

CABOT MICROELECTRONICS CORP
Form 10-Q
May 09, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended

MARCH 31, 2012

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 000-30205

CABOT MICROELECTRONICS CORPORATION
(Exact name of registrant as specified in its charter)

DELAWARE
(State of Incorporation)

36-4324765
(I.R.S. Employer Identification No.)

870 NORTH COMMONS DRIVE
AURORA, ILLINOIS
(Address of principal executive offices)

60504
(Zip Code)

Registrant's telephone number, including area code: (630) 375-6631

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

YES ☒ NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES ☒ NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and smaller reporting

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company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	<input checked="" type="checkbox"/> X	Accelerated filer	Non-accelerated filer	Smaller reporting company
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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES NO ☒ X

As of April 30, 2012, the Company had 23,558,732 shares of Common Stock, par value \$0.001 per share, outstanding.

CABOT MICROELECTRONICS CORPORATION

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PART I. FINANCIAL INFORMATION
ITEM 1.

CABOT MICROELECTRONICS CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited and in thousands, except per share amounts)

	Three Months Ended March 31,		Six Months Ended March 31,	
	2012	2011	2012	2011
Revenue	\$99,236	\$109,660	\$201,358	\$223,865
Cost of goods sold	53,442	56,927	106,285	113,701
Gross profit	45,794	52,733	95,073	110,164
Operating expenses:				
Research, development and technical	14,071	14,919	27,826	28,775
Selling and marketing	7,434	6,791	14,770	14,271
General and administrative	15,177	11,567	28,078	23,243
Total operating expenses	36,682	33,277	70,674	66,289
Operating income	9,112	19,456	24,399	43,875
Interest expense	354	37	393	81
Other income (expense), net	97	683	201	(208)
Income before income taxes	8,855	20,102	24,207	43,586
Provision for income taxes	3,325	7,010	8,262	14,002
Net income	\$5,530	\$13,092	\$15,945	\$29,584
Basic earnings per share	\$0.24	\$0.57	\$0.70	\$1.29
Weighted average basic shares outstanding	22,768	23,032	22,624	22,857
Diluted earnings per share	\$0.23	\$0.55	\$0.68	\$1.26
Weighted average diluted shares outstanding	23,780	23,693	23,378	23,395
Dividends per share	\$15.00	\$-	\$15.00	\$-

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

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CABOT MICROELECTRONICS CORPORATION
CONSOLIDATED BALANCE SHEETS
(Unaudited and in thousands, except share amounts)

	March 31, 2012	September 30, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 155,062	\$ 302,546
Accounts receivable, less allowance for doubtful accounts of \$4,823 at March 31, 2012, and \$1,090 at September 30, 2011	50,802	52,747
Inventories	56,818	56,128
Prepaid expenses and other current assets	10,281	14,735
Deferred income taxes	5,574	4,249
Total current assets	278,537	430,405
Property, plant and equipment, net	125,751	130,791
Goodwill	42,324	41,148
Other intangible assets, net	13,606	14,651
Deferred income taxes	3,093	862
Other long-term assets	12,394	10,372
Total assets	\$475,705	\$628,229
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 14,134	\$ 22,436
Accrued expenses and other current liabilities	21,301	33,104
Current portion of long-term debt	8,750	-
Capital lease obligations	7	10
Total current liabilities	44,192	55,550
Long-term debt, net of current portion	166,250	-
Capital lease obligations, net of current portion	-	2
Other long-term liabilities	6,673	6,323
Total liabilities	217,115	61,875
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Common Stock: Authorized: 200,000,000 shares, \$0.001 par value; Issued: 28,608,474 shares at March 31, 2012, and 27,652,336 shares at September 30, 2011	29	28
Capital in excess of par value of common stock	316,370	278,360
Retained earnings	104,560	435,429
Accumulated other comprehensive income	23,755	24,127
Treasury stock at cost, 5,073,786 shares at March 31, 2012, and 4,715,577 shares at September 30, 2011	(186,124)	(171,590)

Total stockholders' equity	258,590	566,354
Total liabilities and stockholders' equity	\$475,705	\$628,229

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

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CABOT MICROELECTRONICS CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited and amounts in thousands)

	Six Months Ended March 31,	
	2012	2011
Cash flows from operating activities:		
Net income	\$15,945	\$29,584
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	11,868	12,028
Provision for doubtful accounts	3,820	30
Share-based compensation expense	7,419	7,198
Deferred income tax expense (benefit)	(1,449)	2,379
Non-cash foreign exchange (gain) loss	1,233	(51)
Loss on disposal of property, plant and equipment	189	38
Impairment of property, plant and equipment	51	-
Other	(949)	281
Changes in operating assets and liabilities:		
Accounts receivable	(3,297)	(2,349)
Inventories	(1,745)	(3,379)
Prepaid expenses and other assets	2,856	(5,602)
Accounts payable	(4,147)	(2,896)
Accrued expenses, income taxes payable and other liabilities	(10,501)	(9,972)
Net cash provided by operating activities	21,293	27,289
Cash flows from investing activities:		
Additions to property, plant and equipment	(11,641)	(9,737)
Proceeds from the sale of investments	50	25
Proceeds from sales of property, plant and equipment	-	1
Net cash used in investing activities	(11,591)	(9,711)
Cash flows from financing activities:		
Dividends paid	(347,140)	-
Issuance of long-term debt	175,000	-
Repurchases of common stock	(14,534)	(26,380)
Net proceeds from issuance of stock	29,034	31,835
Tax benefits associated with share-based compensation expense	617	908
Principal payments under capital lease obligations	(5)	(637)
Net cash provided by (used in) financing activities	(157,028)	5,726
Effect of exchange rate changes on cash	(158)	866
Increase (decrease) in cash and cash equivalents	(147,484)	24,170
Cash and cash equivalents at beginning of period	302,546	254,164
Cash and cash equivalents at end of period	\$155,062	\$278,334

Supplemental disclosure of non-cash investing and financing activities:

Purchases of property, plant and equipment in accrued liabilities and accounts payable at the end of the period	\$2,385	\$2,489
Issuance of restricted stock	6,198	6,693

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

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CABOT MICROELECTRONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited and in thousands, except share and per share amounts)

1. BACKGROUND AND BASIS OF PRESENTATION

Cabot Microelectronics Corporation ("Cabot Microelectronics", "the Company", "us", "we" or "our") supplies high-performance polishing slurries and pads used in the manufacture of advanced integrated circuit (IC) devices within the semiconductor industry, in a process called chemical mechanical planarization (CMP). CMP is a polishing process used by IC device manufacturers to planarize or flatten many of the multiple layers of material that are deposited upon silicon wafers in the production of advanced ICs. Our products play a critical role in the production of advanced IC devices, thereby enabling our customers to produce smaller, faster and more complex IC devices with fewer defects. We develop, produce and sell CMP slurries for polishing many of the conducting and insulating materials used in IC devices, and also for polishing the disk substrates and magnetic heads used in hard disk drives. We also develop, manufacture and sell CMP polishing pads, which are used in conjunction with slurries in the CMP process. We also pursue other demanding surface modification applications through our Engineered Surface Finishes (ESF) business where we believe we can leverage our expertise in CMP consumables for the semiconductor industry to develop products for demanding polishing applications in other industries. For additional information, refer to Part 1, Item 1, "Business", in our annual report on Form 10-K for the fiscal year ended September 30, 2011.

The unaudited consolidated financial statements have been prepared by Cabot Microelectronics Corporation pursuant to the rules of the Securities and Exchange Commission (SEC) and accounting principles generally accepted in the United States of America. In the opinion of management, these unaudited consolidated financial statements include all normal recurring adjustments necessary for the fair presentation of Cabot Microelectronics' financial position as of March 31, 2012, cash flows for the six months ended March 31, 2012, and March 31, 2011, and results of operations for the three and six months ended March 31, 2012, and March 31, 2011. The results of operations for the three and six months ended March 31, 2012 may not be indicative of results to be expected for future periods, including the fiscal year ending September 30, 2012. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto included in Cabot Microelectronics' annual report on Form 10-K for the fiscal year ended September 30, 2011.

The consolidated financial statements include the accounts of Cabot Microelectronics and its subsidiaries. All intercompany transactions and balances between the companies have been eliminated as of March 31, 2012. Reclassifications of prior period amounts have been made to separate interest expense from other income (expense) to conform to the current period presentation.

Results of Operations

With respect to the comparative periods in fiscal 2011, as noted in our Form 10-Q for the fiscal quarter ended March 31, 2011, the results of operations for the three and six months ended March 31, 2011 included certain adjustments to correct prior period amounts, which we determined to be immaterial to those periods and the prior periods to which they related. Collectively, these adjustments reduced net income for the first six months of fiscal 2011 by \$2,381 and diluted earnings per share by approximately \$0.10. An adjustment in the second quarter of fiscal 2011 reduced net income for the quarter by \$671 and diluted earnings per share by approximately \$0.03. This adjustment related to income tax expense recorded for executive compensation in fiscal 2008 through 2010 for which a previous tax benefit

should not have been recorded. Adjustments in the first quarter of fiscal 2011 related to: (1) \$1,474 (\$1,014, net of tax) in employer-paid fringe benefits for required contributions to our 401(k) Plan, Supplemental Employee Retirement Plan, and non-United States statutory pension plans as a result of our annual payment pursuant to our fiscal 2010 annual incentive bonus program (AIP); (2) the reversal of a \$497 deferred tax asset regarding certain share-based compensation expense which is not subject to such tax treatment; and (3) our under accrual of \$290 (\$199, net of tax) for payments made pursuant to the AIP as a result of the calculation of results against goals under the AIP.

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CABOT MICROELECTRONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited and in thousands, except share and per share amounts)

2. FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair value is defined as the price that would be received from the sale of an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The FASB established a three-level hierarchy for disclosure based on the extent and level of judgment used to estimate fair value. Level 1 inputs consist of valuations based on quoted market prices in active markets for identical assets or liabilities. Level 2 inputs consist of valuations based on quoted prices for similar assets or liabilities, quoted prices for identical assets or liabilities in an inactive market, or other observable inputs. Level 3 inputs consist of valuations based on unobservable inputs that are supported by little or no market activity.

The following table presents assets that we measured at fair value on a recurring basis at March 31, 2012 and September 30, 2011. As permitted under the relevant standards, we have chosen to not measure any of our liabilities at fair value as we believe our current liabilities approximate their fair value due to their short-term, highly liquid characteristics and our long-term debt approximates its fair value as it bears a floating market rate of interest. We have classified the following assets in accordance with the fair value hierarchy set forth in the applicable standards. In instances where the inputs used to measure the fair value of an asset fall into more than one level of the hierarchy, we have classified them based on the lowest level input that is significant to the determination of the fair value.

March 31, 2012	Level 1	Level 2	Level 3	Total Fair Value
Cash and cash equivalents	\$155,062	\$-	\$-	\$155,062
Auction rate securities (ARS)	-	-	7,991	7,991
Other long-term investments	1,067	-	-	1,067
Total	\$156,129	\$-	\$7,991	\$164,120

September 30, 2011	Level 1	Level 2	Level 3	Total Fair Value
Cash and cash equivalents	\$302,546	\$-	\$-	\$302,546
Auction rate securities (ARS)	-	-	8,041	8,041
Other long-term investments	827	-	-	827
Total	\$303,373	\$-	\$8,041	\$311,414

Our cash and cash equivalents consist of various bank accounts used to support our operations and investments in institutional money-market funds which are traded in active markets. The ARS and other long-term investments are included in other long-term assets on our Consolidated Balance Sheet. The fair value of our long-term ARS is determined through two discounted cash flow analyses, one using a discount rate based on a market index comprised of tax exempt variable rate demand obligations and one using a discount rate based on the LIBOR swap curve, adding a risk factor to reflect current liquidity issues in the ARS market. Our other long-term investments represent the fair value of investments under the Cabot Microelectronics Supplemental Employee Retirement Plan (SERP), which is a

nonqualified supplemental savings plan. The fair value of the investments is determined through quoted market prices within actively traded markets. Although the investments are allocated to individual participants and investment decisions are made solely by those participants, the SERP has been deemed a nonqualified plan. Consequently, the Company owns the assets and the related offsetting liability for disbursement until such time a participant makes a qualifying withdrawal. The long-term asset was adjusted to \$1,067 in the second quarter of fiscal 2012 to reflect its fair value as of March 31, 2012.

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CABOT MICROELECTRONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited and in thousands, except share and per share amounts)

We applied accounting standards regarding the classification and valuation of financial instruments to the valuation of our investment in ARS at March 31, 2012. Our ARS investments at March 31, 2012 consisted of two tax exempt municipal debt securities with a total par value of \$8,225. The ARS market began to experience illiquidity in early 2008, and this illiquidity continues. Despite this lack of liquidity, there have been no defaults of the underlying securities and interest income on these holdings continues to be received on scheduled interest payment dates. Our ARS, when purchased, were generally issued by A-rated municipalities. Although the credit ratings of both municipalities have been downgraded since our original investment, the ARS are credit enhanced with bond insurance and currently carry a credit rating of AA- by Standard and Poors.

Since an active market for ARS does not currently exist, we determine the fair value of these investments using a Level 3 discounted cash flow analysis and also consider other factors such as the reduced liquidity in the ARS market and nature of the insurance backing. Key inputs to our discounted cash flow model include projected cash flows from interest and principal payments and the weighted probabilities of improved liquidity or debt refinancing by the issuer. We also incorporate certain Level 2 market indices into the discounted cash flow analysis, including published rates such as the LIBOR rate, the LIBOR swap curve and a municipal swap index published by the Securities Industry and Financial Markets Association. The following table presents a reconciliation of the activity in fiscal 2012 for fair value measurements using level 3 inputs:

Balance as of October 1, 2011	\$8,041
Net sales of ARS	(50)
Balance as of March 31, 2012	\$7,991

Based on our fair value assessment, we determined that one ARS continues to be impaired as of March 31, 2012. This security has a fair value of \$3,041 (par value \$3,275). We assessed the impairment in accordance with the applicable standards and determined that the impairment was due to the lack of liquidity in the ARS market rather than to credit risk. We have maintained the \$234 temporary impairment that we previously recorded. We believe that this ARS is not permanently impaired because in the event of default by the issuer, we expect the insurance provider would pay interest and principal following the original repayment schedule, we successfully monetized at par value \$50 of this security during the quarter ended March 31, 2012, and we do not intend to sell the security nor do we believe we will be required to sell the security before the value recovers, which may be at maturity. We determined that the fair value of the other ARS was not impaired as of March 31, 2012. In November 2011, the municipality that issued our impaired ARS filed for bankruptcy protection. We considered these developments, in light of the continued insurance backing, and have concluded the impairment we have maintained remains adequate and temporary. See Note 6 for more information on these investments.

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CABOT MICROELECTRONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited and in thousands, except share and per share amounts)

3. ACCOUNTS RECEIVABLE

Accounts receivable, net of allowances for doubtful accounts, was \$50,802 as of March 31, 2012 and \$52,747 as of September 30, 2011. The decrease was primarily due to an increase in the allowance for doubtful accounts, partially offset by an increase in gross accounts receivable. The increase in the allowance for doubtful accounts was primarily related to \$3,727 in bad debt expense recorded in the second quarter of fiscal 2012 for Elpida Memory, Inc. (Elpida), a significant customer in Japan that filed for bankruptcy protection in February 2012. Amounts charged to expense are recorded in general and administrative expenses. Elpida owed the Company \$3,727 in accounts receivable for shipments made prior to its bankruptcy filing. Since collection of any or all of this balance is uncertain, we have reserved the entire balance. Elpida has stated its intent to reorganize its business and its operations remain ongoing. Elpida has been paying the Company on a current basis for all shipments made subsequent to its bankruptcy filing. Our allowance for doubtful accounts changed during the six months ended March 31, 2012 as follows:

Balance as of September 30, 2011	\$1,090
Amounts charged to expense	3,820
Deductions and adjustments	(87)
Balance as of March 31, 2012	\$4,823

4. INVENTORIES

Inventories consisted of the following:

	March 31, 2012	September 30, 2011
Raw materials	\$ 26,830	\$ 26,217
Work in process	5,377	4,964
Finished goods	24,611	24,947
Total	\$ 56,818	\$ 56,128

5. GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill was \$42,324 as of March 31, 2012, and \$41,148 as of September 30, 2011. The increase in goodwill was due to foreign exchange fluctuations of the New Taiwan dollar.

Goodwill and indefinite lived intangible assets are tested for impairment annually in the fourth quarter of the fiscal year or more frequently if indicators of potential impairment exist, using a fair-value-based approach. The recoverability of goodwill is measured at the reporting unit level, which is defined as either an operating segment or one level below an operating segment. Prior to September 2011, accounting guidance required entities to compare the fair value of a reporting unit with its carrying amount, including goodwill (“step one”). If the fair value of a reporting unit is less than its carrying amount, then the second step of the test is to be performed to measure the amount of the impairment loss, if any. Historically, we consistently determined the fair value of our reporting units using a discounted cash flow analysis (“step one”) of our projected future results. Effective September 30, 2011, we adopted a new accounting pronouncement related to our goodwill impairment analysis, which allowed an entity to first perform a qualitative analysis (“step zero”) of the fair value of its reporting units to determine whether it is necessary to perform the two-step quantitative goodwill analysis. In the fourth quarter of fiscal 2011, we used this new guidance in our annual impairment analysis for goodwill, determining that it was more likely than not that the carrying amounts of all reporting units exceeded their respective fair values.

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CABOT MICROELECTRONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited and in thousands, except share and per share amounts)

The recoverability of indefinite lived intangible assets is measured using the royalty savings method. The use of discounted projected future results is based on assumptions that are consistent with our estimates of future growth within the strategic plan used to manage the underlying business. Factors requiring significant judgment include assumptions related to future growth rates, discount factors, royalty rates and tax rates, among others. Changes in economic and operating conditions that occur after the annual impairment analysis or an interim impairment analysis that impact these assumptions may result in future impairment charges.

We completed our annual impairment test during our fourth quarter of fiscal 2011 and concluded that no impairment existed. There were no indicators of potential impairment during the quarter ended March 31, 2012, so it was not necessary to perform an impairment review for goodwill and indefinite lived intangible assets during the quarter. There have been no cumulative impairment charges recorded on the goodwill of any of our reporting units.

The components of other intangible assets are as follows:

	March 31, 2012		September 30, 2011	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Other intangible assets subject to amortization:				
Product technology	\$8,366	\$ 4,409	\$8,266	\$ 3,890
Acquired patents and licenses	8,115	6,601	8,115	6,446
Trade secrets and know-how	2,550	2,550	2,550	2,550
Distribution rights, customer lists and other	12,509	5,564	12,154	4,738
Total other intangible assets subject to amortization	31,540	19,124	31,085	17,624
Total other intangible assets not subject to amortization*	1,190		1,190	
Total other intangible assets	\$32,730	\$ 19,124	\$32,275	\$ 17,624

* Total other intangible assets not subject to amortization consist primarily of trade names.

Amortization expense on our other intangible assets was \$675 and \$1,344 for the three and six months ended March 31, 2012, respectively. Amortization expense on our other intangible assets was \$682 and \$1,344 for the three and six months ended March 31, 2011, respectively. Estimated future amortization expense for the five succeeding fiscal years is as follows:

Fiscal Year	Estimated Amortization Expense
	\$ 1,324

Remainder of 2012	
2013	2,516
2014	2,471
2015	2,431
2016	2,011

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CABOT MICROELECTRONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited and in thousands, except share and per share amounts)

6. OTHER LONG-TERM ASSETS

Other long-term assets consisted of the following:

	March 31, 2012	September 30, 2011
Auction rate securities	\$ 7,991	\$ 8,041
Other long-term assets	3,336	1,504
Other long-term investments	1,067	827
Total	\$ 12,394	\$ 10,372

As discussed in Note 2 of this Form 10-Q, our two ARS that we owned as of March 31, 2012 are classified as long-term investments. The securities are credit enhanced with bond insurance to an AA- credit rating and all interest payments continue to be received on a timely basis. Although we believe these securities will ultimately be collected in full, we believe that it is not likely that we will be able to monetize the securities in our next business cycle (which for us is generally one year). We maintain a \$234 pretax reduction (\$151 net of tax) in fair value on one of the ARS that we had first recognized in fiscal 2008. We continue to believe this decline in fair value is temporary based on: (1) the nature of the underlying debt; (2) the presence of bond insurance; (3) the fact that all interest payments have been received; (4) our successful monetization of \$50 of this security during the quarter ended March 31, 2012; and (5) our intention not to sell the security nor be required to sell the security until the value recovers, which may be at maturity.

The increase in other long-term assets was primarily due to prepaid debt costs incurred as a result of the completion of our new credit agreement, discussed in Note 8 of this Form 10-Q. The prepaid debt costs are being amortized on a straight-line basis over five years and the amortization expense is recorded in other income (expense) on the Consolidated Statement of Income. As discussed in Note 2 of this Form 10-Q, we recorded a long-term asset and a corresponding long-term liability of \$1,067 representing the fair value of our SERP investments as of March 31, 2012.

7. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

Accrued expenses and other current liabilities consisted of the following:

March	September
31,	30,
2012	2011

A c c r u e d compensation	\$ 11,498	\$ 23,922
G o o d s a n d s e r v i c e s received, not yet invoiced	3,985	3,457
D e f e r r e d revenue and c u s t o m e r advances	2,279	2,420
W a r r a n t y accrual	324	384
Taxes, other than income taxes	1,307	808
Other	1,908	2,113
Total	\$ 21,301	\$ 33,104

The decrease in accrued compensation was primarily due to the payment of our annual incentive bonus program earned in fiscal 2011, partially offset by two quarters of accrual under our annual incentive bonus program related to fiscal 2012.

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CABOT MICROELECTRONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited and in thousands, except share and per share amounts)

8. DEBT

On February 13, 2012, we entered into a credit agreement (the “Credit Agreement”) among the Company, as Borrower, Bank of America, N.A., as administrative agent, swing line lender and an L/C issuer, Bank of America Merrill Lynch and J.P. Morgan Securities LLC, as joint lead arrangers and joint book managers, JPMorgan Chase Bank, N.A., as syndication agent, and Wells Fargo Bank, N.A. as documentation agent. The Credit Agreement provided us with a \$175,000 term loan (the “Term Loan”), which we drew on February 27, 2012 to fund approximately half of the special cash dividend we paid to our stockholders on March 1, 2012, and a \$100,000 revolving credit facility (the “Revolving Credit Facility”), with sub-limits for multicurrency borrowings, letters of credit and swing-line loans. The Term Loan and the Revolving Credit Facility are referred to as the “Credit Facilities.” The Credit Agreement provides for an uncommitted accordion feature that allows us to request the existing lenders or, if necessary, third-party financial institutions to provide additional capacity in the Revolving Credit Facility, in an amount not to exceed \$75,000. The Term Loan has periodic scheduled principal repayments; however, we may prepay the loan without penalty. The Credit Facilities are scheduled to expire on February 13, 2017. In connection with the Credit Agreement, the Company simultaneously terminated its previously existing \$50,000 unsecured revolving credit facility, which had no outstanding balance at the time of termination.

Borrowings under the Credit Facilities (other than in respect of swing-line loans) bear interest at a rate per annum equal to the “Applicable Rate” (as defined below) plus, at our option, either (1) a LIBOR rate determined by reference to the cost of funds for deposits in the relevant currency for the interest period relevant to such borrowing or (2) the “Base Rate”, which is the highest of (x) the prime rate of Bank of America, N.A., (y) the federal funds rate plus 1/2 of 1.00% and (z) the one-month LIBOR rate plus 1.00%. The initial Applicable Rate for borrowings under the Credit Facilities will be 1.75% with respect to LIBOR borrowings and 0.25% with respect to Base Rate borrowings, with such Applicable Rate subject to adjustment based on our consolidated leverage ratio. Swing-line loans will bear interest at the Base Rate plus the Applicable Rate for Base Rate loans under the Revolving Credit Facility. In addition to paying interest on outstanding principal under the Credit Agreement, we will pay a commitment fee to the lenders under the Revolving Credit Facility in respect of the unutilized commitments thereunder at a rate ranging from 0.25% to 0.35%, based on our consolidated leverage ratio. Interest expense and commitment fees are paid, according to the relevant interest period, and no less frequently than at the end of each calendar quarter. We paid \$2,617 in customary arrangement fees, upfront fees and administration fees, of which \$541 and \$2,032 remains in prepaid expenses and other current assets and other long-term assets, respectively, on our Consolidated Balance Sheet as of March 31, 2012. We must also pay letter of credit fees as necessary. We may voluntarily prepay the Credit Facilities without premium or penalty, subject to customary “breakage” fees and reemployment costs in the case of LIBOR borrowings. All obligations under the Credit Agreement are guaranteed by each of our existing and future direct and indirect domestic subsidiaries (the “Guarantors”). The obligations under the Credit Agreement and guarantees of those obligations are secured, subject to certain exceptions, by first priority liens and security interests in the assets of the Company and its domestic subsidiaries.

The Credit Agreement contains covenants that restrict the ability of the Company and its subsidiaries to take certain actions, including, among other things and subject to certain significant exceptions: creating liens, incurring indebtedness, making investments, engaging in mergers, selling property, paying dividends or amending

organizational documents. The Credit Agreement requires us, beginning with the quarter ended June 30, 2012, to comply with certain financial ratio maintenance covenants, including a maximum consolidated leverage ratio and a minimum consolidated fixed charge coverage ratio. The Credit Agreement also contains customary affirmative covenants and events of default. We are not aware of noncompliance with these covenants.

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CABOT MICROELECTRONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited and in thousands, except share and per share amounts)

At March 31, 2012, we believe the fair value of the Term Loan approximates its carrying value of \$175,000 as the loan bears a floating market rate of interest.

As of March 31, 2012, scheduled principal repayments of the Term Loan were as follows:

Fiscal Year	Principal Repayments
Remainder of 2012	\$ 4,375
2013	8,750
2014	10,938
2015	15,312
2016	21,875
2017	113,750
Total	175,000

9. DERIVATIVE FINANCIAL INSTRUMENTS

Periodically we enter into forward foreign exchange contracts in an effort to mitigate the risks associated with currency fluctuations on certain foreign currency balance sheet exposures. Our foreign exchange contracts do not qualify for hedge accounting; therefore, the gains and losses resulting from the impact of currency exchange rate movements on our forward foreign exchange contracts are recognized as other income or expense in the accompanying consolidated income statements in the period in which the exchange rates change. We do not use derivative financial instruments for trading or speculative purposes. In addition, all derivatives, whether designated in hedging relationships or not, are required to be recorded on the balance sheet at fair value. At March 31, 2012, we had one forward foreign exchange contract to sell Japanese yen related to intercompany notes with one of our subsidiaries in Japan and for the purpose of hedging the risk associated with a net transactional exposure in Japanese yen.

The fair value of our derivative instrument included in the Consolidated Balance Sheet, which was determined using Level 1 inputs, was as follows:

		Asset Derivatives		Liability Derivatives	
		Fair Value at March 31, 2012	Fair Value at September 30, 2011	Fair Value at March 31, 2012	Fair Value at September 30, 2011
Balance Sheet Location					
Derivatives not designated as hedging instruments					
Foreign exchange contracts	Prepaid expenses and other current assets	\$33	\$48	\$-	\$-
		\$-	\$-	\$-	\$-

Accrued expenses and other
current liabilities

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CABOT MICROELECTRONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited and in thousands, except share and per share amounts)

The following table summarizes the effect of our derivative instrument on our Consolidated Statement of Income for the three and six months ended March 31:

		Gain (Loss) Recognized in Statement of Income			
		Three Months Ended		Six Months Ended	
		March 31,	March 31,	March 31,	March 31,
		2012	2011	2012	2011
Statement of Income Location					
Derivatives not designated as hedging instruments					
Foreign exchange contracts	Other income (expense), net	\$468	\$133	\$468	\$(62)

10. CONTINGENCIES

LEGAL PROCEEDINGS

While we are not involved in any legal proceedings that we believe will have a material impact on our consolidated financial position, results of operations or cash flows, we periodically become a party to legal proceedings in the ordinary course of business. For example, from 2007 to 2011, we were involved in a legal action in the United States against DuPont Air Products NanoMaterials LLC (DA Nano), a CMP slurry competitor, regarding whether certain specific formulations of slurry products used for tungsten CMP infringe certain CMP slurry patents that we own, and the validity of those and other of our patents. All of the Cabot Microelectronics Corporation patents at issue in the case were found valid, but the specific products at issue were found to not infringe the asserted claims of these patents.

Refer to Note 17 of “Notes to the Consolidated Financial Statements” in Item 8 of Part II of our annual report on Form 10-K for the fiscal year ended September 30, 2011, for additional information regarding commitments and contingencies.

PRODUCT WARRANTIES

We maintain a warranty reserve that reflects management’s best estimate of the cost to replace product that does not meet customers’ specifications and performance requirements, and costs related to such replacement. The warranty reserve is based upon a historical product replacement rate, adjusted for any specific known conditions or circumstances. Additions and deductions to the warranty reserve are recorded in cost of goods sold. Our warranty reserve requirements changed during the first six months of fiscal 2012 as follows:

Balance as of September 30, 2011	\$384
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Reserve for p r o d u c t w a r r a n t y during the reporting period	413
Settlement of warranty	(473)
Balance as of March 31, 2012	\$324

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CABOT MICROELECTRONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited and in thousands, except share and per share amounts)

11. SHARE-BASED COMPENSATION PLANS

We historically have issued share-based payments under the following programs: our Second Amended and Restated Cabot Microelectronics Corporation 2000 Equity Incentive Plan, as amended and restated September 23, 2008 (EIP); our Cabot Microelectronics Corporation 2007 Employee Stock Purchase Plan, as Amended and Restated January 1, 2010 (ESPP), and, pursuant to our EIP, our Directors' Deferred Compensation Plan, as amended September 23, 2008 and our 2001 Executive Officer Deposit Share Program. For additional information regarding these programs, refer to Note 12 of "Notes to the Consolidated Financial Statements" included in Item 8 of Part II of our annual report on Form 10-K for the fiscal year ended September 30, 2011. In March 2012, our stockholders approved our new 2012 Omnibus Incentive Plan (OIP). All share-based awards granted as of March 6, 2012 are being made from the OIP, and the EIP is no longer available for any awards. For additional information regarding the OIP, refer to our Definitive Proxy Statement filed with the SEC on January 20, 2012, which is incorporated by reference into our Annual Report on Form 10-K for the fiscal year ended September 30, 2011 (Proxy Statement).

On March 2, 2012, we completed a leveraged recapitalization pursuant to which we paid a special cash dividend of \$15 per share to our stockholders. In conjunction with this recapitalization, the EIP required us to proportionally adjust the stock options and restricted stock units outstanding on the dividend payment date (March 1, 2012) to preserve the value of such awards as a result of the special cash dividend. As required by the EIP, the exercise prices and the number of outstanding non-qualified stock options (NQSOs) were adjusted to reflect the special cash dividend. The exercise prices of outstanding NQSOs were reduced by multiplying them by a factor of 0.68933, representing the ratio of the official opening price of our common stock on the NASDAQ stock market of \$35.79 on March 2, the ex-dividend date, to the official closing price of our common stock on the NASDAQ stock market of \$51.92 on March 1, which was the last trading day immediately prior to the ex-dividend date. The number of outstanding NQSOs was increased by multiplying the number by a factor of 1.45068, representing the ratio of the official NASDAQ closing price of \$51.92 on the dividend payment date to the official NASDAQ opening price of \$35.79 on the ex-dividend date. This adjustment did not result in additional share-based compensation expense in the period as the fair value of the outstanding NQSOs immediately following the payment of the special cash dividend was equal to the fair value immediately prior to such distribution. A summary of stock option activity as of March 31, 2012 and changes during fiscal 2012 are presented below:

	Stock Options	Weighted Average Exercise Price
Outstanding at September 30, 2011	3,950,537	\$ 39.52
Granted	460,044	39.91
Exercised	(759,456)	36.35
	(47,355)	43.63

Forfeited or
canceled

Mandatory
proportional
adjustment due

t o
recapitalization

1,780,394 -

Outstanding at

March 31, 2012 5,384,164 \$ 26.90

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CABOT MICROELECTRONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited and in thousands, except share and per share amounts)

Similarly, the EIP required that we adjust the number of outstanding restricted stock units (RSUs) as a result of the special cash dividend. The number of outstanding RSUs was increased by multiplying the number by a factor of 1.45068, representing the ratio of the official NASDAQ closing price of \$51.92 on the dividend payment date to the official NASDAQ opening price of \$35.79 on the ex-dividend date. This adjustment did not result in additional share-based compensation expense in the period as the fair value of the outstanding RSUs immediately following the payment of the special cash dividend was equal to the fair value immediately prior to such distribution. A summary of the status of the restricted stock awards and restricted stock unit awards outstanding as of March 31, 2012, and changes during fiscal 2012, are presented below:

	Restricted Stock Awards and Units	Weighted Average Grant Date Fair Value
Nonvested at September 30, 2011	369,681	\$ 34.29
Granted	158,370	40.12
Vested	(165,124)	34.65
Forfeited	(2,958)	36.80
Mandatory proportional adjustment due to recapitalization	37,674	-
Nonvested at March 31, 2012	397,643	\$ 34.09

Similar to the proportional adjustment to the outstanding NQSOs and RSUs, as required by the EIP, the maximum number of shares issuable under the EIP was proportionally adjusted to reflect the special cash dividend, and, as required by the OIP, the maximum number of shares issuable under the OIP also was proportionally adjusted to reflect the special cash dividend. For additional information regarding the mandatory proportional adjustments to the shares issuable under the EIP and OIP, refer to the section in the Proxy Statement titled “Approval of 2012 Omnibus Incentive Plan” and to our amended Form S-8 POS filed with the SEC on March 8, 2012.

We record share-based compensation expense for all share-based awards, including stock option grants, restricted stock and restricted stock unit awards under our EIP and OIP and employee stock purchases pursuant to our Employee Stock Purchase Plan (ESPP). We calculate share-based compensation expense using the straight-line approach based on awards ultimately expected to vest, which requires the use of an estimated forfeiture rate. Our estimated forfeiture rate is primarily based on historical experience, but may be revised in future periods if actual forfeitures differ from

the estimate. We use the Black-Scholes model to estimate the grant date fair value of our stock options and employee stock purchases. This model requires the input of highly subjective assumptions, including the price volatility of the underlying stock, the expected term of our stock options and the risk-free interest rate. We estimate the expected volatility of our stock options based on a combination of our stock's historical volatility and the implied volatilities from actively-traded options on our stock. Prior to fiscal 2012, we calculated the expected term of our stock options using the simplified method, due to our limited amount of historical option exercise data, and we added a slight premium to this expected term for employees who meet the definition of retirement eligible pursuant to their grants during the contractual term of the grant. The simplified method uses an average of the vesting term and the contractual term of the option to calculate the expected term. We experienced a significant increase in the volume of stock option exercises in fiscal 2011. Consequently, we used this exercise data, as well as historical exercise data, to calculate the expected term of our stock options granted in the first six months of fiscal 2012, rather than using the simplified method, and we continued to add a slight premium for employees who meet the definition of retirement eligible under their grant terms. The expected term we calculated using option exercise history was within 1% of the expected term calculated under the simplified method. The risk-free rate is derived from the U.S. Treasury yield curve in effect at the time of grant.

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CABOT MICROELECTRONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited and in thousands, except share and per share amounts)

Share-based compensation expense for the three and six months ended March 31, 2012, and 2011, was as follows:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2012	2011	2012	2011
Cost of goods sold	\$ 366	\$ 289	\$ 747	\$ 613
Research, development and technical	255	243	545	554
Selling and marketing	292	264	769	580
General and administrative	3,113	2,973	5,358	5,451
Total share-based compensation expense	4,026	3,769	7,419	7,198
Tax benefit	1,300	1,337	2,356	2,552
Total share-based compensation expense, net of tax	\$ 2,726	\$ 2,432	\$ 5,063	\$ 4,646

Our non-employee directors received annual equity awards in March 2012, pursuant to the OIP. The award agreements provide for immediate vesting of the award at the time of termination of service for any reason other than by reason of Cause, Death, Disability or a Change in Control, as defined in the OIP, if at such time the non-employee director has completed an equivalent of at least two full terms as a director of the Company, as defined in the Company's bylaws. Five of the Company's non-employee directors had completed at least two full terms of service as of the date of the March 2012 award. Consequently, the requisite service period for the award has already been satisfied and we recorded the fair value of \$749 of the awards to these five directors to share-based compensation expense in the fiscal quarter ended March 31, 2012 rather than recording that expense over the one-year vesting period stated in the award agreement, as is done for the other two non-employee directors.

For additional information regarding the estimation of fair value, refer to Note 12 of "Notes to the Consolidated Financial Statements" included in Item 8 of Part II of our annual report on Form 10-K for the fiscal year ended September 30, 2011.

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CABOT MICROELECTRONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited and in thousands, except share and per share amounts)

12. OTHER INCOME (EXPENSE), NET

Other income (expense), net, consisted of the following:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2012	2011	2012	2011
Interest income	\$ 28	\$ 63	\$ 79	\$ 141
Other income (expense)	69	620	122	(349)
Total other income (expense), net	\$ 97	\$ 683	\$ 201	\$ (208)

The decrease in other income (expense) for the three months ended March 31, 2012 was primarily due to the absence of a development grant received in Singapore in the second quarter of fiscal 2011 and the foreign exchange effects on revenues and expenses, primarily related to changes in the exchange rate of the Japanese yen and the New Taiwan dollar to the U.S. dollar, net of the gains and losses incurred on forward foreign exchange contracts discussed in Note 9 of this Form 10-Q. The increase in other income (expense) for the six months ended March 31, 2012 was primarily due to these foreign exchange effects, partially offset by the absence of the development grant. As disclosed in Note 1, prior period other income (expense) amounts have been adjusted to exclude interest expense to conform to the current year presentation.

13. COMPREHENSIVE INCOME

The components of comprehensive income were as follows:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2012	2011	2012	2011
Net income	\$ 5,530	\$ 13,092	\$ 15,945	\$ 29,584
Other comprehensive income:				
Foreign currency translation adjustment	(1,235)	(1,609)	(372)	5,517
Minimum pension liability adjustment	-	5	-	10
Total comprehensive income	\$ 4,295	\$ 11,488	\$ 15,573	\$ 35,111

The foreign currency translation adjustments during the three and six months ended March 31, 2012 and 2011 primarily resulted from the changes in the exchange rates of the U.S. dollar relative to the Japanese yen and the New Taiwan dollar.

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CABOT MICROELECTRONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited and in thousands, except share and per share amounts)

14. INCOME TAXES

Our effective income tax rate was 37.5% and 34.1% for the three and six months ended March 31, 2012 compared to 34.9% and 32.1% effective income tax rate for the three and six months ended March 31, 2011. The increase in the effective tax rate during the first six months of fiscal 2012 is primarily due to decreased income in certain foreign subsidiaries where we have elected to permanently reinvest the earnings, which are taxed at lower rates than in the U.S., and the expiration of the U.S. research and experimentation tax credit effective December 31, 2011. These increases were partially offset by the absence of \$671 million in income tax expense recorded in the second quarter of fiscal 2011 related to executive compensation in fiscal 2008 through 2010 and the absence of a \$497 million reversal of a deferred tax asset related to certain share-based compensation expense recorded in the first quarter of fiscal 2011, as discussed in Note 1 under the heading "Results of Operations".

15. EARNINGS PER SHARE

The standards of accounting for earnings per share require companies to provide a reconciliation of the numerator and denominator of the basic and diluted earnings per share computations. Basic and diluted earnings per share were calculated as follows:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2012	2011	2012	2011
Numerator:				
Earnings available to common shares	\$ 5,530	\$ 13,092	\$ 15,945	\$ 29,584
Denominator:				
Weighted average common shares	22,768,425	23,031,947	22,623,978	22,857,413
(Denominator for basic calculation)				
Weighted average effect of dilutive securities:				
Share-based compensation	1,011,108	661,307	753,824	537,355
Diluted weighted average common shares	23,779,533	23,693,254	23,377,802	23,394,768

(Denominator for
diluted calculation)

Earnings per share:

Basic	\$ 0.24	\$ 0.57	\$ 0.70	\$ 1.29
Diluted	\$ 0.23	\$ 0.55	\$ 0.68	\$ 1.26

For the three months ended March 31, 2012 and 2011, approximately 0.4 million and 1.3 million shares, respectively, attributable to outstanding stock options were excluded from the calculation of diluted earnings per share because the exercise price of the options was greater than the average market price of our common stock and, therefore, their inclusion would have been anti-dilutive.

For the six months ended March 31, 2012 and 2011, approximately 1.3 million and 1.4 million shares, respectively, attributable to outstanding stock options were excluded from the calculation of diluted earnings per share because the exercise price of the options was greater than the average market price of our common stock and, therefore, their inclusion would have been anti-dilutive.

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CABOT MICROELECTRONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited and in thousands, except share and per share amounts)

16. FINANCIAL INFORMATION BY INDUSTRY SEGMENT AND PRODUCT LINE

We operate predominantly in one industry segment – the development, manufacture, and sale of CMP consumables.

Revenue generated by product line for the three and six months ended March 31, 2012, and 2011, was as follows:

Three Months Ended March 31,	Six Months Ended March 31,
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