

CARPENTER TECHNOLOGY CORP

Form 10-Q

November 05, 2010

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2010

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 1-5828

**CARPENTER TECHNOLOGY CORPORATION**

(Exact name of Registrant as specified in its Charter)

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|   |  |
|---|--|
| <b>Delaware</b><br>(State or other jurisdiction of<br>incorporation or organization)                  | <b>23-0458500</b><br>(I.R.S. Employer<br>Identification No.) |
| <b>P.O. Box 14662</b><br><br><b>Reading, Pennsylvania</b><br>(Address of principal executive offices) | <b>19610</b><br>(Zip Code)                                   |
| <b>610-208-2000</b><br><br>(Registrant's telephone number, including area code)                       |  |

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 (§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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.:

|   |   |
|---|---|
| Large accelerated filer: <input checked="" type="checkbox"/>                                  | Accelerated filer: <input type="checkbox"/>         |
| Non-accelerated filer: <input type="checkbox"/> (Do not check if a smaller reporting company) | Smaller reporting company: <input type="checkbox"/> |

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

The number of shares outstanding of the issuer's common stock as of October 26, 2010 was 43,970,744.

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Items 2, 3, 4 and 5 of Part II are omitted because there is no information to report.

**Table of Contents****PART I****Item 1. Financial Statements****CARPENTER TECHNOLOGY CORPORATION****CONSOLIDATED BALANCE SHEETS****(Unaudited)****(in millions, except share data)**

|   | <b>September 30,<br/>2010</b> | <b>June 30,<br/>2010</b> |
|---|-------------------------------|--------------------------|
| <b>ASSETS</b>   |                               |                          |
| Current assets:   |                               |                          |
| Cash and cash equivalents   | \$ 258.3                      | \$ 265.4                 |
| Marketable securities   | 68.5                          | 105.2                    |
| Accounts receivable, net  | 200.7                         | 188.5                    |
| Inventories   | 272.7                         | 203.6                    |
| Deferred income taxes   | 21.9                          | 21.5                     |
| Other current assets  | 43.8                          | 36.0                     |
| <b>Total current assets</b>   | <b>865.9</b>                  | <b>820.2</b>             |
| Property, plant and equipment, net  | 612.1                         | 617.5                    |
| Goodwill  | 35.2                          | 35.2                     |
| Other intangibles, net  | 17.4                          | 17.6                     |
| Deferred income taxes   | 12.7                          | 16.2                     |
| Other assets  | 89.1                          | 76.5                     |
| <b>Total assets</b>   | <b>\$ 1,632.4</b>             | <b>\$ 1,583.2</b>        |
| <b>LIABILITIES</b>  |                               |                          |
| Current liabilities:  |                               |                          |
| Accounts payable  | \$ 154.0                      | \$ 130.5                 |
| Accrued liabilities   | 95.2                          | 87.6                     |
| Current portion of long-term debt   | 100.0                         |                          |
| <b>Total current liabilities</b>  | <b>349.2</b>                  | <b>218.1</b>             |
| Long-term debt, net of current portion  | 160.1                         | 259.6                    |
| Accrued pension liabilities   | 312.1                         | 322.6                    |
| Accrued postretirement benefits   | 145.6                         | 146.7                    |
| Other liabilities   | 69.5                          | 62.8                     |
| <b>Total liabilities</b>  | <b>1,036.5</b>                | <b>1,009.8</b>           |
| Contingencies and commitments (see Note 8)  |                               |                          |
| <b>STOCKHOLDERS' EQUITY</b>   |                               |                          |
| Common stock — authorized 100,000,000 shares; issued 54,651,695 shares at September 30, 2010 and 54,644,401 shares at June 30, 2010; outstanding 43,968,973 shares at September 30, 2010 and 43,967,084 | 273.3                         | 273.2                    |

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|   |            |            |
|---|------------|------------|
| shares at June 30, 2010   |            |            |
| Capital in excess of par value  | 226.9      | 223.3      |
| Reinvested earnings   | 982.7      | 983.2      |
| Common stock in treasury (10,682,722 shares and 10,677,317 shares at September 30, 2010 and June 30, 2010, respectively), at cost | (535.4)    | (535.2)    |
| Accumulated other comprehensive loss  | (351.6)    | (371.1)    |
| Total stockholders' equity  | 595.9      | 573.4      |
| Total liabilities and stockholders' equity  | \$ 1,632.4 | \$ 1,583.2 |

See accompanying notes to consolidated financial statements.

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**CARPENTER TECHNOLOGY CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

(Unaudited)

(in millions, except per share data)

|  | <b>Three Months Ended</b> |             |
|--|---------------------------|-------------|
|  | <b>September 30,</b>      |             |
|  | <b>2010</b>               | <b>2009</b> |
| <b>NET SALES</b>                                   | \$ 351.7                  | \$ 233.7    |
| Cost of sales                                      | 301.9                     | 214.5       |
| <b>Gross profit</b>                                | 49.8                      | 19.2        |
| Selling, general and administrative expenses       | 35.7                      | 32.5        |
| <b>Operating income (loss)</b>                     | 14.1                      | (13.3)      |
| Interest expense                                   | (4.2)                     | (4.3)       |
| Other income, net                                  | 1.6                       | 1.5         |
| <b>Income (loss) before income taxes</b>           | 11.5                      | (16.1)      |
| Income tax expense (benefit)                       | 3.9                       | (6.8)       |
| <b>NET INCOME (LOSS)</b>                           | \$ 7.6                    | \$ (9.3)    |
| <b>EARNINGS PER COMMON SHARE:</b>                  |                           |             |
| Basic  | \$ 0.17                   | \$ (0.21)   |
| Diluted  | \$ 0.17                   | \$ (0.21)   |
| <b>WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:</b> |                           |             |
| Basic  | 44.1                      | 43.9        |
| Diluted  | 44.5                      | 43.9        |
| <b>Cash dividends per common share</b>             | \$ 0.18                   | \$ 0.18     |

See accompanying notes to consolidated financial statements.

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**CARPENTER TECHNOLOGY CORPORATION**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(Unaudited)

(in millions)

|  | <b>Three Months Ended</b> |             |
|--|---------------------------|-------------|
|  | <b>September 30,</b>      |             |
|  | <b>2010</b>               | <b>2009</b> |
| Net income (loss)  | \$ 7.6                    | \$ (9.3)    |
| Pension and post-retirement benefits, net of tax of (\$2.8), and (\$2.4), respectively | 4.3                       | 3.9         |
| Net gain on derivative instruments, net of tax of (\$4.0), and (\$8.0), respectively   | 6.5                       | 12.8        |
| Unrealized loss on marketable securities, net of tax of \$0.1, and \$0.0, respectively | (0.1)                     |             |
| Foreign currency translation   | 8.8                       | 1.8         |
| <br>Comprehensive income   | <br>\$ 27.1               | <br>\$ 9.2  |

See accompanying notes to consolidated financial statements.

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**CARPENTER TECHNOLOGY CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

(in millions)

|   | <b>Three Months Ended<br/>September 30,</b> |                 |
|---|---|-----------------|
|   | <b>2010</b>                                 | <b>2009</b>     |
| <b>OPERATING ACTIVITIES</b>   |   |                 |
| Net income (loss)   | \$ 7.6                                      | \$ (9.3)        |
| Adjustments to reconcile net income (loss) to net cash (used for) provided from operating activities: |   |                 |
| Depreciation and amortization   | 15.1  | 14.4            |
| Deferred income taxes   | (3.7)                                       | (4.8)           |
| Net pension expense   | 15.2  | 15.3            |
| Net loss (gain) on disposal of property and equipment   | 0.1   | (0.7)           |
| Changes in working capital and other:   |   |                 |
| Accounts receivable   | (8.6)                                       | (4.5)           |
| Inventories   | (66.6)                                      | 4.8             |
| Other current assets  | 1.3   | 7.6             |
| Accounts payable  | 22.9  | 20.8            |
| Accrued current liabilities   | (15.4)                                      | (3.3)           |
| Other, net  | 1.6   | (4.1)           |
| <b>Net cash (used for) provided from operating activities</b>   | <b>(30.5)</b>                               | <b>36.2</b>     |
| <b>INVESTING ACTIVITIES</b>   |   |                 |
| Purchases of property, equipment and software   | (8.1)                                       | (11.3)          |
| Proceeds from disposals of property and equipment   | 0.1   | 0.9             |
| Purchases of marketable securities  | (53.1)                                      |                 |
| Proceeds from sales and maturities of marketable securities   | 89.8  | 15.0            |
| <b>Net cash provided from investing activities</b>  | <b>28.7</b>                                 | <b>4.6</b>      |
| <b>FINANCING ACTIVITIES</b>   |   |                 |
| Dividends paid  | (8.0)                                       | (8.0)           |
| Proceeds from common stock options exercised  | 0.1   |                 |
| <b>Net cash used for financing activities</b>   | <b>(7.9)</b>                                | <b>(8.0)</b>    |
| Effect of exchange rate changes on cash and cash equivalents  | 2.6   | 1.7             |
| <b>(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>   | <b>(7.1)</b>                                | <b>34.5</b>     |
| Cash and cash equivalents at beginning of period  | 265.4                                       | 340.1           |
| <b>Cash and cash equivalents at end of period</b>   | <b>\$ 258.3</b>                             | <b>\$ 374.6</b> |

See accompanying notes to consolidated financial statements.





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**CARPENTER TECHNOLOGY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Basis of Presentation**

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal and recurring adjustments, considered necessary for a fair presentation are reflected in the interim periods presented. The June 30, 2010 consolidated balance sheet data was derived from audited financial statements, but does not include all the disclosures required by U.S. generally accepted accounting principles. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in Carpenter's annual report on Form 10-K for the year ended June 30, 2010. Operating results for the three months ended September 30, 2010 are not necessarily indicative of the operating results for any future period.

As used throughout this report, unless the context requires otherwise, the terms "Carpenter", "the Company", "Registrant", "Issuer", "we" and "our" refer to Carpenter Technology Corporation.

**2. Earnings Per Common Share**

The Company calculates basic earnings per share using the two class method. Under the two class method, earnings are allocated to common stock and participating securities (nonvested restricted shares and units that receive non-forfeitable dividends) according to their participation rights in dividends and undistributed earnings. The earnings available to each class of stock is divided by the weighted average number of shares for the period in each class. Because the participating securities have no obligation to share in net losses, losses are not allocated to the participating securities in this calculation.

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## CARPENTER TECHNOLOGY CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The calculations of basic and diluted earnings per common share for the three months ended September 30, 2010 and 2009 were as follows:

| (\$ in millions, except per share data)  | Three Months Ended<br>September 30, |                  |
|--|-------------------------------------|------------------|
|  | 2010                                | 2009             |
| Net income (loss)  | \$ 7.6                              | \$ (9.3)         |
| Less: earnings allocated to participating securities                                       | (0.1)                               | (0.1)            |
| <b>Earnings (loss) available for common shareholders</b>                                   | <b>\$ 7.5</b>                       | <b>\$ (9.4)</b>  |
| Weighted average number of common shares outstanding for basic earnings per common share   | 44.1                                | 43.9             |
| Effect of shares issuable under share based compensation plans                             | 0.4                                 |                  |
| Weighted average number of common shares outstanding for diluted earnings per common share | 44.5                                | 43.9             |
| <b>Basic earnings per common share</b>   | <b>\$ 0.17</b>                      | <b>\$ (0.21)</b> |
| Diluted earnings per common share  | \$ 0.17                             | \$ (0.21)        |

The following awards issued under share-based compensation plans were excluded from the calculations of diluted earnings per share above because their effects were anti-dilutive:

| (in millions)           | Three Months Ended<br>September 30, |      |
|-------------------------|-------------------------------------|------|
|                         | 2010                                | 2009 |
| Stock options           | 0.4                                 | 0.9  |
| Restricted stock awards | 0.1                                 | 0.5  |

**Table of Contents****CARPENTER TECHNOLOGY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****3. Marketable Securities**

The fair value of the Company's marketable securities was based on quoted market prices or estimates of fair value as of September 30, 2010 and June 30, 2010. The following is a summary of marketable securities, all of which were classified as available-for-sale as of September 30, 2010 and June 30, 2010:

| <b>September 30, 2010</b><br><b>(\$ in millions)</b> | <b>Cost</b>     | <b>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|--|-----------------|------------------------------|-------------------------------------|
| <b>Current</b>                                       |                 |                              |                                     |
| Government agency bonds                              | \$ 45.6         | \$                           | \$ 45.6                             |
| Corporate bonds                                      | 20.9            |                              | 20.9                                |
| Commercial paper                                     | 2.0             |                              | 2.0                                 |
|  | <b>\$ 68.5</b>  | <b>\$</b>                    | <b>\$ 68.5</b>                      |
| <b>Non-current</b>                                   |                 |                              |                                     |
| Municipal auction rate securities                    | \$ 6.2          | \$ (1.1)                     | \$ 5.1                              |
| <b>June 30, 2010</b><br><b>(\$ in millions)</b>      |                 |                              |                                     |
|  | <b>Cost</b>     | <b>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair Value</b>     |
| <b>Current</b>                                       |                 |                              |                                     |
| Government agency bonds                              | \$ 78.9         | \$                           | \$ 78.9                             |
| Corporate bonds                                      | 15.4            |                              | 15.4                                |
| Certificate of deposit                               | 10.0            |                              | 10.0                                |
| Commercial paper                                     | 0.9             |                              | 0.9                                 |
|  | <b>\$ 105.2</b> | <b>\$</b>                    | <b>\$ 105.2</b>                     |
| <b>Non-current</b>                                   |                 |                              |                                     |
| Municipal auction rate securities                    | \$ 6.2          | \$ (0.9)                     | \$ 5.3                              |

For the three months ended September 30, 2010 and 2009, proceeds from sales and maturities of marketable securities were \$89.8 million and \$15.0 million, respectively.

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## CARPENTER TECHNOLOGY CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

**4. Inventories**

Inventories consisted of the following components as of September 30, 2010 and June 30, 2010:

| (\$ in millions)                | September 30,<br>2010 | June 30,<br>2010 |
|---------------------------------|-----------------------|------------------|
| Raw materials and supplies      | \$ 43.2               | \$ 30.7          |
| Work in process                 | 153.0                 | 109.1            |
| Finished and purchased products | 76.5                  | 63.8             |
| Total inventory                 | \$ 272.7              | \$ 203.6         |

Inventories are valued at the lower of cost or market. Cost for inventories is principally determined by the last-in, first-out ( LIFO ) method.

**5. Accrued Liabilities**

Accrued liabilities consisted of the following as of September 30, 2010 and June 30, 2010:

| (\$ in millions)                 | September 30,<br>2010 | June 30,<br>2010 |
|----------------------------------|-----------------------|------------------|
| Employee benefits                | \$ 41.5               | \$ 25.9          |
| Compensation                     | 21.4                  | 38.6             |
| Derivative financial instruments | 8.7                   | 1.9              |
| Other                            | 23.6                  | 21.2             |
| Total accrued liabilities        | \$ 95.2               | \$ 87.6          |

**6. Pension and Other Postretirement Benefits**

The components of the net periodic benefit cost related to Carpenter's pension and other postretirement benefits for the three months ended September 30, 2010 and 2009 were as follows:

| Three months ended September 30,<br>(\$ in millions) | Pension Plans |        | Other Postretirement<br>Plans |        |
|--|---------------|--------|-------------------------------|--------|
|  | 2010          | 2009   | 2010                          | 2009   |
| Service cost   | \$ 5.7        | \$ 5.2 | \$ 0.7                        | \$ 0.6 |
| Interest cost  | 11.6          | 12.5   | 2.7                           | 3.0    |

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|  |         |         |        |        |
|--|---------|---------|--------|--------|
| Expected return on plan assets               | (11.3)  | (11.2)  | (1.3)  | (1.1)  |
| Amortization of net loss                     | 7.2     | 6.8     | 1.5    | 1.3    |
| Amortization of prior service cost (benefit) | 0.3     | 0.2     | (1.9)  | (2.0)  |
| Net pension expense                          | \$ 13.5 | \$ 13.5 | \$ 1.7 | \$ 1.8 |

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**CARPENTER TECHNOLOGY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**7. Revolving Credit Agreement**

The Company has a revolving credit facility ( Credit Agreement ) that permits the Company to borrow funds for working capital and other general corporate purposes based on a revolving credit commitment amount of \$200 million subject to the Company's right, from time to time, to request an increase of the commitment to \$300 million in the aggregate and provides for the issuance of Letters of Credit within such amount. The Credit Agreement expires November 24, 2012. The Company has the right to voluntarily prepay and reborrow loans and to terminate or reduce the commitments under the facility. As of September 30, 2010, the Company had \$3.8 million of issued letters of credit under the Credit Agreement, with the balance of \$196.2 million available for future borrowings.

The Company is subject to certain financial and restrictive covenants under the Credit Agreement, which, among other things, require the maintenance of a minimum interest coverage ratio (which begins at 3.0 to 1.0 for the period through September 30, 2010, and ultimately increases to 3.5 to 1.0). The interest coverage ratio is defined in the Credit Agreement as, for any period, the ratio of consolidated EBITDA to consolidated interest expense for such period. The Credit Agreement also requires the Company to maintain a debt to capital ratio of less than 55%. The debt to capital ratio is defined in the Credit Agreement as the ratio of consolidated indebtedness, as defined, to consolidated capitalization, as defined. As of September 30, 2010, the Company was in compliance with all of the covenants of the Credit Agreement.

**8. Contingencies and Commitments**

***Environmental***

Carpenter is subject to various federal, state, local and international environmental laws and regulations relating to pollution, protection of public health and the environment, natural resource damages and occupational safety and health. Although compliance with these laws and regulations may affect the costs of Carpenter's operations, compliance costs to date have not been material. Carpenter has environmental remediation liabilities at some of its owned operating facilities and has been designated as a potentially responsible party ( PRP ) with respect to certain third-party Superfund waste disposal sites and other third party owned sites. Additionally, Carpenter has been notified that it may be a PRP with respect to other Superfund sites as to which no proceedings have been instituted against Carpenter. Neither the exact amount of remediation costs nor the final method of their allocation among all designated PRP's at these Superfund sites has been determined. The liability for future environmental remediation costs is evaluated by management on a quarterly basis. Carpenter accrues amounts for environmental remediation costs that represent management's best estimate of the probable and reasonably estimable costs related to environmental remediation. During the three months ended September 30, 2010, no additional accruals were recorded. The liabilities recorded for environmental remediation costs at Superfund sites, at other third party-owned sites and at Carpenter-owned current or former operating facilities were \$4.9 million at September 30, 2010 and June 30, 2010.

Estimates of the amount and timing of future costs of environmental remediation requirements are inherently imprecise because of the continuing evolution of environmental laws and regulatory requirements, the availability and application of technology, the identification of currently unknown remediation sites and the allocation of costs among the PRP's. Based upon information currently available, such future costs are not expected to have a material effect on Carpenter's financial position, results of operations or cash flows over the long term. However, such costs could be material to Carpenter's financial position, results of operations or cash flows in a particular future quarter or year.

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**CARPENTER TECHNOLOGY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

***Boarhead Farms***

In June 2002, the Company was named as a defendant in a lawsuit filed by a group of plaintiffs in the District Court for the Eastern District of Pennsylvania titled *Boarhead Farm Agreement Group v. Advanced Environmental Technology Corporation et al.* (since amended to include the individual members). The suit alleges that the Company and the other named defendants contributed to damages caused at Boarhead Farms, a Superfund site located in Bridgeton, Pennsylvania. The Boarhead Farms site was the home of a now defunct chemical and waste hauling company that the Company engaged to dispose of certain wastes during the 1970 s. The plaintiff group was individually named as PRP s for the Boarhead site in the EPA s Record of Decision in November 1998. Their suit, in June of 2002, against various defendants, including the Company, sought contributions for a portion of costs incurred for various site cleanup activities as well as contributions to future cleanup efforts. The suit went to trial in June 2008. Prior to trial, all of the named co-defendants, except for the Company, reached an out of court settlement with the plaintiffs. The Company denied the claims made by the plaintiff group. On August 18, 2008, the Court awarded the plaintiffs judgment against the Company for 80 percent of the plaintiffs past costs of remediating the site, including prejudgment interest from June 18, 2002 to January 1, 2008, and held the Company liable for 80 percent of future costs of the cleanup activities at the site. The Company appealed the Court s decision and oral arguments took place before the United States Court of Appeals for the Third Circuit on December 17, 2009. On April 12, 2010, the Court of Appeals for the Third Circuit vacated the previous judgment by the District Court and remanded the case for further proceedings. The Company intends to continue to defend against the claims in this case, but is unable to predict the outcome of the proceedings at this time. As of September 30, 2010 and June 30, 2010, the Company has recorded a liability related to this case of \$21.8 million.

***Duty Drawback***

Historically, the Company has participated in a program offered by U.S. Customs and Border Protection ( U.S. Customs ) known as duty drawback. Under the program, the Company claimed a refund of import duties on items manufactured and exported to customers in foreign countries. Certain vendors of the Company prepared certificates authorizing the Company to claim duty drawback refunds against imported goods purportedly shipped by the vendor to the Company. Because of the complexity of the program, the Company engaged a licensed U.S. customs broker specializing in duty drawback claims. The customs broker was responsible for performing the administration of the process which included maintaining and collecting various forms of supporting evidence for each claim including collecting appropriate certificates from vendors, as well as preparing and submitting the refund claims.

In fiscal year 2008, the Company received notice from U.S. Customs that the Company was under investigation related to claims previously filed by the customs broker on the Company s behalf. The investigation alleged certain discrepancies and a lack of supporting documentation for the claims that had been filed by the broker. The Company initiated an internal review of the claims filed with U.S. Customs to determine the extent of claims that may have inadequate supporting documentation and engaged a new licensed U.S. customs broker. The Company has cooperated fully with U.S. Customs investigation of this matter. As of the date of this filing, the Company s internal review remains ongoing due to the extensive amount of documentation which must be compiled and reviewed.

During the period the Company s customs broker was filing claims on the Company s behalf, July 2003 through December 2006, the Company applied for and received refund claims totaling \$6.9 million. While the ultimate outcome of the U.S. Customs investigation and the Company s internal review is not yet known, based on current facts the Company believes that the reserve recorded of \$2.5 million as of September 30, 2010 is a reasonable estimate of the probable future loss that will result from the investigation. The Company does not expect that any additional material liabilities will be incurred related to this matter.



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**CARPENTER TECHNOLOGY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

***Export Regulations***

In fiscal year 2008, the Company became aware of potential violations of federal export regulations at a business unit that has since been divested. Upon investigation, the Company discovered that approximately 40 foreign nationals employed over time at the business unit's facility may have been exposed to protected technical data related to the production of various products for military applications. An export license from the Department of State and the Department of Commerce is required prior to the exporting of technical data for military applications. The Company has applied for and received similar applications for other business units, but did not have such a license for the divested business unit. Violations of Federal export regulations can be subject to civil penalties depending upon the severity of the violation. The Company filed voluntary disclosures with the Department of State and the Department of Commerce before the divestiture of the business unit on March 31, 2008. The Department of State responded to the voluntary disclosure without assessing civil penalties. The Department of Commerce has not yet responded to the voluntary disclosure. It is not possible to determine the amount, if any, of civil penalties that may be assessed by the Department of Commerce. As a result, the Company has not recorded any liability for potential penalties as of September 30, 2010.

***Other***

The Company is defending various routine claims and legal actions that are incidental to its business, and the Company is subject to contingencies that are common to its operations, including those pertaining to product claims, commercial disputes, employment actions, employee benefits, compliance with domestic and foreign laws, personal injury claims and tax issues. The Company provides for costs relating to these matters when a loss is probable and the amount of the loss is reasonably estimable. The effect of the outcome of these matters on the Company's future results of operations and liquidity cannot be predicted because any such effect depends on future results of operations and the amount and timing (both as to recording future charges to operations and cash expenditures) of the resolution of such matters. While it is not feasible to determine the outcome of these matters, management believes that the total liability from these matters will not have a material effect on the Company's financial position, results of operations or cash flows over the long-term. However, there can be no assurance that an increase in the scope of pending matters, or that any future lawsuits, claims, proceedings or investigations, will not be material to the Company's financial position, results of operations or cash flows in a particular future quarter or year.

**9. Fair Value Measurements**

The fair value hierarchy has three levels based on the inputs used to determine fair value. Level 1 refers to quoted prices in active markets for identical assets or liabilities. Level 2 refers to observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data. Level 3, which the Company does not currently use, refers to unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets and liabilities. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

**Table of Contents****CARPENTER TECHNOLOGY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following tables present the Company's assets and liabilities that are measured at fair value on a recurring basis and are categorized using the fair value hierarchy.

| <b>September 30, 2010</b><br><b>(in millions)</b> | <b>Fair Value Measurements Using</b> |                | <b>Total</b>    |
|---|--------------------------------------|----------------|-----------------|
|   | <b>Level 1</b>                       | <b>Level 2</b> |                 |
| <b>Assets:</b>                                    |                                      |                |                 |
| Marketable securities                             |                                      |                |                 |
| Government agency bonds                           | \$ 45.6                              | \$             | \$ 45.6         |
| Corporate bonds                                   | 20.9                                 |                | 20.9            |
| Commercial paper                                  | 2.0                                  |                | 2.0             |
| Municipal auction rate securities                 |                                      | 5.1            | 5.1             |
| Derivative financial instruments                  |                                      | 31.9           | 31.9            |
| <b>Total assets</b>                               | <b>\$ 68.5</b>                       | <b>\$ 37.0</b> | <b>\$ 105.5</b> |
| <b>Liabilities:</b>                               |                                      |                |                 |
| Derivative financial instruments                  | \$                                   | \$ 19.7        | \$ 19.7         |

| <b>June 30, 2010</b><br><b>(in millions)</b> | <b>Fair Value Measurements Using</b> |                | <b>Total</b>    |
|--|--------------------------------------|----------------|-----------------|
|  | <b>Level 1</b>                       | <b>Level 2</b> |                 |
| <b>Assets:</b>                               |                                      |                |                 |
| Marketable securities                        |                                      |                |                 |
| Government agency bonds                      | \$ 78.9                              | \$             | \$ 78.9         |
| Corporate bonds                              | 15.4                                 |                | 15.4            |
| Certificates of deposit                      | 10.0                                 |                | 10.0            |
| Commercial Paper                             | 0.9                                  |                | 0.9             |
| Municipal auction rate securities            |                                      | 5.3            | 5.3             |
| Derivative financial instruments             |                                      | 9.2            | 9.2             |
| <b>Total assets</b>                          | <b>\$ 105.2</b>                      | <b>\$ 14.5</b> | <b>\$ 119.7</b> |
| <b>Liabilities:</b>                          |                                      |                |                 |
| Derivative financial instruments             | \$                                   | \$ 6.7         | \$ 6.7          |

The Company's derivative financial instruments consist of commodity forward contracts, foreign exchange forward contracts and interest rate swaps. These instruments are measured at fair value using the market method valuation technique. The inputs to this technique utilize information related to foreign exchange rates, commodity prices and interest rates published by third-party leading financial news and data providers. This is observable data; however, the valuation of these instruments is not based on actual transactions for the same instruments so they are classified as Level 2. The Company's use of derivatives and hedging policies are more fully discussed in Note 11.



**Table of Contents****CARPENTER TECHNOLOGY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The Company has currently chosen not to elect the fair value option for any items that are not already required to be measured at fair value in accordance with accounting principles generally accepted in the United States.

The carrying amounts of other financial instruments not listed in the table below approximate fair value due to the short-term nature of these items.

The carrying amounts and estimated fair values of Carpenter's financial instruments not recorded at fair value in the financial statements were as follows:

| (\$ in millions)                          | September 30, 2010 |            | June 30, 2010  |            |
|---|--------------------|------------|----------------|------------|
|   | Carrying Value     | Fair Value | Carrying Value | Fair Value |
| Company-owned life insurance              | \$ 9.1             | \$ 9.1     | \$ 9.3         | \$ 9.3     |
| Long-term debt, including current portion | \$ 260.1           | \$ 270.4   | \$ 259.6       | \$ 267.9   |

The carrying amount for company-owned life insurance reflects cash surrender values based upon the market values of underlying securities, net of any outstanding policy loans. The carrying value associated with the cash surrender value of these policies is recorded in other assets in the accompanying consolidated balance sheets.

The fair values of long-term debt as of September 30, 2010 and June 30, 2010 were determined by using current interest rates for debt with terms and maturities similar to the Company's existing debt arrangements.

**10. Other Income, Net**

Other income, net consisted of the following:

| (\$ in millions)                                | Three Months Ended |                    |
|---|--------------------|--------------------|
|   | September 30, 2010 | September 30, 2009 |
| Interest income                                 | \$ 0.3             | \$ 0.3             |
| Equity in earnings of unconsolidated subsidiary | 0.6                | 0.2                |
| Other income                                    | 0.7                | 1.0                |
| Total other income, net                         | \$ 1.6             | \$ 1.5             |

**11. Derivatives and Hedging Activities**

The Company uses commodity swaps and forwards, interest rate swaps and foreign currency forwards to manage risks generally associated with commodity price, interest rate and foreign currency rate fluctuations. The following explains the various types of derivatives and includes a recap about the impact the derivative instruments had on the Company's financial position, results of operations, and cash flows.



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**CARPENTER TECHNOLOGY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

*Cash Flow Hedging Commodity forward contracts:* The Company enters into commodity forward contracts to fix the price of a portion of anticipated future purchases of certain critical raw materials and energy to manage the risk of cash flow variability associated with volatile commodity prices. The commodity forward contracts have been designated as cash flow hedges. The qualifying hedge contracts are marked-to-market at each reporting date and any unrealized gains or losses are included in accumulated other comprehensive income to the extent effective, and reclassified to costs of sales in the period during which the hedged transaction affects earnings or it becomes probable that the forecasted transaction will not occur.

*Cash Flow Hedging Forward Interest Rate Swaps:* The Company has entered into forward swap contracts to manage the risk of cash flow variability associated with fixed interest debt expected to be issued to refinance the \$100 million of fixed rate debt scheduled to mature in August 2011. The forward interest rate swaps have been designated as cash flow hedges. The qualifying hedge contracts are marked-to-market at each reporting date and any unrealized gains or losses are included in accumulated other comprehensive income to the extent effective, and reclassified to interest expense in the period during which the hedged transaction affects earnings or it becomes probable that the forecasted transaction will not occur.

*Cash Flow Hedging Foreign currency forward contracts:* The Company uses foreign currency forward contracts to hedge a portion of anticipated future sales denominated in foreign currencies, principally the Euro and Pound Sterling, in order to offset the effect of changes in exchange rates. The qualifying hedge contracts are marked-to-market at each reporting date and any unrealized gains or losses are included in other comprehensive income to the extent effective, and reclassified to net sales in the period during which the transaction affects earnings or it becomes probable that the forecasted transaction will not occur.

The Company also uses foreign currency forward contracts to protect certain short-term asset positions denominated in foreign currency against the effect of changes in exchange rates. These positions do not qualify for hedge accounting and accordingly, are marked-to-market at each reporting date through charges to other income and expense. As of September 30, 2010 and June 30, 2010, the fair value of the outstanding foreign currency forwards not designated as hedging instruments and the charges to income for changes in fair value for these contracts, were not material.

*Fair Value Hedging Interest rate swaps:* The Company uses interest rate swaps to achieve a level of floating rate debt relative to fixed rate debt where appropriate. The Company has designated fixed to floating interest rate swaps as fair value hedges. Accordingly, the changes in the fair value of these instruments are immediately recorded in earnings. The mark-to-market values of both the fair value hedging instruments and the underlying debt obligations are recorded as equal and offsetting gains and losses in interest expense in the consolidated statements of operations. As of both September 30, 2010 and June 30, 2010, the total notional amount of floating interest rate contracts was \$65.0 million. For the three months ended September 30, 2010 and 2009, net gains of \$0.6 million were recorded as a reduction to interest expense for both periods. These amounts include the impact of previously terminated swaps which are being amortized over the remaining term of the underlying debt.

**Table of Contents****CARPENTER TECHNOLOGY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The fair value and location of outstanding derivative contracts recorded in the accompanying consolidated balance sheets were as follows as of September 30, 2010 and June 30, 2010:

| <b>September 30, 2010</b>                             | <b>Interest<br/>Rate<br/>Swaps</b> | <b>Foreign<br/>Currency<br/>Contracts</b> | <b>Commodity<br/>Contracts</b> | <b>Total<br/>Derivatives</b> |
|---|------------------------------------|---|--------------------------------|------------------------------|
| <b>(\$ in millions)</b>                               |                                    |   |                                |                              |
| <b>Asset Derivatives:</b>                             |                                    |   |                                |                              |
| <i>Derivatives designated as hedging instruments:</i> |                                    |   |                                |                              |
| Other current assets                                  | \$ 0.9                             | \$  | \$ 14.0                        | \$ 14.9                      |
| Other assets  | 3.7                                |   | 13.3                           | 17.0                         |
| <b>Total asset derivatives</b>                        | <b>\$ 4.6</b>                      | <b>\$</b>                                 | <b>\$ 27.3</b>                 | <b>\$ 31.9</b>               |
| <b>Liability Derivatives:</b>                         |                                    |   |                                |                              |
| <i>Derivatives designated as hedging instruments:</i> |                                    |   |                                |                              |
| Accrued liabilities                                   | \$ 0.9                             | \$ 0.7                                    | \$ 7.1                         | \$ 8.7                       |
| Other liabilities                                     |                                    |   | 11.0                           | 11.0                         |
| <b>Total liability derivatives</b>                    | <b>\$ 0.9</b>                      | <b>\$ 0.7</b>                             | <b>\$ 18.1</b>                 | <b>\$ 19.7</b>               |
| <br>  |                                    |   |                                |                              |
| <b>June 30, 2010</b>                                  |                                    |   |                                |                              |
| <b>(\$ in millions)</b>                               |                                    |   |                                |                              |
| <b>Asset Derivatives:</b>                             |                                    |   |                                |                              |
| <i>Derivatives designated as hedging instruments:</i> |                                    |   |                                |                              |
| Other current assets                                  | \$ 0.5                             | \$ 1.8                                    | \$ 3.4                         | \$ 5.7                       |
| Other assets  | 3.2                                |   | 0.3                            | 3.5                          |
| <b>Total asset derivatives</b>                        | <b>\$ 3.7</b>                      | <b>\$ 1.8</b>                             | <b>\$ 3.7</b>                  | <b>\$ 9.2</b>                |
| <b>Liability Derivatives:</b>                         |                                    |   |                                |                              |
| <i>Derivatives designated as hedging instruments:</i> |                                    |   |                                |                              |
| Accrued liabilities                                   | \$                                 | \$  | \$ 1.9                         | \$ 1.9                       |
| Other liabilities                                     |                                    |   | 4.8                            | 4.8                          |
| <b>Total liability derivatives</b>                    | <b>\$</b>                          | <b>\$</b>                                 | <b>\$ 6.7</b>                  | <b>\$ 6.7</b>                |

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## CARPENTER TECHNOLOGY CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

*Cash Flow Hedges*

For derivative instruments that are designated and qualify as cash flow hedges, the effective portion of the gain or loss on the derivative is reported as a component of accumulated other comprehensive income ( AOCI ) and reclassified into earnings in the same period or periods during which the hedged transactions affect earnings. The following is a summary of the gains (losses) related to cash flow hedges recognized during the three months ended September 30, 2010 and 2009:

| (\$ in millions)                               | Amount of Gain (Loss)<br>Recognized in AOCI on<br>Derivatives (Effective<br>Portion) |         |
|--|--|---------|
|  | Three Months Ended<br>September 30,  |         |
| Derivatives in Cash Flow Hedging Relationship: | 2010   | 2009    |
| Commodity contracts                            | \$ 12.8  | \$ 21.1 |
| Foreign exchange contracts                     | (1.4)  | (0.3)   |
| Forward interest rate swaps                    | (0.8)  |         |
| Total  | \$ 10.6  | \$ 20.8 |

| (\$ in millions)                               | Location of Gain (Loss)<br>Reclassified from AOCI into<br>Income (Effective<br>Portion) | Amount of (Loss) Gain<br>Reclassified from<br>AOCI<br>into Income<br>(Effective<br>Portion) |          |
|--|---|---|----------|
|  |   | Three Months Ended<br>September 30,   |          |
| Derivatives in Cash Flow Hedging Relationship: |   | 2010  | 2009     |
| Commodity contracts                            | Cost of sales   | \$ (0.3)  | \$ (6.0) |
| Foreign exchange contracts                     | Net sales   | 0.1   | 0.2      |
| Total  |   | \$ (0.2)  | \$ (5.8) |

The Company estimates that \$4.1 million of net derivative gains included in AOCI as of September 30, 2010 will be reclassified into earnings within the next 12 months. No significant cash flow hedges were discontinued during the quarter ended September 30, 2010. There was no ineffectiveness during the three months ended September 30, 2010 and 2009.

The changes in accumulated other comprehensive income associated with derivative hedging activities during the three months ended September 30, 2010 and 2009 were as follows:



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| (\$ in millions)                                 | September 30, |           |
|--|---------------|-----------|
|  | 2010          | 2009      |
| Balance at beginning                             | \$ (2.4)      | \$ (17.3) |
| Current period changes in fair value, net of tax | 6.0           | 5.2       |
| Reclassifications to earnings, net of tax        | 0.6           | 7.6       |
| Balance at ending                                | \$ 4.2        | \$ (4.5)  |

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**CARPENTER TECHNOLOGY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

According to the provisions of the Company's derivative arrangements, in the event that the fair value of outstanding derivative positions with certain counterparties exceeds certain thresholds, the Company may be required to issue cash collateral to the counterparties. The Company's contracts with these counterparties allow for netting of derivative instrument positions executed under each contract. As of September 30, 2010 and June 30, 2010 the Company had no cash collateral held by counterparties.

The Company is exposed to credit loss in the event of nonperformance by counterparties on its derivative instruments as well as credit or performance risk with respect to its customer commitments to perform. Although nonperformance is possible, the Company does not anticipate nonperformance by any of the parties. In addition, various master netting arrangements are in place with counterparties to facilitate settlement of gains and losses on these contracts.

**12. Income Taxes**

The effective tax rate used for interim periods is the estimated annual effective consolidated tax rate, based on the current estimate of full year results, except that taxes related to specific events, if any, are recorded in the interim period in which they occur.

Income taxes in the recent first quarter were \$3.9 million, or 33.9 percent of pre-tax income versus a benefit of \$6.8 million, or 42.2 percent of pre-tax loss in the same quarter a year ago. The decrease in the effective tax rate for the three months ended September 30, 2010 is primarily due to the less dilutive impact that our permanent differences have had on our effective tax rate in the current year as a result of higher income levels in the current quarter as compared with a pre-tax loss a year ago.

For the three months ended September 30, 2010, the Company's unrecognized tax benefits increased \$0.1 million as a result of tax positions taken during a prior period. Interest and penalties are recognized as a component of income tax expense. During the three months ended September 30, 2010 and 2009 the Company recognized in income tax expense, \$0.1 million and \$0.3 million of interest and penalties, respectively. As of September 30, 2010 and June 30, 2010, the amount of interest and penalties accrued was \$0.7 million and \$0.6 million, respectively.

**13. Business Segments**

The Company has two reportable business segments: Advanced Metals Operations and Premium Alloys Operations.

The Advanced Metals Operations (AMO) segment includes the manufacturing and distribution of high temperature and high strength metal alloys, stainless steels, and titanium in the form of small bars and rods, wire, narrow strip and powder. Products in this segment typically go through more finishing operations, such as rolling, turning, grinding, drawing, and atomization, than products in our Premium Alloys Operations segment. Sales in the AMO segment are spread across a diverse list of end-use markets, including the aerospace, industrial, consumer, automotive, and medical industries. AMO products are sold under the Carpenter, Dynamet, Talley, Carpenter Powder Products and Aceros Fortuna brand names.

**Table of Contents****CARPENTER TECHNOLOGY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The Premium Alloys Operations ( PAO ) segment includes the manufacturing and distribution of high temperature and high strength metal alloys and stainless steels in the form of ingots, billets, large bars and hollows. Also, the PAO segment includes conversion processing of metal for other specialty metals companies. A significant portion of PAO sales are to customers in the aerospace and energy industries. Much of PAO sales are to forging companies that further shape, mill, and finish the metals into more specific dimensions. All such sales are made under the Carpenter brand name.

The Company's consolidated total assets are managed as corporate-level assets and, therefore, are not allocated to the business segments. Only a portion of the expenses related to these assets, principally depreciation and amortization, is allocated to the individual business segments for inclusion in their respective measures of operating income.

The service cost component of the Company's net pension expense, which represents the estimated cost of future pension liabilities earned associated with active employees, is included in the operating income of the business segments. The residual net pension expense, which is comprised of the expected return on plan assets, interest costs on the projected benefit obligations of the plans, and amortization of actuarial gains and losses and prior service costs, is included under the heading Pension earnings, interest & deferrals .

A single customer accounted for 10 percent and 11 percent of the Company's net sales for the three months ended September 30, 2010 and 2009, respectively.

| <b>Segment Data<br/>(\$ in millions)</b>    | <b>Three Months Ended<br/>September 30,</b> |                  |
|---|---|------------------|
|   | <b>2010</b>                                 | <b>2009</b>      |
| <b>Net Sales:</b>                           |   |                  |
| Advanced Metals Operations                  | \$ 246.6                                    | \$ 175.3         |
| Premium Alloys Operations                   | 107.7                                       | 59.3             |
| Intersegment                                | (2.6)                                       | (0.9)            |
| <b>Consolidated net sales</b>               | <b>\$ 351.7</b>                             | <b>\$ 233.7</b>  |
| <b>Operating Income (Loss):</b>             |   |                  |
| Advanced Metals Operations                  | \$ 8.6                                      | \$ (2.6)         |
| Premium Alloys Operations                   | 24.3  | 7.9              |
| Corporate costs                             | (9.9)                                       | (9.0)            |
| Pension earnings, interest & deferrals      | (8.8)                                       | (9.5)            |
| Intersegment                                | (0.1)                                       | (0.1)            |
| <b>Consolidated operating income (loss)</b> | <b>\$ 14.1</b>                              | <b>\$ (13.3)</b> |

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**CARPENTER TECHNOLOGY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**14. Subsequent Event**

On October 19, 2010, Carpenter established a strategic partnership with Sandvik Materials Technology to further strengthen its leadership position in high-performance powder metal products. As part of the joint venture arrangement, the Company will acquire a 40 percent interest in Sandvik Powdermet AB and Sandvik AB will acquire a 40 percent interest in Carpenter Powder Products AB.

Carpenter Powder Products AB, a unit of Carpenter based in Torshalla, Sweden, manufactures high-alloy powder and is currently one of Sandvik Powdermet AB's major suppliers. The joint venture will provide Carpenter with access to Sandvik Powdermet AB's market for near-net-shape powder products, and will ensure Sandvik's long-term supply of high quality powder. As the name implies, near-net-shapes are produced using a manufacturing technique in which the initial production of the item is very close to the final (net) shape resulting in lower production costs for end users of the products. The cooperation is expected to provide accelerated growth opportunities for both companies in powder metal markets. The two businesses, each with current annual revenues of approximately \$20 million, will continue to operate under their current respective brands, Carpenter and Sandvik.

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
***Background and General***

Carpenter is engaged in the manufacturing, fabrication, and distribution of specialty metals. We primarily process basic raw materials such as nickel, cobalt, titanium, manganese, chromium, molybdenum, iron scrap and other metal alloying elements through various melting, hot forming and cold working facilities to produce finished products in the form of billet, bar, rod, wire and narrow strip in many sizes and finishes. We also produce certain metal powders. Our sales are distributed directly from our production plants and distribution network as well as through independent distributors. Unlike many other specialty steel producers, we operate a worldwide network of service/distribution centers. These service centers, located in the United States, Canada, Mexico, Asia and Europe, allow us to work more closely with customers and to offer various just-in-time stocking programs. As a result, we often serve as a technical partner in customizing specialty metals or in developing new ones.

Our discussions below in this Item 2 are based upon the more detailed discussions about our business, operations and financial condition included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010, under Item 8 thereof. Our discussions here focus on our results during or as of the three-month period ended September 30, 2010 and the comparable periods of fiscal year 2010, and, to the extent applicable, on material changes from information discussed in that Form 10-K or other important intervening developments or information that we have reported on Form 8-K. These discussions should be read in conjunction with that Form 10-K for detailed background information and with any such intervening Form 8-K.

***Impact of Raw Material Prices and Product Mix***

We value most of our inventory utilizing the last-in, first-out ( LIFO ) inventory costing methodology. Under the LIFO inventory costing method, changes in the cost of raw materials and production activities are recognized in cost of sales in the current period even though these materials may have been acquired at potentially significantly different values due to the length of time from the acquisition of the raw materials to the sale of the processed finished goods to the customers. In a period of rising raw material costs, the LIFO inventory valuation normally results in higher costs of sales. Conversely, in a period of decreasing raw material costs, the LIFO inventory valuation normally results in lower costs of sales.

The volatility of the costs of raw materials has impacted our operations over the past several years. We, and others in our industry, generally have been able to pass cost increases on major raw materials through to our customers using surcharges that are structured to recover increases in raw material costs. Generally, the formula used to calculate a surcharge is based on published prices of the respective raw materials for the previous month which correlates to the prices we pay for our raw material purchases. However, a portion of our surcharges to customers may be calculated using a different surcharge formula or may be based on the raw material prices at the time of order, which creates a lag between surcharge revenue and corresponding raw material costs recognized in costs of sales. The surcharge mechanism protects our net income on such sales except for the lag effect discussed above. However, surcharges have had a dilutive effect on our gross margin and operating margin percentages as described later in this report.

A portion of our business consists of sales to customers under firm price sales arrangements. Firm price sales arrangements involve a risk of profit margin fluctuations, particularly when raw material prices are volatile. In order to reduce the risk of fluctuating profit margins on these sales, we enter into commodity forward contracts to purchase certain critical raw materials necessary to produce the related products sold. Firm price sales arrangements generally include certain annual purchasing commitments and consumption schedules agreed to by the customers at selling prices based on raw material prices at the time the arrangements are established. If a customer fails to meet the volume commitments (or the consumption schedule deviates from the agreed-upon terms of the firm price sales arrangements), the Company may need to absorb the gains or losses associated with the commodity forward contracts on a temporary basis. Gains or losses associated with

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commodity forward contracts are reclassified to earnings/loss when earnings are impacted by the hedged transaction. Because we value most of our inventory under the LIFO costing methodology, the gains and/or losses associated with commodity forward contracts may not impact the same period that the firm price sales arrangements revenue is recognized, and comparisons of gross profit from period to period may be impacted.

We produce hundreds of grades of materials, with a wide range of pricing and profit levels depending on the grade. In addition, our product mix within a period is subject to the fluctuating order patterns of our customers as well as decisions we may make to participate in certain lower margin business in order to utilize available capacity. While we expect to see positive contribution from a more favorable product mix in our margin performance over time, the impact by period may fluctuate, and period-to-period comparisons may vary.

**Net Pension Expense**

Net pension expense, as we define it below, includes the net periodic benefit costs related to both our pension and other postretirement plans. The current quarter's results include non-cash net pension expense of \$15.2 million or \$0.21 per diluted share versus \$15.3 million or \$0.21 per diluted share in the same quarter last year. See the section "Non-GAAP Financial Measures" below for further discussions of these financial measures.

Net pension expense is recorded in accounts that are included in both the Cost of sales and Selling, general and administrative expenses lines of our statements of operations. The following is a summary of the classification of net pension expense included in our statements of operations for the three months ended September 30, 2010 and 2009:

| (\$ in millions)                             | Three Months Ended<br>September 30, |                |
|--|-------------------------------------|----------------|
|  | 2010                                | 2009           |
| Cost of sales                                | \$ 11.5                             | \$ 11.2        |
| Selling, general and administrative expenses | 3.7                                 | 4.1            |
| <b>Net pension expense</b>                   | <b>\$ 15.2</b>                      | <b>\$ 15.3</b> |

Net pension expense is determined annually based on beginning of year balances, and is recorded ratably throughout the fiscal year, unless a significant re-measurement event occurs. We currently expect that the total net pension expense for fiscal year 2011 will be \$60.8 million as compared with \$61.3 million recorded in fiscal year 2010.

| (\$ in millions)                         | Three Months Ended<br>September 30, |                |
|--|-------------------------------------|----------------|
|  | 2010                                | 2009           |
| Service cost                             | \$ 6.4                              | \$ 5.8         |
| Pension earnings, interest and deferrals | 8.8                                 | 9.5            |
| <b>Net pension expense</b>               | <b>\$ 15.2</b>                      | <b>\$ 15.3</b> |

The service cost component of net pension expense represents the estimated cost of future pension liabilities earned associated with active employees. The pension earnings, interest and deferrals expense is comprised of the expected return on plan assets, interest costs on the projected benefit obligations of the plans, and amortization of actuarial gains and losses and prior service costs.

**Table of Contents*****Operating Performance Overview***

For the quarter ended September 30, 2010, we reported net income of \$7.6 million, or \$0.17 per diluted share, compared with a loss for the same period a year earlier of \$9.3 million, or \$0.21 per diluted share.

Strong revenue and volume growth contributed to a significant increase in operating margin and profitability over the prior year. We also maintained a consistent operating margin compared to our recent fourth quarter on slightly lower, seasonally adjusted volumes, which was in line with our expectations. The increase in order activity is creating tight capacity and longer customer lead times. We are hiring and training employees to expand available production capacity and have increased inventories to meet this demand. We are also taking pricing actions and making mix management decisions to improve our profitability and create additional flex capacity for attractive incremental volume.

**Results of Operations Three Months Ended September 30, 2010 vs. Three Months Ended September 30, 2009****Net Sales**

Net sales for the three months ended September 30, 2010 were \$351.7 million, which was a 50 percent increase over the same period a year ago. Excluding surcharge revenue, sales increased 40 percent. Overall, pounds shipped were 39 percent higher than the first fiscal quarter a year ago. Demand in our key end markets continues to strengthen. In addition to ongoing strong demand for materials used in aerospace engines, we have seen a significant pick-up in our energy business. This includes increased demand for materials used in power generation and our expanded participation in oil and gas applications.

Geographically, sales outside the United States increased 53 percent from the same period a year ago to \$109.8 million. Net sales in Europe were up 42 percent on 36 percent higher volume driven mainly by significant broad based growth in most markets particularly in our key target markets aerospace and energy. Revenues increased 63 percent in Asia on 45 percent higher volume driven by significant broad based growth in most markets. International sales remained the same at 31 percent of total net sales for the quarter ended September 30, 2010 compared to the quarter ended September 30, 2009.

***Sales by End-Use Markets***

We sell to customers across diversified end-use markets. The table below includes comparative information for our estimated sales by end-use markets:

| (\$ in millions)       | Three Months Ended |                    | \$              | %          |
|------------------------|--------------------|--------------------|-----------------|------------|
|                        | September 30, 2010 | September 30, 2009 |                 |            |
| Aerospace              | \$ 146.1           | \$ 103.1           | \$ 43.0         | 42%        |
| Industrial             | 83.0               | 49.5               | 33.5            | 68         |
| Energy                 | 29.9               | 12.2               | 17.7            | 145        |
| Medical                | 28.7               | 26.0               | 2.7             | 10         |
| Consumer               | 33.7               | 23.3               | 10.4            | 45         |
| Automotive             | 30.3               | 19.6               | 10.7            | 55         |
| <b>Total net sales</b> | <b>\$ 351.7</b>    | <b>\$ 233.7</b>    | <b>\$ 118.0</b> | <b>50%</b> |

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The following table includes comparative information for our estimated net sales by the same principal end-use markets, but excluding surcharge revenue:

| (\$ in millions)                                    | Three Months Ended<br>September 30, |                 | \$<br>Increase | %<br>Increase |
|---|-------------------------------------|-----------------|----------------|---------------|
|   | 2010                                | 2009            |                |               |
| Aerospace   | \$ 107.6                            | \$ 81.3         | \$ 26.3        | 32%           |
| Industrial  | 60.1                                | 41.3            | 18.8           | 46            |
| Energy  | 24.3                                | 9.5             | 14.8           | 156           |
| Medical   | 24.8                                | 21.4            | 3.4            | 16            |
| Consumer  | 24.8                                | 18.2            | 6.6            | 36            |
| Automotive  | 22.1                                | 16.2            | 5.9            | 36            |
| <b>Total net sales excluding surcharge revenues</b> | <b>\$ 263.7</b>                     | <b>\$ 187.9</b> | <b>\$ 75.8</b> | <b>40%</b>    |

Sales to the aerospace market increased 42 percent from the first quarter a year ago to \$146.1 million. Excluding surcharge revenue, sales increased 32 percent from the first quarter a year ago on 29 percent higher shipment volume. Aerospace results reflect the fourth consecutive quarter of strong demand for engine components and the beginning stages of improved fastener order activity.

Industrial market sales increased 68 percent from the first quarter a year ago to \$83.0 million. Excluding surcharge revenue, sales increased approximately 46 percent on a 36 percent increase in shipment volume. The year-over-year result reflects increased overall demand for industrial products that outpaced general market growth rates. There was also a positive mix shift to higher value fittings and semiconductor applications.

Sales to the energy market of \$29.9 million reflected a 145 percent increase from the first quarter a year ago. Excluding surcharge revenue, sales increased 156 percent from a year ago on higher shipment volume of 149 percent. The year-over-year increase reflects sharply higher demand and expansion into new applications for materials used in the oil and gas sectors as well as recovering demand for high value materials used in industrial gas turbines.

Sales to the medical market increased 10 percent from a year ago to \$28.7 million. Excluding surcharge revenue, sales increased 16 percent on higher shipment volume of 9 percent. The year-over-year increase reflects increased demand and re-stocking of titanium products within the supply chain.

Sales to the consumer market increased 45 percent to \$33.7 million from a year ago. Excluding surcharge revenue, sales increased 36 percent, while shipment volume increased by 38 percent. Increases in volumes and revenues resulted from supply chain inventory restocking and demand growth from Asia for fasteners and electronic applications.

Automotive market sales increased 55 percent from the first quarter a year ago to \$30.3 million. Excluding surcharge revenue, sales increased 36 percent on 46 percent higher shipment volume. The year-over-year volume increase reflects demand growth related to fuel system components as well as strong shipments of lower value automotive valves.



**Table of Contents****Sales by Product Class**

The following table includes comparative information for our net sales by major product class:

| (\$ in millions)       | Three Months Ended<br>September 30, |                 | \$           | %          |
|------------------------|-------------------------------------|-----------------|--------------|------------|
|                        | 2010                                | 2009            | Increase     | Increase   |
| Special alloys         | \$ 180.8                            | \$ 120.8        | \$ 60.0      | 50%        |
| Stainless steels       | 119.2                               | 74.0            | 45.2         | 61         |
| Titanium products      | 34.0                                | 26.8            | 7.2          | 27         |
| Other materials        | 17.7                                | 12.1            | 5.6          | 46         |
| <b>Total net sales</b> | <b>\$ 351.7</b>                     | <b>\$ 233.7</b> | <b>118.0</b> | <b>50%</b> |

The following table includes comparative information for our net sales by the same major product class, but excluding surcharge revenue:

| (\$ in millions)                                    | Three Months Ended<br>September 30, |                 | \$             | %          |
|---|-------------------------------------|-----------------|----------------|------------|
|   | 2010                                | 2009            | Increase       | Increase   |
| Special alloys                                      | \$ 122.4                            | \$ 88.2         | \$ 34.2        | 39%        |
| Stainless steels                                    | 91.3                                | 61.0            | 30.3           | 50         |
| Titanium products                                   | 34.0                                | 26.8            | 7.2            | 27         |
| Other materials                                     | 16.0                                | 11.9            | 4.1            | 34         |
| <b>Total net sales excluding surcharge revenues</b> | <b>\$ 263.7</b>                     | <b>\$ 187.9</b> | <b>\$ 75.8</b> | <b>40%</b> |

Sales of special alloys products increased 50 percent from a year ago. Excluding surcharge revenue, sales increased 39 percent on a 41 percent increase in shipment volume. The sales increase principally reflects the increase in demand for special alloys used in the aerospace and energy markets.

Sales of stainless steels increased 61 percent from a year ago to \$119.2 million. Excluding surcharge revenue, sales increased 50 percent on 40 percent higher shipment volume. Stainless steels sales benefited from increased shipments of material used in the medical, automotive and consumer markets.

Sales of titanium products increased 27 percent from a year ago to \$34.0 million. Excluding surcharge revenue, sales increased 27 percent on 41 percent higher volume. The results reflect increased demand for titanium products used in the aerospace and medical end-use markets offset by the impact of lower titanium prices during the current quarter as compared with the prior year quarter.

**Gross Profit**

Our gross profit in the first quarter increased 159 percent to \$49.8 million, or 14.2 percent of net sales (18.9 percent of net sales excluding surcharges), as compared with \$19.2 million, or 8.2 percent of net sales (10.2 percent of net sales excluding surcharges), in the same quarter a year ago. The higher gross profit in this year's first quarter was driven by significantly higher volumes and better overall cost performance, partially offset by a slightly weaker product mix. The overall mix results are comprised of strong margins in our Premium Alloy Operations segment, more than offset by weaker mix in our Advanced Metals Operations segment as result of taking on increased volumes over the last year in lower value applications within automotive and other markets.



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Our surcharge mechanism is structured to recover increases in raw material costs, although generally with a lag effect. While the surcharge generally protects the absolute gross profit dollars, it does have a dilutive effect on gross margin as a percent of sales. The following represents a summary of the dilutive impact of the surcharges on gross margin for the comparative three-month periods. See the section **Non-GAAP Financial Measures** below for further discussion of these financial measures.

| (\$ in millions)                                     | Three Months Ended<br>September 30, |          |
|--|-------------------------------------|----------|
|  | 2010                                | 2009     |
| Net sales  | \$ 351.7                            | \$ 233.7 |
| Less: surcharge revenue                              | 88.0                                | 45.8     |
| Net sales excluding surcharges                       | \$ 263.7                            | \$ 187.9 |
| Gross profit   | \$ 49.8                             | \$ 19.2  |
| Gross margin   | 14.2%                               | 8.2%     |
| Gross margin excluding dilutive effect of surcharges | 18.9%                               | 10.2%    |

***Selling, General and Administrative Expenses***

Selling, general and administrative expenses of \$35.7 million were 10.2 percent of net sales (13.5 percent of net sales excluding surcharges) as compared with \$32.5 million or 13.9 percent of net sales (17.3 percent of net sales excluding surcharges) in the same quarter a year ago. The year-over-year increase is due to higher variable compensation accruals versus the prior period and increases associated with resources added to drive strategic growth initiatives.

***Operating Income (Loss)***

Our operating income in the first quarter increased to \$14.1 million as compared with a loss of \$13.3 million in the same quarter a year ago. Excluding surcharge revenue and pension earnings, interest and deferrals, operating margin was 8.7 percent for the quarter as compared with a negative 2.0 percent a year ago. There was little impact in the current quarter from LIFO effects.

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Operating income has been significantly impacted by our pension earnings, interest and deferrals ( pension EID ) expense, which may be volatile based on conditions in the financial markets. The following presents our operating income and operating margin, in each case excluding the impact of surcharges on net sales and excluding the impacts of pension EID expense from operating income. We present and discuss these financial measures because management believes removing the impact of volatile and non-recurring charges provides a more consistent and meaningful basis for comparing results of operations from period to period. See the section Non-GAAP Financial Measures below for further discussion of these financial measures.

| (\$ in millions)   | Three Months Ended<br>September 30, |                 |
|--|-------------------------------------|-----------------|
|  | 2010                                | 2009            |
| Net sales  | \$ 351.7                            | \$ 233.7        |
| Less: surcharge revenue  | 88.0                                | 45.8            |
| <b>Net sales excluding surcharges</b>                                | <b>\$ 263.7</b>                     | <b>\$ 187.9</b> |
| Operating income (loss)  | \$ 14.1                             | \$ (13.3)       |
| Add back: Pension EID expense  | 8.8                                 | 9.5             |
| Operating income (loss) excluding pension EID expense                | \$ 22.9                             | \$ (3.8)        |
| <b>Operating margin excluding surcharges and pension EID expense</b> | <b>8.7%</b>                         | <b>(2.0)%</b>   |

In addition to the impacts of the surcharge mechanism and pension EID expense, fluctuations in raw material prices (combined with fluctuations in inventory levels) and the lag effect of the surcharge mechanism have impacted our operating income (loss) from quarter to quarter. We estimate that the effect of such combined fluctuations negatively impacted operating margin by 80 basis points during the recent first quarter and also had a negative impact of 170 basis points on our operating margin during the prior year's first quarter.

**Interest Expense**

Interest expense for the quarter was \$4.2 million, as compared with \$4.3 million in the same quarter in the prior year. The decrease in interest expense is attributable to the reductions in outstanding debt related to prior year repayments offset by lower capitalized interest costs during fiscal year 2011.

**Other Income, Net**

Other income was \$1.6 million for the recent quarter compared with \$1.5 million in the first quarter a year ago.

**Income Taxes**

Income taxes in the recent first quarter were \$3.9 million, or 33.9 percent of pre-tax income versus a benefit of \$6.8 million, or 42.2 percent of pre-tax loss in the same quarter a year ago. The decrease in the effective tax rate for the three months ended September 30, 2010 is primarily due to the less dilutive impact that our permanent differences have had on our effective tax rate in the current year as a result of higher income levels in the current quarter as compared with a pre-tax loss a year ago.

**Table of Contents****Business Segment Results**

We have two reportable business segments: Advanced Metals Operations ( AMO ) and Premium Alloys Operations ( PAO ).

The following table includes comparative information for our net sales by business segment:

| (\$ in millions)           | Three Months Ended |          | \$                      | %                       |
|----------------------------|--------------------|----------|-------------------------|-------------------------|
|                            | September 30,      |          |                         |                         |
|                            | 2010               | 2009     | Increase/<br>(Decrease) | Increase/<br>(Decrease) |
| Advanced Metals Operations | \$ 246.6           | \$ 175.3 | \$ 71.3                 | 41%                     |
| Premium Alloys Operations  | 107.7              | 59.3     | 48.4                    | 82                      |
| Intersegment               | (2.6)              | (0.9)    | (1.7)                   | 189                     |
| Total net sales            | \$ 351.7           | \$ 233.7 | \$ 118.0                | 50%                     |

The following table includes comparative information for our net sales by business segment, but excluding surcharge revenue:

| (\$ in millions)                            | Three Months Ended |          | \$                      | %                       |
|---|--------------------|----------|-------------------------|-------------------------|
|   | September 30,      |          |                         |                         |
|   | 2010               | 2009     | Increase/<br>(Decrease) | Increase/<br>(Decrease) |
| Advanced Metals Operations                  | \$ 191.0           | \$ 145.7 | \$ 45.3                 | 31%                     |
| Premium Alloys Operations                   | 75.3               | 43.1     | 32.2                    | 75                      |
| Intersegment                                | (2.6)              | (0.9)    | (1.7)                   | 189                     |
| Total net sales excluding surcharge revenue | \$ 263.7           | \$ 187.9 | \$ 75.8                 | 40%                     |

**Advanced Metals Operations Segment**

Net sales for the quarter ended September 30, 2010 for the AMO segment increased 41 percent to \$246.6 million, as compared with \$175.3 million in the same quarter a year ago. Excluding surcharge revenue, net sales increased 31 percent on 30 percent higher shipment volume from a year ago. The results reflect increased shipment volume related to higher demand in the automotive, industrial and consumer markets.

Operating income for the AMO segment was \$8.6 million or 3.5 percent of net sales (4.5 percent of net sales excluding surcharge revenue) in the recent quarter, as compared with a loss of \$2.6 million or 1.5 percent of net sales (1.8 percent of net sales excluding surcharge revenue) in the same quarter a year ago. The increase in operating income reflects the impacts of the higher volumes offset by a weaker product mix resulting from growth within the lower value markets.

**Premium Alloys Operations Segment**

Net sales for the quarter ended September 30, 2010 for the PAO segment increased 82 percent to \$107.7 million, as compared with \$59.3 million in the same quarter a year ago. Excluding surcharge revenue, net sales increased 75 percent on 80 percent higher shipment volume from a year ago. The increase in net sales is due to strong demand in the aerospace and energy markets.

Operating income for the PAO segment was \$24.3 million or 22.6 percent of net sales (32.3 percent of net sales excluding surcharge revenue) in the recent quarter, compared with \$7.9 million or 13.3 percent of net sales (18.3 percent of net sales excluding surcharge revenue) in the same quarter a year ago. The increase in operating income reflects the impacts of the significantly higher volume particularly in high value applications used in the aerospace and energy markets.



**Table of Contents*****Liquidity and Financial Condition***

We have the ability to generate cash to meet our needs through cash flow from operations, management of working capital and the availability of outside sources of financing to supplement internally generated funds. We believe that our cash and cash equivalents and short-term marketable securities of approximately \$327 million as of September 30, 2010, together with cash generated from operations and available borrowing capacity of approximately \$196 million under our credit facilities, will be sufficient to fund our operating activities, planned capital expenditures, current maturities of long-term debt totaling \$100 million and other obligations for the foreseeable future.

Our strong balance sheet position allows us to fund growth initiatives, both organic and external, while maintaining an appropriately conservative financial structure given the inherent cyclicality of our industry. We reclassified the \$100 million notes that mature in August 2011 from long-term debt to current portion of long term debt on our consolidated balance sheet as of September 30, 2010. It is our intent to refinance that note upon maturity and we have begun to hedge the risk of rates rising between now and the refinancing date.

Our revolving credit facility expires November 2012 and contains a revolving credit commitment of \$200 million. As of September 30, 2010, we had \$3.8 million of issued letters of credit under the revolving credit facility. The balance of the revolving credit facility (\$196.2 million) remains available to us. The revolving credit facility contains financial covenants, including maintenance of an interest coverage ratio and a debt-to-capital ratio.

As of September 30, 2010, we were in compliance with all the covenants of the credit facility. The following table shows our actual ratio performance with respect to the financial covenants, as of September 30, 2010:

|                                | <b>Covenant Requirement</b> | <b>Actual Ratio</b> |
|--------------------------------|-----------------------------|---------------------|
| Consolidated interest coverage | 3.0 to 1.0 (minimum)        | 9.5 to 1.0          |
| Consolidated debt to capital   | 55% (maximum)               | 30%                 |

During the three months ended September 30, 2010, our free cash flow, which we define under Non-GAAP Financial Measures below, was negative \$46.5 million as compared to \$17.8 million for the same period a year ago. The free cash flow in the three months ended September 30, 2010 principally reflects the impacts of investment in increased inventory levels to support growing customer demand.

Capital expenditures for plant, equipment and software were \$8.1 million for the three months ended September 30, 2010, as compared with \$11.3 million for the same period a year ago. We expect to finish the fiscal year with about \$70 million of capital expenditures.

Dividends during the three months ended September 30, 2010 and 2009 were \$8.0 million, and were paid at the same quarterly rate of \$0.18 per share of common stock in both periods.

**Table of Contents*****Non-GAAP Financial Measures***

The following provides additional information regarding certain non-GAAP financial measures that we use in this report. Our definitions and calculations of these items may not necessarily be the same as those used by other companies.

***Net Pension Expense Per Diluted Share***

| (\$ in millions, except per share data)    | Three Months<br>Ended<br>September 30, |         |
|--|--|---------|
|  | 2010                                   | 2009    |
| Pension plans expense                      | \$ 13.5                                | \$ 13.5 |
| Other postretirement benefit plans expense | 1.7                                    | 1.8     |
|  | 15.2                                   | 15.3    |
| Income tax benefit                         | (5.7)                                  | (6.1)   |
| Net pension expense                        | \$ 9.5                                 | \$ 9.2  |
| Weighted average diluted common shares     | 44.5                                   | 43.9    |
| Net pension expense per diluted share      | \$ 0.21                                | \$ 0.21 |

Management believes that net pension expense per diluted share is helpful in analyzing the operational performance of the Company from period to period.

***Net Sales and Gross Margin Excluding Surcharges***

This report includes discussions of net sales and gross margin as adjusted to exclude the impact of raw material surcharges, which represent financial measures that have not been determined in accordance with U.S. GAAP. We present and discuss these financial measures because management believes removing the impact of raw material surcharges from net sales and gross margin provides a more consistent basis for comparing results of operations from period to period for the reasons discussed earlier in this report. See our earlier discussion of gross profit for a reconciliation of net sales and gross margin excluding surcharges to net sales as determined in accordance with U.S. GAAP.

***Operating Income and Operating Margin Excluding Surcharges and Pension EID Expense***

This report includes discussions of operating income and operating margin as adjusted to exclude the impact of raw material surcharges and pension EID expense, which represent financial measures that have not been determined in accordance with U.S. GAAP. We present and discuss these financial measures because management believes removing the impact of raw material surcharges from net sales provides a more consistent and meaningful basis for comparing results of operations from period to period for the reasons discussed earlier in this report. In addition, management believes that excluding pension earnings, interest and deferrals expense from operating income and operating margin is helpful in analyzing our operating performance particularly as pension EID expense may be volatile due to changes in the financial markets. See our earlier discussion of operating income for a reconciliation of operating income and operating margin excluding pension EID expense to operating income and operating margin determined in accordance with U.S. GAAP.



**Table of Contents***Free Cash Flow*

The following provides a reconciliation of free cash flow, as used in this report, to its most directly comparable U.S. GAAP financial measures:

| (\$ in millions)                                       | Three Months Ended |                       |
|--|--------------------|-----------------------|
|  | 2010               | September 30,<br>2009 |
| Net cash (used for) provided from operating activities | \$ (30.5)          | \$ 36.2               |
| Purchases of property, equipment, and software         | (8.1)              | (11.3)                |
| Proceeds from disposals of property and equipment      | 0.1                | 0.9                   |
| Dividends paid   | (8.0)              | (8.0)                 |
| <b>Free cash flow</b>                                  | <b>\$ (46.5)</b>   | <b>\$ 17.8</b>        |

Management believes that the presentation of free cash flow provides useful information to investors regarding our financial condition because it is a measure of cash generated which management evaluates for alternative uses. It is management's current intention to use excess cash to fund investments in capital equipment, acquisition opportunities and consistent dividend payments. Free cash flow is not a U.S. GAAP financial measure and should not be considered in isolation of, or as a substitute for, cash flows calculated in accordance with U.S. GAAP.

***Contingencies****Environmental*

We are subject to various federal, state, local and international environmental laws and regulations relating to pollution, protection of public health and the environment, natural resource damages and occupational safety and health. Although compliance with these laws and regulations may affect the costs of our operations, compliance costs to date have not been material. We have environmental remediation liabilities at some of our owned operating facilities and have been designated as a potentially responsible party ( PRP ) with respect to certain third-party Superfund waste disposal sites and other third party owned sites. Additionally, we have been notified that we may be a PRP with respect to other Superfund sites as to which no proceedings have been instituted against us. Neither the exact amount of remediation costs nor the final method of their allocation among all designated PRP's at these Superfund sites has been determined. The liability for future environmental remediation costs is evaluated on a quarterly basis. We accrue amounts for environmental remediation costs that represent our best estimate of the probable and reasonably estimable costs related to environmental remediation. During the three months ended September 30, 2010, no additional accruals were recorded. The liabilities recorded for environmental remediation costs at Superfund sites, at other third party-owned sites and at Company-owned current or former operating facilities were \$4.9 million at September 30, 2010 and June 30, 2010.

Estimates of the amount and timing of future costs of environmental remediation requirements are inherently imprecise because of the continuing evolution of environmental laws and regulatory requirements, the availability and application of technology, the identification of currently unknown remediation sites and the allocation of costs among the PRP's. Based upon information currently available, such future costs are not expected to have a material effect on our financial position, results of operations or cash flows. However, such costs could be material to our financial position, results of operations or cash flows in a particular future quarter or year.

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### *Boarhead Farms*

In June 2002, we were named as a defendant in a lawsuit filed by a group of plaintiffs in the District Court for the Eastern District of Pennsylvania titled Boarhead Farm Agreement Group v. Advanced Environmental Technology Corporation et al. (since amended to include the individual members). The suit alleges that we and the other named defendants contributed to damages caused at Boarhead Farms, a Superfund site located in Bridgeton, Pennsylvania. The Boarhead Farms site was the home of a now defunct chemical and waste hauling company that we engaged to dispose of certain wastes during the 1970 s. The plaintiff group was individually named as PRP s for the Boarhead site in the EPA s Record of Decision in November 1998. Their suit, in June of 2002, against various defendants, including Carpenter, sought contributions for a portion of costs incurred for various site cleanup activities as well as contributions to future cleanup efforts. The suit went to trial in June 2008. Prior to trial, all of the named co-defendants, except for Carpenter, reached an out of court settlement with the plaintiffs. We denied the claims made by the plaintiff group. On August 18, 2008, the Court awarded the plaintiffs judgment against us for 80 percent of the plaintiffs past costs of remediating the site, including prejudgment interest from June 18, 2002 to January 1, 2008, and held us liable for 80 percent of future costs of the cleanup activities at the site. We appealed the Court s decision and oral arguments took place before the United States Court of Appeals for the Third Circuit on December 17, 2009. On April 12, 2010, the Court of Appeals for the Third Circuit vacated the previous judgment by the District Court and remanded the case for further proceedings. We intend to continue to defend against the claims in this case, but are unable to predict the outcome of the proceedings at this time. As of September 30, 2010 and June 30, 2010, we recorded a liability related to this case of \$21.8 million.

### *Duty Drawback*

Historically, we have participated in a program offered by U.S. Customs and Border Protection ( U.S. Customs ) known as duty drawback. Under the program, we claimed a refund of import duties on items manufactured and exported to customers in foreign countries. Certain vendors prepared certificates authorizing us to claim duty drawback refunds against imported goods purportedly shipped by the vendor to us. Because of the complexity of the program, we engaged a licensed U.S. customs broker specializing in duty drawback claims. The customs broker was responsible for performing the administration of the process which included maintaining and collecting various forms of supporting evidence for each claim including collecting appropriate certificates from vendors, as well as preparing and submitting the refund claims.

In fiscal year 2008, we received notice from U.S. Customs that we were under investigation related to claims previously filed by the customs broker on our behalf. The investigation alleged certain discrepancies and a lack of supporting documentation for the claims that had been filed by the broker. We initiated an internal review of the claims filed with U.S. Customs to determine the extent of claims that may have inadequate supporting documentation and we also engaged a new licensed U.S. customs broker. We have cooperated fully with U.S. Customs investigation of this matter. As of the date of this filing, our internal review remains ongoing due to the extensive amount of documentation that must be compiled and reviewed.

During the period our customs broker was filing claims on our behalf, July 2003 through December 2006, we applied for and received refund claims totaling \$6.9 million. While the ultimate outcome of the U.S. Customs investigation and our internal review is not yet known, based on current facts we believe that the net remaining reserve recorded as of September 30, 2010 of \$2.5 million is a reasonable estimate of the probable loss that will result from the investigation. We do not expect that any additional material liabilities will be incurred.

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### *Export Regulations*

In fiscal year 2008, we became aware of potential violations of federal export regulations at a business unit that has since been divested. Upon investigation, we discovered that approximately 40 foreign nationals employed over time at the business unit's facility may have been exposed to protected technical data related to the production of various products for military applications. An export license from the Department of State and the Department of Commerce is required prior to the exporting of technical data for military applications. We have applied for and received similar applications for other business units, but did not have such a license for the divested business unit. Violations of federal export regulations can be subject to civil penalties depending upon the severity of the violation. We filed voluntary disclosures with the Department of State and the Department of Commerce before the divestiture of the business unit on March 31, 2008. The Department of State responded to the voluntary disclosure without assessing civil penalties. The Department of Commerce has not yet responded to the voluntary disclosure. It is not possible to determine the amount, if any, of civil penalties that may be assessed by the Department of Commerce. As a result, we have not recorded any liability for potential penalties as of September 30, 2010.

### *Other*

We are defending various routine claims and legal actions that are incidental to our business, and we are subject to contingencies that are common to our operations, including those pertaining to product claims, commercial disputes, employment actions, employee benefits, compliance with domestic and foreign laws, personal injury claims and tax issues. We provide for costs relating to these matters when a loss is probable and the amount of the loss is reasonably estimable. The effect of the outcome of these matters on our future results of operations and liquidity cannot be predicted because any such effect depends on future results of operations and the amount and timing (both as to recording future charges to operations and cash expenditures) of the resolution of such matters. While it is not feasible to determine the outcome of these matters, we believe that the total liability from these matters will not have a material effect on our financial position, results of operations or cash flows over the long-term. However, there can be no assurance that an increase in the scope of pending matters, or that any future lawsuits, claims, proceedings or investigations, will not be material to our financial position, results of operations or cash flows in a particular future quarter or year.

### *Critical Accounting Policies and Estimates*

#### *Inventories*

Inventories are stated at the lower of cost or market. The cost of inventories is primarily determined using the LIFO method. Costs include direct materials, direct labor and applicable manufacturing overhead, and other direct costs. Under the LIFO inventory valuation method, changes in the cost of raw materials and production activities are recognized in cost of sales in the current period even though these materials and other costs may have been incurred at significantly different values due to the length of time of our production cycle. The prices for many of the raw materials we use have been volatile. Because we value most of our inventory utilizing the LIFO inventory costing methodology, rapid changes in raw material costs have an impact on our operating results. In a period of rising prices, cost of sales expense recognized under LIFO is generally higher than the cash costs incurred to acquire the inventory sold. Conversely, in a period of declining raw material prices, cost of sales recognized under LIFO is generally lower than cash costs incurred to acquire the inventory sold.

Since the LIFO inventory valuation methodology is designed for annual determination, interim estimates of the annual LIFO valuation are required. We recognize the effects of the LIFO inventory valuation method on an interim basis by estimating the expected annual LIFO cost based on cost increases or decreases to date. These projections of annual LIFO inventory valuation reserve changes are updated quarterly and are evaluated based upon material, labor and overhead costs.

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***Other Critical Accounting Policies and Estimates***

A summary of other significant accounting policies is discussed in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations and in Note 1, Summary of Significant Accounting Policies, of Notes to Consolidated Financial Statements, included in Part II, Item 8 of our Annual Report on Form 10-K for the year ended June 30, 2010.

***Forward-Looking Statements***

This Quarterly Report on Form 10-Q contains various Forward-looking Statements pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements, which represent our expectations or beliefs concerning various future events, include statements concerning future revenues, earnings and liquidity associated with continued growth in various market segments and cost reductions expected from various initiatives. These forward-looking statements are subject to risks and uncertainties that could cause actual results to differ from those projected, anticipated or implied. The most significant of these uncertainties are described in our annual report on Form 10-K for the year ended June 30, 2010. They include but are not limited to: (1) the cyclical nature of the specialty materials business and certain end-use markets, including aerospace, industrial, automotive, consumer, medical, and energy, or other influences on our business such as new competitors, the consolidation of competitors, customers, and suppliers or the transfer of manufacturing capacity from the United States to foreign countries; (2) our ability to achieve cost savings, productivity improvements or process changes; (3) the volatility of, and our ability to recoup increases in, the cost of energy, raw materials, freight or other factors; (4) domestic and foreign excess manufacturing capacity for certain metals; (5) fluctuations in currency exchange rates; (6) the degree of success of government trade actions; (7) the valuation of the assets and liabilities in our pension trusts and the accounting for pension plans; (8) possible labor disputes or work stoppages; (9) the potential that our customers may substitute alternate materials or adopt different manufacturing practices that replace or limit the suitability of our products; (10) the ability to successfully acquire and integrate acquisitions; (11) the availability of credit facilities to us, our customers or other members of the supply chain; (12) the ability to obtain energy or raw materials, especially from suppliers located in countries that may be subject to unstable political or economic conditions; (13) our manufacturing processes are dependent upon highly specialized equipment located primarily in one facility in Reading, Pennsylvania and for which there may be limited alternatives if there are significant equipment failures or catastrophic events; and (14) our future success depends on the continued service and availability of key personnel, including members of our executive management team, metallurgists and other skilled personnel and the loss of these key personnel could affect our ability to perform until suitable replacements are found. The forward-looking statements in this document are intended to be subject to the safe harbor protection provided by Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We undertake no obligation to update or revise any forward-looking statements.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We use derivative financial instruments to reduce certain types of financial risk. Firm price sales arrangements involve a risk of profit margin fluctuations particularly as raw material prices have been volatile. As discussed in Note 11 to the consolidated financial statements included in Part I, Item 1, Financial Statements, in order to reduce the risk of fluctuating profit margins on these sales, we enter into commodity forward contracts to purchase certain critical raw materials necessary to produce the products sold under the firm price sales arrangements. If a customer fails to perform its obligations under the firm price sales arrangements, we may realize losses as a result of the related commodity forward contracts. These customers have historically performed under these arrangements and we believe that they will honor such obligations in the future.

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We are actively involved in managing risks associated with energy resources. Risk containment strategies include interaction with primary and secondary energy suppliers as well as obtaining adequate insurance coverage to compensate us for potential business interruption related to lack of availability of energy resources. In addition, we have used forwards and options to fix the price of a portion of our anticipated future purchases of certain energy requirements to protect against the impact of significant increases in energy costs. We also use surcharge mechanisms to offset a portion of these charges where appropriate.

Fluctuations in foreign currency exchange rates could subject us to risk of losses on anticipated future cash flows from our international operations or customers. Foreign currency forward contracts are used to hedge certain foreign exchange risk.

We have used interest rate swaps to achieve a level of floating rate debt relative to fixed rate debt where appropriate.

All hedging strategies are reviewed and approved by senior financial management before being implemented. Senior financial management has established policies regarding the use of derivative instruments that prohibit the use of speculative or leveraged derivatives. Market valuations are performed at least quarterly to monitor the effectiveness of our risk management programs.

Our pension plan assets are invested in different asset classes including large-, mid- and small-cap growth and value funds, index and international equity funds, short-term and medium-term duration fixed-income funds and high yield funds. The plan's current allocation policy is to invest approximately 60 percent of plan assets in U.S. and international equities and 40 percent of plan assets in fixed income securities.

The status of our financial instruments as of September 30, 2010 is provided in Note 10 to the consolidated financial statements included in Part I, Item 1, Financial Statements, of this Quarterly Report on Form 10-Q. Assuming on September 30, 2010, (a) an instantaneous 10 percent decrease in the price of raw materials and energy for which we have commodity forward contracts, and (b) a 10 percent strengthening of the U.S. dollar versus foreign currencies for which foreign exchange forward contracts existed, our results of operations would not have been materially affected in either scenario.

**Item 4. Controls and Procedures**

***(a) Evaluation of Effectiveness of Disclosure Controls and Procedures***

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the Company's disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended, (the Exchange Act) as of September 30, 2010. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures as of September 30, 2010 were effective in providing a reasonable level of assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods required under the Securities and Exchange Commission's rules and forms, including a reasonable level of assurance that information required to be disclosed by us in such reports is accumulated and communicated to the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

***(b) Changes in Internal Control Over Financial Reporting***

There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2010 that have materially affected, or are likely to materially affect, the Company's internal control over financial reporting.

**Table of Contents****PART II OTHER INFORMATION****Item 1. Legal Proceedings**

Pending legal proceedings involve ordinary routine litigation incidental to our business, which we do not believe would have a material adverse effect on our business regardless of their outcome.

**Item 1A. Risk Factors**

We have evaluated the risks associated with our business and operations and determined that those risk factors included in Part 1, Item 1A of our Annual Report on Form 10-K adequately disclose the material risks that we face.

**Item 6. Exhibits**

| Exhibit No.   | Description  |
|---------------|--|
| <b>10 (A)</b> | Amended and Restated Carpenter Technology Corporation Change in Control Severance Plan, incorporated herein by reference to Exhibit 10.1 of Carpenter's Current Report on Form 8-K filed on September 3, 2010.   |
| <b>10 (B)</b> | Form of Restricted Unit Award Agreement (pursuant to Carpenter's Stock-Based Incentive Plan for Officers and Key Employees) is attached as an Exhibit to this Quarterly Report on Form 10-Q.   |
| <b>10 (C)</b> | Employment Letter Agreement of David Strobel, dated September 2, 2010, is attached as an Exhibit to this Quarterly Report on Form 10-Q.  |
| <b>10 (D)</b> | Employment Agreement of Michael L. Shor, dated September 2, 2010, is attached as an Exhibit to this Quarterly Report on Form 10-Q.   |
| <b>10 (E)</b> | Agreement, dated September 2, 2010, by and between the Company and Dr. Sunil Y. Widge, is attached as an Exhibit to this Quarterly Report on Form 10-Q.  |
| <b>10 (F)</b> | Employment Letter of Agreement of James Dee, dated August 13, 2010, is attached as an Exhibit to this Quarterly Report on Form 10-Q.   |
| <b>10 (G)</b> | Form of Indemnification Agreement, entered into between Carpenter and each of the directors and the following executive officers: William A. Wulfsohn, K. Douglas Ralph, David L. Strobel, Sunil Y. Widge and James D. Dee, is incorporated herein by reference to Exhibit 10 (J) of Carpenter's 2005 Annual Report on Form 10-K filed September 9, 2005.  |
| <b>31 (A)</b> | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended. (filed herewith)  |
| <b>31 (B)</b> | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended. (filed herewith)  |
| <b>32</b>     | Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (filed herewith)  |
| <b>101</b>    | The following financial information from this Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2010, formatted in XBRL (Extensible Business Reporting Language) and furnished electronically herewith: (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Operations; (iii) the Consolidated Statements of Comprehensive Income; (iv) the Consolidated Statements of Cash Flows; and (v) the Notes to the Consolidated Financial Statements, tagged as blocks of text. |



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**SIGNATURE**

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

**Carpenter Technology Corporation**

(Registrant)

Date: November 5, 2010

/s/ K. DOUGLAS RALPH  
**K. Douglas Ralph**  
**Senior Vice President**  
**and Chief Financial Officer**