale of non-operating assets, net gains on foreign exchange transactions, other non-operating income related to Holston Defense Corporation, and the Company's portion of net earnings from its equity investments. Included in other charges are net losses on foreign exchange transactions, the Company's portion of losses from its equity investments, and fees on securitized receivables.

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## Provision for Income Taxes

| (Dollars in millions)      | Second Quarter |       | First Six Months |       |
|----------------------------|----------------|-------|------------------|-------|
|                            | 2008           | 2007  | 2008             | 2007  |
| Provision for income taxes | \$ 38          | \$ 49 | \$ 76            | \$ 96 |
| Effective tax rate         | 25 %           | 33 %  | 25 %             | 33 %  |

The second quarter 2008 effective tax rate reflects an estimated benefit from a federal gasification investment tax credit, discussed below, associated with the Company's expected capital spending in 2008 on the Beaumont, Texas industrial gasification project. Excluding discrete items, the second quarter 2008 and 2007 effective tax rates reflect the Company's expected full year tax rate on reported operating earnings from continuing operations before income tax, of approximately 30 percent and 33 percent, respectively.

The 2008 first six months effective tax rate reflects the estimate for the federal gasification investment tax credit, an \$8 million benefit from the reversal of a U. S. capital loss valuation allowance associated with the sale of businesses, and a \$6 million benefit from the settlement of a non-U.S. income tax audit. Excluding discrete items, the first six months 2008 and 2007 effective tax rates reflects the Company's expected full year rate on reported operating earnings before income tax of approximately 30 percent and 33 percent, respectively.

In 2006, the Company was awarded a federal investment tax credit of \$130 million related to a project which was to be located at the Company's Longview, Texas facility. Subsequently, the Company decided to relocate the project to Beaumont, Texas. Federal legislation enacted during the second quarter of 2008 directed the transfer of federal investment tax credits between sites for projects meeting specific criteria. Based on the passage of the federal legislation and the Company's determination that it is probable that the Beaumont, Texas project meets the criteria outlined in the legislation, the Company included the estimated benefit of the federal investment tax credit in the effective tax rate for the second quarter and the first six months 2008. The use of the credit is dependent on the level of annual qualified capital spending on the gasification project. The Company expects to continue to benefit from this credit through 2010, as qualifying capital expenditures are incurred.

## Earnings from Continuing Operations

| (Dollars in millions)  | Second Quarter |        | First Six Months |        |
|--|----------------|--------|------------------|--------|
|  | 2008           | 2007   | 2008             | 2007   |
| Earnings from continuing operations  | \$ 115         | \$ 102 | \$ 230           | \$ 195 |
| Accelerated depreciation costs included in cost of goods sold, net of tax  | 2              | 8      | 3                | 18     |
| Asset impairments and restructuring charges, net of tax  | 2              | 1      | 14               | 1      |
| Net deferred tax benefits related to the previous divestiture of businesses  | --             | --     | (11)             | --     |
| Earnings from continuing operations excluding accelerated depreciation costs and asset impairments and restructuring charges, net of tax | \$ 119         | \$ 111 | \$ 236           | \$ 214 |



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## Net Earnings

| (Dollars in millions)                                    | Second Quarter |        | First Six Months |        |
|--|----------------|--------|------------------|--------|
|  | 2008           | 2007   | 2008             | 2007   |
| Earnings from continuing operations                      | \$ 115         | \$ 102 | \$ 230           | \$ 195 |
| Earnings (loss) from discontinued operations, net of tax | --             | 1      | --               | (2)    |
| Gain (loss) from disposal of discontinued operations     | --             | 2      | 18               | (11)   |
| Net earnings   | \$ 115         | \$ 105 | \$ 248           | \$ 182 |

The gain on disposal of discontinued operations, net of tax of \$18 million for first six months 2008 is from the sale of the Company's PET polymers and PTA production facilities in the Netherlands and its PET production facility in the United Kingdom and related businesses for approximately \$340 million in first quarter 2008. The gain on disposal of discontinued operations, net of tax of \$2 million in second quarter 2008 and the loss on disposal of discontinued operations, net of tax of \$11 million for the first six months 2007 are from the sale of the Company's PET polymers manufacturing facility in Spain for approximately \$42 million in second quarter 2007. For additional information, see Note 2, "Discontinued Operations", to the Company's unaudited consolidated financial statements.

## SUMMARY BY OPERATING SEGMENT

The Company's products and operations are managed and reported in five reportable operating segments, consisting of the CASPI segment, the Fibers segment, the PCI segment, the Performance Polymers segment, and the SP segment. For additional information concerning the Company's operating businesses and products, see Note 23, "Segment Information", to the consolidated financial statements in Part II, Item 8 of the Company's 2007 Annual Report on Form 10-K.

R&D and other expenses not identifiable to an operating segment are not included in segment operating results for either of the periods presented and are shown in Note 16, "Segment Information", as "other" operating losses in this Form 10-Q.

## CASPI Segment

| (Dollars in millions) | Second Quarter |        |        |       | First Six Months |        |        |      |
|-----------------------|----------------|--------|--------|-------|------------------|--------|--------|------|
|                       | 2008           | 2007   | Change |       | 2008             | 2007   | Change |      |
|                       |                |        | \$     | %     |                  |        | \$     | %    |
| Sales                 | \$ 414         | \$ 376 | \$ 38  | 10 %  | \$ 803           | \$ 721 | \$ 82  | 11 % |
| Volume effect         |                |        | (9)    | (2) % |                  |        | (3)    | -- % |
| Price effect          |                |        | 33     | 9 %   |                  |        | 57     | 8 %  |
| Product mix effect    |                |        | 6      | 1 %   |                  |        | 11     | 1 %  |
|                       |                |        | 8      | 2 %   |                  |        | 17     | 2 %  |

| Exchange rate effect   |     |    |      |           |     |     |      |           |
|--|-----|----|------|-----------|-----|-----|------|-----------|
| Operating earnings   | 53  | 66 | (13) | (20)<br>% | 112 | 131 | (19) | (14)<br>% |
| Asset impairments and restructuring gains                              |     |    |      |           |     |     |      |           |
|  | (2) | -- | (2)  |           | (2) | --  | (2)  |           |
| Operating earnings excluding asset impairments and restructuring gains |     |    |      |           |     |     |      |           |
|  | 51  | 66 | (15) | (23)<br>% | 110 | 131 | (21) | (16)<br>% |

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Sales revenue increased \$38 million in second quarter 2008 compared to second quarter 2007 and \$82 million in the first six months 2008 compared to the first six months 2007 due to higher selling prices in response to higher raw material and energy costs, particularly for propylene, propane, and adhesives raw materials. Sales volume declined slightly due primarily to the divestiture of certain adhesives product lines and to lower sales volume in North America which was mostly offset by higher sales volume in Asia Pacific.

Excluding asset impairments and restructuring gains, operating earnings decreased \$15 million for second quarter 2008 compared to second quarter 2007 and \$21 million for the first six months 2008 compared to the first six months 2007 as higher raw material and energy costs were partially offset by higher selling prices. The segment especially had difficulty offsetting higher raw material and energy costs for its specialty products. Asset impairments and restructuring charges, net reflects an adjustment to a reserve for the first quarter 2008 divestiture of certain product lines.

Fibers Segment

| (Dollars in millions) | 2008   | Second Quarter |       | 2008 | First Six Months |        | 2008  | 2007 | Change |   |
|-----------------------|--------|----------------|-------|------|------------------|--------|-------|------|--------|---|
|                       |        | 2007           | \$    |      | %                | 2007   |       |      | \$     | % |
| Sales                 | \$ 260 | \$ 239         | \$ 21 | 9 %  | \$ 514           | \$ 473 | \$ 41 | 9 %  |        |   |
| Volume effect         |        |                | --    | -- % |                  |        | 12    | 3 %  |        |   |
| Price effect          |        |                | 15    | 7 %  |                  |        | 27    | 6 %  |        |   |
| Product mix effect    |        |                | 5     | 2 %  |                  |        | 1     | -- % |        |   |
| Exchange rate effect  |        |                | 1     | -- % |                  |        | 1     | -- % |        |   |
| Operating earnings    | 62     | 51             | 11    | 22 % | 130              | 110    | 20    | 18 % |        |   |

Sales revenue increased \$21 million in second quarter 2008 compared to second quarter 2007 and \$41 million in the first six months 2008 compared to the first six months 2007 due to higher selling prices. The higher selling prices were in response to higher raw material and energy costs, particularly for wood pulp and methanol. An increase in acetate tow sales volume was offset by a decrease in acetyl chemical sales volume.

Operating earnings increased \$11 million for second quarter 2008 compared to second quarter 2007 and \$20 million for the first six months 2008 compared to the first six months 2007 primarily due to customer buying patterns and higher selling prices in the Asia Pacific region for acetate tow products.





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## PCI Segment

| (Dollars in millions)  | Second Quarter |        |        |       | First Six Months |          |        |       |
|--|----------------|--------|--------|-------|------------------|----------|--------|-------|
|  | 2008           | 2007   | Change |       | 2008             | 2007     | Change |       |
|  |                |        | \$     | %     |                  |          | \$     | %     |
| Sales  | \$ 618         | \$ 552 | \$ 66  | 12 %  | \$ 1,174         | \$ 1,050 | \$ 124 | 12 %  |
| Volume effect  |                |        |        | (8)   |                  |          |        | (8)   |
|  |                |        | (43)   | %     |                  |          | (87)   | %     |
| Price effect   |                |        | 99     | 18 %  |                  |          | 187    | 18 %  |
| Product mix effect   |                |        | 6      | 1 %   |                  |          | 16     | 1 %   |
| Exchange rate effect   |                |        | 4      | 1 %   |                  |          | 8      | 1 %   |
| Sales – contract ethylene sales  | 102            | 74     | 28     |       | 194              | 144      | 50     |       |
| Sales – continuing product lines   | 516            | 478    | 38     | 8 %   | 980              | 906      | 74     | 8 %   |
| Volume effect  |                |        |        | (8)   |                  |          |        | (8)   |
|  |                |        | (38)   | %     |                  |          | (71)   | %     |
| Price effect   |                |        | 68     | 14 %  |                  |          | 126    | 14 %  |
| Product mix effect   |                |        | 4      | 1 %   |                  |          | 11     | 1 %   |
| Exchange rate effect   |                |        | 4      | 1 %   |                  |          | 8      | 1 %   |
| Operating earnings   | 54             | 57     | (3)    | (5) % | 98               | 111      | (13)   | 12 %  |
| Accelerated depreciation costs included in cost of goods sold  | 1              | 7      | (6)    |       | 2                | 14       | (12)   |       |
| Asset impairments and restructuring charges, net   | 3              | --     | 3      |       | 19               | --       | 19     |       |
| Operating earnings excluding accelerated depreciation costs and asset impairments and restructuring charges, net | 58             | 64     | (6)    | (9) % | 119              | 125      | (6)    | (5) % |

Sales revenue increased \$66 million in second quarter 2008 compared to second quarter 2007 and \$124 million in the first six months 2008 compared to the first six months 2007. Excluding contract ethylene sales under the transition agreement resulting from the divestiture of the Performance Polymers segment's PE business in the fourth quarter 2006, sales revenue increased due to higher selling prices in response to higher raw material and energy costs more than offsetting lower sales volume. The lower sales volume was primarily due to lower production volumes for bulk olefins product lines resulting from the previously reported shutdown of a cracking unit in fourth quarter 2007 which

was partially offset by higher sales volumes for acetyl product lines. Contract ethylene sales revenues increased due to higher selling prices more than offsetting lower sales volumes resulting from the shutdown of one of the cracking units.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
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Excluding accelerated depreciation costs and asset impairments and restructuring charges, net, operating earnings decreased \$6 million in second quarter 2008 compared to second quarter 2007 and in the first six months 2008 compared to the first six months 2007 due to higher raw material and energy costs, particularly for propylene, propane, and natural gas, more than offsetting higher selling prices. Contract ethylene sales had minimal impact. The accelerated depreciation costs are related to the continuation of the previously reported planned staged phase-out of older cracking units at the Company's Longview, Texas facility.

The Company is currently experiencing a production outage at the manufacturing facility in Singapore due to a supplier's inability to deliver a key raw material. The Company expects that this will have a modest impact on the segment's results in third quarter 2008.

#### Performance Polymers Segment

As a result of the Company's strategic actions in the Performance Polymers segment, the discussion below is of results from continuing operations in all periods presented. For additional information, see Note 2, "Discontinued Operations", to the Company's unaudited consolidated financial statements.

| (Dollars in millions)  | Second Quarter |        |         |       | First Six Months |        |          |       |
|--|----------------|--------|---------|-------|------------------|--------|----------|-------|
|  | 2008           | 2007   | Change  |       | 2008             | 2007   | Change   |       |
|  |                |        | \$      | %     |                  |        | \$       | %     |
| Sales  | \$ 289         | \$ 382 | \$ (93) | (24)% | \$ 593           | \$ 730 | \$ (137) | (19)% |
| Volume effect  |                |        | (121)   | (32)% |                  |        | (201)    | (28)% |
| Price effect   |                |        | 31      | 9%    |                  |        | 64       | 9%    |
| Product mix effect   |                |        | (4)     | (1)%  |                  |        | --       | --%   |
| Exchange rate effect   |                |        | --      | --%   |                  |        | --       | --%   |
| Sales from Mexico and Argentina PET manufacturing facilities (1) | --             | 110    | (110)   |       | --               | 235    | (235)    |       |
| Sales – contract polymer intermediates sales (2)                 | 26             | --     | 26      |       | 82               | --     | 82       |       |
| Sales – U.S. PET manufacturing facilities                        | 263            | 272    | (9)     | (4)%  | 511              | 495    | 16       | 3%    |
| Volume effect  |                |        | (37)    | (14)% |                  |        | (48)     | (10)% |
| Price effect   |                |        | 32      | 12%   |                  |        | 64       | 13%   |
| Product mix effect   |                |        | (4)     | (2)%  |                  |        | --       | --%   |
| Exchange rate effect   |                |        | --      | --%   |                  |        | --       | --%   |

(1)

Sales revenue and operating results for 2007 includes sales revenue from PET manufacturing facilities and related businesses in Cosoleacaque, Mexico and Zarate, Argentina divested in fourth quarter 2007.

Sales revenue for 2008 includes contract polymer intermediates sales under the transition supply agreement (2) related to the divestiture of the PET manufacturing facilities and related businesses in Mexico and Argentina in fourth quarter 2007.

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| (Dollars in millions)   | Second Quarter |         |        |       | First Six Months |         |        |       |
|---|----------------|---------|--------|-------|------------------|---------|--------|-------|
|   | 2008           | 2007    | Change |       | 2008             | 2007    | Change |       |
|   |                |         | \$     | %     |                  |         | \$     | %     |
| Operating earnings (loss) (1)   | \$ 2           | \$ (21) | \$ 23  | >100% | \$ (4)           | \$ (53) | \$ 49  | 92%   |
| Operating loss – from sales from Mexico and Argentina PET manufacturing facilities (2)(3)                 | --             | (4)     | 4      | 100%  | --               | (4)     | 4      | 100%  |
| Operating earnings (loss) – U.S. PET manufacturing facilities (1)(3)                                      | 2              | (17)    | 19     | >100% | (4)              | (49)    | 45     | 92%   |
| Operating earnings (loss) excluding items (1)(4)  | 6              | (14)    | 20     | >100% | 2                | (39)    | 41     | >100% |
| Operating loss excluding items – from sales from Mexico and Argentina PET manufacturing facilities (2)(3) | --             | (4)     | 4      | 100%  | --               | (4)     | 4      | 100%  |
| Operating earnings (loss) excluding items – U.S. PET manufacturing facilities (1)(3)(4)                   | 6              | (10)    | 16     | >100% | 2                | (35)    | 37     | >100% |

- (1) Includes allocated costs not included in discontinued operations, some of which may remain and could be reallocated to the remainder of the segment and other segments.
- (2) Operating results for 2007 includes sales revenue from PET manufacturing facilities and related businesses in Cosoleacaque, Mexico and Zarate, Argentina divested in fourth quarter 2007.
- (3) Includes allocated costs consistent with the Company's historical practices, some of which may remain and could be reallocated to the remainder of the segment and other segments.
- (4) Items are accelerated depreciation costs and asset impairments and restructuring charges, net. Accelerated depreciation costs of \$2 million and \$6 million in second quarter of 2008 and 2007, respectively, and \$3 million and \$13 million for the first six months 2008 and 2007, respectively, resulted from restructuring actions associated with higher cost PET polymer assets in Columbia, South Carolina. In second quarter and first six months, 2008, asset impairments and restructuring charges, net of \$2 million and \$3 million, respectively, related to restructuring at the South Carolina facility using IntegRex™ technology. Asset impairments and restructuring charges, net of \$1 million for both second quarter and the first six months, 2007 related to the divested PET manufacturing facilities in Mexico and Argentina.

Sales revenue decreased \$93 million in second quarter 2008 compared to second quarter 2007 and \$137 million in the first six months 2008 compared to the first six months 2007 due to the divestiture of PET manufacturing facilities and related businesses in Cosoleacaque, Mexico and Zarate, Argentina.



MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
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For U.S. PET manufacturing facilities excluding contract polymer intermediates sales to the buyer of the divested Mexico and Argentina facilities and sales from the divested PET facilities in Mexico and Argentina, sales revenue decreased \$9 million in second quarter 2008 compared to second quarter 2007 due to lower sales volume more than offsetting higher selling prices. Sales revenue increased \$16 million in first six months 2008 compared to first six months 2007 due to higher selling prices more than offsetting lower sales volume. Higher selling prices were in response to higher raw material and energy costs, particularly paraxylene and ethylene glycol, in 2008 and transition issues in the first half of 2007 from the Company's ParaStar™ PET facility based on IntegRex™ technology. Decreased sales volume was related to rationalization of higher cost PET and intermediate assets associated with the continued transformation of the PET business.

Excluding accelerated depreciation costs and asset impairments and restructuring charges, net operating results increased \$20 million for second quarter 2008 compared to second quarter 2007 and \$41 million for the first six months 2008 compared to the first six months 2007 due primarily to improved operation of the South Carolina PET facility based on IntegRex™ technology. The results in 2007 were impacted by costs associated with the new PET facility based on IntegRex™ technology becoming fully operational and the timing of the commercial launch of ParaStar™ PET.

Production began in November 2006 at the Company's new PET manufacturing facility utilizing IntegRex™ technology in Columbia, South Carolina. Manufacturing ParaStar™ PET resins, the 350,000 metric tons facility was fully operational in first quarter of 2007. A previously disclosed reduction of \$30 million in annual costs at this facility was completed in second quarter 2008. The Company plans to debottleneck this facility beginning in the second half of 2008 to increase capacity to over 525,000 metric tons of ParaStar™ PET resins.

## SP Segment

| (Dollars in millions)                   | 2008   | Second Quarter |       | First Six Months |        | 2008   | 2007  | Change |    |
|---|--------|----------------|-------|------------------|--------|--------|-------|--------|----|
|   |        | 2007           | \$    | %                | 2008   |        |       | 2007   | \$ |
| Sales                                   | \$ 253 | \$ 215         | \$ 38 | 17 %             | \$ 477 | \$ 427 | \$ 50 | 12 %   |    |
| Volume effect                           |        |                | 18    | 8 %              |        |        | 19    | 4 %    |    |
| Price effect                            |        |                | 7     | 3 %              |        |        | 11    | 2 %    |    |
| Product mix effect                      |        |                | 7     | 3 %              |        |        | 9     | 2 %    |    |
| Exchange rate effect                    |        |                | 6     | 3 %              |        |        | 11    | 4 %    |    |
| Operating earnings                      | 13     | 18             | (5)   | (28) %           | 30     | 36     | (6)   | (17) % |    |
| Accelerated depreciation costs included | --     | 1              | (1)   |                  | --     | 1      | (1)   |        |    |

in cost of  
goods sold

Asset  
impairments  
and  
restructuring  
charges, net

|    |   |     |    |   |     |
|----|---|-----|----|---|-----|
| -- | 1 | (1) | -- | 1 | (1) |
|----|---|-----|----|---|-----|

Operating  
earnings  
excluding  
accelerated  
depreciation  
costs and  
asset  
impairments  
and  
restructuring  
charges, net

|    |    |     |        |    |    |     |        |
|----|----|-----|--------|----|----|-----|--------|
| 13 | 20 | (7) | (35) % | 30 | 38 | (8) | (21) % |
|----|----|-----|--------|----|----|-----|--------|



MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
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Sales revenue increased \$38 million in second quarter 2008 compared to second quarter 2007 due to increased sales volume, particularly in Asia Pacific and North America, higher selling prices, favorable shift in product mix, and favorable foreign exchange rates. Sales volume increased primarily due to growth in copolyester and cellulose triacetate ("CTA") used in liquid crystal display ("LCD") screens. Selling prices increased in response to higher raw material and energy costs.

Sales revenue increased \$50 million in the first six months 2008 compared to the first six months 2007 due to increased sales volume and favorable foreign exchange rates.

Excluding accelerated depreciation costs and asset impairments and restructuring charges, net operating earnings decreased \$7 million for second quarter 2008 compared to second quarter 2007 and \$8 million in first six months 2008 compared to first six months 2007 due to higher raw material and energy costs, particularly for paraxylene and ethylene glycol, more than offsetting higher selling prices and favorable foreign exchange rates. Second quarter and first six months 2007 operating results included \$1 million in asset impairment and restructuring costs primarily for the Spain cyclohexane dimethanol ("CHDM") facility and \$1 million of accelerated depreciation costs for restructuring actions associated with higher cost PET polymer assets in Columbia, South Carolina.

The SP segment is progressing with the introduction of its new copolyester, Eastman Tritan™ copolyester, including a new 30,000 metric ton Tritan™ manufacturing facility expected to be online by early 2010.

#### SUMMARY BY CUSTOMER LOCATION

##### Sales Revenue

| (Dollars in millions)           | Second Quarter |          | Change | Volume Effect | Price Effect | Product Mix Effect | Exchange Rate Effect |
|---------------------------------|----------------|----------|--------|---------------|--------------|--------------------|----------------------|
|                                 | 2008           | 2007     |        |               |              |                    |                      |
| United States and Canada        | \$ 1,112       | \$ 1,065 | 4 %    | (10) %        | 14 %         | -- %               | -- %                 |
| Asia Pacific                    | 334            | 270      | 23 %   | 8 %           | 7 %          | 7 %                | 1 %                  |
| Europe, Middle East, and Africa | 271            | 245      | 11 %   | 3 %           | 4 %          | (2) %              | 6 %                  |
| Latin America                   | 117            | 184      | (36) % | (41) %        | 3 %          | 2 %                | -- %                 |
|                                 | \$ 1,834       | \$ 1,764 | 4 %    | (9) %         | 11 %         | 1 %                | 1 %                  |

Sales revenue in the United States and Canada increased for second quarter 2008 compared to second quarter 2007 primarily due to higher selling prices particularly in the PCI segment partially offset by lower sales volumes for contract ethylene sales in the PCI segment. Excluding contract ethylene sales, sales revenue increased 2 percent primarily due to higher selling prices in the Performance Polymers, PCI, and CASPI segments more than offsetting lower sales volume in all segments, except for the SP segment. Lower sales volume was attributed to generally weakened economic conditions.

Sales revenue in Asia Pacific increased for second quarter 2008 compared to second quarter 2007 primarily due to increased sales volume in the Fibers, SP, and CASPI segments, a favorable shift in product mix in all segments and higher selling prices in all segments. The Company is currently experiencing a production outage at its PCI manufacturing facility in Singapore due to a supplier's inability to deliver a key raw material. The Company expects that this will have a modest impact on the region's results in third quarter 2008.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
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Sales revenue in Europe, Middle East and Africa increased for second quarter 2008 compared to second quarter 2007, primarily due to a favorable foreign exchange rate in all segments and higher selling prices in all segments excluding the SP segment.

Sales revenue in Latin America decreased for second quarter 2008 compared to second quarter 2007 primarily due to lower sales volume resulting from the divestiture of the PET manufacturing facilities and related businesses in Cosoleacaque, Mexico and Zarate, Argentina in fourth quarter 2007. Excluding divested product lines and contract polymer intermediates sales to the divested facilities, sales revenue increased 23 percent due to increased sales volumes in all segments.

| (Dollars in millions)           | First Six Months |          |        | Volume Effect | Price Effect | Product Mix Effect | Exchange Rate Effect |
|---------------------------------|------------------|----------|--------|---------------|--------------|--------------------|----------------------|
|                                 | 2008             | 2007     | Change |               |              |                    |                      |
| United States and Canada        | \$ 2,163         | \$ 2,032 | 6 %    | (8) %         | 14 %         | -- %               | -- %                 |
| Asia Pacific                    | 612              | 523      | 17 %   | 5 %           | 6 %          | 5 %                | 1 %                  |
| Europe, Middle East, and Africa | 526              | 463      | 14 %   | 4 %           | 3 %          | 1 %                | 6 %                  |
| Latin America                   | 260              | 383      | (32) % | (37) %        | 3 %          | 2 %                | -- %                 |
|                                 | \$ 3,561         | \$ 3,401 | 5 %    | (8) %         | 11 %         | 1 %                | 1 %                  |

Sales revenue in the United States and Canada increased for the first six months 2008 compared to the first six months 2007 primarily due to higher selling prices particularly in the PCI segment partially offset by lower sales volumes for contract ethylene sales in the PCI segment. Excluding contract ethylene sales, sales revenue increased 4 percent primarily due to higher selling prices in the Performance Polymers, PCI, and CASPI segments.

Sales revenue in Asia Pacific increased for the first six months 2008 compared to the first six months 2007 primarily due to higher selling prices, increased sales volume, and a favorable shift in product mix in all segments excluding PCI. Higher sales volume in the Fibers, SP, and CASPI segments were offset by lower sales volume in the Performance Polymers and PCI segments. The Company is currently experiencing a production outage at its manufacturing facility in Singapore due to a supplier's inability to deliver a key raw material. The Company expects that this will have a modest impact on the region's results in third quarter 2008.

Sales revenue in Europe, Middle East and Africa increased for the first six months 2008 compared to the first six months 2007, primarily due to a favorable foreign exchange rate and higher sales volume in all segments.

Sales revenue in Latin America decreased for the first six months 2008 compared to the first six months 2007 primarily due to lower sales volume resulting from the divestiture of the PET manufacturing facilities and related businesses in Cosoleacaque, Mexico and Zarate, Argentina in fourth quarter 2007. Excluding divested product lines and contract polymer intermediates sales to the divested facilities, sales revenue increased 20 percent primarily due to higher sales volume and selling prices.

With a substantial portion of sales to customers outside the United States, Eastman is subject to the risks associated with operating in international markets. To mitigate its exchange rate risks, the Company frequently seeks to negotiate payment terms in U.S. dollars. In addition, where it deems such actions advisable, the Company engages in foreign currency hedging transactions and requires letters of credit and prepayment for shipments where its assessment of individual customer and country risks indicates their use is appropriate. For additional information, see Note 10 to the consolidated financial statements in Part II, Item 8 and Part II, Item 7A of the Company's 2007 Annual Report on Form 10-K and Forward-Looking Statements and Risk Factors of this Quarterly Report on Form 10-Q.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
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LIQUIDITY, CAPITAL RESOURCES, AND OTHER FINANCIAL INFORMATION

Cash Flows

| (Dollars in millions)  | First Six Months |        |
|--|------------------|--------|
|  | 2008             | 2007   |
| Net cash provided by (used in)                               |                  |        |
| Operating activities   | \$ 79            | \$ 99  |
| Investing activities   | 6                | (146)  |
| Financing activities   | (412)            | 2      |
| Effect of exchange rate changes on cash and cash equivalents | 1                | (3)    |
| Net change in cash and cash equivalents                      | (326)            | (48)   |
| Cash and cash equivalents at beginning of period             | 888              | 939    |
| Cash and cash equivalents at end of period                   | \$ 562           | \$ 891 |

Cash provided by operating activities was \$79 million in the first six months 2008 compared to \$99 million provided by operating activities in the first six months 2007. The lower level of cash provided by operating activities in the first six months 2008 was primarily due to a greater increase in working capital largely resulting from an increase in inventory attributable to higher raw material costs. In the first six months 2007, the Company contributed \$100 million to its U.S. defined benefit pension plan and does not plan to make contributions to the pension plan in 2008.

Cash provided by investing activities was \$6 million in first six months 2008 compared to \$146 million used in the first six months 2007. Proceeds of \$329 million were received in first six months 2008 primarily from the sale of the Company's PET polymers and PTA manufacturing facilities in the Netherlands and the PET manufacturing facility in the United Kingdom. Capital spending of \$278 million increased consistent with the Company's higher expected capital spending in 2008.

Cash used in financing activities totaled \$412 million in first six months 2008 compared to \$2 million provided by financing activities in first six months 2007 and included cash paid for share repurchases totaling \$270 million, a repayment of borrowings of \$72 million, and a decrease in credit facility and other borrowings, including bank overdrafts, of \$40 million, partially offset by cash received from stock option exercises of \$39 million.

The payment of dividends is also reflected in financing activities in all periods.

Liquidity

At June 30, 2008, the Company had credit facilities with various U.S. and foreign banks totaling approximately \$800 million. These credit facilities consist of a \$700 million revolving credit facility (the "Credit Facility") and a 60 million euro credit facility ("Euro Facility"). These credit facilities will expire in 2012 and 2013. Borrowings under these credit facilities are subject to interest at varying spreads above quoted market rates. The Credit Facility requires a facility fee on the total commitment that is based on Eastman's credit rating. In addition, these credit facilities

contain a number of customary covenants and events of default, including the maintenance of certain financial ratios. The Company was in compliance with all such covenants for all periods presented. At June 30, 2008, the Company's credit facility borrowings totaled \$95 million at an effective interest rate of 4.82 percent. At December 31, 2007, the Company's credit facility borrowings were \$188 million at an effective interest rate of 4.79 percent.

The Company used part of the proceeds from the sale of its PET polymers and PTA production facilities in the Netherlands and its PET production facility in the United Kingdom and related businesses to reduce the balance outstanding on its Euro Facility by \$103 million in the second quarter 2008.

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The Credit Facility provides liquidity support for general corporate purposes.

For more information regarding interest rates, refer to Note 7, "Borrowings", to the Company's unaudited consolidated financial statements.

The Company repaid \$72 million of 3 1/4% notes that matured June 15, 2008.

The Company has effective shelf registration statements filed with the Securities and Exchange Commission ("SEC") to issue a combined \$1.1 billion of debt or equity securities.

The Company is repurchasing shares of the Company's outstanding stock at such times, in such amounts, and on such terms, as determined to be in the best interests of the Company. For additional information, see "Treasury Stock" below.

The Company contributed \$100 million to its U.S. defined benefit pension plan in the first quarter 2007 and expects no contributions to this plan during 2008.

Cash flows from operations and the sources of capital described above are expected to be available and sufficient to meet foreseeable cash flow requirements. However, the Company's cash flows from operations can be affected by numerous factors including risks associated with global operations, raw material availability and cost, demand for and pricing of Eastman's products, capacity utilization, and other factors described under "Forward-Looking Statements and Risk Factors" below. The Company believes maintaining a financial profile consistent with an investment grade company is important to its long term strategic and financial flexibility.

#### Capital Expenditures

Capital expenditures were \$278 million and \$198 million for the first six months for 2008 and 2007, respectively. The Company expects capital spending in 2008 will be above \$600 million, with the increase over 2007 primarily due to completing the acetate tow capacity expansion in Workington, England, debottlenecking the South Carolina PET manufacturing facility utilizing IntegRex™ technology, completing front-end engineering and design for the industrial gasification project, increasing capacity of CTA for LCD screens, and increasing manufacturing capacity for Eastman Tritan™ copolyester.

#### Other Commitments

At June 30, 2008, the Company's obligations related to notes and debentures totaled approximately \$1.3 billion to be paid over a period of up to 20 years. Other borrowings, related primarily to credit facility borrowings, totaled approximately \$100 million.

The Company had various purchase obligations at June 30, 2008 totaling approximately \$2.1 billion over a period of approximately 15 years for materials, supplies and energy incident to the ordinary conduct of business. For information regarding the Company's lease commitments, refer to Note 11, "Commitments", to the Company's unaudited consolidated financial statements.

In addition, the Company had other liabilities at June 30, 2008 totaling approximately \$1.0 billion primarily related to pension, retiree medical, and other post-employment obligations.





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The items described above are summarized in the following table:

| Period             | Payments Due for        |   |                     |                         |                     |                             |                 | Total |
|--------------------|-------------------------|---|---------------------|-------------------------|---------------------|-----------------------------|-----------------|-------|
|                    | Notes and<br>Debentures | Credit<br>Facility<br>Borrowings<br>and Other | Interest<br>Payable | Purchase<br>Obligations | Operating<br>Leases | Other<br>Liabilities<br>(a) |                 |       |
| 2008               | \$ --                   | \$ --   | \$ 48               | \$ 245                  | \$ 18               | \$ 40                       | \$ 351          |       |
| 2009               | --                      | 14  | 97                  | 499                     | 29                  | 85                          | 724             |       |
| 2010               | --                      | --  | 96                  | 469                     | 26                  | 70                          | 661             |       |
| 2011               | 2                       | --  | 96                  | 250                     | 23                  | 59                          | 430             |       |
| 2012               | 147                     | 95  | 84                  | 247                     | 13                  | 55                          | 641             |       |
| 2013 and<br>beyond | 1,182                   | --  | 948                 | 409                     | 17                  | 653                         | 3,209           |       |
| <b>Total</b>       | <b>\$ 1,331</b>         | <b>\$ 109</b>                                 | <b>\$ 1,369</b>     | <b>\$ 2,119</b>         | <b>\$ 126</b>       | <b>\$ 962</b>               | <b>\$ 6,016</b> |       |

(a) Amounts represent the current estimated cash payments to be made by the Company primarily for pension and other post-employment benefits and taxes payable in the periods indicated. The amount and timing of such payments is dependent upon interest rates, health care trends, actual returns on plan assets, retirement and attrition rates of employees, continuation or modification of the benefit plans, and other factors. Such factors can significantly impact the amount and timing of any future contributions by the Company.

#### Off-Balance Sheet and Other Financing Arrangements

If certain operating leases are terminated by the Company, it guarantees a portion of the residual value loss, if any, incurred by the lessors in disposing of the related assets. For information on the Company's residual value guarantees, refer to Note 11, "Commitments", to the Company's unaudited consolidated financial statements.

Eastman entered into an agreement in 1999 that allows it to generate cash by reducing its working capital through the sale of undivided interests in certain domestic trade accounts receivable under a planned continuous sale program to a third party. For information on the Company's accounts receivable securitization program, refer to Note 11, "Commitments", to the Company's unaudited consolidated financial statements.

The Company did not have any other material relationships with unconsolidated entities or financial partnerships, including special purpose entities, for the purpose of facilitating off-balance sheet arrangements with contractually narrow or limited purposes. Thus, Eastman is not materially exposed to any financing, liquidity, market, or credit risk related to the above or any other such relationships.

The Company has evaluated its material contractual relationships and has concluded that the entities involved in these relationships are not Variable Interest Entities ("VIEs") or, in the case of Primester, a joint venture that manufactures

cellulose acetate at the Company's Kingsport, Tennessee plant, the Company is not the primary beneficiary of the VIE. As such, in accordance with Financial Accounting Standards Board, ("FASB") Interpretation Number 46, "Consolidation of Variable Interest Entities", the Company is not required to consolidate these entities. In addition, the Company has evaluated long-term purchase obligations with an entity that may be a VIE at June 30, 2008. This potential VIE is a joint venture from which the Company has purchased raw materials and utilities for several years and purchases approximately \$60 million of raw materials and utilities on an annual basis. The Company has no equity interest in this entity and has confirmed that one party to this joint venture does consolidate the potential VIE. However, due to competitive and other reasons, the Company has not been able to obtain the necessary financial information to determine whether the entity is a VIE, and whether or not the Company is the primary beneficiary.

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Guarantees and claims also arise during the ordinary course of business from relationships with suppliers, customers, and non-consolidated affiliates when the Company undertakes an obligation to guarantee the performance of others if specified triggering events occur. Non-performance under a contract could trigger an obligation of the Company. These potential claims include actions based upon alleged exposures to products, intellectual property and environmental matters, and other indemnifications. The ultimate effect on future financial results is not subject to reasonable estimation because considerable uncertainty exists as to the final outcome of these claims. However, while the ultimate liabilities resulting from such claims may be significant to results of operations in the period recognized, management does not anticipate they will have a material adverse effect on the Company's consolidated financial position or liquidity.

#### Treasury Stock

In February 2007, the Company's Board of Directors authorized the repurchase of up to \$300 million of the Company's outstanding common stock. In September 2007, the Company completed the \$300 million authorization repurchasing a total of 4.6 million shares. In October 2007, the Board of Directors authorized an additional \$700 million for the repurchase of the Company's outstanding common shares at such times, in such amounts, and on such terms, as determined to be in the best interests of the Company. As of December 31, 2007, a total of 1.3 million shares had been repurchased under this authorization for a total amount of \$82 million. During the first six months 2008, the Company repurchased an additional 4.2 million shares of common stock for a cost of \$270 million. Additional share repurchases are anticipated in 2008.

#### Dividends

The Company declared cash dividends of \$0.44 per share in second quarter 2008 and 2007 and \$0.88 per share in the first six months 2008 and 2007.

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RECENTLY ISSUED ACCOUNTING STANDARDS

Effective first quarter 2008, the Company adopted Statement of Financial Accounting Standard ("SFAS") No. 157, "Fair Value Measurements", ("SFAS No. 157"), except as it applies to those nonfinancial assets and nonfinancial liabilities addressed in FASB Staff Position FAS 157-2 ("FSP FAS 157-2"). The FASB issued FSP FAS 157-2 which delays the effective date of SFAS No. 157 to fiscal years beginning after November 15, 2008 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The Company is currently evaluating the effect FSP FAS 157-2 will have on its consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007) "Business Combinations" ("SFAS No. 141R") which replaces SFAS No. 141 "Business Combinations" ("SFAS No. 141"). SFAS No. 141R retains the fundamental requirements of SFAS No. 141 that the acquisition method of accounting be used for all business combinations. However, SFAS No. 141R provides for the following changes from SFAS No. 141: an acquirer will record 100% of assets and liabilities of acquired business, including goodwill, at fair value, regardless of the level of interest acquired; certain contingent assets and liabilities will be recognized at fair value at the acquisition date; contingent consideration will be recognized at fair value on the acquisition date with changes in fair value to be recognized in earnings upon settlement; acquisition-related transaction and restructuring costs will be expensed as incurred; reversals of valuation allowances related to acquired deferred tax assets and changes to acquired income tax uncertainties will be recognized in earnings; and when making adjustments to finalize preliminary accounting, acquirers will revise any previously issued post-acquisition financial information in future financial statements to reflect any adjustments as if they occurred on the acquisition date. SFAS No. 141R applies prospectively to business combinations for which the acquisition date is on or after January 1, 2009. SFAS No. 141R will not have an impact on the Company's consolidated financial statements when effective, but the nature and magnitude of the specific effects will depend upon the nature, terms, and size of the acquisitions consummated after the effective date.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51" ("SFAS No. 160"), which establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS No. 160 provides that accounting and reporting for minority interests be recharacterized as noncontrolling interests and classified as a component of equity. This Statement also establishes reporting requirements that provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 applies to all entities that prepare consolidated financial statements but will affect only those entities that have an outstanding noncontrolling interest in one or more subsidiaries or that deconsolidate a subsidiary. This Statement is effective as of the beginning of an entity's first fiscal year beginning after December 15, 2008. The Company has concluded that SFAS No. 160 will not have a material impact on the Company's consolidated financial statements.

In March 2008, the FASB issued SFAS Statement No. 161 "Disclosures about Derivative Instruments and Hedging Activities" ("SFAS No. 161"). The new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The new standard also improves transparency about the location and amounts of derivative instruments in an entity's financial statements; how derivative instruments and related hedged items are accounted for under SFAS No. 133

"Accounting for Derivative Instruments and Hedging Activities"; and how derivative instruments and related hedged items affect its financial position, financial performance, and cash flows. The Company has concluded that SFAS No. 161 will not have a material impact on the Company's consolidated financial statements.

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OUTLOOK

For 2008, the Company expects:

- to maintain strong volumes due to continued substitution of Eastman products for other materials, and new applications for existing products despite uncertain prospects for the U.S. and global economies;
- the volatility of raw material and energy cost increases to continue and that the Company will continue to use pricing strategies and ongoing cost control initiatives in an attempt to offset the effects on gross profit;
- to improve the profitability of its PET product lines in the Performance Polymers segment, including completing the divestiture of its underperforming PET manufacturing facilities outside the United States (which was completed in first quarter 2008); debottlenecking the new South Carolina PET facility utilizing IntegRex™ technology beginning in the second half of 2008 for a total capacity of 525,000 metric tons of ParaStar™ PET; shutting down another 300,000 metric tons of conventional PET polymers capacity at the South Carolina manufacturing facility and dimethyl terephthalate assets (which was completed in first quarter 2008); eliminating approximately \$30 million of annual costs at the South Carolina site by the middle of 2008 (which was completed in second quarter 2008); and continuing to pursue options to create additional value from its IntegRex™ technology, primarily by actively pursuing licensing opportunities;
- to improve SP segment results by completing the conversion of 50,000 metric tons of PET capacity to copolyester by the middle of 2008 (which was completed in second quarter 2008) and continue progress with the introduction of its new copolyester, Eastman Tritan™ copolyester, including a new 30,000 metric ton Tritan™ manufacturing facility expected to be online by early 2010;
- that the staged phase-out of older cracking units in Longview, Texas and a planned shutdown of higher cost PET assets in Columbia, South Carolina will result in accelerated depreciation costs of approximately \$10 million;
- ethylene volumes to decline in the PCI segment due to the staged phase-out of older cracking units at the Company's Longview, Texas facility;
- to increase volumes in the Performance Polymers segment due to the transition agreement for polymer intermediates pertaining to the PET manufacturing facilities and related businesses in Cosoleacaque, Mexico and Zarate, Argentina divested in fourth quarter 2007;
- modest sales volume growth for acetate tow in the Fibers segment, to complete the expansion of its acetate tow plant in Workington, England, in the second half of 2008, and to announce plans for new acetate tow capacity in Asia;
  - the PCI segment to have operating margins at the high end of the 5 to 10 percent range;
- the CASPI segment to maintain solid earnings slightly below the typical range of 15 to 20 percent operating margin, with continued weakness in the U.S. housing and automotive sectors offset by strength in Europe and Asia;
- front-end engineering and design for the industrial gasification project to be completed in the second half of 2008, and project financing to be obtained by the end of the year;

- net interest expense to increase compared with 2007 primarily due to lower interest income, driven by lower average interest rates and lower average invested cash balances;
- the effective tax rate to be approximately 30 percent including the benefit of the federal gasification investment tax credit, based on expected capital spending;

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- capital spending will be above \$600 million as it funds targeted growth efforts, including the debottlenecking of the South Carolina manufacturing facility utilizing IntegRex™ technology, the completion of front-end engineering and design for the industrial gasification project, increased capacity of CTA for LCD screens, increased capacity for Eastman Tritan™ copolyester, and the completion of the acetate tow expansion in Workington, England; and
  - priorities for uses of available cash to be to pay the quarterly cash dividend, fund targeted growth initiatives, repay debt (which was completed in second quarter 2008), and repurchase shares.

For third quarter 2008, the Company expects:

- a softening U.S. economy and global economic uncertainty;
- continued significant rise in raw material and energy costs, particularly for propane, paraxylene, and natural gas; and
- due to its global geographic profile and diverse product portfolio, earnings per share from continuing operations to be similar to those for third quarter 2007, excluding gains and charges in both periods related to previous strategic actions and decisions.

In addition to the above, the Company expects to improve earnings significantly through strategic efforts in industrial gasification and growth initiatives in existing businesses over the next five years, and expects:

- the industrial gasification project in Texas to break ground in early 2009, to be online by 2011, and to contribute significantly to earnings in 2012;
- the SP segment further to improve earnings by completing the conversion of an additional 50,000 metric tons of PET to be converted by 2010, increasing sales revenue from cellulose esters used in LCD screens and continued progress with the introduction of its high performance copolyesters;
- to pursue licensing opportunities for the PCI segment's acetyl and oxo technologies and for the Performance Polymers segment's IntegRex™ technology;
  - to pursue growth opportunities in Asia for acetate tow in the Fibers segment; and
- to complete an additional 30 percent expansion of its CASPI segment's hydrogenated hydrocarbon resins manufacturing capacity in Middelburg, the Netherlands in early 2009.

See "Forward-Looking Statements and Risk Factors below."



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FORWARD-LOOKING STATEMENTS AND RISK FACTORS

The expectations under "Outlook" and certain other statements in this Quarterly Report on Form 10-Q may be forward-looking in nature as defined in the Private Securities Litigation Reform Act of 1995. These statements and other written and oral forward-looking statements made by the Company from time to time may relate to, among other things, such matters as planned and expected capacity increases and utilization; anticipated capital spending; expected depreciation and amortization; environmental matters; legal proceedings; exposure to, and effects of hedging of, raw material and energy costs, foreign currencies and interest rates; global and regional economic, political, and business conditions; competition; growth opportunities; supply and demand, volume, price, cost, margin, and sales; earnings, cash flow, dividends and other expected financial results and conditions; expectations, strategies, and plans for individual assets and products, businesses and segments as well as for the whole of Eastman Chemical Company; cash requirements and uses of available cash; financing plans; pension expenses and funding; credit ratings; anticipated restructuring, divestiture, and consolidation activities; cost reduction and control efforts and targets; integration of acquired businesses; strategic initiatives and development, production, commercialization, and acceptance of new products, services and technologies and related costs; asset, business and product portfolio changes; and expected tax rates and net interest costs.

These plans and expectations are based upon certain underlying assumptions, including those mentioned with the specific statements. Such assumptions are in turn based upon internal estimates and analyses of current market conditions and trends, management plans and strategies, economic conditions and other factors. These plans and expectations and the assumptions underlying them are necessarily subject to risks and uncertainties inherent in projecting future conditions and results. Actual results could differ materially from expectations expressed in the forward-looking statements if one or more of the underlying assumptions and expectations proves to be inaccurate or is unrealized. In addition to the factors described in this report, the following are some of the important factors that could cause the Company's actual results to differ materially from those in any such forward-looking statements:

- The Company is reliant on certain strategic raw materials and energy commodities for its operations and utilizes risk management tools, including hedging, as appropriate, to mitigate short-term market fluctuations in raw material and energy costs. There can be no assurance, however, that such measures will result in cost savings or that all market fluctuation exposure will be eliminated. In addition, natural disasters, changes in laws or regulations, war or other outbreak of hostilities or terrorism or other political factors in any of the countries or regions in which the Company operates or does business or in countries or regions that are key suppliers of strategic raw materials and energy commodities, or breakdown or degradation of transportation infrastructure used for delivery of strategic raw materials and energy commodities, could affect availability and costs of raw materials and energy commodities.
- While temporary shortages of raw materials and energy may occasionally occur, these items have historically been sufficiently available to cover current and projected requirements. However, their continuous availability and price are impacted by natural disasters, plant interruptions occurring during periods of high demand, domestic and world market and political conditions, changes in government regulation, war or other outbreak of hostilities or terrorism, and breakdown or degradation of transportation infrastructure. Eastman's operations or products may, at times, be adversely affected by these factors.
- The Company's competitive position in the markets in which it participates is, in part, subject to external factors in addition to those that the Company can impact. Natural disasters, pandemic illnesses, changes in laws or regulations, war or other outbreak of hostilities or terrorism, or other political factors in any of the countries or

regions in which the Company operates or does business or in countries or regions that are key suppliers of strategic raw materials, and breakdown or degradation of transportation infrastructure used for delivery of raw materials and energy supplies to the Company and for delivery of the Company's products to customers, could negatively impact the Company's competitive position and its ability to maintain market share. For example, supply and demand for certain of the Company's products is driven by end-use markets and worldwide capacities which, in turn, impact demand for and pricing of the Company's products.

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- Limitation of the Company's available manufacturing capacity due to significant disruption in its manufacturing operations, including natural disasters, pandemic illnesses, changes in laws or regulations, war or other outbreak of hostilities or terrorism, or other political factors in any of the countries or regions in which the Company operates or does business, or breakdown or degradation of transportation infrastructure used for delivery of raw materials and energy supplies to the Company and for delivery of the Company's products to customers, could have a material adverse affect on sales revenue, costs and results of operations and financial condition.
- The Company has an extensive customer base; however, loss of, or material financial weakness of, certain of the largest customers could adversely affect the Company's financial condition and results of operations until such business is replaced and no assurances can be made that the Company would be able to regain or replace any lost customers.
- The Company has efforts underway to exploit growth opportunities in certain core businesses by developing new products and technologies, expanding into new markets, and tailoring product offerings to customer needs. Current examples include IntegRex™ technology and new PET polymers products and copolyester product innovations. There can be no assurance that such efforts will result in financially successful commercialization of such products or acceptance by existing or new customers or new markets or that large capital projects for such growth efforts can be completed within the time or at the costs projected due, among other things, to demand for and availability of construction materials and labor.
- The Company has made, and intends to continue making, strategic investments, including industrial gasification, and has entered, and expects to continue to enter, into strategic alliances in technology, services businesses, and other ventures in order to build, diversify, and strengthen certain Eastman capabilities, improve Eastman's raw materials and energy cost and supply position, and maintain high utilization of manufacturing assets. There can be no assurance that such investments and alliances will achieve their underlying strategic business objectives or that they will be beneficial to the Company's results of operations or that large capital projects for such growth efforts can be completed within the time or at the costs projected due, among other things, to demand for and availability of construction materials and labor and obtaining regulatory approvals and operating permits and reaching agreement on terms of key agreements and arrangements with potential suppliers and customers. Such delays or cost overruns or inability to obtain such approvals or to reach such agreements on acceptable terms could negatively affect the returns from these strategic investments and projects.
- The Company anticipates obtaining non-recourse financing for its industrial gasification project. There is risk that such financing cannot be obtained or if, obtained, may be on terms different than those assumed in the Company's projections for financial performance of the project, due to any circumstance, change, or condition in the loan syndication, financial, or capital markets generally that could reasonably be expected to materially affect availability, terms, and syndication of such financing. The ability to enter into financially acceptable project commercial agreements for such elements as engineering, procurement, and construction, off-take agreements, commodity and/or interest hedges, utilities, administrative services, and others, as well as obtaining all necessary regulatory approvals and operating permits, may impact the available financing for the project or the terms of such financing, if available, including the nature and terms of any recourse back to the Company.
- In addition to productivity and cost reduction initiatives, the Company is striving to improve margins on its products through price increases where warranted and accepted by the market; however, the Company's earnings could be negatively impacted should such increases be unrealized, not be sufficient to cover increased raw material

and energy costs, or have a negative impact on demand and volume. There can be no assurances that price increases will be realized or will be realized within the Company's anticipated timeframe.

- The Company has undertaken and expects to continue to undertake productivity and cost reduction initiatives and organizational restructurings to improve performance and generate cost savings. There can be no assurance that these will be completed as planned or beneficial or that estimated cost savings from such activities will be realized.

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- The Company's facilities and businesses are subject to complex health, safety and environmental laws and regulations, which require and will continue to require significant expenditures to remain in compliance with such laws and regulations currently and in the future. The Company's accruals for such costs and associated liabilities are subject to changes in estimates on which the accruals are based. The amount accrued reflects the Company's assumptions about remediation requirements at the contaminated site, the nature of the remedy, the outcome of discussions with regulatory agencies and other potentially responsible parties at multi-party sites, and the number and financial viability of other potentially responsible parties. Changes in the estimates on which the accruals are based, unanticipated government enforcement action, or changes in health, safety, environmental, chemical control regulations, and testing requirements could result in higher or lower costs.
- The Company and its operations from time to time are parties to or targets of lawsuits, claims, investigations, and proceedings, including product liability, personal injury, asbestos, patent and intellectual property, commercial, contract, environmental, antitrust, health and safety, and employment matters, which are handled and defended in the ordinary course of business. The Company believes amounts reserved are adequate for such pending matters; however, results of operations could be affected by significant litigation adverse to the Company.
- The Company has deferred tax assets related to capital and operating losses. The Company establishes valuation allowances to reduce these deferred tax assets to an amount that is more likely than not to be realized. The Company's ability to utilize these deferred tax assets depends on projected future operating results, the reversal of existing temporary differences, and the availability of tax planning strategies. Realization of these assets is expected to occur over an extended period of time. As a result, changes in tax laws, assumptions with respect to future taxable income, and tax planning strategies could result in adjustments to these assets.
- Due to the Company's global sales, earnings, and asset profile, it is exposed to volatility in foreign currency exchange rates and interest rates. The Company may use derivative financial instruments, including swaps, options and forwards, to mitigate the impact of changes in exchange rates and interest rates on its financial results. However, there can be no assurance that these efforts will be successful and operating results could be affected by significant adverse changes in currency exchange rates or interest rates.

The foregoing list of important factors does not include all such factors nor necessarily present them in order of importance. This disclosure, including that under "[Outlook](#)" and "[Forward-Looking Statements and Risk Factors](#)," and other forward-looking statements and related disclosures made by the Company in this Quarterly Report on Form 10-Q and elsewhere from time to time, represents management's best judgment as of the date the information is given. The Company does not undertake responsibility for updating any of such information, whether as a result of new information, future events, or otherwise, except as required by law. Investors are advised, however, to consult any further public Company disclosures (such as in filings with the Securities and Exchange Commission or in Company press releases) on related subjects.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There are no material changes to the Company's market risks since February 29, 2008. For more information regarding the Company's disclosure about market risks, see Part II, Item 7A of the Company's 2007 Annual Report on Form 10-K.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

The Company maintains a set of disclosure controls and procedures designed to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities and Exchange Act of 1934 is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. An evaluation was carried out under the supervision and with the participation of the Company's management, including the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), of the effectiveness of the Company's disclosure controls and procedures. Based on that evaluation, the CEO and CFO have concluded that the Company's disclosure controls and procedures are effective as of June 30, 2008.

Changes in Internal Control Over Financial Reporting

There has been no change in the Company's internal control over financial reporting that occurred during the second quarter of 2008 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

General

From time to time, the Company and its operations are parties to, or targets of, lawsuits, claims, investigations and proceedings, including product liability, personal injury, asbestos, patent and intellectual property, commercial, contract, environmental, antitrust, health and safety, and employment matters, which are being handled and defended in the ordinary course of business. While the Company is unable to predict the outcome of these matters, it does not believe, based upon currently available facts, that the ultimate resolution of any such pending matters, including the asbestos litigation, will have a material adverse effect on its overall financial condition, results of operations or cash flows. However, adverse developments could negatively impact earnings or cash flows in a particular future period. For additional information about the asbestos litigation, refer to Note 17, "Legal Matters", to the Company's unaudited consolidated financial statements.

Middelburg (Netherlands) Environmental Proceeding

In June 2005, Eastman Chemical Middelburg, B.V., a wholly owned subsidiary of the Company (the "Subsidiary"), received a summons from the Middelburg (Netherlands) District Court Office to appear before the economic magistrate of that District and respond to allegations that the Subsidiary's manufacturing facility in Middelburg had exceeded certain conditions in the permit that allows the facility to discharge wastewater into the municipal wastewater treatment system. The summons proposed penalties in excess of \$100,000 as a result of the alleged violations. A hearing in this matter took place on July 28, 2005, at which time the magistrate bifurcated the proceeding into two phases: a compliance phase and an economic benefit phase. With respect to the compliance phase, the magistrate levied a fine of less than \$100,000. With respect to the economic benefit phase, where the prosecutor proposed a penalty in excess of \$100,000, the district court in November 2006 assessed against the Subsidiary a penalty of less than \$100,000. The prosecutor has appealed this ruling, and the appeal is pending. This disclosure is made pursuant to SEC Regulation S-K, Item 103, Instruction 5.C., which requires disclosure of administrative proceedings commenced under environmental laws that involve governmental authorities as parties and potential monetary sanctions in excess of \$100,000. The Company believes that the ultimate resolution of this proceeding will not have a material impact on the Company's financial condition, results of operations, or cash flows.

Jefferson (Pennsylvania) Environmental Proceeding

In December 2005, Eastman Chemical Resins, Inc., a wholly-owned subsidiary of the Company (the "ECR Subsidiary"), received a Notice of Violation ("NOV") from the United States Environmental Protection Agency's Region III Office ("EPA") alleging that the ECR Subsidiary's West Elizabeth, Jefferson Borough, Allegheny County, Pennsylvania manufacturing operation violated certain federally enforceable local air quality regulations and certain provisions in a number of air quality-related permits. The NOV did not assess a civil penalty and EPA has to date not proposed any specific civil penalty amount. In October 2006, EPA referred the matter to the United States Department of Justice's Environmental Enforcement Section ("DOJ"). Company representatives met with EPA and DOJ in November 2006 and again in December 2007, and determined that it is not reasonably likely that any civil penalty assessed by the EPA and DOJ will be less than \$100,000. While the Company intends to vigorously defend against these allegations, this disclosure is made pursuant to SEC Regulation S-K, Item 103, Instruction 5.C., which

requires disclosure of administrative proceedings commenced under environmental laws that involve governmental authorities as parties and potential monetary sanctions in excess of \$100,000. The Company believes that the ultimate resolution of this proceeding will not have a material impact on the Company's financial condition, results of operations, or cash flows.



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## ITEM 1A. RISK FACTORS

For identification and discussion of the most significant risks applicable to the Company and its business, see "Part I – Item 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations – Forward-Looking Statements and Risk Factors" of this Quarterly Report on Form 10-Q.

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

## (c) Purchases of Equity Securities by the Issuer

| Period           | Total<br>Number<br>of Shares<br>Purchased<br>(1) | Average Price<br>Paid Per<br>Share<br>(2) | Total Number of<br>Shares Purchased<br>as Part of Publicly<br>Announced Plans<br>or Programs<br>(3) | Approximate<br>Dollar<br>Value (in millions)<br>that May Yet Be<br>Purchased Under<br>the Plans or<br>Programs<br>(3) |
|------------------|--|---|---|---|
| April 1-30, 2008 | 308,600  | \$ 62.52                                  | 308,600   | \$ 353  |
| May 1-31, 2008   | --   | \$ --                                     | --  | \$ 353  |
| June 1-30, 2008  | 77,850   | \$ 74.11                                  | 75,000  | \$ 348  |
| Total            | 386,450  | \$ 64.86                                  | 383,600   |   |

- (1) Shares repurchased under a Company announced repurchase plan and shares surrendered to the Company by employees to satisfy individual tax withholding obligations upon vesting of previously issued shares of restricted common stock.
- (2) Average price paid per share reflects the weighted average purchase price paid for share repurchases and the closing price of Eastman stock on the business date the shares were surrendered by the employee stockholder to satisfy individual tax withholding obligations upon vesting of restricted common stock.
- (3) In October 2007, the Board of Directors authorized the repurchase of up to \$700 million of the Company's outstanding common stock at such times, in such amounts, and on such terms, as determined to be in the best interests of the Company. As of June 30, 2008, a total of 5.5 million shares have been repurchased under this authorization for a total amount of \$352 million. For additional information, see Note 14, "Earnings and Dividends Per Share", to the Company's unaudited consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q. Repurchased shares may be used for compensation and benefit plans and other corporate purposes.

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

The 2008 Annual Meeting of the Stockholders of Eastman Chemical Company was held on May 1, 2008. There were 77,544,913 shares of common stock outstanding and entitled to be voted, and 67,159,933 shares represented in person or by proxy, at the Annual Meeting.

Four items of business were acted upon by stockholders at the Annual Meeting:

-

the election of three directors to serve in the class for which the term in office expires at the Annual Meeting of Stockholders in 2011 and their successors are duly elected and qualified;

- the ratification of the action by the Audit Committee of the Board of Directors appointing PricewaterhouseCoopers LLP as independent auditors for the Company for the year ended December 31, 2008;
- the adoption of a stockholder proposal requesting that management revise the Company's employment nondiscrimination policy to prohibit "discrimination based on sexual orientation and gender identity"; and
- the adoption of a stockholder proposal requesting that the Board of Directors take the steps necessary to elect each of the Company's directors annually;

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The results of the voting on the election of directors were as follows:

| Nominee            | Votes For  | Votes Against | Abstentions | Broker<br>Non-Votes |
|--------------------|------------|---------------|-------------|---------------------|
| Michael P. Connors | 65,719,974 | 808,476       | 631,483     | -0-                 |
| J. Brian Ferguson  | 64,159,222 | 2,386,547     | 614,164     | -0-                 |
| Howard L. Lance    | 65,756,033 | 771,870       | 632,030     | -0-                 |

Accordingly, each of the three nominees received a majority of votes cast in favor of that director's election and was elected.

The results of the voting on the ratification of the action by the Audit Committee of the Board of Directors appointing PricewaterhouseCoopers LLP as independent auditors for the Company for 2008 were as follows:

| Votes For  | Votes Against | Abstentions | Broker<br>Non-Votes |
|------------|---------------|-------------|---------------------|
| 64,094,846 | 2,378,986     | 686,101     | -0-                 |

Accordingly, a majority of votes was cast in favor of the proposal and the appointment of PricewaterhouseCoopers LLP as independent auditors was ratified.

The results of the voting on the stockholder proposal requesting that management revise the Company's employment nondiscrimination policy to prohibit "discrimination based on sexual orientation and gender identity" were as follows:

| Votes For | Votes Against | Abstentions | Broker<br>Non-Votes |
|-----------|---------------|-------------|---------------------|
| 5,549,790 | 49,468,108    | 6,364,229   | 5,777,806           |

Accordingly, a majority of votes was not cast in favor of this stockholder proposal and the proposal was not adopted.

The results of the voting on the stockholder proposal requesting that the Board of Directors take the steps necessary for each of the Company's directors to be elected annually to a one year term were as follows:

| Votes For  | Votes Against | Abstentions | Broker<br>Non-Votes |
|------------|---------------|-------------|---------------------|
| 35,517,572 | 25,086,039    | 778,888     | 5,777,434           |

Accordingly, a majority of votes was cast, but less than a majority of shares outstanding was voted, in favor of this stockholder proposal and the proposal was adopted. The adoption of the stockholder proposal did not change the Company's classified Board to a board with each director elected annually; that would require that the Board and stockholders holding a majority of outstanding shares approve an amendment to the Company's Certificate of Incorporation.

ITEM 6. EXHIBITS

Exhibits filed as part of this report are listed in the Exhibit Index appearing on page 51.

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SIGNATURES

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

Eastman Chemical Company

Date: July 30, 2008

By: /s/Richard A. Lorraine  
Richard A. Lorraine  
Senior Vice President and Chief Financial Officer

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| Exhibit<br>Number | EXHIBIT INDEX   |  | Sequential<br>Page<br>Number |
|-------------------|---|--|------------------------------|
|                   | Description   |  |                              |
| 3.01              | Amended and Restated Certificate of Incorporation of Eastman Chemical Company, as amended (incorporated herein by reference to Exhibit 3.01 to Eastman Chemical Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2001)                                    |  |                              |
| 3.02              | Amended and Restated Bylaws of Eastman Chemical Company, as amended November 9, 2007 (incorporated herein by referenced to Exhibit 3.02 to Eastman Chemical Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2007 (the September 30, 2007 10-Q))     |  |                              |
| 4.01              | Form of Eastman Chemical Company common stock certificate as amended February 1, 2001 (incorporated herein by reference to Exhibit 4.01 to Eastman Chemical Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2001)                                       |  |                              |
| 4.02              | Indenture, dated as of January 10, 1994, between Eastman Chemical Company and The Bank of New York, as Trustee (the "Indenture") (incorporated herein by reference to Exhibit 4(a) to Eastman Chemical Company's Current Report on Form 8-K dated January 10, 1994 (the "8-K")) |  |                              |
| 4.03              | Form of 7 1/4% Debentures due January 15, 2024 (incorporated herein by reference to Exhibit 4(d) to the 8-K)  |  |                              |
| 4.04              | Officers' Certificate pursuant to Sections 201 and 301 of the Indenture (incorporated herein by reference to Exhibit 4(a) to Eastman Chemical Company's Current Report on Form 8-K dated June 8, 1994 (the "June 8-K"))   |  |                              |
| 4.05              | Form of 7 5/8% Debentures due June 15, 2024 (incorporated herein by reference to Exhibit 4(b) to the June 8-K)  |  |                              |
| 4.06              | Form of 7.60% Debentures due February 1, 2027 (incorporated herein by reference to Exhibit 4.08 to Eastman Chemical Company's Annual Report on Form 10-K for the year ended December 31, 1996 (the "1996 10-K"))  |  |                              |
| 4.07              | Form of 7% Notes due April 15, 2012 (incorporated herein by reference to Exhibit 4.09 to Eastman Chemical Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002)   |  |                              |

- 4.08 Officer's Certificate pursuant to Sections 201 and 301 of the Indenture related to 7.60% Debentures due February 1, 2027 (incorporated herein by reference to Exhibit 4.09 to the 1996 10-K)
- 4.09 \$200,000,000 Accounts Receivable Securitization agreement dated April 13, 1999 (amended April 11, 2000, July 14, 2005, and July 9, 2008), between the Company and The Bank of Tokyo-Mitsubishi UFJ, Ltd., as agent. Pursuant to Item 601(b)(4)(iii) of Regulation S-K, in lieu of filing a copy of such agreement, the Company agrees to furnish a copy of such agreement to the Commission upon request
- 4.10 Letter Amendments dated November 16, 2007 and March 10, 2008 (incorporated herein by reference to Exhibit 4.10 to Eastman Chemical Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2008) to the Amended and Restated Credit Agreement, dated as of April 3, 2006 (the "Credit Agreement") among Eastman Chemical Company, the Lenders named therein, and Citigroup Global Markets, Inc. and J. P. Morgan Securities Inc., as joint lead arrangers (incorporated herein by reference to Exhibit 4.11 to Eastman Chemical Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2006)

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
AND RESULTS OF OPERATIONS

| Exhibit<br>Number | EXHIBIT INDEX<br><br>Description  | Sequential<br>Page<br>Number |
|-------------------|---|------------------------------|
| 4.11              | Amended and Restated Credit Agreement, dated as of April 3, 2006 (the "Credit Agreement") among Eastman Chemical Company, the Lenders named therein, and Citigroup Global Markets , Inc. and J. P. Morgan Securities Inc., as joint lead arrangers (incorporated herein by reference to Exhibit 4.11 to Eastman Chemical Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2006) |                              |
| 4.12              | Form of 6.30% Notes due 2018 (incorporated herein by reference to Exhibit 4.14 to Eastman Chemical Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003)  |                              |
| <u>12.01</u>      | Statement re: Computation of Ratios of Earnings (Loss) to Fixed Charges   | 53                           |
| <u>31.01</u>      | Rule 13a – 14(a) Certification by J. Brian Ferguson, Chairman of the Board and Chief Executive Officer, for the quarter ended June 30, 2008   | 54                           |
| <u>31.02</u>      | Rule 13a – 14(a) Certification by Richard A. Lorraine, Senior Vice President and Chief Financial Officer, for the quarter ended June 30, 2008   | 55                           |
| <u>32.01</u>      | Section 1350 Certification by J. Brian Ferguson, Chairman of the Board and Chief Executive Officer, for the quarter ended June 30, 2008   | 56                           |
| <u>32.02</u>      | Section 1350 Certification by Richard A. Lorraine, Senior Vice President and Chief Financial Officer, for the quarter ended June 30, 2008   | 57                           |