EASTMAN CHEMICAL CO
Form 10-K
March 01, 2007

**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**WASHINGTON, DC 20549**

**FORM 10-K**

(Mark One)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended **December 31, 2006**
OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission file number 1-12626

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

| **Delaware** | **62-1539359** |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification no.) |
| **200 South Wilcox Drive Kingsport, Tennessee** | **37662** |
| (Address of principal executive offices) | (Zip Code) |

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

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|---|---|
| **Common Stock, par value $0.01 per share** | **New York Stock Exchange** |

Securities registered pursuant to Section 12(g) of the Act: **None**

EXHIBIT INDEX ON PAGE 125

| | Yes | No |
|---|---|---|
| Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. | [X] | |
| Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. | | [X] |
| Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. | [X] | |
| Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. | [X] | |

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

Large accelerated filer [X] Accelerated filer [ ] Non-accelerated filer [ ]

| | Yes | No |
|---|---|---|
| Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). | | [X] |

The aggregate market value (based upon the closing price on the New York Stock Exchange on June 30, 2006) of the 83,230,422 shares of common equity held by nonaffiliates as of December 31, 2006 was approximately $4,494,442,788, using beneficial ownership rules adopted pursuant to Section 13 of the Securities Exchange Act of 1934, as amended, to exclude common stock that may be deemed beneficially owned as of December 31, 2006 by Eastman Chemical Company’s (“Eastman” or the “Company”) directors and executive officers and charitable foundation, some of whom might not be held to be affiliates upon judicial determination. A total of 83,637,623 shares of common stock of the registrant were outstanding at December 31, 2006.

## DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement relating to the 2007 Annual Meeting of Stockholders (the "2007 Proxy Statement"), to be filed with the Securities and Exchange Commission, are incorporated by reference in Part III, Items 10 to 14 of this Annual Report on Form 10-K (the "Annual Report") as indicated herein.

## FORWARD-LOOKING STATEMENTS

Certain statements in this Annual Report are forward-looking in nature as defined in the Private Securities Litigation Reform Act of 1995. These statements, and other written and oral forward-looking statements made by the Company from time to time, may relate to, among other things, such matters as planned and expected capacity increases and utilization; anticipated capital spending; expected depreciation and amortization; environmental matters; legal proceedings; exposure to, and effects of hedging of, raw material and energy costs and foreign currencies; global and regional economic, political, and business conditions; competition; growth opportunities; supply and demand, volume, price, cost, margin, and sales; earnings, cash flow, dividends, and other expected financial results and conditions;

expectations, strategies, and plans for individual assets and products, businesses, and segments, as well as for the whole of Eastman Chemical Company; cash requirements and uses of available cash; financing plans; pension expenses and funding; credit ratings; anticipated restructuring, divestiture, and consolidation activities; cost reduction and control efforts and targets; integration of acquired businesses; strategic initiatives and development, production, commercialization, and acceptance of new products, services and technologies and related costs; asset, business and product portfolio changes; and expected tax rates and net interest costs.

These plans and expectations are based upon certain underlying assumptions, including those mentioned with the specific statements. Such assumptions are in turn based upon internal estimates and analyses of current market conditions and trends, management plans and strategies, economic conditions, and other factors. These plans and expectations and the assumptions underlying them are necessarily subject to risks and uncertainties inherent in projecting future conditions and results. Actual results could differ materially from expectations expressed in the forward-looking statements if one or more of the underlying assumptions and expectations proves to be inaccurate or is unrealized. Certain important factors that could cause actual results to differ materially from those in the forward-looking statements are included with such forward-looking statements and in Part II—Item 7—"Management's Discussion and Analysis of Financial Condition and Results of Operations—Forward-Looking Statements and Risk Factors" of this Annual Report on Form 10-K.

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## PART I

### ITEM 1. BUSINESS

### CORPORATE OVERVIEW

Eastman Chemical Company ("Eastman" or the "Company") is a global chemical company which manufactures and sells a broad portfolio of chemicals, plastics, and fibers. Eastman began business in 1920 for the purpose of producing chemicals for Eastman Kodak Company's photographic business and became a public company, incorporated in Delaware, as of December 31, 1993. Eastman has 16 manufacturing sites in 10 countries that supply chemicals, plastics, and fibers products to customers throughout the world. The Company's headquarters and largest manufacturing site are located in Kingsport, Tennessee.

In 2006, the Company had sales revenue of $7.5 billion, operating earnings of $640 million, and net earnings of $409 million. Earnings per diluted share were $4.91 in 2006. Included in 2006 operating earnings were accelerated depreciation related to restructuring decisions of $10 million, asset impairments and restructuring charges of $101 million and other operating income of $68 million.

The Company’s products and operations are managed and reported in five operating segments: the Coatings, Adhesives, Specialty Polymers, and Inks ("CASPI") segment, the Fibers segment, the Performance Chemicals and Intermediates ("PCI") segment, the Performance Polymers segment and the Specialty Plastics ("SP") segment. A segment is determined primarily by the customer markets in which it sells its products and services. For additional information related to the Company’s operating segments, see Note 21 "Segment Information" to the Company’s consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10K.

In addition to the segments, the Company manages certain costs and initiatives at the corporate level including certain research and development costs not allocated to any one operating segment. Coal gasification, including chemicals from coal, is one of the more significant of these corporate initiatives.

Eastman's management believes that the Company is well-positioned for sustained success both in the near-term and the long-term. Eastman's objective is to leverage its heritage of expertise and innovation in acetyl, polyester, and olefins chemistries to drive growth, meet increasing demand and create new opportunities for the Company's products in key markets.

- The Company expects continued strong and steady financial performance from its solid base of businesses in the Fibers, CASPI and SP segments, and growth of the SP segment's business through introduction by Eastman of a new family of copolyesters to be commercially available by the end of 2007.
    - Through innovation and strategic actions, Eastman expects to substantially improve the profitability of its polyethylene terephthalate ("PET") polymers business by the second half of 2008.
- By leveraging its expertise in coal gasification, Eastman expects over time to increase the volume of products derived from coal as a raw material to approximately 50 percent, from approximately 20 percent, thereby providing the Company with a significant cost advantage.

To better focus on its core strengths, the Company divested a portion of its product portfolio in the fourth quarter 2006. The Company sold its Batesville, Arkansas manufacturing facility and related assets in the PCI segment and its polyethylene ("PE") related assets in the Performance Polymers and CASPI segments. In 2006, these divested product lines had sales revenue of $811 million and operating earnings of $124 million.

**Manufacturing Streams**

As stated above, Eastman's objective is to leverage its heritage of expertise and innovation in acetyl, polyester, and olefins chemistries to drive growth in key markets including packaging, tobacco, durable goods, building and construction, and others. For each of these chemistries, Eastman has developed a combination of assets and technologies that are operated within three manufacturing "streams".

- In the acetyl stream, the Company begins with high sulfur coal which is then gasified in its coal gasification facility. The resulting synthesis gas is converted into a number of chemicals including methanol, methyl acetate, acetic acid and acetic anhydride. These chemicals are used in products throughout the Company including acetate tow, acetate yarn and cellulose esters. The Company's ability to use coal is a competitive advantage for raw materials and energy. The Company is investigating opportunities to further leverage its coal-based process know-how in a corporate initiative referred to as "chemicals from coal", with the objective of increasing product volume derived from coal gasification-based raw materials versus crude oil to enable Eastman to achieve lower, more stable costs.
- In the polyester stream, the Company begins with purchased paraxylene and produces purified terephthalic acid ("PTA") and dimethyl terephthalate ("DMT") while most of its polyester competitors start with PTA and DMT. The Company also purchases PTA for use at some of its facilities outside the U.S. PTA or DMT is then reacted with ethylene glycol, which the Company both makes and purchases, along with other raw materials (some of which the Company makes and are proprietary) to produce PET and copolyesters. This backward integration of its polyester manufacturing provides several competitive advantages. For PET, this gives Eastman a cost advantage in a commodity market. For copolyester, Eastman adds a specialty monomer to provide clear, tough, chemically resistant product characteristics. As a result, the Company's copolyesters can compete with materials such as polycarbonate and acrylic.
- In the olefins stream, the Company begins primarily with propane and ethane, which are then cracked at its facility in Longview, Texas into propylene and ethylene. The company also purchases propylene for use at its facilities outside the U.S. The propylene is used in oxo derivative products, while the ethylene is used in oxo derivatives, acetaldehyde and ethylene glycol production and also sold to external markets.

The following chart shows markets and significant Eastman products by segment and manufacturing stream.

| SEGMENT | ACETYL STREAM | POLYESTER STREAM | OLEFINS STREAM | KEY PRODUCTS, MARKETS AND END USES |
|---|---|---|---|---|
| CASPI | **X** | | **X** | Adhesives (tape, label, nonwovens), paint and coatings (architectural, automotive, industrial, and original equipment manufacturing ("OEM")) |
| Fibers | **X** | | | Acetate tow, apparel, home furnishings, and industrial applications |
| PCI | **X** | **X** | **X** | Agrochemical, automotive, beverages, nutrition, pharmaceuticals, coatings, medical devices, toys, photographic and imaging, household products, polymers, textiles, and consumer and industrials |
| Performance Polymers | **X** | **X** | | Beverage and food packaging, custom-care and cosmetic packaging, health care and pharmaceutical uses, household products, and industrial packaging applications |
| SP | **X** | **X** | | Appliances, store fixtures and displays, building and construction, electronic packaging, medical devices and packaging, graphic arts, general purpose packaging, personal care and cosmetics, food and beverage packaging, performance films, tape and labels, fibers/nonwovens, photographic and optical films, and liquid crystal displays |

**Cyclicality and Seasonality**

Certain segments, particularly the PCI and Performance Polymers segments, are impacted by the cyclicality of key products and markets, while other segments are more sensitive to global economic conditions. Supply and demand dynamics determine profitability at different stages of cycles and global economic conditions affect the length of each cycle. Despite some sensitivity to global economic conditions, many of the products in the Fibers, CASPI and SP segments provide a more stable foundation of earnings.

The Company's earnings and cash flows also typically have some seasonal characteristics. The Company's earnings are typically greater in the second and third quarters, while cash from operations is usually greater in the fourth quarter. Demand for CASPI segment products is typically stronger in the second and third quarters due to the increased use of coatings products in the building and construction industries, while demand is typically weaker during the winter months because of seasonal construction downturns. The PCI segment typically has a weaker fourth

quarter, due in part to a seasonal downturn in demand for products used in certain building and construction and agricultural markets. The Performance Polymers segment typically has stronger demand for its PET polymers for beverage container plastics during the second and early third quarters due to higher consumption of beverages in the Northern hemisphere, while demand typically weakens during the late third and fourth quarters.

**CASPI SEGMENT**

· **Overview**

The CASPI segment manufactures liquid vehicles, additives, specialty polymers, and other raw materials which are integral to the production of paints and coatings, inks, adhesives, and other formulated products. The CASPI segment focuses on producing raw materials rather than finished products in order to develop long-term, strategic relationships and achieve preferred supplier status with its customers. Growth in these markets in North America and Europe typically approximates economic growth in general, due to the wide variety of end uses for these applications and dependence on the economic conditions of the markets for durable goods, packaged goods, automobiles, and housing. However, higher growth sub-markets exist within North America and Europe, driven by customers' growing demands for performance requirements that are protective of the environment and meet increasingly stringent government regulation. For example, the coatings and adhesives industries are promoting products and technologies designed to reduce air emissions. Growth in Asia and Latin America is substantially higher than general economic growth, driven primarily by the increasing government regulations in industrializing economies.

In 2006, the CASPI segment had sales revenue of $1.4 billion, which represented 19 percent of Eastman’s total sales. In fourth quarter 2006, the Company sold the CASPI segment's *Epolene* polymer businesses and related assets in conjunction with the sale of the polyethylene business. Product lines associated with the divestiture had sales revenue of $65 million in 2006.

· **Products**

**Ø Coatings Additives, Coalescents and Solvents**

The additives product lines consist of differentiated and proprietary products, including cellulosic polymers which enhance the aesthetic appeal and improve the performance of industrial and automotive original equipment and refinish coatings and inks. Coalescents include products such as *Texanol* ester alcohol which improves film formation and durability in architectural latex paints, and chlorinated polyolefins which promote the adherence of paints and coatings to plastic substrates. Solvents, which consist of ester, ketone, glycol ether and alcohol solvents, are used in both paints and inks to maintain the formulation in liquid form for ease of application. Environmental regulations that impose limits on the emission of volatile organic compounds and hazardous air pollutants continue to impact coatings formulations requiring compliant coatings raw materials. Eastman’s coatings additives, coalescents and solvents are currently used in compliant coatings. Additional products are under development to meet the growing demand for waterborne and high solids coatings. Coatings additives, coalescents and solvents comprised 60 percent of the CASPI segment’s total sales for 2006.

**Ø Adhesives Raw Materials**

The adhesives product lines consist of hydrocarbon resins, rosin resins, resin dispersions, and polymer raw materials. These products are sold to adhesive formulators and tape and label manufacturers for use as raw materials in hot melt and pressure sensitive adhesives and as binders in nonwoven products such as disposable diapers, feminine products, and pre-saturated wipes. Eastman is one of the largest manufacturers of hydrogenated gum rosins used in adhesive and chewing gum applications. Eastman offers the broadest product portfolio of raw materials for the adhesives industry, ranking as the second largest global tackifier supplier. Adhesives raw materials comprised 40 percent of the CASPI segment’s total sales for 2006.

The profitability of the CASPI segment products is sensitive to the global economy, exchange rates, market trends and broader chemical cycles, particularly the olefins cycle. The CASPI segment's specialty products, which include coatings additives, coalescents, and selected hydrocarbon resins, are less sensitive to the olefins cycle due to their functional performance attributes. The cyclical commodity products, which include commodity solvents and polymer raw materials, are impacted by the olefins cycle. The Company leverages its proprietary technologies, competitive

cost structure and integrated manufacturing facilities to maintain a strong competitive position throughout such cycles.

· **Strategy and Innovation**

A key element of the CASPI segment growth strategy is the continued development of innovative product offerings, building on proprietary technologies in high-growth markets and regions that meet customers' evolving needs and improve the quality and performance of customers' end products. Management believes that its ability to leverage the CASPI segment's broad product line and Eastman's research and development capabilities makes it uniquely capable of offering a broad array of solutions for new and emerging markets. The Company is pursuing high value incremental expansions of existing CASPI manufacturing assets to ensure that adequate capacity is available to meet the increasing demand for the segment's differentiated products.

The CASPI segment is focused on the expansion of the coatings and inks additives and specialty solvents product offerings into other high-growth areas. These include market areas with growth due to specific market trends and product developments, such as high solids and water-based coatings and inks, as well as growth in geographic areas due to the level and timing of industrial development. The Company's global manufacturing presence positions the CASPI segment to take advantage of areas of high industrial growth, particularly in Asia from its facility in Singapore and joint venture operations in China.

The CASPI segment is also focused on the expansion of the adhesives raw materials product offerings into high-growth markets and regions by leveraging applications technology and increasing production capacity. The segment expects to take advantage of growth in demand for specialty hydrocarbon resins through the 25 percent expansion of the Company's hydrogenated hydrocarbon resins manufacturing capacity in Middelburg, the Netherlands, completed in the fourth quarter 2006, and through the 30 percent expansion of hydrocarbon resin production capacity at Eastman's joint venture operation in Nanjing, China, completed in the second quarter 2006. Additionally, the CASPI segment has increased profitability within this group of product lines through cost reduction initiatives and leveraging of best manufacturing practices.

The Company intends to continue to leverage its resources to strengthen its CASPI segment innovation pipeline through improved market connect and the expanded use of proprietary products and technologies. Although CASPI segment sales and application development are often specialized by end-use markets, developments in technology may be successfully shared across multiple end-uses and markets.

· **Customers and Markets**

As a result of the variety of end uses for its products, the customer base for the CASPI segment is broad and diverse. This segment has more than 1,250 customers around the world, and approximately 80 percent of its sales revenue in 2006 was attributable to approximately 90 customers. The CASPI segment focuses on establishing long-term, customer service-oriented relationships with its strategic customers in order to become their preferred supplier and to leverage these relationships to pursue sales opportunities in previously underserved markets and to expand the scope of its value-added services. However, from time to time, customers decide to develop products internally or diversify their sources of supply that had been provided by Eastman's CASPI segment. Growth in North American and European markets typically coincides with economic growth in general, due to the wide variety of end uses for these applications and their dependence on the economic conditions of the markets for durable goods, packaged goods, automobiles, and housing.

· **Competition**

Competition within the CASPI segment's markets varies widely depending on the specific product or product group. Because of the depth and breadth of its product offerings, Eastman does not believe any one of its competitors presently offers all the products it manufactures within the CASPI segment. The Company's major competitors in the CASPI segment's markets include larger companies such as Dow Chemical Company ("Dow"), BASF and Exxon Mobil Corporation, which may have greater financial and other resources than Eastman. Additionally, within each CASPI segment product market the Company competes with other smaller, regionally focused companies that may have advantages based upon location, local market knowledge, manufacturing strength in a specific product, or other similar factors. However, Eastman does not believe that any of its competitors has a dominant position within the CASPI segment's markets. The Company believes its competitive advantages include its level of vertical integration, breadth of product and technology offerings, low-cost manufacturing position, consistent product quality, and process and market knowledge. In addition, Eastman attempts to leverage its strong customer base and long-standing customer relationships to promote substantial recurring business, further strengthening its competitive position.

**FIBERS SEGMENT**

· **Overview**

The Fibers segment manufactures *Estron* acetate tow and *Estrobond* triacetin plasticizers, which are used primarily in cigarette filters; *Estron* natural and *Chromspun* solution-dyed acetate yarns for use in apparel, home furnishings and industrial fabrics; and acetate flake and acetyl raw materials for other acetate fiber producers. The Fibers segment is one of the world's two largest suppliers of acetate tow and has been a market leader in the manufacture and sale of acetate tow since it began producing the product in the early 1950s. The Fibers segment is the world's largest producer of acetate yarn and has been in this business for over 75 years. In 2006, the Fibers segment had sales revenue of $910 million, which represented 12 percent of Eastman's total sales.

The Fibers segment's long history and experience in the fibers markets are reflected in its operating expertise, both within the Company and in support of its customers' processes. The Fibers segment's expertise in internal operating processes allows it to achieve a consistently high level of product quality, a differentiating factor in the industry. The Fibers segment's knowledge of the industry and of customers' processes allows it to assist its customers in maximizing their processing efficiencies, promoting repeat sales and mutually beneficial, long-term customer relationships. The Fibers segment's fully integrated facilities from coal-based acetyl raw materials through acetate tow and yarn allow a reduction in dependence on petrochemicals from third parties. Management believes the Fibers segment employs the only continuous flake manufacturing process that can use multiple sources of wood pulp as raw material. As a result, the segment has qualified all major high-purity wood pulp suppliers that make pulp suitable for acetate fibers. Despite the continuing consolidation of pulp suppliers, the Fibers segment has dependable sources of pulp supply. The Fibers segment management believes that these factors combine to make it an industry leader in reliability of supply and cost position.

In addition to the cost advantage of being coal-based, the Fibers segment believes its competitive strengths include high-quality products, technical expertise, large scale vertically-integrated processes, reliability of supply, reputation for excellent technical and commercial customer service, and a strong customer base characterized by long-term customer relationships. The Fibers segment is capitalizing and building on these strengths to improve its strategic position.

· **Products**

**Ø Acetate Tow**

The Fibers segment manufactures acetate tow under the *Estron* trademark according to a wide variety of customer specifications, primarily for use in the manufacture of cigarette filters. World-wide demand for acetate tow is expected to increase by approximately 3 percent per year through 2010.

**Ø Acetate Yarn**

The Fibers segment manufactures acetate filament yarn under the *Estron* and *Chromspun* trademarks in a wide variety of specifications. Consisting of pure cellulose acetate, *Estron* acetate yarn is available in bright and dull luster and is suitable for subsequent dyeing in the fabric form. *Chromspun* acetate yarn is solution-dyed in the manufacturing process and is available in more than 20 colors. These products are used in fabrics for apparel, home furnishings, and industrial applications. From a retail customer's perspective, garments containing acetate yarn are noted for their rich colors, silky feel, supple drape, breathability, and comfort. World-wide demand for acetate yarn is expected to continue to be negatively affected by lower-priced substitute materials.

**Ø Acetyl Chemical Products**

Acetyl chemicals products sold primarily to other acetate fiber producers include acetate flake, acetylation-grade acetic acid, and acetic anhydride. In addition, the Fibers segment markets acetyl-based triacetin plasticizers under the *Estrobond* trademark, generally for use by cigarette manufacturers as a bonding agent in cigarette filters.

. **Strategy and Innovation**

**Ø Growth**

In the Fibers segment, Eastman is leveraging its strong customer relationships and knowledge of the industry to identify growth options.

In September 2006, the Company announced a 60 percent capacity expansion of acetate tow at its Workington, England site with a targeted completion date in mid-2008. The location of this site will serve existing customers in Western Europe and the growing demand in Eastern Europe. The acetate flake for the capacity expansion will be sourced from existing flake capacity in Kingsport, Tennessee.

The Company is also considering the construction of new acetate tow capacity in Asia, a major growth region. The Company would likely supply acetate flake for this expansion from its Kingsport, Tennessee site.

Ø **Continue to Capitalize on Fiber Technology Expertise**

The Fibers segment intends to continue to make use of its capabilities in fibers technology to maintain a strong focus on incremental product and process improvements, with the goals of meeting customers' evolving needs and improving the segment's manufacturing process efficiencies.

**Ø Maintain Cost-Effective Operations and Consistent Cash Flows and Earnings**

The Fibers segment expects to continue to operate in a cost effective manner, capitalizing on its scale and vertical integration, and to make further productivity and efficiency improvements through continued investments in research and development. The Company plans to reinvest in the Fibers business to sustain consistently strong earnings and cash flows.

**Ø Research and Development**

Research and development efforts for the Fibers segment are primarily focused on incremental process and product improvements, as well as cost reduction, with the objectives of increasing sales and reducing costs. Recent achievements have included fiber product advancements that allow improved processability on customers' equipment and improved packaging designs. The Fibers segment also engages in research to assist acetate tow customers in the effective use of the segment's products and in the customers' product development efforts.

. **Customers and Markets**

The customer base in the Fibers segment is relatively concentrated, consisting of approximately 175 companies in the tobacco and textile industries, located in all regions of the world. The largest 20 customers within the Fibers segment

include multinational as well as regional cigarette producers, fabric manufacturers and other acetate fiber producers. These top 20 customers accounted for about 80 percent of the segment's total sales revenue in 2006. The segment maintains a strong position in acetate tow imports into China, one of the largest and fastest growing markets in the world.

· **Competition**

Competitors in the fibers market for acetate tow include one global competitor, Celanese Corporation ("Celanese"); three multi-regional competitors, Acetate Products Ltd. ("Acordis"), Rhodia S.A. and Daicel Chemical Industries Ltd ("Daicel").; and two regional competitors, SK Chemicals Co. ("SK"), Ltd. and Mitsubishi Rayon Co., Ltd. ("Mitsubishi Rayon"). Some consolidation is ongoing within the acetate fiber industry with the pending acquisition of Acordis by Celanese. For acetate yarn, major competitors include three companies that target multi-regional markets, BembergCell, INACSA and UAB Korelita, and two regional producers, SK and Mitsubishi Rayon.

In the acetate tow market, two major competitors, Celanese and Daicel, have joint venture capacity in China and expanded their capacity in 2005 and 2006. However, current global capacity utilization rates are expected to remain high given the world-wide growth in demand and the industry structure changes that occurred in 2005 when a major competitor closed a North American acetate tow production facility.

Eastman is the world leader in acetate yarn production, the only acetate yarn producer vertically integrated in acetate flake production, and the only acetate yarn producer in North America. The Fibers segment is well positioned to serve this market due to an in-depth knowledge of end-use markets; careful selection of a balanced portfolio of markets, customers, and products; and a highly integrated, large-scale manufacturing operation. Eastman's reputation for quality and supply stability gives it a competitive advantage in the market.

**PCI SEGMENT**

· **Overview**

The Company’s PCI segment manufactures diversified products that are sold externally, as well as used internally by other segments. The PCI segment's earnings are highly dependent on how the Company chooses to optimize the acetyls stream and the olefins stream. In 2006, the PCI segment had sales revenue of $1.7 billion, which represented 22 percent of Eastman’s total sales.

In fourth quarter 2006, Eastman sold its Batesville, Arkansas manufacturing facility and related assets and the specialty organic chemicals product lines in the PCI segment. Product lines associated with the divestiture had revenue of $111 million in 2006. In addition, as part of the sale of the Performance Polymers segment's polyethylene business, the Company has agreed to supply ethylene to the buyer. These sales of ethylene, which was previously used internally, will be reported in the PCI segment. The company also expects to begin a staged phase-out of older cracking units in 2007, with timing dependent in part on market conditions.

· **Products**

The PCI segment offers over 135 products that include intermediates based on oxo and acetyl chemistries, and performance chemicals. The PCI segment's 2006 sales revenue was approximately 55 percent olefin-based, 15 percent acetyl-based, 5 percent polymer-based, and 25 percent based on performance and other chemicals. Approximately 73 percent of the PCI segment's sales revenue is generated in North America. Sales in all regions are generated through a mix of the Company’s direct sales force and a network of distributors. The Company's PCI segment is the largest marketer of acetic anhydride in the United States, an intermediate that is a critical component of analgesics and other pharmaceutical and agricultural products, and is the only U.S. producer of acetaldehyde, a key intermediate in the production of vitamins and other specialty products. Eastman manufactures one of the world's broadest ranges of products derived from oxo aldehydes. The PCI segment’s other intermediate products include plasticizers and glycols. Many of the intermediates products in the PCI segment are priced based on supply and demand of substitute and competing products. In order to maintain a competitive position, the Company strives to operate with a low cost manufacturing base.

The PCI segment also manufactures performance chemicals, that are complex organic molecules such as diketene derivatives, specialty ketones, and specialty anhydrides for pharmaceutical, fiber, and food and beverage ingredients, which are typically used in specialty market applications. These specialty products are typically priced based on the amount of value added rather than supply and demand factors.

**· Strategy and Innovation**

To build on and maintain its status as a low cost producer, the PCI segment continuously focuses on cost control, operational efficiency, and capacity utilization to maximize earnings. Through the PCI segment, the Company maximizes the advantage of its highly integrated and world-scale manufacturing facilities. For example, the Kingsport, Tennessee manufacturing facilities allow the PCI segment to produce acetic anhydride and other acetyl derivatives from coal rather than natural gas or other petroleum feedstocks. At the Longview, Texas facility, Eastman's PCI segment uses its proprietary oxo-technology in the world’s largest single-site, oxo aldehyde manufacturing facility to produce a wide range of alcohols, esters, and other derivative products utilizing propane and local ethane supplies, as well as purchased propylene. These integrated facilities, combined with large scale production processes and a continuous focus on additional process improvements, allow the PCI segment to remain cost competitive with, and for some products cost-advantaged over, its competitors.

The PCI segment selectively focuses on continuing to develop and access markets with high-growth potential for the Company’s chemicals. The Company engages in customer-focused research and development initiatives in order to develop new PCI products and find additional applications for existing products. The Company is currently focusing these efforts on applications in the personal care market and markets using plasticizers.

**· Customers and Markets**

The PCI segment’s products are used in a variety of markets and end uses, including agrochemical, automotive, beverages, nutrition, pharmaceuticals, coatings, flooring, medical devices, toys, photographic and imaging, household products, polymers, textiles, and industrials. The markets for products with market-based pricing in the PCI segment are cyclical. This cyclicality is caused by periods of supply and demand imbalance, either when incremental capacity additions are not offset by corresponding increases in demand, or when demand exceeds existing supply. Demand, in turn, is based on general economic conditions, raw material and energy prices, consumer demand and other factors beyond the Company’s control. Eastman may be unable to increase or maintain the PCI segment's gross margins in periods of economic stagnation or downturn, and future PCI segment results may fluctuate from period to period due to these economic conditions. The Company believes many of these markets are being positively affected by the current olefins upcycle. However, the strength of product-specific olefin derivative markets will vary widely based upon prevailing supply and demand conditions.

An important trend within the PCI segment's markets is a tendency toward increased regionalization of key markets, especially for acetyls and olefins products, due to increased transportation costs. Additionally, the PCI segment is engaged in continuous efforts directed toward optimizing product and customer mix. Approximately 80 percent of the PCI segment’s sales revenue in 2006 was from 100 out of approximately 1,200 customers worldwide.

**· Competition**

Historically, there have been significant barriers to entry for competitors with respect to a majority of the PCI segment's products, primarily due to the fact that the relevant technology has been held by a small number of companies. As this technology has become more readily available, competition from multinational chemical manufacturers has intensified. Eastman competes with these and other producers primarily based on price, as products are interchangeable, but also on technology, marketing and services. Eastman’s major competitors in this segment include large multinational companies such as Dow, Celanese, BASF, and Exxon Mobil Corporation. While some competitors in PCI's product markets may have greater financial resources than Eastman, the Company believes it maintains a strong competitive position due to the combination of its scale of operations, breadth of product line, level of integration, and technology leadership.

**PERFORMANCE POLYMERS SEGMENT**

**· Overview**

In 2006, the Performance Polymers segment had revenues of $2.6 billion, which represented 36 percent of the Company's total sales. The segment consisted of two principal product lines, PET and PE.

In fourth quarter 2006, Eastman concluded the sale of its PE business. The PE product lines were manufactured entirely in the United States and had a relatively small market share. The low density polyethylene and linear low density polyethylene product lines of the PE business accounted for approximately 25 percent of the Performance Polymers segment's sales revenue in 2006.

The PET product line competes to a large degree on price in a capital intensive industry. Profitability is achieved by attaining low cost positions through technology innovation, manufacturing scale, capacity utilization, access to reliable and competitive utilities, energy and raw materials, efficient manufacturing processes and distribution.

The Company's PET production is vertically integrated back to the raw material paraxylene for a substantial majority of its capacity. The Performance Polymers segment's PET product line for the packaging market is the world's largest based on capacity share; the most global based on manufacturing sites; and the broadest based on formula diversity. PET is used in a wide variety of packaging products including those for carbonated soft drinks, water, juice, personal care items, household cleaners, beer and food containers. The Performance Polymers segment has PET manufacturing sites in the United States, Mexico, Argentina, Spain, England, and the Netherlands. The Performance Polymers segment competes primarily in North America, Latin America, and Europe.

In 2007, the Company will transform the Performance Polymers segment. Through innovation and strategic actions, Eastman expects to substantially improve the operating margin of its PET polymers business to approximately 10 percent by the second half of 2008. Through the Company's new facility utilizing *IntegRex* technology in South Carolina, the Company expects to increase PET production through a combination of new capacity and debottlenecking, partially offset by rationalization of higher cost assets. The new facility using *IntegRex* technology will be in full operation in the first quarter of 2007, resulting in 33 percent of the Company's North American PET capacity being *IntegRex*-based capacity. The segment is also taking strategic actions to address under-performing PET assets outside the U.S, including entering into an agreement to sell the San Roque, Spain manufacturing facility. Additionally, the Performance Polymers segment is evaluating the possible construction of a second PET manufacturing facility fully utilizing *IntegRex* technology.

**· Products**

**Ø PET**

PET is used in beverage and food packaging and other applications such as custom-care and cosmetics packaging, health care and pharmaceutical uses, household products, and industrial packaging applications. PET offers fast and easy processing, superb clarity, excellent colorability and color consistency, durability and strength, impact and chemical resistance, and high heat stability. Packages made from PET are characterized by their light weight, high strength, durability, clarity, low cost, safety, and recyclability. PET accounted for 75 percent of the sales revenue in the Performance Polymers segment in 2006.

· **Strategy and Innovation**

**Ø Growth**

The Performance Polymers segment intends to capitalize on the growth in the PET industry with timely and efficient capacity additions including debottlenecking existing production processes, asset expansions, new assets, contract-manufacturing arrangements, and manufacturing alliances. This growth strategy will rely on continuous process technology improvements from the efficient use of research and development, as well as the rationalization of smaller scale, higher cost PET assets, which could be redirected to the manufacture of copolyester products.

Production began in November 2006 at the Company's new PET manufacturing facility utilizing *IntegRex* technology in Columbia, South Carolina. Delivering *ParaStar* next generation PET resins, the facility is expected to be at its full operational capacity of 350 thousand metric tons during the first quarter of 2007. The Company is also evaluating the possible construction of a fully integrated *IntegRex* facility in the United States or elsewhere.

**Ø Innovation**

The Performance Polymers segment expects to continue to provide customers with innovative new products and incremental improvements in existing products. Eastman currently maintains the industry’s broadest product offering for PET polymers including *ParaStar* next generation PET resins for carbonated soft drink packaging enabled by *IntegRex* technology, *Aqua* polymer for the water bottle market, *Heatwave* polymer for hotfill markets and *Vitiva* polymer for ultraviolet light sensitive applications.

**Ø Research and Development**

Eastman directs its research and development programs for the Performance Polymers segment toward three key objectives:

· Lowering manufacturing costs through process technology innovations and process improvement efforts;

· Developing new products and services in PET polymers that both meet customers' fitness for use requirements and are protective of the environment through applications research and customer feedback; and

· Enhancing product quality by improvement in manufacturing technology and processes.

The Company's Performance Polymer's research and development efforts have resulted in significant improvements in manufacturing process efficiencies and are continuing to yield sustainable competitive advantage. In 2004, after two years of significant, concentrated research and development efforts, Eastman announced its new *IntegRex* technology, a breakthrough innovation in the integrated manufacturing of paraxylene to PET resin, specifically designed for packaging applications. During 2005, research and development efforts further enhanced *IntegRex* technology allowing for a debottlenecking of the new plant to provide an additional 100 thousand metric tons by the middle of 2008 for a total capacity of 450 thousand metric tons. In November 2006, the Company announced it was evaluating a second world-class, fully integrated facility utilizing *Integrex* technology.

Enabled by *IntegRex* technology, *ParaStar* next generation PET resins offer Eastman's customers significant advantages in the performance and delivered cost of their packages, including higher clarity and lower energy use in conversion from pellets to containers.

**· Customers and Markets**

The largest 43 PET customers within the Performance Polymers segment accounted for more than 80 percent of the segment's continuing product lines' total sales revenue in 2006. These customers are primarily PET container suppliers to large volume beverage markets such as carbonated soft drinks, water, and juice, with strong participation in custom areas such as food, liquor, sport and fruit beverages, health and beauty aids, and household products. In 2006, the worldwide market for PET, including containers, film and sheet, was approximately 11 million metric tons. Demand for PET has grown steadily over the past several years, driven by its popularity for recyclable, single-serve containers and as a substitute for glass and aluminum. PET has already made significant inroads in soft drink and water bottles, and producers are currently targeting markets such as hot-fill soups and sauces and containers for beer. Industry analysts report that PET consumption grew worldwide from 1.0 million metric tons in 1989 to approximately 11 million metric tons in 2006, a compound annual growth rate of 15 percent. Global demand for PET is expected to grow approximately 6 to 8 percent annually over the next several years.

**· Competition**

Major competitors for the Performance Polymers segment include DAK Americas, Equipolymers, Far Eastern Textiles Ltd., Invista, Mossi & Ghisolfi Group, Nan Ya Plastics Corporation, Reliance Industries Ltd., and Wellman Inc.

The strong growth in demand for PET, coupled with ease of access to conventional manufacturing technology, has resulted in the presence of over 100 significant resin producers in this market in 2006, up from fewer than 20 in 1995. The Performance Polymers segment is a global competitor with manufacturing sites in North America, Latin America and Western Europe. The level of competition, however, varies by region. Competition is primarily on the basis of price with product performance, quality, service, and reliability also being competitive factors.

Industry pricing is strongly affected by raw material costs and capacity utilization. PET global supply has exceeded demand since 1997 as a result of capacity being introduced into the market at a rate exceeding that of demand growth. While the demand for PET continues to increase steadily, excess capacity, particularly in Asia, remains. Excess Asian capacity and related exports are expected to continue to have an adverse impact on PET pricing worldwide.

**SP SEGMENT**

**· Overview**

The SP segment produces highly specialized copolyesters and cellulosic plastics that possess differentiated performance properties for value-added end uses such as appliances, store fixtures and displays, building and construction, electronic packaging, medical devices and packaging, graphic arts, general purpose packaging, personal care and cosmetics packaging, food and beverage packaging, performance films, tape and labels, fibers/nonwovens, photographic and optical films, and liquid crystal displays. In 2006, the SP segment had sales revenue of $818 million, which represented just over 11 percent of Eastman's total sales.

The SP segment competes in the market for plastics that meet specific performance criteria, typically determined on an application-by-application basis. Product development in the SP segment is dependent upon Eastman's ability to design plastics products that achieve performance characteristics specified by its customers, while providing a better value proposition than alternative materials such as polycarbonate and acrylic. Increases in market share are gained through the development of new applications, substitution of plastic for other materials, and, displacement of other plastic resins in existing applications. The SP segment produces polyesters, specialty copolyesters, cellulose esters, and cellulosic plastics. The Company estimates that the market growth for copolyesters will continue to be higher than general economic growth due to continued material innovations and displacement opportunities. Eastman believes that

cellulosic materials will grow at the growth rate of the economy in general, driven by the strong demand for cellulose esters in liquid crystal displays more than offsetting the decline in legacy photographic markets.

Eastman's specialty copolyesters, which generally are based on Eastman's market leading supply of cyclohexane dimethanol ("CHDM") modified polymers, typically fill a market position between polycarbonates and acrylics. Polycarbonates traditionally have had some superior performance characteristics, while acrylics have been less expensive. Specialty copolyesters combine superior performance with competitive pricing and are being substituted for both polycarbonates and acrylics based on their relative performance and pricing.

The SP segment also includes cellulosic materials, which have historically been a steady business with strong operating margins for the Company, and includes what Eastman believes is a market-leading position in North American cellulose esters for tape and film products and cellulose plastics for molding applications. Eastman has recently commercialized a new family of materials, *Visualize* cellulose esters, for the liquid crystal displays market.

Eastman has the ability within its SP segment to modify its polymers and plastics to control and customize their final properties, creating numerous opportunities for new application development, including the expertise to develop new materials and new applications starting from the molecular level in the research laboratory to the final designed application in the customer's plant. In addition, the SP segment has a long history of manufacturing excellence with strong process improvement programs providing continuing cost reduction. Manufacturing process models and information technology systems support global manufacturing sites and provide monitoring and information transfer capability that speed up the innovation process.

· **Products**

Ø **Engineering and Specialty Polymers**

Engineering and specialty polymers accounted for approximately 50 percent of the SP segment's 2006 sales revenue. These polymers include a broad line of polyesters, copolyesters, alloys, cellulose flake, and cellulosic plastics that are sold to a diverse and highly fragmented customer base in numerous market segments on a global basis. Sales in all regions are generated through a mix of the Company's direct sales force and a network of distributors. Engineering and specialty polymers products are sold into three sectors: durable goods (principally components used in appliances); medical goods (disposable medical devices, health care equipment and instruments, and pharmaceutical packaging); and personal care and consumer goods (housewares, cosmetics, eyewear, tools, toys, and food and beverage packaging).

Engineering and specialty polymers products are heavily specification-driven. The Company works with OEM companies to enable product designers to use polymers for a specified use in their products. Although the average life cycle of many of these products is shrinking over time, the Company works to identify uses for the polymers in products that will have multi-year lives. In working with OEM companies on new consumer product designs, new polymer products are often developed for use in a particular type of end-use product.

Ø **Specialty Film and Sheet**

Sales of specialty film and sheet products represented approximately 30 percent of the SP segment's 2006 revenue. The key end-use markets for specialty film and sheet are packaging and in-store fixtures and displays. Direct customers are film and sheet producers, but marketing activities focus downstream through designers, specifiers, OEMs and brand owners in targeted end-use markets.

In the packaging market, specialty film and sheet is sold to end-use markets including medical and electronic component trays, shrink label films, general purpose packaging, and multilayer films. Eastman continues to innovate materials solutions for the packaging market which include high melt strength copolyesters for handleware applications and modified copolyesters used to produce shrink packaging labels. Competitive materials in these end-use markets are typically PET polymers, high density polyethylene, polyvinyl chloride ("PVC") and oriented polystyrene. Eastman's primary brands for these markets are *Eastar* and *Embrace* copolyesters.

In the in-store fixture and display market, *Spectar* copolyester is marketed primarily for point of purchase displays including indoor sign and store fixtures. *Eastar* copolyester is marketed into the graphics market. Copolyester use in these end-use markets is expected to grow above display market rates as a result of new business growth. Competitive materials in these end-use markets are polymethylmethacrylate and polycarbonate.

**Ø Optical Films and Fibers**

Packaging, film and fiber products, which represented approximately 20 percent of the SP segment's 2006 revenue, include a range of specialty polymer products for markets such as photographic film, optical film, fibers/nonwovens, tapes/labels and liquid crystal displays. Customers are typically manufacturers of film and fiber products, employing a range of processing technologies, including film melt extrusion, solvent casting, and fiber extrusion. These films and fibers products are further converted to produce value-added products, such as photographic film, liquid crystal displays film, adhesive tape, or nonwoven articles, which are sold as branded items. Products include cellulose esters, copolyesters, specialty polyesters and concentrates/additives. Sales of products that are used as raw materials in traditional photographic markets continue to be under pressure due to the conversion of traditional photographic technology to digital imaging. The SP segment has commercialized a new family of materials, *Visualize* cellulose esters, for the liquid crystal displays market.

**· Strategy and Innovation**

The SP segment is focused on delivering consistent gross margins and reinvesting for continued growth. Over the past three years, the SP segment has divested certain non-core businesses, shut-down certain non-integrated manufacturing operations, and expanded certain integrated facilities. The Company continues to leverage the advantages of being an integrated polyester manufacturer and will continue to pursue opportunities within the integrated polyester stream. The SP segment is taking advantage of the opportunity to utilize rationalized PET assets to reduce copolyester conversion costs and enhance its ability to market its products against competitive materials. This opportunity is expected to capture the synergies of the Performance Polymers segment's integrated structure and the SP segment's ability to develop higher value markets. These synergies should enable the SP segment to reduce costs and expand production, increase the scale necessary to substitute for competitive materials, and focus on targeted growth markets. The SP segment continues to pursue growth by investing in marketing, research and development, and manufacturing to meet the needs of the global marketplace. For example, the segment is beginning a capital project to increase copolyester capacity at Eastman's South Carolina site in order to meet expected growth in global demand. The SP segment is also expanding its Kingsport-based CHDM capacity to provide additional intermediates to support global market growth for copolyester products. The SP segment is also investigating options to increase capacity for its cellulose ester products to support continued demand in key markets such as liquid crystal displays.

Eastman has a broad portfolio of key monomers that can be combined in various ways to yield a range of polymers with widely varying properties for different applications. Development of proprietary technology is currently underway to enable the SP segment to produce a new family of products that would allow entry into applications that have been beyond the reach of the current portfolio of copolyester products. This new copolyester innovation is expected to offer a combination of chemical and temperature resistance that should enable the SP segment to create new material solutions in markets and applications that the SP segment's current copolyesters have insufficient properties to meet. These new applications are estimated to represent 1.5 billion pounds of opportunities in markets such as medical, building and construction, durables and personal care. The SP segment anticipates having commercial product available for these new applications by the end of 2007.

The Company competes in market niches requiring polymers with combinations of clarity, toughness, and chemical resistance. The liquid crystal display market is a developing growth market for the SP segment. The Company is investing in the development of copolyester and cellulosic based product solutions for this high-growth market, with the objective of becoming a strategic raw material supplier in the liquid crystal displays market. The SP segment's management anticipates continued strong growth of *Visualize* cellulose esters.

The SP segment develops product enhancements in order to respond to specific market needs, and expects this to result in increased market penetration for existing products. Likewise, the introduction of new products will provide access to previously underserved markets. In addition, the SP segment is focusing on global growth by investing resources to provide product solutions to customers in previously underserved regional markets. The SP segment

model of innovation leverages a unique and growing portfolio of cellulosics and specialty copolyesters, such as *Visualize* cellulose esters for liquid crystal displays, *Embrace* copolyesters for shrink films, and *Eastar* copolyesters for cosmetics packaging and clear handleware containers.

The Company is a major supplier of resins to the specialty film and sheet markets. With Eastman serving less than 10 percent of the global specialty film and sheet end-use markets, substantial growth opportunities exist for Eastman. The growth strategy is to penetrate new market segments or geographies and offer a substitute for other materials by providing an improved value proposal or design flexibility that enhances the growth potential of the Company's customers. One example is Eastman's technology for Encapsulated Image Layer Technology ("EILT"). EILT deploys patented technology that allows licensees to construct decorative laminate sheeting using Eastman copolyesters for high value architectural design applications.

· **Customers and Markets**

The customer base in the SP segment is broad and diverse, consisting of over 700 companies worldwide in a variety of industries. Approximately 80 percent of the SP segment's 2006 revenue was attributable to approximately 70 customers. The SP segment seeks to develop mutually beneficial relationships with its customers throughout various stages of product life cycles. By doing so, it is better able to understand its customers' needs as those customers develop new products, and more effectively bring new solutions to market.

· **Competition**

Competition in the SP segment varies as a function of where the products are in their life cycle. For example, the SP segment's products in the introduction phase of the life cycle compete mainly on the basis of performance. As products begin to advance in the life cycle, and substitute products come into existence, the basis of competition begins to shift, taking into account factors such as price, customer service, and brand loyalty. At maturity, where one or more competitors may have equivalent products in the market, competition is based primarily on price. Many large, well-recognized manufacturers produce substitute products of different materials, some of which may offer better performance characteristics than those of the Company's products, and others of which may be offered at a lower price.

The SP segment has a full array of products moving across the life cycle as described above. For example, two commonly used plastics materials in the heavy gauge sheet market are acrylic and polycarbonate. In general, acrylics are lower in cost, while polycarbonates provide higher performance at a higher cost. Eastman's products capture portions of both markets. Customers of the SP segment can select from products that offer improved performance over acrylics at a slightly higher cost, or products that are lower cost than polycarbonates while still possessing excellent performance properties. In this way, the SP segment is able to meet the industry need for low-cost, high performance plastics materials and maintain a significant advantage over its competitors. With regard to engineering and specialty polymers products, the Company competes in market areas requiring polymers with combinations of clarity, toughness, and chemical resistance. Eastman's primary competitors for engineering and specialty polymers are companies such as Bayer AG, Lanxess AG, Dow, GE Plastics, Nova Chemicals Corporation and others, including polycarbonate, acrylic and clear acrylonitrile butadiene styrene producers in regions outside North America. Specialty film and sheet competitors also include polymer companies, such as GE Plastics, Bayer AG, Dow, Cyro Industries, Ineos, Atoglas, SK Chemical Industries, and Selenis, which sell copolyesters, polycarbonate, acrylic, and/or polyvinyl chloride resins. Competition for packaging, film and fiber products is primarily from other producers of polyester and producers of cellulose ester polymers such as Acetati SpA and Daicel. Competition with other polymers such as acrylic, PVC, polystyrene, polypropylene and polycarbonate is also significant in several markets and applications. Channels to customers include corporate accounts, direct sales, e-commerce, and distributors.

The SP segment believes that it maintains competitive advantages over its competitors throughout the product life cycle. At product introduction, the segment's breadth of offerings combined with its research and development capabilities and customer service orientation enable it to quickly bring a wide variety of products to market. As products enter the growth phase of the life cycle, the SP segment is able to continue to leverage its product breadth by receiving revenues from multiple sources, as well as retaining customers from long-term relationships. As products

become price sensitive, the SP segment can take advantage of Eastman's scale of operations and vertical integration to maintain a superior product conversion cost position.

The SP segment believes it has competitive advantages in copolyester and cellulose esters plastics. However, new competitors have begun selling copolyester products in the past few years. These new competitors cannot yet produce the wide variety of specialty copolyesters offered by the SP segment or offer the same level of technical assistance. Additionally, the Company is committed to investing for growth in SP product lines to support continued market growth and maintaining the cost advantages obtained from its scale of operations and manufacturing expertise. There can be no assurance, however, that the SP segment will be able to maintain this competitive advantage and if it is unable to do so, its results of operations could be adversely affected.

**EASTMAN CHEMICAL COMPANY GENERAL INFORMATION**

**Sales, Marketing, and Distribution**

The Company markets products primarily through a global sales organization, which has a presence in the United States and in over 35 other countries around the world. Eastman has a number of broad product lines which require a sales and marketing strategy that is tailored to specific customers in order to deliver high quality products and high levels of service to all of its customers worldwide. Technical expertise and process knowledge are critical in determining the application of products for a particular customer. Through a highly skilled and specialized sales force that is capable of providing customized business solutions for each of its five operating segments, Eastman is able to establish long-term customer relationships and strives to become the preferred supplier of specialty chemicals and plastics.

The Company's products are marketed through a variety of selling channels, with the majority of sales being direct and the balance sold primarily through indirect channels such as distributors. Non-U.S. sales tend to be made more frequently through distributors than U.S. sales. The Company's customers throughout the world have the choice of obtaining products and services through Eastman's website, www.eastman.com, through any of its global customer service centers, or through any of Eastman's direct sales force or independent distributors. Customers who choose to use the Company’s website can conduct a wide range of business transactions such as ordering online, accessing account and order status, and obtaining product and technical data. Eastman is an industry leader in the implementation and utilization of e-business technology for marketing and selling products to customers and was one of the first chemical companies to offer this capability. Eastman views this as an opportunity to increase supply chain efficiency by having an enterprise resource-planning platform with connectivity to customers. These sales and marketing capabilities combine to reduce costs and provide a platform for growth opportunities for the Company by providing potential customers new methods to access Eastman’s products.

The Company’s products are shipped to customers directly from Eastman's manufacturing plants as well as from distribution centers worldwide, with the method of shipment generally determined by the customer.

**Sources and Availability of Raw Materials and Energy**

Eastman purchases a substantial portion, estimated to be approximately 80 percent, of its key raw materials and energy through long-term contracts, generally of three to five years initial duration with renewal or cancellation options for each party. Most of those agreements do not require the Company to purchase materials or energy if its operations are reduced or idle. The cost of raw materials and energy is generally based on market price at the time of purchase, although derivative financial instruments, valued at quoted market prices, have been utilized to mitigate the impact of short-term market price fluctuations. Key raw materials and purchased energy include propane, ethane, paraxylene, ethylene glycol, PTA, natural gas, coal, cellulose, methanol, electricity, and a wide variety of precursors for specialty organic chemicals. The Company has multiple suppliers for most key raw materials and energy and uses quality management principles, such as the establishment of long-term relationships with suppliers and on-going performance assessment and benchmarking, as part of the supplier selection process. When appropriate, the Company purchases raw materials from a single source supplier to maximize quality and cost improvements, and has developed

contingency plans that would minimize the impact of any supply disruptions from single source suppliers.

While temporary shortages of raw materials and energy may occasionally occur, these items are generally sufficiently available to cover current and projected requirements. However, their continuous availability and price are subject to unscheduled plant interruptions occurring during periods of high demand, or due to domestic or world market and political conditions, changes in government regulation, natural disasters, war or other outbreak of hostilities. Eastman's operations or products have been in the past and may be in the future, at times, adversely affected by these factors. The Company's cost of raw materials and energy as a percent of total cost of operations was estimated to be approximately 70 percent for 2006, compared with 65 percent in 2005 and 55 percent in 2004.

**Capital Expenditures**

Capital expenditures were $389 million, $343 million, and $248 million for 2006, 2005 and 2004, respectively. The Company expects that 2007 capital spending will be up to $450 million which will exceed estimated 2007 depreciation and amortization of approximately $350 million, including accelerated depreciation of approximately $50 million, as it funds targeted growth efforts.

**Employees**

Eastman employs approximately 11,000 men and women worldwide. Approximately 7 percent of the total worldwide labor force is represented by unions, mostly outside the United States.

**Customers**

Eastman has an extensive customer base and, while it is not dependent on any one customer, loss of certain top customers could adversely affect the Company until such business is replaced. The top 100 customers accounted for approximately 65 percent of the Company's 2006 sales revenue.

**Intellectual Property and Trademarks**

While the Company's intellectual property portfolio is an important Company asset which it expands and vigorously protects globally through a combination of patents that expire at various times, trademarks, copyrights, and trade secrets, neither its business as a whole nor any particular segment is materially dependent upon any one particular patent, trademark, copyright, or trade secret. As a producer of a broad and diverse portfolio of both specialty and commodity chemicals, plastics, and fibers, Eastman owns over 850 active United States patents and more than 1,500 active foreign patents, expiring at various times over several years, and also owns over 3,000 active worldwide trademarks. The Company's intellectual property relates to a wide variety of products and processes. With two recent significant research and development innovations, Eastman continues to actively protect its intellectual property. In support of the development of the *IntegRex* technology, the Company has filed over 140 patent applications. In support of the development of the copolyester innovation products, the Company has filed over 50 patent applications. Eastman can not assure that a patent will be granted from every application filed. As the laws of many foreign countries do not protect intellectual property to the same extent as the laws of the United States, Eastman cannot assure that it will be able to adequately protect its intellectual property assets.

**Research and Development**

For 2006, 2005 and 2004, Eastman's research and development expenses totaled $167 million, $162 million and $154 million, respectively. Research and development expenses are expected to decrease slightly in 2007 due to divestitures, partially offset by increased spending on growth initiatives.

**Environmental**

Eastman is subject to laws, regulations, and legal requirements relating to the use, storage, handling, generation, transportation, emission, discharge, disposal and remediation of, and exposure to, hazardous and non-hazardous substances and wastes in all of the countries in which it does business. These health, safety and environmental considerations are a priority in the Company’s planning for all existing and new products and processes. The Health, Safety, Environmental and Security Committee of Eastman’s Board of Directors reviews the Company's policies and practices concerning health, safety and the environment and its processes for complying with related laws and regulations, and monitors related matters.

The Company’s policy is to operate its plants and facilities in a manner that protects the environment and the health and safety of its employees and the public. The Company intends to continue to make expenditures for environmental protection and improvements in a timely manner consistent with its policies and with the technology available. In some cases, applicable environmental regulations such as those adopted under the U.S. Clean Air Act and Resource Conservation and Recovery Act, and related actions of regulatory agencies, determine the timing and amount of environmental costs incurred by the Company.

The Company accrues environmental costs when it is probable that the Company has incurred a liability and the amount can be reasonably estimated. In some instances, the amount cannot be reasonably estimated due to insufficient data, particularly in the nature and timing of the future performance. In these cases, the liability is monitored until such time that sufficient data exists. With respect to a contaminated site, the amount accrued reflects the Company’s assumptions about remedial requirements at the site, the nature of the remedy, the outcome of discussions with regulatory agencies and other potentially responsible parties at multi-party sites, and the number and financial viability of other potentially responsible parties. Changes in the estimates on which the accruals are based, unanticipated government enforcement action, or changes in health, safety, environmental, chemical control regulations, and testing requirements could result in higher or lower costs.

The Company's cash expenditures related to environmental protection and improvement were estimated to be approximately $215 million, $198 million and $184 million in 2006, 2005 and 2004, respectively. These amounts pertain primarily to operating costs associated with environmental protection equipment and facilities, but also include expenditures for construction and development. The Company does not expect future environmental capital expenditures arising from requirements of recently promulgated environmental laws and regulations to materially increase the Company's planned level of annual capital expenditures for environmental control facilities.

Other matters concerning health, safety, and the environment are discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations in Part II Item 7 and in Notes 1, "Significant Accounting Policies", and 12, "Environmental Matters", to the Company’s consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10-K.

**Backlog**

On January 1, 2007, Eastman’s backlog of firm sales orders was estimated to be approximately $290 million compared with approximately $295 million at January 1, 2006. All orders are expected to be filled in 2007. The Company manages its inventory levels to control the backlog of products depending on customers' needs. In areas where the Company is the single source of supply, or competitive forces or customers' needs dictate, the Company may carry additional inventory to meet customer requirements.

**Financial Information About Geographic Areas**

For revenues and long-lived assets by geographic areas, see Note 21, "Segment Information", to the Company’s consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10-K.

**Available Information - SEC Filings and Corporate Governance Materials**

The Company makes available free of charge, through the "Investors - SEC Filings" section of its Internet website (www.eastman.com), its annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as soon as reasonably practicable after electronically filing such material with, or furnishing it to, the Securities and Exchange Commission (the "SEC"). Once filed with the SEC, such documents may be read and/or copied at the SEC’s Public Reference Room at 100 F Street N.E., 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 that contains reports, proxy and information statements, and other information regarding issuers, including Eastman Chemical Company, that electronically file with the SEC at http://www.sec.gov.

The Company also makes available free of charge, through the "Investors - Corporate Governance" section of its internet website (www.eastman.com), the Corporate Governance Guidelines of its Board of Directors, the charters of each of the committees of the board, and codes of ethics and business conduct for directors, officers and employees. Such materials are also available in print upon the written request of any stockholder to Eastman Chemical Company, P.O. Box 431, Kingsport, Tennessee 37662-5280, Attention: Investor Relations.

**Stockholder Information**

Corporate Offices Address: See Cover Page to this Form 10-K
Telephone: 877-EMN-INFO (877-366-4636)
Corporate Website: www.eastman.com

Annual Meeting:
Toy F. Reid Employee Center
Kingsport, Tennessee
Thursday, May 3, 2007
11:30 a.m. (ET)

Stock Exchange Listing:
Eastman Chemical Company common stock is listed and traded on the New York Stock Exchange under the ticker symbol "EMN." Most newspaper tables list the Company's stock as "EmanChem."

Stock Transfer Agent and Registrar:
Inquiries and changes to stockholder accounts should be directed to our transfer agent:
American Stock Transfer & Trust Company
59 Maiden Lane
New York, NY 10038
In the United States: 800-937-5449
Outside the United States: (1) 212-936-5100 or (1) 718-921-8200
Website: //www.amstock.com

**New York Stock Exchange and Securities and Exchange Commission Certifications**

In 2006, the Company submitted to the New York Stock Exchange (the "NYSE") the certification of the Chief Executive Officer that he was not aware of any violation by Eastman Chemical Company of the NYSE's corporate governance listing standards as required by Section 303A.12(a) of the New York Stock Exchange Listed Company Manual. In addition, the Company has filed with the SEC, as exhibits to this Form 10-K for the year ended December 31, 2006, the Chief Executive Officer's and Chief Financial Officer's certifications regarding the quality of the Company's public disclosure, disclosure controls and procedures, and internal controls over financial reporting as required by Section 302 of the Sarbanes-Oxley Act of 2002 and related SEC rules.

**ITEM 1A. RISK FACTORS**

For identification and discussion of the most significant risks applicable to the Company and its business, see Part II - Item 7 - "Management's Discussion and Analysis of Financial Condition and Results of Operations - Forward-Looking Statements and Risk Factors" of this 2006 Annual Report on Form 10-K.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

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**EXECUTIVE OFFICERS OF THE COMPANY**

Certain information about the Company's executive officers is provided below:

J. Brian Ferguson, age 52, is Chairman of the Board and Chief Executive Officer. Mr. Ferguson joined the Company in 1977. He was named Vice President, Industry and Federal Affairs in 1994, became Managing Director, Greater China in 1996, was named President, Eastman Chemical Asia Pacific in 1998, became President, Polymers Group in 1999, became President, Chemicals Group in 2001, and was elected to his current position in 2002.

James P. Rogers, age 55, is President of Eastman Chemical Company and Chemicals & Fibers Business Group Head. Mr. Rogers was appointed Executive Vice President of the Company and President of Eastman Division effective November 2003. Mr. Rogers joined the Company in 1999 as Senior Vice President and Chief Financial Officer and in 2002, was also appointed Chief Operations Officer of Eastman Division. He was appointed to his current position in 2006. Mr. Rogers served previously as Executive Vice President and Chief Financial Officer of GAF Materials Corporation ("GAF"). He also served as Executive Vice President, Finance, of International Specialty Products, Inc., which was spun off from GAF in 1997.

Gregory O. Nelson, age 55, is Executive Vice President and Polymers Business Group Head. Dr. Nelson joined Eastman in 1982 as a research chemist and held a number of positions in the research and development organization. He became Director, Polymers Research Division in 1995 and was named Vice President, Polymers Technology in 1997. He was appointed as Chief Technology Officer in 2001 and named Senior Vice President in 2002. He was appointed to his present position in 2006.

Mark Costa, age 40, is Senior Vice President, Corporate Strategy & Marketing. Prior to joining Eastman on June 1, 2006, Mr. Costa was a senior partner within Monitor Group's integrated North American and global client service networks. He joined Monitor in 1988 and his experience included corporate and business unit strategies, asset portfolio strategies, innovation and marketing, and channel strategies across a wide range of industries, including specialty and commodity chemicals, electricity, natural gas and truck/auto manufacturing.

Theresa K. Lee, age 54, is Senior Vice President, Chief Legal Officer and Corporate Secretary. Ms. Lee joined Eastman as a staff attorney in 1987, served as Assistant General Counsel for the health, safety, and environmental legal staff from 1993 to 1995, and served as Assistant General Counsel for the corporate legal staff from 1995 until her appointment as Vice President, Associate General Counsel and Secretary in 1997. She became Vice President, General Counsel, and Corporate Secretary of Eastman in 2000 and was appointed to her current position in 2002.

Richard A. Lorraine, age 61, joined Eastman in November 2003 as Senior Vice President and Chief Financial Officer. Mr. Lorraine served as Executive Vice President and Chief Financial Officer of Occidental Chemical Corporation from 1995 until 2003, and at ITT Automotive Group as President of the Aftermarket Group from 1990 to 1995 and Vice President and Chief Financial Officer from 1985 to 1990. Mr. Lorraine started his career with Westinghouse Electric Corporation, where he held various financial positions.

Ronald C. Lindsay, age 48, is Senior Vice President and Chief Technology Officer. He joined Eastman in 1980 and held a number of positions in manufacturing and business organizations. In 2003, Mr. Lindsay was appointed Vice President and General Manager of the Intermediates Business Organization and in 2005 he became Vice President, Performance Chemicals Business. He was appointed to his current position in April 2006.

Norris P. Sneed, age 51, is Senior Vice President, Human Resources, Communications and Public Affairs. Mr. Sneed joined the Company in 1979 as a chemical engineer. In 1989, he was assigned to Eastman’s Arkansas Operations where he was superintendent for different manufacturing and new business development departments. In 1997, he served as assistant to the Chief Executive Officer. He was named managing director for Eastman’s Argentina

operations in 1999, Vice President of Organization Effectiveness in 2001, and was appointed to his current position in June 2003.

Curtis E. Espeland, age 42, is Vice President, Finance, and Chief Accounting Officer. Mr. Espeland joined Eastman in 1996, and has served in various financial management positions, including Controller; Director of Corporate Planning and Forecasting; Director of Financial Services, Asia Pacific; and Director of Internal Auditing. He has served as the Company's Chief Accounting Officer since December 2002. Prior to joining Eastman, Mr. Espeland was an audit and business advisory manager with Arthur Andersen LLP.

**ITEM 2. PROPERTIES**

**PROPERTIES**

At December 31, 2006, Eastman operated 16 manufacturing sites in 10 countries. Utilization of these facilities may vary with product mix and economic, seasonal, and other business conditions, but, except as indicated below, none of the principal plants are substantially idle. The Company's plants, including approved expansions, generally have sufficient capacity for existing needs and expected near-term growth. These plants are generally well maintained, in good operating condition, and suitable and adequate for their use. Unless otherwise indicated, all of the properties are owned. The locations and general character of the major manufacturing facilities are:

| | Segment using manufacturing facility | | | | |
|---|---|---|---|---|---|
| **Location** | **CASPI** | **PCI** | **SP** | **Performance Polymers** | **Fibers** |
| **USA** | | | | | |
| Jefferson, Pennsylvania | x | | | | |
| Columbia, South Carolina | | | x | x | |
| Kingsport, Tennessee | x | x | x | x | x |
| Longview, Texas | x | x | | | |
| Franklin, Virginia* | x | | | | |
| **Europe** | | | | | |
| Workington, England | | | | x | x |
| Middelburg, the Netherlands | x | | | | |
| Rotterdam, the Netherlands* | | | | x | |
| San Roque, Spain*** | | | | x | |
| Llangefni, Wales | | x | | | |
| **Asia Pacific** | | | | | |
| Kuantan, Malaysia* | | | x | | |
| Jurong Island, Singapore* | x | x | | | |
| Zibo City, China** | x | x | | | |
| **Latin America** | | | | | |
| Zarate, Argentina | | | | x | |
| Cosoleacaque, Mexico | | | | x | |
| Uruapan, Mexico | x | | | | |

* indicates a location that Eastman leases from a third party.
** Eastman holds a 51 percent share in the joint venture Qilu Eastman Specialty Chemical Ltd.
*** In first quarter 2007, the Company entered into an agreement to sell this manufacturing site.

In addition, Eastman has a 50 percent interest in Primester, a joint venture that manufactures cellulose acetate at Eastman's Kingsport, Tennessee plant. The production of cellulose acetate is an intermediate step in the manufacture of acetate tow and other cellulose acetate based products. The Company also has a 50 percent interest in a manufacturing facility in Nanjing, China. The Nanjing facility produces *Eastotac* hydrocarbon tackifying resins for pressure-sensitive adhesives, caulks, and sealants. *Eastotac* hydrocarbon resins are also used to produce hot melt adhesives for packaging applications in addition to glue sticks, tapes, labels, and other adhesive applications.

Eastman has distribution facilities at all of its plant sites. In addition, the Company owns or leases over 100 stand-alone distribution facilities in the United States and 17 other countries. Corporate headquarters are in Kingsport, Tennessee. The Company's regional headquarters are in Miami, Florida; Capelle aan den Ijssel, the Netherlands; Zug, Switzerland; Singapore; and Kingsport, Tennessee. Technical service is provided to the Company's customers from technical service centers in Kingsport, Tennessee; Kirkby, England; Shanghai, China and Singapore. Customer service centers are located in Kingsport, Tennessee; Capelle aan den Ijssel, the Netherlands; Miami, Florida; and Singapore.

A summary of properties, classified by type, is included in Note 3, "Properties and Accumulated Depreciation", to the Company’s consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10K.

**ITEM 3. LEGAL PROCEEDINGS**

**General**

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

**Sorbates Litigation**

Two civil cases relating to sorbates remain. In each case, the Company prevailed at the trial court, and in each case, the plaintiff appealed the trial court's decision. In one case, the appeal is still pending. In the other case, the court of appeals overturned the trial court's decision and ruled that the plaintiff could amend and re-file its complaint with the trial court. The Company has appealed this court of appeals decision to the state supreme court. In each case the Company intends to continue to vigorously defend its position.

**Asbestos Litigation**

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

To date, the Company has obtained dismissals or settlements of its asbestos-related lawsuits with no material effect on its financial condition, results of operations or cash flows, and over the past several years, has substantially reduced its number of pending asbestos-related claims. The Company has also obtained insurance coverage that applies to a portion of certain of the Company’s defense costs and payments of settlements or judgments in connection with asbestos-related lawsuits.

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

**Middelburg (Netherlands) Environmental Proceeding**

In June 2005, Eastman Chemical Middelburg, B.V., a wholly owned subsidiary of the Company, (the "Subsidiary") received a summons from the Middelburg (Netherlands) District Court Office to appear before the economic magistrate of that District and respond to allegations that the Subsidiary's manufacturing facility in Middelburg has exceeded certain conditions in the permit that allows the facility to discharge wastewater into the municipal wastewater treatment system. The summons proposed penalties in excess of $100,000 as a result of the alleged violations. A hearing in this matter took place on July 28, 2005, at which time the magistrate bifurcated the proceeding into two phases: a compliance phase and an economic benefit phase. With respect to the compliance phase, the magistrate levied a fine of less than $100,000. With respect to the economic benefit phase, where the prosecutor proposed a penalty in excess of $100,000, the district court in November 2006 assessed against the

Subsidiary a penalty of less than $100,000. The prosecutor has appealed this ruling, and the appeal is pending. This disclosure is made pursuant to SEC Regulation S-K, Item 103, Instruction 5.C., which requires disclosure of administrative proceedings commenced under environmental laws that involve governmental authorities as parties and potential monetary sanctions in excess of $100,000. The Company believes that the ultimate resolution of this proceeding will not have a material impact on the Company's financial condition, results of operations, or cash flows.

**Jefferson (Pennsylvania) Environmental Proceeding**

In December 2005, Eastman Chemical Resins, Inc., a wholly-owned subsidiary of the Company (the "ECR Subsidiary"), received a Notice of Violation ("NOV") from the United States Environmental Protection Agency's Region III Office ("EPA") alleging that the ECR Subsidiary's West Elizabeth, Jefferson Borough, Allegheny County, Pennsylvania manufacturing operation (the "Jefferson Facility") violated certain federally enforceable local air quality regulations and certain provisions in a number of air quality-related permits. The NOV did not assess a civil penalty and EPA has to date not proposed any specific civil penalty amount. In October 2006, EPA referred the matter to the United States Department of Justice's Environmental Enforcement Section ("DOJ"). Company representatives met with EPA and DOJ in November, 2006 and subsequent to that meeting the Company determined that it is not reasonably likely that any civil penalty assessed by the EPA and DOJ will be less than $100,000. While the Company intends to vigorously defend against these allegations, this disclosure is made pursuant to SEC Regulation S-K, Item 103, Instruction 5.C., which requires disclosure of administrative proceedings commenced under environmental laws that involve governmental authorities as parties and potential monetary sanctions in excess of $100,000. The Company believes that the ultimate resolution of this proceeding will not have a material impact on the Company's financial condition, results of operations, or cash flows.

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

There were no matters submitted to a vote of the Company's stockholders during the fourth quarter of 2006.

## PART II

### ITEM 5. MARKET FOR THE REGISTRANT'S COMMON STOCK, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

(a) Eastman Chemical Company's ("Eastman" or the "Company") common stock is traded on the New York Stock Exchange ("NYSE") under the symbol "EMN". The following table presents the high and low sales prices of the common stock on the NYSE and the cash dividends per share declared by the Company's Board of Directors for each quarterly period of 2006 and 2005.

| | | High | Low | Cash Dividends Declared |
|---|---|---|---|---|
| **2006** | First Quarter | $ 53.83 | $ 47.30 | $ 0.44 |
| | Second Quarter | 58.15 | 50.00 | 0.44 |
| | Third Quarter | 54.69 | 48.72 | 0.44 |
| | Fourth Quarter | 61.29 | 53.62 | 0.44 |
| **2005** | First Quarter | $ 61.80 | $ 50.48 | $ 0.44 |
| | Second Quarter | 60.80 | 47.40 | 0.44 |
| | Third Quarter | 58.38 | 44.10 | 0.44 |
| | Fourth Quarter | 56.77 | 45.34 | 0.44 |

As of December 31, 2006, there were 83,637,623 shares of the Company's common stock issued and outstanding, which shares were held by 29,190 stockholders of record. These shares include 106,771 shares held by the Company's charitable foundation. The Company has declared a cash dividend of $0.44 per share during the first quarter of 2007. Quarterly dividends on common stock, if declared by the Company's Board of Directors, are usually paid on or about the first business day of the month following the end of each quarter. The payment of dividends is a business decision made by the Board of Directors from time to time based on the Company's earnings, financial position and prospects, and such other considerations as the Board considers relevant. Accordingly, while management currently expects that the Company will continue to pay the quarterly cash dividend, its dividend practice may change at any time.

During the fourth quarter of 2006, the Board of Directors of the Company redeemed all of the outstanding preferred stock purchase rights issuable pursuant to the Stockholder Protection Rights Agreement and terminated the Stockholder Protection Rights Agreement.

See Part III, Item 12 — “Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters—Securities Authorized for Issuance Under Equity Compensation Plans” of this 2006 Annual Report on Form 10-K for the Information required by Item 201(d) of Regulation S-K.

(b) Not applicable

(c) Purchases of Equity Securities by the Issuer and Affiliated Purchasers

| Period | Total Number of Shares Purchased (1) | | Average Price Paid Per Share (2) | | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (3) | | Approximate Dollar Value (in Millions) that May Yet Be Purchased Under the Plans or Programs (3) |
|---|---|---|---|---|---|---|---|
| October 1- 31, 2006 | 59,526 | $ | 60.48 | | 0 | | |
| November 1-30, 2006 | 44,517 | $ | 58.87 | | 0 | | |
| December 1-31, 2006 | 8,107 | $ | 58.03 | | 0 | | |
| Total | 112,150 | | | | 0 | $ | 288 |

(1) Shares surrendered to the Company by employees to satisfy individual tax withholding obligations upon vesting of previously issued shares of restricted common stock and shares surrendered by employees as payment to the Company of the purchase price for shares of common stock under the terms of previously granted stock options. Shares are not part of any Company repurchase plan.

(2) Average price paid per share reflects the weighted average of the closing price of Eastman common stock on the business days the shares were surrendered by the employee stockholders.

(3) The Company was authorized by the Board of Directors on February 4, 1999 to repurchase up to $400 million of its common stock. Common share repurchases under this authorization in 1999, 2000 and 2001 were $51 million, $57 million and $4 million, respectively. The Company has not repurchased any common shares under this authorization after 2001. On February 20, 2007, the Board of Directors cancelled its prior authorization for stock repurchases dated February 4, 1999 and approved a new authorization for the repurchase of up to $300 million of the Company's outstanding common stock at such times, in such amounts, and on such terms, as determined to be in the best interests of the Company. Repurchased shares may be used for such purposes or otherwise applied in such a manner as determined to be in the best interests of the Company. For additional information, see Note 14, "Stockholders' Equity", to the Company’s consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10-K.

**ITEM 6. SELECTED FINANCIAL DATA**

Summary of Operating Data

| (Dollars in millions, except per share amounts) | 2006 | 2005 | 2004 | 2003 | 2002 |
|---|---|---|---|---|---|
| Sales | $ 7,450 | $ 7,059 | $ 6,580 | $ 5,800 | $ 5,320 |
| Operating earnings (loss) | 640 | 757 | 175 | (267) | 208 |
| Earnings (loss) before cumulative effect of change in accounting principles | 409 | 557 | 170 | (273) | 79 |
| Cumulative effect of change in accounting principles, net | -- | -- | -- | 3 | (18) |
| Net earnings (loss) | $ 409 | $ 557 | $ 170 | $ (270) | $ 61 |
| Basic | | | | | |
| Earnings (loss) per share before cumulative effect of change in accounting principles | $ 4.98 | $ 6.90 | $ 2.20 | $ (3.54) | $ 1.02 |
| Cumulative effect of change in accounting principles, net | -- | -- | -- | 0.04 | (0.23) |
| Net earnings (loss) per share | $ 4.98 | $ 6.90 | $ 2.20 | $ (3.50) | $ 0.79 |
| Diluted | | | | | |
| Earnings (loss) per share before cumulative effect of change in accounting principles | $ 4.91 | $ 6.81 | $ 2.18 | $ (3.54) | $ 1.02 |
| Cumulative effect of change in accounting principles, net | -- | -- | -- | 0.04 | (0.23) |
| Net earnings (loss) per share | $ 4.91 | $ 6.81 | $ 2.18 | $ (3.50) | $ 0.79 |
| **Statement of Financial Position Data** | | | | | |
| Current assets | $ 2,422 | $ 1,924 | $ 1,768 | $ 2,010 | $ 1,547 |
| Net properties | 3,069 | 3,162 | 3,192 | 3,419 | 3,753 |
| Total assets | 6,173 | 5,773 | 5,839 | 6,244 | 6,287 |
| Current liabilities | 1,059 | 1,051 | 1,099 | 1,477 | 1,247 |
| Long-term borrowings | 1,589 | 1,621 | 2,061 | 2,089 | 2,054 |
| Total liabilities | 4,144 | 4,161 | 4,655 | 5,201 | 5,016 |
| Total stockholders’ equity | 2,029 | 1,612 | 1,184 | 1,043 | 1,271 |
| Dividends declared per share | 1.76 | 1.76 | 1.76 | 1.76 | 1.76 |

Effective January 1, 2003, the Company’s method of accounting for environmental closure and post-closure costs changed as a result of the adoption of Statement of Accounting Standards ("SFAS") No. 143, “Accounting for Asset Retirement Obligations.” If the provisions of SFAS No. 143 had been in effect in prior years, the impact on the

Company’s financial results would have been immaterial. For additional information see Note 12, "Environmental Matters", to the Company’s consolidated financial statements in Part II, Item 8 of the 2005 Annual Report on Form 10-K.

On July 31, 2004, the Company completed the sale of certain businesses, product lines and related assets within the Coatings, Adhesives, Specialty Polymers and Inks ("CASPI") segment. For more information regarding the impact of this divestiture on financial results, refer to the CASPI segment discussion of Part II, Item 7 - "Management Discussion and Analysis" of this 2006 Annual Report on Form 10-K.

In second quarter 2005, the Company completed the sale of its equity investment in Genencor International, Inc. ("Genencor"). For more information, refer to Note 5, "Equity Investments and Other Noncurrent Assets and Liabilities", to the Company's consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10-K.

In second quarter 2005, the Company completed the early repayment of $500 million of its outstanding long-term bonds. For more information, refer to Note 8, "Early Extinguishment of Debt", to the Company's consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10-K.

In fourth quarter 2006, the Company completed the sale of its Batesville, Arkansas manufacturing facility and related assets and specialty organic chemicals product lines in the Performance Chemicals and Intermediates segment and the sale of its polyethylene and *Epolene* polymer businesses and related assets located at the Longview, Texas site and the Company's ethylene pipeline. The polyethylene assets and product lines were in the Performance Polymers segment, while the *Epolene* assets and product lines were in the CASPI segment. For more information regarding the impact of these divestitures on financial results, refer to the segment discussions of Part II, Item 7 - "Management Discussion and Analysis" and Part II, Item 8 - "Notes the Audited Consolidated Financial Statements" - Note 24, "Divestitures" of this 2006 Annual Report on Form 10-K.

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**



This Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon the consolidated financial statements for Eastman Chemical Company ("Eastman" or the "Company"), which have been prepared in accordance with accounting principles generally accepted in the United States, and should be read in conjunction with the Company's consolidated financial statements included elsewhere in this Annual Report on Form 10-K. All references to earnings per share contained in this report are diluted earnings per share unless otherwise noted.

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

### CRITICAL ACCOUNTING POLICIES

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

#### Allowances for Doubtful Accounts

The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. The Company believes, based on historical results, the likelihood of actual write-offs having a material impact on financial results or earnings per share is low. However, if one of the Company's key customers were to file for bankruptcy, or otherwise be unable to make its required payments, or there was a significant continued slowdown in the economy, the Company could be forced to increase its allowances. This could result in a material charge to earnings. For trade receivables of $698 million and $595 million at December 31, 2006 and 2005, respectively, the Company's allowances were $16 million and $20 million, respectively.

#### Impairment of Long-Lived Assets

The Company evaluates the carrying value of long-lived assets, including definite-lived intangible assets, when events or changes in circumstances indicate that the carrying value may not be recoverable. Such events and circumstances include, but are not limited to, significant decreases in the market value of the asset, adverse change in the extent or manner in which the asset is being used, significant changes in business climate, or current or projected cash flow losses associated with the use of the assets. The carrying value of a long-lived asset is considered impaired when the total projected undiscounted cash flows from such asset is separately identifiable and is less than its carrying value. In that event, a loss is recognized based on the amount by which the carrying value exceeds the fair value of the long-lived asset. For long-lived assets to be held and used, fair value of fixed (tangible) assets and definite-lived intangible assets is determined primarily using either the projected cash flows discounted at a rate commensurate with the risk involved or an appraisal. For long-lived assets to be disposed of by sale or other than by sale, fair value is determined in a similar manner, except that fair values are reduced for disposal costs.

The provisions of Statement of Financial Accounting Standards ("SFAS") No. 142 "Goodwill and Other Intangible Assets," require that goodwill and indefinite-lived intangible assets be tested at least annually for impairment and require reporting units to be identified for the purpose of assessing potential future impairments of goodwill. The carrying value of goodwill and indefinite lived intangibles is considered impaired when their fair value, as established by appraisal or based on undiscounted future cash flows of certain related products, is less than their carrying value. The Company conducts its annual testing of goodwill and indefinite-lived intangible assets for impairment in the third

quarter of each year, unless events warrant more frequent testing.

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

As the Company's assumptions related to long-lived assets are subject to change, additional write-downs may be required in the future. If estimates of fair value less costs to sell are revised, the carrying amount of the related asset is adjusted, resulting in a charge to earnings. The Company recorded fixed (tangible) asset impairments of $55 million and definite-lived intangible asset impairments of $1 million during 2006. The Company recorded fixed (tangible) asset impairments of $9 million and definite-lived intangible asset impairments of $3 million during 2005.

**Environmental Costs**

The Company accrues environmental remediation costs when it is probable that the Company has incurred a liability at a contaminated site and the amount can be reasonably estimated. When a single amount cannot be reasonably estimated but the cost can be estimated within a range, the Company accrues the minimum amount. This undiscounted accrued amount reflects the Company's assumptions about remediation requirements at the contaminated site, the nature of the remedy, the outcome of discussions with regulatory agencies and other potentially responsible parties at multi-party sites, and the number and financial viability of other potentially responsible parties. Changes in the estimates on which the accruals are based, unanticipated government enforcement action, or changes in health, safety, environmental, and chemical control regulations and testing requirements could result in higher or lower costs. Estimated future environmental expenditures for remediation costs range from the minimum or best estimate of $18 million to the maximum of $32 million at December 31, 2006.

In accordance with SFAS No. 143, "Accounting for Asset Retirement Obligations," the Company also establishes reserves for closure/postclosure costs associated with the environmental and other assets it maintains. Environmental assets, as defined in SFAS No. 143, include but are not limited to waste management units, such as landfills, water treatment facilities, and ash ponds. When these types of assets are constructed or installed, a reserve is established for the future costs anticipated to be associated with the retirement or closure of the asset based on an expected life of the environmental assets and the applicable regulatory closure requirements. These future expenses are charged into earnings over the estimated useful life of the assets. Currently, the Company estimates the useful life of each individual asset is up to 50 years. If the Company changes its estimate of the asset retirement obligation costs or its estimate of the useful lives of these assets, expenses to be charged into earnings could increase or decrease.

In accordance with Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" ("FIN 47"), the Company also monitors conditional obligations and will record reserves associated with them when and to the extent that more detailed information becomes available concerning applicable retirement costs.

The Company's reserve for environmental contingencies was $47 million and $51 million at December 31, 2006 and 2005, respectively, representing the minimum or best estimate for remediation costs and, for asset retirement obligation costs, the best estimate of the amount accrued to date over the regulated assets' estimated useful lives.

**United States Pension and Other Post-employment Benefits**

The Company maintains defined benefit pension plans that provide eligible employees with retirement benefits. Additionally, Eastman provides life insurance and health care benefits for eligible retirees and health care benefits for retirees' eligible survivors. The costs and obligations related to these benefits reflect the Company's assumptions related to general economic conditions (particularly interest rates) and expected return on plan assets. At December 31, 2006, the Company assumed a discount rate of 5.86 percent and an expected return on assets of 9 percent. The cost of providing plan benefits also depends on demographic assumptions including retirements, mortality, turnover, and plan participation.

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

The following table illustrates the sensitivity to a change in the expected return on assets and assumed discount rate for U.S. pension plan and other postretirement welfare plans:

| Change in Assumption | Impact on 2007 Pre-tax U.S. Benefits Expense | Impact on December 31, 2006 Projected Benefit Obligation for U.S. Pension Plan | Impact on December 31, 2006 Benefit Obligation for Other U.S. Postretirement Plans |
|---|---|---|---|
| 25 basis point decrease in discount rate | +$5 Million | +$49 Million | +$21 Million |
| 25 basis point increase in discount rate | -$5 Million | -$46 Million | -$21 Million |
| 25 basis point decrease in expected return on assets | +$3 Million | No Impact | N/A |
| 25 basis point increase in expected return on assets | -$3 Million | No Impact | N/A |

The expected return on assets and assumed discount rate used to calculate the Company’s pension and other post-employment benefit obligations are established each December 31. The expected return on assets is based upon the long-term expected returns in the markets in which the pension trust invests its funds, primarily the domestic, international, and private equities markets. The actual return on assets has exceeded the expected return for the last 3 years. The assumed discount rate is based upon a portfolio of high-grade corporate bonds, which are used to develop a yield curve. This yield curve is applied to the expected durations of the pension and post-employment benefit obligations. A 1 percent increase or decrease in the health care trend would have had no material impact.

If actual experience differs from these assumptions, the difference is recorded as an unrecognized actuarial gain (loss) and then amortized into earnings over a period of time, which may cause the expense related to providing these benefits to increase or decrease. The charges applied to earnings in 2006, 2005, and 2004 due to the amortization of these unrecognized actuarial losses, largely due to actual experience versus assumptions of discount rates, were $54 million, $56 million, and $44 million, respectively.

The Company does not anticipate that a change in pension and other post-employment obligations caused by a change in the assumed discount rate will impact the cash contributions to be made to the pension plans during 2007. However, an after-tax charge or credit will be recorded directly to accumulated other comprehensive income (loss), a component of stockholders’ equity, as of December 31, 2007 for the impact on the pension’s projected benefit obligation of the

change in interest rates, if any. While the amount of the change in these obligations does not correspond directly to cash funding requirements, it is an indication of the amount the Company will be required to contribute to the plans in future years. The amount and timing of such cash contributions is dependent upon interest rates, actual returns on plan assets, retirement, attrition rates of employees, and other factors. For further information regarding pension and other post-employment obligations, see Note 10, "Retirement Plans", to the Company’s consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10-K.

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

**Litigation and Contingent Liabilities**

From time to time, the Company and its operations are parties to or targets of lawsuits, claims, investigations and proceedings, including product liability, personal injury, asbestos, patent and intellectual property, commercial, contract, environmental, antitrust, health and safety, and employment matters, which are handled and defended in the ordinary course of business. The Company accrues a liability for such matters when it is probable that a liability has been incurred and the amount can be reasonably estimated. When a single amount cannot be reasonably estimated but the cost can be estimated within a range, the Company accrues the minimum amount. The Company expenses legal costs, including those expected to be incurred in connection with a loss contingency, as incurred. The Company believes the amounts reserved are adequate for such pending matters; however, results of operations could be affected by significant litigation adverse to the Company.

**Income Taxes**

The Company records deferred tax assets and liabilities based on temporary differences between the financial reporting and tax bases of assets and liabilities, applying enacted tax rates expected to be in effect for the year in which the differences are expected to reverse. The ability to realize the deferred tax assets is evaluated through the forecasting of taxable income using historical and projected future operating results, the reversal of existing temporary differences, and the availability of tax planning strategies. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized. In the event that the actual outcome of future tax consequences differs from our estimates and assumptions, the resulting change to the provision for income taxes could have a material adverse impact on the consolidated results of operations and statement of financial position. As of December 31, 2006, a valuation allowance of $130 million has been provided against the deferred tax assets.

**2006 OVERVIEW**

The Company generated sales revenue of $7.5 billion for full year 2006, which was the highest in the Company's history and a 6 percent increase over 2005. Operating earnings were $640 million in 2006, a decline of $117 million compared with 2005. These results reflect continued strong earnings from the Company's broad base of businesses, with the decline substantially due to lower results in the Performance Polymers segment. During 2006, the Company was impacted by $400 million higher raw material and energy costs. Most of the Company's businesses were able to offset these costs with higher selling prices, higher volumes and lower operating costs. However, the Performance Polymers segment had lower selling prices, particularly for polyethylene terephthalate ("PET") polymers, in spite of higher raw material costs, due to lower industry capacity utilization rates.

The Company continued to evaluate its portfolio of businesses and product lines to better focus on its core strengths and improve overall profitability. As a result of the strategic decisions made, operating earnings were negatively impacted by $10 million of accelerated depreciation and $101 million in asset impairment and restructuring charges. These charges were partially offset by $68 million of other operating income from the sale of its polyethylene ("PE") business and related assets and the sale of its Batesville, Arkansas manufacturing facility and related assets. In 2006, these divested product lines had sales revenue of $811 million and operating earnings of $124 million. Operating earnings in 2005 included asset impairments and restructuring charges were $33 million and other operating income was $2 million.

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

In addition to achieving the above results, Eastman continued to progress on its overall growth objectives and announced its plans to improve the performance of its PET polymer product lines in the Performance Polymers segment. These efforts included:

- the start-up of the Company's 350 thousand metric tons new PET facility using *IntegRex* technology in Columbia, South Carolina which is expected to be at full production by the end of the first quarter of 2007;
- plans to debottleneck the *IntegRex* technology facility for an additional 100 thousand metric tons of capacity, to be completed in early 2008;
- rationalizing 350 thousand metric tons of existing capacity in North America, to be completed by mid-2008;
- plans to expand its acetate tow capacity in Workington, England in the Fibers segment;
- continuing development of a new family of copolyesters in the Specialty Plastics ("SP") segment to be commercialized in 2007; and
- furthering the advancement of its coal gasification efforts.

The Company is also considering various strategic options for its underperforming PET manufacturing facilities outside the United States that could lead to further restructuring, divestiture, or consolidation of product lines in the Performance Polymers segment to improve profitability. In first quarter 2007, the Company entered into an agreement to sell the San Roque, Spain manufacturing facility.

Net earnings for 2006 were $409 million versus 2005 net earnings of $557 million. Included in 2005 results were a $111 million gain, net of tax, on the sale of the Company's equity investment in Genencor International, Inc. ("Genencor") and early debt retirement costs of $28 million, net of tax.

The Company generated $609 million in cash from operating activities during 2006, a decrease of $160 million compared to 2005. The decline was due primarily to higher net earnings in 2005 compared with 2006 and an increase of $128 million in working capital in 2006, partially offset by lower pension contributions in the current year.

**RESULTS OF OPERATIONS**

**SUMMARY OF CONSOLIDATED RESULTS - 2006 COMPARED WITH 2005**

The Company’s results of operations as presented in the Company’s consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10-K are summarized and analyzed below:

| (Dollars in millions) | 2006 | 2005 | Change | Volume Effect | Price Effect | Product Mix Effect | Exchange Rate Effect |
|---|---|---|---|---|---|---|---|
| **Sales** | $ 7,450 | $ 7,059 | 6 % | 2 % | 5 % | (1) % | -- % |

Sales revenue for 2006 increased compared with 2005 primarily due to higher selling prices in response to both higher raw material and energy costs and continued strong economic conditions.

| (Dollars in millions) | 2006 | 2005 | Change |
|---|---|---|---|
| **Gross Profit** | $ 1,277 | $ 1,404 | (9) % |

| | | |
|---|---|---|
| As a percentage of sales | 17.1% | 19.9% |

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

Gross profit and gross profit as a percentage of sales for 2006 decreased, particularly in the Performance Polymers segment, compared with 2005 primarily due to increased raw material and energy costs and operational disruptions that were partially offset by higher selling prices. In 2006, raw material and energy costs increased by approximately $400 million compared to the prior year, compared to a selling price increase of $323 million. In addition, 2006 included $10 million of accelerated depreciation related to previously disclosed restructuring decisions in association with cracking units in Longview, Texas, and higher cost PET polymer assets in Columbia, South Carolina, which are scheduled for shutdown. In 2007, accelerated depreciation will be approximately $50 million related to these assets.

| (Dollars in millions) | 2006 | 2005 | Change |
|---|---|---|---|
| **Selling, General and Administrative Expenses ("SG&A")** | $ 437 | $ 454 | (4) % |
| **Research and Development Expenses ("R&D")** | 167 | 162 | 3 % |
| | $ 604 | $ 616 | (2) % |
| As a percentage of sales | 8.1% | 8.7% | |

SG&A expenses in 2006 decreased compared to 2005 primarily due to lower incentive compensation expense in 2006, which included compensation expense recorded under SFAS No. 123 Revised December 2004 ("SFAS No. 123(R)"), "Share-Based Payment". For more information concerning SFAS No. 123(R), see Note 15, "Share Based Compensation Plans and Awards", to the Company’s consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10-K.

R&D expenses for 2006 increased compared with 2005 primarily due to increased spending on growth initiatives, particularly in the SP segment, which more than offset lower expenses in the Performance Polymers segment.

**Asset Impairments and Restructuring Charges, Net**

Asset impairments and restructuring charges totaled $101 million and $33 million during 2006 and 2005, respectively. The Company continues to review its portfolio of products and businesses, which could result in further restructuring, divestiture, and consolidation. For more information regarding asset impairments and restructuring charges, see Note 16, "Asset Impairments and Restructuring Charges, Net", to the Company’s consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10-K.

**Other Operating Income**

Other operating income for 2006 reflects a gain of $75 million on the sale of the Company's PE and *Epolene* polymer businesses, related assets, and the Company's ethylene pipeline and charges of approximately $7 million related to the sale of the Company's Batesville, Arkansas manufacturing facility and its related assets and product lines. For more information concerning divestitures, see Note 24, "Divestitures", to the Company’s consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10-K.

Other operating income for 2005 reflects a $2 million gain related to the 2004 divestiture of certain businesses and product lines within the Coatings, Adhesives, Specialty Polymers and Inks ("CASPI") segment.

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

**Interest Expense, Net**

| (Dollars in millions) | 2006 | 2005 | Change |
|---|---|---|---|
| Gross interest costs | $ 112 | $ 118 | |
| Less: capitalized interest | 7 | 5 | |
| Interest expense | 105 | 113 | (7) % |
| Interest income | 25 | 13 | |
| Interest expense, net | $ 80 | $ 100 | (20) % |

Lower gross interest costs for 2006 compared to 2005 reflected lower average borrowings that more than offset higher average interest rates.

Higher interest income for 2006 compared to 2005 reflected higher invested cash balances as well as higher average interest rates, resulting in lower net interest expense.

For 2007, the Company expects net interest expense to decrease compared with 2006 primarily due to higher interest income, driven by higher invested cash balances.

**Income from Equity Investment in Genencor**

For 2005, income from equity investment in Genencor includes the Company's portion of earnings from its equity investment in Genencor. In second quarter 2005, the Company completed the sale of its equity interest in Genencor for net cash proceeds of approximately $417 million. The book value of the investment prior to sale was $246 million resulting in a pre-tax gain on the sale of $171 million.

**Early Debt Extinguishment Costs**

In the second quarter 2005, the Company completed the early repayment of $500 million of its outstanding long-term debt for $544 million in cash and recorded a charge of $46 million for early debt extinguishment costs including $2 million in unamortized bond issuance costs. The book value of the purchased debt was $500 million.

**Other (Income) Charges, net**

| (Dollars in millions) | 2006 | 2005 | Change |
|---|---|---|---|
| Other income | $ (24) | $ (11) | $ (13) |
| Other charges | 8 | 12 | (4) |
| Other (income) charges, net | $ (16) | $ 1 | $ (15) |

Included in other income are the Company’s portion of net earnings from its equity investments (excluding Genencor); gains on the sale of certain technology business venture investments, royalty income, net gains on foreign exchange transactions and other non-operating income, related to Holston Defense Corporation ("HDC"). Included in other charges are net losses on foreign exchange transactions, the Company’s portion of losses from its equity investments (excluding Genencor); write-downs to fair value of certain technology business venture investments due to other than temporary declines in value and fees on securitized receivables.

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

Included in 2006 other income is a $12 million gain related to a favorable award from the U.S. Department of the Army regarding a request for reimbursement for post-employment benefits being provided to retirees of HDC, a wholly owned subsidiary. This gain reflected a portion of the unrecognized gain resulting from the award that will be amortized into earnings over future periods. For additional information, see Note 10, "Retirement Plans", to the Company’s consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10-K.

**Provision for Income Taxes**

| (Dollars in millions) | 2006 | 2005 | Change |
|---|---|---|---|
| Provision for income taxes | $ 167 | $ 226 | (26) % |
| Effective tax rate | 29 % | 29 % | |

The 2006 effective tax rate reflects the Company's tax rate on reported operating earnings before income tax, excluding discrete items, of 33 percent. The effective tax rate was impacted by $25 million of deferred tax benefit resulting from the reversal of capital loss carryforward valuation reserves and $11 million of deferred tax benefit resulting from the reversal of foreign net operating loss valuation reserves.

The 2005 effective tax rate reflects the Company's tax rate on reported operating earnings before income tax, excluding discrete items, of 35 percent. The effective tax rate was impacted by $13 million of deferred tax benefit resulting from the reversal of capital loss carryforward valuation reserves, $14 million of tax benefit resulting from the change in reserves for tax contingencies due to the favorable resolution of prior periods' tax contingencies and a $11 million charge resulting from the repatriation of $321 million of foreign earnings and capital pursuant to provisions of the American Jobs Creation Act of 2004.

The Company expects its effective tax rate in 2007 will be approximately 35 percent.

**Net Earnings**

| (Dollars in millions, except per share amounts) | 2006 | 2005 |
|---|---|---|
| Net earnings | $ 409 | $ 557 |
| Earnings per share | | |
| Basic | $ 4.98 | $ 6.90 |
| Diluted | 4.91 | 6.81 |

**SUMMARY BY OPERATING SEGMENT**

The Company’s products and operations are managed and reported in five reportable operating segments, consisting of the CASPI segment, the Fibers segment, the Performance Chemicals and Intermediates ("PCI") segment, the Performance Polymers segment and the SP segment. The Company's segments were previously aligned in a divisional structure that provided for goods and services to be transferred between divisions at predetermined prices that may have been in excess of cost, which resulted in the recognition of intersegment sales revenue and operating earnings. Such interdivisional transactions were eliminated in the Company's consolidated financial statements. In first quarter 2006, the Company realigned its organizational structure to support its growth strategy and to better reflect the

integrated nature of the Company's assets. A result of the realigned organizational structure is that goods and services are transferred among the segments at cost. As part of this change, the Company's segment results have been restated to eliminate the impact of interdivisional sales revenue and operating earnings. For additional information and analysis of the results of the Company’s operating segments, see Note 21, "Segment Information", to the Company’s consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10-K and Exhibits 99.01to this Annual Report.

In the first quarter of 2006, management determined that the Developing Businesses ("DB") segment is not of continuing significance for financial reporting purposes. As a result, revenues and costs previously included in the DB segment and R&D expenses not identifiable to an operating segment are not included in segment operating results for either of the periods presented and are shown in Note 21, "Segment Information", to the Company's consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10-K as "other" revenues and operating losses.

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

In fourth quarter 2006, certain product lines were transferred from the PCI segment to the Performance Polymers segment. During 2005 and 2004, these amounts were included within the PCI segment. Accordingly, the prior year's amounts for sales and operating earnings have been adjusted to retrospectively apply these changes to all periods presented.

**CASPI Segment**

| (Dollars in millions) | 2006 | 2005 | Change $ | Change % |
|---|---|---|---|---|
| Sales | $ 1,421 | $ 1,299 | $ 122 | 9 % |
| Volume effect | | | 6 | -- % |
| Price effect | | | 115 | 9 % |
| Product mix effect | | | 4 | -- % |
| Exchange rate effect | | | (3) | -- % |
| Operating earnings | 229 | 228 | 1 | -- % |
| Asset impairments and restructuring charges, net | 13 | 4 | 9 | |
| Other operating income | -- | (2) | 2 | |

Sales revenue increased $122 million in 2006 compared to 2005 due to an increase in selling prices in response to higher raw material and energy costs.

Operating earnings increased $1 million for 2006 compared to 2005 including increased asset impairments and restructuring charges. Asset impairments and restructuring charges of $13 million for 2006 related to previously closed manufacturing facilities and severance related to a voluntary reduction in force. Asset impairments and restructuring charges of $4 million for 2005 related primarily to previously closed manufacturing facilities. These charges are more fully described in Note 16, "Impairments and Restructuring Charges", to the Company’s consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10-K. Excluding these items, operating earnings increased due to an increase in selling prices that more than offset higher raw material and energy costs, and favorable product mix that resulted from higher sales volume for specialty coatings.

In November 2006, the Company sold the CASPI segment's *Epolene* polymer businesses and related assets. CASPI sales revenue and operating earnings attributed to the divested businesses were $65 million and $3 million, respectively, for 2006.

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

**Fibers Segment**

| (Dollars in millions) | 2006 | 2005 | Change $ | Change % |
|---|---|---|---|---|
| Sales | $ 910 | $ 869 | $ 41 | 5 % |
| Volume effect | | | 17 | 2 % |
| Price effect | | | 55 | 6 % |
| Product mix effect | | | (31) | (3) % |
| Exchange rate effect | | | -- | -- % |
| Operating earnings | 226 | 216 | 10 | 5 % |
| Asset impairments and restructuring charges, net | 2 | -- | 2 | |

Sales revenue increased $41 million in 2006 compared to 2005 primarily due to higher selling prices and higher sales volume that were partially offset by an unfavorable shift in product mix. The higher selling prices were in response to higher raw material and energy costs as well as continued strong demand for and limited supply of acetate yarn and acetyl chemical products. The increased sales volume and shift in product mix were due to strong demand for acetyl chemical products attributed to strengthened global acetate tow demand.

Operating earnings for 2006 compared to 2005 increased $10 million as higher selling prices and increased sales volume more than offset higher raw material and energy costs. Asset impairment and restructuring charges of $2 million in 2006 related primarily to severance due to a voluntary reduction in force.

The Company believes that acetate tow has modest growth potential in future years and has been evaluating growth options in Europe and Asia. In the third quarter 2006, the Company announced plans to add capacity and expand production of *Estron* acetate tow in Europe at its Workington, England facility. The Company continues to evaluate options for growth in Asia.

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

**PCI Segment**

| (Dollars in millions) | 2006 | 2005 | Change $ | Change % |
|---|---|---|---|---|
| Sales | $ 1,659 | $ 1,560 | $ 99 | 6 % |
| Volume effect | | | 1 | -- % |
| Price effect | | | 118 | 7 % |
| Product mix effect | | | (19) | (1) % |
| Exchange rate effect | | | (1) | -- % |
| Operating earnings | 132 | 143 | (11) | (8) % |
| Accelerated depreciation included in cost of goods sold | 2 | -- | 2 | |
| Asset impairments and restructuring charges, net | 20 | 11 | 9 | |
| Other operating charges | 7 | -- | 7 | |

Sales revenue for 2006 compared to 2005 increased $99 million primarily due to higher selling prices, particularly in the intermediates product lines, in response to increases in raw material and energy costs.

Operating earnings for 2006 included asset impairments and restructuring charges of $20 million primarily related to the divestiture of the PCI segment's Batesville, Arkansas manufacturing facility and related assets and specialty organic chemicals product lines completed in the fourth quarter 2006 and to severance related to a voluntary reduction in force. The 2006 operating earnings also included $2 million of accelerated depreciation for cracking units at the Company's Longview, Texas facility and $7 million of other operating charges related to the above mentioned divestiture. Excluding those items, operating earnings increased compared with 2005 as higher selling prices more than offset higher raw material and energy costs. PCI sales revenue and operating loss attributed to the divested product lines were $111 million and $15 million, respectively, for 2006. The 2005 operating earnings included $11 million in asset impairments and restructuring charges for previously impaired sites and $10 million of operating earnings from the achievement of certain milestones under an acetyls technology licensing agreement.

In addition, as part of the transition agreement pertaining to the PE divestiture, the Company will supply ethylene to the buyer. The supply of ethylene to the buyer, which was formerly used internally, will be reported in the PCI segment. The Company also expects to begin a staged phase-out of older cracking units in 2007, with timing dependent in part on market conditions.

**Performance Polymers Segment**

| (Dollars in millions) | 2006 | 2005 | Change $ | Change % |
|---|---|---|---|---|
| Total sales | $ 2,642 | $ 2,586 | $ 56 | 2 % |
| Sales - divested product lines | 635 | 618 | 17 | 3 % |
| Sales - continuing product lines | 2,007 | 1,968 | 39 | 2 % |
| Volume effect | | | 41 | 1 % |
| Price effect | | | 2 | -- % |
| Product mix effect | | | 8 | 1 % |
| Exchange rate effect | | | 5 | -- % |
| Total operating earnings | 54 | 176 | (122) | (69) % |
| Operating earnings - divested product lines [1] | 136 | 75 | 61 | 81 % |
| Operating earnings - continuing product lines | (82) | 101 | (183) | > (100)% |
| Accelerated depreciation included in cost of goods sold | 7 | -- | 7 | |
| Accelerated depreciation - divested product lines [1] | -- | -- | -- | |
| Accelerated depreciation - continuing product lines | 7 | -- | 7 | |
| Asset impairments and restructuring charges, net | 46 | -- | 46 | |
| Asset impairments and restructuring charges, net - divested product lines [1] | -- | -- | -- | |
| Asset impairments and restructuring charges, net - continuing product lines | 46 | -- | 46 | |
| Other operating income | (75) | -- | (75) | |
| Other operating income - divested product lines [1] | (75) | -- | (75) | |
| Other operating income - continuing product lines | -- | -- | -- | |

[1] Includes allocated costs consistent with the Company’s historical practices, some of which may remain and could be reallocated to the remainder of the segment and other segments.

In fourth quarter 2006, the Company completed the divestiture of the Performance Polymer segment's PE businesses and related assets located at the Longview, Texas site and the Company's ethylene pipeline.

Sales revenue increased $56 million for 2006 compared to 2005 primarily due to higher sales volume, particularly for PET polymers in Latin America, mostly offset by lower sales volume for PET polymers in North America attributed to lower industry capacity utilization rates. Excluding the divested product lines, sales revenue increased $39 million.

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

Operating earnings decreased $122 million for 2006 compared to 2005 primarily due to higher and continued volatile raw material and energy costs, lower selling prices for PET polymers globally, increased asset impairments and restructuring charges and increased accelerated depreciation more than offsetting other operating income and increased sales volume. Asset impairments and restructuring charges of $46 million for 2006 were primarily related to the shutdown of a research and development Kingsport, Tennessee pilot plant, discontinued production of cyclohexane dimethanol ("CHDM") modified polymers in San Roque, Spain and severance related to a reduction in force in the U.S. and Spain. CHDM, an internal intermediate product primarily used in copolyester and PET production, was discontinued in San Roque, Spain to gain operational efficiencies at other facilities. These charges are more fully described in Note 16, "Impairments and Restructuring Charges", to the Company's consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10-K. Accelerated depreciation of $7 million for 2006 related to previously disclosed restructuring decisions in association with cracking units in Longview, Texas, and higher cost PET polymer intermediates assets in Columbia, South Carolina, which are scheduled for shutdown. Other operating income for 2006 reflects a gain of $75 million on the above mentioned divestiture. Excluding the divested product lines, operating earnings decreased $183 million.

Production began in November 2006 at the Company's new PET manufacturing facility utilizing *IntegRex* technology in Columbia, South Carolina. Manufacturing *ParaStar* next generation PET resins, the Company expects the facility to be at its full operational capacity of 350 thousand metric tons during the first quarter of 2007. The Company is evaluating the construction of a PET facility using the full *IntegRex* technology in the U.S. or elsewhere and utilizing further refinements to *IntegRex* technology.

The Company is continuing to evaluate its strategic and operational options related to certain underperforming PET assets to improve profitability of the segment. In first quarter 2007, the Company entered into an agreement to sell the San Roque, Spain manufacturing facility.

**SP Segment**

| (Dollars in millions) | 2006 | 2005 | Change $ | Change % |
|---|---|---|---|---|
| Sales | $ 818 | $ 718 | $ 100 | 14 % |
| Volume effect | | | 81 | 11 % |
| Price effect | | | 34 | 5 % |
| Product mix effect | | | (11) | (1) % |
| Exchange rate effect | | | (4) | (1) % |
| Operating earnings | 46 | 64 | (18) | (28) % |
| Accelerated depreciation | 1 | -- | 1 | |
| Asset impairments and restructuring charges, net | 16 | -- | 16 | |

Sales revenue for 2006 increased $100 million compared to 2005 due primarily to increased sales volume and higher selling prices. The increased sales volume was primarily attributed to continued market development efforts, particularly in copolyester product lines. Selling prices increased to offset higher raw material and energy costs with increases limited by competitive industry dynamics.

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

Operating earnings for 2006 declined $18 million compared with 2005 primarily due to asset impairment and restructuring charges, increased expenditures related to growth initiatives and higher raw material and energy costs slightly more than offsetting increased sales volume and higher selling prices. Asset impairment and restructuring charges of $16 million in 2006 were related to the discontinued production of CHDM, an internal intermediate product primarily used in copolyester and PET production, in San Roque, Spain to gain operational efficiencies at other facilities. Accelerated depreciation of $1 million for 2006 related primarily to South Carolina operations.

**SUMMARY BY CUSTOMER LOCATION - 2006 COMPARED WITH 2005**

**Sales Revenue**

| (Dollars in millions) | 2006 | 2005 | Change | Volume Effect | Price Effect | Product Mix Effect | Exchange Rate Effect |
|---|---|---|---|---|---|---|---|
| United States and Canada | $ 4,223 | $ 4,098 | 3 % | (1) % | 5 % | (1) % | -- % |
| Europe, Middle East, and Africa | 1,436 | 1,344 | 7 % | 3 % | 4 % | -- % | -- % |
| Asia Pacific | 941 | 930 | 1 % | (4) % | 8 % | (2) % | (1) % |
| Latin America | 850 | 687 | 24 % | 25 % | (2) % | 1 % | -- % |
| | $ 7,450 | $ 7,059 | 6 % | 2 % | 5 % | (1) % | -- % |

Sales revenue in the United States and Canada increased primarily due to higher selling prices, particularly in the PCI segment, which had a $78 million positive impact on sales revenue. The higher selling prices were primarily in response to increases in raw material and energy costs.

Sales revenue in Europe, the Middle East and Africa increased primarily due to higher selling prices, particularly in the CASPI segment, and higher volumes particularly in the Performance Polymer segment. The higher selling prices were primarily in response to increases in raw material and energy costs.

Sales revenue in Asia Pacific increased primarily due to higher selling prices, partially offset by lower sales volume and changes in mix. Higher selling prices, particularly in the Fibers segment, had a $76 million positive impact on sales revenue. Lower sales volume and negative mix, particularly for the Fibers segment, had a $61 million negative impact on sales revenue.

Sales revenue in Latin America increased primarily due to higher sales volume, particularly in the Performance Polymers segment.

With a substantial portion of sales to customers outside the United States, Eastman is subject to the risks associated with operating in international markets. To mitigate its exchange rate risks, the Company frequently seeks to negotiate payment terms in U.S. dollars and euros. In addition, where it deems such actions advisable, the Company engages in foreign currency hedging transactions and requires letters of credit and prepayment for shipments where its assessment of individual customer and country risks indicates their use is appropriate. For more information on these practices see Note 9 to the Company’s consolidated financial statements in Part II, Item 8 of this 2006 Annual Report on Form 10-K and Part II, Item 7A--"Quantitative and Qualitative Disclosures About Market Risk."

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

### SUMMARY OF CONSOLIDATED RESULTS - 2005 COMPARED WITH 2004

| (Dollars in millions) | 2005 | 2004 | Volume Effect | Price Effect | Product Mix Effect | Exchange Rate Effect |
|---|---|---|---|---|---|---|