

Filed pursuant to Rule 424(B)(3)  
Registration No. 333-81555

## PROSPECTUS

6,015,000 SHARES

[LENNOX INTERNATIONAL INC. LOGO]  
COMMON STOCK

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WE MAY OFFER AND ISSUE THE 6,015,000 SHARES OF OUR COMMON STOCK COVERED BY THIS PROSPECTUS FROM TIME TO TIME IN BUSINESS COMBINATION TRANSACTIONS INVOLVING OUR ACQUISITION, DIRECTLY OR INDIRECTLY, OF BUSINESSES OR OTHER OPERATING ASSETS. WE EXPECT THAT WE WILL DETERMINE THE TERMS OF THESE ACQUISITIONS BY DIRECT NEGOTIATIONS WITH THE OWNERS OR CONTROLLING PERSONS OF THE BUSINESSES OR ASSETS TO BE ACQUIRED AND THE SHARES OF OUR COMMON STOCK ISSUED WILL BE VALUED AT PRICES REASONABLY RELATED TO MARKET PRICES PREVAILING EITHER AT THE TIME AN ACQUISITION AGREEMENT IS EXECUTED OR AT OR ABOUT THE TIME OF DELIVERY OF THE SHARES.

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OUR COMMON STOCK IS TRADED ON THE NEW YORK STOCK EXCHANGE UNDER THE TRADING SYMBOL "LII." ON AUGUST 27, 1999, THE LAST REPORTED SALES PRICE OF OUR COMMON STOCK ON THE NEW YORK STOCK EXCHANGE WAS \$17 7/16 PER SHARE.

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INVESTING IN OUR COMMON STOCK INVOLVES RISKS. SEE "RISK FACTORS" BEGINNING ON PAGE 6.

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The Securities and Exchange Commission and state securities regulators have not approved or disapproved these securities, or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

August 30, 1999

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## PROSPECTUS SUMMARY

You should read the following summary together with the more detailed information and our financial statements and notes appearing elsewhere in this prospectus.

## LENNOX

We are a leading global provider of climate control solutions and had 1998 net sales of \$1.8 billion. We design, manufacture and market a broad range of products for the heating, ventilation, air conditioning and refrigeration markets, which is sometimes referred to as "HVACR." Our products are sold under well-established brand names including "Lennox", "Armstrong Air", "Bohn", "Larkin", "Heatcraft" and others. In September 1998, we initiated a program to acquire dealers in metropolitan areas in the U.S. and Canada so we can provide heating and air conditioning products and services directly to consumers.

Our furnaces, heat pumps, air conditioners, pre-fabricated fireplaces and related products are available in a variety of designs, efficiency levels and price points that provide an extensive line of comfort systems. A majority of our sales of residential heating and air conditioning products in the U.S. and Canada are to the repair and replacement market, which is less cyclical than the new construction market. We also provide a range of air conditioning products for commercial market applications such as mid-size office buildings, restaurants, churches and schools. Our commercial refrigeration products are used primarily in cold storage applications for food preservation in supermarkets, convenience stores, restaurants, warehouses and distribution centers. Our heat transfer products are used by us in our HVACR products and sold to third parties.

We market our products using multiple brand names and distribute our products through multiple distribution channels to penetrate different segments of the HVACR market. Our "Lennox" brand of residential heating and air conditioning products is sold directly through approximately 6,000 installing dealers -- the "one-step" distribution system -- which has created strong and long-term relationships with our dealers in North America. Our "Armstrong Air", "Air-Ease", "Concord" and "Magic-Pak" residential heating and air conditioning brands are sold to regional distributors that in turn sell the products to installing contractors -- the "two-step" distribution system typically utilized in the heating and air conditioning industry. The acquisition of heating and air conditioning dealers in the U.S. and Canada allows us to participate in the retail sale and service of heating and air conditioning products. Our hearth products, commercial air conditioning products and refrigeration products are also sold under multiple brand names and through a combination of wholesalers, contractors, original equipment manufacturers, manufacturers' representatives and national accounts.

## COMPETITIVE STRENGTHS

We have a combination of strengths that position us to continue to be a leading provider of climate control solutions, including:

- strong brand recognition and reputation, particularly with the well recognized "Lennox" name;
- one of the broadest distribution systems of any major HVACR manufacturer;
- leading heat transfer design and manufacturing expertise;
- commitment to product innovation and technological leadership; and
- demonstrated manufacturing efficiency for our products.

## GROWTH STRATEGY

Our growth strategy is designed to capitalize on our competitive strengths in order to expand our market share and profitability in the worldwide HVACR markets. We will continue to pursue internal programs and

strategic acquisitions that broaden our product and service offerings, expand our market opportunities and enhance our technological expertise. The key elements of this strategy include:

- expanding our market opportunities in North America through a series of initiatives, including the acquisition of heating and air conditioning dealers;
- exploiting international opportunities through acquisitions and internal growth;
- increasing our presence in the hearth products market by selling in the distribution channels we acquired and through our historical distribution channels; and
- continuing to invest in research and new product development.

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#### RECENT EVENTS

On August 3, 1999, we completed the initial public offering of our common stock. We sold 8,088,490 shares of our common stock and certain selling stockholders sold 411,510 shares at an initial price to the public of \$18.75 per share. We estimate that the net proceeds from the offering were \$140.3 million, after deducting estimated expenses and underwriting discounts and commissions. All of the proceeds from the offering were used to repay a portion of the borrowings under our former revolving credit facility and a term credit facility which terminated upon completion of the offering.

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We are located at 2140 Lake Park Blvd., Richardson, Texas 75080 and our telephone number is (972) 497-5000.

#### THE OFFERING

We may offer and issue the 6,015,000 shares of our common stock covered by this prospectus from time to time in business combination transactions involving our acquisition, directly or indirectly, of businesses or other operating assets. We expect that we will determine the terms of these acquisitions by direct negotiations with the owners or controlling persons of the businesses or assets to be acquired and the shares of our common stock issued will be valued at prices reasonably related to market prices prevailing either at the time an acquisition agreement is executed or at or about the time of delivery of the shares.

## SUMMARY FINANCIAL AND OTHER DATA

The following summary financial and other data for each of the years ended December 31, 1996, 1997 and 1998 have been derived from our audited financial statements included elsewhere in this prospectus. The summary financial and other data for each of the six months ended June 30, 1998 and 1999 are derived from our unaudited financial statements which, in our opinion, have been prepared on the same basis as the audited financial statements and include all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of this information. Our fiscal quarters are each comprised of 13 weeks. For convenience, the 26-week periods ended July 3, 1998 and July 2, 1999 are referred to as the six months ended June 30, 1998 and 1999, respectively. Effective September 30, 1997 we increased our ownership of Ets. Brancher S.A., our European joint venture, from 50% to 70% and, accordingly, changed our accounting method of recognizing this investment from the equity method to the consolidation method. You should read "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our financial statements and notes included elsewhere in this prospectus for a further explanation of the financial data summarized here.

	YEAR ENDED DECEMBER 31,			SIX MONTHS ENDED JUNE 30,	
	1996	1997	1998	1998	1999
	(IN THOUSANDS, EXCEPT PER SHARE DATA)				
<b>STATEMENT OF OPERATIONS DATA:</b>					
Net sales.....	\$1,364,546	\$1,444,442	\$1,821,836	\$835,630	\$1,080,900
Cost of goods sold.....	961,696	1,005,913	1,245,623	570,801	743,000
Gross profit.....	402,850	438,529	576,213	264,829	337,900
Selling, general and administrative expenses.....	298,049	326,280	461,143	205,618	267,794
Other operating expense, net.....	4,213	7,488	8,467	7,291	3,408
Product inspection charge(1).....	--	140,000	--	--	--
Income (loss) from operations.....	100,588	(35,239)	106,603	51,920	66,698
Interest expense, net.....	13,417	8,515	16,184	6,466	15,100
Other.....	(943)	1,955	1,602	532	(781)
Minority interest.....	--	(666)	(869)	(788)	(620)
Income (loss) before income taxes.....	88,114	(45,043)	89,686	45,710	52,999
Provision (benefit) for income taxes.....	33,388	(11,493)	37,161	20,336	22,798
Net income (loss).....	\$ 54,726	\$ (33,550)	\$ 52,525	\$ 25,374	\$ 30,201
Earnings (loss) per share:					
Basic.....	\$ 1.62	\$ (0.99)	\$ 1.50	\$ 0.73	\$ 0.84
Diluted.....	1.59	(0.99)	1.47	0.72	0.82
Weighted average shares outstanding:					
Basic.....	33,693	33,924	34,914	34,617	35,805
Diluted.....	34,386	33,924	35,739	35,310	36,696
Dividends per share.....	\$ 0.26	\$ 0.28	\$ 0.32	\$ 0.16	\$ 0.17
<b>OTHER DATA:</b>					
Depreciation and amortization.....	34,149	33,430	43,545	19,502	26,877
Capital expenditures.....	31,903	34,581	52,435	21,110	37,877
Research and development expenses.....	23,235	25,444	33,260	15,169	19,381

JUNE 30,  
1999  
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(IN THOUSANDS)

<b>BALANCE SHEET DATA:</b>	
Cash and cash equivalents.....	\$ 34,381
Working capital.....	239,612
Total assets.....	1,504,437
Total debt.....	576,278
Stockholders' equity.....	422,381

(1) Represents a pre-tax charge taken in the fourth quarter of 1997 for estimated costs of an inspection program for our Pulse furnaces installed from 1982 to 1990 in the U.S. and Canada. We initiated the inspection program because we received anecdotal reports of accelerated corrosion of a component of these products under extreme operating conditions. The program ended on June 30, 1999 with a current liability remaining of \$2 million, which we estimate will be adequate to cover any estimated remaining costs associated with the program.

## RISK FACTORS

You should carefully consider the risks described below before making an investment decision.

## RISK FACTORS RELATING TO OUR BUSINESS

Our business is subject to the following risks, which include risks relating to the industry in which we operate.

## WE MAY INCUR MATERIAL COSTS AS A RESULT OF WARRANTY AND PRODUCT LIABILITY CLAIMS WHICH WOULD NEGATIVELY IMPACT OUR PROFITABILITY

The development, manufacture, sale and use of our products involve a risk of warranty and product liability claims. In addition, as we increase our efforts to acquire installing heating and air conditioning dealers in the U.S. and Canada, we incur the risk of liability claims for the installation and service of heating and air conditioning products. We maintain product liability insurance. Our product liability insurance policies have limits, however, that if exceeded, may result in material costs that would have an adverse effect on our future profitability. In addition, warranty claims are not covered by our product liability insurance and there may be types of product liability claims that are also not covered by our product liability insurance.

## WE MAY NOT BE ABLE TO REALIZE OUR BUSINESS STRATEGY OF SUCCESSFULLY COMPLETING OR OPERATING STRATEGIC ACQUISITIONS

We intend to grow in part through the acquisition of heating and air conditioning dealers and other complementary businesses both in the U.S. and internationally. This strategy will involve reviewing and potentially reorganizing the operations, corporate infrastructure and systems and financial controls of acquired businesses. The success of our acquisition strategy may be limited because of unforeseen expenses, difficulties, complications and delays encountered in connection with the expansion of our operations through acquisitions. We may not be able to acquire or manage profitably additional businesses or to integrate successfully any acquired businesses into our business without substantial costs, delays or other operational or financial difficulties. In addition, we may be required to incur additional debt or issue equity to pay for future acquisitions.

## WE ARE ENTERING NEW BUSINESSES IN WHICH WE HAVE LIMITED EXPERIENCE AND WE MAY NOT BE ABLE TO SUCCESSFULLY MANAGE OR OPERATE THESE NEW BUSINESSES

With our recently initiated program of acquiring heating and air conditioning dealers and with our recent acquisitions of hearth products manufacturers, we have entered into new lines of business. We cannot assure you that we will be able to successfully manage or operate these new businesses.

## THE CONSOLIDATION OF DISTRIBUTORS AND DEALERS COULD FORCE US TO LOWER OUR PRICES OR HURT OUR BRAND NAMES WHICH WOULD RESULT IN LOWER SALES

There is currently an effort underway in the U.S. by several companies to purchase independent distributors and dealers and consolidate them into large enterprises. These large enterprises may be able to exert pressure on us or our competitors to reduce prices. Additionally, these new enterprises tend to emphasize their company name, rather than the brand of the manufacturer, in their promotional activities, which could lead to dilution of the importance and value of our brand names. Future price reductions and the brand dilution caused by the consolidation among HVACR distributors and dealers could have an adverse effect on our future sales and profitability.

## OUR DEALER ACQUISITION PROGRAM COULD LEAD TO LOSS OF SALES FROM INDEPENDENT DEALERS AND DEALERS OWNED BY CONSOLIDATORS

With our recently initiated program of acquiring heating and air conditioning dealers in the U.S. and Canada, we face the risk that dealers owned by consolidators and independent dealers may discontinue using

our heating and air conditioning products because we are and increasingly will be in competition with them. We sold approximately \$50 million of heating and air conditioning products to consolidators in 1998, representing 2.7% of our net sales.

**COOLER THAN NORMAL SUMMERS AND WARMER THAN NORMAL WINTERS MAY DEPRESS OUR SALES**

Demand for our products and for our services is strongly affected by the weather. Hotter than normal summers generate strong demand for our replacement air conditioning and refrigeration products and colder than normal winters have the same effect on our heating products. Conversely, cooler than normal summers and warmer than normal winters depress our sales. Because a high percentage of our overhead and operating expenses is relatively fixed throughout the year, operating earnings and net earnings tend to be lower in quarters with lower sales.

**WE MAY NOT BE ABLE TO COMPETE FAVORABLY IN THE HIGHLY COMPETITIVE HVACR BUSINESS**

Competition in our various markets could cause us to reduce our prices or lose market share, or could negatively affect our cash flow, which could have an adverse effect on our future financial results. Substantially all of the markets in which we participate are highly competitive. The most significant competitive factors we face are product reliability, product performance, service and price, with the relative importance of these factors varying among our product lines. In addition, in our new distribution channel in which we will sell our products directly to consumers, we face competition from independent dealers and dealers owned by consolidators and utility companies, some of whom may be able to provide their products or services at lower prices than we can.

**WE MAY BE ADVERSELY AFFECTED BY PROBLEMS IN THE AVAILABILITY OF OR INCREASES IN THE PRICES OF COMPONENTS AND RAW MATERIALS**

Increases in the prices of raw materials or components or problems in their availability could depress our sales or increase the costs of our products. We are dependent upon components purchased from third parties as well as raw materials such as copper, aluminum and steel. We enter into contracts each year for the supply of key components at fixed prices. However, if a key supplier is unable or unwilling to meet our supply requirements, we could experience supply interruptions or cost increases, either of which could have an adverse effect on our gross profit. In addition, we regularly pre-purchase a portion of our raw materials at a fixed price each year to hedge against price fluctuations, but a large increase in raw materials prices could significantly increase the cost of our products.

**THE PROFITABILITY OF OUR INTERNATIONAL OPERATIONS COULD BE ADVERSELY AFFECTED BY ECONOMIC TURMOIL, WAR OR CIVIL UNREST**

Our international operations are subject to various economic, political and other risks that are generally not present in our North American operations. International risks include:

- instability of foreign economies and governments;
- price and currency exchange controls;
- unfavorable changes in monetary and tax policies and other regulatory changes;
- fluctuations in the relative value of currencies;
- expropriation and nationalization of our foreign assets; and
- war and civil unrest.

We sell products in over 70 countries and have business units located in Europe, Asia Pacific, Latin America and Mexico. Sales of our products outside of the U.S. represented approximately 19.2% of our 1998 net sales. We anticipate that, over time, international sales will continue to grow as a percentage of our total sales.

OUR OPERATIONS ARE SUBJECT TO INHERENT RISKS THAT COULD RESULT IN LOSS OF LIFE OR SEVERE DAMAGE TO OUR PROPERTIES AND THE SUSPENSION OF OPERATIONS

Our operations are subject to hazards and risks inherent in operating large manufacturing facilities, including fires, natural disasters and explosions, all of which can result in loss of life or severe damage to our properties and the suspension of operations. We maintain business interruption and other types of property insurance as protection against operating hazards. The occurrence of a significant event not fully covered by insurance could have an adverse effect on our profitability.

SINCE A SIGNIFICANT PERCENTAGE OF OUR WORKFORCE IS UNIONIZED, WE FACE RISKS OF WORK STOPPAGES AND OTHER LABOR RELATIONS PROBLEMS

We are subject to a risk of work stoppage and other labor relations matters because a significant percentage of our workforce is unionized. As of December 31, 1998, approximately 30% of our workforce was unionized. Within the U.S., we currently have eight manufacturing facilities and five distribution centers, along with our North American Parts Center in Des Moines, Iowa, with collective bargaining agreements ranging from three to eight years in length. Of our significant manufacturing facilities, the contract at our Lynwood, California facility expires in December 1999. Following the expiration of the collective bargaining agreement in April 1999, we experienced a work stoppage at our Bellevue, Ohio factory for three weeks in May 1999. This facility has a new collective bargaining agreement that expires April 2002. Outside of the U.S., we have 12 significant facilities that are represented by unions. The agreement for our manufacturing facility in Toronto, Ontario expired in April 1999 and the agreement for our facility in Laval, Quebec expires in December 1999. As has been the case in the past, the employees at our Toronto facility are continuing to work under the expired contract pending negotiation of a new agreement. As we expand our operations, we are subject to increased unionization of our workforce. The results of future negotiations with these unions, including the effects of any production interruptions or labor stoppages, could have an adverse effect on our future financial results. You should read "Business -- Employees" for a more complete discussion of our collective bargaining agreements.

EXPOSURE TO ENVIRONMENTAL LIABILITIES COULD ADVERSELY AFFECT OUR RESULTS OF OPERATIONS

Our future profitability could be adversely affected by current or future environmental laws. We are subject to extensive and changing federal, state and local laws and regulations designed to protect the environment in the U.S. and in other parts of the world. These laws and regulations could impose liability for remediation costs or result in civil or criminal penalties in cases of non-compliance. Compliance with environmental laws increases our costs of doing business. Because these laws are subject to frequent change, we are unable to predict the future costs resulting from environmental compliance.

The U.S. and other countries have established programs for limiting the production, importation and use of certain ozone depleting chemicals, including refrigerants used by us in most of our air conditioning and refrigeration products. Some categories of these refrigerants have been banned completely and others are currently scheduled to be phased out in the U.S. by the year 2030. The U.S. is under pressure from the international environmental community to accelerate the current 2030 deadline. In Europe, this phaseout may occur even sooner. The industry's failure to find suitable replacement refrigerants for substances that have been or will be banned or the acceleration of any phase out schedules for these substances by governments could have an adverse effect on our future financial results. You should read "Business -- Regulation" for a more complete discussion of environmental regulations which affect our business.

WE MAY BE ADVERSELY IMPACTED BY THE YEAR 2000 AND THE CONVERSION OF OUR MANAGEMENT INFORMATION SYSTEMS TO DISTRIBUTED PROCESSING SYSTEMS

Year 2000 problems might require us to incur unanticipated expenses or experience interruptions of operations that could have an adverse effect on our future sales and profitability. In 1996, we began converting all of our major domestic management information systems from mainframe systems to distributed processing systems. In order to avoid disruption to our operations, we have conducted the conversion on a phased basis.



We anticipate that our major domestic operations will be supported by distributed processing by the end of 1999. In addition, we have and will continue to make investments in our computer systems and applications in an effort to ensure that they are Year 2000 compliant. However, we may experience interruptions of operations because of problems in implementing distributed processing or because of Year 2000 problems within our company. Our suppliers or customers might experience Year 2000 problems. You should read "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Year 2000 Compliance" and "Business -- Information Systems" for a more complete discussion of our systems upgrade and Year 2000 compliance initiative.

#### THE NORRIS FAMILY WILL BE ABLE TO EXERCISE SIGNIFICANT CONTROL OVER OUR COMPANY

The ability of the Norris family to exercise significant control over Lennox may discourage, delay or prevent a takeover attempt that a stockholder might consider in his or her best interest and that might result in a stockholder receiving a premium for his or her common stock. Approximately 110 descendants of or persons otherwise related to D.W. Norris, one of our original owners, collectively control over 70% of the outstanding shares of our common stock. Accordingly, if the Norris family were to act together, it would have the ability to:

- control the vote of most matters submitted to our stockholders, including any merger, consolidation or sale of all or substantially all of our assets;
- elect all of the members of our board of directors;
- prevent or cause a change in control of our company; and
- decide whether to issue additional common stock or other securities or declare dividends.

#### RISK FACTORS RELATING TO SECURITIES MARKETS

There are risks relating to the securities markets that you should consider in connection with your investment in and ownership of our stock.

#### ANTI-TAKEOVER PROVISIONS IN OUR GOVERNING DOCUMENTS AND DELAWARE LAW COULD PREVENT OR DELAY A CHANGE IN CONTROL OF OUR COMPANY

Our governing documents contain provisions that make it more difficult to implement corporate actions that may have the effect of delaying, deterring or preventing a change in control. A stockholder might consider a change in control in his or her best interest because he or she might receive a premium for his or her common stock. Examples of these provisions include:

- a vote of more than 80% of the outstanding voting stock is required for stockholders to amend specified provisions of the governing documents;
- our board of directors is divided into three classes, each serving three-year terms;
- members of our board of directors may be removed only for cause and only upon the affirmative vote of at least 80% of the outstanding voting stock; and
- a vote of more than 80% of the outstanding voting stock is required to approve specified transactions between us and any person or group that owns at least 10% of our voting stock.

Our board of directors has the ability, without stockholder action, to issue shares of preferred stock that could, depending on their terms, delay, discourage or prevent a change in control of Lennox. In addition, the Delaware General Corporation Law, under which we are incorporated, contains provisions that impose restrictions on business combinations such as mergers between us and a holder of 15% or more of our voting stock. You should read the "Description of Capital Stock" section for a more complete description of these provisions.

A SUBSTANTIAL NUMBER OF OUR SHARES WILL BE AVAILABLE FOR SALE IN THE PUBLIC MARKET AND SALES OF THOSE SHARES COULD ADVERSELY AFFECT OUR STOCK PRICE

Sales of a substantial number of shares of our common stock into the public market or the perception that these sales could occur, could adversely affect our stock price or could impair our ability to obtain capital through an offering of equity securities. As of August 10, 1999, we have 44,896,165 shares of common stock outstanding. Of these shares, the 8,500,000 shares sold in our initial public offering are freely tradeable without restriction or further registration under the Securities Act of 1933, except for any shares purchased by our "affiliates" as that term is defined by Rule 144. The remaining 36,396,165 shares of common stock outstanding, which represents approximately 81% of the total outstanding shares of common stock, are "restricted" as that term is defined by Rule 144. You should read the "Shares Eligible For Future Sale" section for a more complete discussion of these matters.

THE PRICE OF OUR COMMON STOCK MAY FLUCTUATE SIGNIFICANTLY AND YOU COULD LOSE ALL OR PART OF YOUR INVESTMENT AS A RESULT

The price of our common stock may be affected by a number of factors, including:

- actual or anticipated fluctuations in our operating results;
- changes in expectations as to our future financial performance or changes in financial estimates of securities analysts;
- announcements of new products or technological innovations; and
- the operating and stock price performance of other comparable companies.

In addition, the stock market in general has experienced extreme volatility that often has been unrelated to the operating performance of particular companies. These broad market and industry fluctuations may adversely affect the trading price of our common stock, regardless of our actual operating performance.

## SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

Some of the statements under "Prospectus Summary," "Risk Factors," "Management's Discussion and Analysis of Financial Condition and Results of Operations," "Business," and elsewhere in this prospectus constitute forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "expects," "plans," "anticipates," "believes," "estimates," "predicts," "potential" or "continue" or the negative of such terms or other comparable terminology. These statements are only predictions. Actual events or results may differ materially. In evaluating these statements, you should specifically consider various factors, including the risks outlined under "Risk Factors." These factors may cause our actual results to differ materially from any forward-looking statement.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance, or achievements. Moreover, neither we nor any other person assumes responsibility for the accuracy and completeness of these statements. We are under no duty to update any of the forward-looking statements after the date of this prospectus to conform these statements to actual results.

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You should rely only on the information contained in this prospectus. We have not authorized anyone to provide you with information different from that contained in this prospectus. We are offering to sell, and seeking offers to buy, shares of common stock only in jurisdictions where offers and sales are permitted.

We own or otherwise have rights to trademarks or trade names that we use in connection with the sale of our products. Lennox(R), Armstrong Air(TM), Bohn(R), Larkin(TM), Heatcraft(R), CompleteHeat(R), Climate Control(TM), Chandler Refrigeration(R), Advanced Distributor Products(R), Raised Lance(TM), Air-Ease(R), Concord(R), Magic-Pak(R), Superior(TM), Marco(R), Whitfield(R), Security Chimneys(R), Alcair(TM), Friga-Bohn(TM) and Janka(TM), among others, are trademarks that are owned by us. This prospectus also makes reference to trademarks of other companies.

## PRICE RANGE OF COMMON STOCK

Our common stock began trading on the New York Stock Exchange under the symbol "LII" on July 29, 1999. The following table sets forth the high and low sales prices for our common stock for the periods indicated:

	HIGH -----	LOW -----
1999:		
Third quarter (July 29 through August 26).....	\$19 7/8	\$16 1/4

The closing price of the common stock on the New York Stock Exchange on August 27, 1999 was \$17 7/16. As of August 27, 1999 there were approximately 310 holders of record of common stock, as shown on the records of the transfer agent and registrar for the common stock. The number of record holders does not bear any relationship to the number of beneficial owners of common stock.

## DIVIDEND POLICY

We paid cash dividends of \$0.26, \$0.28 and \$0.32 per share on our common stock during 1996, 1997 and 1998, respectively. We anticipate that we will continue to pay cash dividends on our common stock, but any future determination as to the payment or amount of dividends will depend upon our future results of operations, capital requirements, financial condition and other factors as our board of directors may consider. In addition, our revolving credit facility, term credit agreement and our other debt instruments prohibit the payment of dividends unless we can incur \$1.00 of additional indebtedness according to the terms of these instruments. For more information about our debt instruments, see "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Liquidity and Capital Resources."

## SELECTED FINANCIAL AND OTHER DATA

The following selected financial and other data for each of the years in the five-year period ended December 31, 1998 have been derived from our financial statements which have been audited by Arthur Andersen LLP. The summary financial and other data for each of the six months ended June 30, 1998 and 1999 are derived from our unaudited financial statements which, in our opinion, have been prepared on the same basis as the audited financial statements and include all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of such information. Our fiscal quarters are each comprised of 13 weeks. For convenience, the 26-week periods ended July 3, 1998 and July 2, 1999 are referred to as the six months ended June 30, 1998 and 1999, respectively. Effective September 30, 1997 we increased our ownership of Ets. Brancher, our European joint venture, from 50% to 70% and, accordingly, changed our accounting method of recognizing this investment from the equity method to the consolidation method. You should read "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our financial statements and notes included elsewhere in this prospectus for a further explanation of the financial data summarized here.

	YEAR ENDED DECEMBER 31,					SIX MONTHS ENDED JUNE 30,	
	1994	1995	1996	1997	1998	1998	1999
	(IN THOUSANDS, EXCEPT PER SHARE DATA)						
<b>STATEMENT OF OPERATIONS DATA:</b>							
Net sales.....	\$1,168,099	\$1,306,999	\$1,364,546	\$1,444,442	\$1,821,836	\$ 835,630	\$1,080,900
Cost of goods sold.....	815,511	946,881	961,696	1,005,913	1,245,623	570,801	743,000
Gross profit.....	352,588	360,118	402,850	438,529	576,213	264,829	337,900
Selling, general and administrative expenses.....	273,421	285,938	298,049	326,280	461,143	205,618	267,794
Other operating expense, net.....	7,460	2,555	4,213	7,488	8,467	7,291	3,408
Product inspection charge(1).....	--	--	--	140,000	--	--	--
Income (loss) from operations.....	71,707	71,625	100,588	(35,239)	106,603	51,920	66,698
Interest expense, net.....	20,830	20,615	13,417	8,515	16,184	6,466	15,100
Other.....	836	(622)	(943)	1,955	1,602	532	(781)
Minority interest.....	--	--	--	(666)	(869)	(788)	(620)
Income (loss) before income taxes.....	50,041	51,632	88,114	(45,043)	89,686	45,710	52,999
Provision (benefit) for income taxes.....	19,286	17,480	33,388	(11,493)	37,161	20,336	22,798
Net income (loss).....	\$ 30,755	\$ 34,152	\$ 54,726	\$ (33,550)	\$ 52,525	\$ 25,374	\$ 30,201
Earnings (loss) per share:							
Basic.....	\$ 0.93	\$ 1.04	\$ 1.62	\$ (0.99)	\$ 1.50	\$ 0.73	\$ 0.84
Diluted.....	0.93	1.04	1.59	(0.99)	1.47	0.72	0.82
Weighted average shares outstanding:							
Basic.....	32,938	32,899	33,693	33,924	34,914	34,617	35,805
Diluted.....	32,994	32,964	34,386	33,924	35,739	35,310	36,696
Dividends per share.....	\$ 0.20	\$ 0.22	\$ 0.26	\$ 0.28	\$ 0.32	\$ 0.16	\$ 0.17
<b>OTHER DATA:</b>							
Depreciation and amortization.....	\$ 32,896	\$ 32,212	\$ 34,149	\$ 33,430	\$ 43,545	\$ 19,502	\$ 26,877
Capital expenditures.....	36,189	26,675	31,903	34,581	52,435	21,110	37,877
Research and development expenses....	22,773	22,682	23,235	25,444	33,260	15,169	19,381

	DECEMBER 31,					JUNE 30,	
	1994	1995	1996	1997	1998	1998	1999
	(IN THOUSANDS)						
<b>BALANCE SHEET DATA:</b>							
Cash and cash equivalents.....	\$ 2,980	\$ 73,811	\$ 151,877	\$ 147,802	\$ 28,389	\$ 134,012	\$ 34,381
Working capital.....	252,301	307,502	325,956	335,891	263,289	410,754	239,612
Total assets.....	737,528	768,517	820,653	970,892	1,152,952	1,079,217	1,504,437
Total debt.....	243,480	219,346	184,756	198,530	317,441	277,654	576,278
Stockholders' equity.....	286,849	315,313	361,464	325,478	376,440	346,806	422,381

- (1) Represents a pre-tax charge taken in the fourth quarter of 1997 for estimated costs of an inspection program for our Pulse furnaces installed from 1982 to 1990 in the U.S. and Canada. We initiated the inspection program because we received anecdotal reports of accelerated corrosion of a component of these products under extreme operating conditions. The program ended on June 30, 1999 with a current liability remaining of \$2 million, which we estimate will be adequate to cover any estimated remaining costs associated with the program.

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

OVERVIEW

We participate in four reportable business segments of the HVACR industry. The first segment is the North American residential market in which we manufacture and market a full line of heating, air conditioning and hearth products for the residential replacement and new construction markets in the U.S. and Canada. The North American residential segment also includes installation, maintenance and repair services performed by Lennox-owned dealers. The second segment is the global commercial air conditioning market in which we manufacture and sell rooftop products and applied systems for commercial applications. The third segment is the global commercial refrigeration market which consists of unit coolers, condensing units and other commercial refrigeration products. The fourth segment is the heat transfer market in which we design, manufacture and sell evaporator and condenser coils, copper tubing and related manufacturing equipment to original equipment manufacturers and other specialty purchasers on a global basis.

We sell our products to numerous types of customers, including distributors, installing dealers, homeowners, national accounts and original equipment manufacturers. The demand for our products is cyclical and influenced by national and regional economic and demographic factors, such as interest rates, the availability of financing, regional population and employment trends and general economic conditions, especially consumer confidence. In addition to economic cycles, demand for our products is seasonal and dependent on the weather. Hotter than normal summers generate strong demand for replacement air conditioning and refrigeration products and colder than normal winters have the same effect on heating products. Conversely, cooler than normal summers and warmer than normal winters depress sales of HVACR products.

The principal components of cost of goods sold are labor, raw materials, component costs, factory overhead and estimated costs of warranty expense. The principal raw materials used in our manufacturing processes are copper, aluminum and steel. In instances where we are unable to pass on to our customers increases in the costs of copper and aluminum, we enter into forward contracts for the purchase of such materials. We attempt to minimize the risk of price fluctuations in key components by entering into contracts, typically at the beginning of the year, which generally provide for fixed prices for our needs throughout the year. These hedging strategies enable us to establish product prices for the entire model year while minimizing the impact of price increases of components and raw materials on our margins. Warranty expense is estimated based on historical trends and other factors.

In September 1997, we increased our ownership in Ets. Brancher from 50% to 70%. As a result, we assumed control of the venture and began consolidating the financial position and operating results of the venture in the fourth quarter of 1997. Previously, we used the equity method of accounting for our investment in this entity. In the fourth quarter of 1998, we restructured our ownership of our various European entities to allow for more efficient transfer of funds and to provide for tax optimization. Although our European operations contributed to revenue, they had an operating loss in 1997, 1998 and the first half of 1999, primarily due to the performance of the commercial air conditioning business. In the second half of 1998, we commenced and substantially completed the installation of a new management team for our European operations. We are in the process of bringing our manufacturing and operating expertise to the European businesses.

We acquired Superior Fireplace Company, Marco Mfg., Inc. and Pyro Industries, Inc. in the third quarter of 1998 and Security Chimneys International, Ltd. in the first quarter of 1999 for an aggregate purchase price of approximately \$120 million. These acquisitions give us one of the broadest lines of hearth products in the industry. These businesses had aggregate revenues of approximately \$150 million in 1998, \$68.6 million of which was reflected in our 1998 net sales, and contributed aggregate revenues of approximately \$73.4 million to our net sales for the six months ended June 30, 1999.

We acquired James N. Kirby Pty. Ltd., an Australian company that participates in the commercial refrigeration and heat transfer markets in Australia, in June 1999 for approximately \$65 million in cash, common stock and seller financing. In addition, we assumed approximately \$28 million of Kirby's debt. Kirby

had revenues of approximately \$123 million for the twelve months ended June 30, 1999, \$8.6 million of which was reflected in our net sales for the six months ended June 30, 1999.

In September 1998, we initiated a program to acquire high quality heating and air conditioning dealers in metropolitan areas in the U.S. and Canada to market "Lennox" and other brands of heating and air conditioning products. This strategy will enable us to extend our distribution directly to the consumer and permit us to participate in the revenues and margins available at the retail level while strengthening and protecting our brand equity. We believe that the retail sales and service market represents a significant growth opportunity because this market is large and highly fragmented. The retail sales and service market in the U.S. is comprised of over 30,000 dealers. In addition, we believe that the heating and air conditioning service business is somewhat less seasonal than the business of manufacturing and selling heating and air conditioning products. As of August 26, 1999, we had acquired 55 dealers in Canada and eight in the U.S. for an aggregate purchase price of approximately \$114 million and had signed letters of intent to acquire six additional Canadian dealers and 19 U.S. dealers for an aggregate purchase price of approximately \$74 million. As we acquire more heating and air conditioning dealers, we expect that we will incur additional costs to expand our infrastructure to effectively manage these businesses.

We have assigned a 40-year life to the goodwill acquired in the acquisitions of the hearth products companies and the dealers acquired to date. These companies and dealers are all profitable and all have been in business for extended periods of time. They all operate in established industries where the basic product technology has changed very little over time. In addition, all of these companies and dealers have strong brand names and market share in their respective industries or markets. Based upon these factors, we concluded that the anticipated future cash flows associated with the goodwill recognized in the acquisitions will continue for at least 40 years.

Our fiscal year ends on December 31 of each year, and our fiscal quarters are each comprised of 13 weeks. For convenience, throughout this Management's Discussion and Analysis of Financial Condition and Results of Operations, the 13 week periods comprising each fiscal quarter are denoted by the last day of the calendar quarter.

#### RESULTS OF OPERATIONS

The following table sets forth, as a percentage of net sales, our statement of income data for the years ended December 31, 1996, 1997 and 1998 and the six months ended June 30, 1998 and 1999.

	YEAR ENDED DECEMBER 31,			SIX MONTHS ENDED JUNE 30,	
	1996	1997	1998	1998	1999
Net sales.....	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of goods sold.....	70.5	69.6	68.4	68.3	68.7
Gross profit.....	29.5	30.4	31.6	31.7	31.3
Selling, general and administrative expenses.....	21.8	22.6	25.3	24.6	24.8
Other operating expense, net.....	0.3	0.5	0.4	0.9	0.3
Product inspection charge.....	--	9.7	--	--	--
Income (loss) from operations....	7.4	(2.4)	5.9	6.2	6.2
Interest expense, net.....	1.0	0.6	0.9	0.8	1.4
Other.....	(0.1)	0.1	0.1	0.0	(0.1)
Minority interest.....	--	0.0	0.0	(0.1)	0.0
Income (loss) before income taxes.....	6.5	(3.1)	4.9	5.5	4.9
Provision (benefit) for income taxes.....	2.5	(0.8)	2.0	2.5	2.1
Net income (loss).....	4.0%	(2.3)%	2.9%	3.0%	2.8%

The following table sets forth net sales by business segment and geographic market (dollars in millions):

	YEARS ENDED DECEMBER 31,						SIX MONTHS ENDED JUNE 30,			
	1996		1997		1998		1998		1999	
	AMOUNT	%	AMOUNT	%	AMOUNT	%	AMOUNT	%	AMOUNT	%
<b>BUSINESS SEGMENT:</b>										
North American residential.....	\$ 857.1	62.8%	\$ 865.1	59.9%	\$1,013.7	55.7%	\$463.5	55.5%	\$ 623.3	57.7%
Commercial air conditioning.....	228.9	16.8	278.8	19.3	392.1	21.5	173.8	20.8	210.1	19.4
Commercial refrigeration.....	135.6	9.9	154.3	10.7	237.3	13.0	109.0	13.0	144.2	13.3
Heat transfer.....	142.9	10.5	146.2	10.1	178.7	9.8	89.3	10.7	103.3	9.6
Total net sales.....	\$1,364.5	100.0%	\$1,444.4	100.0%	\$1,821.8	100.0%	\$835.6	100.0%	\$1,080.9	100.0%
<b>GEOGRAPHIC MARKET:</b>										
U.S.....	\$1,252.5	91.8%	\$1,274.9	88.3%	\$1,472.3	80.8%	\$681.8	81.6%	\$ 825.8	76.4%
International.....	112.0	8.2	169.5	11.7	349.5	19.2	153.8	18.4	255.1	23.6
Total net sales.....	\$1,364.5	100.0%	\$1,444.4	100.0%	\$1,821.8	100.0%	\$835.6	100.0%	\$1,080.9	100.0%

#### SIX MONTHS ENDED JUNE 30, 1999 COMPARED TO SIX MONTHS ENDED JUNE 30, 1998

Net sales. Net sales increased \$245.3 million, or 29.4%, to \$1,080.9 million for the six months ended June 30, 1999 from \$835.6 million for the six months ended June 30, 1998.

Net sales related to the North American residential segment were \$623.3 million during the six months ended June 30, 1999, an increase of \$159.8 million, or 34.5%, from \$463.5 million for the corresponding six months in 1998. Of the \$159.8 million increase, \$133.0 million was due to sales from the hearth products acquisitions, our Canadian dealers and acquired heating and air conditioning distributors. The remaining \$26.8 million increase in North American residential net sales was primarily due to a 5.8% increase in sales of our existing business, almost all of which resulted from increased sales volumes, principally caused by two factors. First, the hot summer in 1998 depleted the inventory levels at our distributors and they increased their purchases in the first quarter of 1999 to refill their inventories. Second, our volume increased as a result of sales to new dealers, which were added as a result of programs to expand our dealer base. Sales to dealers in the U.S. and Canada which we have acquired are no longer reflected as sales in our existing business and are instead reflected as sales due to acquisitions. If sales to these acquired dealers were included in sales of our existing business, sales of our existing business would have increased by 7.8%.

Commercial air conditioning net sales increased \$36.3 million, or 20.9%, to \$210.1 million for the six months ended June 30, 1999 compared to the corresponding six months in 1998. Of this increase, \$18.9 million was due to increased sales volumes in North America primarily due to the effectiveness of recently established commercial sales districts and \$17.4 million was due to increased international sales, \$6.8 million of which was due to acquisitions. Net sales related to the commercial refrigeration segment were \$144.2 million during the six months ended June 30, 1999, an increase of \$35.2 million, or 32.3%, from \$109.0 million for the corresponding six months in 1998. Of this increase, \$31.9 million was due to the international acquisitions of McQuay do Brasil, Lovelock Luke Pty. Limited and James N. Kirby Pty. Ltd. North American commercial refrigeration sales increased \$5.3 million primarily due to strong sales volumes to our supermarket customers and increased activity with our large distributors, while sales in Europe decreased \$2.0 million as compared to the prior period principally due to reduced sales in Russia and Eastern Europe. Heat transfer revenues increased \$14.0 million, or 15.7%, to \$103.3 million for the six months ended June 30, 1999 compared to the corresponding six months in 1998. Of this increase, \$8.9 million was due to increased sales volumes in our existing North American business and \$5.1 million was due to the acquisitions of James N. Kirby Pty. Ltd. and Livernois Engineering Holding Company.

Domestic sales increased \$144.0 million, or 21.1%, to \$825.8 million for the first six months of 1999 from \$681.8 million for the first six months of 1998. International sales increased \$101.3 million, or 65.9%, to \$255.1 million for the first six months of 1999 from \$153.8 million for the first six months of 1998.

Gross profit. Gross profit was \$337.9 million for the six months ended June 30, 1999 as compared to \$264.8 million for the six months ended June 30, 1998, an increase of \$73.1 million. Gross profit margin was



31.3% for the six months ended June 30, 1999 and 31.7% for the six months ended June 30, 1998. The increase of \$73.1 million in gross profit was primarily attributable to increased sales in the 1999 period as compared to 1998. The gross profit margins of our traditional businesses remain essentially unchanged from the first half of 1999 compared to the first half of 1998. The majority of the decrease in gross profit margin for the first half of 1999 is due to the acquisition of business with lower margins than our other businesses.

Selling, general and administrative expenses. Selling, general and administrative expenses were \$267.8 million for the six months ended June 30, 1999, an increase of \$62.2 million, or 30.2%, from \$205.6 million for the six months ended June 30, 1998. Selling, general and administrative expenses represented 24.8% and 24.6% of total net revenues for the first six months of 1999 and 1998, respectively. Of the \$62.2 million increase, \$40.8 million, or 65.6%, was related to increased infrastructure associated with acquisitions. The majority of the remaining \$21.4 million increase was due to increases in selling, general and administrative expenses for the North American residential segment which was primarily comprised of increases in costs due to additions of personnel, increased information technology costs and increased sales and marketing expenses.

Other operating expense, net. Other operating expense, net totaled \$3.4 million for the six months ended June 30, 1999, a decrease of \$3.9 million from \$7.3 million for the corresponding six months in 1998. Other operating expense, net is comprised of (income) loss from joint ventures, amortization of goodwill, and other intangibles and miscellaneous items. In June 1998, we recorded a restructuring charge of \$3.5 million for our European business.

Income from operations. Income from operations was \$66.7 million for the six months ended June 30, 1999 compared to \$51.9 million for the six months ended June 30, 1998. Income from operations represented 6.2% of net sales for both the six months ended June 30, 1999 and 1998.

Domestic income from operations was \$61.9 million during the six months ended June 30, 1999, an increase of 17.7% from \$52.6 million during the corresponding period in 1998. International income (loss) from operations was \$4.8 million during the 1999 period and \$(0.7) million during the 1998 period.

Interest expense, net. Interest expense, net for the six months ended June 30, 1999 increased to \$15.1 million from \$6.5 million for the same period in 1998. Of the \$8.6 million increase in interest expense, \$1.3 million was due to the incurrence of \$75 million in additional long-term borrowings in April 1998 and \$7.3 million was due to increased usage of our credit lines. Short-term borrowing increased in the first half of 1999 as a result of acquisitions, payments related to the Pulse inspection program and increased working capital for seasonal needs.

Other. Other expense (income) was \$(0.8) million for the six months ended June 30, 1999 and \$0.5 million for the six months ended June 30, 1998. Other expense is primarily comprised of currency exchange gains or losses. The majority of the improvement in other expense (income) was due to the strengthening of the Canadian dollar.

Minority interest. Minority interest in subsidiaries' net losses of \$(0.6) million for the six months ended June 30, 1999 and (0.8) million for the six months ended June 30, 1998 represents the minority interest in Ets. Brancher and, for 1999, McQuay do Brasil.

Provision for income taxes. The provision for income taxes was \$22.8 million for the six months ended June 30, 1999 and \$20.3 million for the six months ended June 30, 1998. The effective tax rate of 43.0% and 44.5% for the six months ended June 30, 1999 and 1998, respectively, differs from the statutory federal rate of 35.0% principally due to state and local taxes, non-deductible goodwill expenses and foreign operating losses for which no tax benefits have been recognized. Tax benefits will be recognized when our European operations are profitable.

Net income. Net income was \$30.2 million and \$25.4 million for the six months ended June 30, 1999 and 1998, respectively. Net income represented 2.8% and 3.0% of net sales for the six months ended June 30, 1999 and 1998, respectively.

## YEAR ENDED DECEMBER 31, 1998 COMPARED TO YEAR ENDED DECEMBER 31, 1997

Net sales. Net sales increased \$377.4 million, or 26.1%, to \$1,821.8 million for the year ended December 31, 1998 from \$1,444.4 million for the year ended December 31, 1997. If the effect of the consolidation of Ets. Brancher is excluded, net sales would have increased by \$226.7 million, or 16.1%, to \$1,630.9 million for 1998 as compared to 1997.

Net sales related to the North American residential segment were \$1,013.7 million during 1998, an increase of 17.2% from \$865.1 million for 1997. This increase was primarily due to increased unit sales of "Lennox" and "Armstrong Air" brands of heating and air conditioning equipment and the inclusion of \$68.6 million of sales beginning in the third quarter of 1998 of the hearth products companies. Hot weather in the spring of 1998 and an expanded dealer and distributor base led to greater sales of the "Lennox" and "Armstrong Air" brands. Commercial air conditioning revenues increased \$113.3 million, or 40.6%, to \$392.1 million for 1998 compared to 1997. If the effect of the consolidation of Ets. Brancher is excluded, commercial air conditioning revenues would have increased \$46.5 million, or 17.9%, to \$306.1 million for 1998 as compared to 1997. This increase was primarily due to increased volumes of rooftop air conditioner sales in the U.S. and Canada. Net sales related to the commercial refrigeration segment were \$237.3 million during 1998, an increase of 53.8% from \$154.3 million for 1997. If the effect of the consolidation of Ets. Brancher is excluded, net sales related to the commercial refrigeration products segment would have increased \$20.2 million, or 14.8%, to \$156.8 million for 1998 as compared to 1997. This increase is primarily caused by sales volume increases due to hot weather in North America in 1998 and the acquisition of McQuay do Brasil in September 1998. Heat transfer revenues increased \$32.5 million, or 22.3%, to \$178.7 million for 1998 compared to 1997. If the effect of the consolidation of Ets. Brancher is excluded, heat transfer revenues would have increased \$11.4 million, or 8.0%, to \$154.3 million for 1998 as compared to 1997. This increase is primarily caused by sales volume increases due to hot weather in North America in 1998.

Domestic sales increased \$197.4 million, or 15.5%, to \$1,472.3 million for 1998 from \$1,274.9 million for 1997. Of this increase, \$68.6 million is due to the inclusion of the hearth products companies and the balance was caused primarily by increased unit sales of "Lennox" and "Armstrong Air" brands due to the hot weather in 1998 and an expanded dealer and distributor base for these brands. International sales increased \$180.0 million, or 106.2%, to \$349.5 million for 1998 from \$169.5 million for 1997. Of this increase, \$150.7 million is due to the consolidation of Ets. Brancher and the remainder is primarily due to the acquisition of McQuay do Brasil and Lovelock Luke.

Gross profit. Gross profit was \$576.2 million for the year ended December 31, 1998 as compared to \$438.5 million for the year ended December 31, 1997, an increase of \$137.7 million. Gross profit margin increased to 31.6% in 1998 from 30.4% for 1997. The increase of \$137.7 million in gross profit was primarily attributable to increased sales in 1998 as compared to 1997 and the effect of the consolidation of Ets. Brancher for the full year. Ets. Brancher contributed \$47.7 million and \$11.2 million to gross profit in 1998 and 1997, respectively, and its gross profit margin was 25.0% and 27.9% in 1998 and 1997, respectively. If the effect of the consolidation of Ets. Brancher is excluded, gross profit margin would have been 32.4% and 30.4% for 1998 and 1997, respectively. The improved gross profit margin for 1998 is due to lower material costs, improved manufacturing processes and increased overhead absorption associated with the higher volume of sales in North America.

Selling, general and administrative expenses. Selling, general and administrative expenses were \$461.1 million for 1998, an increase of \$134.8 million, or 41.3%, from \$326.3 million for 1997. Selling, general and administrative expenses represented 25.3% and 22.6% of total net revenues for 1998 and 1997, respectively. If the effect of the consolidation of Ets. Brancher is excluded, selling, general and administrative expenses would have been \$413.9 million for 1998, an increase of \$99.8 million, or 31.8%, from \$314.1 million for 1997, representing 25.4% and 22.4% of total net sales for 1998 and 1997, respectively. Approximately \$16.7 million of the increase in selling, general and administrative expenses is composed of three non-recurring items: \$7.1 million associated with the settlement of a lawsuit; approximately \$5.0 million of incremental expense associated with the implementation of the SAP enterprise business software system; and \$4.6 million associated with increased expenses of a terminated performance share plan. If the effect of these non-recurring

items and the consolidation of Ets. Brancher is excluded, selling, general and administrative expenses would have been \$397.2 million for 1998, an increase of \$83.1 million, or 26.5%, from \$314.1 million for 1997, representing 24.4% and 22.4% of total net sales for 1998 and 1997, respectively. The remaining increase in selling, general and administrative expenses is primarily due to increased variable costs associated with sales growth in North America and costs associated with creating infrastructure to manage international businesses, such as the establishment of a sales office in Singapore and the business development functions for our global operation.

Other operating expense, net. Other operating expense, net totaled \$8.5 million for 1998, an increase of \$1.1 million from \$7.4 million for 1997. Other operating expense, net is comprised of (income) loss from joint ventures, amortization of goodwill and other intangibles and miscellaneous items. The \$1.1 million increase is due to increases in amortization of goodwill of \$1.7 million and losses from joint ventures of \$1.3 million, partially offset by a decrease in other intangible and miscellaneous expense of \$2.0 million.

Product inspection charge. In the fourth quarter of 1997, we recorded a non-recurring pre-tax charge of \$140.0 million to provide for management's best estimate of the projected expenses of the product inspection program related to our Pulse furnace. As part of our normal warranty process, we continuously monitor the replacement rate for, among other components, heat exchangers in our products. During 1997, it was determined that, under certain circumstances, certain joint connections on Pulse furnace heat exchangers manufactured between 1982 and 1988 could fail and potentially create a safety hazard in the home. Once this was determined, we publicly announced the Pulse inspection program in 1997. Under the program, we offered the owners of all Pulse furnaces installed between 1982 and 1990 a subsidized inspection and a free carbon monoxide detector. The inspection included a severe pressure test to determine the serviceability of the heat exchanger. If the heat exchanger did not pass the test, we either replaced the heat exchanger or offered a new furnace and subsidized the labor costs for installation. The cost required for the program depended on the number of units we found, the number of units that failed the pressure test, whether consumers selected to replace the heat exchanger or receive a new furnace and the cost of the replacement products. Based on the results of our historical experience, input from our dealers and consultation with the Consumer Products Safety Commission, we estimated we could ultimately locate approximately 67% of the Pulse furnaces that were manufactured between 1982 and 1988. In terms of estimated failure rates, we utilized the data gathered from "field experience" tests, which indicated a failure rate of approximately 30%. In terms of consumer selection, we estimated that half would elect the new heat exchanger and half would elect the new furnace. Finally, we utilized our standard costs of heat exchangers and new furnaces, the cost of the dealer inspection allowance and the cost of the dealer replacement allowance in calculating the liability. We believe we had adequate information to develop reasonable assumptions in estimating the cost of the Pulse inspection program.

The program ended on June 30 1999 with a current liability remaining of \$2 million, which we estimate will be adequate to cover any estimated remaining costs associated with the program.

Income (loss) from operations. Income (loss) from operations was \$106.6 million for 1998 compared to \$(35.2) million for 1997. Excluding the Ets. Brancher consolidation, the special charge for the Pulse inspection program and the three non-recurring selling, general and administrative expense items mentioned above, income from operations would have been \$122.6 million for 1998, or 7.5% of net sales, as compared to \$106.1 million for 1997, or 7.6% of net sales.

Domestic income from operations was \$108.7 million during 1998 as compared to a loss of \$(17.8) million during 1997. International income (loss) from operations was \$(2.1) million during 1998 and \$(17.4) million for 1997.

Interest expense, net. Interest expense, net for 1998 increased to \$16.2 million from \$8.5 million for 1997. Of the \$7.7 million increase in interest expense, \$3.6 million was due to the incurrence of \$75 million in additional long-term borrowings in April 1998, \$1.6 million was due to the consolidation of Ets. Brancher for the full year and the remainder was due to less interest income in 1998.

Other. Other expense was \$1.6 million for 1998 and \$2.0 million for 1997. Other expense is primarily comprised of currency exchange gains or losses.

Minority interest. Minority interest in subsidiaries' net loss of \$(0.7) million in 1997 and \$(0.9) million in 1998 represents the minority interest in Ets. Brancher and, for 1998, McQuay do Brasil.

Provision (benefit) for income taxes. The effective tax rates for the 1998 provision and the 1997 benefit were 41.4% and 25.5%, respectively. The effective tax rates differ from the federal statutory rate of 35% primarily due to state income taxes and valuation reserves provided for foreign operating losses.

Net income (loss). Net income (loss) was \$52.5 million and \$(33.6) million for the year ended December 31, 1998 and 1997, respectively. If the effects of the consolidation of Ets. Brancher and the non-recurring charge relating to the Pulse inspection program are excluded, net income would have been \$52.9 million and \$55.2 million for 1998 and 1997, representing 3.2% and 3.9% of net sales for 1998 and 1997, respectively.

#### YEAR ENDED DECEMBER 31, 1997 COMPARED TO YEAR ENDED DECEMBER 31, 1996

Net sales. Net sales increased \$79.9 million, or 5.9%, to \$1,444.4 million for the year ended December 31, 1997 from \$1,364.5 million for the year ended December 31, 1996. If the effect of the consolidation of Ets. Brancher is excluded, net sales would have increased by \$39.7 million, or 2.9%, to \$1,404.2 million for 1997 compared to 1996.

Net sales related to the North American residential segment were \$865.1 million during 1997, an increase of 0.9% from \$857.1 million for 1996. This increase was principally due to increases in the number of heating and air conditioning units sold by us, despite the fact that industry shipments were generally down 5% for 1997. The weather in 1997 was mild with a cool spring and modest winter over most of the U.S., and inventory levels for both dealers and distributors were higher than normal at the end of 1996. Commercial air conditioning revenues increased \$49.9 million, or 21.8%, to \$278.8 million for 1997 compared to 1996. Of the \$49.9 million increase, 49.3% was due to increased volumes of rooftop air conditioner sales in North America and the balance was due to the consolidation of Ets. Brancher in the fourth quarter of 1997. Rooftop air conditioner business increased in 1997 principally due to focused sales efforts through commercial districts that we established early in 1997 as well as the continued roll out of the L Series rooftop product line. Net sales related to the commercial refrigeration segment were \$154.3 million during 1997, an increase of 13.8% from \$135.6 million for 1996. This increase was primarily due to the consolidation of Ets. Brancher in the fourth quarter of 1997. Heat transfer revenues increased \$3.3 million, or 2.3%, to \$146.2 million for 1997 compared to 1996. Ets. Brancher contributed \$3.3 million to heat transfer product sales in 1997.

Domestic sales increased \$22.4 million, or 1.8%, to \$1,274.9 million for 1997 from \$1,252.5 million for 1996 primarily due to the factors discussed above. International sales increased \$57.5 million, or 51.3%, to \$169.5 million for 1997 from \$112.0 million for 1996. This increase is primarily due to the consolidation of Ets. Brancher in the last quarter of 1997.

Gross profit. Gross profit was \$438.5 million for the year ended December 31, 1997 as compared to \$402.9 million for the year ended December 31, 1996, an increase of \$35.6 million. Gross profit margins were 30.4% and 29.5% for 1997 and 1996, respectively. The increase of \$35.6 million in gross profit was primarily attributable to increased sales in 1997 and the effect of the consolidation of Ets. Brancher. Ets. Brancher contributed \$11.2 million to gross profit in 1997, and its gross profit margin was 27.9%. If the effect of the consolidation of Ets. Brancher is excluded, gross profit margin would have remained the same for 1997.

Selling, general and administrative expenses. Selling, general and administrative expenses were \$326.3 million for 1997, an increase of \$28.3 million, or 9.5%, from \$298.0 million for 1996. Selling, general and administrative expenses represented 22.6% and 21.8% of net sales for 1997 and 1996, respectively. Of the \$28.3 million increase, \$12.2 million was related to the consolidation of Ets. Brancher. Excluding the effect of the consolidation of Ets. Brancher, selling, general and administrative expenses would have represented 22.4% of net sales in 1997. The remaining \$16.1 million increase in selling, general and administrative expenses

related to expenses in establishing specialized commercial sales districts in North America, increased expenses related to a profit sharing plan and other variable cost increases associated with increased sales.

Other operating expense, net. Other operating expense, net totaled \$7.4 million for 1997, an increase of \$3.2 million from \$4.2 million for 1996. In 1996, we recognized a non-recurring \$4.6 million gain on the sale of a portion of our interest in Alliance Compressors, a joint venture to manufacture compressors. After the sale, we owned a 24.5% interest in Alliance Compressors.

Income (loss) from operations. Income (loss) from operations was \$(35.2) million in 1997, a decrease of \$135.8 million from \$100.6 million in 1996. The \$135.8 million decrease was primarily due to the \$140.0 million non-recurring pre-tax charge relating to the Pulse inspection program. Excluding the special charge for the Pulse inspection program and the consolidation of Ets. Brancher, income from operations would have been \$106.1 million in 1997, representing 7.6% of net sales, the same percent as in 1996.

Domestic income (loss) from operations was \$(17.8) million during 1997 as compared to \$98.0 million during 1996. International income from operations was \$(17.4) million during 1997 and \$2.6 million for 1996.

Interest expense, net. Interest expense, net for 1997 decreased to \$8.5 million from \$13.4 million for 1996. The decrease of \$4.9 million in interest expense was primarily due to higher average cash balances resulting from improved working capital management. We did not have any short-term borrowings in 1996 or 1997 and long-term debt remained fairly consistent each year.

Other. Other expense was \$2.0 million for 1997 and \$(0.9) million for 1996. Other expense is primarily comprised of currency exchange gains or losses.

Minority interest. Minority interest in subsidiaries' net loss of \$(0.7) million in 1997 represents the minority interest in Ets. Brancher.

Provision (benefit) for income taxes. The effective tax rates for the 1997 benefit and the 1996 provision were 25.5% and 37.9%, respectively. The effective tax rates differ from the federal statutory rate of 35% primarily due to state income taxes and valuation reserves provided for foreign operating losses.

Net income (loss). There was a net loss of \$(33.6) million for the year ended December 31, 1997 compared to net income of \$54.7 million for the year ended December 31, 1996. If the non-recurring charge relating to the Pulse inspection program and the consolidation of Ets. Brancher are excluded, net income would have been \$55.2 million for 1997, representing 3.9% of net sales, compared to 4.0% of net sales for 1996.

#### LIQUIDITY AND CAPITAL RESOURCES

We have historically financed our operations and capital requirements from internally generated funds and, to a lesser extent, borrowings from external sources. Our capital requirements have related principally to acquisitions, the expansion of our production capacity and increased working capital needs that have accompanied sales growth.

Net cash provided by operating activities totaled \$158.8 million, \$58.5 million and \$5.0 million for 1996, 1997 and 1998, respectively. The reduction in cash provided by operating activities is primarily due to the Pulse inspection program as we spent \$26.6 million and \$86.1 million on this program in 1997 and 1998, respectively. In addition, we had unusually strong sales of our "Lennox" brand of North American air conditioning products late in 1997 and accordingly accounts receivable in December 1997 were higher than normal. Net cash used in operating activities was \$49.1 million for the six months ended June 30, 1999 compared to \$64.5 million for the six months ended June 30, 1998. The decrease in cash used in operating activities is primarily due to an increase in net income and a decrease in payments related to the Pulse inspection program. Net cash used in investing activities totaled \$37.1 million, \$44.6 million, \$212.4 million, \$22.4 million and \$165.8 million for 1996, 1997 and 1998 and the six months ended June 30, 1998 and 1999, respectively. The greater use of cash for investing relates primarily to increased acquisition activity as we spent \$14.3 million, \$160.5 million, \$1.4 million and \$128.3 million for acquisitions in 1997 and 1998 and the six months ended June 30, 1998 and 1999, respectively. Net cash provided by (used in) financing activities was (\$44.0) million, (\$17.3) million, \$89.5 million, \$73.6 million and \$221.7 million for 1996, 1997 and 1998 and

the six months ended June 30, 1998 and 1999, respectively. In 1998, we issued \$75.0 million principal amount of notes and increased short term borrowings by \$36.7 million. In the first half of 1999, we increased short-term borrowings by \$188.0 million primarily to fund acquisitions. Due to the seasonality of the air conditioning and refrigeration businesses, we typically use cash in the first six months and generate cash during the latter half of the year. Accordingly, we do not believe it is appropriate to compare interim periods to the full fiscal year. Our internally generated cash flow, along with borrowings under our revolving credit facility, have been sufficient to cover our working capital, capital expenditure and debt service requirements over the last three years.

In the past, we have used a combination of internally generated funds, external borrowings and our stock to make acquisitions. We intend to acquire additional heating and air conditioning dealers in the U.S. and Canada. We plan to finance these acquisitions with a combination of cash, including a portion of the net proceeds of this offering, stock and debt. As of August 26, 1999, we had acquired 55 dealers in Canada and eight in the U.S. for an aggregate purchase price of approximately \$114 million and had signed letters of intent to acquire six additional Canadian dealers and 19 U.S. dealers for an aggregate purchase price of approximately \$74 million.

On August 3, 1999, we completed the initial public offering of our common stock. We sold 8,088,490 shares of our common stock and certain selling stockholders sold 411,510 shares at an initial price to the public of \$18.75 per share. We estimate that our net proceeds from the offering were \$140.3 million, after deducting estimated expenses and underwriting discounts and commissions. All of the proceeds from the offering were used to repay a portion of the borrowings under our former revolving credit facility and a term credit facility which terminated upon completion of the offering.

We have agreed to purchase on March 31, 2000 the remaining 30% interest in Ets. Brancher not owned by us for approximately \$17 million. In June 1999, we acquired James N. Kirby Pty. Ltd. for approximately \$65 million. In addition, we assumed approximately \$28 million of Kirby's debt. The purchase price consisted of approximately \$16 million in cash, \$33 million in deferred payments and 650,430 shares of common stock. The \$33 million in deferred payments will be made in installments of approximately \$11 million per year over the next three years. If our common stock does not trade at a price greater than \$29.09 per share for five consecutive days from the period from June 2000 to June 2001, then we are obligated to pay the former owners of Kirby the difference between the trading price for the last five days of this period and \$29.09 for 577,500 of the shares of common stock.

Our capital expenditures were \$31.9 million, \$34.6 million, \$52.4 million and \$37.9 million for 1996, 1997 and 1998 and the six months ended June 30, 1999, respectively. We have budgeted approximately \$42 million for capital expenditures for the remainder of 1999. These expenditures primarily relate to production equipment (including tooling), training facilities, leasehold improvements and information systems. The majority of these planned capital expenditures are discretionary. We plan to finance these capital expenditures using cash flow from operations and available borrowings under our revolving credit facility.

At June 30, 1999, we had long-term debt obligations outstanding of \$331.1 million. The majority of the long-term debt consists of six issues of notes with an aggregate principal amount of \$240.6 million, interest rates ranging from 6.56% to 9.69% and maturities ranging from 2001 to 2008. The notes contain restrictive covenants, including financial maintenance covenants and covenants that place limitations on our ability to incur additional indebtedness, encumber our assets, sell our assets or pay dividends. The ratio of total funded debt to earnings before interest, taxes, depreciation and amortization, hereinafter referred to as "EBITDA," cannot exceed 3.0 based upon a rolling four quarter basis. The ratio of EBITDA less capital expenditures to interest expense should be greater than 3.0 based on a rolling four quarter basis. Our ability to incur debt is limited to 60.0% of our consolidated capitalization. As of June 30, 1999, our consolidated indebtedness as a percent of consolidated capitalization was 52.7% as defined in the note agreements. Generally, the aggregate sale of assets outside the ordinary course of business cannot exceed 15% of our consolidated assets during any fiscal year and all transfers after January 1, 1998 cannot exceed 30% of our consolidated assets. In addition, in order to pay dividends or make a sale of assets outside the ordinary course of business, we must be able to incur \$1.00 of additional indebtedness. In addition, we are required to maintain a consolidated net worth equal

to \$261.0 million plus 15% of our consolidated quarterly net income beginning April 1, 1998. At June 30, 1999, the required consolidated net worth was \$274.0 million and we had a consolidated net worth of \$422.4 million. Upon a change of control, we must make an offer to repurchase the notes at a price equal to 100% of the principal amount of the notes, plus accrued and unpaid interest. Our debt service requirements (including principal and interest payments) for our current outstanding long-term debt are \$39.3 million for all of 1999. As of December 31, 1998, we had approximate minimum commitments on all non-cancelable operating leases of \$22 million and \$19 million in 1999 and 2000, respectively.

We have a \$300 million revolving credit facility with a syndicate of banks led by Chase Bank of Texas, National Association, as administrative agent, Wachovia Bank, N.A., as syndication agent, and The Bank of Nova Scotia, as documentation agent. The credit facility has restrictive covenants and maintenance tests identical to those in the notes. Borrowings under this new credit facility bear interest, at our option, at a rate equal to either (a) the greater of the administrative agent's prime rate or the federal funds rate plus 0.5% or (b) the London Interbank Offered Rate plus a margin equal to 0.5% to 1.125%, depending upon our ratio of total funded debt to EBITDA. We pay a commitment fee equal to 0.15% to 0.30% of the unused commitment, depending upon the ratio of total funded debt to EBITDA. This credit facility has a term of five years.

We are currently negotiating an agreement with The Prudential Insurance Company of America or its affiliates which, if entered into, will allow us to borrow up to \$100 million in the form of senior notes from time to time within the first three years of the agreement. We expect that the minimum amount of notes that we could draw at any one time would be \$10 million and that the maturity and interest rate would be selected from alternatives provided by Prudential at the time the notes are issued, up to a maximum maturity of 15 years. We expect that this agreement will have customary covenants and that they will be substantially similar to those contained in our outstanding series of notes.

We believe that cash flow from operations, as well as available borrowings under our revolving credit facility, will be sufficient to fund our operations for the foreseeable future. We may pursue additional debt or equity financing in connection with acquisitions.

#### QUARTERLY RESULTS OF OPERATIONS

The following table presents certain of our quarterly information for the years ended December 31, 1997 and 1998 and the six months ended June 30, 1999. Such information is derived from our unaudited financial statements and, in the opinion of our management, includes all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of such information. Operating results for any given quarter are not necessarily indicative of results for any future period and should not be relied upon as an indicator of future performance. Beginning with the fourth quarter of 1997, our results of operations reflect the consolidation of Ets. Brancher.

	QUARTER ENDED									
	1997				1998				1999	
	MAR. 31	JUNE 30	SEPT. 30	DEC. 31	MAR. 31	JUNE 30	SEPT. 30	DEC. 31	MAR. 31	JUNE 30
	(IN MILLIONS)									
Net sales.....	\$307.1	\$365.4	\$381.9	\$390.0	\$379.6	\$456.0	\$529.2	\$457.0	\$489.0	\$591.8
Cost of goods sold.....	211.6	252.0	265.2	277.1	261.8	309.0	359.6	315.2	337.5	405.5
Gross profit.....	95.5	113.4	116.7	112.9	117.8	147.0	169.6	141.8	151.5	186.3
Selling, general and administrative expenses.....	76.1	79.8	80.1	90.3	97.3	108.4	125.7	129.8	129.3	138.5
Other operating expense, net.....	3.0	0.5	0.9	3.0	2.6	4.6	(1.1)	2.3	2.5	0.9
Product inspection charge.....	--	--	--	140.0	--	--	--	--	--	--
Income (loss) from operations.....	16.4	33.1	35.7	(120.4)	17.9	34.0	45.0	9.7	19.7	46.9
Net income (loss).....	\$ 7.9	\$ 17.6	\$ 18.5	\$(77.6)	\$ 8.3	\$ 17.2	\$ 24.5	\$ 2.5	\$ 6.6	\$ 23.6

The following table sets forth, as a percentage of net sales, statement of income data by quarter for the years ended December 31, 1997 and 1998 and the six months ended June 30, 1999.

	QUARTER ENDED									
	1997				1998				1999	
	MAR. 31	JUNE 30	SEPT. 30	DEC. 31	MAR. 31	JUNE 30	SEPT. 30	DEC. 31	MAR. 31	JUNE 30
Net sales.....	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of goods sold.....	68.9	69.0	69.4	71.1	69.0	67.8	68.0	69.0	69.0	68.5
Gross profit.....	31.1	31.0	30.6	28.9	31.0	32.2	32.0	31.0	31.0	31.5
Selling, general and administrative expenses.....	24.8	21.8	21.0	23.1	25.6	23.8	23.7	28.4	26.5	23.4
Other operating expense, net.....	1.0	0.2	0.2	0.8	0.7	1.0	(0.2)	0.5	0.5	0.2
Product inspection charge.....	--	--	--	35.9	--	--	--	--	--	--
Income (loss) from operations.....	5.3	9.0	9.4	(30.9)	4.7	7.4	8.5	2.1	4.0	7.9
Net income (loss).....	2.6%	4.8%	4.8%	(19.9)%	2.2%	3.8%	4.6%	0.5%	1.4%	4.0%

Our quarterly operating results have varied significantly and are likely to vary significantly in the future. Demand for our products is seasonal and dependent on the weather. In addition, a majority of our revenue is derived from products whose sales peak in the summer months. Consequently, we often experience lower sales levels in the first and fourth quarters of each year. Because a high percentage of our overhead and operating expenses are relatively fixed throughout the year, operating earnings and net earnings tend to be lower in quarters with lower sales.

#### MARKET RISK

The estimated fair values of our financial instruments approximate their respective carrying amounts at June 30, 1999, except as follows (in thousands):

	CARRYING AMOUNT	FAIR VALUE	
		AMOUNT	INTEREST RATE
9.69% promissory notes.....	\$24,600	\$26,400	6.75%
9.53% promissory notes.....	21,000	21,700	6.75

The fair values presented above are based on the amount of future cash flows associated with each instrument, discounted using our current borrowing rate for similar debt instruments of comparable maturity. The fair values are estimates as of June 30, 1999, and are not necessarily indicative of amounts for which we could settle currently or indicative of the intent or ability of us to dispose of or liquidate such instruments.

Our results of operations can be affected by changes in exchange rates. Net sales and expenses in currencies other than the U.S. dollar are translated into U.S. dollars for financial reporting purposes based on the average exchange rate for the period. During 1996, 1997 and 1998 and the six months ended June 30, 1998 and 1999, net sales from outside the U.S. represented 8.2%, 11.7%, 19.2%, 18.4% and 23.6%, respectively, of total net sales. Historically, foreign currency transaction gains (losses) have not had a material effect on our operations.

We have entered into foreign currency exchange contracts to hedge our investment in Ets. Brancher. We do not engage in currency speculation. These contracts do not subject us to risk from exchange rate movements because the gains or losses on the contracts offset the losses or gains, respectively, on the assets and liabilities of Ets. Brancher. As of June 30, 1999, we had entered into foreign currency exchange contracts with a nominal value of 165.5 million French francs (approximately \$26.1 million). These contracts require us to exchange French francs for U.S. dollars at maturity, which is in May 2003, at rates agreed to at inception of the contracts. If the counterparties to the exchange contracts do not fulfill their obligations to deliver the contracted currencies, we could be at risk for any currency related fluctuations.

From time to time we enter into foreign currency exchange contracts to hedge receivables from our foreign subsidiaries. These contracts do not subject us to risk from exchange rate movements because the gains or losses on the contracts offset losses or gains, respectively, on the receivables being hedged. As of



June 30, 1999, we had obligations to deliver the equivalent of \$114.4 million of various foreign currencies at various dates through July 31, 2000, for which the counterparties to the contracts will pay fixed contract amounts.

We have contracts with various suppliers to purchase copper and aluminum for use in our manufacturing processes. As of June 30, 1999, we had contracts to purchase 22.7 million pounds of copper over the next 18 months at fixed prices that average \$0.7264 per pound (\$16.5 million) and contracts to purchase six million pounds of copper at a variable price equal to the COMEX copper price (\$0.69 per pound at June 30, 1999) over the next 12 months. We also had contracts to purchase 20.1 million pounds of aluminum at \$0.654 per pound (\$13.1 million) over the next 12 months. The fair value of the copper and aluminum purchase commitments was a liability of \$0.8 million at June 30, 1999.

#### INFLATION

Historically, inflation has not had a material effect on our results of operations.

#### YEAR 2000 COMPLIANCE

The Year 2000 issue concerns the ability of information technology and non-information technology systems and processes to properly recognize and process date-sensitive information before, during and after December 31, 1999. We have a variety of computer software program applications, computer hardware equipment and other equipment with embedded electronic circuits, including applications used in our financial business systems, manufacturing processes and administrative functions, which are collectively referred to as the "systems". We expect that our systems will be ready for the Year 2000 transition.

In order to identify and resolve Year 2000 issues affecting us, we established a Year 2000 compliance program. The Year 2000 compliance program is administered by a task force, consisting of members of senior management as well as personnel from our accounting, internal audit and legal departments, which has oversight of the information systems managers and other administrative personnel charged with implementing our Year 2000 compliance program. The task force has established a specific compliance team for Lennox Corporate and for each of our operating locations.

In 1994 we began the replacement of all core business systems for our domestic subsidiaries. The purpose of this replacement was to upgrade systems architecture and functionality, improve business integration and implement process improvements. SAP was selected as the enterprise resource for planning ("ERP") system to replace mission critical software and hardware for Lennox Industries, Heatcraft's Heat Transfer and Refrigeration Products Divisions and the Lennox Corporate operations. Fourth Shift was selected as the ERP system for the Electrical Products Division of Heatcraft and is also being implemented for various subsidiaries of Lennox Global. A new version of ROI Manage 2000 was implemented for Armstrong. As of December 31, 1998, all replacements were complete except for the Heat Transfer Division of Heatcraft, which is scheduled to be complete by September 30, 1999, and upgrades for some subsidiaries of Lennox Global.

SAP, Fourth Shift and ROI Manage 2000 have certified that these systems are Year 2000 compliant. Hardware, operating systems and databases installed to support these systems are either compliant or have Year 2000 vendor supplied updates to be applied in 1999. Other smaller applications integrated with SAP have been replaced or upgraded with Year 2000 compliant software.

The implementations of SAP, Fourth Shift and ROI Manage 2000 and the related hardware, operating systems and databases comprise the systems that are most critical to our operations, which are referred to as "critical systems," and address the areas of our business which would have otherwise been significantly affected by the Year 2000. As of July 1, 1999, we were approximately 85% complete with the implementation of the Year 2000 compliance program for all critical systems, and we expect to be 100% complete by September 30, 1999.

Our Year 2000 Program also addresses compliance in areas in addition to critical systems, including: voice and data networks, desktop computers, peripherals, EDI, contracted or purchased departmental software, computer controlled production equipment, test stations, building security, transport and heating and air conditioning systems, service providers, key customers and suppliers and Lennox manufactured and

purchased products. As of July 1, 1999, we were more than 60% complete with the implementation of the Year 2000 compliance program for all such areas, and we expect to be 100% complete by September 30, 1999.

We have initiated communications with significant suppliers, customers and other third parties to identify and assess Year 2000 risks and by September 1999 expect to have developed solutions that will minimize the impact on us. Lennox Industries distributed surveys to approximately 200 of its major suppliers in January 1999 and over half of these suppliers have responded. All of these respondents stated that they are either compliant or are planning to be compliant. In April 1999, a follow-up survey was sent to the suppliers who had not yet responded. We expect to resolve any identified problems with critical or non-responding suppliers or to develop contingency plans where needed. We depend on third-party trucking companies to deliver finished products from our factories to our customers. None of Lennox Industries' trucking contractors is individually critical to our business. About 125 different trucking companies handle 95% of Lennox Industries' distribution. We have communicated with approximately 50 of the largest trucking contractors and received assurances that they will not have service disruptions due to the Year 2000. Our manufacturing facilities are highly dependent on public utilities, especially electrical power, natural gas, water and communications companies. If third party providers, due to the Year 2000 issue, fail to provide us with components or materials which are necessary to manufacture our products, with sufficient electrical power and other utilities to sustain our manufacturing process, or with adequate and reliable means of transporting our products to our customers, and we have not developed adequate contingency plans, then there could be an adverse effect on our results of operations at any facility affected by these problems. Currently, we are not aware of any of our significant third party providers or customers that are not or will not be Year 2000 compliant.

We believe that our most reasonably likely worst case scenario is some short-term, localized disruptions of systems, transportation or suppliers that will affect an individual business operation, rather than broad-based and long-term problems that affect operating segments or our operations as a whole. For the most part, our manufacturing processes are not affected by Year 2000 issues. The most significant uncertainties relate to critical suppliers, particularly electrical power, water, natural gas and communications companies, and suppliers of parts that are vital to the continuity of our operations. Where possible, contingency plans are being formulated and put into place for all critical suppliers. These plans include developing the necessary safety stock levels for single source items. These contingency plans should be completed by October 1999.

Our estimated cost to become Year 2000 compliant is approximately \$7.5 million, of which we have already spent approximately \$3.4 million. All of these expenses will reduce our net income. Of the \$7.5 million in total costs, approximately \$5.1 million relates to application software, including consulting and training relating to the software, of which approximately \$2.8 million has been spent to date. The remaining \$2.3 million in total estimated costs relates to infrastructure and hardware, of which approximately \$0.7 million has been spent and the remaining \$1.6 million is expected to be expensed over a three-year period. The costs of application and infrastructure changes made for reasons other than the Year 2000 and which were not accelerated are not included in these estimates. We have not deferred any significant information technology projects because of our response to Year 2000 issues. All Year 2000 costs are being funded from our operating cash flows. These costs are generally not incremental to existing information technology budgets.

The total costs, anticipated impact and the expected dates to complete the various phases of the project are based on our best estimates using assumptions about future events. However, no assurance can be given that actual results will be consistent with such estimates and, therefore, actual costs, completion dates and impact may differ materially from the plans. See "Special Note Regarding Forward-Looking Statements."

#### RECENT ACCOUNTING PRONOUNCEMENTS

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities." This statement establishes accounting and reporting standards for derivative instruments, including certain derivatives embedded in other contracts (collectively referred to as derivatives) and for hedging activities. This statement is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. We do not believe that the adoption of this pronouncement will have a significant impact on our financial statements.

## BUSINESS

We are a leading global provider of climate control solutions. We design, manufacture and market a broad range of products for the HVACR markets. Our products are sold under well-established brand names including "Lennox", "Armstrong Air", "Bohn", "Larkin", "Heatcraft" and others. We are also one of the largest manufacturers in North America of heat transfer products, such as evaporator coils and condenser coils. We have leveraged our expertise in heat transfer technology, which is critical to the efficient operation of any heating or cooling system, to become an industry leader known for our product innovation and the quality and reliability of our products. As a result of recent acquisitions, we have also become a leader in the growing market for hearth products, which includes pre-fabricated fireplaces and related products. Historically, we have sold our "Lennox" brand of residential heating and air conditioning products directly to a network of installing dealers, which currently numbers approximately 6,000, making us the largest wholesale distributor of these products in North America. In September 1998, we initiated a program to acquire dealers in metropolitan areas in the U.S. and Canada so that we can provide heating and air conditioning products and services directly to consumers.

Our furnaces, heat pumps, air conditioners, pre-fabricated fireplaces and related products are available in a variety of designs, efficiency levels and price points that provide an extensive line of comfort systems. A majority of our sales of residential heating and air conditioning products in the U.S. and Canada are to the repair and replacement market, which is less cyclical than the new construction market. We also provide a range of air conditioning products for commercial market applications such as mid-size office buildings, restaurants, churches and schools. Our commercial refrigeration products are used primarily in cold storage applications for food preservation in supermarkets, convenience stores, restaurants, warehouses and distribution centers. Our heat transfer products are used by us in our HVACR products and sold to third parties.

Shown below are our four business segments, the key products and brand names within each segment and 1998 net sales by segment. The North American residential segment also includes installation, maintenance and repair services performed by Lennox-owned dealers. See our audited financial statements included elsewhere in this prospectus for more information on our segments.

SEGMENT -----	PRODUCTS -----	BRAND NAMES -----	1998 NET SALES ----- (IN MILLIONS)
North American residential	Furnaces, heat pumps, air conditioners, packaged heating and cooling systems and related products; pre-fabricated fireplaces, free standing stoves, fireplace inserts and accessories	Lennox, Armstrong Air, Air-Ease, Concord, Magic-Pak, Advanced Distributor Products, Superior, Marco, Whitfield and Security Chimneys	\$1,013.7
Commercial air conditioning	Unitary air conditioning and applied systems	Lennox, Alcair and Janka	392.1
Commercial refrigeration	Chillers, condensing units, unit coolers, fluid coolers, air cooled condensers and air handlers	Bohn, Friga-Bohn, Larkin, Climate Control and Chandler Refrigeration	237.3
Heat transfer	Evaporator and condenser coils and equipment and tooling to manufacture coils	Heatcraft and Friga-Bohn	178.7
		Total.....	----- \$1,821.8 =====

We market and distribute our products using multiple brand names through multiple distribution channels to penetrate different segments of the HVACR market. Our "Lennox" brand of residential heating and air conditioning products is sold directly through installing dealers -- the "one-step" distribution system -- which has created strong and long-term relationships with dealers in North America. Our "Armstrong Air," "Air-Ease," "Concord" and "Magic-Pak" residential heating and air conditioning brands are sold to regional distributors that in turn sell the products to installing contractors -- the "two-step" distribution system typically utilized in the heating and air conditioning industry. The acquisition of heating and air conditioning dealers in the U.S. and Canada allows us to participate in the retail sale and service of

heating and air conditioning products. Our hearth products, commercial air conditioning products and refrigeration products are also sold under multiple brand names and through a combination of wholesalers, contractors, original equipment manufacturers, manufacturers' representatives and national accounts.

From our beginning in 1895 until the mid-1980's, we focused primarily on the North American residential heating and air conditioning market. In the 1980's, we expanded our product offerings by acquiring several heat transfer and commercial refrigeration businesses. In the mid-1990's, we increased our international presence, product offerings and brand portfolio through acquisitions in Europe, Latin America and the Asia Pacific region. The most significant international acquisition was the purchase in 1996 of a 50% interest in two operating subsidiaries of Ets. Brancher for approximately \$22.0 million, which significantly expanded our geographic presence and provided us with an entry into the commercial air conditioning and refrigeration markets in Europe. In 1997, we increased our ownership interest in Ets. Brancher to 70% for an additional \$18.4 million. In September 1998, we acquired a majority interest in McQuay do Brasil S.A., a Brazilian company which participates in the commercial refrigeration and heat transfer markets in Brazil and surrounding countries, for \$20.5 million. We recently expanded our product offerings to include hearth products through the acquisitions of Superior Fireplace Company, Marco Mfg., Inc. and Pyro Industries, Inc. in the third quarter of 1998 and Security Chimneys International, Ltd. in the first quarter of 1999 for an aggregate purchase price of approximately \$120 million. As a result of these acquisitions, we are one of the largest manufacturers of hearth products in the U.S. and Canada, offering a broad line of products through a variety of distribution channels. In the fourth quarter of 1998, we acquired the assets of Lovelock Luke Pty. Limited, a distributor of refrigeration and related equipment in Australia and New Zealand, for approximately \$7 million. In May 1999, we acquired Livernois Engineering Holding Company and related patents for approximately \$19 million. Livernois produces heat transfer manufacturing equipment for the HVACR and automotive industries. In May 1999, we entered into a letter of intent to acquire essentially all of the assets of the air conditioning and heating division of The Ducane Company, based in South Carolina, for approximately \$45 million. This acquisition, if completed, will give us additional capacity to manufacture heating and air conditioning products. We acquired James N. Kirby Pty. Ltd., an Australian company that participates in the commercial refrigeration and heat transfer markets in Australia, in June 1999 for approximately \$65 million.

We were founded in 1895 in Marshalltown, Iowa when Dave Lennox, who owned a machine repair business for the railroads, successfully developed and patented a riveted steel coal-fired furnace which was substantially more durable than the cast iron furnaces used at the time. By 1904, the manufacture of these furnaces had grown into a significant business and was diverting the Lennox Machine Shop from its core business. As a result, in 1904, a group of investors headed by D.W. Norris bought the furnace business and named it the Lennox Furnace Company. Over the years, D.W. Norris ensured that ownership of Lennox was distributed to all generations of his family. Today, Lennox's ownership is broadly distributed among approximately 110 descendants of or persons otherwise related to D.W. Norris.

## INDUSTRY OVERVIEW

### NORTH AMERICAN RESIDENTIAL

Residential Heating and Air Conditioning. The residential market in the U.S. and Canada is divided into two basic categories: furnaces and air conditioning systems. Air conditioning is further divided into two basic categories: residential split systems and heat pumps and window and room air conditioners. We do not participate in the window and room air conditioner category. Split system air conditioners are comprised of a condensing unit, normally located outside of the household, and an evaporator unit, which is typically positioned indoors to use the blower mechanism of a furnace or fan coil unit in the case of a heat pump.

In recent decades the functions performed by the products of this market have become increasingly important to modern life. The advent of modern, high efficiency air conditioning was one of the significant factors contributing to the growth of large metropolitan areas in parts of the southern U.S. According to a report published by the U.S. Department of Housing and Urban Development for 1995, 98% of all new houses constructed in the southern region of the U.S. and 80% of all new houses in the U.S. included central air conditioning. According to the U.S. Census Bureau, manufacturers' sales for all residential air conditioners

and warm air furnaces produced in 1997 for the U.S. market were approximately \$5.5 billion, reflecting a compound annual growth rate of approximately 7.2% from 1993 to 1997. We estimate that manufacturers' sales in Canada were approximately \$200 million in 1997.

Services in the residential market in North America consist of the installation, replacement, maintenance and repair of heating and air conditioning systems at existing residences and the installation of heating and air conditioning systems at newly constructed homes. This market is served by small, owner-operated businesses operating in a single geographic area and dealers owned by consolidators, utility companies and others, some of whom may operate under a uniform trade name and in multiple geographic locations. The retail sales and service market in the U.S. is comprised of over 30,000 dealers.

The principal factors affecting market growth in the North American residential market are new home construction, the weather and economic conditions, especially consumer confidence. Residential heating and air conditioning products are sold for both the replacement and new construction markets. The residential new construction market has historically been a more price sensitive market because many homebuilders focus on initial price rather than operating efficiency or ongoing service costs.

Hearth Products. The main components of the hearth products market are pre-fabricated gas fireplaces and inserts, pre-fabricated wood burning fireplaces and inserts, pellet stoves, gas logs, and accessories and miscellaneous items. We participate in all major aspects of the hearth products market. According to the Hearth Products Association, an industry trade group, there were 2.3 million unit sales in 1998, including all gas and wood burning appliances, and this market is expected to grow at 7.5% per year through 2000. The addition of a fireplace is considered one of the best return on investment decisions that a homeowner can make. Hearth products are distributed and sold through many channels, ranging from contractors to specialty retailers.

#### COMMERCIAL AIR CONDITIONING

The global commercial air conditioning market is divided into two basic categories: unitary air conditioners and applied systems. We primarily participate in the unitary air conditioning market in North America and in both the unitary and applied systems markets in Europe. Unitary products consist of modular split systems and packaged products with up to 30 tons of cooling capacity. One ton of cooling capacity is equivalent to 12,000 BTUs and is generally adequate to air condition approximately 500 square feet of space. Packaged units are self-contained heating and cooling or cooling only units that typically fit on top of a low rise commercial building such as a shopping center or a restaurant. Applied systems are typically larger engineered systems, which are designed to operate in multi-story buildings and include air cooled and water cooled chillers, air handling units and equipment to monitor and control the entire system.

According to the Air-Conditioning & Refrigeration Institute, an industry trade group, global manufacturers' sales for all commercial air conditioning systems produced in 1994 (the latest available data) were approximately \$14 billion. The principal factors affecting growth in this market are new construction, economic conditions and environmental regulation of refrigerants. Unlike residential heating and air conditioning systems, some commercial air conditioning systems use refrigerants that have been banned or that are currently being phased out, especially in Europe. We expect that such regulation will lead to increased growth in this market.

#### COMMERCIAL REFRIGERATION

The global refrigeration market is a highly diversified market, including everything from household refrigerators and walk-in coolers to large, ammonia based flash freezing plants and process cooling equipment. We define our served market as the design and manufacture of equipment used in cold storage, primarily for the preservation of perishable goods. Our served market includes condensing units, unit coolers, air cooled condensers, non-supermarket racks and packaged systems. According to the U.S. Census Bureau, our served market in the U.S. accounted for approximately \$510.9 million in revenues in 1997, reflecting a compound annual growth rate of approximately 5.3% from 1993 to 1997.

The principal factors affecting growth in the commercial refrigeration market are:

- new commercial construction activity, including construction of supermarkets, restaurants, convenience stores and distribution centers;
- replacement and retrofit activity in commercial buildings such as efficiency improvements and store design changes; and
- emergency replacement activity such as replacement of weather related product/component breakdowns and product maintenance.

#### HEAT TRANSFER

The heat transfer surface or coil is a fundamental technology employed in the heating and cooling cycles for HVACR products. The global heat transfer surface market is comprised not only of the traditional HVACR applications such as furnaces, air conditioners and unit coolers, but also numerous other applications such as ice machines, refrigerated trucks, farm equipment and off-road vehicles, recreational vehicles, computer room air conditioners and process cooling equipment used with sophisticated laser cutting machines. We produce heat transfer surfaces not only for traditional HVACR applications, but also for many of these other applications. Many HVACR manufacturers produce standard coils for their own use and generally do not sell coils to third parties. Coils are also designed and produced by independent coil manufacturers and sold to original equipment manufacturers for use in their products. Coils are typically designed, developed and sold by engineers who work with customers to produce a coil that will meet the customer's precise specifications. Factors affecting a coil purchaser's decision are quality, delivery time, engineering and design capability, and price.

Since heat transfer products are a fundamental part of HVACR products, the heat transfer market is driven by the same economic factors that affect the HVACR markets generally. Because of the fragmented nature of this market and the fact that coils are often produced internally by HVACR manufacturers, it is difficult to gauge the size of the worldwide served heat transfer market. According to the U.S. Census Bureau, the served market in the U.S. (i.e., third party sales) accounted for approximately \$528.1 million in revenues in 1997, reflecting a compound annual growth rate of approximately 6.2% from 1993 to 1997.

#### COMPETITIVE STRENGTHS

We have a combination of strengths that position us to continue to be a leading provider of climate control solutions including:

##### STRONG BRAND RECOGNITION AND REPUTATION

We believe that our well known brand names and reputation for quality products and services position us to compete successfully in our existing markets and to continue to expand internationally. Our studies indicate that our "Lennox" brand is the most widely recognized brand name in the North American residential heating and air conditioning markets. Furthermore, in a recent survey of home builders, the "Lennox" brand received the highest overall rating in terms of product quality for furnaces and unitary air conditioners. We market our other HVACR and hearth products under the well known brand names of "Armstrong Air", "Bohn", "Larkin" and "Superior", among others.

##### BREADTH OF DISTRIBUTION

We market and distribute our products using multiple brand names through multiple distribution channels to penetrate different segments of the HVACR market. We sell our heating and air conditioning products through independent and Lennox-owned installing dealers, as well as through regional distributors. Our hearth products, commercial air conditioning and refrigeration products are also sold under multiple brand names and through a combination of wholesalers, installing contractors, manufacturers' representatives, original equipment manufacturers, national accounts and specialty retailers. We believe that sales growth is

driven, in part, by the level of exposure to our customers and our distribution strategy is designed to maximize this exposure.

#### PROVEN HEAT TRANSFER EXPERTISE

Heat transfer surfaces, which include evaporator and condenser coils, are critical to the operation of most HVACR products. For a given application, a variety of factors must be evaluated, such as the size of the HVACR unit and desired energy efficiency, while considering such additional elements as manufacturing ease. Since our acquisition of the Heatcraft business in 1986, we have devoted significant resources to the development of heat transfer surfaces. We use computer-aided design and other advanced software to improve the efficiency of designs and simulate and evaluate the movement of refrigerants even before a prototype is built. Since we also produce coils for sale to third parties, we are able to spread our research and development costs over third party purchases of heat transfer products as well as sales of our own HVACR products. We acquired Livernois Engineering Holding Company and related patents in May 1999 which provides us with access to additional heat transfer technology. Livernois produces heat transfer manufacturing equipment for the HVACR and automotive industries.

#### COMMITMENT TO PRODUCT INNOVATION AND TECHNOLOGICAL LEADERSHIP

Throughout our history, we have dedicated substantial resources to research and development and product innovation. We pioneered the introduction of the forced air furnace in 1935, which resulted in new approaches to home design for more efficient heating. Other examples of our product innovation include:

- the multi-zone rooftop air conditioner in 1965;
- the two-speed condensing unit for more efficient air conditioning in 1973;
- the high efficiency gas furnace in 1982;
- the first commercially available high efficiency combination hot water heater and furnace in 1994; and
- "Floating Tube" and "Thermoflex" technologies, which significantly reduce leaks in air cooled condensers and unit coolers, in 1995.

We have invested approximately \$127 million over the last five years on research and development activities, and we intend to continue to invest in these activities to create innovative and technologically superior products.

#### DEMONSTRATED MANUFACTURING EFFICIENCY

Over the last several years, we have implemented advanced manufacturing techniques and created programs to incentivize our employees to reduce production cycle lead times to a week in many of our manufacturing facilities, compared to lead times of 90 days or more before the introduction of such concepts. These programs have not only led to improvements in inventory turnover, but also reductions in controllable working capital, which we define as inventories plus trade accounts receivables less accounts payable. From January 1996 to December 1998, controllable working capital as a percent of sales has declined from 36.1% to 26.7%, a reduction of 9.4%. If controllable working capital management had not improved, we estimate that our investment in working capital would have been approximately \$170 million higher at December 31, 1998, which is based on the 9.4% improvement multiplied by 1998 net sales.

## GROWTH STRATEGY

Our growth strategy is designed to capitalize on our competitive strengths in order to expand our market share and profitability in the worldwide HVACR markets. We will continue to pursue internal programs and strategic acquisitions that broaden our product and service offerings, expand our market opportunities and enhance our technological expertise. We continually review acquisition candidates but do not have any agreements or commitments with respect to any significant acquisitions except for the acquisition of The Ducane Company and North American heating and air conditioning dealers. The key elements of this strategy include:

## EXPAND MARKET IN NORTH AMERICA

Our program to acquire heating and air conditioning dealers in the U.S. and Canada represents a new direction for the heating and air conditioning industry because, to our knowledge, no other major manufacturer has made a significant investment in retail distribution. This strategy will enable us to extend our distribution directly to the consumer, thereby permitting us to participate in the revenues and margins available at the retail level while strengthening and protecting our brand equity. We believe that the retail sales and service market represents a significant growth opportunity because this market is large and highly fragmented. The retail sales and service market in the U.S. is comprised of over 30,000 dealers. We started this program in September 1998, and as of August 26, 1999 we had acquired 55 dealers in Canada and eight in the U.S. for an aggregate purchase price of approximately \$114 million and had signed letters of intent to acquire six additional Canadian and 19 U.S. dealers for an aggregate purchase price of approximately \$74 million. We intend to start acquiring dealers in the U.S. by initially focusing on our existing "Lennox" dealers and will try to achieve a balance between residential new construction, residential replacement and light commercial activities. We believe our long history of direct relationships with our dealers through the one-step distribution system and the resulting knowledge of local markets will give us advantages in identifying and acquiring suitable candidates. We have assembled an experienced management team to administer the dealer operations, and we have developed a portfolio of training programs, management procedures and goods and services that we believe will enhance the quality, effectiveness and profitability of dealer operations.

In addition to our acquisition program, we have initiated a program to strengthen our independent dealer network by providing all dealers with a broad array of services and support. Participants in a newly-created associate dealer program will receive retirement and other benefits in exchange for agreeing that at least 75% of their residential heating and air conditioning purchases will be of our products and for granting us a right of first refusal to acquire their businesses. As of July 2, 1999, over 1,200 dealers in the U.S. and Canada had joined our associate dealer program. All independent dealers, including participants in the associate dealer program, will be provided with access to Lennox-sponsored volume purchasing programs with third parties for goods and services used in their businesses.

We also intend to increase our market share in North America by:

- selectively expanding our "Lennox" independent dealer network;
- promoting the cross-selling of our "Armstrong Air" and other residential heating and air conditioning brands to our existing network of "Lennox" dealers as a second line;
- promoting the cross-selling of our hearth products to our "Lennox" dealer base;
- expanding the geographic market for the "Armstrong Air" brand of residential heating and air conditioning products from its traditional presence in the Northeast and Central U.S. to the southern and western portions of the U.S.;
- exploiting the fragmented third-party evaporator coil market; and
- pursuing complementary acquisitions that expand our product offerings or geographic presence.



## EXPLOIT INTERNATIONAL OPPORTUNITIES

Worldwide demand for residential and commercial heating, air conditioning, refrigeration and heat transfer products is increasing. We believe that the increasing international demand for these products presents substantial opportunities, especially in emerging markets and particularly for heat transfer and refrigeration products. An example is the increasing use of refrigeration products to preserve perishables including food products in underdeveloped countries. Refrigeration products generally have the same design and applications globally. To take advantage of international opportunities, we have made substantial investments in manufacturing facilities in Europe, Latin America and Asia Pacific through acquisitions, including a 70% interest in Ets. Brancher. Our international sales have grown from \$112.0 million in 1996 to \$349.5 million in 1998. We will continue to focus on expanding our international operations through acquisitions and internal growth to take advantage of international growth opportunities. We are also investing additional resources in our international operations with the goal of achieving manufacturing and distribution efficiencies comparable to that of our North American operations.

## INCREASE PRESENCE IN HEARTH PRODUCTS MARKET

With our recent acquisitions of hearth products companies, we now manufacture and sell one of the broadest lines of hearth products in North America. We offer multiple brands of hearth products at a range of price points. We believe that this broad product line will allow us to compete successfully in the hearth products market since many distributors prefer to concentrate their product purchases with a limited number of suppliers. We believe that we can increase our penetration of this market by selling in the distribution channels we acquired and through our historical distribution channels. Many of our heating and air conditioning dealers have begun to expand their product offerings to include hearth products.

## CONTINUE PRODUCT INNOVATION

An important part of our growth strategy is to continue to invest in research and new product development. We have designated a number of our facilities as "centers for excellence" that are responsible for the research and development of core competencies vital to our success, such as combustion technology, vapor compression, heat transfer and low temperature refrigeration. Technological advances are disseminated from these "centers for excellence" to all of our operating divisions. Historically, our commitment to research and development has resulted in product innovations such as the first high efficiency gas furnace. More recently, we were the first to manufacture and market a complete combination high efficiency water heater and furnace, the CompleteHeat, and also developed an integrated electronic refrigeration control system, the Beacon control system.

## PRODUCTS

## NORTH AMERICAN RESIDENTIAL PRODUCTS AND SERVICES

Heating and Air Conditioning Products. We manufacture and market a broad range of furnaces, heat pumps, air conditioners, packaged heating and cooling systems and related products. These products are available in a variety of product designs and efficiency levels at a range of price points intended to provide a complete line of home comfort systems for both the residential replacement and new construction markets. We market these products through multiple brand names. In addition, we manufacture zoning controls, thermostats and a complete line of replacement parts. We believe that by maintaining a broad product line with multiple brand names, we can address different market segments and penetrate multiple distribution channels.

Our Advanced Distributor Products division builds evaporator coils, unit heaters and air handlers under the "ADP" brand as well as the "Lennox" and "Armstrong Air" brands. This division supplies us with components for our heating and air conditioning products and produces evaporator coils to be used in connection with competitors' heating and air conditioning products and as an alternative to such competitors' brand name components. We started this business in 1993 and have been able to achieve an approximate 20% share of this market for evaporator coils through the application of our technological and manufacturing skills.

Hearth Products. We believe we are the only North American HVACR manufacturer that also designs, manufactures and markets residential hearth products. Our hearth products include prefabricated gas and wood burning fireplaces, free standing pellet and gas stoves, fireplace inserts, gas logs and accessories. Many of the fireplaces are built with a blower or fan option and are efficient heat sources as well as attractive amenities to the home. Prior to the hearth products acquisitions, we offered a limited selection of hearth products in Canada and, to a lesser extent, in the U.S. We substantially expanded our offering of hearth products and distribution outlets with these acquisitions. We currently market our hearth products under the "Lennox", "Superior", "Marco", "Whitfield", and "Security Chimneys" brand names. We believe that our strong relationship with our dealers and our brand names will assist in selling into this market.

Retail Service. With our recently initiated program of acquiring dealers in the U.S. and Canada, we have begun to provide installation, maintenance, repair and replacement services for heating and air conditioning systems directly to both residential and light commercial customers. Installation services include the installation of heating and air conditioning systems in new construction and the replacement of existing systems. Other services include preventative maintenance, emergency repairs and the replacement of parts associated with heating and air conditioning systems. We also sell a wide range of mechanical and electrical equipment, parts and supplies in connection with these services.

#### COMMERCIAL AIR CONDITIONING

We manufacture and sell commercial air conditioning equipment in North America, Europe, Asia Pacific and South America.

North America. In the North American commercial markets, our air conditioning equipment is used in applications such as low rise office buildings, restaurants, retail and supermarket centers, churches and schools. Our product offerings for these applications include rooftop units which range from two to 30 tons of cooling capacity and split system/air handler combinations which range from two to 20 tons. In North America, we sell unitary equipment as opposed to larger applied systems. Our newest rooftop unit, the L Series, was introduced in 1995 and has been well received by the national accounts market where it is sold to restaurants, mass merchandisers and other retail outlets. We believe that this product's success is attributable to its efficiency, design flexibility, low life cycle cost, ease of service and advanced control technology.

International. We compete in the commercial air conditioning market in Europe through our ownership of 70% of Ets. Brancher and Ets. Brancher's operating subsidiaries, HCF S.A. and Friga-Bohn S.A. We have agreed to buy the remaining 30% interest in Ets. Brancher on March 31, 2000 for 102.5 million French francs, or approximately \$17 million. HCF manufactures and sells unitary products which range from two to 30 tons and applied systems which range up to 500 tons. HCF's products consist of chillers, air handlers, fan coils and large rooftop units and serve medium high-rise buildings, institutional applications and other field engineered applications. HCF manufactures its air conditioning products in several locations throughout Europe, including sites in the United Kingdom, France, Holland and Spain, and markets such products through various distribution channels in these countries and in Italy, Germany, Belgium and the Czech Republic.

We have been active in Australia for several years, primarily in the distribution of our residential and light commercial heating and air conditioning products manufactured in North America. In 1997, we acquired the assets of Alcair Industries, an Australian manufacturer of commercial heating and air conditioning products (packaged and split systems) ranging in size from two to 60 tons. This acquisition provided us with a manufacturing presence, doubled our revenues in Australia and added marketing, distribution and management strength to our operations in Australia.

Through our 50% owned Fairco joint venture in Argentina, we manufacture split system heating and air conditioning products and a limited range of L Series commercial air conditioning products for sale in Argentina, Chile and the surrounding Mercosur trading zone, which includes Brazil, Argentina, Bolivia, Paraguay and Uruguay.

## COMMERCIAL REFRIGERATION

North America. We are one of the leading manufacturers of commercial refrigeration products in North America. Our refrigeration products include chillers, condensing units, unit coolers, fluid coolers, air cooled condensers and air handlers. Our refrigeration products are sold for cold storage applications to preserve food and other perishables. These products are used by supermarkets, convenience stores, restaurants, warehouses and distribution centers. As part of our sale of commercial refrigeration products, we routinely provide application engineering for consulting engineers, contractors and others. Some of our larger commercial refrigeration projects have included the sale of custom designed systems for the Georgia Dome, Camden Yards, Ohio University, the Boston Museum of Fine Arts and Ericsson Stadium.

International. Friga-Bohn manufactures and markets refrigeration products through manufacturing facilities and joint ventures located in France, Italy and Spain. Friga-Bohn's refrigeration products include small chillers, unit coolers, air cooled condensers, fluid coolers and refrigeration racks. These products are sold to distributors, installing contractors and original equipment manufacturers.

We also own 50% of a joint venture in Mexico that produces unit coolers and condensing units of the same design and quality as those manufactured by us in the U.S. Since this venture produces a smaller range of products, the product line is complemented with imports from the U.S. which are sold through the joint venture's distribution network. Sales are made in Mexico to wholesalers, installing contractors and original equipment manufacturers. As production volumes increase, there exists the potential to export some of the high labor content products from the joint venture into North America and Latin America.

In the third quarter of 1998, we acquired an 84% interest in McQuay do Brasil S.A., a Brazilian company that manufactures condensing units and unit coolers. We believe this acquisition gives us the leading market share for commercial refrigeration products in Brazil.

In the fourth quarter of 1998, we acquired the assets of Lovelock Luke Pty. Limited, a distributor of refrigeration and related equipment in Australia and New Zealand. This acquisition gives us an established commercial refrigeration business in Australia and New Zealand.

In June 1999, we acquired James N. Kirby Pty. Ltd. for approximately \$65 million. Kirby is an Australian company that manufactures commercial refrigeration and heat transfer products in Australia and distributes commercial refrigeration equipment through its and Lovelock Luke's distribution network. Kirby also designs and manufactures precision machining stations primarily for the automobile industry. The Kirby acquisition provides a technological and manufacturing base for the growth of our commercial refrigeration and heat transfer business in the Asia Pacific region.

## HEAT TRANSFER

We are one of the largest manufacturers of heat transfer coils in the U.S., Europe, Mexico and Brazil. These products are used primarily by original equipment manufacturers of residential and commercial air conditioning products, transportation air conditioning and refrigeration systems, and commercial refrigeration products. A portion of our original equipment manufacturer coils are produced for use in our residential and commercial HVACR products. We also produce private label replacement coils for use in other manufacturers' HVACR equipment. We believe that the engineering expertise of our sales force provides us with an advantage in designing and applying these products for our customers. Advanced computer software enables us to predict with a high degree of accuracy the performance of complete air conditioning and refrigeration systems.

In addition to supplying the original equipment manufacturer market, we also produce replacement coils for large commercial air conditioning, heating and industrial processing systems. Many of these coils are specially designed for particular systems and in the event of a failure may need to be replaced quickly. We are the industry leader in this market and have designed our manufacturing processes and systems in North America so that we can deliver custom coils within 48 hours of receipt of an order. This premium service enables us to receive superior prices and generate attractive margins.

We also design and manufacture the equipment and tooling necessary to produce coils. We use such equipment and tooling in our manufacturing facilities and sell it to third parties. Typically, there is a long lead time between the initial order and receipt for this type of equipment and tooling from third parties. Since we have the ability to quickly produce the equipment and tooling necessary to manufacture heat transfer products and systems, we can accelerate the international growth of our heat transfer products segment. For example, we were able to design, manufacture and deliver the equipment necessary to produce evaporator and condenser coils for our joint venture in Mexico in what we estimate was half the time than would otherwise have been required to obtain the equipment from third parties. Upon completion of our acquisition of Livernois, we will also supply heat transfer manufacturing equipment to the automotive industry.

In addition to manufacturing heat transfer products in the North American market, we produce coils for the European market through a joint venture in the Czech Republic. Our joint venture in Mexico produces evaporator and condenser coils for use in that country and for export to the Caribbean and the U.S. Our Brazilian joint venture manufactures heat transfer coils that are sold to both HVACR manufacturers and automotive original equipment manufacturers in Brazil.

#### MARKETING AND DISTRIBUTION

We manage numerous distribution channels for our products in order to better penetrate the HVACR market. Generally, our products are sold through a combination of distributors, independent and company-owned dealers, wholesalers, manufacturers' representatives, original equipment manufacturers and national accounts. We have also established separate distribution networks in each country in which we conduct operations. We deploy dedicated sales forces across all our business segments and brands in a manner designed to maximize the ability of each sales force to service its particular distribution channel. To maximize enterprise-wide effectiveness, we have active cross-functional and cross-organizational teams working on issues such as pricing and coordinated approaches to product design and national account customers with interests cutting across business segments. We have approximately 1,600 persons employed in sales and marketing positions and spent \$50.2 million on advertising, promotions and related marketing activities in 1998.

One example of the competitive strength of our marketing and distribution strategy is in the North American residential heating and air conditioning market, in which we use three distinctly different distribution approaches -- the one-step distribution system, the two-step distribution system and sales made directly to consumers through Lennox-owned dealers. We market and distribute our "Lennox" brand of heating and air conditioning products directly to approximately 6,000 dealers that install these products.

We distribute our "Armstrong Air", "Air-Ease", "Concord" and "Magic-Pak" brands of residential heating and air conditioning products through the traditional two-step distribution process whereby we sell our products to distributors who, in turn, sell the products to a local installing dealer. Accordingly, by using multiple brands and distribution channels, we are able to better penetrate the North American residential heating and air conditioning market. In addition, we have begun to acquire or establish distributors in key strategic areas when a satisfactory relationship with an independent distributor is not available.

We have initiated a program to acquire high quality dealers in metropolitan areas in the U.S. and Canada so we can provide heating and air conditioning products and services directly to consumers. We have started acquiring dealers in the U.S. by initially focusing on our existing "Lennox" dealers who are part of our one-step distribution system.

Through the years, the "Lennox" brand has become synonymous with the "Dave Lennox" image, which is utilized in national television and print advertising as well as in numerous locally produced dealer ads, open houses and trade events, and is easily the best recognized advertising icon in the heating and air conditioning industry. We spent an aggregate of \$40.1 million in advertising, promotions and related marketing activities in 1998 on the "Lennox" brand alone.

## MANUFACTURING

We operate 15 manufacturing facilities in the U.S. and Canada and 23 outside the U.S. and Canada. These plants range from small manufacturing facilities to large 1,000,000 square foot facilities in Grenada, Mississippi and Marshalltown, Iowa. In our facilities most impacted by seasonal demand, we manufacture both heating and air conditioning products to smooth seasonal production demands and maintain a relatively stable labor force. We are generally able to hire temporary employees to meet changes in demand.

Some of the recently acquired manufacturing facilities have not yet reached the levels of efficiency that have been achieved at our plants which we have owned for a longer time. However, we intend to bring our manufacturing and operating expertise to these plants.

## PURCHASING

We rely on various suppliers to furnish the raw materials and components used in the manufacture of our products. To maximize our buying power in the marketplace, we utilize a "purchasing council" that consolidates purchases of our entire domestic requirements of particular items across all business segments. The purchasing council generally concentrates its purchases for a given material or component with one or two suppliers, although we believe that there are alternative suppliers for all of our key raw material and component needs. Compressors, motors and controls constitute our most significant component purchases, while steel, copper and aluminum account for the bulk of our raw material purchases. Although most of the compressors used by us are purchased directly from major compressor manufacturers, we own a 24.5% interest in a joint venture to manufacture compressors in the one and one-half to seven horsepower range. We expect that this joint venture, which began limited production in April 1998, will be capable of providing us with a substantial portion of our compressor requirements in the residential air conditioning market after achieving full production levels, which is expected in 2001.

We attempt to minimize the risk of price fluctuations in key components by entering into contracts, typically at the beginning of the year, which generally provide for fixed prices for our needs throughout the year. In instances where we are unable to pass on to our customers increases in the costs of copper and aluminum, we enter into forward contracts for the purchase of such materials.

## INFORMATION SYSTEMS

Our North American operations are supported by enterprise business systems which support all core business processes. Enterprise business systems are designed to enhance the continuity of operations, ensure appropriate controls, and support timely and efficient decision making. Our largest operating divisions began installing the SAP enterprise business software system in 1996. We have substantially completed the implementation of SAP software and full implementation by all divisions converting to SAP is expected to be completed by the end of 1999. The SAP software system is designed to facilitate the flow of information and business processes across all business functions such as sales, manufacturing, distribution and financial accounting.

## TECHNOLOGY AND RESEARCH AND DEVELOPMENT

We support an extensive research and development program focusing on the development of new products and improvements to our existing product lines. We spent an aggregate of \$23.2 million, \$25.4 million and \$33.3 million on research and development during 1996, 1997 and 1998, respectively. As of December 31, 1998, we employed approximately 480 persons dedicated to research and development activities. We have a number of research and development facilities located around the world, including a limited number of "centers for excellence" that are responsible for the research and development of particular core competencies vital to our business, such as combustion technology, vapor compression, heat transfer and low temperature refrigeration.

We use advanced, commercially available computer-aided design, computer-aided manufacturing, computational fluid dynamics and other sophisticated software not only to streamline the design and

manufacturing processes, but also to give us the ability to run complex computer simulations on a product design before a working prototype is created. We operate a full line of metalworking equipment and advanced laboratories certified by applicable industry associations.

#### PATENTS AND PROPRIETARY RIGHTS

We hold numerous patents that relate to the design and use of our products. We consider these patents important, but no single patent is material to the overall conduct of our business. Our policy is to obtain and protect patents whenever such action would be beneficial to us. No patent which we consider material will expire in the next five years. We own several trademarks that we consider important in the marketing of our products, including Lennox(R), Heatcraft(R), CompleteHeat(R), Raised Lance(TM), Larkin(TM), Climate Control(TM), Chandler Refrigeration(R), Bohn(R), Advanced Distributor Products(R), Armstrong Air(TM), Air-Ease(R), Concord(R), Magic-Pak(R), Superior(TM), Marco(R), Whitfield(R), Security Chimneys(R), Janka(TM), Alcair(TM) and Friga-Bohn(TM). These trademarks have no fixed expiration dates and we believe our rights in these trademarks are adequately protected.

#### COMPETITION

Substantially all of the markets in which we participate are highly competitive. The most significant competitive factors facing us are product reliability, product performance, service and price, with the relative importance of these factors varying among our product lines. In addition, as we acquire more heating and air conditioning dealers, we will face increasing competition from independent dealers and dealers owned by consolidators and utility companies. Our competitors may have greater financial and marketing resources than we have. Listed below are some of the companies that we view as our main manufacturing competitors in each segment we serve, with relevant brand names, when different than the company name, shown in parentheses.

- North American residential -- United Technologies Corporation (Carrier); Goodman Manufacturing Company (Janitrol, Amana); American Standard Companies Inc. (Trane); York International Corporation; Hearth Technologies Inc. (Heatilator); and CFM Majestic, Inc. (Majestic).
- Commercial air conditioning -- United Technologies Corporation (Carrier); American Standard Companies Inc. (Trane); York International Corporation; Daikin Industries, Ltd.; and McQuay International.
- Commercial refrigeration -- United Technologies Corporation (Ardco Group); Tecumseh Products Co.; Copeland Corporation; and Hussmann International Inc. (Krack).
- Heat transfer -- Modine Manufacturing Company and Super Radiator Coils.

#### EMPLOYEES

As of December 31, 1998, we employed approximately 11,700 employees, approximately 3,400 of which were represented by unions. The number of hourly workers we employ during the course of the year may vary in order to match our labor needs during periods of fluctuating demand. We believe that our relationships with our employees are generally good.

Within the U.S., we have eight manufacturing facilities and five distribution centers, along with our North American Parts Center in Des Moines, Iowa, with collective bargaining agreements ranging from three to eight years in length. The five distribution centers are covered by a single contract that expires in 2001. At our significant manufacturing facilities, one collective bargaining agreement expires in December 1999 -- Lynwood, California. Three collective bargaining agreements expire in 2000 -- Marshalltown, Iowa, Burlington, Washington and Atlanta, Georgia -- and three expire in 2002 -- Bellevue, Ohio, Danville, Illinois and Union City, Tennessee. Following the expiration of the collective bargaining agreement in April 1999, we experienced a work stoppage at our Bellevue, Ohio factory for three weeks in May 1999. This facility has a new collective bargaining agreement that expires April 2002. Outside of the U.S., we have 13 significant facilities that are represented by unions. The four agreements for HCF in France have no fixed expiration date. The agreement at our facility in Laval, Quebec expires in December 1999 and the agreement at our facility in

Burgos, Spain expires in 2000. The agreement at our facility in Toronto, Ontario expired in April 1999 and, as has been the case in the past, the employees at this facility are continuing to work under the expired contract pending negotiation of a new agreement. We believe that our relationships with the unions representing our employees are generally good, and do not anticipate any material adverse consequences resulting from negotiations to renew these agreements.

#### PROPERTIES

The following chart lists our major domestic and international manufacturing, distribution and office facilities and whether such facilities are owned or leased:

#### DOMESTIC FACILITIES

LOCATION -----	DESCRIPTION AND APPROXIMATE SIZE -----	PRINCIPAL PRODUCTS -----	OWNED/LEASED -----
Richardson, TX	World headquarters and offices; Lennox Industries headquarters; 230,000 square feet	N/A	Owned and Leased
Bellevue, OH	Armstrong headquarters, factory and distribution center; 800,000 square feet	Residential furnaces, residential and light commercial air conditioners and heat pumps	Owned and Leased
Grenada, MS	Heatcraft Heat Transfer Division headquarters and factory, 1,000,000 square feet; Advanced Distributor Products factory, 300,000 square feet; commercial products factory, 217,000 square feet	Coils and copper tubing; evaporator coils, gas-fired unit heaters and residential air handlers; and custom order replacement coils	Owned and Leased
Stone Mountain, GA	Heatcraft Refrigeration Products Division headquarters, R&D and factory; 145,000 square feet	Commercial and industrial condensing units, packaged chillers and custom refrigeration racks	Owned
Marshalltown, IA	Lennox Industries heating and air conditioning products factory, 1,000,000 square feet; distribution center, 300,000 square feet	Residential heating and cooling products, gas furnaces, split-system condensing units, split-system heat pumps and CompleteHeat	Owned and Leased
Des Moines, IA	Lennox Industries distribution center and light manufacturing; 352,000 square feet	Central supplier of Lennox repair parts	Leased
Carrollton, TX	Lennox Industries heating and air conditioning products development and research facility; 130,000 square feet	N/A	Owned
Stuttgart, AR	Lennox Industries light commercial heating and air conditioning factory; 500,000 square feet	Commercial rooftop equipment and accessories	Owned and Leased
Union City, TN	Superior Fireplace Company factory; 294,690 square feet	Gas and wood burning fireplaces	Owned
Lynwood, CA	Marco Mfg. Inc. headquarters and factory; 200,000 square feet	Gas and wood burning fireplaces	Leased

## INTERNATIONAL FACILITIES

LOCATION	DESCRIPTION AND APPROXIMATE SIZE	PRINCIPAL PRODUCTS	OWNED/LEASED
Genas, France	Friga-Bohn headquarters and factory; 16,000 square meters	Heat exchangers for refrigeration and air conditioning; refrigeration products, condensers, fluid coolers, pressure vessels, liquid receivers and refrigeration components	*
Mions, France	HCF-Lennox headquarters and factories; 12,000 square meters	Air cooled chillers, water cooled chillers, reversible chillers and packaged boilers	*
Burgos, Spain	Lennox-Refac factory; 8,000 square meters	Comfort air conditioning equipment, packaged and split units (cooling or heat pump); small and medium capacity water cooled chillers	*
Krunkel, Germany	European headquarters and factories for HYFRA GmbH products; 6,000 square meters	Process cooling systems	*
Prague, Czech Republic	Janka and Friga-Coil factories; 30,000 square meters	Air handling equipment; heat transfer coils	*
Sydney, Australia	Lennox Australia Pty. Ltd. headquarters and factory; 20,000 square feet	Rooftop packaged and split commercial air conditioners	Leased
Sydney, Australia	James N. Kirby Pty. Ltd. headquarters and factory; 412,000 square feet	Refrigeration condensing units, evaporators, heat transfer coils and machine tools	Owned
San Jose dos Campos, Brazil	McQuay do Brasil headquarters and factory; 160,000 square feet	Refrigeration condensing units, unit coolers and heat transfer coils	*
Etobicoke, Canada	Lennox-Canada factory, 212,000 square feet	Multi-position gas furnaces, gas fireplaces and commercial unit heaters	Owned

\* Facilities owned or leased by a joint venture in which we have an interest.

In addition to the properties described above and excluding dealer facilities, we lease over 55 facilities in the U.S. for use as sales offices and district warehouses and a limited number of additional facilities worldwide for use as sales and service offices and regional warehouses. We believe that our properties are in good condition and adequate for our requirements. We also believe that our principal plants are generally adequate to meet our production needs.

## REGULATION

Our operations are subject to evolving and often increasingly stringent federal, state, local and international laws and regulations concerning the environment. Environmental laws that affect or could affect our domestic operations include, among others, the Clean Air Act, the Clean Water Act, the Resource Conservation and Recovery Act, the Comprehensive Environmental Response, Compensation, and Liability Act, the Occupational Safety and Health Act, the National Environmental Policy Act, the Toxic Substances Control Act, any regulations promulgated under these acts and various other Federal, state and local laws and regulations governing environmental matters. We believe we are in substantial compliance with such existing environmental laws and regulations. Our non-U.S. operations are also subject to various environmental statutes and regulations. Generally, these statutes and regulations impose operational requirements that are similar to those imposed in the U.S. We believe we are in substantial compliance with applicable non-U.S. environmental statutes and regulations.

Refrigerants. In the past decade, there has been increasing regulatory and political pressure to phase out the use of certain ozone depleting substances, including hydrochlorofluorocarbons, which are sometimes referred to as "HCFCs". This development is of particular importance to us and our competitors because of the common usage of HCFCs as refrigerants for air conditioning and refrigeration equipment. As discussed below, we do not believe that implementation of the phase out schedule for HCFCs contained in the current regulations will have a material adverse effect on our financial position or results of operations. We do believe, however, that there will likely be continued pressure by the international environmental community for the U.S. and other countries to accelerate the phase out schedule. We have been an active participant in the ongoing international dialogue on these issues and believe that we are well positioned to react to any changes in the regulatory landscape.



In September 1987, the U.S. became a signatory to an international agreement titled the Montreal Protocol on Substances that Deplete the Ozone Layer. The Montreal Protocol requires its signatories to phase out HCFCs on an orderly basis. All countries in the developed world have become signatories to the Montreal Protocol. The manner in which these countries implement the Montreal Protocol and regulate HCFCs differs widely.

The 1990 U.S. Clean Air Act amendments implement the Montreal Protocol by establishing a program to limit the production, importation and use of specified ozone depleting substances, including HCFCs currently used as refrigerants by us and our competitors. Under the Act and implementing regulations, all HCFCs must be phased out between 2010 and 2030. We believe that these regulations as currently in effect will not have a material adverse effect on our operations. It is not expected that the planned phase out of HCFCs will have a significant impact on the sales of products utilizing these refrigerants prior to the end of the decade. Nonetheless, as the supply of virgin and recycled HCFCs falls, it will be necessary to address the need to substitute permitted substances for HCFCs. Further, the U.S. is under pressure from the international environmental community to accelerate the current 2030 deadline for phase out of HCFCs. An accelerated phase out schedule could adversely affect our future financial results and the industry generally.

We, together with major chemical manufacturers, are continually in the process of reviewing and addressing the potential impact of refrigerant regulations on our products. We believe that the combination of products that presently utilize HCFCs, and products in the field which can be retrofitted to alternate refrigerants, provide a complete line of commercial and industrial products. Therefore, we do not foresee any material adverse impact on our business or competitive position as a result of the Montreal Protocol, the 1990 Clean Air Act amendments or their implementing regulations. However, we believe that the implementation of severe restrictions on the production, importation or use of refrigerants we employ in larger quantities or acceleration of the current phase out schedule could have such an impact on us and our competitors.

We are subject to appliance efficiency regulations promulgated under the National Appliance Energy Conservation Act of 1987, as amended, and various state regulations concerning the energy efficiency of our products. We have developed and are developing products which comply with National Appliance Energy Conservation Act regulations, and do not believe that such regulations will have a material adverse effect on our business. The U.S. Department of Energy began in 1998 its review of national standards for comfort products covered under National Appliance Energy Conservation Act. It is anticipated that the National Appliance Energy Conservation Act regulations requiring manufacturers to phase in new higher efficiency products will not take effect prior to 2006. We believe we are well positioned to comply with any new standards that may be promulgated by the Department of Energy and do not foresee any adverse material impact from a National Appliance Energy Conservation Act standard change.

**Remediation Activity.** In addition to affecting our ongoing operations, applicable environmental laws can impose obligations to remediate hazardous substances at our properties, at properties formerly owned or operated by us and at facilities to which we sent or send waste for treatment or disposal. We are currently involved in remediation activities at our facility in Grenada, Mississippi and at a formerly owned site in Ft. Worth, Texas. In addition, former hazardous waste management units at two of our facilities, Danville, Illinois and Wilmington, North Carolina, are currently in the process of being closed under the Resource Conservation and Recovery Act.

The Resource Conservation and Recovery Act closure process can result in the need to conduct soil and/or groundwater remediation to address any on-site releases. The Grenada facility is subject to an administrative order issued by the Mississippi Department of Environmental Quality under which we will conduct groundwater remediation. We have established a \$1.8 million reserve to cover costs of remediation at the Grenada facility and possible costs associated with the Resource Conservation and Recovery Act closure at the Danville facility. We also have installed and are operating a groundwater treatment system at our previously owned facility in Ft. Worth, Texas. We have established a reserve having a balance of approximately \$200,000 to cover the projected \$50,000 annual operating costs for ongoing treatment at the Ft. Worth site. Resource Conservation and Recovery Act closure activities at the Wilmington facility include an ongoing groundwater remediation project. This project is being conducted and funded by a prior owner of

the facility, under an indemnification obligation under the contract pursuant to which we acquired the facility. We have no reason to believe that the prior owner will not continue to conduct and pay for the required remediation at the Wilmington facility. However, if the prior owner refused to meet its contractual obligations, we would be required to complete the remediation. Through soil and groundwater sampling, usually obtained during site acquisition due diligence, we are aware of contamination at some of our other facilities. Based on the levels of the contaminants detected, however, we do not believe we are required to remediate the contamination at these facilities under existing environmental laws. Nonetheless, it is possible that we may be required to conduct remediation at these facilities in the future. Also, it is possible that third parties may file property damage or personal injury claims against us related to this contamination, particularly if the contamination on our property has migrated offsite.

During environmental due diligence for a plant we acquired in 1998 in Czechoslovakia, we learned of soil and groundwater contamination at the site. The source of the contamination is not known and it is not known at this time whether the applicable governmental authority will require us to remediate the contamination. If remediation is required, a preliminary estimate of remediation costs prepared in 1995 is \$114,000. Additional evaluation would need to be performed to refine this estimate and it is possible that the actual cost to remediate the plant would significantly exceed this preliminary estimate.

From time to time we have received notices that we are a potentially responsible party along with other potentially responsible parties in Superfund proceedings for cleanup of hazardous substances at certain sites to which the potentially responsible parties are alleged to have sent waste. At present, our only active Superfund involvements are at the Granville Solvents Superfund Site located in Ohio, the Envirochem Third Site in Illinois and the Operating Industries site in California. Since 1994, we have spent an average of \$49,000 per year for costs related to the Granville Solvents site and expect to incur similar costs at the site over the next few years. Total estimated exposure costs at the Envirochem Third Site are approximately \$30,000. Marco Mfg., an indirect subsidiary of Lennox, is one of more than 4,000 companies identified as potentially responsible parties for the Operating Industries site. In June 1998, Marco Mfg. received a settlement offer from the Operating Industries steering committee to settle its liability as a de minimis party for approximately \$60,000. Marco rejected the settlement offer and has no reason to believe that its ultimate liability will exceed the proposed settlement amount. In May 1999, we received a settlement offer from the Gurley-Related Sites Group, a group of potentially responsible parties for two related Superfund sites in Arkansas -- the South 8th Street Landfill and the Gurley Pit Sites -- to settle our potential liability at those sites for \$10,500. Although we accepted the settlement offer and paid the settlement amount, under the terms of the settlement agreement, there is the possibility for additional liability in the event the Gurley-Related Sites Group is not successful in its effort to finalize its settlement in principle with the EPA and the Arkansas Department of Pollution Control and Technology. In the event additional liability should arise, however, we do not expect it to be material. Based on the facts presently known, we do not believe that environmental cleanup costs associated with these Superfund sites will have a material adverse effect on our financial position or results of operations.

Dealer operations. The heating and air conditioning dealers acquired in the U.S. and Canada will be subject to various federal, state and local laws and regulations, including, among others:

- permitting and licensing requirements applicable to service technicians in their respective trades;
- building, heating, ventilation, air conditioning, plumbing and electrical codes and zoning ordinances;
- laws and regulations relating to consumer protection, including laws and regulations governing service contracts for residential services; and
- laws and regulations relating to worker safety and protection of the environment.

A large number of state and local regulations governing the residential and commercial maintenance services trades require various permits and licenses to be held by individuals. In some cases, a required permit or license held by a single individual may be sufficient to authorize specified activities for all of our service technicians who work in the geographic area covered by the permit or license.

## LEGAL PROCEEDINGS

We are involved in various claims and lawsuits incidental to our business. In the opinion of our management, these claims and suits in the aggregate will not have a material adverse effect on our business, financial condition or results of operations.

## MANAGEMENT

The directors and executive officers of our company, their present positions and their ages are as follows:

NAME ----	AGE ---	POSITION -----
John W. Norris, Jr. ....	63	Chairman of the Board and Chief Executive Officer
H. E. French.....	57	President and Chief Operating Officer, Heatcraft Inc.
Robert E. Schjerven.....	56	President and Chief Operating Officer, Lennox Industries Inc.
Michael G. Schwartz.....	41	President and Chief Operating Officer, Armstrong Air Conditioning Inc.
Harry J. Ashenhurst.....	51	Executive Vice President, Human Resources
Scott J. Boxer.....	48	Executive Vice President, Lennox Global Ltd. and President, European Operations
Carl E. Edwards, Jr. ....	58	Executive Vice President, General Counsel and Secretary
W. Lane Pennington.....	43	Executive Vice President, Lennox Global Ltd. and President, Asia Pacific Operations
Clyde W. Wyant.....	60	Executive Vice President, Chief Financial Officer and Treasurer
John J. Hubbuch.....	56	Vice President, Controller and Chief Accounting Officer
Linda G. Alvarado.....	48	Director
David H. Anderson.....	58	Director
Richard W. Booth.....	67	Director
Thomas W. Booth.....	41	Director
David V. Brown.....	51	Director
James J. Byrne.....	63	Director
Janet K. Cooper.....	45	Director
John E. Major.....	53	Director
Donald E. Miller.....	68	Director
Terry D. Stinson.....	57	Director
Richard L. Thompson.....	59	Director

There are currently two vacancies on our board of directors which we expect to fill with non-employee directors. The following biographies describe the business experience of our executive officers and directors.

John W. Norris, Jr. was elected Chairman of the board of directors of Lennox in 1991. He has served as a director of Lennox since 1966. After joining Lennox in 1960, Mr. Norris held a variety of key positions including Vice President of Marketing, President of Lennox Industries (Canada) Ltd., a subsidiary of Lennox, and Corporate Senior Vice President. He became President of Lennox in 1977 and was appointed President and Chief Executive Officer of Lennox in 1980. Mr. Norris is on the board of directors of the Air-Conditioning & Refrigeration Institute of which he was chairman in 1986. He is also an active board member of the Gas Appliance Manufacturers Association, where he was Chairman from 1980 to 1981. He also serves as a director of AmerUs Life Holdings, Inc., a life insurance and annuity company, and Metroplex Regional Advisory Board of Chase Bank of Texas, NA.

H. E. French is the President and Chief Operating Officer of Heatcraft Inc., a subsidiary of Lennox. Mr. French joined Lennox in 1989 as Vice President and General Manager of the Refrigeration Products division for Heatcraft Inc. In 1995 he was named President and Chief Operating Officer of Armstrong Air Conditioning Inc., a subsidiary of Lennox. Mr. French was appointed to his current role in 1997. Prior to joining Lennox, Mr. French spent 11 years in management with Wickes/Larkin, Inc.

Robert E. Schjerven was named President and Chief Operating Officer of Lennox Industries Inc., a subsidiary of Lennox, in 1995. In 1986, he joined Lennox as Vice President of Marketing and Engineering for Heatcraft Inc. From 1988 to 1991 he held the position of Vice President and General Manager of that subsidiary. From 1991 to 1995 he served as President and Chief Operating Officer of Armstrong Air

Conditioning Inc. Mr. Schjerven spent the first 20 years of his career with the Trane Company, a HVACR manufacturer, and McQuay-Perfex Inc.

Michael G. Schwartz became the President and Chief Operating Officer of Armstrong Air Conditioning Inc. in 1997. He joined Heatcraft in 1990 when Lennox acquired Bohn Heat Transfer Inc. and served as Director of Sales and Marketing, Original Equipment Manufacturer Products. Prior to his current appointment, he served as Vice President of Commercial Products for Heatcraft Inc. where his responsibilities included the development of Heatcraft's position in the A-Coil market. Mr. Schwartz began his career with Bohn Heat Transfer Inc. in 1981.

Harry J. Ashenhurst was appointed Executive Vice President, Human Resources and Administration in 1994. He joined Lennox in 1989 as Vice President of Human Resources. Dr. Ashenhurst was named Executive Vice President, Human Resources for Lennox in 1990 and in 1994 moved to his current position and assumed responsibility for the Public Relations and Communications and Aviation departments. Prior to joining Lennox, he worked as an independent management consultant with the consulting firm of Roher, Hibler and Replogle. While at Roher, Hibler and Replogle, Dr. Ashenhurst was assigned to work as a corporate psychologist for Lennox.

Scott J. Boxer joined Lennox in 1998 as Executive Vice President, Lennox Global Ltd., a subsidiary of Lennox, and President, European Operations. Prior to joining Lennox, Mr. Boxer spent 26 years with York International Corporation, a HVACR manufacturer, in various roles, most recently as President, Unitary Products Group Worldwide, where he reported directly to the Chairman of that company and was responsible for directing that company's residential and light commercial heating and air conditioning operations worldwide.

Carl E. Edwards, Jr. joined Lennox in February 1992 as Vice President and General Counsel. He became the Secretary of Lennox in April 1992 and was also named Executive Vice President and General Counsel in December 1992. Prior to joining Lennox, he was Vice President, General Counsel and Secretary for Elcor Corporation. He also serves as a director of Kentucky Electric Steel Inc.

W. Lane Pennington was appointed to his current position of Executive Vice President, Lennox Global Ltd. and President, Asia Pacific Operations in 1998. He joined Lennox in 1997 as Vice President, Asia Pacific Operations. From 1988 until 1997, Mr. Pennington was with Hilti International Corp., a worldwide supplier of specialized building products and engineering services for the commercial construction industry, where he most recently served as President, Hilti Asia Limited, based in Hong Kong.

Clyde W. Wyant joined Lennox in 1990 and was appointed Executive Vice President, Chief Financial Officer and Treasurer, the position he still holds. Prior to joining Lennox, he served as Executive Vice President, Chief Financial Officer and Director of Purolator Products Co. (formerly Facet Enterprises, Inc.), a manufacturer of filtration equipment, from 1985 to 1990. In 1965, Mr. Wyant began his career with Helmerich & Payne Inc., an oil service company, where he last served as Vice President, Finance.

John J. Hubbuch was named Vice President, Controller and Chief Accounting Officer of Lennox in 1998. Mr. Hubbuch joined Lennox in 1986 as the Division Controller for Heatcraft Inc. In 1989 he became Heatcraft's Group Controller. From 1982 to 1986, Mr. Hubbuch was the Division Controller for McQuay-Perfex Inc./SynderGeneral. In 1992 he became Corporate Controller of Lennox.

Linda G. Alvarado has served as a director of Lennox since 1987. She is President of Alvarado Construction, Inc. a general contracting firm specializing in commercial, government and industrial construction and environmental remediation projects. She currently serves on the Board of Directors of Cyprus Amax Minerals Company, a diversified mining company, US West, Inc., a telecommunications company, Englehard Corporation, a commercial catalyst and pigments company, and Pitney Bowes Inc., an office equipment and services company, and is part owner of the Colorado Rockies Baseball Club.

David H. Anderson has served as a director of Lennox since 1973. Mr. Anderson currently serves as the Co-Executive Director of the Santa Barbara Museum of Natural History. He formerly had a private law practice specializing in land use and environmental law. Mr. Anderson also serves as legal counsel for a local

land conservation organization in Santa Barbara County. He currently serves on the Boards of the California Nature Conservancy, the Land Trust for Santa Barbara County and the Santa Barbara Foundation.

Richard W. Booth has served as a director of Lennox since 1966. Mr. Booth retired from Lennox in 1992 as Executive Vice President, Administration and Secretary, a position he had held since 1983. Mr. Booth held a variety of key positions after joining Lennox in 1954. He serves on the board of directors of Employers Mutual Casualty Company, a casualty insurance company, and is a member of the board of trustees of Grinnell College.

Thomas W. Booth has served as a director of Lennox since April 1999. Since 1997, Mr. Booth has been the Director, Business Development of Heatcraft Inc. Mr. Booth joined Lennox in 1984 and has served in various capacities including the District Manager for the Baltimore/Virginia sales branch of Lennox Industries from 1994 to 1997.

David V. Brown has served as a director of Lennox since 1989. Dr. Brown owns the Plantation Farm Camp, a working 500-acre ranch with livestock that provides learning in a farm setting for children. He is currently serving on the Strategic Planning Board of the Western Association of Independent Camps, an educational organization for training camp advisors.

James J. Byrne has served as a director of Lennox since 1990. He has been chairman and chief executive officer of OpenConnect Systems Incorporated, a developer of computer software products, since May 1999. In addition, he serves as chairman of Byrne Technology Partners, Ltd., a management services company for technology companies, a position he has held since January 1996. Prior to his current role, he held a number of positions in the technology industry including President of Harris Adacom Corporation, a network products and services company, Senior Vice President of United Technologies Corporation's Semiconductor Operation and President of North American group of Mohawk Data Sciences, a manufacturer of distributed computer products. Mr. Byrne began his career with General Electric Company. Mr. Byrne is a director of STB Systems Inc., a developer of video boards for personal computer manufacturers.

Janet K. Cooper has served as a director of Lennox since April 1999. Ms. Cooper has been the Vice President and Treasurer of US West, Inc., a regional Bell operating company, since 1998. From 1978 to 1998, Ms. Cooper served in various capacities with The Quaker Oats Company, including its Vice President, Treasurer & Tax from 1992 to 1998. Ms. Cooper serves on the board of directors of The TORO Company, a manufacturer of equipment for lawn and turf care maintenance.

John E. Major has served as a director of Lennox since 1993. Mr. Major has been the Chairman, Chief Executive Officer and President of Wireless Knowledge, a QUALCOMM Incorporated and Microsoft joint venture which operates a network operation center, since November 1998. Previously he was Executive Vice President of QUALCOMM and President of its Wireless Infrastructure Division, and was responsible for managing and guiding the market potential for CDMA infrastructure products. Prior to joining QUALCOMM in 1997, Mr. Major served most recently as Senior Vice President and Staff Chief Technical Officer at Motorola, Inc., a manufacturer of telecommunications equipment, and Senior Vice President and General Manager for Motorola's Worldwide Systems Group of the Land Mobile Products Sector. Mr. Major currently serves on the board of directors of Littlefuse, Inc., a manufacturer of fuses, and Verilink Corporation, a manufacturer of network access devices.

Donald E. Miller has served as a director of Lennox since 1987. Mr. Miller spent his 35 year career with The Gates Corporation, an industrial and automotive rubber products manufacturer. He retired as Vice Chairman of that company in 1996. From 1987 until 1994 he held the position of President and Chief Operating Officer of The Gates Corporation. Mr. Miller serves on the board of directors of Sentry Insurance Corporation, a mutual insurance company, OEA, Inc., a company engaged in specialized automotive and aerospace technologies, and Chateau Communities Inc., a real estate investment trust, and is the President of the Board of Colorado School of Mines Foundation.

Terry D. Stinson has served as a director of Lennox since 1998. Mr. Stinson has been the Chairman and Chief Executive Officer of Bell Helicopter Textron Inc., the aircraft segment of Textron Inc., a multi-industry corporation, since 1998 and was its President from 1996 to 1998. From 1991 to 1996, Mr. Stinson served as

Group Vice President and Segment President of Textron Aerospace Systems and Components for Textron Inc. Prior to that position, he had been the President of Hamilton Standard Division of United Technologies Corporation, a defense supply company, since 1986.

Richard L. Thompson has served as a director of Lennox since 1993. In 1995, Mr. Thompson was named to his present position of Group President and member of the Executive Office of Caterpillar Inc., a manufacturer of construction and mining equipment. He joined Caterpillar in 1983 as Vice President, Customer Services. In 1990, he was appointed President of Solar Turbines Inc., a wholly owned subsidiary of Caterpillar and manufacturer of gas turbines. From 1990 to 1995, he held the role of Vice President of Caterpillar, with responsibility for its worldwide engine business. Previously, he had held the positions of Vice President of Marketing and Vice President and General Manager, Components Operations with RTE Corporation, a manufacturer of electrical distribution products. Mr. Thompson is a director of Gardner Denver, Inc., a manufacturer of air compressors, blowers and petroleum pumps.

John W. Norris, Jr., Richard W. Booth, David H. Anderson and David V. Brown are all grandchildren of D.W. Norris, and Thomas W. Booth is a great grandchild of D.W. Norris. John W. Norris, Jr., David V. Brown, Richard W. Booth and David H. Anderson are first cousins. Richard W. Booth is the father of Thomas W. Booth.

#### INFORMATION REGARDING THE BOARD OF DIRECTORS AND COMMITTEES

Our board of directors is divided into three classes of directors, with each class elected to a three-year term every third year and holding office until their successors are elected and qualified. The class whose term of office will expire at our 2000 Annual Meeting of Stockholders consists of Linda G. Alvarado, Richard W. Booth, David V. Brown and John E. Major. The class whose term of office will expire at our 2001 Annual Meeting of Stockholders consists of Janet K. Cooper, Terry D. Stinson and Richard L. Thompson. The class whose term of office will expire at our 2002 Annual Meeting of Stockholders consists of David H. Anderson, Thomas W. Booth, James J. Byrne, Donald E. Miller and John W. Norris, Jr.

Our board of directors has established an audit committee, acquisition committee, board operations committee, human resource committee, compensation committee and a pension and risk management committee. The audit committee is responsible for meeting with management and our independent accountants to determine the adequacy of internal controls and other financial reporting matters. The following directors currently serve on the audit committee: John E. Major (chair), Linda G. Alvarado, Janet K. Cooper, Donald E. Miller and Terry D. Stinson.

The acquisition committee is responsible for evaluating potential acquisitions and making recommendations on proposed acquisitions. The following directors currently serve on the acquisition committee: Donald E. Miller (chair), David H. Anderson, Janet K. Cooper, Terry D. Stinson and Richard L. Thompson.

The board operations committee is responsible for making recommendations on the election of directors and officers, the number of directors, and other matters pertaining to the operations of our board of directors. The following directors currently serve on the board operations committee: Richard W. Booth (chair), David V. Brown, James J. Byrne, Janet K. Cooper and Terry D. Stinson.

The human resource committee is responsible for succession planning, management development programs and other human resource matters. The following directors currently serve on the human resource committee: James J. Byrne (chair), Linda G. Alvarado, David V. Brown, John E. Major and Richard L. Thompson.

The compensation committee is responsible for evaluating the performance of our chief executive officer, making recommendations with respect to the salary of our chief executive officer, approving the compensation of executive staff members, approving the compensation for non-employee directors and committee members, approving incentive stock options for senior management, approving all employee benefit plan designs and other matters relating to the compensation of our directors, officers and employees. The following directors currently serve on the compensation committee: Richard L. Thompson (chair), Linda G. Alvarado, James J. Byrne and John E. Major. During 1988, the following directors served on the compensation committee or its

predecessor committee: Linda G. Alvarado, David V. Brown, James J. Byrne, Thomas B. Howard, Jr., a former director, and Richard L. Thompson.

The pension and risk management committee is responsible for overseeing the administration of our pension and profit sharing plans, overseeing matters relating to our insurance coverage, reviewing matters of legal liability and environmental issues, and other matters relating to risk management. The following directors currently serve on the pension and risk management committee: David H. Anderson (chair), Richard W. Booth, Thomas W. Booth and Donald E. Miller.

#### COMPENSATION OF DIRECTORS

In 1999, non-employee directors will receive an annual retainer of \$21,000 in cash and \$5,000 in common stock for board of directors and committee service, an annual retainer of \$4,000 in cash for serving as a committee chair and a fee of \$1,000, or \$500 in the event of a telephonic meeting, in cash for attending each meeting day of the board of directors or any committee of the board. Board members may elect to receive the cash portion of their annual retainer in cash or shares of common stock. All directors receive reimbursement for reasonable out-of-pocket expenses incurred in connection with attendance at meetings of the board of directors or any committee of the board. In addition, each non-employee director may receive, under our 1998 incentive plan, options to purchase shares of common stock at an exercise price equal to the fair market value of such shares at the date of grant.

#### EXECUTIVE COMPENSATION

The following table sets forth information on compensation earned in 1998 by our Chief Executive Officer and our four other most highly compensated executive officers, such individuals sometimes being referred to as the "named executive officers". In the third quarter of 1998, we terminated the Lennox International Inc. performance share plan in connection with the adoption of the 1998 incentive plan. We terminated the performance share plan to reduce potential earnings volatility associated with the application of variable price accounting rules to the provisions of the plan. The amounts in the LTIP Payouts column in the Summary Compensation Table below consists of the value of common stock issued to the named executive officers in connection with the termination of the performance share plan and in full settlement of our obligations under that plan. Performance awards are now granted under our 1998 incentive plan.

SUMMARY COMPENSATION TABLE

NAME	ANNUAL COMPENSATION		LONG-TERM COMPENSATION				ALL OTHER COMPENSATION(4)
			AWARDS		PAYOUTS		
			RESTRICTED STOCK AWARDS(2)	SECURITIES UNDERLYING OPTIONS/SARS GRANTED	LTIP PAYOUTS(3)		
SALARY	BONUS(1)						
John W. Norris, Jr.....	\$648,660	\$1,130,003	\$1,960,304	\$148,500	\$2,043,909	\$146,600	
Robert L. Jenkins(5).....	361,200	370,158	288,206	0	859,815	91,425	
Robert E. Schjerven.....	335,400	323,562	739,038	49,500	750,994	86,656	
H.E. French.....	309,852	328,902	502,320	36,300	595,940	80,389	
Clyde W. Wyant.....	291,300	348,639	516,762	36,300	718,883	67,645	

(1) Includes annual incentive payments for the respective year from two annual variable pay plans.

(2) Represents performance share awards of the following number of shares of restricted common stock granted pursuant to the 1998 incentive plan in December 1998 multiplied by the stock price on the grant date, \$19.03 per share: Mr. Norris -- 103,026; Mr. Jenkins -- 15,147; Mr. Schjerven -- 38,841; Mr. French -- 26,400; and Mr. Wyant -- 27,159. Such shares represent all of such individual's holdings of restricted common stock at December 31, 1998. For the named executive officers, 27,423 shares will vest at December 31, 1999, 75,900 shares will vest at December 31, 2000 and the remainder will vest at December 31, 2001, in each case if performance targets are met. Shares which do not vest in any



performance period due to failure to achieve such goals will vest in 2006, 2007 and 2008, respectively. Information about performance share awards made under the 1998 incentive plan in December 1998 which do not vest unless certain performance goals are met is set forth in the table titled "Long-Term Incentive Plans -- Awards in Last Fiscal Year."

- (3) Represents awards of shares of common stock multiplied by the stock price on the award date, \$19.03 per share, in connection with the termination of the performance share plan.
- (4) Composed of contributions by Lennox to its profit sharing retirement plan and to profit sharing restoration plan and the dollar value of term life insurance premiums paid by us for the benefit of the named executive officers. Contributions to the plans for the named executive officers were as follows: Mr. Norris -- \$139,730; Mr. Jenkins -- \$86,223; Mr. Schjerven -- \$81,369; Mr. French -- \$73,833; and Mr. Wyant -- \$62,619.
- (5) On December 31, 1998, Mr. Jenkins retired from his position as the Assistant to the Chairman of the Board -- Business Development.

We maintain a pay-for-performance compensation philosophy to pay market-competitive base salaries, while also delivering variable pay which is directly linked to the achievement of performance measurements and to the performance and contribution of the individual.

Executive compensation is composed of three primary components: base salary, variable pay and benefits and perquisites. In order to evaluate the competitiveness of our total compensation programs, we have periodically engaged Hewitt Associates LLC, a human resources consulting firm, to conduct market analyses of the compensation programs for executive level jobs within our organization. In doing so, we emphasize delivering competitive total compensation opportunities, while maintaining the flexibility to design individual compensation components to support critical business objectives.

The following table provides information concerning stock options granted to the named executive officers in 1998.

OPTION/SAR GRANTS IN LAST FISCAL YEAR

NAME	INDIVIDUAL GRANTS				GRANT DATE PRESENT VALUE(1)
	NUMBER OF SECURITIES UNDERLYING OPTIONS/SARS GRANTED	PERCENT OF TOTAL OPTIONS/SARS GRANTED TO EMPLOYEES IN FISCAL YEAR	EXERCISE OR BASE PRICE	EXPIRATION DATE	
John W. Norris, Jr. ....	148,500	16.7%	\$19.03	December 11, 2008	\$755,325
Robert L. Jenkins....	0	--	--	--	--
Robert E. Schjerven...	49,500	5.6	19.03	December 11, 2008	251,775
H. E. French.....	36,300	4.1	19.03	December 11, 2008	184,635
Clyde W. Wyant.....	36,300	4.1	19.03	December 11, 2008	184,635

- (1) The grant date present values shown in the table were determined using the Black-Scholes option valuation model using the following assumptions: stock price volatility of 35.4% which represents an average volatility among general industry companies; expected option life of 10.0 years; dividend yield of 1.66%; risk free interest rate of 4.53%; Hewitt Associates Modified Derived Value: \$5.09 which includes the following additional assumptions: discounts for the probability of termination for death, disability, retirement and voluntary/involuntary terminations.

The following table provides for each of the named executive officers the options exercised during 1998 and the number of options and the value of unexercised options held by the named executive officers as of December 31, 1998.

AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR AND FISCAL YEAR-END OPTION VALUES

NAME	SHARES ACQUIRED ON EXERCISE	VALUE REALIZED	NUMBER OF SECURITIES UNDERLYING UNEXERCISED OPTIONS/SARS AT DECEMBER 31, 1998		VALUE OF UNEXERCISED IN-THE-MONEY OPTIONS/SARS AT DECEMBER 31, 1998(1)	
			EXERCISABLE	UNEXERCISABLE	EXERCISABLE	UNEXERCISABLE
John W. Norris, Jr.....	--	--	249,150	148,500	\$1,872,771	0
Robert L. Jenkins.....	160,380	\$ 812,648	--	--	--	--
Robert E. Schjerven.....	166,980	1,042,300	--	49,500	--	0
H. E. French.....	147,906	1,363,807	--	36,300	--	0
Clyde W. Wyant.....	33,660	360,121	126,720	36,300	1,106,297	0

(1) Calculated on the basis of the fair market value of the underlying securities as of December 31, 1998, \$19.03 per share, minus the exercise price of "in-the-money" options.

The following table provides information concerning performance share awards made under the 1998 incentive plan to the named executive officers in 1998. The named executive officers are awarded a number of shares of common stock subject to achievement of performance targets based on the average return on equity for a three year period. Information about the portion of the award that becomes vested regardless of whether the performance goals are met is presented under the Restricted Stock Awards column in the table titled "Summary Compensation Table." Presented below is the maximum number of shares of common stock that may be payable to each of the named executive officers that is subject to achievement of the performance goals. The actual number of shares awarded depends on the level of achievement of the performance objectives.

LONG-TERM INCENTIVE PLANS -- AWARDS IN LAST FISCAL YEAR

NAME	NUMBER OF SHARES, UNITS OR OTHER RIGHTS	PERFORMANCE OR OTHER PERIOD UNTIL MATURATION OR PAYOUT
John W. Norris, Jr.....	103,026	3 years
Robert L. Jenkins.....	15,147	3 years
Robert E. Schjerven.....	38,841	3 years
H. E. French.....	26,400	3 years
Clyde W. Wyant.....	27,159	3 years

1998 INCENTIVE PLAN

GENERAL

Our board of directors has adopted, and our stockholders have approved, the 1998 incentive plan. The 1998 incentive plan amends and restates the 1994 stock option and restricted stock plan. Any outstanding awards under the 1994 stock option and restricted stock plan will remain outstanding. The objectives of the 1998 incentive plan are to attract and retain employees, to attract and retain qualified directors and to stimulate the active interest of such persons in our development and financial success. Awards provide participants with a proprietary interest in our growth and performance. The description below represents a summary of the principal terms and conditions of the 1998 incentive plan.

Awards to our employees or independent contractors under the 1998 incentive plan may be made in the form of grants of stock options, stock appreciation rights, restricted or non-restricted stock or units denominated in stock, cash awards or performance awards or any combination of these awards. Awards to non-employee directors under the 1998 incentive plan will be in the form of grants of stock options.

The 1998 incentive plan provides for awards to be made in respect of a maximum of 4,603,500 shares of our common stock, of which 3,943,500 shares will be available for awards to our employees and independent contractors and the remainder of which will be available for awards to non-employee directors. No participant under the 1998 incentive plan may be granted in any 12-month period awards consisting of stock options or stock appreciation rights for more than 165,000 shares of common stock, stock awards for more than 165,000 shares of common stock or cash awards in excess of 5,000,000. Shares of common stock which are the subject of awards that are forfeited or terminated or expire unexercised will again immediately become available for awards under the 1998 incentive plan.

Our compensation committee will have the exclusive authority to administer the 1998 incentive plan as it relates to employee awards and to take all actions which are specifically contemplated by the plan or are necessary or appropriate in connection with the administration thereof. The compensation committee may, in its discretion:

- provide for the extension of the exercisability of an award;
- accelerate the vesting or exercisability of an award to our employees;
- eliminate or make less restrictive any restrictions contained in an award to our employees;
- waive any restriction or other provision of the 1998 incentive plan or in any award to our employees; or
- otherwise amend or modify an award to our employees in any manner that is either not adverse to the employee holding the award or consented to by such employee.

#### EMPLOYEE AWARDS

The compensation committee will determine the type or types of awards made under the 1998 incentive plan and will designate the employees who are to be recipients of such awards. Each award may be embodied in an agreement, which will contain such terms, conditions and limitations as are determined by the compensation committee. Awards to our employees may be granted singly, in combination or in tandem. Awards to our employees may also be made in combination or in tandem with, in replacement of, or as alternatives to, grants or rights under the 1998 incentive plan or any other employee plan or program of Lennox, including any acquired entity. All or part of an award to our employees may be subject to conditions established by the compensation committee, which may include continuous service with Lennox, achievement of specific business objectives, increases in specified indices, attainment of specified growth rates and other comparable measurements of performance.

The types of awards to our employees that may be made under the 1998 incentive plan are as follows:

**Options:** Options are rights to purchase a specified number of shares of common stock at a specified price. An option granted under the 1998 incentive plan may consist of either an incentive stock option that complies with the requirements of Section 422 of the Internal Revenue Code of 1986, or a non-qualified stock option that does not comply with such requirements. Incentive stock options must have an exercise price per share that is not less than the fair market value of the common stock on the date of grant. To the extent that the aggregate fair market value, measured at the time of grant, of common stock subject to incentive stock options that first become exercisable by an employee in any one calendar year exceeds \$100,000, such options shall be treated as non-qualified stock options and not as incentive stock options. Non-qualified stock options must have an exercise price per share that is not less than, but may exceed, the fair market value of the common stock on the date of grant. In either case, the exercise price must be paid in full at the time an option is exercised in cash or, if the employee so elects, by means of tendering common stock or surrendering another award.

**Stock Appreciation Rights:** Stock appreciation rights are rights to receive a payment, in cash or common stock, equal to the excess of the fair market value or other specified valuation of a specified number of shares of common stock on the date the rights are exercised over a specified strike price. A stock appreciation right may be granted in tandem under the 1998 incentive plan to the holder of an option with respect to all or a portion of the shares of common stock subject to such option or may be granted separately. The terms,

conditions and limitations applicable to any stock appreciation rights, including the term of any stock appreciation rights and the date or dates upon which they become exercisable, will be determined by our compensation committee.

**Stock Awards:** Stock awards consist of grants of restricted common stock or non-restricted common stock or units denominated in common stock. The terms, conditions and limitations applicable to any stock awards will be determined by our compensation committee. The compensation committee may remove any restrictions on stock awards, at its discretion. Rights to dividends or dividend equivalents may be extended to and made part of any stock award in the discretion of the compensation committee.

**Cash Awards:** Cash awards consist of grants denominated in cash. The terms, conditions and limitations applicable to any cash awards will be determined by our compensation committee.

**Performance Awards:** Performance awards consist of grants made to an employee subject to the attainment of one or more performance goals. A performance award will be paid, vested or otherwise deliverable solely upon the attainment of one or more pre-established, objective performance goals established by our compensation committee prior to the earlier of (a) 90 days after the commencement of the period of service to which the performance goals relate and (b) the elapse of 25% of the period of service, and in any event while the outcome is substantially uncertain. A performance goal may be based upon one or more business criteria that apply to the employee, one or more business units of Lennox or Lennox as a whole. The terms, conditions and limitations applicable to any performance awards will be determined by our compensation committee.

#### DIRECTOR AWARDS

Our board of directors will administer the 1998 incentive plan as it relates to awards to non-employee directors. The board will have the right to determine on an annual basis, or at any other time in its sole discretion, to award options which are non-qualified stock options to non-employee directors. No such options awarded in any year shall provide for the purchase of more than 16,500 shares of common stock. All options awarded to directors shall have a term of 10 years and shall vest and become exercisable in increments of one-third on each of the three succeeding anniversaries after the date of grant. Unvested options awarded to directors shall be forfeited if a director resigns without the consent of the majority of our board of directors.

#### OTHER PROVISIONS

Our board of directors may amend, modify, suspend or terminate the 1998 incentive plan for the purpose of addressing any changes in legal requirements or for any other purpose permitted by law, except that:

- no amendment that would impair the rights of any employee or non-employee director to any award may be made without the consent of such employee or non-employee director; and
- no amendment requiring stockholder approval under any applicable legal requirements will be effective until such approval has been obtained.

In the event of any subdivision or consolidation of outstanding shares of our common stock, declaration of a stock dividend payable in shares of our common stock or other stock split, the 1998 incentive plan provides for our board of directors to make appropriate adjustments to:

- the number of shares of common stock reserved under the 1998 incentive plan;
- the number of shares of common stock covered by outstanding awards in the form of common stock or units denominated in common stock;
- the exercise or other price in respect of such awards;
- the appropriate fair market value and other price determinations for awards in order to reflect such transactions; and

- the limitations in the 1998 incentive plan regarding the number of awards which may be made to any employee in a given year.

Furthermore, in the event of any other recapitalization or capital reorganization of Lennox, any consolidation or merger of Lennox with another corporation or entity, the adoption by Lennox of any plan of exchange affecting the common stock or any distribution to holders of common stock or securities or property, other than normal cash dividends or stock dividends, our board of directors will make appropriate adjustments to the amounts or other items referred to above to give effect to such transactions, but only to the extent necessary to maintain the proportionate interest of the holders of the awards and to preserve, without exceeding, the value of the awards.

#### RETIREMENT PLANS

The named executive officers participate in four Lennox-sponsored retirement plans. The plans are as follows: the pension plan for salaried employees, the profit sharing retirement plan, the supplemental retirement plan, and the profit sharing restoration plan. The supplemental retirement plan and the profit sharing restoration plan are non-qualified plans. We pay the full cost of all these plans.

The pension plan for salaried employees is a floor offset plan. A target benefit is calculated using credited service and final average pay during the five highest consecutive years. The benefit is currently based on 1.00% of final average pay, plus .60% of final average pay above Social Security covered compensation, times the number of years of credited service, not to exceed 30 years. Employees vest after five years of service and may commence unreduced benefits at age 65. If specified age and service requirements are met, benefits may commence earlier on an actuarially reduced basis. At time of retirement, a participant may choose one of five optional forms of payment. The supplemental retirement plan permits income above Internal Revenue Service limitations to be considered in determining final average pay, doubles the rate of benefit accrual, limits credited service to 15 years and permits early retirement on somewhat more favorable terms than the pension plan.

The profit sharing retirement plan is a defined contribution plan. Profit sharing contributions, as determined by our board of directors, are credited annually to participants' accounts based on pay. Participants are fully vested after 6 years. The assets of the plan are employer directed. Distributions may occur at separation of employment and can be paid directly to the participant. The restoration plan permits accruals that otherwise could not occur because of Internal Revenue Service limitations on compensation.

The estimates of annual retirement benefits shown in the following table are the targets established by the supplemental retirement plan.

FINAL AVERAGE EARNINGS(1)	YEARS OF SERVICE					
	5	10	15	20	25	30
\$ 250,000.....	\$ 35,896	\$ 71,792	\$107,688	\$107,688	\$107,688	\$107,688
425,000.....	63,896	127,792	191,688	191,688	191,688	191,688
600,000.....	91,896	183,792	275,688	275,688	275,688	275,688
775,000.....	119,896	239,792	359,688	359,688	359,688	359,688
950,000.....	147,896	295,792	443,688	443,688	443,688	443,688
1,125,000.....	175,896	351,792	527,688	527,688	527,688	527,688

(1) Final Average Earnings are the average of the five highest consecutive years of includible earnings. Compensation for these purposes includes salary and bonuses, and excludes extraordinary compensation such as benefits from the 1998 incentive plan or its predecessor plans. Bonus numbers used in these calculations, as per plan requirements, are the bonuses actually paid in those years. In the Summary Compensation Table, the 1998 bonus reported is the bonus earned in 1998, but not paid until 1999.

As of December 31, 1998, the final average pay and the eligible years of credited service for each of the named executive officers was as follows: Mr. Norris, \$855,001 -- 38.25 years; Mr. Jenkins, \$483,948 --

14.00 years; Mr. Wyant, \$402,391 -- 8.30 years; Mr. Schjerven, \$411,416 -- 12.80 years; Mr. French, \$340,666 -- 9.80 years.

#### EMPLOYMENT AGREEMENTS

We have entered into an employment agreement with each of the named executive officers who are currently employees of Lennox. Each of the employment agreements is identical except for the name of the named executive officer who is a party to the agreement and the date of the agreement. These employment agreements establish the basis of compensation and assignments; and post-employment covenants covering confidential information, the diverting of employees, vendors and contractors and the solicitation of customers. These agreements also establish binding arbitration as the mechanism for resolving disputes and provide benefits and income in the event employment terminates under specified circumstances.

The agreements commence on the date they are signed by both parties and remain in effect until December 31 of that year and afterwards for a series of one-year terms. On January 1 of each year after the end of the first term and for each year afterwards, the agreements automatically renew for an additional year, unless either party notifies the other, in writing, at least 30 days prior to such date, of a decision not to renew the agreement.

If we terminate the employee prior to the expiration of the term of the agreement or if we do not renew the agreement for any reason other than for cause, the employee will be entitled to receive monthly payments of the greater of the employee's base salary for the remainder of the agreement's term or three months of the employee's base salary in addition to any other compensation or benefits applicable to an employee at the employee's level.

If we terminate the employee other than for cause, including our non-renewal of the agreement, and the employee agrees to execute a written general release of any and all possible claims against us existing at the time of termination, we will provide the employee with an enhanced severance package. That package includes payment of the employee's base monthly salary for a period of twenty-four months following the date of termination, a lump sum payment of \$12,000 in lieu of perquisites lost, and forgiveness of COBRA premiums due for group health insurance coverage for up to eighteen months while the employee remains unemployed. If the employee remains unemployed at the end of eighteen months, the equivalent of the COBRA premium will be paid to the employee on a month to month basis for up to six additional months while the employee remains unemployed. Outplacement services are provided or, at the employee's election, a lump-sum payment of 10% of the employee's annual base salary will be made to the employee in lieu of those services. Additionally, the employee's beneficiary will receive a lump-sum death benefit equivalent to six months of the employee's base salary should the employee die while entitled to enhanced severance payments.

#### CHANGE OF CONTROL EMPLOYMENT AGREEMENTS

We have entered into a change of control employment agreement with each of the named executive officers who are currently employees of Lennox. Each of the change of control agreements is identical except for the name of the named executive officer who is a party to the agreement and the date of the agreement. The change of control agreements provide for certain benefits under specified circumstances if the officer's employment is terminated following a change of control transaction involving Lennox. The change of control agreements are intended to provide protections to the officers that are not afforded by their existing employment agreements, but not to duplicate benefits provided by the existing employment agreements. The term of the change of control agreements is generally two years from the date of a potential change of control, as discussed below, or a change of control. If the officer remains employed at the conclusion of such term, the officer's existing employment agreement will continue to apply. The employment rights of the named executive officers under the change of control agreements would be triggered by either a change of control or a potential change of control. Following a potential change of control, the term of the change of control agreement may terminate but the change of control agreement will remain in force and a new term of the agreement will apply to any future change of control or potential change of control, if either (a) our board of directors determines that a change of control is not likely or (b) the named executive officer, upon proper

notice to us, elects to terminate his term of the change of control agreement as of any anniversary of the potential change of control.

A "change of control" generally includes the occurrence on or after the date of the offering of any of the following:

(a) any person, other than specified exempt persons, including Lennox and its subsidiaries and employee benefit plans, becoming a beneficial owner of 35% or more of the shares of common stock or voting stock of Lennox then outstanding, including as a result of the offering;

(b) a change in the identity of a majority of the persons serving as members of our board of directors, unless such change was approved by a majority of the incumbent members of our board of directors;

(c) the approval by the stockholders of a reorganization, merger or consolidation in which:

(1) existing stockholders would not own more than 65% of the common stock and voting stock of the resulting company;

(2) a person, other than specified exempt persons, would own 35% or more of the common stock or voting stock of the resulting company; or

(3) less than a majority of the board of the resulting company would consist of the then incumbent members of our board of directors; or

(d) the approval by the stockholders of a liquidation or dissolution of Lennox, unless such liquidation or dissolution is part of a plan of liquidation or dissolution involving a sale to a company of which following such transaction:

(1) more than 65% of the common stock and voting stock would be owned by existing stockholders;

(2) no person, other than specified exempt persons, would own 35% or more of the common stock or voting stock of such company; and

(3) at least a majority of the board of directors of such company would consist of the then incumbent members of our board of directors.

A "potential change in control" generally includes any of the following:

- the commencement of a tender or exchange offer for voting stock that, if consummated, would result in a change of control;
- Lennox entering into an agreement which, if consummated, would constitute a change of control;
- the commencement of a contested election contest subject to proxy rules; or
- the occurrence of any other event that our board of directors determines could result in a change of control.

During the term of the change of control agreement, an officer's position, authority, duties and responsibilities may not be diminished, and all forms of compensation, including salary, bonus, regular salaried employee plan benefits, stock options, restricted stock and other awards, must continue on a basis no less favorable than at the beginning of the term of the change of control agreement and, in the case of specified benefits, must continue on a basis no less favorable in the aggregate than the most favorable application of such benefits to any of our employees.

If an officer terminates employment during the term of the change of control agreement for good reason and we fail to honor the terms of the change of control agreement, we will pay the officer:

- his then unpaid current salary and a pro rata portion of the highest bonus earned during the three preceding years, as well as previously deferred compensation and accrued vacation time;
- a lump-sum benefit equal to the sum of three times the officer's annual base salary and three times the annual bonus he would have earned in the year of termination;
- for purposes of our supplemental retirement plan and our profit sharing restoration plan, three additional years added to both his service and age criteria; and
- continued coverage under our employee welfare benefits plans for up to four and one-half years.

In addition, all options, restricted stock and other compensatory awards held by the officer will immediately vest and become exercisable, and the term of these awards will be extended for up to one year following termination of employment. The officer may also elect to cash out equity-based compensatory awards at the highest price per share paid by specified persons during the term of the change of control agreement or the six-month period prior to the beginning of the term of the change of control agreement.

In the event of any contest concerning a change of control agreement in which the officer is successful, in whole or in part, on the merits:

- we have no right of offset;
- the officer is not required to mitigate damages; and
- we agree to pay any legal fees incurred by the officer in connection with such contest.

We also agree to pay all amounts owing to the officer during any period of dispute, subject only to the officer's agreement to repay any amounts to which he is determined not to be entitled. The change of control agreements provide for a tax gross-up in the event that specified excise taxes are applicable to payments made by us under a change of control agreement or otherwise. The change of control agreements require the officer to maintain the confidentiality of our information, and, for a period of 24 months following his termination of employment, to avoid any attempts to induce our employees to terminate their employment with us.

#### INDEMNIFICATION AGREEMENTS

We have entered into indemnification agreements with our directors and a number of our executive officers. Each of the indemnification agreements is identical except for the name of the director or executive officer who is a party to the agreement and the date of the agreement. Under the terms of the indemnification agreements, we have generally agreed to indemnify, and advance expenses to, each indemnitee to the fullest extent permitted by applicable law on the date of the agreements and to such greater extent as applicable law may at a future time permit. In addition, the indemnification agreements contain specific provisions pursuant to which we have agreed to indemnify each indemnitee:

- if such person is, by reason of his or her status as a director, nominee for director, officer, agent or fiduciary of ours or of any other corporation, partnership, joint venture, trust, employee benefit plan or other enterprise with which such person was serving at our request, any such status being referred to as a "corporate status," made or threatened to be made a party to any threatened, pending or completed action, suit, arbitration, alternative dispute resolution mechanism, investigation or other proceeding, other than a proceeding by or in the right of Lennox;
- if such person is, by reason of his or her corporate status, made or threatened to be made a party to any proceeding brought by or in the right of Lennox to procure a judgment in its favor, except that no indemnification shall be made in respect of any claim, issue or matter in such proceeding as to which such indemnitee shall have been adjudged to be liable to Lennox if applicable law prohibits such indemnification, unless and only to the extent that a court shall otherwise determine;



- against expenses actually and reasonably incurred by such person or on his or her behalf in connection with any proceeding to which such indemnitee was or is a party by reason of his or her corporate status and in which such indemnitee is successful, on the merits or otherwise;
- against expenses actually and reasonably incurred by such person or on his or her behalf in connection with a proceeding to the extent that such indemnitee is, by reason of his or her corporate status, a witness or otherwise participates in any proceeding at a time when such person is not a party in the proceeding; and
- against expenses actually and reasonably incurred by such person in certain judicial adjudications of or awards in arbitration to enforce his or her rights under the indemnification agreements.

In addition, under the terms of the indemnification agreements, we have agreed to pay all reasonable expenses incurred by or on behalf of an indemnitee in connection with any proceeding, whether brought by or in the right of Lennox or otherwise, in advance of any determination with respect to entitlement to indemnification and within 15 days after the receipt by us of a written request from such indemnitee for such payment. In the indemnification agreements, each indemnitee has agreed that he or she will reimburse and repay us for any expenses so advanced to the extent that it shall ultimately be determined that he or she is not entitled to be indemnified by us against such expenses.

The indemnification agreements also include provisions that specify the procedures and presumptions which are to be employed to determine whether an indemnitee is entitled to indemnification. In some cases, the nature of the procedures specified in the indemnification agreements varies depending on whether we have undergone a change in control.

## PRINCIPAL STOCKHOLDERS

The following table contains information regarding the beneficial ownership of our common stock as of August 10, 1999 by the following individuals:

- each person known by us to own more than 5% of the outstanding shares of common stock;
- each of our directors;
- each named executive officer; and
- all executive officers and directors as a group.

All persons listed have an address in care of our principal executive offices and have sole voting and investment power of their shares unless otherwise indicated.

The information contained in this table reflects "beneficial ownership" as defined in Rule 13d-3 of the Securities Exchange Act of 1934. In computing the number of shares beneficially owned by a person and the percentage ownership of that person, shares of common stock subject to options held by that person that were exercisable on August 10, 1999 or became exercisable within 60 days following August 10, 1999 are considered outstanding. However, such shares are not considered outstanding for the purpose of computing the percentage ownership of any other person. To our knowledge and unless otherwise indicated, each stockholder has sole voting and investment power over the shares listed as beneficially owned by such stockholder, subject to community property laws where applicable. Percentage of ownership is based on 44,896,165 shares of common stock outstanding as of August 10, 1999.

BENEFICIAL OWNER	SHARES BENEFICIALLY OWNED	
	NUMBER	PERCENTAGE
John W. Norris, Jr.(1)	3,997,225	8.9%
H. E. French	92,499	*
Robert E. Schjerven	215,226	*
Robert L. Jenkins	242,220	*
Clyde W. Wyant(2)	226,842	*
Linda G. Alvarado(3)	117,150	*
David H. Anderson(4)	4,391,787	9.8
Richard W. Booth(5)	4,997,533	11.1
Thomas W. Booth(6)	2,952,279	6.6
David V. Brown(7)	1,327,854	3.0
James J. Byrne(8)	149,629	*
Janet K. Cooper	1,297	*
John E. Major(9)	135,878	*
Donald E. Miller(10)	121,209	*
Terry D. Stinson	5,594	*
Richard L. Thompson(11)	145,663	*
All executive officers and directors as a group (21 persons)(12)	17,354,515	37.4
A.O.C. Corporation(13)	2,695,770	6.0
Robert W. Norris(14)	2,458,203	5.5
Frank E. Zink(15)	2,487,210	5.5
Phillip L. Zink(16)	4,310,460	9.6

\* Less than 1%

(1) Includes:

- (a)321,750 shares held by the Robert W. Norris Trust A of which John W. Norris, Jr. is a co-trustee;
- (b)321,750 shares held by the John W. Norris, Jr. Trust A of which John W. Norris, Jr. is a co-trustee;
- (c)663,135 shares held by the Megan E. Norris Trust A of which John W. Norris, Jr. is a co-trustee;
- (d)120,120 shares of the Robert W. Norris Irrevocable Descendants' Trust of which John W. Norris, Jr. is the trustee; and
- (e)204,600 shares subject to options.

- (2) Includes 126,720 shares of common stock subject to options.
- (3) Includes 117,150 shares subject to options.
- (4) Includes:
- (a) 3,810 shares held by the Leo E. Anderson Trust of which David H. Anderson is the trustee;
  - (b) 199,881 shares held by the Kristin H. Anderson Trust of which David H. Anderson is a co-trustee;
  - (c) 3,916,341 shares held by the David H. Anderson Trust of which David H. Anderson is the trustee;
  - (d) 66,825 shares held by the Betty Oakes Trust of which David H. Anderson is the trustee;
  - (e) 87,780 shares held by David H. Anderson's child; and
  - (f) 117,150 shares subject to options.
- (5) Includes:
- (a) 52,470 shares held by the 1996 Anderson GST Exempt Trust of which Richard W. Booth is the trustee;
  - (b) 2,029,731 shares held by trusts for the benefit of Richard W. Booth of which Richard W. Booth is a co-trustee;
  - (c) 2,036,364 shares held by a trust for the benefit of Anne Zink of which Richard W. Booth is a co-trustee;
  - (d) 53,333 shares held by The Richard W. and Anne C. Booth Charitable Remainder Unitrust of which Richard W. Booth is a co-trustee;
  - (e) 117,150 shares subject to options.
- (6) Includes:
- (a) 2,029,731 shares held by trusts for the benefit of Richard W. Booth of which Thomas W. Booth is a co-trustee;
  - (b) 40,062 shares held by the Thomas W. Booth Trust of which Thomas W. Booth is a co-trustee.
  - (c) 160,000 shares held by The Booth Family Charitable Lead Annuity Trust of which Thomas W. Booth is a co-trustee;
  - (d) 71,181 shares held by Thomas W. Booth's children; and
  - (e) 2,475 shares subject to options.
- (7) Includes:
- (a) 315,117 shares held by David V. Brown's children; and
  - (b) 117,150 shares subject to options.
- (8) Includes 117,150 shares subject to options.
- (9) Includes 117,150 shares subject to options.
- (10) Includes:
- (a) 4,059 shares held by the Donald E. Miller Trust of which Donald E. Miller is a co-trustee; and
  - (b) 117,150 shares subject to options.
- (11) Includes 117,150 shares subject to options.
- (12) Includes 1,449,492 shares subject to options.
- (13) John W. Norris, Jr., David H. Anderson, Richard W. Booth and David V. Brown are members of the board of directors of A.O.C. Corporation.
- (14) Includes:
- (a) 321,750 shares held by the Robert W. Norris Trust A of which Robert W. Norris is a co-trustee;
  - (b) 321,750 shares held by the John W. Norris, Jr. Trust A of which Robert W. Norris is a co-trustee;
  - (c) 1,148,169 shares held by the Robert W. Norris Revocable Trust of which Robert W. Norris is the trustee;
  - (d) 140,514 shares held by the Christine Marie Dammann 1991 Revocable Trust of which Robert W. Norris is the trustee;
  - (e) 196,812 shares held by the Stefan Robert Norris Revocable Trust of which Robert W. Norris is the trustee; and
  - (f) 171,402 shares held by the Nicholas W. Norris 1991 Revocable Trust of which Robert W. Norris is the trustee; and
  - (g) 127,050 shares subject to options.
- (15) Includes 2,036,364 shares held by trusts for the benefit of Anne Zink of which Frank E. Zink is a co-trustee.
- (16) Includes:
- (a) 2,029,731 shares held by trusts for the benefit of Richard W. Booth of which Phillip L. Zink is a co-trustee;
  - (b) 2,036,364 shares held by trusts for the benefit of Anne Zink of which Phillip L. Zink is a co-trustee; and
  - (c) 94,578 shares held by the Zink Family Grandchildren's Education Trust of which Phillip L. Zink is the trustee.

## CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS

John W. Norris, Jr., our Chairman and Chief Executive Officer, and David H. Anderson, Richard W. Booth and David V. Brown, each one of our directors, as well as some of our stockholders, are members of AOC Land Investment, LLC. AOC Land Investment, LLC owns 70% of AOC Development II, LLC. AOC Development II, LLC is building a new office building and we have agreed to lease part of it for use as our corporate headquarters. The lease will have a term of 25 years and the annual lease payments are expected to be approximately \$2.1 million per year for the first five years. We believe that the terms of our lease with AOC Development II, LLC are at least as favorable as could be obtained from unaffiliated third parties.

From time to time we have entered into stock disposition agreements which allowed our executives, directors and stockholders to borrow money and use our capital stock held by them as collateral. The stock disposition agreements provided that in the event of a default on the underlying loan, we would do one of several things, including registering the capital stock under the Securities Act of 1933 finding a buyer to purchase the stock or purchasing the stock ourselves. There were never any defaults under these agreements. Currently, there are stock disposition agreements in existence covering 1,814,439 shares of common stock. We will not enter into these type of agreements in the future.

These transactions were not the result of arms-length negotiations. Accordingly certain of the terms of these transactions may be more or less favorable to us than might have been obtained from unaffiliated third parties. We do not intend to enter into any future transactions in which our directors, executive officers or principal stockholders and their affiliates have a material interest unless such transactions are approved by a majority of the disinterested members of our board of directors and are on terms that are no less favorable to us than those that we could obtain from unaffiliated third parties.

## DESCRIPTION OF CAPITAL STOCK

Our authorized capital stock consists of 200,000,000 shares of common stock and 25,000,000 shares of preferred stock, par value \$.01 per share. At August 10, 1999, 44,896,165 shares of common stock were outstanding. None of the preferred stock is outstanding.

## COMMON STOCK

The holders of common stock are entitled to one vote per share on all matters to be voted on by stockholders. Generally, all matters to be voted on by stockholders must be approved by a majority (or, in the case of election of directors, by a plurality) of the votes entitled to be cast by all shares of common stock present in person or represented by proxy, voting together as a single class, except as may be required by law and subject to any voting rights granted to holders of any preferred stock. However, the removal of a director from office, the approval and authorization of specified business combinations and amendments to specified provisions of our certificate of incorporation each require the approval of not less than 80% of the combined voting power of our outstanding shares of stock entitled to vote generally in the election of directors, voting together as a single class. See "-- Certificate of Incorporation and Bylaw Provisions". The common stock does not have cumulative voting rights.

Subject to the prior rights of the holders of any shares of our preferred stock, the holders of common stock shall be entitled to receive, to the extent permitted by law, such dividends as may be declared from time to time by our board of directors. On our liquidation, dissolution or winding up, after payment in full of the amounts required to be paid to holders of preferred stock, if any, all holders of common stock are entitled to share ratably in any assets available for distribution to holders of shares of common stock.

The outstanding shares of common stock are legally issued, fully paid and nonassessable. The common stock does not have any preemptive, subscription or conversion rights. Additional shares of authorized common stock may be issued, as authorized by our board of directors from time to time, without stockholder approval, except as may be required by applicable stock exchange requirements.

## PREFERRED STOCK

As of the date of this prospectus, no shares of preferred stock are outstanding. Our board of directors may authorize the issuance of preferred stock in one or more series and may determine, for the series, the designations, powers, preferences and rights of such series, and the qualifications, limitations and restrictions of the series, including:

- the designation of the series;
- the consideration for which the shares of any such series are to be issued;
- the rate or amount per annum, if any, at which holders of the shares of such series shall be entitled to receive dividends, the dates on which such dividends shall be payable, whether the dividends shall be cumulative or noncumulative, and if cumulative, the date or dates from which such dividends shall be cumulative;
- the redemption rights and price or prices, if any, for shares of the series;
- the amounts payable on and the preferences, if any, of shares of the series in the event of dissolution or upon distribution of our assets;
- whether the shares of the series will be convertible into or exchangeable for other of our securities, and the price or prices or rate or rates at which conversion or exchange shall be exercised;
- the terms and amounts of any sinking fund provided for the purchase or redemption of shares of the series;
- the voting rights, if any, of the holders of shares of the series; and
- such other preferences and rights, privileges and restrictions applicable to any such series as may be permitted by law.

We believe that the ability of our board of directors to issue one or more series of preferred stock will provide us with flexibility in structuring possible future financings and acquisitions and in meeting other corporate needs that might arise. The authorized shares of preferred stock will be available for issuance without further action by our stockholders, unless such action is required by applicable law or the rules of any stock exchange on which our securities may be listed or traded.

Although our board of directors has no intention at the present time of doing so, it could issue a series of preferred stock that could, depending on the terms of such series, impede the completion of a merger, tender offer or other takeover attempt. Our board of directors will make any determination to issue such shares based on its judgment as to our best interests and the best interests of our stockholders. Our board of directors, in so acting, could issue preferred stock having terms that could discourage a potential acquiror from making, without first negotiating with our board of directors, an acquisition attempt through which such acquiror may be able to change the composition of our board of directors, including a tender offer or other transaction that some, or a majority, of our stockholders might believe to be in their best interests or in which stockholders might receive a premium for their stock over the then current market price of such stock.

## BUSINESS COMBINATION STATUTE

As a corporation organized under the laws of the State of Delaware, we will be subject to Section 203 of the Delaware General Corporation Law, which restricts specified business combinations between us and an "interested stockholder" or its affiliates or associates for a period of three years following the time that the stockholder becomes an "interested stockholder." In general, an "interested stockholder" is defined as a stockholder owning 15% or more of our outstanding voting stock. The restrictions do not apply if:

- prior to an interested stockholder becoming such, our board of directors approved either the business combination or the transaction which resulted in the stockholder becoming an interested stockholder;

- upon completion of the transaction which resulted in any person becoming an interested stockholder, such interested stockholder owns at least 85% of our voting stock outstanding at the time the transaction commenced, excluding shares owned by employee stock ownership plans and persons who are both directors and officers of Lennox; or
- at or subsequent to the time an interested stockholder becomes such, the business combination is both approved by our board of directors and authorized at an annual or special meeting of our stockholders, not by written consent, by the affirmative vote of at least 66 2/3% of the outstanding voting stock not owned by the interested stockholder.

Under some circumstances, Section 203 makes it more difficult for a person who would be an "interested stockholder" to effect various business combinations with a corporation for a three-year period, although the stockholders may elect to exclude a corporation from the restrictions imposed under Section 203. Our certificate of incorporation does not exclude us from the restrictions imposed under Section 203. It is anticipated that the provisions of Section 203 may encourage companies interested in acquiring us to negotiate in advance with our board of directors since the stockholder approval requirement would be avoided if a majority of the directors then in office approves, prior to the date on which a stockholder becomes an interested stockholder, either the business combination or the transaction which results in the stockholder becoming an interested stockholder.

#### CERTIFICATE OF INCORPORATION AND BYLAW PROVISIONS

The summary below describes provisions of our certificate of incorporation and bylaws. The provisions of our certificate of incorporation and bylaws discussed below may have the effect, either alone or in combination with the provisions of Section 203 discussed above, of making more difficult or discouraging a tender offer, proxy contest or other takeover attempt that is opposed by our board of directors but that a stockholder might consider to be in such stockholder's best interest. Those provisions include:

- restrictions on the rights of stockholders to remove directors;
- prohibitions against stockholders calling a special meeting of stockholders or acting by unanimous written consent in lieu of a meeting;
- requirements for advance notice of actions proposed by stockholders for consideration at meetings of the stockholders; and
- restrictions on business combination transactions with "related persons."

#### CLASSIFIED BOARD OF DIRECTORS; REMOVAL; NUMBER OF DIRECTORS; FILLING VACANCIES

Our certificate of incorporation and bylaws provide that the board of directors shall be divided into three classes, designated Class I, Class II and Class III, with the classes to be as nearly equal in number as possible. The term of office of each class shall expire at the third annual meeting of stockholders for the election of directors following the election of such class. See "Management -- Information Regarding the Board of Directors and Committees" for a discussion of the directors in each class. Each director is to hold office until his or her successor is duly elected and qualified, or until his or her earlier resignation or removal.

Our bylaws provide that the number of directors will be fixed from time to time by to a resolution adopted by the board of directors; provided that the number so fixed shall not be more than 15 nor less than three directors. Our bylaws also provide that any vacancies will be filled only by the affirmative vote of a majority of the remaining directors, even if less than a quorum. Accordingly, absent an amendment to the bylaws, our board of directors could prevent any stockholder from enlarging the board of directors and filling the new directorships with such stockholder's own nominees. Moreover, our certificate of incorporation and bylaws provide that directors may be removed only for cause and only upon the affirmative vote of holders of at least 80% of our voting stock at a special meeting of stockholders called expressly for that purpose.

The classification of directors could have the effect of making it more difficult for stockholders to change the composition of the board of directors. At least two annual meetings of stockholders, instead of one, are

generally required to effect a change in a majority of the board of directors. Such a delay may help ensure that our directors, if confronted by a holder attempting to force a proxy contest, a tender or exchange offer, or an extraordinary corporate transaction, would have sufficient time to review the proposal as well as any available alternatives to the proposal and to act in what they believe to be the best interest of the stockholders. The classification provisions will apply to every election of directors, however, regardless of whether a change in the composition of the board of directors would be beneficial to us and our stockholders and whether or not a majority of our stockholders believe that such a change would be desirable.

The classification provisions could also have the effect of discouraging a third party from initiating a proxy contest, making a tender offer or otherwise attempting to obtain control of us, even though such an attempt might be beneficial to us and our stockholders. The classification of the board of directors could thus increase the likelihood that incumbent directors will retain their positions. In addition, because the classification provisions may discourage accumulations of large blocks of our stock by purchasers whose objective is to take control of us and remove a majority of the board of directors, the classification of the board of directors could tend to reduce the likelihood of fluctuations in the market price of the common stock that might result from accumulations of large blocks. Accordingly, stockholders could be deprived of opportunities to sell their shares of common stock at a higher market price than might otherwise be the case.

#### NO STOCKHOLDER ACTION BY WRITTEN CONSENT; SPECIAL MEETINGS

Our certificate of incorporation and bylaws provide that stockholder action can be taken only at an annual or special meeting of stockholders and stockholder action may not be taken by written consent in lieu of a meeting. Special meetings of stockholders can be called only by our board of directors by a resolution adopted by a majority of the board of directors, or by the chairman of the board, vice chairman or the president. Moreover, the business permitted to be conducted at any special meeting of stockholders is limited to the business brought before the meeting under the notice of meeting given by us.

The provisions of our certificate of incorporation and bylaws prohibiting stockholder action by written consent and permitting special meetings to be called only by the chairman, vice chairman or president, or at the request of a majority of the board or directors, may have the effect of delaying consideration of a stockholder proposal until the next annual meeting. The provisions would also prevent the holders of a majority of our voting stock from unilaterally using the written consent procedure to take stockholder action. Moreover, a stockholder could not force stockholder consideration of a proposal over the opposition of the chairman, vice chairman or president, or a majority of the board of directors, by calling a special meeting of stockholders prior to the time such parties believe such consideration to be appropriate.

#### ADVANCE NOTICE PROVISIONS FOR STOCKHOLDER NOMINATIONS AND STOCKHOLDER PROPOSALS

Our bylaws establish an advance notice procedure for stockholders to make nominations of candidates for election as directors or bring other business before an annual meeting of stockholders.

The stockholder notice procedure provides that only persons who are nominated by, or at the direction of, the board of directors, or by a stockholder who has given timely written notice containing specified information to our secretary prior to the meeting at which directors are to be elected, will be eligible for election as our directors. The stockholder notice procedure also provides that at an annual meeting only such business may be conducted as has been brought before the meeting by, or at the direction of, the chairman of the board of directors, or in the absence of the chairman of the board, the president, or by a stockholder who has given timely written notice containing specified information to our secretary of such stockholder's intention to bring such business before such meeting. Under the stockholder notice procedure, for notice of stockholder nominations or proposals to be made at an annual meeting to be timely, such notice must be received by us not less than 60 days nor more than 90 days in advance of such meeting. For notice of stockholder nominations or proposals to be made at a special meeting of stockholders to be timely, such notice must be received by us not later than the close of business on the tenth day following the date on which notice of such meeting is first given to stockholders. However, in the event that less than 70 days notice or prior public disclosure of the date of the meeting of stockholders is given or made to the stockholders, to be timely, notice of a nomination or

proposal delivered by the stockholder must be received by our secretary not later than the close of business on the tenth day following the day on which notice of the date of the meeting of stockholders was mailed or such public disclosure was made to the stockholders. If the board of directors or, alternatively, the presiding officer at a meeting, in the case of a stockholder proposal, or the chairman of the meeting, in the case of a stockholder nomination to the board of directors, determines at or prior to the meeting that business was not brought before the meeting or a person was not nominated in accordance with the stockholder notice procedure, such business will not be conducted at such meeting, or such person will not be eligible for election as a director, as the case may be.

By requiring advance notice of nominations by stockholders, the stockholder notice procedure will afford our board of directors an opportunity to consider the qualifications of the proposed nominees and, to the extent considered necessary or desirable by the board of directors, to inform stockholders about such qualifications. By requiring advance notice of other proposed business, the stockholder notice procedure will also provide a more orderly procedure for conducting annual meetings of stockholders and, to the extent considered necessary or desirable by the board of directors, will provide the board of directors with an opportunity to inform stockholders, prior to such meetings, of any business proposed to be conducted at such meetings, together with any recommendations as to the board of directors' position regarding action to be taken regarding such business, so that stockholders can better decide whether to attend such a meeting or to grant a proxy regarding the disposition of any such business.

Although our bylaws do not give the board of directors any power to approve or disapprove stockholder nominations for the election of directors or proposals for action, they may have the effect of precluding a contest for the election of directors or the consideration of stockholder proposals if the proper procedures are not followed, and of discouraging or deterring a third party from conducting a solicitation of proxies to elect its own slate of directors or to approve its own proposal, without regard to whether consideration of such nominees or proposals might be harmful or beneficial to us and our stockholders.

#### FAIR PRICE PROVISION

Our certificate of incorporation contains a "fair price" provision that applies to specified business combination transactions involving any person, entity or group that beneficially owns at least 10% of our aggregate voting stock -- such person, entity or group is sometimes referred to as a "related person". This provision requires the affirmative vote of the holders of not less than 80% of our voting stock to approve specified transactions between a related person and us or our subsidiaries, including:

- any merger, consolidation or share exchange;
- any sale, lease, exchange, mortgage, pledge, transfer or other disposition of our assets, or the assets of any of our subsidiaries having a fair market value of more than 10% of our total consolidated assets, or assets representing more than 10% of our earning power and our subsidiaries taken as a whole, which is referred to as a "substantial part";
- any sale, lease, exchange, mortgage, pledge, transfer or other disposition to or with us or any of our subsidiaries of all or a substantial part of the assets of a related person;
- the issuance or transfer of any of our securities or any of our subsidiaries by us or any of our subsidiaries to a related person;
- any reclassification of securities, recapitalization, or any other transaction involving us or any of our subsidiaries that would have the effect of increasing the voting power of a related person;
- the adoption of a plan or proposal for our liquidation or dissolution proposed by or on behalf of a related person;
- the acquisition by or on behalf of a related person of shares constituting a majority of our voting power; and



- the entering into of any agreement, contract or other arrangement providing for any of the transactions described above.

This voting requirement will not apply to certain transactions, including:

- (a) any transaction approved by a two-thirds vote of the continuing directors; or
- (b) any transaction in which:
  - (1) the consideration to be received by the holders of common stock, other than the related person involved in the business combination, is not less in amount than the highest per share price paid by the related person in acquiring any of its holdings of common stock; and
  - (2) if necessary, a proxy statement complying with the requirements of the Securities Exchange Act of 1934 shall have been mailed at least 30 days prior to any vote on such business combination to all of our stockholders for the purpose of soliciting stockholder approval of such business combination.

This provision could have the effect of delaying or preventing a change in control of us in a transaction or series of transactions that did not satisfy the "fair price" criteria.

#### LIABILITY OF DIRECTORS; INDEMNIFICATION

Our certificate of incorporation provides that a director will not be personally liable for monetary damages to us or our stockholders for breach of fiduciary duty as a director, except for liability:

- for any breach of the director's duty of loyalty to us or our stockholders;
- for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;
- for paying a dividend or approving a stock repurchase in violation of Section 174 of the Delaware General Corporation Law; or
- for any transaction from which the director derived an improper personal benefit.

Any amendment or repeal of such provision shall not adversely affect any right or protection of a director existing under such provision for any act or omission occurring prior to such amendment or repeal.

Our bylaws provide that each person who at any time serves or served as one of our directors or officers, or any person who, while one of our directors or officers, is or was serving at our request as a director or officer of another corporation, partnership, joint venture, trust or other enterprise, shall be entitled to indemnification and the advancement of expenses from us, and to the fullest extent, permitted by Section 145 of the Delaware General Corporation Law or any successor statutory provision. We will indemnify any person who was or is a party to any threatened, pending or completed action, suit or proceeding because he or she is or was one of our directors or officers, or is or was serving at our request as a director or officer of another corporation, partnership or other enterprise. However, as provided in Section 145, this indemnification will only be provided if the indemnitee acted in good faith and in a manner he or she reasonably believed to be in, or not opposed to, our best interests.

#### AMENDMENTS

Our certificate of incorporation provides that we reserve the right to amend, alter, change, or repeal any provision contained in our certificate of incorporation, and all rights conferred to stockholders are granted subject to such reservation. The affirmative vote of holders of not less than 80% of our voting stock, voting together as a single class, shall be required to alter, amend, adopt any provision inconsistent with or repeal specified provisions of our certificate of incorporation, including those provisions discussed in this section. In addition, the 80% vote described in the prior sentence shall not be required for any alteration, amendment, adoption of inconsistent provision or repeal of the "fair price" provision discussed under "-- Fair Price

Provision" above which is recommended to the stockholders by two-thirds of the continuing directors of Lennox and such alteration, amendment, adoption of inconsistent provision or repeal shall require the vote, if any, required under the applicable provisions of the Delaware General Corporation Law and our certificate of incorporation. In addition, our certificate of incorporation provides that stockholders may only adopt, amend or repeal our bylaws by the affirmative vote of holders of not less than 80% of our voting stock, voting together as a single class. Our bylaws may be amended by our board of directors.

#### RIGHTS TO PURCHASE SECURITIES AND OTHER PROPERTY

Our certificate of incorporation authorizes the board of directors to create and issue rights, warrants and options entitling the holders of them to purchase from us shares of any class or classes of our capital stock or other securities or property upon such terms and conditions as the board of directors may deem advisable.

#### TRANSFER AGENT AND REGISTRAR

The transfer agent and registrar for the common stock is ChaseMellon Shareholder Services, L.L.C.

## SHARES ELIGIBLE FOR FUTURE SALE

Future sales of substantial amounts of common stock in the public market could adversely affect prevailing market prices.

At August 10, 1999, 44,896,165 shares of common stock were outstanding. Of these shares, the 8,500,000 shares of common stock sold in our initial public offering are freely tradable without restrictions or further registration under the Securities Act of 1933, except that shares purchased by an "affiliate" of ours, as that term is defined in Rule 144 under the Securities Act of 1933, are subject to the resale limitations of Rule 144. The remaining 36,396,165 shares of common stock outstanding are "restricted securities" as that term is defined by Rule 144.

In general, under Rule 144 as currently in effect, if a period of at least one year has elapsed after the later of the date on which "restricted" shares were acquired from us or the date on which they were acquired from an "affiliate," then the holder of these shares, including an affiliate, is entitled to sell a number of shares within any three-month period that does not exceed the greater of:

- one percent of the then outstanding shares of the common stock; or
- the average weekly reported volume of trading of the common stock during the four calendar weeks preceding such sale.

Sales under Rule 144 are also subject to requirements pertaining to the manner of such sales, notices of such sales and the availability of current public information concerning Lennox. Affiliates may sell shares not constituting "restricted" shares in accordance with the above volume limitations and other requirements but without regard to the one-year period. Under Rule 144(k), if a period of at least two years has elapsed between the later of the date on which "restricted" shares were acquired from us and the date on which they were acquired from an affiliate, a holder of such shares who is not an affiliate at the time of the sale and has not been an affiliate for at least three months prior to the sale would be entitled to sell the shares immediately without regard to the volume limitations and other conditions described above. This description of Rule 144 is not intended to be a complete description thereof.

Sales of significant amounts of the common stock, or the perception that such sales could occur, could have an adverse impact on the market price of the common stock.

In connection with our initial public offering, each of Lennox and its directors, executive officers, the selling stockholders and certain other stockholders of Lennox agreed that, without the prior written consent of Morgan Stanley & Co. Incorporated on behalf of the underwriters, it will not, during the period ending January 24, 2000:

- offer, pledge, sell, contract to sell, sell any option or contract to purchase, purchase any option or contract to sell, grant any option, right or warrant to purchase or otherwise transfer or dispose of, directly or indirectly, any shares of common stock or any securities convertible into or exercisable or exchangeable for common stock; or
- enter into any swap or other arrangement that transfers to another, in whole or in part, any of the economic consequences of ownership of the common stock;

whether any transaction described above is to be settled by delivery of common stock or such other securities, in cash or otherwise. However, any such person or entity may make a bona fide gift of shares during the restricted period if the person or entity delivers to Morgan Stanley & Co. Incorporated an agreement substantially similar to the above executed by the donee.

The restrictions described in the previous paragraph do not apply to:

- transactions by any person other than Lennox relating to shares of common stock or other securities acquired in open market transactions after the completion of our initial public offering of the shares;

- the issuance or sale of shares of common stock pursuant to Lennox stock option plans existing on the date of completion of our initial public offering;
- the granting by Lennox of stock options and/or performance share awards pursuant to Lennox's employee benefit plans; or
- the issuance of up to 5,400,000 shares of common stock in connection with acquisitions.

In the event that consent to a waiver of these restrictions is requested by Lennox or any such person, Morgan Stanley & Co. Incorporated will consider the specific facts and circumstances of the request in deciding whether to grant its consent.

Pursuant to Rule 145 under the Securities Act of 1933, the volume limitations and some other requirements of Rule 144 will apply to resales of the shares of common stock covered by this prospectus by affiliates of the businesses we acquire for a period of one year from the date of their acquisition or such shorter period as the Securities and Exchange Commission may prescribe. Otherwise, these securities will be freely tradeable after their issuance by persons not affiliated with us unless we contractually restrict their sale.

#### PLAN OF DISTRIBUTION

This prospectus covers the offer and sale of up to 6,015,000 shares of our common stock which we may offer from time to time in connection with future direct and indirect acquisitions of other businesses, properties or securities in business combination transactions. In addition to the shares of common stock offered by this prospectus, we may offer other consideration, including stock options, cash, notes or other evidences of debt, assumption of liabilities and/or a combination of these types of consideration. In addition, we may lease property from, and enter into management agreements and consulting and noncompetition agreements with, the former owners and key executive personnel of the businesses to be acquired.

We expect that we will determine the terms on which we may issue the shares of common stock covered by this prospectus by direct negotiations with the owners or controlling persons of the business or assets to be acquired and that the shares of common stock issued will be valued at prices reasonably related to market prices prevailing either at the time an acquisition agreement is executed or at or about the time of delivery of those shares.

In an effort to maintain an orderly market in the common stock or for other reasons, we may negotiate agreements with persons receiving common stock covered by this prospectus that will limit the number of shares that such persons may sell for specified periods. These agreements may be more restrictive than restrictions on sales made pursuant to the exemption from registration requirements of the Securities Act of 1933, including the requirements under Rule 144 or Rule 145, and the persons party to these agreements may not otherwise be subject to the Securities Act requirements.

#### LEGAL MATTERS

The validity of the issuance of the shares of common stock offered by this prospectus will be passed upon for us by Baker & Botts, L.L.P., Dallas, Texas.

#### EXPERTS

Our financial statements and schedule as of December 31, 1997 and 1998 and for each of the three years in the period ended December 31, 1998 included in this prospectus and elsewhere in the registration statement have been audited by Arthur Andersen LLP, independent public accountants, as indicated in their report which is included in this prospectus, and are included in this prospectus in reliance upon the authority of said firm as experts in giving said reports.

## WHERE YOU CAN FIND MORE INFORMATION

We have filed with the Securities and Exchange Commission, Washington, D.C. 20549, a registration statement on Form S-4 under the Securities Act of 1933 for the common stock offered by this prospectus. This prospectus does not contain all of the information included in the registration statement and the exhibits and schedules of the registration statement. Certain items are omitted in accordance with the rules and regulations of the SEC. For further information with respect to Lennox and the common stock, reference is made to the registration statement and the exhibits and any schedules filed with the registration statement. Statements contained in this prospectus as to the contents of any contract or other document that is required to be summarized or outlined in the prospectus are not necessarily complete and in each instance, if such contract or document is filed as an exhibit, reference is made to the copy of such contract or other documents filed as an exhibit to the registration statement, each statement being qualified in all respects by such reference. A copy of the registration statement, including its exhibits and schedules, may be read and copied at the SEC's Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an Internet site at <http://www.sec.gov>, from which interested persons can electronically access the registration statement, including its exhibits and schedules.

As a result of our initial public offering, we will become subject to the full informational requirements of the Securities Exchange Act of 1934. We will fulfill our obligations under such requirements by filing periodic reports and other information with the SEC. We intend to furnish our shareholders with annual reports containing consolidated financial statements certified by an independent public accounting firm.

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## LENNOX INTERNATIONAL INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS  
AS OF DECEMBER 31, 1998 AND JUNE 30, 1999  
(IN THOUSANDS, EXCEPT SHARE DATA)

## ASSETS

	DECEMBER 31, 1998	JUNE 30, 1999
	-----	-----
		(UNAUDITED)
CURRENT ASSETS:		
Cash and cash equivalents.....	\$ 28,389	\$ 34,381
Accounts and notes receivable, net.....	318,858	457,514
Inventories.....	274,679	341,274
Deferred income taxes.....	37,426	38,529
Other assets.....	36,183	39,096
	-----	-----
Total current assets.....	695,535	910,794
INVESTMENTS IN JOINT VENTURES.....	17,261	9,823
PROPERTY, PLANT, AND EQUIPMENT, net.....	255,125	294,317
GOODWILL, net.....	155,290	248,497
OTHER ASSETS.....	29,741	41,006
	-----	-----
TOTAL ASSETS.....	\$1,152,952	\$1,504,437
	=====	=====

## LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES:		
Short-term debt.....	\$ 56,070	\$ 245,168
Current maturities of long-term debt.....	18,778	25,640
Accounts payable.....	149,824	187,048
Accrued expenses.....	207,040	204,180
Income taxes payable.....	534	9,146
	-----	-----
Total current liabilities.....	432,246	671,182
LONG-TERM DEBT.....	242,593	305,470
DEFERRED INCOME TAXES.....	11,628	9,579
POSTRETIREMENT BENEFITS, OTHER THAN PENSIONS.....	16,511	16,669
OTHER LIABILITIES.....	60,845	66,332
	-----	-----
Total liabilities.....	763,823	1,069,232
	-----	-----
MINORITY INTEREST.....	12,689	12,824
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Preferred stock, \$.01 par value, 25,000,000 shares authorized, no shares issued or outstanding.....	--	--
Common stock, \$.01 par value, 200,000,000 shares authorized, 35,546,940 shares and 36,572,250 shares issued and outstanding for 1998 and 1999, respectively.....	355	366
Additional paid-in capital.....	32,889	57,242
Retained earnings.....	350,851	374,945
Currency translation adjustments.....	(7,655)	(10,172)
	-----	-----
Total stockholders' equity.....	376,440	422,381
	-----	-----
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY.....	\$1,152,952	\$1,504,437
	=====	=====

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

## LENNOX INTERNATIONAL INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME  
FOR THE SIX MONTHS ENDED JUNE 30, 1998 AND 1999  
(UNAUDITED, IN THOUSANDS, EXCEPT SHARE DATA)

	FOR THE SIX MONTHS ENDED JUNE 30,	
	1998	1999
NET SALES.....	\$835,630	\$1,080,900
COST OF GOODS SOLD.....	570,801	743,000
Gross profit.....	264,829	337,900
OPERATING EXPENSES:		
Selling, general and administrative.....	205,618	267,794
Other operating expense, net.....	7,291	3,408
Income from operations.....	51,920	66,698
INTEREST EXPENSE, net.....	6,466	15,100
OTHER.....	532	(781)
MINORITY INTEREST.....	(788)	(620)
Income before income taxes.....	45,710	52,999
PROVISION FOR INCOME TAXES.....	20,336	22,798
Net income.....	\$ 25,374	\$ 30,201
EARNINGS PER SHARE:		
Basic.....	\$ 0.73	\$ 0.84
Diluted.....	\$ 0.72	\$ 0.82

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



## LENNOX INTERNATIONAL INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE SIX MONTHS ENDED JUNE 30, 1998 AND 1999  
(UNAUDITED, IN THOUSANDS)

	FOR THE SIX MONTHS ENDED JUNE 30,	
	1998	1999
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income.....	\$ 25,374	\$ 30,201
Adjustments to reconcile net income to net cash used in operating activities --		
Minority interest.....	(788)	(620)
Joint venture losses.....	1,877	1,845
Depreciation and amortization.....	19,502	26,877
Loss on disposal of equipment.....	44	642
Other.....	4,493	(364)
Changes in assets and liabilities, net of effects of acquisitions --		
Accounts and notes receivable.....	(66,933)	(98,772)
Inventories.....	(56,558)	(28,069)
Other current assets.....	(857)	1,875
Accounts payable.....	46,579	16,766
Accrued expenses.....	(33,611)	(8,263)
Deferred income taxes.....	(829)	(950)
Income taxes payable and receivable.....	13,892	14,553
Long-term warranty, deferred income and other liabilities.....	(16,638)	(4,827)
Net cash used in operating activities.....	(64,453)	(49,106)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Proceeds from the disposal of property, plant and equipment.....	52	393
Purchases of property, plant and equipment.....	(21,110)	(37,887)
Acquisitions, net of cash acquired.....	(1,357)	(128,284)
Net cash used in investing activities.....	(22,415)	(165,778)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Short-term borrowings.....	7,410	187,957
Repayments of long-term debt.....	(4,197)	(2,170)
Long-term borrowings.....	75,000	41,524
Sales of common stock.....	3,751	688
Repurchases of common stock.....	(3,201)	(152)
Cash dividends paid.....	(5,136)	(6,107)
Net cash provided by financing activities.....	73,627	221,740
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS.....	(13,241)	6,856
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS.....	(549)	(864)
CASH AND CASH EQUIVALENTS, beginning of period.....	147,802	28,389
CASH AND CASH EQUIVALENTS, end of period.....	\$134,012	\$ 34,381
<b>Supplementary disclosures of cash flow information:</b>		
Cash paid during the period for:		
Interest.....	\$ 9,266	\$ 14,902
Income taxes.....	\$ 5,262	\$ 10,878

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

## LENNOX INTERNATIONAL INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 SIX MONTHS ENDED JUNE 30, 1998 AND 1999  
 (UNAUDITED)

## 1. BASIS OF PRESENTATION AND OTHER ACCOUNTING INFORMATION:

The accompanying unaudited consolidated balance sheet as of June 30, 1999, and the consolidated statements of income and cash flows for the six months ended June 30, 1998 and 1999 should be read in conjunction with Lennox International Inc.'s (the "Company") consolidated financial statements and accompanying footnotes as of December 31, 1997 and 1998 and for each of the three years in the period ended December 31, 1998 included elsewhere herein. In the opinion of management, the accompanying consolidated financial statements contain all material adjustments, consisting principally of normal recurring adjustments, necessary for a fair presentation of the Company's financial position, results of operations, and cash flows. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to applicable rules and regulations, although the Company believes that the disclosures herein are adequate to make the information presented not misleading. The operating results for the interim periods are not necessarily indicative of the results to be expected for a full year.

The Company's fiscal year ends on December 31 of each year, and the Company's fiscal quarters are each comprised of 13 weeks. For convenience, throughout these financial statements, the 13 weeks comprising each three month period are denoted by the last day of the respective calendar quarter.

## 2. PRODUCT INSPECTION CHARGE:

During 1997, the Company recorded a pre-tax charge of \$140 million to provide for projected expenses of the product inspection program related to its Pulse furnace. The Company has offered the owners of all Pulse furnaces installed between 1982 and 1990 a subsidized inspection and a free carbon monoxide detector. The inspection includes a severe pressure test to determine the serviceability of the heat exchanger. If the heat exchanger does not pass the test, the Company will either replace the heat exchanger or offer a new furnace and subsidize the labor costs for installation. The cost required for the program depends on the number of furnaces located, the percentage of those located that do not pass the pressure test, and the replacement option chosen by the homeowner.

The inspection program ended in June 1999, with a current liability remaining of \$2 million, which the Company estimates will be adequate to cover any estimated remaining costs associated with the program.

## 3. REPORTABLE BUSINESS SEGMENTS:

As of December 31, 1998, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 131, which requires disclosure of business segment data in accordance with the "management approach." The management approach is based on the way segments are organized within the Company for making operating decisions and assessing performance. The Company's business operations are organized within the following four reportable business segments as follows (in thousands):

	FOR THE SIX MONTHS ENDED JUNE 30,	
	1998	1999
NET SALES		
North American residential.....	\$463,457	\$ 623,303
Commercial air conditioning.....	173,845	210,063
Commercial refrigeration.....	109,009	144,175
Heat transfer(1).....	89,319	103,359
	-----	-----
	\$835,630	\$1,080,900
	=====	=====

(1) In addition to the sales described above, the Heat Transfer segment had affiliate intersegment sales of \$14,419 and \$11,974 for the six months ended June 30, 1998 and 1999, respectively.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

INCOME (LOSS) FROM OPERATIONS	FOR THE SIX MONTHS ENDED JUNE 30,	
	1998	1999
-----	-----	-----
North American residential.....	\$ 59,495	\$ 64,651
Commercial air conditioning.....	(5,090)	1,147
Commercial refrigeration.....	7,928	9,170
Heat transfer.....	6,897	7,457
Corporate and other.....	(17,310)	(15,727)
	-----	-----
	\$ 51,920	\$ 66,698
	=====	=====

IDENTIFIABLE ASSETS	AS OF DECEMBER 31,	AS OF JUNE 30,
	1998	1999
-----	-----	-----
North American residential.....	\$ 528,660	\$ 665,226
Commercial air conditioning.....	198,982	267,935
Commercial refrigeration.....	194,601	267,827
Heat transfer.....	88,633	160,341
Corporate and other.....	142,076	148,313
	-----	-----
	\$1,152,952	\$1,509,642
	=====	=====

## 4. INVENTORIES:

Components of inventories are as follows (in thousands):

	DECEMBER 31,	JUNE 30,
	1998	1999
	-----	-----
Finished goods.....	\$177,490	\$223,221
Repair parts.....	31,674	32,555
Work in process.....	15,574	26,927
Raw materials.....	102,876	107,051
	-----	-----
Reduction for last-in, first-out.....	327,614	389,754
	52,935	48,480
	-----	-----
	\$274,679	\$341,274
	=====	=====

## 5. LINES OF CREDIT AND SHORT-TERM DEBT:

The Company has bank lines of credit and short-term loans aggregating \$307 million, of which \$245 million was outstanding at June 30, 1999 with a weighted average interest rate of 5.1%. The unsecured promissory note agreements and lines of credit provide for restrictions with respect to additional borrowings, maintenance of minimum working capital and payment of dividends. (See "Subsequent Events" for further information on short-term loans.)

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## 6. EARNINGS PER SHARE:

Basic earnings per share are computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per share are computed by dividing net income by the sum of the weighted average number of shares and the number of equivalent shares assumed outstanding, if dilutive, under the Company's stock-based compensation plans. Diluted earnings per share are computed as follows (in thousands, except per share amounts):

	SIX MONTHS ENDED JUNE 30,	
	1998	1999
Net income.....	\$25,374	\$30,201
Weighted average shares outstanding.....	34,617	35,805
Effect of assumed exercise of options.....	693	891
Weighted average shares outstanding, as adjusted.....	35,310	36,696
Diluted earnings per share.....	\$ 0.72	\$ 0.82

## 7. INVESTMENTS IN SUBSIDIARIES:

## LIVERNOIS

In May 1999, the Company acquired Livernois Engineering Holding Company, its operating subsidiary and its licensed patents for \$18.9 million. Livernois produces heat transfer manufacturing equipment for the HVACR and automotive industries. The purchase price, consisting of cash of \$13.2 million and \$5.7 million in shares of the Company's stock (304,953 shares), has been allocated, based on fair value, to assets totaling \$16.0 million and to liabilities totaling \$3.0 million, with \$5.9 million being allocated to goodwill. This goodwill is being amortized over 40 years. The acquisition was accounted for in accordance with the purchase method of accounting. The results of the operations of Livernois have been fully consolidated with those of the Company since the date of acquisition.

## DEALERS

In September 1998, the Company initiated a program to acquire high quality heating and air conditioning dealers in metropolitan areas in the United States and Canada to market "Lennox" and other brands of heating and air conditioning products. During the first six months of 1999, the Company acquired 32 additional dealers (the "Dealers") in Canada and the United States. The aggregate purchase price for the Dealers acquired was \$49.0 million, all by cash. These acquisitions were accounted for in accordance with the purchase method of accounting. The purchase price of each Dealer has been allocated, based on fair values, to assets totaling \$23.4 million and to liabilities totaling \$14.1 million with \$39.7 million being allocated to goodwill, which is being amortized over 40 years. The results of the operations of the Dealers have been fully consolidated with those of the Company since the dates of acquisition.

## KIRBY

In June 1999 the Company acquired the outstanding stock of James N. Kirby Pty. Ltd., an Australian manufacturer and distributor of refrigeration and heat transfer technology. The purchase price of \$65.4 million was paid in cash and in shares of the Company's stock (650,430 shares) in the amounts of \$49.3 million and \$16.1 million, respectively. The acquisition was accounted for in accordance with the purchase method of accounting, and accordingly, the purchase price was allocated, based on fair value, to assets totaling \$76.0 million and to liabilities totaling \$50.2 million, with \$39.6 million being allocated to goodwill. In order to finance the cash portion of the purchase price, the Company borrowed approximately \$49.3 million in the form

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

of three promissory notes. The first promissory note of \$16.1 million bears interest at 5.68% and is payable December 31, 1999 at which time permanent financing will be arranged. The second promissory note of \$11.6 million is payable in June 2000 at no interest charge. The third promissory note of \$21.6 million is payable \$11.1 million in 2001 and \$10.5 million in 2002. The stated interest rate on the third promissory note escalates from no interest in year one to 4% in year three. Accordingly, the Company recorded a discount on the third promissory note of \$1.6 million, which is being amortized over three years, to record the promissory note at fair value. The goodwill is being amortized over 40 years. In conjunction with the acquisition, the Company assumed a \$20.5 million promissory note bearing interest at 5.5% which is payable upon the arranging of permanent financing. The results of the operations of this acquired company have been fully consolidated with those of the Company since the date of acquisition.

The following table presents the pro forma results as if the above companies and other companies acquired during 1999 had been acquired on January 1, 1998 (in thousands, except per share data):

	FOR THE SIX MONTHS ENDED JUNE 30,	
	1998	1999
Net sales.....	\$961,834	\$1,160,906
Net income.....	30,333	31,364
Basic earnings per share.....	0.88	0.88
Diluted earnings per share.....	0.86	0.85

## 8. SUBSEQUENT EVENTS:

Between June 30, 1999 and July 31, 1999, the Company acquired 2 dealers in Canada for an aggregate purchase price of approximately \$5.7 million in cash. The Company has also signed letters of intent to acquire 9 additional dealers in Canada and 22 dealers in the U.S. for an aggregate purchase price of approximately \$110 million.

The Company has entered into an agreement to purchase the remaining 30% interest in Ets. Brancher for 102.5 million French francs (approximately \$17 million) on March 31, 2000.

The Company has issued a letter of intent to purchase certain assets and assume certain related liabilities of the Ducane Company. The purchase price is expected to be approximately \$45 million, and is expected to close in September 1999.

On July 29, 1999 the Company entered into a new Revolving Credit Facility Agreement with a syndicate of banks providing a revolving credit line of up to \$300 million. The facility contains certain financial covenants and bears interest, at the Company's option, at a rate equal to either (a) the greater of the banks prime rate or the federal funds rate plus 0.5% or (b) the London Interbank Offered Rate plus a margin equal to 0.5% to 1.125%, depending upon our ratio of total funded debt to EBITDA. The agreement provides for restrictions on additional debt, maintenance of capital and limitations on interest expense.

On August 3, 1999, the Company completed an initial public offering of its common stock in which 8,088,490 shares of common stock were issued at an offering price of \$18.75 per share. The Company borrowed \$67 million under the revolving credit agreement on August 3, 1999, using these proceeds and the proceeds from the initial public offering of approximately \$140 million to retire all outstanding loans under the previous U.S. based revolving credit and short-term credit facilities.

In July 1999, the Company declared a 33-for-1 common stock split. Accordingly, all information related to the number of shares of the Company's common stock and options has been adjusted to reflect the stock split.

## REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Stockholders and Board of Directors of  
Lennox International Inc.:

We have audited the accompanying consolidated balance sheets of Lennox International Inc. (a Delaware corporation) and Subsidiaries as of December 31, 1997 and 1998, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Lennox International Inc. and Subsidiaries as of December 31, 1997 and 1998, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles.

ARTHUR ANDERSEN LLP

Dallas, Texas,  
February 18, 1999

## LENNOX INTERNATIONAL INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS  
AS OF DECEMBER 31, 1997 AND 1998  
(IN THOUSANDS, EXCEPT SHARE DATA)

## ASSETS

	AS OF DECEMBER 31,	
	1997	1998
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents.....	\$147,802	\$ 28,389
Accounts and notes receivable, net.....	273,229	318,858
Inventories.....	183,077	274,679
Deferred income taxes.....	51,137	37,426
Other assets.....	15,260	36,183
	-----	-----
Total current assets.....	670,505	695,535
INVESTMENTS IN JOINT VENTURES.....	14,803	17,261
PROPERTY, PLANT, AND EQUIPMENT, net.....	215,333	255,125
GOODWILL, net.....	42,620	155,290
OTHER ASSETS.....	27,631	29,741
	-----	-----
<b>TOTAL ASSETS.....</b>	<b>\$970,892</b>	<b>\$1,152,952</b>
	=====	=====
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Short-term debt.....	\$ 6,021	\$ 56,070
Current maturities of long-term debt.....	8,926	18,778
Accounts payable.....	104,679	149,824
Accrued expenses.....	210,668	207,040
Income taxes payable.....	4,320	534
	-----	-----
Total current liabilities.....	334,614	432,246
LONG-TERM DEBT.....	183,583	242,593
DEFERRED INCOME TAXES.....	2,690	11,628
POSTRETIREMENT BENEFITS, OTHER THAN PENSIONS.....	17,288	16,511
OTHER LIABILITIES.....	92,471	60,845
	-----	-----
Total liabilities.....	630,646	763,823
	-----	-----
MINORITY INTEREST.....	14,768	12,689
COMMITMENTS AND CONTINGENCIES		
<b>STOCKHOLDERS' EQUITY:</b>		
Preferred stock, \$.01 par value, 25,000,000 shares authorized, no shares issued or outstanding.....	--	--
Common stock, \$.01 par value, 200,000,000 shares authorized, 34,407,384 shares and 35,546,940 shares issued and outstanding for 1997 and 1998, respectively.....	344	355
Additional paid-in capital.....	19,260	32,889
Retained earnings.....	309,610	350,851
Currency translation adjustments.....	(3,736)	(7,655)
	-----	-----
Total stockholders' equity.....	325,478	376,440
	-----	-----
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY.....</b>	<b>\$970,892</b>	<b>\$1,152,952</b>
	=====	=====

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

## LENNOX INTERNATIONAL INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME  
 FOR THE YEARS ENDED DECEMBER 31, 1996, 1997 AND 1998  
 (IN THOUSANDS, EXCEPT PER SHARE DATA)

	FOR THE YEARS ENDED DECEMBER 31,		
	1996	1997	1998
NET SALES.....	\$1,364,546	\$1,444,442	\$1,821,836
COST OF GOODS SOLD.....	961,696	1,005,913	1,245,623
Gross profit.....	402,850	438,529	576,213
OPERATING EXPENSES:			
Selling, general and administrative.....	298,049	326,280	461,143
Other operating expense, net.....	4,213	7,488	8,467
Product inspection charge.....	--	140,000	--
Income (loss) from operations.....	100,588	(35,239)	106,603
INTEREST EXPENSE, net.....	13,417	8,515	16,184
OTHER.....	(943)	1,955	1,602
MINORITY INTEREST.....	--	(666)	(869)
Income (loss) before income taxes.....	88,114	(45,043)	89,686
PROVISION (BENEFIT) FOR INCOME TAXES.....	33,388	(11,493)	37,161
Net income (loss).....	\$ 54,726	\$ (33,550)	\$ 52,525
EARNINGS (LOSS) PER SHARE:			
Basic.....	\$ 1.62	\$ (0.99)	\$ 1.50
Diluted.....	\$ 1.59	\$ (0.99)	\$ 1.47

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



## LENNOX INTERNATIONAL INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
 FOR THE YEARS ENDED DECEMBER 31, 1996, 1997 AND 1998  
 (IN THOUSANDS, EXCEPT PER SHARE DATA)

	COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	CURRENCY TRANSLATION ADJUSTMENTS	TOTAL STOCKHOLDERS' EQUITY	COMPREHENSIVE INCOME
	SHARES ISSUED AND OUTSTANDING	AMOUNT					
BALANCE AT DECEMBER 31, 1995.....	32,956	\$ 330	\$ 3,758	\$313,044	\$(1,819)	\$315,313	\$ --
Net income.....	--	--	--	54,726	--	54,726	54,726
Dividends, \$0.26 per share.....	--	--	--	(8,845)	--	(8,845)	--
Stock dividend -- 2%.....	660	6	6,091	(6,097)	--	--	--
Foreign currency translation adjustments.....	--	--	--	--	(156)	(156)	(156)
Common stock repurchased.....	(138)	(1)	(1,459)	--	--	(1,460)	--
Common stock issued.....	225	2	1,884	--	--	1,886	--
Comprehensive income.....	--	--	--	--	--	--	54,570
BALANCE AT DECEMBER 31, 1996.....	33,703	337	10,274	352,828	(1,975)	361,464	--
Net loss.....	--	--	--	(33,550)	--	(33,550)	(33,550)
Dividends, \$0.28 per share.....	--	--	--	(9,668)	--	(9,668)	--
Foreign currency translation adjustments.....	--	--	--	--	(1,761)	(1,761)	(1,761)
Common stock repurchased.....	(369)	(4)	(4,888)	--	--	(4,892)	--
Common stock issued.....	1,073	11	13,874	--	--	13,885	--
Comprehensive income (loss).....	--	--	--	--	--	--	(35,311)
BALANCE AT DECEMBER 31, 1997.....	34,407	344	19,260	309,610	(3,736)	325,478	--
Net income.....	--	--	--	52,525	--	52,525	52,525
Dividends, \$0.32 per share.....	--	--	--	(11,284)	--	(11,284)	--
Foreign currency translation adjustments.....	--	--	--	--	(3,919)	(3,919)	(3,919)
Common stock repurchased.....	(506)	(5)	(8,505)	--	--	(8,510)	--
Common stock issued.....	1,646	16	22,134	--	--	22,150	--
Comprehensive income.....	--	--	--	--	--	--	\$ 48,606
BALANCE AT DECEMBER 31, 1998.....	35,547	\$ 355	\$32,889	\$350,851	\$(7,655)	\$376,440	

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

## LENNOX INTERNATIONAL INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE YEARS ENDED DECEMBER 31, 1996, 1997 AND 1998  
(IN THOUSANDS)

	FOR THE YEARS ENDED DECEMBER 31,		
	1996	1997	1998
	-----	-----	-----
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income (loss).....	\$ 54,726	\$(33,550)	\$ 52,525
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Minority interest.....	--	(666)	(869)
Joint venture losses.....	1,118	1,782	3,111
Depreciation and amortization.....	34,149	33,430	43,545
Loss (gain) on disposal of equipment.....	1,315	(251)	570
Other.....	(962)	2,112	(130)
Changes in assets and liabilities, net of effects of acquisitions:			
Accounts and notes receivable.....	13,269	(25,878)	(20,567)
Inventories.....	28,539	17,258	(52,445)
Other current assets.....	(3,239)	3,622	(4,739)
Accounts payable.....	(3,018)	(4,774)	29,851
Accrued expenses.....	38,774	64,400	(17,040)
Deferred income taxes.....	(5,103)	(42,195)	26,424
Income taxes payable and receivable.....	4,166	(2,361)	(18,610)
Long-term warranty, deferred income and other liabilities.....	(4,890)	45,557	(36,662)
Net cash provided by operating activities.....	158,844	58,486	4,964
	-----	-----	-----
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Proceeds from the disposal of property, plant and equipment.....	547	4,205	538
Purchases of property, plant and equipment.....	(31,903)	(34,581)	(52,435)
Investments in joint ventures.....	(23,395)	(3,735)	(458)
Acquisitions, net of cash acquired.....	--	(10,527)	(160,063)
Proceeds from the sale of businesses.....	17,633	--	--
Net cash used in investing activities.....	(37,118)	(44,638)	(212,418)
	-----	-----	-----
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Short-term borrowings.....	--	(3,732)	36,724
Repayments of long-term debt.....	(34,588)	(5,712)	(12,499)
Long-term borrowings.....	--	5,572	75,044
Sales of common stock.....	630	729	9,607
Repurchases of common stock.....	(1,460)	(4,892)	(8,510)
Cash dividends paid.....	(8,560)	(9,312)	(10,820)
Net cash provided by (used in) financing activities.....	(43,978)	(17,347)	89,546
	-----	-----	-----
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS.....	77,748	(3,499)	(117,908)
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS.....	318	(576)	(1,505)
CASH AND CASH EQUIVALENTS, beginning of year.....	73,811	151,877	147,802
	-----	-----	-----
CASH AND CASH EQUIVALENTS, end of year.....	\$151,877	\$147,802	\$ 28,389
	=====	=====	=====
Supplementary disclosures of cash flow information:			
Cash paid during the year for:			
Interest.....	\$ 18,481	\$ 15,016	\$ 20,351
	=====	=====	=====
Income taxes.....	\$ 34,198	\$ 33,938	\$ 29,347
	=====	=====	=====

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

## LENNOX INTERNATIONAL INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED DECEMBER 31, 1996, 1997 AND 1998

## 1. NATURE OF OPERATIONS:

Lennox International Inc. and subsidiaries (the "Company"), a Delaware corporation, is a global designer, manufacturer, and marketer of a broad range of products for the heating, ventilation, air conditioning, and refrigeration ("HVACR") markets. The Company participates in four reportable business segments of the HVACR industry. The first is North American residential heating, air conditioning and hearth products in which the Company manufactures and markets a full line of these products for the residential replacement and new construction markets in North America. The second reportable segment is the global commercial air conditioning market in which the Company manufactures and sells rooftop products and applied systems for commercial applications. The third is the global commercial refrigeration market which consists of unit coolers, condensing units and other commercial refrigeration products. The fourth reportable segment is heat transfer products in which the Company designs, manufactures and sells evaporator and condenser coils, copper tubing, and related equipment to original equipment manufacturers ("OEMs") and other specialty purchasers on a global basis. See Note 4 for financial information regarding the Company's reportable segments.

The Company sells its products to numerous types of customers, including distributors, installing dealers, national accounts and OEMs.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

## PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of Lennox International Inc. and its subsidiaries. All intercompany transactions and balances have been eliminated. Investments in joint ventures where the Company has a 50% or less ownership interest are being accounted for using the equity method of accounting.

As discussed in Note 7, the Company increased its ownership in Ets. Brancher from 50% to 70% in September 1997. As a result, the Company assumed control of the venture and began consolidating the financial position and results of operations in the fourth quarter of 1997. Previously, the Company used the equity method of accounting for its investment in this entity.

## CASH EQUIVALENTS

The Company considers all highly liquid temporary investments with original maturity dates of three months or less to be cash equivalents. Cash equivalents consist of investment grade securities and are stated at cost which approximates fair value. The Company earned interest income of \$4.8 million, \$6.4 million and \$4.5 million for the years ended December 31, 1996, 1997 and 1998, respectively, which is included in interest expense, net on the accompanying consolidated statements of income.

## ACCOUNTS AND NOTES RECEIVABLE

Accounts and notes receivable have been shown net of an allowance for doubtful accounts of \$16.9 million and \$18.5 million as of December 31, 1997 and 1998, respectively. The Company has no significant credit risk concentration among its diversified customer base.

## INVENTORIES

Inventory costs include applicable material, labor, depreciation, and plant overhead. Inventories of \$125.5 million and \$169.6 million in 1997 and 1998, respectively, are valued at the lower of cost or market using the last-in, first-out (LIFO) cost method. The remaining portion of the inventory is valued at the lower of cost or market with cost being determined on the first-in, first-out (FIFO) basis.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment is stated at cost. Expenditures for renewals and betterments are capitalized, and expenditures for maintenance and repairs are charged to expense as incurred. Gains and losses resulting from the dispositions of property, plant and equipment are included in other operating expense. Depreciation is computed using the straight-line method over the following estimated useful lives:

Buildings and improvements.....	10 to 39 years
Machinery and equipment.....	3 to 10 years

## GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill and other intangible assets have been recorded based on their fair value at the date of acquisition and are being amortized on a straight-line basis over periods generally ranging from thirty to forty years. As of December 31, 1997 and 1998, accumulated amortization was \$26.5 million and \$34.4 million, respectively.

The Company periodically reviews long-lived assets and identifiable intangibles for impairment as events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. In order to assess recoverability, the Company compares the estimated expected future cash flows (undiscounted and without interest charges) identified with each long-lived asset or related asset grouping to the carrying amount of such assets. For purposes of such comparisons, portions of goodwill are attributed to related long-lived assets and identifiable intangible assets based upon relative fair values of such assets at acquisition. If the expected future cash flows do not exceed the carrying value of the asset or assets being reviewed, an impairment loss is recognized based on the excess of the carrying amount of the impaired assets over their fair value. As a result of these periodic reviews, there have been no adjustments to the carrying value of long-lived assets, identifiable intangibles, or goodwill in 1996, 1997 and 1998.

## PRODUCT WARRANTIES

A liability for estimated warranty expense is established by a charge against operations at the time products are sold. The subsequent costs incurred for warranty claims serve to reduce the product warranty liability. The Company recorded warranty expense of \$14.6 million, \$17.7 million and \$15.6 million for the years ended December 31, 1996, 1997, and 1998, respectively.

The Company's estimate of future warranty costs is determined for each product line. The number of units that are expected to be repaired or replaced is determined by applying the estimated failure rate, which is generally based on historical experience, to the number of units that have been sold and are still under warranty. The estimated units to be repaired under warranty are multiplied by the average cost (undiscounted) to repair or replace such products to determine the Company's estimated future warranty cost. The Company's estimated future warranty cost is subject to adjustment from time to time depending on actual experience.

Total liabilities for estimated warranty expense are \$155.7 million and \$83.2 million as of December 31, 1997 and 1998, respectively, and are included in the following captions on the accompanying consolidated balance sheets (in thousands):

	DECEMBER 31,	
	1997	1998
Current accrued expenses.....	\$ 94,042	\$48,467
Other non-current liabilities.....	61,617	34,707
	\$155,659	\$83,174
	=====	=====

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

Liabilities for estimated warranty expense as of December 31, 1997 and 1998, include approximately \$113.4 million and \$27.3 million, respectively, in remaining estimated liabilities associated with a product inspection program initiated in 1997 (see Note 3).

## INCOME TAXES

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

## REVENUE RECOGNITION

Sales are recorded when products are shipped or when services are rendered.

## RESEARCH AND DEVELOPMENT EXPENSES

Research and development costs are expensed as incurred. The Company expended approximately \$23.2 million, \$25.4 million, and \$33.3 million for the years ended December 31, 1996, 1997, and 1998, respectively, for research and product development activities. Research and development costs are included in selling, general and administrative expense on the accompanying consolidated statements of income.

## ADVERTISING

Production costs of commercials and programming are charged to operations in the period first aired. The costs of other advertising, promotion and marketing programs are charged to operations in the period incurred. Advertising expense was \$36.4 million, \$37.9 million, and \$50.2 million for the years ended December 31, 1996, 1997, and 1998, respectively.

## TRANSLATION OF FOREIGN CURRENCIES

All assets and liabilities of foreign subsidiaries and joint ventures are translated into United States dollars using rates of exchange in effect at the balance sheet date. Revenues and expenses are translated at average exchange rates during the respective years. The unrealized translation gains and losses are accumulated in a separate component of stockholders' equity. Transaction gains (losses) included in the accompanying statements of income were \$943,000, \$(1,955,000), and \$(1,602,000) for the years ended December 31, 1996, 1997, and 1998, respectively.

## FOREIGN CURRENCY CONTRACTS

The Company has entered into foreign currency exchange contracts to hedge its investment in Ets. Brancher S.A. (see Note 7) and not to engage in currency speculation. These contracts do not subject the Company to risk from exchange rate movements because the gains or losses on the contracts offset the losses or gains, respectively, on the assets and liabilities of the subsidiary. The Company has entered into contracts to sell 165.5 million French francs on May 7, 2003 for \$31.7 million. The fair value of these contracts was approximately \$4.1 million and \$2.1 million as of December 31, 1997 and 1998, respectively.

These contracts require the Company to exchange French francs for U.S. dollars at maturity (May 2003), at rates agreed to at inception of the contracts. If the counterparty to the exchange contracts does not fulfill their obligations to deliver the contracted currencies, the Company could be at risk for any

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

currency related fluctuations. The gains and losses associated with these contracts, net of tax, are recorded as a component of currency translation adjustments on the accompanying 1996, 1997 and 1998 consolidated statements of stockholders' equity.

The Company from time to time enters into foreign currency exchange contracts to hedge receivables from its foreign subsidiaries, and not to engage in currency speculation. These contracts do not subject the Company to risk from exchange rate movements because the gains or losses on the contracts offset losses or gains, respectively, on the receivables being hedged. As of December 31, 1998, the Company had obligations to deliver \$33.2 million of various foreign currencies within the next three months, for which the counterparties to the contracts will pay fixed contract amounts. The fair values of such contracts were insignificant as of December 31, 1998.

## PURCHASE COMMITMENTS

The Company has contracts with various suppliers to purchase copper and aluminum for use in its manufacturing processes. As of December 31, 1998, the Company had contracts to purchase 19.8 million pounds of copper over the next 24 months at fixed prices that average \$0.76 per pound (\$15.1 million) and contracts to purchase 6 million pounds of copper at a variable price equal to the COMEX copper price (\$0.72 per pound at December 31, 1998) over the next 12 months. The Company also had contracts to purchase 23.4 million pounds of aluminum at \$0.68 per pound (\$15.9 million) over the next 12 months. The fair value of the copper and aluminum purchase commitments was insignificant as of December 31, 1997 and was a liability of \$2.6 million at December 31, 1998.

## USE OF ESTIMATES

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

## 3. PRODUCT INSPECTION CHARGE:

During 1997, the Company recorded a pre-tax charge of \$140.0 million to provide for projected expenses of the product inspection program related to its Pulse furnace. The Company has offered the owners of Pulse furnaces installed between 1982 and 1990 a subsidized inspection and a free carbon monoxide detector. The inspection includes a severe pressure test to determine the serviceability of the heat exchanger. If the heat exchanger does not pass the test, the Company will either replace the heat exchanger or offer a new furnace and subsidize the labor costs for installation. The cost required for the program depends on the number of furnaces located, the percentage of those located that do not pass the pressure test, and the replacement option chosen by the homeowner.

As of December 31, 1998, the Company had incurred approximately \$112.7 million in costs related to the product inspection program. Consequently, there is a current liability of \$27.3 million recorded on the accompanying consolidated balance sheet as of December 31, 1998, to accrue for the estimated remaining costs of the program. The product inspection program ends in June 1999 and the Company believes its current liability of \$27.3 million is adequate to cover the remaining costs of the program.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## 4. REPORTABLE BUSINESS SEGMENTS:

As of December 31, 1998, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 131, which requires disclosure of business segment data in accordance with the "management approach." The management approach is based on the way segments are organized within the Company for making operating decisions and assessing performance. The Company's business operations are organized within the following four reportable business segments as follows (in thousands):

	FOR THE YEARS ENDED DECEMBER 31,		
	1996	1997	1998
<b>Net Sales</b>			
North American residential.....	\$ 857,131	\$ 865,147	\$1,013,747
Commercial air conditioning.....	228,935	278,837	392,053
Commercial refrigeration.....	135,566	154,247	237,264
Heat transfer(1).....	142,914	146,211	178,772
	<u>\$1,364,546</u>	<u>\$1,444,442</u>	<u>\$1,821,836</u>
<b>Income (Loss) from Operations</b>			
North American residential(2).....	\$ 99,658	\$ (47,516)	\$ 123,426
Commercial air conditioning.....	(9,477)	4,521	(6,579)
Commercial refrigeration.....	13,717	15,407	20,383
Heat transfer.....	17,311	16,857	12,700
Corporate and other(3).....	(20,621)	(24,508)	(43,327)
	<u>\$ 100,588</u>	<u>\$ (35,239)</u>	<u>\$ 106,603</u>

	AS OF DECEMBER 31,	
	1997	1998
<b>Identifiable Assets</b>		
North American residential.....	\$330,864	\$ 528,660
Commercial air conditioning.....	175,748	198,982
Commercial refrigeration.....	146,118	194,601
Heat transfer.....	69,272	88,633
Corporate and other(4).....	248,890	142,076
	<u>\$970,892</u>	<u>\$1,152,952</u>

- (1) The Heat transfer segment had intersegment sales of \$34,911, \$23,571, and \$32,307 in 1996, 1997, and 1998, respectively.
- (2) Includes a \$140.0 million charge in 1997 related to a product inspection program (see Note 3).
- (3) The increase in corporate and other from 1997 to 1998 is primarily due to \$7.1 million of expense for the settlement of a lawsuit in 1998 and \$4.6 million associated with increased expenses of the Company's Performance Plan.
- (4) The decrease in corporate and other is primarily due to a reduction in cash and cash equivalents of approximately \$120 million.

## LENNOX INTERNATIONAL INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

	FOR THE YEARS ENDED DECEMBER 31,		
	1996	1997	1998
Capital Expenditures			
North American residential.....	\$18,561	\$12,914	\$14,942
Commercial air conditioning.....	2,577	5,677	6,180
Commercial refrigeration.....	3,779	6,798	7,367
Heat transfer.....	6,453	6,907	12,136
Corporate and other(1).....	533	2,285	11,810
	-----	-----	-----
	\$31,903	\$34,581	\$52,435
	=====	=====	=====

(1) The increase in corporate and other is primarily due to an increase in expenditures related to the implementation of SAP.

Depreciation and Amortization			
North American residential.....	\$15,170	\$14,892	\$15,437
Commercial air conditioning.....	4,447	4,048	5,802
Commercial refrigeration.....	6,428	6,390	9,376
Heat transfer.....	3,963	3,991	5,912
Corporate and other.....	4,141	4,109	7,018
	-----	-----	-----
	\$34,149	\$33,430	\$43,545
	=====	=====	=====

The following table sets forth certain financial information relating to the Company's operations by geographic area (in thousands):

	FOR THE YEARS ENDED DECEMBER 31,		
	1996	1997	1998
Net Sales to External Customers			
United States.....	\$1,252,515	\$1,274,875	\$1,472,342
International.....	112,031	169,567	349,494
	-----	-----	-----
Total net sales to external customers.....	\$1,364,546	\$1,444,442	\$1,821,836
	=====	=====	=====

	AS OF DECEMBER 31,	
	1997	1998
Long-Lived Assets		
United States.....	\$246,133	\$344,137
International.....	54,254	113,280
	-----	-----
Total long-lived assets.....	\$300,387	\$457,417
	=====	=====



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## 5. INVENTORIES:

Components of inventories are as follows (in thousands):

	AS OF DECEMBER 31,	
	1997	1998
Finished goods.....	\$116,052	\$177,490
Repair parts.....	37,248	31,674
Work in process.....	15,755	15,574
Raw materials.....	70,223	102,876
	-----	-----
	239,278	327,614
Reduction for last-in, first-out.....	56,201	52,935
	-----	-----
	\$183,077	\$274,679
	=====	=====

## 6. PROPERTY, PLANT AND EQUIPMENT:

Components of property, plant and equipment are as follows (in thousands):

	AS OF DECEMBER 31,	
	1997	1998
Land.....	\$ 9,478	\$ 18,531
Buildings and improvements.....	150,866	162,916
Machinery and equipment.....	325,392	404,848
	-----	-----
Total.....	485,736	586,295
Less -- accumulated depreciation.....	(270,403)	(331,170)
	-----	-----
Property, plant and equipment, net.....	\$ 215,333	\$ 255,125
	=====	=====

## 7. INVESTMENTS IN JOINT VENTURES AND SUBSIDIARIES:

## ALLIANCE

In 1994, the Company acquired a 50% interest in a joint venture, Alliance Compressors, with American Standard Inc.'s Trane subsidiary ("Trane") to develop, manufacture, and market both reciprocating and scroll compressor products.

In December 1996, Alliance Compressors was restructured to admit a new partner, Copeland Corporation, and to focus solely on the development, manufacturing, and marketing of scroll compressors. In connection with the restructuring, the net assets associated with the reciprocating compressor business were distributed equally to the Company and Trane. The Company subsequently sold its share of the reciprocating compressor net assets to Trane. In addition, the Company and Trane sold portions of their interests in Alliance Compressors to Copeland Corporation. As a result, Alliance Compressors is now owned 51% by Copeland Corporation, 24.5% by the Company, and 24.5% by Trane. During 1996, the Company recognized a pretax gain of \$4.6 million as a result of the restructuring, which is included in other operating expense, net on the accompanying 1996 consolidated statement of income. The Company's investment in Alliance Compressors at December 31, 1998, is \$6.1 million and is being accounted for using the equity method of accounting.

## ETS. BRANCHER

In May 1996, the Company's subsidiary, Lennox Global Ltd., acquired a 50% interest in HCF-Lennox, a manufacturer of air conditioning and refrigeration equipment. In addition to acquiring an interest in HCF-Lennox, the Company increased its ownership of an existing joint venture, Friga-Bohn, from 20% to

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

50%. The aggregate purchase price for these acquisitions was approximately \$22 million in cash. The aggregate purchase price exceeded the Company's interests in the underlying equity in the ventures at the date of acquisition. As a result, the Company recorded goodwill of approximately \$2.9 million, which is being amortized on a straight-line basis over a 30-year period.

Effective September 30, 1997, Lennox Global Ltd. acquired an additional 20% interest in HCF-Lennox and Friga-Bohn. In conjunction with the purchase, the stock of HCF-Lennox and Friga-Bohn was combined into an existing holding company, Ets. Brancher S.A. Ets. Brancher also owns certain land and buildings that were leased to HCF-Lennox and Friga-Bohn. As a result of the acquisition, Lennox Global Ltd. owns 70% of HCF-Lennox and Friga-Bohn as well as a 70% interest in the land and buildings through its ownership of 70% of the stock of Ets. Brancher S.A. The aggregate purchase price for this acquisition was \$18.4 million, of which \$10 million was in cash and \$8.4 million was in Company stock (631,389 shares). The acquisition was accounted for in accordance with the purchase method of accounting. Accordingly, the purchase price has been allocated to the assets and liabilities based upon their estimated fair values at the date of acquisition. As a result, the Company recorded additional goodwill of approximately \$6.4 million, which is being amortized on a straight-line basis over a 30-year period.

The Company has entered into an agreement to acquire the remaining 30% interest in Ets. Brancher S.A. on March 31, 2000 for 102.5 million French francs, or approximately \$17 million.

The Company obtained control of Ets. Brancher S.A. on September 30, 1997, and, accordingly, began consolidating the financial position and operating results of the subsidiary. The 30% interest in Ets. Brancher S.A. not owned by the Company is reflected as minority interest on the accompanying consolidated balance sheets and statements of income.

The following table presents the pro forma results as if the Company's 70% interest in Ets. Brancher had been consolidated beginning January 1, 1996 (in thousands, except per share data).

	YEAR ENDED DECEMBER 31,	
	1996	1997
Net sales.....	\$1,576,418	\$1,588,985
Net income (loss).....	54,605	(33,381)
Basic earnings per share.....	1.62	(0.98)
Diluted earnings per share.....	1.59	(0.98)

## CANADIAN DEALERS

In the fourth quarter of 1998, the Company's Lennox Industries (Canada) Ltd. subsidiary, which is included in the North American residential segment, purchased for cash fourteen dealers (the "Dealers") in Canada that had been independent retail outlets of the Company's products. The aggregate purchase price of the Dealers was \$22.9 million in cash. These acquisitions were accounted for in accordance with the purchase method of accounting. The purchase price of each Dealer has been allocated to the assets and liabilities of the Dealers, and the excess of \$19.0 million has been allocated to goodwill, which is being amortized on a straight-line basis over 40 years. The results of operations of the Dealers, including sales of \$8.2 million and net income of \$139,000, have been fully consolidated with those of the Company since the dates of acquisition.

## HEARTH COMPANIES

During June and July 1998, the Company's Hearth Products Inc. subsidiary, which is included in the North American residential segment, purchased substantially all of the assets and certain liabilities of Superior Fireplace Co. and all of the outstanding stock of Marco Mfg. Inc. and Pyro Industries Inc. The aggregate purchase price for these acquisitions was \$102.9 million, of which \$99.1 million was in cash and \$3.8 million

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

was in the form of a note payable. These acquisitions were accounted for in accordance with the purchase method of accounting. Accordingly, the aggregate purchase price has been allocated to assets totaling \$131.5 million and to liabilities totaling \$28.6 million of the acquired companies based upon the fair value of those assets and liabilities. As a result, the Company recorded goodwill of approximately \$73.8 million which is being amortized on a straight-line basis over 40 years. The results of operations of the acquired Hearth companies, including sales of \$68.6 million and net income of \$1.9 million, have been fully consolidated with those of the Company since the dates of acquisition.

## MCQUAY DO BRASIL

During August 1998, the Company's Lennox Global Ltd. subsidiary purchased 84% of the outstanding stock of McQuay do Brasil, a Brazilian company engaged in the manufacture and sale of refrigeration, automotive air conditioning equipment, and heat transfer products. The purchase price of \$20.5 million in cash has been allocated to the acquired assets and liabilities based upon the fair value of those assets and liabilities, and the excess of \$11.3 million has been allocated to goodwill, which is being amortized on a straight-line basis over 40 years. The results of operations of McQuay do Brasil have been consolidated with those of the Company since the date of acquisition.

The following table presents the pro forma results as if the Dealers, the Hearth companies, and McQuay do Brasil had been acquired on January 1, 1997 (in thousands, except per share data).

	YEAR ENDED DECEMBER 31,	
	1997	1998
Net sales.....	\$1,648,642	\$1,944,036
Net income (loss).....	(37,750)	47,325
Basic earnings per share.....	(1.11)	1.36
Diluted earnings per share.....	(1.11)	1.32

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## 8. LONG-TERM DEBT AND LINES OF CREDIT:

Long-term debt at December 31 consists of the following (in thousands):

	1997	1998
	-----	-----
6.73% promissory notes, payable \$11,111 annually 2000 through 2008.....	\$100,000	\$100,000
9.69% promissory notes, payable \$4,900 annually 1998 through 2002 and \$5,000 in 2003.....	29,500	24,600
5.75% promissory note, payable in 1999.....	1,596	951
5.84% promissory note, payable in 2000.....	2,146	2,275
4.80% promissory note, payable annually through 2004....	1,197	1,119
6.50% promissory note, payable annually 1999 through 2005.....	1,334	1,382
5.50% promissory note, payable annually through 2004....	--	639
6.50% promissory note, payable annually through 2003....	--	371
9.53% promissory notes, payable \$10,000 in 1999, \$8,000 in 2000, and \$3,000 in 2001.....	21,000	21,000
7.06% promissory note, payable \$10,000 annually in 2004 and 2005.....	20,000	20,000
6.56% promissory note, payable in 2005.....	--	25,000
6.75% promissory note, payable in 2008.....	--	50,000
11.10% mortgage note, payable semiannually through 2000.....	8,306	7,547
Texas Housing Opportunity Fund, Ltd. note, payable in 1999.....	205	109
Capitalized lease obligations and other.....	7,225	6,378
	-----	-----
	192,509	261,371
Less current maturities.....	8,926	18,778
	-----	-----
	\$183,583	\$242,593
	=====	=====

At December 31, 1998, the aggregate amounts of required payments on long-term debt are as follows (in thousands):

1999.....	\$ 18,778
2000.....	35,354
2001.....	20,712
2002.....	17,534
2003.....	17,424
Thereafter.....	151,569
	-----
	\$261,371
	=====

The Company has bank lines of credit aggregating \$164 million, of which \$56 million was outstanding at December 31, 1998. Included in the bank lines is a \$135 million revolving credit facility. The revolving credit facility provides for both "standby loans" and "offered rate loans." Standby loans are made ratably by all lenders under the revolving credit facility, while offered rate loans are, subject to the terms and conditions of the credit facility, separately negotiated between the Company and one or more members of the lending syndicate. Standby loans bear interest at a rate equal to either (a) the London Interbank Offered Rate plus a margin equal to 0.150% to 0.405% depending on the ratio of debt to total capitalization, or (b) the greater of (1) the Federal Funds Effective Rate plus 0.5%, and (2) the Prime Rate. Offered rate loans bear interest at a fixed rate negotiated with the lender or lenders making such loans. Under the revolving credit facility, the Company is obligated to pay certain fees, including (a) a quarterly facility fee to each lender under the credit facility equal to a percentage, varying from 0.100% to 0.220% (depending on the ratio of debt to total capitalization), of each lender's total commitment, whether used or unused, under the revolving credit facility

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

and (b) certain administrative fees to the administrative agent and documentation agent under the revolving credit facility. The revolving credit facility will expire on July 13, 2001, unless earlier terminated pursuant to its terms and conditions. The unsecured promissory note agreements and lines of credit provide for restrictions with respect to additional borrowings, maintenance of minimum working capital and payment of dividends.

## 9. FAIR VALUE OF FINANCIAL INSTRUMENTS:

The estimated fair values of the Company's financial instruments approximate their respective carrying amounts at December 31, 1997 and 1998, except as follows (in thousands):

	AS OF DECEMBER 31,					
	1997			1998		
	CARRYING AMOUNT	FAIR VALUE	INTEREST RATE	CARRYING AMOUNT	FAIR VALUE	INTEREST RATE
9.69% promissory notes.....	\$29,500	\$32,068	6.75%	\$24,600	\$26,601	6.75%
9.53% promissory notes.....	21,000	22,375	6.75%	21,000	21,923	6.75%
11.10% mortgage note.....	8,306	8,498	9.00%	7,547	7,739	9.00%

The fair values presented above are based on the amount of future cash flows associated with each instrument, discounted using the Company's current borrowing rate for similar debt instruments of comparable maturity. The fair values are estimates as of December 31, 1997 and 1998, and are not necessarily indicative of amounts for which the Company could settle currently or indicative of the intent or ability of the Company to dispose of or liquidate such instruments.

## 10. INCOME TAXES:

The income tax provision (benefit) consisted of the following (in thousands):

	FOR THE YEARS ENDED DECEMBER 31,		
	1996	1997	1998
Current --			
Federal.....	\$33,615	\$ 24,673	\$15,820
State.....	3,950	790	944
Foreign.....	926	5,239	(6,027)
Total current.....	38,491	30,702	10,737
Deferred --			
Federal.....	(5,135)	(31,144)	30,946
State.....	32	(1,917)	2,237
Foreign.....	--	(9,134)	(6,759)
Total deferred.....	(5,103)	(42,195)	26,424
Total income tax provision (benefit).....	\$33,388	\$(11,493)	\$37,161
	=====	=====	=====

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

The difference between the income tax provision (benefit) computed at the statutory federal income tax rate and the financial statement provision (benefit) for taxes is summarized as follows (in thousands):

	1996	1997	1998
	-----	-----	-----
Provision (benefit) at the U.S. statutory rate of 35%.....	\$30,840	\$(15,765)	\$31,390
Increase (reduction) in tax expense resulting from --			
State income tax, net of federal income tax benefit.....	2,437	(350)	705
Foreign losses not providing a current benefit.....	--	1,044	3,572
Other.....	(111)	3,578	1,494
	-----	-----	-----
Total income tax provision (benefit).....	\$33,388	\$(11,493)	\$37,161
	=====	=====	=====

Deferred income taxes reflect the tax consequences on future years of temporary differences between the tax basis of assets and liabilities and their financial reporting basis and are reflected as current or noncurrent depending on the timing of the expected realization. The deferred tax provision (benefit) for the periods shown represents the effect of changes in the amounts of temporary differences during those periods.

Deferred tax assets (liabilities), as determined under the provisions of SFAS No. 109, "Accounting for Income Taxes," were comprised of the following at December 31 (in thousands):

	1997	1998
	-----	-----
Gross deferred tax assets --		
Warranties.....	\$ 60,421	\$ 28,281
Foreign operating losses.....	14,537	12,652
Postretirement and pension benefits.....	7,799	7,852
Inventory reserves.....	4,907	6,383
Receivable allowance.....	3,420	3,950
Other.....	3,518	9,253
	-----	-----
Total deferred tax assets.....	94,602	68,371
Valuation allowance.....	(14,543)	(12,652)
	-----	-----
Net deferred tax assets.....	80,059	55,719
	-----	-----
Gross deferred tax liabilities --		
Depreciation.....	(19,241)	(17,999)
Intangibles.....	(1,873)	(1,674)
Other.....	(10,498)	(10,248)
	-----	-----
Total deferred tax liabilities.....	(31,612)	(29,921)
	-----	-----
Net deferred tax asset.....	\$ 48,447	\$ 25,798
	=====	=====

The Company has net foreign operating loss carryforwards, mainly in Europe, which expire at various dates in the future. All such loss carryforwards have a full valuation allowance. The net change in the deferred tax asset valuation reserve for the year ended December 31, 1998, was a decrease of \$1,891. The decrease is a result of operating loss carryforwards which have expired.

No provision has been made for income taxes which may become payable upon distribution of the foreign subsidiaries' earnings since management considers substantially all of these earnings permanently invested. As of December 31, 1998, the unrecorded deferred tax liability related to the undistributed earnings of the Company's foreign subsidiaries was insignificant.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## 11. CURRENT ACCRUED EXPENSES:

Significant components of current accrued expenses are as follows (in thousands):

	DECEMBER 31,	
	1997	1998
Accrued product inspection charge.....	\$ 71,956	\$ 27,336
Accrued wages.....	46,685	52,915
Accrued warranties.....	22,086	21,131
Other.....	69,941	105,658
	-----	-----
Total current accrued expenses.....	\$210,668	\$207,040
	=====	=====

## 12. EMPLOYEE BENEFIT PLANS:

## PROFIT SHARING PLANS

The Company maintains noncontributory profit sharing plans for its salaried employees. These plans are discretionary as the Company's contributions are determined annually by the Board of Directors. Provisions for contributions to the plans amounted to \$12.0 million, \$11.5 million, and \$13.6 million in 1996, 1997, and 1998, respectively.

## 401(K) PLAN

The Company provides a 401(k) plan to substantially all eligible hourly and salary employees of the Company, as defined. Participants may contribute up to 12% of their compensation to a 401(k) plan under Internal Revenue Code Section 401(k).

## LONG-TERM INCENTIVE PLAN

The Company provided a long-term incentive plan, the Lennox International Inc. Performance Share Plan (the "Performance Plan") to certain employees. During 1998, the Company terminated the Performance Plan. Under the Performance Plan, participants earned shares of the Company's common stock in accordance with a discretionary formula established by the Board of Directors based on the Company's performance over a three-year period. The value of the shares earned was determined using an independent appraisal. Under the Performance Plan 66,297 shares, 239,019 shares, and 174,669 shares earned in fiscal 1995, 1996, and 1997, respectively, were issued in 1996, 1997, and 1998, respectively. During 1998, 358,974 shares were earned and issued in the same year. Compensation expense recognized under the Performance Plan was \$1,900,000, \$2,259,616, and \$6,876,335 for the years ended December 31, 1996, 1997, and 1998, respectively, based on the fair value of the shares earned.

## EMPLOYEE BENEFITS TRUST

The Company also has an Employee Benefits Trust (the "Trust") to provide eligible employees of the Company, as defined, with certain medical benefits. Trust contributions are made by the Company as defined by the Trust agreement.

## PENSION AND POSTRETIREMENT BENEFIT PLANS

The Company has domestic and foreign pension plans covering substantially all employees. The Company makes annual contributions to the plans equal to or greater than the statutory required minimum. The Company also maintains an unfunded postretirement benefit plan which provides certain medical and life insurance benefits to eligible employees. The pension plans are accounted for under provisions of SFAS No. 87, "Employers' Accounting for Pensions." The postretirement benefit plan is accounted for under the

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

provisions of SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other than Pensions." The following table sets forth amounts recognized in the Company's financial statements and the plans' funded status (in thousands):

	PENSION BENEFITS		OTHER BENEFITS	
	1997	1998	1997	1998
Change in benefit obligation --				
Benefit obligation at beginning of year.....	\$113,942	\$119,835	\$ 15,679	\$ 16,055
Service cost.....	3,439	3,875	457	494
Interest cost.....	8,411	9,128	1,166	1,128
Plan participants' contributions.....	304	189	1,274	1,452
Amendments.....	93	2,132	--	--
Actuarial (gain)/loss.....	993	7,471	40	(449)
Exchange rate changes.....	--	83	--	--
Benefits paid.....	(7,347)	(7,892)	(2,561)	(2,382)
Benefit obligation at end of year....	\$119,835	\$134,821	\$ 16,055	\$ 16,298
Changes in plan assets --				
Fair value of plan assets at beginning of year.....	\$112,588	\$131,376	\$ --	\$ --
Actual return on plan assets.....	21,510	17,466	--	--
Employer contribution.....	4,610	3,792	1,287	930
Plan participants' contributions.....	304	189	1,274	1,452
Expenses.....	(664)	(549)	(79)	(34)
Benefits paid.....	(6,972)	(7,405)	(2,482)	(2,348)
Fair value of plan assets at end of year.....	131,376	144,869	--	--
Funded status.....	11,541	10,048	(16,055)	(16,298)
Unrecognized actuarial (gain)/loss...	(16,151)	(14,420)	(2,158)	(1,311)
Unrecognized prior service cost.....	747	641	--	--
Unrecognized net obligation/(asset).....	6,248	7,420	(520)	(347)
Net amount recognized.....	\$ 2,385	\$ 3,689	\$(18,733)	\$(17,956)
Amounts recognized in the consolidated balance sheets consist of --				
Prepaid benefit cost.....	\$ 13,588	\$ 13,303	\$ --	\$ --
Accrued benefit liability.....	(12,742)	(12,540)	(18,733)	(17,956)
Intangible assets.....	1,539	2,926	--	--
Net amount recognized.....	\$ 2,385	\$ 3,689	\$(18,733)	\$(17,956)
Weighted-average assumptions as of December 31 --				
Discount rate.....	7.50%	7.25%	7.50%	7.25%
Expected return on plan assets.....	9.50	9.50	--	--
Rate of compensation increase.....	4.00	4.00	--	--



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

For measurement purposes, an 8.5% annual rate of increase in the per capita cost of covered health care benefits was assumed for 1998. The rate was assumed to decrease gradually to 5.0% by 2003 and remain at that level thereafter.

	PENSION BENEFITS			OTHER BENEFITS		
	1996	1997	1998	1996	1997	1998
	(IN THOUSANDS)			(IN THOUSANDS)		
Components of net periodic benefit cost --						
Service cost.....	\$ 3,344	\$ 3,439	\$ 3,875	\$ 268	\$ 457	\$ 494
Interest cost.....	8,153	8,411	9,128	1,161	1,166	1,128
Expected return on plan assets.....	(8,655)	(9,844)	(10,931)	--	--	--
Amortization of prior service cost.....	716	716	880	(173)	(173)	(173)
Recognized actuarial loss.....	--	--	--	(961)	(1,129)	(1,297)
Net periodic benefit cost.....	\$ 3,558	\$ 2,722	\$ 2,952	\$ 295	\$ 321	\$ 152
	=====	=====	=====	=====	=====	=====

The benefit obligation and fair value of plan assets for the pension plans with benefit obligations in excess of plan assets were approximately \$10,770,000 and \$0, respectively, as of December 31, 1997, and \$12,478,000 and \$3,607,000, respectively, as of December 31, 1998.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plan. A one-percentage-point change in assumed health care cost trend rates would have the following effects (in thousands):

	1-PERCENTAGE- POINT INCREASE	1-PERCENTAGE- POINT DECREASE
	-----	-----
Effect on total of service and interest cost components.....	\$ 230	\$ (187)
Effect on the post-retirement benefit obligation.....	1,882	(1,605)

## 13. COMMITMENTS AND CONTINGENCIES:

## OPERATING LEASES

The Company has various leases relating principally to the use of operating facilities. Rent expense for 1996, 1997 and 1998 was approximately \$18.6 million, \$23.2 million and \$28.2 million, respectively.

The approximate minimum commitments under all noncancelable leases at December 31, 1998, are as follows (in thousands):

1999.....	\$ 22,244
2000.....	18,825
2001.....	13,241
2002.....	10,977
2003.....	10,049
Thereafter.....	33,386
	-----
	\$108,722
	=====

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## LITIGATION

The Company is involved in various claims and lawsuits incidental to its business. In the opinion of management, these claims and suits in the aggregate will not have a material adverse effect on the Company's business, financial condition or results of operations.

## 14. STOCK-BASED COMPENSATION PLAN:

The Company has a Stock Option and Restricted Stock Plan, which was amended in September 1998 (the "1998 Incentive Plan"). The 1998 Incentive Plan is accounted for under APB Opinion No. 25, under which no compensation cost has been recognized. If the 1998 Incentive Plan had been accounted for under the provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," the Company's net income (loss) would have been adjusted to the following pro forma amounts (in thousands, except per share data):

		YEARS ENDED DECEMBER 31,		
		1996	1997	1998
Net income (loss):	As reported.....	\$54,726	\$(33,550)	\$52,525
	Pro forma.....	52,557	(35,595)	52,525
Basic earnings (loss) per share:	As reported.....	\$ 1.62	\$ (0.99)	\$ 1.50
	Pro forma.....	1.56	(1.05)	1.50
Diluted earnings (loss) per share:	As reported.....	\$ 1.59	\$ (0.99)	\$ 1.47
	Pro forma.....	1.53	(1.05)	\$ 1.47

Because the method of accounting under SFAS No. 123 has not been applied to options granted prior to January 1, 1995, the resulting pro forma compensation cost may not be representative of that to be expected in future years.

Under the 1998 Incentive Plan, the Company is authorized to issue options for 8,216,571 shares of common stock. As of December 31, 1998, options for 5,462,457 shares of common stock have been granted and options for 821,436 shares have been cancelled or repurchased. Consequently, as of December 31, 1998, there are options for 3,575,550 shares available for grant. Under the 1998 Incentive Plan, the option exercise price equals the stock's fair value on the date of grant. 1998 Incentive Plan options granted prior to 1998 vest on the date of grant. 1998 Incentive Plan options granted in 1998 vest over three years. All 1998 Incentive Plan options expire after ten years.

The Plan's status is as follows (in thousands, except per share data):

		YEARS ENDED DECEMBER 31,					
		1996		1997		1998	
		SHARES	WEIGHTED AVERAGE EXERCISE PRICE	SHARES	WEIGHTED AVERAGE EXERCISE PRICE	SHARES	WEIGHTED AVERAGE EXERCISE PRICE
Outstanding at beginning of year.....	2,218	\$ 7.19	3,039	\$ 9.02	3,822	\$10.13	
Granted.....	946	13.05	877	13.88	1,071	18.87	
Exercised.....	(122)	7.13	(71)	7.67	(1,048)	9.04	
Forfeited.....	(3)	7.68	(23)	13.31	(47)	8.64	
Outstanding at end of year.....	3,039	\$ 9.02	3,822	\$10.13	3,798	\$12.92	
Exercisable at end of year.....	3,039	\$ 9.02	3,822	\$10.13	2,737	\$12.92	
Fair value of options granted.....		\$ 3.86		\$ 3.76		\$ 5.83	

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

The following table summarizes information about stock options outstanding at December 31, 1998 (in thousands, except per share data):

RANGE OF EXERCISE PRICES	OPTIONS OUTSTANDING		
	NUMBER OUTSTANDING AT DECEMBER 31, 1998	WEIGHTED-AVERAGE REMAINING CONTRACTUAL LIFE(YEARS)	WEIGHTED-AVERAGE EXERCISE PRICE
\$ 7.28 - \$ 7.53	1,338	6	\$ 7.45
\$13.21 - \$13.90	1,399	7	13.60
\$15.50 - \$19.03	1,061	9.5	18.92
	-----	---	-----
	3,798	8	\$12.92
	=====	===	=====

As of December 31, 1998, options to purchase 1,337,622 shares of common stock with exercise prices ranging from \$7.28 to \$7.53 and options to purchase 1,399,497 shares of common stock with exercise prices ranging from \$13.21 to \$13.90 were exercisable. The fair value of each option is estimated on the date of grant based on a risk-free interest rate of 6%, expected life of ten years, and an expected dividend yield of 2% in 1996, 1997 and 1998.

## 15. EARNINGS PER SHARE:

Basic earnings per share are computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per share are computed by dividing net income by the sum of the weighted average number of shares and the number of equivalent shares assumed outstanding, if dilutive, under the Company's stock-based compensation plans. Diluted earnings per share are computed as follows (in thousands, except per share data):

	1996	1997	1998
	-----	-----	-----
Net income (loss).....	\$54,726	\$(33,550)	\$52,525
	=====	=====	=====
Weighted average shares outstanding.....	33,693	33,924	34,914
Effect of assumed exercise of options.....	693	--	825
	-----	-----	-----
Weighted average shares outstanding, as adjusted.....	34,386	33,924	35,739
	-----	-----	-----
Diluted earnings (loss) per share.....	\$ 1.59	\$ (0.99)	\$ 1.47
	=====	=====	=====

Options to purchase 904,200 shares of common stock at \$13.31 per share, 3,822,324 shares of common stock at prices ranging from \$5.14 per share to \$13.90 per share and 1,037,850 shares of common stock at \$19.03 per share were outstanding for the years ended December 31, 1996, 1997, and 1998, respectively, but were not included in the diluted earnings per share calculation because the assumed exercise of such options would have been antidilutive.

## 16. RECENT ACCOUNTING PRONOUNCEMENTS:

In June 1998, the FASB issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." This statement establishes accounting and reporting standards for derivative instruments, including certain derivatives embedded in other contracts (collectively referred to as derivatives) and for hedging activities. This statement is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. The Company does not believe that the adoption of this pronouncement will have a significant impact on the Company's financial statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

## 17. RELATED PARTY TRANSACTIONS:

John W. Norris, Jr., the Company's Chairman and Chief Executive Officer, and David H. Anderson, Richard W. Booth, David V. Brown, Loraine B. Millman, Robert W. Norris and Lynn B. Storey, directors of the Company, as well as certain stockholders, are members of AOC Land Investment, LLC. AOC Land Investment, LLC owns 70% of AOC Development II, LLC. AOC Development II, LLC is building a new office building and the Company has agreed to lease part of it for use in conjunction with the Company's corporate headquarters. The lease will have a term of 25 years and the annual lease payments are expected to be approximately \$2.1 million per year for the first five years. The Company believes that the terms of the lease with AOC Development II, LLC are at least as favorable as could be obtained from unaffiliated third parties.

## 18. SUBSEQUENT EVENTS (UNAUDITED):

The Company is filing a registration statement for an initial public offering of its common stock, the proceeds of which will be used to repay a portion of the borrowings under the Company's revolving credit facility and term credit agreement.

[LENNOX LOGO]