

CPI INTERNATIONAL, INC.
Form 10-Q
May 13, 2009
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE
COMMISSION
Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended April 3, 2009

or

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

For the transition period from _____ to _____

Commission file number: 000-51928

CPI INTERNATIONAL, INC.
(Exact Name of Registrant as Specified in Its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization) 75-3142681 (I.R.S. Employer Identification No.)

811 Hansen Way, Palo Alto, California 94303
(Address of Principal Executive Offices and Zip Code)
(650) 846-2900

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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

Edgar Filing: CPI INTERNATIONAL, INC. - Form 10-Q

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 definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

| | | |
|-------------------------|-------------------------------------|-------------------|
| Large accelerated filer | <input type="checkbox"/> | Accelerated |
| filer | <input checked="" type="checkbox"/> | |
| Non-accelerated filer | <input type="checkbox"/> | Smaller reporting |
| company | <input type="checkbox"/> | |

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding for each of the registrant's classes of Common Stock, as of the latest practicable date: 16,517,206 shares of Common Stock, \$0.01 par value, at May 5, 2009.

CPI INTERNATIONAL, INC.
and Subsidiaries

10-Q REPORT
INDEX

| | | |
|-----------------|--|----|
| <u>Part</u> | <u>FINANCIAL INFORMATION</u> | 4 |
| <u>I:</u> | | |
| <u>Item 1.</u> | <u>Unaudited Condensed Consolidated Financial Statements</u> | 4 |
| | <u>Condensed Consolidated Balance Sheets</u> | 4 |
| | <u>Condensed Consolidated Statements of Operations and Comprehensive Income</u> | 5 |
| | <u>Condensed Consolidated Statements of Cash Flows</u> | 6 |
| | <u>Notes to Unaudited Condensed Consolidated Financial Statements</u> | 7 |
| <u>Item 2.</u> | <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u> | 42 |
| <u>Item 3.</u> | <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 65 |
| <u>Item 4.</u> | <u>Controls and Procedures</u> | 66 |
| <u>Part</u> | <u>OTHER INFORMATION</u> | 67 |
| <u>II:</u> | | |
| <u>Item 1.</u> | <u>Legal Proceedings</u> | 67 |
| <u>Item 1A.</u> | <u>Risk Factors</u> | 67 |
| <u>Item 2.</u> | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 67 |
| <u>Item 3.</u> | <u>Defaults Upon Senior Securities</u> | 67 |
| <u>Item 4.</u> | <u>Submission of Matters to a Vote of Security Holders</u> | 67 |
| <u>Item 5.</u> | <u>Other Information</u> | 68 |
| <u>Item 6.</u> | <u>Exhibits</u> | 69 |

CPI INTERNATIONAL, INC.
and Subsidiaries

Cautionary Statements Regarding Forward-Looking Statements

This document contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, that relate to future events or our future financial performance. In some cases, readers can identify forward-looking statements by terminology such as “may,” “will,” “should,” “expect,” “plan,” “anticipate,” “believe,” “estimate,” “predict,” “potential” or “continue,” the negative or other comparable terminology. These statements are only predictions. Actual events or results may differ materially.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we nor any other person assumes responsibility for the accuracy and completeness of the forward-looking statements. Forward-looking statements are subject to known and unknown risks and uncertainties, which could cause actual results to differ materially from the results projected, expected or implied by the forward-looking statements. These risk factors include, without limitation, competition in our end markets; the impact of a general slowdown in the global economy; our significant amount of debt; changes or reductions in the United States defense budget; currency fluctuations; goodwill impairment considerations; customer cancellations of sales contracts; U.S. Government contracts laws and regulations; changes in technology; the impact of unexpected costs; the impact of environmental laws and regulations; and inability to obtain raw materials and components. All written and oral forward-looking statements made in connection with this report that are attributable to us or persons acting on our behalf are expressly qualified in their entirety by the foregoing risk factors and other cautionary statements included herein and in our other filings with the Securities and Exchange Commission (“SEC”). We are under no duty to update any of the forward-looking statements after the date of this report to conform such statements to actual results or to changes in our expectations.

The information in this report is not a complete description of our business or the risks and uncertainties associated with an investment in our securities. You should carefully consider the various risks and uncertainties that impact our business and the other information in this report and in our other filings with the SEC before you decide to invest in our securities or to maintain or increase your investment.

- 3 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

Part I: FINANCIAL INFORMATION

Item 1. Unaudited Condensed Consolidated Financial Statements

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data – unaudited)

| | April 3, 2009 | October 3, 2008 |
|--|-------------------|--------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 27,863 | \$ 28,670 |
| Restricted cash | 1,101 | 776 |
| Accounts receivable, net | 41,882 | 47,348 |
| Inventories | 68,321 | 65,488 |
| Deferred tax assets | 13,146 | 11,411 |
| Prepaid and other current assets | 3,808 | 3,823 |
| Total current assets | 156,121 | 157,516 |
| Property, plant, and equipment, net | 60,346 | 62,487 |
| Deferred debt issue costs, net | 4,321 | 4,994 |
| Intangible assets, net | 77,024 | 78,534 |
| Goodwill | 162,293 | 162,611 |
| Other long-term assets | 3,651 | 806 |
| Total assets | \$ 463,756 | \$ 466,948 |
| Liabilities and stockholders' equity | | |
| Current liabilities: | | |
| Current portion of long-term debt | \$ - | \$ 1,000 |
| Accounts payable | 21,065 | 21,109 |
| Accrued expenses | 21,924 | 23,044 |
| Product warranty | 3,981 | 4,159 |
| Income taxes payable | 3,612 | 7,766 |
| Advance payments from customers | 12,898 | 12,335 |
| Total current liabilities | 63,480 | 69,413 |
| Deferred income taxes | 26,508 | 27,321 |
| Long-term debt, less current portion | 217,916 | 224,660 |
| Other long-term liabilities | 1,897 | 1,689 |
| Total liabilities | 309,801 | 323,083 |
| Commitments and contingencies | | |
| Stockholders' equity | | |
| Common stock (\$0.01 par value, 90,000 shares authorized; 16,723 and 16,538 shares issued; 16,517 and 16,332 shares outstanding) | 167 | 165 |

Edgar Filing: CPI INTERNATIONAL, INC. - Form 10-Q

| | | |
|--|------------|------------|
| Additional paid-in capital | 73,824 | 71,818 |
| Accumulated other comprehensive loss | (5,071) | (1,809) |
| Retained earnings | 87,835 | 76,491 |
| Treasury stock, at cost (206 shares) | (2,800) | (2,800) |
| Total stockholders' equity | 153,955 | 143,865 |
| Total liabilities and stockholders' equity | \$ 463,756 | \$ 466,948 |

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

- 4 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

CONDENSED CONSOLIDATED
STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
(In thousands, except per share data – unaudited)

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|-------------------|------------------|-------------------|
| | April 3, 2009 | March 28, 2008 | April 3, 2009 | March 28, 2008 |
| Sales | \$ 81,903 | \$ 94,804 | \$ 159,049 | \$ 180,714 |
| Cost of sales | 60,137 | 66,738 | 117,367 | 128,512 |
| Gross profit | 21,766 | 28,066 | 41,682 | 52,202 |
| Operating costs and expenses: | | | | |
| Research and development | 3,157 | 2,930 | 5,340 | 5,654 |
| Selling and marketing | 4,801 | 5,328 | 9,790 | 10,500 |
| General and administrative | 5,196 | 5,492 | 10,400 | 11,645 |
| Amortization of acquisition-related intangible assets | 691 | 781 | 1,385 | 1,562 |
| Net loss on disposition of fixed assets | 44 | 41 | 64 | 75 |
| Total operating costs and expenses | 13,889 | 14,572 | 26,979 | 29,436 |
| Operating income | 7,877 | 13,494 | 14,703 | 22,766 |
| Interest expense, net | 4,306 | 4,805 | 8,761 | 9,617 |
| (Gain) loss on debt extinguishment | (197) | 393 | (197) | 393 |
| Income before income taxes | 3,768 | 8,296 | 6,139 | 12,756 |
| Income tax expense (benefit) | 79 | 2,142 | (5,205) | 4,092 |
| Net income | \$ 3,689 | \$ 6,154 | \$ 11,344 | \$ 8,664 |
| Other comprehensive income, net of tax | | | | |
| Net unrealized gain (loss) on cash flow hedges and other comprehensive income | 617 | (2,001) | (3,262) | (3,202) |
| Comprehensive income | \$ 4,306 | \$ 4,153 | \$ 8,082 | \$ 5,462 |
| Earnings per share - Basic | \$ 0.23 | \$ 0.38 | \$ 0.70 | \$ 0.53 |
| Earnings per share - Diluted | \$ 0.21 | \$ 0.35 | \$ 0.65 | \$ 0.49 |
| Shares used to compute earnings per share - Basic | 16,317 | 16,387 | 16,293 | 16,379 |
| Shares used to compute earnings per share - Diluted | 17,319 | 17,656 | 17,353 | 17,744 |

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

- 5 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands – unaudited)

| | Six Months Ended | |
|--|------------------|-----------|
| | April 3, | March |
| | 2009 | 2008 |
| Cash flows from operating activities | | |
| Net cash provided by operating activities | \$ 7,865 | \$ 10,439 |
| Cash flows from investing activities | | |
| Capital expenditures | (1,818) | (2,558) |
| Proceeds from adjustment to acquisition purchase price | - | 1,615 |
| Payment of patent application fees | - | (147) |
| Net cash used in investing activities | (1,818) | (1,090) |
| Cash flows from financing activities | | |
| Repayments of debt | (7,495) | (10,000) |
| Proceeds from issuance of common stock to employees | 605 | 418 |
| Proceeds from exercise of | 36 | - |

| | | |
|---|-----------|-----------|
| stock options | | |
| Net cash used in financing activities | (6,854) | (9,582) |
| Net decrease in cash and cash equivalents | (807) | (233) |
| Cash and cash equivalents at beginning of period | 28,670 | 20,474 |
| Cash and cash equivalents at end of period | \$ 27,863 | \$ 20,241 |
| Supplemental cash flow disclosures | | |
| Cash paid for interest | \$ 8,323 | \$ 8,293 |
| Cash paid for income taxes, net of refunds | \$ 2,270 | \$ 8,722 |

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

- 6 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(All tabular dollar amounts in thousands except share and per share amounts)

1. The Company and a Summary of its Significant Accounting Policies

The Company

Unless the context otherwise requires, “CPI International” means CPI International, Inc., and “CPI” means Communications & Power Industries, Inc. CPI is a direct subsidiary of CPI International. CPI International is a holding company with no operations of its own. The term “the Company” refers to CPI International and its direct and indirect subsidiaries on a consolidated basis.

The accompanying consolidated financial statements represent the consolidated results and financial position of CPI International, which is controlled by affiliates of The Cypress Group L.L.C. (“Cypress”). CPI International, through its wholly owned subsidiary, CPI, develops, manufactures and distributes microwave and power grid Vacuum Electron Devices (“VEDs”), microwave amplifiers, modulators, antenna systems and various other power supply equipment and devices. The Company has two reportable segments, VED and satcom equipment.

Basis of Presentation and Consolidation

The Company’s fiscal year is the 52- or 53-week period that ends on the Friday nearest September 30. Fiscal year 2009 comprises the 52-week period ending October 2, 2009 and fiscal year 2008 comprised the 53-week period ending October 3, 2008. The second quarters of fiscal years 2009 and 2008 both include 13 weeks. The first two quarters of fiscal years 2009 and 2008 both include 26 weeks. All period references are to the Company’s fiscal periods unless otherwise indicated.

The accompanying unaudited condensed consolidated financial statements of the Company as of April 3, 2009 and for the three and six months ended April 3, 2009 are unaudited and reflect all normal recurring adjustments which are, in the opinion of management, necessary for the fair presentation of such financial statements. These unaudited condensed consolidated financial statements should be read in conjunction with the Company’s consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended October 3, 2008. The condensed consolidated balance sheet as of October 3, 2008 has been derived from the audited financial statements at that date. The results of operations for the interim period ended April 3, 2009 are not necessarily indicative of results to be expected for the full year.

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances, transactions and stockholdings have been eliminated in consolidation.

Foreign Currency Translation

The functional currency of the Company’s foreign subsidiaries is the U.S. dollar. Gains or losses resulting from the translation into U.S. dollars of amounts denominated in foreign currencies are included in the determination of net income or loss. Foreign currency translation gains and losses are generally reported on a net basis in the caption “general and administrative” in the condensed consolidated statements of operations and comprehensive income, except

for translation gains or losses on income tax-related assets and liabilities, which are reported in “income tax expense (benefit)” in the condensed consolidated statements of operations and comprehensive income.

- 7 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

Use of Estimates and Assumptions

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of sales and costs and expenses during the reporting period. On an ongoing basis, the Company evaluates its estimates, including those related to provision for revenue recognition; inventory and inventory reserves; product warranty; business combinations; recoverability and valuation of recorded amounts of long-lived assets and identifiable intangible assets, including goodwill; recognition of share-based compensation; and recognition and measurement of current and deferred income tax assets and liabilities. The Company bases its estimates on various factors and information, which may include, but are not limited to, history and prior experience, experience of other enterprises in the same industry, new related events, current economic conditions and information from third-party professionals that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Revenue Recognition

Sales are recognized when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed or determinable, and collectibility is reasonably assured. The Company's products are generally subject to warranties, and the Company provides for the estimated future costs of repair, replacement or customer accommodation in cost of sales.

The Company has commercial and U.S. Government fixed-price contracts that are accounted for under American Institute of Certified Public Accountants Statement of Position No. 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts." These contracts are generally greater than one year in duration and include a significant amount of product development. The Company uses the percentage-of-completion method when reasonably dependable estimates of the extent of progress toward completion, contract revenues and contract costs can be made. The portion of revenue earned or the amount of gross profit earned for a period is determined by measuring the extent of progress toward completion using total cost incurred to date and estimated costs at contract completion.

Sales under cost-reimbursement contracts, which are primarily for research and development, are recorded as costs are incurred and include estimated earned fees in the proportion that costs incurred to date bear to total estimated costs. The fees under certain commercial and U.S. Government contracts may be increased or decreased in accordance with cost or performance incentive provisions that measure actual performance against established targets or other criteria. Such incentive fee awards or penalties are included in revenue at the time the amounts can be reasonably determined.

Revenue is recorded net of taxes collected from customers that are remitted to governmental authorities, with the collected taxes recorded as current liabilities until remitted to the relevant government authority.

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

2. Recently Issued Accounting Standards

In September 2006, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards (“SFAS”) No. 157, “Fair Value Measurements,” which defines fair value, establishes a framework for measuring fair value under other accounting pronouncements that permit or require fair value measurements, changes the methods used to measure fair value and expands disclosures about fair value measurements. In particular, disclosures are required to provide information on: the extent to which fair value is used to measure assets and liabilities; the inputs used to develop measurements; and the effect of certain of the measurements on earnings (or changes in net assets). SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. In February 2008, the FASB issued FASB Staff Position (“FSP”) SFAS No. 157-1, “Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13,” which removes certain leasing transactions from the scope of SFAS No. 157 and FSP SFAS No. 157-2, “Effective Date of FASB Statement No. 157,” which defers the effective date of SFAS No. 157 for one year for certain nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis. Effective October 4, 2008, the Company adopted SFAS No. 157 for financial assets and liabilities recognized at fair value on a recurring basis. The adoption of SFAS No. 157 did not have a significant impact on the Company’s consolidated financial statements, and the resulting fair values calculated under SFAS No. 157 after adoption were not significantly different than the fair values that would have been calculated under previous guidance. See Note 4 for further details on the Company’s fair value measurements.

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115.” SFAS No. 159 permits companies to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The objective of SFAS No. 159 is to provide opportunities to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply hedge accounting provisions. SFAS No. 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company adopted SFAS No. 159 effective October 4, 2008. The Company currently does not have any instruments for which it has elected the fair value option under SFAS No. 159. Therefore, the adoption of SFAS No. 159 has not impacted the Company’s consolidated financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), or 141(R), “Business Combinations,” which replaces SFAS No. 141. SFAS No. 141(R) establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non-controlling interest in the acquiree and the goodwill acquired. The Statement also establishes disclosure requirements which will enable users to evaluate the nature and financial effects of the business combination. SFAS No. 141(R) is effective for fiscal years beginning after December 15, 2008. The Company will be required to adopt SFAS No. 141(R) in its fiscal year 2010 commencing October 3, 2009.

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133." SFAS No. 161 requires enhanced disclosures about an entity's derivative instruments and hedging activities including: (1) how and why an entity uses derivative instruments; (2) how derivative instruments and related hedged items are accounted for under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," and its related interpretations; and (3) how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. SFAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with earlier application encouraged. The Company adopted SFAS No. 161 in the second quarter of fiscal year 2009. Since SFAS No. 161 only required additional disclosure, the adoption did not have an impact on the Company's consolidated financial position, results of operations or cash flows. See Note 6 for further details on the Company's derivative instruments and hedging activities.

In October 2008, FASB issued FSP No.132 (R)-1, "Employers' Disclosures about Pensions and Other Postretirement Benefits," to require that an employer disclose the following information about the fair value of plan assets: 1) the level within the fair value hierarchy in which fair value measurements of plan assets fall; 2) information about the inputs and valuation techniques used to measure the fair value of plan assets; and 3) a reconciliation of beginning and ending balances for fair value measurements of plan assets using significant unobservable inputs. The final FSP will be effective for fiscal years ending after December 15, 2009, with early application permitted. The Company will be required to adopt FSP No.132 (R)-1 in its fiscal year 2010 commencing October 3, 2009. At initial adoption, application of the FSP would not be required for earlier periods that are presented for comparative purposes. The Company is currently evaluating the potential impact of adopting this FSP on the disclosures in its consolidated financial statements.

In April 2009, the FASB issued FSP SFAS No. 141R-1, "Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies." FSP SFAS No. 141R-1 amends the provisions in SFAS No. 141R, "Business Combinations," and requires an acquirer to recognize at fair value, at the acquisition date, an asset acquired or a liability assumed that arises from a contingency if the acquisition date fair value of that asset or liability can be determined during the measurement period. If the acquisition date fair value cannot be determined during the measurement period, an asset or liability shall be recognized at the acquisition date if (i) information available before the end of the measurement period indicates that it is probable that an asset existed or that a liability had been incurred at the acquisition date, and (ii) the amount of the asset or liability can be reasonably estimated. FSP SFAS No. 141R-1 is effective for contingent assets and contingent liabilities acquired in business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company will apply the provisions of FSP SFAS No. 141R-1 if and when a future acquisition occurs.

In April 2009, the FASB issued FSP SFAS No. 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly," which provides additional guidance in evaluating certain factors that are indicative of a significant decrease in the volume and level of activity for an asset or liability when compared to normal market activity. Additionally, this statement clarifies the circumstances to consider when evaluating whether a transaction is not orderly, in which quoted prices may not be determinative of fair value. FSP SFAS No. 157-4 is applied prospectively to all fair value measurements where appropriate and will be effective for interim and annual periods ending after June 15, 2009. The

Company will adopt the provisions of FSP SFAS No. 157-4 effective April 4, 2009. The Company is currently assessing the impact of FSP SFAS No. 157-4 on its results of operations and financial position.

- 10 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

In April 2009, the FASB issued FSP SFAS No. 107-1 and APB No. 28-1, "Interim Disclosures about Fair Value of Financial Instruments." FSP SFAS No. 107-1 and APB No. 28-1 amend FASB Statement No. 107, "Disclosures about Fair Value of Financial Instruments," to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. FSP FAS No. 107-1 and APB No. 28-1 is effective for interim reporting periods ending after June 15, 2009. The Company's disclosures about fair value of financial instruments will reflect the adoption of this FSP in the third quarter of fiscal year 2009.

3. Supplemental Balance Sheet Information

Accounts Receivable: Accounts receivable are stated net of allowances for doubtful accounts as follows:

| | April 3, 2009 | October 3, 2008 |
|--|------------------|--------------------|
| Accounts receivable | \$ 41,994 | \$ 47,437 |
| Less: Allowance for doubtful accounts | (112) | (89) |
| Accounts receivable, net | \$ 41,882 | \$ 47,348 |

Inventories: The following table provides details of inventories, net of reserves:

| | April 3, 2009 | October 3, 2008 |
|------------------------|------------------|--------------------|
| Raw material and parts | \$ 39,401 | \$ 40,187 |
| Work in process | 19,323 | 17,622 |
| Finished goods | 9,597 | 7,679 |
| | \$ 68,321 | \$ 65,488 |

Reserve for excess, slow-moving and obsolete inventory: The following table summarizes the activity related to reserves for excess, slow-moving and obsolete inventory:

| | Six Months Ended | |
|--|------------------|----------------------|
| | April 3, 2009 | March 28, 2008 |
| Balance at beginning of period | \$ 9,860 | \$ 9,784 |
| Inventory provision, charged to cost of sales | 335 | 550 |
| Inventory write-offs | (451) | (397) |

| | | |
|-----------------------------|----------|----------|
| Balance at end of period | \$ 9,744 | \$ 9,937 |
|-----------------------------|----------|----------|

- 11 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

Reserve for loss contracts: The following table summarizes the activity related to reserves for loss contracts:

| | Six Months Ended | |
|--|------------------|----------------------|
| | April 3, 2009 | March 28, 2008 |
| Balance at beginning of period | \$ 1,928 | \$ 2,700 |
| Provision for loss contracts, charged to cost of sales | 1,454 | 1,431 |
| Credit to cost of sales upon revenue recognition | (1,101) | (2,096) |
| Balance at end of period | \$ 2,281 | \$ 2,035 |

Reserve for loss contracts are reported in the condensed consolidated balance sheet in the following accounts:

| | April 3, 2009 | March 28, 2008 |
|------------------|------------------|----------------------|
| Inventories | \$ 2,273 | \$ 953 |
| Accrued expenses | 8 | 1,082 |
| | \$ 2,281 | \$ 2,035 |

Intangible Assets: The following tables present the details of the Company's total acquisition-related intangible assets:

| | Weighted Average Useful Life (in years) | April 3, 2009 | | | October 3, 2008 | | |
|----------------------------|--|---------------|-----------------------------|-----------|-----------------|-----------------------------|-----------|
| | | Cost | Accumulated Amortization | Net | Cost | Accumulated Amortization | Net |
| VED Core Technology | 50 | \$ 30,700 | \$ (3,194) | \$ 27,506 | \$ 30,700 | \$ (2,887) | \$ 27,813 |
| VED Application Technology | 25 | 19,800 | (4,109) | 15,691 | 19,800 | (3,713) | 16,087 |
| X-ray Generator and Satcom | | | | | | | |

Edgar Filing: CPI INTERNATIONAL, INC. - Form 10-Q

| | | | | | | | |
|----------------------------|-----------------|-----------|-------------|-----------|-----------|-------------|-----------|
| Application | | | | | | | |
| Technology | 15 | 8,000 | (2,775) | 5,225 | 8,000 | (2,508) | 5,492 |
| Antenna and Telemetry | | | | | | | |
| Technology | 25 | 5,300 | (347) | 4,953 | 5,300 | (241) | 5,059 |
| Customer backlog | 1 | 580 | (580) | - | 580 | (580) | - |
| Land lease | 46 | 11,810 | (1,308) | 10,502 | 11,810 | (1,181) | 10,629 |
| Tradename | 20 - Indefinite | 7,600 | (165) | 7,435 | 7,600 | (55) | 7,545 |
| Customer list and programs | 25 | 6,280 | (1,083) | 5,197 | 6,280 | (950) | 5,330 |
| Noncompete agreement | 5 | 640 | (272) | 368 | 640 | (208) | 432 |
| Patent application fees | - | 147 | - | 147 | 147 | - | 147 |
| | | \$ 90,857 | \$ (13,833) | \$ 77,024 | \$ 90,857 | \$ (12,323) | \$ 78,534 |

- 12 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

Intangible assets, net as of April 3, 2009 include a total of approximately \$0.1 million of application costs and associated legal costs incurred to obtain certain patents. Once obtained, these patents will be amortized on a straight-line basis and charged to operations over their estimated useful lives, not to exceed 17 years.

The amortization of intangible assets amounted to \$0.8 million and \$1.5 million for the three and six months ended April 3, 2009, respectively, and \$0.8 million and \$1.7 million for the corresponding periods of fiscal year 2008.

The estimated future amortization expense of intangible assets, excluding the Company's unamortized tradenames, is as follows:

| Fiscal Year | Amount |
|-----------------------------|-----------|
| 2009 (remaining six months) | \$ 1,513 |
| 2010 | 3,006 |
| 2011 | 3,006 |
| 2012 | 2,992 |
| 2013 | 2,900 |
| Thereafter | 60,407 |
| | \$ 73,824 |

Goodwill: The following table sets forth the changes in goodwill by reportable segment:

| | Reportable Segments | | | Total |
|--------------------------------------|---------------------|-----------|-----------|------------|
| | VED | Satcom | Other | |
| Balance at October 3, 2008 | \$ 132,897 | \$ 13,830 | \$ 15,884 | \$ 162,611 |
| Purchase accounting adjustment | (215) | (103) | - | (318) |
| Balance at April 3, 2009 | \$ 132,682 | \$ 13,727 | \$ 15,884 | \$ 162,293 |

The purchase accounting adjustment represents the correction of income tax rates that were used to establish Canadian deferred tax accounts related to the Company's merger in fiscal year 2004.

Product Warranty: The following table summarizes the activity related to product warranty:

| Six Months Ended | |
|------------------|-------------|
| March | |
| April 3, 2009 | 28, 2008 |
| | |

| | | |
|--|----------|----------|
| Beginning accrued warranty | \$ 4,159 | \$ 5,578 |
| Estimates for product warranty, charged to cost of sales | 2,014 | 1,406 |
| Actual costs of warranty claims | (2,192) | (2,032) |
| Ending accrued warranty | \$ 3,981 | \$ 4,952 |

- 13 -

[Table of Contents](#)

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

Accumulated Other Comprehensive Loss: The following table provides the components of accumulated other comprehensive loss in the condensed consolidated balance sheets:

| | April 3, 2009 | October 3, 2008 |
|--|------------------|-----------------------|
| Unrealized loss on cash flow hedges, net of tax | \$ 4,800 | \$ 1,587 |
| Unrealized actuarial loss and prior service credit for pension liability, net of tax | 271 | 222 |
| | \$ 5,071 | \$ 1,809 |

4. Financial Instruments

Effective October 4, 2008, the Company adopted SFAS No. 157 for financial assets and liabilities. SFAS No. 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements by establishing a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under SFAS No. 157 are described below:

Level 1 Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 Inputs reflect quoted prices for identical assets or liabilities in markets that are not active; quoted prices for similar assets or liabilities in active markets; inputs other than quoted prices that are observable for the asset or the liability; or inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3 Unobservable inputs reflecting the Company's own assumptions incorporated in valuation techniques used to determine fair value. These assumptions are required to be consistent with market participant assumptions that are reasonably available.

Under SFAS No. 157, the fair value is the price that would be received to sell an asset or paid to transfer a liability that assumes an orderly transaction in the most advantageous market at the measurement date.

The Company measures certain financial assets and liabilities at fair value on a recurring basis, including cash equivalents, restricted cash, available-for-sale securities and derivative instruments. As of April 3, 2009, financial assets utilizing Level 1 inputs included cash equivalents, such as money market and overnight U.S. Government securities and available-for-sale securities, such as mutual funds. Financial assets and liabilities utilizing Level 2 inputs included restricted cash in the form of certificates of deposit, foreign currency derivatives and interest rate swap derivatives. The Company does not have any financial assets or liabilities requiring the use of Level 3 inputs.

- 14 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

The following table sets forth financial instruments carried at fair value within the SFAS No. 157 hierarchy as of April 3, 2009:

| | Fair Value Measurements at Reporting Date Using | | | |
|--|---|--|---|--|
| | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets: | | | | |
| Money market and overnight U.S. Government securities ¹ | \$ 24,766 | \$ 24,766 | \$ - | \$ - |
| Certificates of deposit ² | 872 | - | 872 | - |
| Mutual funds ³ | 124 | 124 | - | - |
| Foreign exchange forward derivatives ⁴ | 182 | - | 182 | - |
| Total assets at fair value | \$ 25,944 | \$ 24,890 | \$ 1,054 | - |
| Liabilities: | | | | |
| Interest rate swap derivative ⁵ | \$ 2,832 | \$ - | \$ 2,832 | \$ - |
| Foreign exchange forward derivatives ⁴ | 3,924 | - | 3,924 | - |
| Total liabilities at fair value | \$ 6,756 | \$ - | \$ 6,756 | \$ - |

¹ The money market and overnight U.S. Government securities are classified as part of cash and cash equivalents in the condensed consolidated balance sheet.

² The certificates of deposit are classified as part of restricted cash in the condensed consolidated balance sheet.

³ The mutual funds are classified as part of other long-term assets in the condensed consolidated balance sheet.

⁴ The foreign currency derivatives are classified as part of prepaid and other current assets, other long-term assets and accrued expenses in the condensed consolidated balance sheet.

⁵ The interest rate swap derivatives are classified as part of accrued expenses and other long-term liabilities in the condensed consolidated balance sheet.

In general and where applicable, the Company uses quoted prices in active markets for identical assets or liabilities to determine fair value. This pricing methodology applies to the Company's Level 1 investments, such as money market, U.S. Government securities and mutual funds.

If quoted prices in active markets for identical assets or liabilities are not available to determine fair value, then the Company would use quoted prices for similar assets and liabilities or inputs other than the quoted prices that are observable either directly or indirectly. These investments, such as certificates of deposit, would be included in Level 2.

- 15 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

Derivatives

The Company executes foreign exchange forward contracts to purchase Canadian dollars and holds a pay-fixed receive-variable interest rate swap contract, all executed in the retail market with its relationship banks. For recognizing the most appropriate value, the Company uses an in-exchange valuation premise which considers the assumptions that market participants would use in pricing the derivatives. The Company has elected to use the income approach and uses observable (Level 2) market expectations at the measurement date and standard valuation techniques to convert future amounts to a single present amount. Level 2 inputs for derivative valuations are midmarket quoted prices for similar assets or liabilities in active markets and inputs other than quoted prices that are observable for the asset or liability.

Key inputs for currency derivatives are spot rates, forward rates, interest rates and credit derivative rates. The spot rate for the Canadian dollar is the same spot rate used for all balance sheet translations at the measurement date. Forward premiums/discounts and interest rates are interpolated from commonly quoted intervals. Once valued, each forward is identified as either an asset or liability. Assets are further discounted using counterparty annual credit default rates, and liabilities are valued using the Company's credit as reflected in the spread paid over LIBOR on the term loan under the Company's senior credit facilities.

Key inputs for valuing the interest rate swap are the cash rates used for the short term (under three months), futures rates for up to three years and LIBOR swap rates for periods beyond. These inputs are used to derive variable resets for the swap as well as to discount future fixed and variable cash flows to present value at measurement date. A credit spread is used to further discount each net cash flow using, for assets, counterparty credit default rates and, for liabilities, the Company's credit spread over LIBOR on the term loan under the Company's senior credit facilities.

See Note 6 for further information regarding the Company's derivative instruments.

5. Long-term Debt

Long-term debt comprises the following:

| | April 3, 2009 | October 3, 2008 |
|---|------------------|--------------------|
| Term loan, expiring 2014 | \$ 84,000 | \$ 88,750 |
| 8% Senior subordinated notes due 2012 | 122,000 | 125,000 |
| Floating rate senior notes due 2015, net of issue discount of \$84 and \$90 | 11,916 | 11,910 |
| | 217,916 | 225,660 |
| Less: Current portion | - | 1,000 |
| Long-term portion | \$ 217,916 | \$ 224,660 |



| | | | | |
|---------------------------|----|-------|----|-------|
| Standby letters of credit | \$ | 5,724 | \$ | 4,609 |
|---------------------------|----|-------|----|-------|

- 16 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

Senior Credit Facilities: On August 1, 2007, CPI amended and restated its then existing senior credit facilities. The amended and restated senior credit facilities (“Senior Credit Facilities”) provide for borrowings of up to an aggregate principal amount of \$160 million, consisting of a \$100 million term loan facility (“Term Loan”) and a \$60 million revolving credit facility (“Revolver”), with a sub-facility of \$15 million for letters of credit and \$5 million for swing line loans. Upon certain specified conditions, including maintaining a senior secured leverage ratio of 3.75:1 or less on a pro forma basis, CPI may seek commitments for a new class of term loans, not to exceed \$125 million in the aggregate. The Senior Credit Facilities are guaranteed by CPI International and all of CPI’s domestic subsidiaries and are secured by substantially all of the assets of CPI International, CPI and CPI’s domestic subsidiaries.

Except as provided in the following sentence, the Term Loan will mature on August 1, 2014 and the Revolver will mature on August 1, 2013. However, if, prior to August 1, 2011, CPI has not repaid or refinanced its 8% Senior Subordinated Notes due 2012, both the Term Loan and the Revolver will mature on August 1, 2011.

The Senior Credit Facilities replaced CPI’s previous senior credit facilities of \$130 million. On the closing date of the Senior Credit Facilities, CPI borrowed \$100 million under the Term Loan. Borrowings under the Senior Credit Facilities bear interest at a rate equal to, at CPI’s option, LIBOR or the ABR plus the applicable margin. The ABR is the greater of the (a) the prime rate and (b) the federal funds rate plus 0.50%. For Term Loans, the applicable margin will be 2.00% for LIBOR borrowings and 1.00% for ABR borrowings. The applicable margins under the Revolver vary depending on CPI’s leverage ratio, as defined in the Senior Credit Facilities, and range from 1.25% to 2.00% for LIBOR borrowings and from 0.25% to 1.00% for ABR borrowings.

In addition to customary fronting and administrative fees under the Senior Credit Facilities, CPI will pay letter of credit participation fees equal to the applicable LIBOR margin per annum on the average daily amount of the letter of credit exposure and a commitment fee on the average daily unused commitments under the Revolver. The commitment fee will vary depending on CPI’s leverage ratio, as defined in the Senior Credit Facilities, and will range from 0.25% to 0.50%.

The Senior Credit Facilities require that CPI repay \$250,000 of the Term Loan at the end of each fiscal quarter prior to the maturity date of the Term Loan, with the remainder due on the maturity date. CPI is required to prepay its outstanding loans under the Senior Credit Facilities, subject to certain exceptions and limitations, with net cash proceeds received from certain events, including, without limitation, (1) all such proceeds received from certain asset sales by CPI International, CPI or any of CPI’s subsidiaries, (2) all such proceeds received from issuances of debt (other than certain specified permitted debt) or preferred stock by CPI International, CPI or any of CPI’s subsidiaries, and (3) all such proceeds paid to CPI International, CPI or any of CPI’s subsidiaries from casualty and condemnation events in excess of amounts applied to replace, restore or reinvest in any properties for which proceeds were paid within a specified period.

If CPI’s leverage ratio, as defined in the Senior Credit Facilities, exceeds 3.5:1 at the end of any fiscal year, CPI will also be required to make an annual prepayment within 90 days after the end of such fiscal year equal to 50% of excess cash flow, as defined in the Senior Credit Facilities, less optional prepayments made during the fiscal year. CPI can make optional prepayments on the outstanding loans at any time without premium or penalty, except for customary “breakage” costs with respect to LIBOR loans.

- 17 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

The Senior Credit Facilities contain a number of covenants that, among other things, restrict, subject to certain exceptions, the ability of CPI International, CPI or any of CPI's subsidiaries to: sell assets; engage in mergers and acquisitions; pay dividends and distributions or repurchase their capital stock; incur additional indebtedness or issue equity interests; make investments and loans; create liens or further negative pledges on assets; engage in certain transactions with affiliates; enter into sale and leaseback transactions; amend agreements or make repayments relating to subordinated indebtedness; and amend or waive provisions of charter documents in a manner materially adverse to the lenders. CPI and its subsidiaries must comply with a maximum capital expenditure limitation and a maximum total secured leverage ratio, each calculated on a consolidated basis for CPI.

CPI made repayments on the Term Loan of \$4.75 million during the first quarter of fiscal year 2009, \$11.0 million during fiscal year 2008 and \$250,000 during fiscal year 2007, leaving a principal balance of \$84.0 million as of April 3, 2009.

At April 3, 2009, the amount available for borrowing under the Revolver, after taking into account the Company's outstanding letters of credit of \$5.7 million, was approximately \$54.3 million.

8% Senior Subordinated Notes due 2012 of CPI: As of April 3, 2009, CPI had \$122.0 million in aggregate principal amount of its 8% Senior Subordinated Notes due 2012 (the "8% Notes") after giving effect to the repurchase of \$3.0 million in January 2009. The Company repurchased \$3.0 million aggregate principal amount of the 8% Notes at a discount of 8.5% to par value. The Company paid approximately \$2.9 million, including accrued interest of \$0.1 million, for the repurchase and realized a net gain of approximately \$0.2 million. The 8% Notes have no sinking fund requirements.

The 8% Notes bear interest at the rate of 8.0% per year, payable on February 1 and August 1 of each year. The 8% Notes will mature on February 1, 2012. The 8% Notes are unsecured obligations, jointly and severally guaranteed by CPI International and each of CPI's domestic subsidiaries. The payment of all obligations relating to the 8% Notes are subordinated in right of payment to the prior payment in full in cash or cash equivalents of all senior debt (as defined in the indenture governing the 8% Notes) of CPI, including debt under the Senior Credit Facilities. Each guarantee of the 8% Notes is and will be subordinated to guarantor senior debt (as defined in the indenture governing the 8% Notes) on the same basis as the 8% Notes are subordinated to CPI's senior debt.

At any time or from time to time on or after February 1, 2008, CPI, at its option, may redeem the 8% Notes, in whole or in part, at the redemption prices (expressed as percentages of principal amount) set forth below, together with accrued and unpaid interest thereon, if any, to the redemption date, if redeemed during the 12-month period beginning on February 1 of the years indicated below:

| Year | Optional Redemption Price |
|------------------------|---------------------------------|
| 2009 | 102% |
| 2010 and thereafter | 100% |

Upon a change of control, CPI may be required to purchase all or any part of the 8% Notes for a cash price equal to 101% of the principal amount, plus accrued and unpaid interest thereon, if any, to the date of purchase.

- 18 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

The indenture governing the 8% Notes contains a number of covenants that, among other things, restrict, subject to certain exceptions, the ability of CPI and its restricted subsidiaries (as defined in the indenture governing the 8% Notes) to incur additional indebtedness, sell assets, consolidate or merge with or into other companies, pay dividends or repurchase or redeem capital stock or subordinated indebtedness, make certain investments, issue capital stock of their subsidiaries, incur liens and enter into certain types of transactions with their affiliates.

Events of default under the indenture governing the 8% Notes include: failure to make payments on the 8% Notes when due; failure to comply with covenants in the indenture governing the 8% Notes; a default under certain other indebtedness of CPI or any of its restricted subsidiaries that is caused by a failure to make payments on such indebtedness or that results in the acceleration of the maturity of such indebtedness; the existence of certain final judgments or orders against CPI or any of the restricted subsidiaries; and the occurrence of certain insolvency or bankruptcy events.

Floating Rate Senior Notes due 2015 of CPI International: As of April 3, 2009, \$12.0 million of aggregate principal amount remained outstanding under CPI International's Floating Rate Senior Notes due 2015 (the "FR Notes") after giving effect to the redemption of \$10.0 million aggregate principal amount and \$58.0 million aggregate principal amount in fiscal years 2008 and 2007, respectively. The FR Notes were originally issued at a 1% discount and have no sinking fund requirements.

The FR Notes require interest payments at an annual interest rate, reset at the beginning of each semi-annual period, equal to the then six-month LIBOR plus 5.75%, payable semiannually on February 1 and August 1 of each year. The interest rate on the semi-annual interest payment due August 1, 2009 is 7.38% per annum. CPI International may, at its option, elect to pay interest through the issuance of additional FR Notes for any interest payment date on or after August 1, 2006 and on or before February 1, 2010. If CPI International elects to pay interest through the issuance of additional FR Notes, the annual interest rate on the FR Notes will increase by an additional 1% step-up, with the step-up increasing by an additional 1% for each interest payment made through the issuance of additional FR Notes (up to a maximum of 4%). The FR Notes will mature on February 1, 2015.

The FR Notes are general unsecured obligations of CPI International. The FR Notes are not guaranteed by any of CPI International's subsidiaries but are structurally subordinated to all existing and future indebtedness and other liabilities of CPI International's subsidiaries. The FR Notes are senior in right of payment to CPI International's existing and future indebtedness that is expressly subordinated to the FR Notes.

Because CPI International is a holding company with no operations of its own, CPI International relies on distributions from Communications & Power Industries to satisfy its obligations under the FR Notes. The Senior Credit Facilities and the indenture governing the 8% Notes restrict CPI's ability to make distributions to CPI International. The Senior Credit Facilities prohibit CPI from making distributions to CPI International unless there is no default under the Senior Credit Facilities and CPI satisfies a senior secured leverage ratio of 3.75:1 and, in the case of distributions to pay amounts other than interest on the FR Notes, the amount of the distribution and all prior such distributions do not exceed a specified amount. The indenture governing the 8% Notes prohibits CPI from making distributions to CPI International unless, among other things, there is no default under the indenture and the amount of the proposed dividend plus all previous Restricted Payments (as defined in the indenture governing the 8% Notes)

does not exceed a specified amount.

- 19 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

At any time or from time to time on or after February 1, 2008, CPI International, at its option, may redeem the FR Notes in whole or in part at the redemption prices (expressed as percentages of principal amount) set forth below, together with accrued and unpaid interest thereon, if any, to the redemption date, if redeemed during the 12-month period beginning on February 1 of the years indicated below:

| Year | Optional Redemption Price |
|------------------------|---------------------------------|
| 2009 | 101% |
| 2010 and thereafter | 100% |

Upon a change of control, as defined in the indenture governing the FR Notes, CPI International may be required to purchase all or any part of the outstanding FR Notes for a cash price equal to 101% of the principal amount, plus accrued and unpaid interest thereon, if any, to the date of purchase.

The indenture governing the FR Notes contains certain covenants that, among other things, limit the ability of CPI International and its restricted subsidiaries (as defined in the indenture governing the FR Notes) to incur additional indebtedness, sell assets, consolidate or merge with or into other companies, pay dividends or repurchase or redeem capital stock or subordinated indebtedness, make certain investments, issue capital stock of their subsidiaries, incur liens and enter into certain types of transactions with their affiliates.

Events of default under the indenture governing the FR Notes include: failure to make payments on the FR Notes when due; failure to comply with covenants in the indenture governing the FR Notes; a default under certain other indebtedness of CPI International or any of its restricted subsidiaries that is caused by a failure to make payments on such indebtedness or that results in the acceleration of the maturity of such indebtedness; the existence of certain final judgments or orders against CPI International or any of the restricted subsidiaries; and the occurrence of certain insolvency or bankruptcy events.

Debt Maturities: As of April 3, 2009, maturities on long-term debt were as follows:

| Fiscal Year | Term Loan | 8% Senior Subordinated Notes | Floating Rate Senior Notes | Total |
|--------------------------------|--------------|------------------------------------|-------------------------------------|---------|
| 2009 (remaining six months) | \$ - | \$ - | \$ - | \$ - |
| 2010 | - | - | - | - |
| 2011 | 84,000 | - | - | 84,000 |
| 2012 | - | 122,000 | - | 122,000 |
| 2013 | - | - | - | - |

Edgar Filing: CPI INTERNATIONAL, INC. - Form 10-Q

| | | | | |
|------------|-----------|------------|-----------|------------|
| Thereafter | - | - | 12,000 | 12,000 |
| | \$ 84,000 | \$ 122,000 | \$ 12,000 | \$ 218,000 |

- 20 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

The above table assumes (1) that the respective debt instruments will be outstanding until their scheduled maturity dates, except for the Term Loan under the Senior Credit Facilities, which is assumed to mature on the earlier date of August 1, 2011 as described above under "Senior Credit Facilities," and (2) a debt level based on mandatory repayments according to the contractual amortization schedule. The above table also excludes any optional prepayments.

As of April 3, 2009, the Company was in compliance with the covenants under the indentures governing the 8% Notes and FR Notes and the agreements governing the Senior Credit Facilities, and the Company expects to remain in compliance with those covenants throughout the remainder of fiscal year 2009.

Interest rate swap agreements: See Note 6 for information on the interest rate swap agreements entered into by the Company to hedge the interest rate exposure associated with the Term Loan.

6. Derivative Instruments and Hedging Activities

In March 2008, the FASB issued SFAS No. 161, which amends and expands the disclosure requirements of SFAS No. 133 to provide an enhanced understanding of the use of derivative instruments, how they are accounted for under SFAS 133 and their effect on financial position, financial performance and cash flows. The Company adopted the disclosure provisions of SFAS No. 161 in the second quarter of fiscal year 2009.

Foreign Exchange Forward Contracts: Although the majority of the Company's revenue and expense activities are transacted in U.S. dollars, the Company does transact business in foreign countries. The Company's primary foreign currency cash flows are in Canada and several European countries. In an effort to reduce its foreign currency exposure to Canadian dollar denominated expenses, the Company enters into Canadian dollar forward contracts to hedge the Canadian dollar denominated costs for its manufacturing operation in Canada. The Company does not engage in currency speculation.

The Company's Canadian dollar forward contracts in effect as of April 3, 2009 have durations of three to nine months. These contracts are designated as a cash flow hedge and are considered highly effective, as defined by SFAS No. 133. Unrealized gains and losses from foreign exchange forward contracts are included in accumulated other comprehensive income (loss) in the consolidated balance sheets, and the Company anticipates recognizing the entire unrealized gain or loss in operating earnings within the next five fiscal quarters. Changes in the fair value of foreign currency forward contracts due to changes in time value are excluded from the assessment of effectiveness and are immediately recognized in general and administrative expenses in the condensed consolidated statements of operations and comprehensive income. The time value was not material for the first two quarters of fiscal years 2009 and 2008. If the transaction being hedged fails to occur, or if a portion of any derivative is ineffective, then the Company promptly recognizes the gain or loss on the associated financial instrument in general and administrative expenses in the condensed consolidated statements of operations and comprehensive income. No ineffective amounts were recognized due to anticipated transactions failing to occur in the first two quarters of fiscal years 2009 and 2008.

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

As of April 3, 2009, the Company had entered into Canadian dollar forward contracts for approximately \$50.6 million (Canadian dollars), or approximately 87% of estimated Canadian dollar denominated expenses for April 2009 through June 2010, at an average rate of approximately \$0.87 U.S. dollar to Canadian dollar.

Interest Rate Contracts: The Company also uses derivative instruments in order to manage interest costs and risk associated with its long-term debt. During fiscal year 2007, the Company entered into an interest rate swap contract (the "2007 Swap") to receive three-month USD-LIBOR-BBA (British Bankers' Association) interest and pay 4.77% fixed rate interest. Net interest positions are settled quarterly. The Company has structured the 2007 Swap with decreasing notional amounts such that it is less than the balance of its Term Loan under the Senior Credit Facilities discussed in Note 5. The notional value of the 2007 Swap was \$60.0 million at April 3, 2009 and represented approximately 71% of the aggregate Term Loan balance. The Swap agreement is effective through June 30, 2011. Under the provisions of SFAS No. 133, this arrangement was initially designated and qualified as an effective cash flow hedge of interest rate risk related to the Term Loan, which permitted recording the fair value of the 2007 Swap and corresponding unrealized gain or loss to accumulated other comprehensive income (loss) in the consolidated balance sheets. The interest rate swap gain or loss is included in the assessment of hedge effectiveness. Gains and losses representing hedge ineffectiveness are immediately recognized in interest expense, net in the condensed consolidated statements of operations and comprehensive income.

See Note 4, Financial Instruments, for further information regarding the Company's derivative instruments.

The following table summarizes the fair value of derivative instruments designated as cash flow hedges at April 3, 2009:

| | Asset Derivatives | | Liability Derivatives | |
|--|----------------------------------|------------|-----------------------------|------------|
| | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Derivatives designated as hedging instruments under SFAS No. 133 | | | | |
| Interest rate contracts | Prepaid and other current assets | \$ - | Accrued expenses | \$ (1,819) |
| Interest rate contracts | Other long-term assets | - | Other long-term liabilities | (1,013) |
| Forward contracts | Prepaid and other current assets | 56 | Accrued expenses | (3,924) |
| Forward contracts | Other long-term assets | 126 | Other long-term | - |

| | liabilities | |
|--|-------------|------------|
| Total derivatives designated as hedging instruments under SFAS No. 133 | \$ 182 | \$ (6,756) |

As of April 3, 2009, all of the Company's derivative instruments were classified as hedging instruments under SFAS No. 133.

- 22 -

[Table of Contents](#)

CPI INTERNATIONAL, INC.
and SubsidiariesNOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

The following table summarizes the effect of derivative instruments on the condensed consolidated statement of operations and comprehensive income for the six months ended April 3, 2009:

| | Amount of Gain (Loss) Recognized in OCI on Derivative (Effective Portion) | Location of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) | Amount of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) | Location of Gain (Loss) Recognized in Income on Derivative (Ineffective and Excluded Portion) | Amount of Gain (Loss) Recognized in Income on Derivative (Ineffective and Excluded Portion) |
|--|--|---|---|---|--|
| Derivatives in Statement 133 Cash Flow Hedging Relationships | | Interest expense, net | | Interest expense, net | |
| Interest rate contracts | \$ (1,587) | | \$ (700) | | \$ (28) |
| Forward contracts | (6,382) | Cost of sales | (1,846) | General and administrative | (225) (a) |
| Forward contracts | | Research and development | (114) | | |
| Forward contracts | | Selling and marketing | (63) | | |
| Forward contracts | | General and administrative | (188) | | |
| Total | \$ (7,969) | | \$ (2,911) | | \$ (253) |

(a) The amount of loss recognized in income represents \$3,000 related to the ineffective portion of the hedging relationships and \$222,000 related to the amount excluded from the assessment of hedge effectiveness.

As a result of the use of derivative instruments, the Company is exposed to the risk that counterparties to derivative contracts will fail to meet their contractual obligations. The Company does not hold collateral or other security from its counterparties supporting its derivative instruments. To mitigate the counterparty credit risk, the Company has a policy of only entering into contracts with carefully selected major financial institutions based upon their credit ratings and other factors. The Company regularly reviews its credit exposure balances as well as the creditworthiness of the counterparties.

In addition, the Company's interest rate swap contract is subject to an International Swaps and Derivatives Association, Inc. Master Agreement ("ISDA Master Agreement"). The ISDA Master Agreement allows for the aggregation of the market exposures and termination of all transactions between the Company and its counterparty in the event a default (as defined in the ISDA Master Agreement) occurs in respect of either party.

If the counterparty fails to perform, credit risk with such counterparty is equal to the extent of the fair value gain in the derivative. At April 3, 2009, the Company's derivatives were in a net liability position, and the Company, therefore,

was not exposed to any counterparty credit risk.

7. Commitments and Contingencies

Leases: The Company is committed to minimum rentals under non-cancelable operating lease agreements, primarily for land and facility space, that expire on various dates through 2050. Certain of the leases provide for escalating lease payments. Future minimum lease payments for all non-cancelable operating lease agreements at April 3, 2009 were as follows:

| Fiscal Year | Operating Leases |
|-------------------------------------|---------------------|
| 2009 (remaining six months) | \$ 1,065 |
| 2010 | 1,756 |
| 2011 | 676 |
| 2012 | 488 |
| 2013 | 419 |
| Thereafter | 2,896 |
| Total future minimum lease payments | \$ 7,300 |

Real estate taxes, insurance and maintenance are also obligations of the Company. Rental expense under non-cancelable operating leases amounted to \$0.6 million and \$1.3 million for the three and six months ended April 3, 2009, respectively, and to \$0.6 million and \$1.2 million for the corresponding periods of fiscal year 2008. Assets subject to capital leases at April 3, 2009 and October 3, 2008 were not material.

- 23 -

[Table of Contents](#)

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

Restricted cash: The Company has restricted cash of \$1.1 million and \$0.8 million as of April 3, 2009 and October 3, 2008, respectively, consisting primarily of bank guarantees from customer advance payments to the Company's international subsidiaries. The bank guarantees become unrestricted cash when performance under the sales contract is complete.

Purchase commitments: As of April 3, 2009, the Company had the following known purchase commitments, which include primarily future purchases for inventory-related items under various purchase arrangements as well as other obligations in the ordinary course of business that the Company cannot cancel or where it would be required to pay a termination fee in the event of cancellation:

| Fiscal Year | Purchase Contracts |
|-----------------------------|-----------------------|
| 2009 (remaining six months) | \$ 23,785 |
| 2010 | 5,107 |
| 2011 | 233 |
| 2012 | 20 |
| 2013 | - |
| Total purchase commitments | \$ 29,145 |

Contingent Earnout Consideration: Under the terms of the purchase agreement for the acquisition of Malibu Research, Inc. (Malibu) in August 2007, in addition to the \$20.5 million of net cash consideration paid for the acquisition, the Company may be required to pay a potential earnout to the former stockholders of Malibu of up to \$14.0 million, which is primarily contingent upon the achievement of certain financial objectives over the three years following the acquisition ("Financial Earnout") and a discretionary earnout of up to \$1.0 million contingent upon achievement of certain succession planning goals by June 30, 2010. As of April 3, 2009, the Company has not accrued any of these contingent earnout amounts as achievement of the objectives and goals has not occurred. Any earnout consideration paid based on financial performance will be recorded as additional goodwill. Any discretionary succession earnout consideration paid will be recorded as general and administrative expense. No earnout was earned for the first earnout period, and the maximum potential Financial Earnout that could be earned over the three years following the acquisition has been reduced from \$14.0 million to \$12.3 million based on the performance in the first earnout period.

Indemnification: As permitted under Delaware law, the Company has agreements whereby the Company indemnifies its officers, directors and certain employees for certain events or occurrences while the employee, officer or director is, or was serving, at the Company's request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has Director and Officer insurance policies that limit its exposure and may enable it to recover a portion of any future amounts paid.

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

The Company has entered into other standard indemnification agreements in its ordinary course of business. Pursuant to these agreements, the Company agrees to indemnify, defend, hold harmless and to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally the Company's business partners or customers, in connection with any patent, copyright or other intellectual property infringement claim by any third-party with respect to the Company's products. The term of these indemnification agreements is generally perpetual after execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. Management believes that the likelihood of loss under these agreements is remote.

Employment Agreements: The Company has entered into employment agreements with certain members of the executive management, which include provisions for the continued payment of salary, benefits and a pro-rata portion of an annual bonus for periods ranging from 12 months to 30 months upon employment termination.

Contingencies: From time to time, the Company may be subject to claims that arise in the ordinary course of business. Except as noted below, in the opinion of management, all such matters involve amounts that would not have a material adverse effect on the Company's consolidated financial position if unfavorably resolved.

During the first quarter of fiscal year 2009, the Company received a notice from a customer purporting to terminate a sales contract due to alleged nonperformance. The Company plans to contest this matter vigorously. The Company recorded certain costs in the fourth quarter of fiscal year 2008 as a result of the termination; however, at this time, the Company cannot estimate the range of any further possible loss or gain with respect to this matter or whether an unfavorable resolution of this matter would have a material adverse effect on the Company's results of operations and cash flows.

8. Stock-based Compensation Plans

As of April 3, 2009, the Company had an aggregate of 1.7 million shares of its common stock available for future grant and approximately 3.4 million options outstanding under its various equity plans. Awards are subject to terms and conditions as determined by the Company's board of directors.

Stock Options: The following table summarizes stock option activity as of April 3, 2009 and changes during the six months ended April 3, 2009 under the Company's stock option plans:

| | Outstanding Options | | | | Exercisable Options | | | |
|-----------------------|---------------------|---------------------------------|---|---------------------------|---------------------|---------------------------------|---|---------------------------|
| | Number of Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value | Number of Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value |
| Balance at October 3, | | | | | | | | |

Edgar Filing: CPI INTERNATIONAL, INC. - Form 10-Q

| | | | | | | | | | |
|--------------------------------|-----------|----|-------|------|-----------|-----------|----|------|----------------|
| 2008 | | | | | | | | | |
| Granted | 108,000 | | 10.00 | | | | | | |
| Exercised | (8,334) | | 4.32 | | | | | | |
| Forfeited or cancelled | (6,399) | | 16.13 | | | | | | |
| Balance at April 3, 2009 | 3,442,561 | \$ | 6.33 | 5.40 | \$ 16,253 | 2,819,582 | \$ | 4.34 | 4.82 \$ 16,223 |

- 25 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

During the first quarter of fiscal year 2009, the Company granted its officers 108,000 shares of stock options that are subject to time vesting and market performance vesting conditions. All of such shares are broken up into two tranches (each a "Tranche"), each consisting of one-half of the nonvested shares. The nonvested shares in each Tranche become fully vested only if both the time vesting conditions and the performance conditions are satisfied with respect to such nonvested shares. The time vesting conditions with respect to 25% of the nonvested shares in each Tranche generally will be satisfied on each of the first four anniversaries of the grant date. The market performance conditions of each Tranche are based on specified price thresholds reached by the Company's common stock. The nonvested shares in Tranche One are subject to a \$13.50 stock price threshold, and the nonvested shares in Tranche Two are subject to a \$16.00 stock price threshold. In order for the market performance conditions to be satisfied with respect to a Tranche, the average closing share price of the Company's common stock must be at or above the applicable stock price threshold amount for 20 consecutive trading days. The stock options have a term of 10 years at the grant date.

The aggregate intrinsic value in the preceding table represents the total intrinsic value, based on the Company's closing stock price of \$9.50 as of April 3, 2009, which would have been received by the option holders had all option holders exercised their options and sold the shares received upon such exercises as of that date. As of April 3, 2009, approximately 2.6 million exercisable options were in-the-money.

During the three and six months ended April 3, 2009, cash received from option exercises was approximately \$29,411 and \$36,003, respectively, and the total intrinsic value of options exercised was \$20,896 and \$27,900, respectively. There were no options exercised during the three and six months ended March 28, 2008. As of April 3, 2009, there was approximately \$3.7 million of total unrecognized compensation costs related to nonvested stock options, which is expected to be recognized over a weighted-average vesting period of 1.6 years.

Stock Purchase Plan: Employees purchased 22,481 shares for \$0.2 million and 70,851 shares for \$0.6 million in the three and six months ended April 3, 2009, respectively, under the 2006 Employee Stock Purchase Plan (the "2006 ESPP"). As of April 3, 2009, there were no unrecognized compensation costs related to rights to acquire stock under the 2006 ESPP.

Restricted Stock and Restricted Stock Units: There were 223,498 and 117,154 shares outstanding of nonvested restricted stock and restricted stock units granted to directors and employees as of April 3, 2009 and October 3, 2008, respectively. The restricted stock and restricted stock units generally vest over periods of one to four years. Upon vesting, each restricted stock unit will automatically convert into one share of common stock of CPI International.

- 26 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

A summary of the status of the Company's nonvested restricted stock and restricted stock unit awards as of April 3, 2009 and October 3, 2008 and of changes during the six months then ended is presented below:

| | Number of Shares | Weighted-Average Grant-Date Fair Value Per Share |
|---------------------------------|---------------------|--|
| Nonvested at October 3, 2008 | 117,154 | \$ 15.28 |
| Granted | 142,721 | 8.87 |
| Vested | (36,377) | 14.81 |
| Forfeited | - | - |
| Nonvested at April 3, 2009 | 223,498 | \$ 11.26 |

During the first quarter of fiscal year 2009, the Company granted its officers and certain other employees, respectively, 36,000 and 102,900 shares of restricted stock or restricted stock units. The restricted stock and restricted stock units granted to the Company's officers are subject to time vesting and market performance vesting conditions similar to those applicable to the stock option grants described above, except the time vesting conditions with respect to 25% of the nonvested shares will be satisfied on the third trading day following the Company's issuance of its press release reporting first quarter financial results in each of 2010, 2011, 2012 and 2013, but no later than the end of February in each year. The restricted stock and restricted stock units granted to certain other employees of the Company are only subject to time vesting similar to that applicable to restricted stock and restricted stock units granted to the Company's officers.

During the second quarter of fiscal year 2009, the Company granted a member of its board of directors 3,821 shares of restricted stock which will vest after one year.

Aggregate intrinsic value of the nonvested restricted stock and restricted stock unit awards at April 3, 2009 was \$2.1 million. As of April 3, 2009, there was \$2.3 million of unrecognized compensation costs related to restricted stock and restricted stock unit awards. The unrecognized compensation cost is expected to be recognized over a weighted average period of 2.0 years.

The Company settles stock option exercises, restricted stock awards and restricted stock units with newly issued common shares.

Valuation and Expense Information

The fair value of the Company's time-based option awards is estimated on the date of grant using the Black-Scholes model. The fair value of each market performance-based (or combination of market performance- and time-based) option, restricted stock and restricted stock unit award is estimated on the date of grant using the Monte Carlo simulation technique in a risk-neutral framework.

- 27 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

The Black-Scholes and the Monte Carlo simulation valuation models were developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable and requires the input of subjective assumptions, including the expected stock price volatility and estimated option life. The Company currently does not intend to pay dividends and, accordingly, no dividends have been assumed in its Black-Scholes calculation and Monte Carlo simulation. Since the Company's common stock has not been publicly traded for a sufficient time period, the expected volatility used in prior periods was based on expected volatilities of similar companies that have a longer history of being publicly traded. Beginning with fiscal year 2009, the expected volatility is based on a blend of expected volatilities of similar companies and that of the Company based on its available historical data. The risk-free rates are based on the U.S. Treasury yield in effect at the time of the grant. Since the Company's historical data is limited, the expected term of time-based options granted is based on the simplified method for plain vanilla options in accordance with Securities and Exchange Commission ("SEC") Staff Accounting Bulletin ("SAB") No. 107. In December 2007, the SEC issued SAB No. 110, an amendment of SAB No. 107. SAB No. 110 states that the Staff will continue to accept, under certain circumstances, the continued use of the simplified method beyond December 31, 2007. Accordingly, the Company will continue to use the simplified method until it has enough historical experience to provide a reasonable estimate of expected term.

Assumptions used in the Black-Scholes model to estimate the fair value of time-based option grants during the six months ended March 28, 2008 (specifically, in the first quarter of fiscal year 2008) are presented below.

| | |
|--------------------------|--------|
| Expected term (in years) | 6.25 |
| Expected volatility | 41.20% |
| Risk-free rate | 3.82% |
| Dividend yield | 0% |

There were no time-based options granted during the three and six months ended April 3, 2009, nor during the three months ended March 28, 2008.

Assumptions used in the Monte Carlo simulation model to estimate the fair value of time- and market performance-based options first granted during the six months ended April 3, 2009 (specifically, in the first quarter of fiscal year 2009) are presented below.

| | |
|-----------------------------|--------|
| Contractual term (in years) | 10.00 |
| Expected volatility | 51.50% |
| Risk-free rate | 3.53% |
| | 0% |

Dividend
yield

There were no time- and market performance-based options granted during the three months ended April 3, 2009.

The weighted-average grant-date fair value of all the options granted during the six months ended April 3, 2009 and March 28, 2008 was \$5.61 and \$7.83 per share, respectively.

- 28 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

Based on the 15% discount received by the employees, the weighted-average fair value of shares issued under the 2006 ESPP was \$1.43 and \$1.50 per share during the three and six months ended April 3, 2009, respectively, and \$2.67 and \$2.76 per share during the three and six months ended March 28, 2008, respectively.

Assumptions used in the Monte Carlo simulation model to estimate the fair value of time- and market performance-based restricted stock and restricted stock units first granted during the six months ended April 3, 2009 (specifically, in the first quarter of fiscal year 2009) are presented below.

| | |
|---------------------|--------|
| Expected volatility | 51.50% |
| Risk-free rate | 3.54% |
| Dividend yield | 0% |

There were no time- and market performance-based restricted stock and restricted stock units granted during the three months ended April 3, 2009.

The fair value of each time-based restricted stock and restricted stock unit award is calculated using the market price of the Company's common stock on the date of grant.

The weighted-average estimated fair value of all restricted stock and restricted stock units granted was \$7.85 and \$8.87 per share during the three and six months ended April 3, 2009, respectively, and \$10.98 and \$15.22 per share during the three and six months ended March 28, 2008, respectively.

As stock-based compensation expense recognized in the condensed consolidated statements of operations and comprehensive income for the three and six months ended April 3, 2009 and for the corresponding periods of fiscal year 2008 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

The following table summarizes stock-based compensation expense for the three and six months ended April 3, 2009 and March 28, 2008, which was allocated as follows:

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|----------------------|------------------|----------------------|
| | April 3, 2009 | March 28, 2008 | April 3, 2009 | March 28, 2008 |
| Share-based compensation cost recognized in the income statement by caption: | | | | |
| Cost of sales | \$ 127 | \$ 111 | \$ 244 | \$ 191 |
| Research and development | 45 | 38 | 87 | 69 |
| Selling and marketing | 73 | 59 | 141 | 104 |
| General and administrative | 456 | 342 | 850 | 610 |
| | \$ 701 | \$ 550 | \$ 1,322 | \$ 974 |
| Share-based compensation cost capitalized in inventory | | | | |
| | \$ 129 | \$ 119 | \$ 253 | \$ 215 |
| Share-based compensation cost remaining in inventory at end of period | | | | |
| | \$ 85 | \$ 72 | \$ 85 | \$ 72 |
| Share-based compensation expense by type of award: | | | | |
| Stock options | \$ 454 | \$ 395 | \$ 872 | \$ 732 |
| Stock purchase plan | 31 | 38 | 66 | 75 |
| Restricted stock and units | 216 | 117 | 384 | 167 |
| | \$ 701 | \$ 550 | \$ 1,322 | \$ 974 |

The tax benefit realized from option exercises and restricted stock vesting totaled approximately \$29,000 and \$88,000 during the three and six months ended April 3, 2009, respectively. The tax benefit realized from option exercises and restricted stock vesting totaled approximately \$19,000 during the three and six months ended March 28, 2008.

9. Income Taxes

The income tax benefit of \$5.2 million for the six months ended April 3, 2009 and income tax expense of \$4.1 million for the six months ended March 28, 2008 reflect estimated federal, foreign and state taxes. The effective tax rate for the six months ended April 3, 2009 was a negative 85% and diverged from the federal and state statutory rate primarily due to several significant discrete tax benefits: (1) \$5.1 million relating to adjustments to the FASB

Interpretation (“FIN”) No. 48 position for the outstanding audit by the Canada Revenue Agency (“CRA”), (2) \$0.7 million related to certain provisions of the California Budget Act of 2008 signed on February 20, 2009, which will allow a taxpayer to elect an alternative method to attribute taxable income to California for tax years beginning on or after January 1, 2011, which resulted in a reduction to the Company’s deferred tax liability accounts and (3) \$0.9 million for adjustments to Canadian deferred tax accounts.

The effective tax rate for the six months ended March 28, 2008 was 32%. Income tax expense for the six months ended March 28, 2008 included a discrete tax benefit of approximately \$0.4 million that was attributable to the fourth quarter of fiscal year 2007 relating to the correction of an immaterial error in the computation of the warranty expense tax deduction.

- 30 -

[Table of Contents](#)

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

On December 15, 2008, the Treasury Department announced that the Fifth Protocol ("Protocol") to the U.S.-Canada Income Tax Treaty ("Treaty") entered into force. The new treaty mandates arbitration for the resolution of double taxation disputes that are not settled through the competent authority process. As a result, the Company's US tax position related to the issues raised in the outstanding tax audit by the CRA has become more favorable, and the Company recorded income tax benefits of \$5.1 million in the first quarter of fiscal year 2009. This tax benefit was recorded through a \$3.0 million reduction of Canadian tax contingency reserves, inclusive of interest, and the recognition of a \$2.8 million income tax receivable in the U.S., partially offset by a \$0.7 million increase in related deferred tax liabilities.

The \$0.9 million adjustment to Canadian deferred tax accounts includes a \$0.6 million tax benefit to reflect the reduction to Canadian corporate income tax rates and a \$0.3 million tax benefit to correct the computation of certain deferred tax accounts. The \$0.6 million adjustment should have been recorded in the first quarter of fiscal year 2008 rather than in the first quarter of fiscal year 2009 and the \$0.3 million adjustment should have been recorded in several prior year's financial results. These adjustments are deemed immaterial to the Company's results of operations and financial condition in current periods as well as prior affected periods.

The Company is subject to U.S. federal, state and foreign income and franchise tax in various jurisdictions. Generally, fiscal years 2004 to 2007 remain open to examination by the various taxing jurisdictions and the Company has not been audited for U.S. federal income tax matters. The Company has income tax audits in progress in Canada and in several states, local and international jurisdictions in which it operates. The years under examination by the Canadian taxing authorities are 2001 to 2002. The years under examination by other taxing authorities vary, with the earliest year being 2004.

The Company accounts for uncertainty in income taxes in accordance with FIN No. 48, "Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109." As a result, the Company applies a more-likely-than-not recognition threshold for all income tax uncertainties. FIN No. 48 only allows the recognition of those tax benefits that have a greater than 50% likelihood of being sustained upon examination by the taxing authorities. The total unrecognized tax benefit, which excludes any related interest accruals, was \$3.2 million as of April 3, 2009. Of the total unrecognized tax benefit balance, \$2.1 million of unrecognized tax benefits would reduce the effective tax rate if recognized as of April 3, 2009. Estimated interest and penalties related to the underpayment of income taxes are classified as a component of tax expense in the condensed consolidated statement of operations and comprehensive income and totaled to a benefit of approximately \$1.2 million for the six months ended April 3, 2009, primarily as a result of the favorable impact of the new U.S.-Canada income tax treaty on the Company's tax contingency reserves. Accrued interest and penalties, net of interest benefits accrued on receivables anticipated as a result of the change in the U.S.-Canada treaty, were approximately \$0.4 million as of April 3, 2009. The Company had minimal penalties accrued in income tax expense.

The Company believes that it is reasonably possible that, in the next 12 months, the amount of unrecognized tax benefits related to the resolution of federal, state and foreign matters could be reduced by \$3.2 million as audits close and statutes expire.

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

10. Earnings Per Share

Basic earnings per share are computed using the weighted-average number of common shares outstanding during the period excluding outstanding nonvested restricted shares subject to forfeiture. Diluted earnings per share are computed using the weighted-average number of common and dilutive potential common equivalent shares outstanding during the period. Potential common equivalent shares consist of common stock issuable upon exercise of stock options and nonvested restricted shares using the treasury stock method.

The following table is a reconciliation of the shares used to calculate basic and diluted earnings per share (in thousands):

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|-------------------|------------------|-------------------|
| | April 3, 2009 | March 28, 2008 | April 3, 2009 | March 28, 2008 |
| Weighted average common shares outstanding -- Basic | 16,317 | 16,387 | 16,293 | 16,379 |
| Effect of dilutive stock options and nonvested restricted stock awards and units | 1,002 | 1,269 | 1,060 | 1,365 |
| Weighted average common shares outstanding -- Diluted | 17,319 | 17,656 | 17,353 | 17,744 |

The calculation of diluted net income per share excludes all anti-dilutive shares. For the three and six months ended April 3, 2009, the number of anti-dilutive shares, as calculated based on the weighted average price of the Company's common stock for the periods, was approximately 1.1 million and 1.0 million shares, respectively. For the three and six months ended March 28, 2008, the number of anti-dilutive shares, as calculated based on the weighted average price of the Company's common stock for the periods, was approximately 0.9 million and 0.7 million shares, respectively.

11. Segments, Geographic and Customer Information

The Company's reportable segments are VED and satcom equipment. The VED segment develops, manufactures and distributes high-power/high-frequency microwave and radio frequency signal components. The satcom equipment segment manufactures and supplies high-power amplifiers and networks for satellite communication uplink and industrial applications. Segment information reported below is consistent with the manner in which it is reviewed and evaluated by the Company's chief operating decision maker ("CODM"), its chief executive officer and is based on the nature of the Company's operations and products offered to customers.

Amounts not reported as VED or satcom equipment are reported as Other. In accordance with quantitative and qualitative guidelines established by SFAS No. 131, Other includes the activities of the Company's Malibu division

and unallocated corporate expenses, such as business combination-related expenses, share-based compensation expense and certain non-recurring or unusual expenses. The Malibu division is a designer, manufacturer and integrator of advanced antenna systems for radar, radar simulators and telemetry systems, as well as for data links used in ground, airborne, unmanned aerial vehicles (“UAVs”) and shipboard systems.

- 32 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

Summarized financial information concerning the Company's reportable segments is shown in the following tables:

| | April 3, 2009 | March 28, 2008 | April 3, 2009 | March 28, 2008 |
|---------------------------------------|------------------|-------------------|------------------|-------------------|
| Sales to external customers | | | | |
| VED | \$ 62,069 | \$ 73,744 | \$ 117,697 | \$ 137,734 |
| Satcom equipment | 16,174 | 17,134 | 33,625 | 34,709 |
| Other | 3,660 | 3,926 | 7,727 | 8,271 |
| | \$ 81,903 | \$ 94,804 | \$ 159,049 | \$ 180,714 |
| Intersegment product transfers | | | | |
| VED | \$ 4,422 | \$ 7,287 | \$ 9,787 | \$ 13,148 |
| Satcom equipment | - | 14 | 9 | 63 |
| | \$ 4,422 | \$ 7,301 | \$ 9,796 | \$ 13,211 |
| Capital expenditures | | | | |
| VED | \$ 629 | \$ 502 | \$ 1,494 | \$ 1,344 |
| Satcom equipment | 4 | 210 | 15 | 654 |
| Other | 281 | 159 | 309 | 560 |
| | \$ 914 | \$ 871 | \$ 1,818 | \$ 2,558 |
| EBITDA | | | | |
| VED | \$ 11,850 | \$ 18,647 | \$ 22,201 | \$ 32,287 |
| Satcom equipment | 682 | 656 | 2,045 | 2,377 |
| Other | (1,779) | (3,460) | (3,969) | (6,899) |
| | \$ 10,753 | \$ 15,843 | \$ 20,277 | \$ 27,765 |

| | April 3, 2009 | October 3, 2008 |
|---------------------|------------------|--------------------|
| Total assets | | |
| VED | \$ 327,541 | \$ 324,483 |
| Satcom equipment | 46,615 | 48,219 |
| Other | 89,600 | 94,246 |
| | \$ 463,756 | \$ 466,948 |

EBITDA is the measure used by the CODM to evaluate segment profit or loss. EBITDA represents earnings before net interest expense, provision for income taxes and depreciation and amortization. The Company believes that EBITDA is a more meaningful representation of operating performance for leveraged businesses like its own and therefore uses this metric as its primary measure of profitability. For the reasons listed below, the Company believes EBITDA provides investors better understanding of the Company's financial performance in connection with their analysis of the Company's business:

-

EBITDA is a component of the measures used by the Company's board of directors and management team to evaluate the Company's operating performance;

- 33 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

the Senior Credit Facilities contain a covenant that requires the Company to maintain a senior secured leverage ratio that contains EBITDA as a component, and the Company's management team uses EBITDA to monitor compliance with this covenant;

EBITDA is a component of the measures used by the Company's management team to make day-to-day operating decisions;

EBITDA facilitates comparisons between the Company's operating results and those of competitors with different capital structures and, therefore, is a component of the measures used by the Company's management to facilitate internal comparisons to competitors' results and the Company's industry in general; and

the payment of management bonuses is contingent upon, among other things, the satisfaction by the Company of certain targets that contain EBITDA as a component.

Other companies may define EBITDA differently and, as a result, the Company's measure of EBITDA may not be directly comparable to EBITDA of other companies. Although the Company uses EBITDA as a financial measure to assess the performance of its business, the use of EBITDA is limited because it does not include certain material costs, such as interest and taxes, necessary to operate the Company's business. When analyzing the Company's performance, EBITDA should be considered in addition to, and not as a substitute for, net income, cash flows from operating activities or other statements of operations or statements of cash flows data prepared in accordance with GAAP.

The following table reconciles net income to EBITDA:

| | Three Months Ended | | Six Months Ended | |
|-------------------------------|--------------------|----------------------|------------------|----------------------|
| | April 3, 2009 | March 28, 2008 | April 3, 2009 | March 28, 2008 |
| Net income | \$ 3,689 | \$ 6,154 | \$ 11,344 | \$ 8,664 |
| Depreciation and amortization | 2,679 | 2,742 | 5,377 | 5,392 |
| Interest expense, net | 4,306 | 4,805 | 8,761 | 9,617 |
| Income tax expense (benefit) | 79 | 2,142 | (5,205) | 4,092 |
| EBITDA | \$ 10,753 | \$ 15,843 | \$ 20,277 | \$ 27,765 |

Net property, plant and equipment by geographic area were as follows:

| | April 3, 2009 | October 3, 2008 |
|---------------|------------------|--------------------|
| United States | \$ 46,984 | \$ 48,593 |
| Canada | 13,311 | 13,843 |
| Other | 51 | 51 |

\$ 60,346 \$ 62,487

With the exception of goodwill, the Company does not identify or allocate assets by operating segment, nor does its CODM evaluate operating segments using discrete asset information.

- 34 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

Goodwill by geographic area was as follows:

| | April 3, 2009 | October 3, 2008 |
|---------------|------------------|--------------------|
| United States | \$ 114,297 | \$ 114,297 |
| Canada | 47,996 | 48,314 |
| | \$ 162,293 | \$ 162,611 |

Geographic sales by customer location were as follows for external customers:

| | Three Months Ended | | Six Months Ended | |
|-----------------------|--------------------|----------------------|------------------|-------------------|
| | April 3, 2009 | March 28, 2008 | April 3, 2009 | March 28, 2008 |
| United States | \$ 54,495 | \$ 62,206 | \$ 103,591 | \$ 116,729 |
| All foreign countries | 27,408 | 32,598 | 55,458 | 63,985 |
| Total sales | \$ 81,903 | \$ 94,804 | \$ 159,049 | \$ 180,714 |

There were no individual foreign countries with sales greater than 10% of total sales for the periods presented.

The U.S. Government is the only customer that accounted for 10% or more of the Company's consolidated sales in the three and six months ended April 3, 2009 and in the corresponding periods of fiscal year 2008. Direct sales to the U.S. Government were \$14.6 million and \$25.8 million for the three and six months ended April 3, 2009, respectively, and \$16.1 million and \$30.9 million for the three and six months ended March 28, 2008, respectively. Accounts receivable from this customer represented 14% and 17% of consolidated accounts receivable as of April 3, 2009 and October 3, 2008, respectively.

- 35 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

12. Supplemental Guarantors Condensed Consolidating Financial Information (Unaudited)

Issued on January 23, 2004, CPI's 8% Notes, the current balance of which is \$122.0 million, are guaranteed by CPI International and all of CPI's domestic subsidiaries. Separate financial statements of the guarantors are not presented because (i) the guarantors are wholly owned and have fully and unconditionally guaranteed the 8% Notes on a joint and several basis and (ii) the Company's management has determined that such separate financial statements are not material to investors. Instead, presented below are the consolidating financial statements of: (a) the parent, CPI International, (b) the issuer, CPI, (c) the guarantor subsidiaries (all of the domestic subsidiaries), (d) the non-guarantor subsidiaries, (e) the consolidating elimination entries, and (f) the consolidated totals. The accompanying consolidating financial information should be read in connection with the condensed consolidated financial statements of CPI International.

Investments in subsidiaries are accounted for based on the equity method. The principal elimination entries eliminate investments in subsidiaries, intercompany balances, intercompany transactions and intercompany sales.

- 36 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

CONDENSED CONSOLIDATING BALANCE SHEET

As of April 3, 2009

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|---|-----------------------|-------------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Assets | | | | | | |
| Current assets: | | | | | | |
| Cash and cash equivalents | \$ 29 | \$ 17,131 | \$ 608 | \$ 10,095 | \$ - | \$ 27,863 |
| Restricted cash | - | - | 971 | 130 | - | 1,101 |
| Accounts receivable, net | - | 19,145 | 12,054 | 10,683 | - | 41,882 |
| Inventories | - | 44,876 | 7,458 | 17,055 | (1,068) | 68,321 |
| Deferred tax assets | - | 12,326 | 2 | 818 | - | 13,146 |
| Intercompany receivable | - | 13,768 | 4,514 | 8,437 | (26,719) | - |
| Prepaid and other current assets | - | 2,680 | 514 | 614 | - | 3,808 |
| Total current assets | 29 | 109,926 | 26,121 | 47,832 | (27,787) | 156,121 |
| Property, plant and equipment, net | - | 44,028 | 2,971 | 13,347 | - | 60,346 |
| Deferred debt issue costs, net | 368 | 3,953 | - | - | - | 4,321 |
| Intangible assets, net | - | 55,795 | 13,864 | 7,365 | - | 77,024 |
| Goodwill | - | 93,375 | 20,973 | 47,945 | - | 162,293 |
| Other long-term assets | - | 3,271 | 293 | 87 | - | 3,651 |
| Intercompany notes receivable | - | 1,035 | - | - | (1,035) | - |
| Investment in subsidiaries | 192,348 | 107,451 | - | - | (299,799) | - |
| Total assets | \$ 192,745 | \$ 418,834 | \$ 64,222 | \$ 116,576 | \$ (328,621) | \$ 463,756 |
| Liabilities and stockholders' equity | | | | | | |
| Current liabilities: | | | | | | |
| Current portion of long-term debt | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - |
| Accounts payable | - | 11,944 | 2,442 | 6,679 | - | 21,065 |
| Accrued expenses | 155 | 17,277 | 1,497 | 2,995 | - | 21,924 |
| Product warranty | - | 1,913 | 527 | 1,541 | - | 3,981 |

Edgar Filing: CPI INTERNATIONAL, INC. - Form 10-Q

| | | | | | | |
|--|------------|------------|-----------|------------|--------------|------------|
| Income taxes payable | - | 1 | 101 | 3,510 | - | 3,612 |
| Advance payments from customers | - | 7,318 | 3,346 | 2,234 | - | 12,898 |
| Intercompany payable | 26,719 | - | - | - | (26,719) | - |
| Total current liabilities | 26,874 | 38,453 | 7,913 | 16,959 | (26,719) | 63,480 |
| Deferred income taxes | - | 21,661 | - | 4,847 | - | 26,508 |
| Intercompany notes payable | - | - | - | 1,035 | (1,035) | - |
| Long-term debt, less current portion | 11,916 | 206,000 | - | - | - | 217,916 |
| Other long-term liabilities | - | 1,449 | - | 448 | - | 1,897 |
| Total liabilities | 38,790 | 267,563 | 7,913 | 23,289 | (27,754) | 309,801 |
| Common stock | 167 | - | - | - | - | 167 |
| Parent investment | - | 51,089 | 43,167 | 58,351 | (152,607) | - |
| Additional paid-in capital | 73,824 | - | - | - | - | 73,824 |
| Accumulated other comprehensive loss | (5,071) | (5,071) | - | (1,110) | 6,181 | (5,071) |
| Retained earnings | 87,835 | 105,253 | 13,142 | 36,046 | (154,441) | 87,835 |
| Treasury stock, at cost | (2,800) | - | - | - | - | (2,800) |
| Total stockholders' equity | 153,955 | 151,271 | 56,309 | 93,287 | (300,867) | 153,955 |
| Total liabilities and stockholders' equity | \$ 192,745 | \$ 418,834 | \$ 64,222 | \$ 116,576 | \$ (328,621) | \$ 463,756 |

- 37 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

CONDENSED CONSOLIDATING BALANCE SHEET
As of October 3, 2008

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|---|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Assets | | | | | | |
| Current assets: | | | | | | |
| Cash and cash equivalents | \$ 84 | \$ 26,272 | \$ 493 | \$ 1,821 | \$ - | \$ 28,670 |
| Restricted cash | - | - | 629 | 147 | - | 776 |
| Accounts receivable, net | - | 22,453 | 12,353 | 12,542 | - | 47,348 |
| Inventories | - | 42,066 | 6,759 | 17,653 | (990) | 65,488 |
| Deferred tax assets | - | 10,853 | 2 | 556 | - | 11,411 |
| Intercompany receivable | - | 8,523 | 5,135 | 13,454 | (27,112) | - |
| Prepaid and other current assets | - | 2,370 | 632 | 821 | - | 3,823 |
| Total current assets | 84 | 112,537 | 26,003 | 46,994 | (28,102) | 157,516 |
| Property, plant and equipment, net | - | 45,556 | 3,047 | 13,884 | - | 62,487 |
| Deferred debt issue costs, net | 392 | 4,602 | - | - | - | 4,994 |
| Intangible assets, net | - | 56,700 | 14,168 | 7,666 | - | 78,534 |
| Goodwill | - | 93,375 | 20,973 | 48,263 | - | 162,611 |
| Other long-term assets | - | 383 | 287 | 136 | - | 806 |
| Intercompany notes receivable | - | 1,035 | - | - | (1,035) | - |
| Investment in subsidiaries | 182,869 | 101,193 | - | - | (284,062) | - |
| Total assets | \$ 183,345 | \$ 415,381 | \$ 64,478 | \$ 116,943 | \$ (313,199) | \$ 466,948 |
| Liabilities and stockholders' equity | | | | | | |
| Current liabilities: | | | | | | |
| Current portion of long-term debt | | | | | | |
| long-term debt | \$ - | \$ 1,000 | \$ - | \$ - | \$ - | \$ 1,000 |
| Accounts payable | 272 | 10,893 | 2,116 | 7,828 | - | 21,109 |
| Accrued expenses | 186 | 14,905 | 3,143 | 4,810 | - | 23,044 |

Edgar Filing: CPI INTERNATIONAL, INC. - Form 10-Q

| | | | | | | |
|--|------------|------------|-----------|------------|--------------|------------|
| Product warranty | - | 2,002 | 538 | 1,619 | - | 4,159 |
| Income taxes payable | - | 1,280 | 213 | 6,273 | - | 7,766 |
| Advance payments from customers | - | 7,624 | 3,132 | 1,579 | - | 12,335 |
| Intercompany payable | 27,112 | - | - | - | (27,112) | - |
| Total current liabilities | 27,570 | 37,704 | 9,142 | 22,109 | (27,112) | 69,413 |
| Deferred income taxes | - | 21,922 | - | 5,399 | - | 27,321 |
| Intercompany notes payable | - | - | - | 1,035 | (1,035) | - |
| Long-term debt, less current portion | 11,910 | 212,750 | - | - | - | 224,660 |
| Other long-term liabilities | - | 1,213 | - | 476 | - | 1,689 |
| Total liabilities | 39,480 | 273,589 | 9,142 | 29,019 | (28,147) | 323,083 |
| Common stock | 165 | - | - | - | - | 165 |
| Parent investment | - | 50,020 | 43,167 | 58,114 | (151,301) | - |
| Additional paid-in capital | 71,818 | - | - | - | - | 71,818 |
| Accumulated other comprehensive loss | (1,809) | (1,809) | - | (283) | 2,092 | (1,809) |
| Retained earnings | 76,491 | 93,581 | 12,169 | 30,093 | (135,843) | 76,491 |
| Treasury stock, at cost | (2,800) | - | - | - | - | (2,800) |
| Total stockholders' equity | 143,865 | 141,792 | 55,336 | 87,924 | (285,052) | 143,865 |
| Total liabilities and stockholders' equity | \$ 183,345 | \$ 415,381 | \$ 64,478 | \$ 116,943 | \$ (313,199) | \$ 466,948 |

- 38 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

For the Three Months Ended April 3, 2009

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|--|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Sales | \$ - | \$ 52,641 | \$ 17,077 | \$ 30,510 | \$ (18,325) | \$ 81,903 |
| Cost of sales | - | 39,798 | 14,124 | 24,538 | (18,323) | 60,137 |
| Gross profit | - | 12,843 | 2,953 | 5,972 | (2) | 21,766 |
| Operating costs and expenses: | | | | | | |
| Research and development | - | 1,074 | 3 | 2,080 | - | 3,157 |
| Selling and marketing | - | 1,820 | 988 | 1,993 | - | 4,801 |
| General and administrative | - | 4,180 | 1,131 | (115) | - | 5,196 |
| Amortization of acquisition-related intangible assets | - | 390 | 151 | 150 | - | 691 |
| Net loss on disposition of assets | - | 41 | - | 3 | - | 44 |
| Total operating costs and expenses | - | 7,505 | 2,273 | 4,111 | - | 13,889 |
| Operating income | - | 5,338 | 680 | 1,861 | (2) | 7,877 |
| Interest expense (income), net | 253 | 4,045 | (3) | 11 | - | 4,306 |
| Gain on debt extinguishment | - | (197) | - | - | - | (197) |
| (Loss) income before income tax expense and equity in income of subsidiaries | (253) | 1,490 | 683 | 1,850 | (2) | 3,768 |
| Income tax (benefit) expense | (98) | (251) | 271 | 157 | - | 79 |
| Equity in income of subsidiaries | 3,844 | 2,103 | - | - | (5,947) | - |
| Net income | \$ 3,689 | \$ 3,844 | \$ 412 | \$ 1,693 | \$ (5,949) | \$ 3,689 |

CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

For the Three Months Ended March 28, 2008

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|--|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Sales | \$ - | \$ 60,336 | \$ 21,125 | \$ 34,490 | \$ (21,147) | \$ 94,804 |
| Cost of sales | - | 42,877 | 17,891 | 27,079 | (21,109) | 66,738 |
| Gross profit | - | 17,459 | 3,234 | 7,411 | (38) | 28,066 |
| Operating costs and expenses: | | | | | | |
| Research and development | - | 729 | 272 | 1,929 | - | 2,930 |
| Selling and marketing | - | 2,070 | 1,175 | 2,083 | - | 5,328 |
| General and administrative | - | 3,817 | 1,018 | 657 | - | 5,492 |
| Amortization of acquisition-related intangible assets | - | 100 | 531 | 150 | - | 781 |
| Net loss on disposition of assets | - | 22 | 10 | 9 | - | 41 |
| Total operating costs and expenses | - | 6,738 | 3,006 | 4,828 | - | 14,572 |
| Operating income | - | 10,721 | 228 | 2,583 | (38) | 13,494 |
| Interest expense (income), net | 512 | 4,314 | (17) | (4) | - | 4,805 |
| Loss on debt extinguishment | 393 | - | - | - | - | 393 |
| (Loss) income before income tax expense and equity in income of subsidiaries | (905) | 6,407 | 245 | 2,587 | (38) | 8,296 |
| Income tax (benefit) expense | (344) | 2,741 | (135) | (120) | - | 2,142 |
| Equity in income of subsidiaries | 6,715 | 3,049 | - | - | (9,764) | - |
| Net income | \$ 6,154 | \$ 6,715 | \$ 380 | \$ 2,707 | \$ (9,802) | \$ 6,154 |

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS
For the Six Months Ended April 3, 2009

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|--|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Sales | \$ - | \$ 98,856 | \$ 36,784 | \$ 62,233 | \$ (38,824) | \$ 159,049 |
| Cost of sales | - | 76,065 | 30,737 | 49,311 | (38,746) | 117,367 |
| Gross profit | - | 22,791 | 6,047 | 12,922 | (78) | 41,682 |
| Operating costs and expenses: | | | | | | |
| Research and development | - | 1,758 | 3 | 3,579 | - | 5,340 |
| Selling and marketing | - | 3,562 | 2,235 | 3,993 | - | 9,790 |
| General and administrative | - | 7,894 | 2,154 | 352 | - | 10,400 |
| Amortization of acquisition-related intangible assets | - | 780 | 304 | 301 | - | 1,385 |
| Net loss on disposition of assets | - | 57 | - | 7 | - | 64 |
| Total operating costs and expenses | - | 14,051 | 4,696 | 8,232 | - | 26,979 |
| Operating income | - | 8,740 | 1,351 | 4,690 | (78) | 14,703 |
| Interest expense (income), net | 531 | 8,198 | (8) | 40 | - | 8,761 |
| Gain on debt extinguishment | - | (197) | - | - | - | (197) |
| (Loss) income before income tax expense and equity in income of subsidiaries | (531) | 739 | 1,359 | 4,650 | (78) | 6,139 |
| Income tax (benefit) expense | (203) | (4,085) | 386 | (1,303) | - | (5,205) |
| Equity in income of subsidiaries | 11,672 | 6,848 | - | - | (18,520) | - |
| Net income | \$ 11,344 | \$ 11,672 | \$ 973 | \$ 5,953 | \$ (18,598) | \$ 11,344 |

CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS
For the Six Months Ended March 28, 2008

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|--|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Sales | \$ - | \$ 110,098 | \$ 40,951 | \$ 69,328 | \$ (39,663) | \$ 180,714 |
| Cost of sales | - | 80,308 | 34,476 | 53,306 | (39,578) | 128,512 |
| Gross profit | - | 29,790 | 6,475 | 16,022 | (85) | 52,202 |
| Operating costs and expenses: | | | | | | |
| Research and development | - | 1,621 | 421 | 3,612 | - | 5,654 |
| Selling and marketing | - | 3,993 | 2,187 | 4,320 | - | 10,500 |
| General and administrative | - | 7,535 | 2,088 | 2,022 | - | 11,645 |
| Amortization of acquisition-related intangible assets | - | 668 | 593 | 301 | - | 1,562 |
| Net loss on disposition of assets | - | 44 | 12 | 19 | - | 75 |
| Total operating costs and expenses | - | 13,861 | 5,301 | 10,274 | - | 29,436 |
| Operating income | - | 15,929 | 1,174 | 5,748 | (85) | 22,766 |
| Interest expense (income), net | 1,057 | 8,599 | (37) | (2) | - | 9,617 |
| Loss on debt extinguishment | 393 | - | - | - | - | 393 |
| (Loss) income before income tax expense and equity in income of subsidiaries | (1,450) | 7,330 | 1,211 | 5,750 | (85) | 12,756 |
| Income tax (benefit) expense | (551) | 3,482 | 119 | 1,042 | - | 4,092 |
| Equity in income of subsidiaries | 9,563 | 5,715 | - | - | (15,278) | - |
| Net income | \$ 8,664 | \$ 9,563 | \$ 1,092 | \$ 4,708 | \$ (15,363) | \$ 8,664 |

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS
For the Six Months Ended April 3, 2009

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|--|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Cash flows from operating activities | | | | | | |
| Net cash (used in) provided by operating activities | \$ (1,092) | \$ 8,429 | \$ 227 | \$ 301 | \$ - | \$ 7,865 |
| Cash flows from investing activities | | | | | | |
| Capital expenditures | - | (1,679) | (112) | (27) | - | (1,818) |
| Net cash used in investing activities | - | (1,679) | (112) | (27) | - | (1,818) |
| Cash flows from financing activities | | | | | | |
| Repayments of debt | - | (7,495) | - | - | - | (7,495) |
| Proceeds from issuance of common stock to employees | 605 | - | - | - | - | 605 |
| Proceeds from exercise of stock options | 36 | - | - | - | - | 36 |
| Intercompany dividends | 396 | (8,396) | - | 8,000 | - | - |
| Net cash provided by (used in) financing activities | 1,037 | (15,891) | - | 8,000 | - | (6,854) |
| Net (decrease) increase in cash and cash equivalents | (55) | (9,141) | 115 | 8,274 | - | (807) |
| Cash and cash equivalents at beginning of period | 84 | 26,272 | 493 | 1,821 | - | 28,670 |
| Cash and cash equivalents at end of period | \$ 29 | \$ 17,131 | \$ 608 | \$ 10,095 | \$ - | \$ 27,863 |

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

Edgar Filing: CPI INTERNATIONAL, INC. - Form 10-Q

For the Six Months Ended March 28, 2008

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|--|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Cash flows from operating activities | | | | | | |
| Net cash (used in) provided by operating activities | \$ (1,812) | \$ 1,779 | \$ 8,749 | \$ 1,723 | \$ - | \$ 10,439 |
| Cash flows from investing activities | | | | | | |
| Capital expenditures | - | (1,941) | (95) | (522) | - | (2,558) |
| Proceeds from adjustment to acquisition purchase price | - | 1,615 | - | - | - | 1,615 |
| Payment of patent application fees | - | - | (147) | - | - | (147) |
| Net cash used in investing activities | - | (326) | (242) | (522) | - | (1,090) |
| Cash flows from financing activities | | | | | | |
| Repayments of debt | (6,000) | (4,000) | - | - | - | (10,000) |
| Proceeds from issuance of common stock to employees | 418 | - | - | - | - | 418 |
| Intercompany dividends | 6,200 | (6,200) | - | - | - | - |
| Net cash provided by (used in) financing activities | 618 | (10,200) | - | - | - | (9,582) |
| Net (decrease) increase in cash and cash equivalents | (1,194) | (8,747) | 8,507 | 1,201 | - | (233) |
| Cash and cash equivalents at beginning of period | 1,378 | 16,518 | 958 | 1,620 | - | 20,474 |
| Cash and cash equivalents at end of period | \$ 184 | \$ 7,771 | \$ 9,465 | \$ 2,821 | \$ - | \$ 20,241 |

- 41 -

Table of Contents

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

Our fiscal years are the 52- or 53-week periods that end on the Friday nearest September 30. Fiscal year 2009 comprises the 52-week period ending October 2, 2009, and fiscal year 2008 comprised the 53-week period ended October 3, 2008. The second quarters of fiscal years 2009 and 2008 both include 13 weeks. The first two quarters of fiscal years 2009 and 2008 both include 26 weeks. The following discussion should be read in conjunction with the accompanying unaudited condensed consolidated financial statements, and the notes thereto, of CPI International, Inc.

Overview

CPI International, Inc., headquartered in Palo Alto, California, is the parent company of Communications & Power Industries, a provider of microwave, radio frequency, power and control solutions for critical defense, communications, medical, scientific and other applications. Communications & Power Industries develops, manufactures and distributes products used to generate, amplify and transmit high-power/high-frequency microwave and radio frequency signals and/or provide power and control for various applications. End-use applications of these systems include the transmission of radar signals for navigation and location; transmission of deception signals for electronic countermeasures; transmission and amplification of voice, data and video signals for broadcasting, Internet and other types of commercial and military communications; providing power and control for medical diagnostic imaging; and generating microwave energy for radiation therapy in the treatment of cancer and for various industrial and scientific applications.

Unless the context otherwise requires, "CPI International" means CPI International, Inc., and "CPI" means Communications & Power Industries, Inc. CPI is a direct subsidiary of CPI International. CPI International is a holding company with no operations of its own. The terms "we," "us," "our" and the "Company" refer to CPI International and its direct and indirect subsidiaries on a consolidated basis.

Orders

We sell our products into five end markets: radar and electronic warfare, medical, communications, industrial and scientific.

Our customer sales contracts are recorded as orders when we accept written customer purchase orders or contracts. Customer purchase orders with an undefined delivery schedule, or blanket purchase orders, are not reported as orders until the delivery date is determined. Our government sales contracts are not reported as orders until we have been notified that the contract has been funded. Total orders for a fiscal period represent the total dollar amount of customer orders recorded by us during the fiscal period, reduced by the dollar amount of any order cancellations or terminations during the fiscal period.

- 42 -

[Table of Contents](#)

Our orders by market for the six months ended April 3, 2009 and March 28, 2008 are summarized as follows (dollars in millions):

| | Six Months Ended | | | | | |
|------------------------------|------------------|-------------|----------------|-------------|---------------------|---------|
| | April 3, 2009 | | March 28, 2008 | | Increase (Decrease) | |
| | Amount | % of Orders | Amount | % of Orders | Amount | Percent |
| Radar and Electronic Warfare | \$ 75.6 | 41% | \$ 66.7 | 36% | \$ 8.9 | 13% |
| Medical | 39.7 | 22 | 36.7 | 20 | 3.0 | 8 |
| Communications | 54.8 | 30 | 59.9 | 32 | (5.1) | (9) |
| Industrial | 11.1 | 6 | 14.3 | 8 | (3.2) | (22) |
| Scientific | 1.3 | 1 | 7.6 | 4 | (6.3) | (83) |
| Total | \$ 182.5 | 100% | \$ 185.2 | 100% | \$ (2.7) | (1)% |

In the fourth quarter of fiscal year 2008, we changed the way in which we categorize orders and sales of the tactical common data link (“TCDL”) products at our Malibu division, which we acquired in August 2007. TCDL products support intelligence, surveillance and reconnaissance (“ISR”) applications. Previously, orders and sales of our TCDL products were included in our radar and electronic warfare market. We are now reporting these orders and sales in our communications market, which we believe is the more appropriate category for these products. We reclassified previously reported orders and sales information to properly reflect TCDL products as an increase in the communications market and a corresponding decrease in the radar and electronic warfare market. For the six months ended March 28, 2008, the order amount reclassified was \$4.0 million. The table above reflects this change.

In recent months, including the six months ended April 3, 2009, our defense markets, which include our radar and electronic warfare markets, were negatively impacted by ongoing delays in the receipt of orders. While the order levels in our defense markets currently appear to be stabilizing, we believe that these delays have resulted in a decrease in demand for our products to support defense programs, and that the delays in the receipt of defense orders may continue for the foreseeable future.

Our commercial markets, which include our medical, commercial communications, industrial and scientific markets, were negatively impacted in the six months ended April 3, 2009 by the weakening of the U.S. and foreign economies. Many of the commercial programs in which we participate depend on customers upgrading their current equipment or expanding their infrastructures. With the recent softening of global economies, we believe that many of our customers have delayed, reduced or cancelled their upgrade or expansion plans. We believe that the weakening global economies have resulted in a near-term decrease in demand for our products to support commercial programs.

Orders for the six months ended April 3, 2009 of \$182.5 million were \$2.7 million, or approximately 1%, lower than orders of \$185.2 million for the corresponding period of fiscal year 2008. Explanations for the order increase or decrease by market are as follows:

- **Radar and Electronic Warfare:** The majority of our orders in the radar and electronic warfare markets are products for domestic and international defense and government end uses. Orders in these markets are characterized by many smaller orders in the \$0.5 million to \$3.0 million range by product or program, and the timing of the receipt of these orders may vary from year to year. On a combined basis, orders for the radar and electronic warfare markets increased approximately 13% from an aggregate of \$66.7 million in the first six months of fiscal year 2008 to an aggregate of \$75.6 million in the first six months of fiscal year 2009. The increase in orders for these combined markets resulted primarily from the timing of the placement of orders to support various foreign and domestic radar programs, as well as the receipt of several large development orders to support various radar programs, and was partially offset by delays in the receipt of orders for certain other defense programs.
- **Medical:** Orders for our medical products consist of orders for medical imaging applications, such as x-ray imaging, magnetic resonance imaging (“MRI”), and positron emission tomography (“PET”) applications, and for radiation therapy applications for the treatment of cancer. The 8% increase in medical orders was due to increased demand for products to support radiation therapy applications. This increase was partially offset by a decrease in demand for products to support x-ray imaging applications due to the weakening of global economies.
- **Communications:** The 9% decrease in communications orders was primarily attributable to decreases in orders to support commercial communications applications, including direct-to-home broadcast, fixed satellite broadcast and satellite news gathering applications, as well as commercial radio broadcast applications. We believe that these decreases were largely due to the weakening of global economies. Delays in the timing of orders received by our Malibu division also contributed to the decrease in communications orders; we expect to receive a number of the Malibu division’s delayed orders later in fiscal year 2009. These decreases were partially offset by an increase in orders for military communications programs, including an approximately \$13 million order for the Warfighter Information Network – Tactical (WIN-T) program. Military communications is a relatively new sector of the overall communications market for us. We expect our participation in military communications programs to continue to grow.
- **Industrial:** Orders in the industrial market are cyclical and are generally tied to the state of the economy. The \$3.2 million decrease in industrial orders was primarily attributable to decreases in orders for products used in industrial fabrication applications, including semiconductor wafer fabrication, and industrial heating applications.
- **Scientific:** Orders in the scientific market are historically one-time projects and can fluctuate significantly from period to period. The \$6.3 million decrease in scientific orders was primarily the result of the receipt of a \$5.6 million order in the first six months of fiscal year 2008 for products to support a new accelerator project for fusion research at an international scientific institute. This order was not expected to, and did not, repeat in the first six months of fiscal year 2009; shipments for this order are scheduled to be completed in fiscal year 2011.

Incoming order levels can fluctuate significantly on a quarterly or annual basis, and a particular quarter’s or year’s order rate may not be indicative of future order levels. In addition, our sales are highly dependent upon manufacturing scheduling and performance and, accordingly, it is not possible to accurately predict when orders will be recognized as sales.

Backlog

As of April 3, 2009, we had an order backlog of \$225.4 million compared to an order backlog of \$201.8 million as of March 28, 2008. Because our orders for government end-use products generally have much longer delivery terms than our orders for commercial business (which require quicker turn-around), our backlog is primarily composed of government orders.

Backlog represents the cumulative balance, at a given point in time, of recorded customer sales orders that have not yet been shipped or recognized as sales. Backlog is increased when an order is received, and backlog is decreased when we recognize sales. We believe that backlog and orders information is helpful to investors because this information may be indicative of future sales results. Although backlog consists of firm orders for which goods and services are yet to be provided, customers can, and sometimes do, terminate or modify these orders. However, historically the amount of modifications and terminations has not been material compared to total contract volume.

Results of Operations

We derive our revenue primarily from the sale of microwave and radio frequency products, including high-power microwave amplifiers, satellite communications amplifiers, medical x-ray imaging subsystems and other related products. Our products generally have selling prices ranging from \$2,000 to \$100,000, with certain limited products priced up to \$1,000,000.

Cost of goods sold generally includes costs for raw materials, manufacturing costs, including allocation of overhead and other indirect costs, charges for reserves for excess and obsolete inventory, warranty claims and losses on fixed price contracts. Operating expenses generally consist of research and development, selling and marketing and general and administrative expenses.

- 45 -

[Table of Contents](#)

Edgar Filing: CPI INTERNATIONAL, INC. - Form 10-Q

Three Months Ended April 3, 2009 Compared to Three Months Ended March 28, 2008

The following table sets forth our historical results of operations for each of the periods indicated (dollars in millions):

| | Three Months Ended | | | | Increase (Decrease) Amount |
|---|--------------------|---------------|----------------|---------------|----------------------------------|
| | April 3, 2009 | | March 28, 2008 | | |
| | Amount | % of Sales | Amount | % of Sales | |
| Sales | \$ 81.9 | 100.0% | \$ 94.8 | 100.0% | \$ (12.9) |
| Cost of sales | 60.1 | 73.4 | 66.7 | 70.4 | (6.6) |
| Gross profit | 21.8 | 26.6 | 28.1 | 29.6 | (6.3) |
| Research and development | 3.2 | 3.9 | 2.9 | 3.1 | 0.3 |
| Selling and marketing | 4.8 | 5.9 | 5.3 | 5.6 | (0.5) |
| General and administrative | 5.2 | 6.3 | 5.5 | 5.8 | (0.3) |
| Amortization of acquisition-related intangibles | 0.7 | 0.9 | 0.8 | 0.8 | (0.1) |
| Net loss on disposition of assets | - | - | - | - | - |
| Operating income | 7.9 | 9.6 | 13.5 | 14.2 | (5.6) |
| Interest expense, net | 4.3 | 5.3 | 4.8 | 5.1 | (0.5) |
| (Gain) loss on debt extinguishment | (0.2) | (0.2) | 0.4 | 0.4 | (0.6) |
| Income before taxes | 3.8 | 4.6 | 8.3 | 8.8 | (4.5) |
| Income tax expense | 0.1 | 0.1 | 2.1 | 2.2 | (2.0) |
| Net income | \$ 3.7 | 4.5% | \$ 6.2 | 6.5% | \$ (2.5) |
| Other Data: | | | | | |
| EBITDA (a) | \$ 10.8 | 13.2% | \$ 15.8 | 16.7% | \$ (5.0) |

Note: Totals may not equal the sum of the component line items due to independent rounding. Percentages are calculated based on rounded dollar amounts presented.

- (a) EBITDA is the measure used by the CODM to evaluate segment profit or loss. EBITDA represents earnings before net interest expense, provision for income taxes and depreciation and amortization. We believe that EBITDA is a more meaningful representation of operating performance for leveraged businesses like our own and, therefore, use this metric as our primary measure of profitability. For the reasons listed below, we believe EBITDA provides investors better understanding of our financial performance in connection with their analysis of our business:

EBITDA is a component of the measures used by our board of directors and management team to evaluate our operating performance;

our senior credit facilities contain a covenant that requires us to maintain a senior secured leverage ratio that contains EBITDA as a component, and our management team uses EBITDA to monitor compliance with this covenant;

EBITDA is a component of the measures used by our management team to make day-to-day operating decisions;

EBITDA facilitates comparisons between our operating results and those of competitors with different capital structures and therefore is a component of the measures used by the management to facilitate internal comparisons to competitors' results and our industry in general; and

the payment of management bonuses is contingent upon, among other things, the satisfaction by us of certain targets that contain EBITDA as a component.

- 46 -

[Table of Contents](#)

Other companies may define EBITDA differently and, as a result, our measure of EBITDA may not be directly comparable to EBITDA of other companies.

Although we use EBITDA as a financial measure to assess the performance of our business, the use of EBITDA is limited because it does not include certain material costs, such as interest and taxes, necessary to operate our business. When analyzing our performance, EBITDA should be considered in addition to, and not as a substitute for, net income, cash flows from operating activities or other statements of operations or statements of cash flows data prepared in accordance with GAAP.

For a reconciliation of Net Income to EBITDA, see Note 11 of the accompanying unaudited condensed consolidated financial statements.

Sales: Our sales by market for the three months ended April 3, 2009 and March 28, 2008 are summarized as follows (dollars in millions):

| | Three Months Ended | | | | | |
|------------------------------|--------------------|------------|----------------|------------|---------------------|---------|
| | April 3, 2009 | | March 28, 2008 | | Increase (Decrease) | |
| | Amount | % of Sales | Amount | % of Sales | Amount | Percent |
| Radar and Electronic Warfare | \$ 34.3 | 42% | \$ 39.7 | 42% | \$ (5.4) | (14) % |
| Medical | 15.6 | 19 | 17.0 | 18 | (1.4) | (8) |
| Communications | 25.3 | 31 | 28.5 | 30 | (3.2) | (11) |
| Industrial | 4.4 | 5 | 6.6 | 7 | (2.2) | (33) |
| Scientific | 2.3 | 3 | 3.0 | 3 | (0.7) | (23) |
| Total | \$ 81.9 | 100% | \$ 94.8 | 100% | \$ (12.9) | (14) % |

In the fourth quarter of fiscal year 2008, we changed the way in which we categorize orders and sales of the TCDL products at our Malibu division. Previously, orders and sales of our TCDL products were included in our radar and electronic warfare market. We are now reporting these orders and sales in our communications market, which we believe is the more appropriate category for these products. We reclassified previously reported orders and sales information to properly reflect TCDL products as an increase in the communications market and a corresponding decrease in the radar and electronic warfare market. For the three months ended March 28, 2008, the sales amount reclassified was \$0.9 million. The table above reflects this change.

Sales for the three months ended April 3, 2009 of \$81.9 million were \$12.9 million, or approximately 14%, lower than sales of \$94.8 million for the corresponding period of fiscal year 2008. Explanations for the sales increase or decrease by market are as follows:

- **Radar and Electronic Warfare:** The majority of our sales in the radar and electronic warfare markets are products for domestic and international defense and government end uses. The timing of the receipt of orders and subsequent shipments in these markets may vary from year to year. On a combined basis, sales for these two markets decreased approximately 14% from \$39.7 million in the three months ended March 28, 2008 to \$34.3 million in the three months ended April 3, 2009, primarily due to an expected \$1.9 million decrease in shipments of products to support the Aegis weapons system and decreases in sales for several other radar programs due to the timing of order receipts for those programs.

- 47 -

Table of Contents

Demand for our products to support ships with the Aegis weapons system has two components: we support new ship builds and we provide spare and repair products for previously fielded ships. Over the past several years, we have seen high demand for products to support a significant number of funded new ship builds for the Aegis weapons program for U.S. and international military customers. We have now completed supplying our products required to support these funded new ship builds, and, as a result, we expect the near-term demand to be primarily for spare and repair products and the near-term sales to be roughly half of the approximately \$20 million fiscal year 2008 sales level. We expect demand for our products to increase again in several years as the new ships are commissioned, deployed and added to the installed base, after which they also will require spare and repair products.

- Medical: Sales of our medical products consist of sales for medical imaging applications, such as x-ray imaging, MRI and PET applications, and for radiation therapy applications for the treatment of cancer. The 8% decrease in medical product sales was due to decreased sales of x-ray imaging products to international customers as a result of the weakening of global economies.
- Communications: The 11% decrease in sales in the communications market was primarily attributable to decreases in sales to support certain commercial communications applications, including satellite news gathering and direct-to-home broadcast applications as well as commercial radio broadcast applications. We believe the decreases were largely due to the weakening of global economies. These decreases were partially offset by an increase in sales of products for military communications programs, which is a relatively new sector of the overall communications market for us. We expect our participation in military communications programs to continue to grow.
- Industrial: Sales in the industrial market are cyclical and are generally tied to the state of the economy. The \$2.2 million decrease in sales of industrial products was primarily attributable to decreases in orders for products used in industrial fabrication applications, including semiconductor wafer fabrication, and industrial heating applications.
- Scientific: Sales in the scientific market are historically one-time projects and can fluctuate significantly from period to period. The \$0.7 million decrease in scientific sales was primarily the result of the recent completion of product shipments for the Spallation Neutron Source at Oakridge National Laboratory and the timing of certain other scientific programs.

Gross Profit. Gross profit was \$21.8 million, or 26.6% of sales, for the three months ended April 3, 2009 as compared to \$28.1 million, or 29.6% of sales, for the three months ended March 28, 2008. Gross profit is influenced by numerous factors including sales volume and mix, pricing, raw material and manufacturing costs, and warranty costs. The primary reason for the reduction in gross profit for the three months ended April 3, 2009 as compared to the three months ended March 28, 2008 was lower sales volume and therefore lower manufacturing cost absorption due to the reduction in sales volume.

Research and Development. Research and development expenses were \$3.2 million, or 3.9% of sales, for the three months ended April 3, 2009, a \$0.3 million increase from \$2.9 million, or 3.1% of sales, for the three months ended March 28, 2008. The increase in research and development for the three months ended April 3, 2009 compared to the three months ended March 28, 2008 was due primarily to additional development efforts for our new solid state radar products.

Total spending on research and development, including customer-sponsored research and development, was as follows (in millions):

| | Three Months Ended | |
|---|--------------------|----------------------|
| | April 3, 2009 | March 28, 2008 |
| Company sponsored | \$ 3.2 | \$ 2.9 |
| Customer sponsored, charged to cost of sales | 4.1 | 3.5 |
| | \$ 7.3 | \$ 6.4 |

Selling and Marketing. Selling and marketing expenses were \$4.8 million, or 5.9% of sales, for the three months ended April 3, 2009, a \$0.5 million decrease from the \$5.3 million, or 5.6% of sales, for the three months ended March 28, 2008. The reduction in selling and marketing expenses for the three months ended April 3, 2009 compared to the three months ended March 28, 2008 was primarily due to the implementation of cost-reduction initiatives and approximately \$0.1 million of favorable impact from currency translation of our foreign-based expenses.

General and Administrative. General and administrative expenses were \$5.2 million, or 6.3% of sales, for the three months ended April 3, 2009, a \$0.3 million decrease from the \$5.5 million, or 5.8% of sales, for the three months ended March 28, 2008. The decrease in general and administrative expenses in the three months ended April 3, 2009 was primarily due to lower expenses from the implementation of cost-reduction initiatives which were partially offset by foreign currency translation losses. Foreign currency translation was a loss of \$0.5 million for the three months ended April 3, 2009, and a gain of \$15,000 for the three months ended March 28, 2008.

Amortization of Acquisition-Related Intangibles. Amortization of acquisition-related intangibles consists of purchase accounting charges for technology and other intangible assets. Amortization of acquisition-related intangibles was \$0.7 million for the three months ended April 3, 2009 and \$0.8 million for the three months ended March 28, 2008. The \$0.1 million dollar decrease in amortization of acquisition-related intangibles for the three months ended April 3, 2009 compared to the three months ended March 28, 2008 was primarily due to completed amortization of customer backlog in fiscal year 2008 for our Malibu division which was acquired in August 2007.

Interest Expense, net ("Interest Expense"). Interest Expense was \$4.3 million, or 5.3% of sales, for the three months ended April 3, 2009, a \$0.5 million decrease from the \$4.8 million, or 5.1% of sales, for the three months ended March 28, 2008. The reduction in interest expense for the three months ended April 3, 2009 was primarily due to repayments of debt over the past year which resulted in lower interest expense during the three months ended April 3, 2009 compared to the three months ended March 28, 2008.

(Gain) Loss on Debt Extinguishment. The gain on debt extinguishment of \$0.2 million in the three months ended April 3, 2009 resulted from the repurchase of \$3.0 million of our 8% senior subordinated notes at a discount of \$0.3 million, or 8.5% of par value, partially offset by a \$0.1 million non-cash write-off of deferred debt issue costs. The loss on debt extinguishment of \$0.4 million in the three months ended March 28, 2008 resulted from the early redemption of \$6.0 million of our floating rate senior notes in March 2008, consisting of \$0.3 million in non-cash write-offs of deferred debt issue costs and issue discount costs and \$0.1 million in cash payments for call premiums.

Table of Contents

Income Tax (Benefit) Expense. We recorded an income tax expense of \$0.1 million for the three months ended April 3, 2009 and an income tax expense of \$2.1 million for the three months ended March 28, 2008. Our effective tax rate was approximately 2% for the three months ended April 3, 2009 as compared to approximately 26% for the three months ended March 28, 2008.

Income tax expense for the three months ended April 3, 2009 includes a discrete tax benefit of approximately \$0.7 million that is related to certain provisions of the California Budget Act of 2008 signed on February 20, 2009, which will allow a taxpayer to elect an alternative method to attribute taxable income to California for tax years beginning on or after January 1, 2011, which resulted in a reduction to our deferred tax liability accounts. We also recorded a discrete tax benefit of \$0.3 million relating to the correction of an immaterial error in the computation of certain deferred tax accounts which should have been recorded in several prior year's financial results.

Income tax expense for the three months ended March 28, 2008 includes a discrete tax benefit of approximately \$0.4 million that is attributable to the fourth quarter of fiscal year 2007 relating to the correction of an immaterial error in the computation of the warranty expense tax deduction.

Net Income. Net income was \$3.7 million, or 4.5% of sales, for the three months ended April 3, 2009 as compared to \$6.2 million, or 6.5% of sales, in the three months ended March 28, 2008. The decrease in net income in the three months ended April 3, 2009 as compared to the three months ended March 28, 2008 was primarily due to lower gross profit from the reduction in sales volume, partially offset by the reduction of expenses from the implementation of cost-reduction initiatives and discrete tax benefits and interest expense.

EBITDA. EBITDA was \$10.8 million, or 13.2% of sales, for the three months ended April 3, 2009 as compared to \$15.8 million, or 16.7% of sales, for the three months ended March 28, 2008. The decrease in EBITDA in the three months ended April 3, 2009 as compared to the three months ended March 28, 2008 was due primarily to lower gross profit from the reduction in sales volume, partially offset by lower expenses from the implementation of cost-reduction initiatives.

- 50 -

[Table of Contents](#)

Edgar Filing: CPI INTERNATIONAL, INC. - Form 10-Q

Six Months Ended April 3, 2009 Compared to Six Months Ended March 28, 2008

The following table sets forth our historical results of operations for each of the periods indicated (dollars in millions):

| | Six Months Ended | | | | Increase (Decrease) Amount |
|---|------------------|---------------|----------------|---------------|----------------------------------|
| | April 3, 2009 | | March 28, 2008 | | |
| | Amount | % of Sales | Amount | % of Sales | |
| Sales | \$ 159.0 | 100.0% | \$ 180.7 | 100.0% | \$ (21.7) |
| Cost of sales | 117.4 | 73.8 | 128.5 | 71.1 | (11.1) |
| Gross profit | 41.7 | 26.2 | 52.2 | 28.9 | (10.5) |
| Research and development | 5.3 | 3.3 | 5.7 | 3.2 | (0.4) |
| Selling and marketing | 9.8 | 6.2 | 10.5 | 5.8 | (0.7) |
| General and administrative | 10.4 | 6.5 | 11.6 | 6.4 | (1.2) |
| Amortization of acquisition-related intangibles | 1.4 | 0.9 | 1.6 | 0.9 | (0.2) |
| Net loss on disposition of assets | 0.1 | 0.1 | 0.1 | 0.1 | - |
| Operating income | 14.7 | 9.2 | 22.8 | 12.6 | (8.1) |
| Interest expense, net | 8.8 | 5.5 | 9.6 | 5.3 | (0.8) |
| (Gain) loss on debt extinguishment | (0.2) | (0.1) | 0.4 | 0.2 | (0.6) |
| Income before taxes | 6.1 | 3.8 | 12.8 | 7.1 | (6.7) |
| Income tax expense (benefit) | (5.2) | (3.3) | 4.1 | 2.3 | (9.3) |
| Net income | \$ 11.3 | 7.1% | \$ 8.7 | 4.8% | \$ 2.6 |
| Other Data: | | | | | |
| EBITDA (a) | \$ 20.3 | 12.8% | \$ 27.8 | 15.4% | \$ (7.5) |

Note: Totals may not equal the sum of the component line items due to independent rounding. Percentages are calculated based on rounded dollar amounts presented.

- (a) EBITDA is the measure used by the CODM to evaluate segment profit or loss. EBITDA represents earnings before net interest expense, provision for income taxes and depreciation and amortization. We believe that EBITDA is a more meaningful representation of operating performance for leveraged businesses like our own and, therefore, use this metric as our primary measure

of profitability. For the reasons listed below, we believe EBITDA provides investors better understanding of our financial performance in connection with their analysis of our business:

EBITDA is a component of the measures used by our board of directors and management team to evaluate our operating performance;

our senior credit facilities contain a covenant that requires us to maintain a senior secured leverage ratio that contains EBITDA as a component, and our management team uses EBITDA to monitor compliance with this covenant;

EBITDA is a component of the measures used by our management team to make day-to-day operating decisions;

EBITDA facilitates comparisons between our operating results and those of competitors with different capital structures and therefore is a component of the measures used by the management to facilitate internal comparisons to competitors' results and our industry in general; and

the payment of management bonuses is contingent upon, among other things, the satisfaction by us of certain targets that contain EBITDA as a component.

Other companies may define EBITDA differently and, as a result, our measure of EBITDA may not be directly comparable to EBITDA of other companies. Although we use EBITDA as a financial measure to assess the performance of our business, the use of EBITDA is limited because it does not include certain material costs, such as interest and taxes, necessary to operate our business. When analyzing our performance, EBITDA should be considered in addition to, and not as a substitute for, net income, cash flows from operating activities or other statements of operations or statements of cash flows data prepared in accordance with GAAP.

For a reconciliation of EBITDA to Net Income, see Note 11 of the accompanying unaudited condensed consolidated financial statements.

Sales. Our sales by market for the six months ended April 3, 2009 and March 28, 2008 are summarized as follows (dollars in millions):

| | Six Months Ended | | | | | |
|------------------------------|------------------|------------|----------------|------------|---------------------|---------|
| | April 3, 2009 | | March 28, 2008 | | Increase (Decrease) | |
| | Amount | % of Sales | Amount | % of Sales | Amount | Percent |
| Radar and Electronic Warfare | \$ 62.3 | 39% | \$ 73.5 | 41% | \$ (11.2) | (15) % |
| Medical | 31.4 | 20 | 32.7 | 18 | (1.3) | (4) |
| Communications | 51.5 | 32 | 56.8 | 31 | (5.3) | (9) |
| Industrial | 9.8 | 6 | 12.1 | 7 | (2.3) | (19) |
| Scientific | 4.0 | 3 | 5.6 | 3 | (1.6) | (29) |
| Total | \$ 159.0 | 100% | \$ 180.7 | 100% | \$ (21.7) | (12) % |

In the fourth quarter of fiscal year 2008, we changed the way in which we categorize orders and sales of the TCDL products at our Malibu division. Previously, orders and sales of our TCDL products were included in our radar and electronic warfare market. We are now reporting these orders and sales in our communications market, which we believe is the more appropriate category for these products. We reclassified previously reported orders and sales information to properly reflect TCDL products as an increase in the communications market and a corresponding decrease in the radar and electronic warfare market. For the six months ended March 28, 2008, the sales amount reclassified was \$2.3 million. The table above reflects this change.

Sales for the six months ended April 3, 2009 of \$159.0 million were \$21.7 million, or 12%, lower than sales of \$180.7 million for the corresponding period of fiscal year 2008. Explanations for the sales increase or decrease by market are as follows:

- Radar and Electronic Warfare: The majority of our sales in the radar and electronic warfare markets are for products for domestic and international defense and government end uses. The timing of the receipt of orders and subsequent shipments in these markets may vary from year to year. On a combined basis, sales for these two markets decreased approximately 15% from \$73.5 million in the six months ended March 28, 2008 to \$62.3 million in the six months ended April 3, 2009. The decrease in sales was due primarily to an expected \$3.9 million decrease in shipments of products to support the Aegis weapons system and decreases in sales for several other radar and electronic warfare programs due to the timing of order receipts for those programs.

Demand for our products to support ships with the Aegis weapons system has two components: we support new ship builds and we provide spare and repair products for previously fielded ships. Over the past several years, we have seen high demand for products to support a significant number of funded new ship builds for the Aegis weapons program for U.S. and international military customers. We have now completed supplying our products required to support these funded new ship builds, and, as a result, we expect the near-term demand to be primarily for spare and repair products and the near-term sales to be roughly half of the approximately \$20 million fiscal year 2008 sales level. We expect demand for our products to increase again in several years as the new ships are commissioned, deployed and added to the installed base, after which they also will require spare and repair products.

- **Medical:** Sales of our medical products consist of sales for medical imaging applications, such as x-ray imaging, MRI and PET applications, and for radiation therapy applications for the treatment of cancer. The 4% decrease in sales of our medical products was primarily due to decreased sales of x-ray imaging products to international customers as a result of the weakening of global economies. This decrease was partially offset by increased demand for products to support radiation therapy applications.
- **Communications:** The 9% decrease in sales in the communications market was primarily attributable to decreases in sales to support certain commercial communications applications, including direct-to-home broadcast, fixed satellite broadcast and satellite news gathering applications as well as commercial radio broadcast applications. We believe the decreases were largely due to the weakening of global economies. These decreases were partially offset by an increase in sales of products for military communications programs, which is a relatively new sector of the overall communications market for us. We expect our participation in military communications programs to continue to grow.
- **Industrial:** Sales in the industrial market are cyclical and are generally tied to the state of the economy. The \$2.3 million decrease in industrial sales was due to decreases in demand for products used in industrial fabrication applications, including semiconductor wafer fabrication, and a wide variety of other industrial applications.
- **Scientific:** Sales in the scientific market are historically one-time projects and can fluctuate significantly from period to period. The \$1.6 million decrease in scientific sales was primarily the result of the recent completion of product shipments for the Spallation Neutron Source at Oakridge National Laboratory and the timing of certain other scientific programs.

Gross Profit. Gross profit was \$41.7 million, or 26.2% of sales, for the six months ended April 3, 2009, a \$10.5 million decrease from \$52.2 million, or 28.9% of sales, in the six months ended March 28, 2008. Gross profit is influenced by numerous factors including sales volume and mix, pricing, raw material and manufacturing costs, and warranty costs. The primary reason for the reduction in gross profit for the six months ended April 3, 2009 as compared to the six months ended March 28, 2008 was lower sales volume and therefore lower manufacturing cost absorption due to the reduction in sales volume.

Research and Development. Research and development expenses were \$5.3 million, or 3.3% of sales, for the six months ended April 3, 2009, a \$0.4 million decrease from \$5.7 million, or 3.2% of sales, for the six months ended March 28, 2008. The decrease in research and development for the six months ended April 3, 2009 compared to the six months ended March 28, 2008 was due primarily to the completion of significant development efforts on the Army's Warfighter Information Network-Tactical (WIN-T) program and lower research and development spending at our Malibu division in the second quarter of fiscal year 2009, partially offset by higher expenditures on medical diagnostic imaging products.

- 53 -

[Table of Contents](#)

Total spending on research and development, including customer-sponsored research and development, was as follows (in millions):

| | Six Months Ended | |
|---|------------------|----------------------|
| | April 3, 2009 | March 28, 2008 |
| Company sponsored | \$ 5.3 | \$ 5.7 |
| Customer sponsored, charged to cost of sales | 7.3 | 7.2 |
| | \$ 12.6 | \$ 12.9 |

Selling and Marketing. Selling and marketing expenses were \$9.8 million, or 6.2% of sales, for the six months ended April 3, 2009, a \$0.7 million decrease from the \$10.5 million, or 5.8% of sales, for the six months ended March 28, 2008. The reduction in selling and marketing expenses for the six months ended April 3, 2009 compared to the six months ended March 28, 2008 was primarily due to the implementation of cost-reduction initiatives and approximately \$0.2 million of favorable impact from currency translation of our foreign-based expenses.

General and Administrative. General and administrative expenses were \$10.4 million, or 6.5% of sales, for the six months ended April 3, 2009, a \$1.2 million decrease from the \$11.6 million, or 6.4% of sales, for the six months ended March 28, 2008. The decrease in general and administrative expenses in the six months ended April 3, 2009 was primarily due to lower expenses related to the implementation of cost-reduction initiatives.

Amortization of Acquisition-Related Intangibles. Amortization of acquisition-related intangibles consists of purchase accounting charges for technology and other intangible assets. Amortization of acquisition-related intangibles was \$1.4 million for the six months ended April 3, 2009 and \$1.6 million for the six months ended March 28, 2008. The \$0.2 million dollar decrease in amortization of acquisition-related intangibles for the six months ended April 3, 2009 compared to the six months ended March 28, 2008 was primarily due to completed amortization of customer backlog in fiscal year 2008 for our Malibu division which was acquired in August 2007.

Interest Expense, Net (“Interest Expense”). Interest Expense of \$8.8 million for the six months ended April 3, 2009 was \$0.8 million lower than interest expense of \$9.6 million for the six months ended March 28, 2008. The reduction in interest expense for the six months ended April 3, 2009 was primarily due to repayments of debt over the past year which resulted in lower interest expense during the six months ended April 3, 2009 compared to the six months ended March 28, 2008.

(Gain) Loss on Debt Extinguishment. The gain on debt extinguishment of \$0.2 million in the six months ended April 3, 2009 resulted from the repurchase of \$3.0 million of our 8% senior subordinated notes at a discount of \$0.3 million, or 8.5% of par value, partially offset by a \$0.1 million non-cash write-off of deferred debt issue costs. The loss on debt extinguishment of \$0.4 million in the six months ended March 28, 2008 resulted from the early redemption of \$6.0 million of our floating rate senior notes in March 2008, consisting of \$0.3 million in non-cash write-offs of deferred debt issue costs and issue discount costs and \$0.1 million in cash payments for call premiums.

Income Tax (Benefit) Expense. We recorded an income tax benefit of \$5.2 million for the six months ended April 3, 2009 and an income tax expense of \$4.1 million for the six months ended March 28, 2008. The six months ended April 3, 2009 included several significant discrete tax benefits: (1) \$5.1 million related to an outstanding audit by the Canada Revenue Agency (“CRA”), (2) \$0.7 million related to certain provisions of the California Budget Act of 2008 signed on February 20, 2009, which will allow a taxpayer to elect an alternative method to attribute taxable income to California for tax years beginning on or after January 1, 2011, which resulted in a reduction to our deferred tax liability accounts, and (3) \$0.9 million for adjustments to Canadian deferred tax accounts.

In December 2008, a new tax treaty protocol between Canada and the U.S. became effective. The new treaty requires mandatory arbitration for the resolution of double taxation disputes not settled through the competent authority process. As a result of this new treaty, our tax position on an outstanding audit by the CRA has become more favorable, and we reduced our tax contingency reserve in Canada by \$3.0 million, and established an income tax receivable and recognized an income tax benefit in the U.S for \$2.8 million; this tax benefit was partially offset by a related increase in deferred tax liabilities of \$0.7 million.

The \$0.9 million adjustment to Canadian deferred tax accounts includes a \$0.6 million tax benefit to reflect the reduction to Canadian corporate income tax rates, and a \$0.3 million tax benefit to correct the computation of certain deferred tax accounts. The \$0.6 million adjustment should have been recorded in the first quarter of fiscal year 2008 rather than in the first quarter of fiscal year 2009 and the \$0.3 adjustment million should have been recorded in several prior year’s financial results. These adjustments are deemed immaterial to our results of operations and financial condition in current periods as well as prior affected periods.

Income tax expense for the six months ended March 28, 2008 includes a discrete tax benefit of approximately \$0.4 million that was attributable to the fourth quarter of fiscal year 2007 relating to the correction of an immaterial error in the computation of the warranty expense tax deduction.

Our estimated effective income tax rate for the remainder of fiscal year 2009 is expected to be approximately 36% to 37%.

Net Income. Net income was \$11.3 million, or 7.1% of sales, for the six months ended April 3, 2009 as compared to \$8.7 million, or 4.8% of sales, in the six months ended March 28, 2008. The \$2.6 million increase in net income in the six months ended April 3, 2009 as compared to the six months ended March 28, 2008 was primarily due to discrete tax benefits, the reduction of expenses from the implementation of cost-reduction initiatives, and lower interest, partially offset by lower gross profit from the reduction in sales volume.

EBITDA. EBITDA was \$20.3 million, or 12.8% of sales, for the six months ended April 3, 2009 as compared to \$27.8 million, or 15.4% of sales, for the six months ended March 28, 2008. The \$7.5 million decrease in EBITDA for the six months ended April 3, 2009 as compared to the corresponding period of fiscal year 2008 was due primarily to lower gross profit from the reduction in sales volume, partially offset by lower expenses from the implementation of cost-reduction initiatives.

Liquidity and Capital Resources

Overview

Our liquidity is affected by many factors, some of which are based on normal ongoing operations of our business and others that are related to uncertainties in the markets in which we compete and other global economic factors. We have historically financed, and intend to continue to finance, our capital and working capital requirements including debt service and internal growth, through a combination of cash flows from our operations and borrowings under our senior credit facilities. Our primary uses of cash are cost of sales, operating expenses, debt service and capital expenditures.

We believe that we have the financial resources to meet our business requirements, including capital expenditures and working capital requirements, for the next 12 months.

Cash and Working Capital

The following summarizes our cash and cash equivalents and working capital (in millions):

| | April 3, 2009 | October 3, 2008 |
|---------------------------|------------------|-----------------------|
| Cash and cash equivalents | \$ 27.9 | \$ 28.7 |
| Working capital | \$ 92.6 | \$ 88.1 |

We invest cash balances in excess of operating requirements in overnight U.S. Government securities and money market accounts. In addition to the above cash and cash equivalents, we had restricted cash of \$1.1 million as of April 3, 2009, consisting primarily of bank guarantees from customer advance payments to our international subsidiaries. The bank guarantees become unrestricted cash when performance under the sales contract is complete.

The significant factors underlying the net decrease in cash and cash equivalents during the six months ended April 3, 2009 were the repayment of \$7.75 million of the outstanding balance of our senior term loan and senior subordinated notes and capital expenditures of \$1.8 million partially offset by net cash provided by our operating activities of \$7.9 million, proceeds of \$0.6 million from employee stock purchases and \$0.3 million discount from the repurchase of \$3.0 million of our senior subordinated notes.

As of April 3, 2009, we had \$218.0 million in total principal amount of debt outstanding, compared to \$225.75 million as of October 3, 2008. As of April 3, 2009, we had borrowing availability of \$54.3 million under the revolver under our senior credit facilities.

As more fully described below, our most significant debt covenant compliance requirement is maintaining a secured leverage ratio of 3.75:1. Our current secured leverage ratio is approximately 1:1. With this low secured leverage ratio, we do not anticipate any need to restructure our debt or reenter the capital markets until fiscal year 2011 when our Senior Credit Facilities will mature unless we refinance our 8% senior subordinated notes due 2012 prior to July 31, 2011.

Table of Contents

Historical Operating, Investing and Financing Activities

In summary, our cash flows were as follows (in millions):

| | Six Months Ended | |
|---|------------------|----------------------|
| | April 3, 2009 | March 28, 2008 |
| Net cash provided by operating activities | \$ 7.9 | \$ 10.4 |
| Net cash used in investing activities | (1.8) | (1.1) |
| Net cash used in financing activities | (6.9) | (9.5) |
| Net decrease in cash and cash equivalents | \$ (0.8) | \$ (0.2) |

Operating Activities

During the six months ended April 3, 2009 and March 28, 2008, we funded our operating activities through cash generated internally. Cash provided by operating activities is net income adjusted for certain non-cash items and changes to working capital items.

Net cash provided by operating activities of \$7.9 million in the six months ended April 3, 2009 was attributable to net income of \$11.3 million, depreciation, amortization and other non-cash charges of \$5.9 million, partially offset by \$9.3 million net cash used for working capital. The primary working capital uses of cash in the six months ended April 3, 2009 were decreases in accrued expenses and income tax payable and an increase in inventories. The decrease in accrued expenses related primarily to the timing of payroll and employee vacations, combined with lower incentive compensation and timing of interest payments on debt. Income tax payable decreased primarily due to the reduction in our contingency reserve for a Canada tax assessment. Inventories increased due to selective increases of certain work-in-progress and finished goods to meet anticipated customer delivery requirements. These uses of cash were partially offset by a decrease in accounts receivable resulting primarily from decreased sales.

Net cash provided by operating activities of \$10.4 million in the six months ended March 28, 2008 was attributable to net income of \$8.7 million, depreciation, amortization and other non-cash charges of \$6.2 million, partially offset by \$4.5 million net cash used for working capital. The primary uses of cash for working capital in the six months ended March 28, 2008 were a decrease in income taxes payable and accrued expenses, partially offset by a decrease in accounts receivable. The reduction in income taxes payable was due to the timing of payments. The decrease in accrued expenses related primarily to the timing of payroll and employee vacations, combined with timing of interest payments on debt. The decrease in accounts receivables resulted primarily from timing and improved collection of trade receivables.

Investing Activities

Investing activities for the six months ended April 3, 2009 consisted of \$1.8 million capital expenditures.

Investing activities for the six months ended March 28, 2008 consisted of \$2.6 million capital expenditures and \$0.1 million payment of patent application fees, partially offset by cash received as a result of a \$1.6 million adjustment to the purchase price of our Malibu division based on the actual working capital of the Malibu division as of the

acquisition closing date.

- 57 -

Table of Contents

Financing Activities

Net cash used in financing activities for the six months ended April 3, 2009 consisted primarily of senior term loan repayment of \$4.75 million and senior subordinated notes repurchase of \$3.0 million partially offset by \$0.6 million in proceeds from employee stock purchases and \$0.3 million discount from the repurchase of our senior subordinated notes.

Net cash used in financing activities for the six months ended March 28, 2008 consisted primarily of a redemption of \$6.0 million in principal amount of our floating rate senior notes and a term loan repayment of \$4.0 million, partially offset by \$0.4 million in proceeds from employee stock purchases.

If the leverage ratio under our amended and restated senior credit facilities exceeds 3.5:1 at the end of any fiscal year, then we are required to make an annual prepayment within 90 days after the end of the fiscal year based on a calculation of excess cash flow, as defined in the senior credit facilities, multiplied by a factor of 50%, less any optional prepayments made during the fiscal year. There was no excess cash flow payment due for fiscal year 2008, and, therefore, no excess cash flow payment was made in the six months ended April 3, 2009.

Stock Repurchase Program

On May 28, 2008, we announced that our board of directors authorized us to implement a program to repurchase up to \$12.0 million of our common stock from time to time, funded entirely from cash on hand. Repurchases made under the program are subject to the terms and limitations of our debt covenants, as well as market conditions and share price, and will be made at management's discretion in open market trades, through block trades or in privately negotiated transactions. The program may be modified or terminated by our board of directors at any time. During fiscal year 2008, we repurchased 206,243 shares at an average per share price of \$13.54, plus average brokerage commissions of \$0.04 per share, for an aggregate cost of \$2.8 million. During the six months ended April 3, 2009, we did not repurchase any shares of common stock under the program. Repurchased shares have been recorded as treasury shares and will be held until our board of directors designates that these shares be retired or used for other purposes.

Capital Expenditures

Our continuing operations typically do not have large recurring capital expenditure requirements. Capital expenditures are generally made to replace existing assets, increase productivity, facilitate cost reductions or meet regulatory requirements. Total capital expenditures for the six months ended April 3, 2009 were \$1.8 million. In the remainder of fiscal year 2009, ongoing capital expenditures are expected to be approximately \$2.0 to \$2.5 million.

- 58 -

[Table of Contents](#)

Recently Released Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards (“SFAS”) No. 157, “Fair Value Measurements,” which defines fair value, establishes a framework for measuring fair value under other accounting pronouncements that permit or require fair value measurements, changes the methods used to measure fair value and expands disclosures about fair value measurements. In particular, disclosures are required to provide information on: the extent to which fair value is used to measure assets and liabilities; the inputs used to develop measurements; and the effect of certain of the measurements on earnings (or changes in net assets). SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. In February 2008, the FASB issued FASB Staff Position (“FSP”) SFAS No. 157-1, “Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13,” which removes certain leasing transactions from the scope of SFAS No. 157, and FSP SFAS No. 157-2, “Effective Date of FASB Statement No. 157,” which defers the effective date of SFAS No. 157 for one year for certain nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis. Effective October 4, 2008, we adopted SFAS No. 157 for financial assets and liabilities recognized at fair value on a recurring basis. The adoption of SFAS No. 157 did not have a significant impact on our consolidated financial statements, and the resulting fair values calculated under SFAS No. 157 after adoption were not significantly different than the fair values that would have been calculated under previous guidance. See Note 4 to the condensed consolidated financial statements included in this Form 10-Q for further details on our fair value measurements.

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115.” SFAS No. 159 permits companies to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The objective of SFAS No. 159 is to provide opportunities to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply hedge accounting provisions. SFAS No. 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We adopted SFAS No. 159 effective October 4, 2008. We currently do not have any instruments for which we have elected the fair value option under SFAS No. 159. Therefore, the adoption of SFAS No. 159 has not impacted our consolidated financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), or 141(R), “Business Combinations,” which replaces SFAS No. 141. SFAS No. 141(R) establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non-controlling interest in the acquiree and the goodwill acquired. The Statement also establishes disclosure requirements which will enable users to evaluate the nature and financial effects of the business combination. SFAS No. 141(R) is effective for fiscal years beginning after December 15, 2008. We will be required to adopt SFAS No. 141(R) in our fiscal year 2010 commencing October 3, 2009.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133." SFAS No. 161 requires enhanced disclosures about an entity's derivative instruments and hedging activities including: (1) how and why an entity uses derivative instruments; (2) how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations; and (3) how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. SFAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with earlier application encouraged. We adopted SFAS No. 161 in the second quarter of fiscal year 2009. Since SFAS No. 161 only required additional disclosure, the adoption did not have an impact on our consolidated financial position, results of operations or cash flows. See Note 6 to the condensed consolidated financial statements included in this Form 10-Q for further details on our derivative instruments and hedging activities.

In October 2008, FASB issued FSP No.132 (R)-1, "Employers' Disclosures about Pensions and Other Postretirement Benefits," to require that an employer disclose the following information about the fair value of plan assets: 1) the level within the fair value hierarchy in which fair value measurements of plan assets fall; 2) information about the inputs and valuation techniques used to measure the fair value of plan assets; and 3) a reconciliation of beginning and ending balances for fair value measurements of plan assets using significant unobservable inputs. The final FSP will be effective for fiscal years ending after December 15, 2009, with early application permitted. We will be required to adopt FSP No.132 (R)-1 in our fiscal year 2010 commencing October 3, 2009. At initial adoption, application of the FSP would not be required for earlier periods that are presented for comparative purposes. We are currently evaluating the potential impact of adopting this FSP on our disclosures in our consolidated financial statements.

In April 2009, the FASB issued FSP SFAS No. 141R-1, "Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies." FSP SFAS No. 141R-1 amends the provisions in SFAS No. 141R, "Business Combinations," and requires an acquirer to recognize at fair value, at the acquisition date, an asset acquired or a liability assumed that arises from a contingency if the acquisition date fair value of that asset or liability can be determined during the measurement period. If the acquisition date fair value cannot be determined during the measurement period, an asset or liability shall be recognized at the acquisition date if (i) information available before the end of the measurement period indicates that it is probable that an asset existed or that a liability had been incurred at the acquisition date, and (ii) the amount of the asset or liability can be reasonably estimated. FSP SFAS No. 141R-1 is effective for contingent assets and contingent liabilities acquired in business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. We will apply the provisions of FSP SFAS No. 141R-1 if and when a future acquisition occurs.

In April 2009, the FASB issued FSP SFAS No. 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly," which provides additional guidance in evaluating certain factors that are indicative of a significant decrease in the volume and level of activity for an asset or liability when compared to normal market activity. Additionally, this statement clarifies the circumstances to consider when evaluating whether a transaction is not orderly, in which quoted prices may not be determinative of fair value. FSP SFAS No. 157-4 is applied prospectively to all fair value measurements where appropriate and will be effective for interim and annual periods ending after June 15, 2009. We will adopt the provisions of FSP SFAS No. 157-4 effective April 4, 2009. We are currently assessing the impact of FSP SFAS No. 157-4 on our results of operations and financial position.

In April 2009, the FASB issued FSP SFAS No. 107-1 and APB No. 28-1, "Interim Disclosures about Fair Value of Financial Instruments." FSP SFAS No. 107-1 and APB No. 28-1 amend FASB Statement No. 107, "Disclosures about Fair Value of Financial Instruments," to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. FSP FAS No. 107-1 and APB No. 28-1 is effective for interim reporting periods ending after June 15, 2009. Our disclosures about fair value of financial instruments will reflect the adoption of this FSP in the third quarter of our fiscal year 2009.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with generally accepted accounting principles, or GAAP, in the United States of America, which require us to make certain estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions upon which we rely are reasonable based upon various factors and information available to us at the time that these estimates, judgments and assumptions are made. These factors and information may include, but are not limited to, history and prior experience, experience of other enterprises in the same industry, new related events, current economic conditions and information from third-party professionals. The estimates, judgments and assumptions we make can affect the reported amounts of assets and liabilities as of the date of the financial statements, as well as the reported amounts of revenues and expenses during the periods presented. To the extent there are material differences between these estimates, judgments or assumptions and actual results, our financial statements will be affected.

We believe the following critical accounting policies are the most significant to the presentation of our financial statements and require the most subjective and complex judgments. These matters, and the judgments and uncertainties affecting them, are also essential to understanding our reported and future operating results.

Revenue recognition

We generally recognize revenue upon shipment of product, following receipt of written purchase orders, when the price is fixed or determinable, title has transferred and collectibility is reasonably assured. Revenue recognized under the percentage of completion method of accounting is determined on the basis of costs incurred and estimates of costs at completion, which require management estimates of future costs. Changes in estimated costs at completion over time could have a material impact on our operating results.

Inventory reserves

We assess the valuation of inventory and periodically write down the value for estimated excess and obsolete inventory based upon actual usage and estimates about future demand. The excess balance determined by this analysis becomes the basis for our excess inventory charge. Management personnel play a key role in our excess inventory review process by providing updated sales forecasts, managing product rollovers and working with manufacturing to maximize recovery of excess inventory. If our estimates regarding demand are inaccurate or changes in technology affect demand for certain products in an unforeseen manner, we may incur losses or gains in excess of our established markdown reserve that could be material.

Management also reviews the carrying value of inventory for lower of cost or market on an individual product or contract basis. A loss reserve is charged to cost of sales if the estimated product cost or the contract cost at completion is in excess of net realizable value (selling price less estimated cost of disposal). If the actual contract cost at completion is different than originally estimated, then a loss or gain provision adjustment would be recorded that could have a material impact on our operating results.

Product warranty

Our products are generally warranted for a variety of periods, typically one to three years or a predetermined product usage life. A provision for estimated future costs of repair, replacement or customer accommodations is reflected in the consolidated condensed financial statements included in this report. We assess the adequacy of our preexisting warranty liabilities and adjust the balance based on actual experience and changes in future expectations. The determination of product warranty reserves requires us to make estimates of product return rates and expected cost to repair or replace the products under warranty. If actual repair and replacement costs differ significantly from our estimates, then adjustments to recognize additional cost of sales may be required.

Recoverability of long-lived assets

We account for goodwill and other intangible assets in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 142 requires that goodwill and identifiable intangible assets with indefinite useful lives be tested for impairment at least annually. SFAS No. 142 also requires that intangible assets with estimable useful lives be amortized over their respective estimated useful lives and reviewed for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." We amortize identifiable intangible assets on a straight-line basis over their useful lives of up to 50 years.

We assess the recoverability of the carrying value of goodwill and other intangible assets with indefinite useful lives at least annually or whenever events or changes in circumstances indicate that the carrying amount of the asset may not be fully recoverable. Recoverability of goodwill is measured at the reporting unit level (our six divisions) based on a two-step approach. First, the carrying amount of the reporting unit is compared to the fair value as estimated by the future net discounted cash flows expected to be generated by the reporting unit. To the extent that the carrying value of the reporting unit exceeds the fair value of the reporting unit, a second step is performed, wherein the reporting unit's assets and liabilities are valued. The implied fair value of goodwill is calculated as the fair value of the reporting unit in excess of the fair value of all non-goodwill assets and liabilities allocated to the reporting unit. To the extent the reporting unit's carrying value of goodwill exceeds its implied fair value, impairment exists and must be recognized. This process requires the use of discounted cash flow models that utilize estimates of future revenue and expenses as well as the selection of appropriate discount rates. There is inherent uncertainty in these estimates, and changes in these factors over time could result in an impairment charge.

At April 3, 2009 and October 3, 2008, the carrying amount of goodwill and other intangible assets, net was \$239.3 million and \$241.1 million, respectively. As of April 3, 2009, no significant changes in the underlying business assumptions or circumstances that drive the impairment analysis led us to believe that goodwill or other intangible assets might have been impaired. We will continue to evaluate the need for impairment if changes in circumstances or available information indicate that impairment may have occurred, and at least annually in the fourth quarter.

Our market capitalization has historically exceeded our net asset value, although recently it has been particularly volatile. Our market capitalization has dropped below our net asset value in certain days of the past few months largely, we believe, as a result of the recent global economic downturn and volatility in the financial markets. If our stock price would again fall below our net asset value per share, the decline in our market capitalization could trigger the requirement of performing the impairment test on goodwill later in fiscal year 2009, which could result in an impairment of our goodwill.

At April 3, 2009 and October 3, 2008, the carrying amount of property, plant and equipment was \$60.3 million and \$62.5 million, respectively. We assess the recoverability of property, plant and equipment to be held and used by a comparison of the carrying amount of an asset or group of assets to the future net undiscounted cash flows expected to be generated by the asset or group of assets. If such assets are considered impaired, then the impairment recognized is measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets. This process requires the use of cash flow models that utilize estimates of future revenue and expenses. There is inherent uncertainty in these estimates, and changes in these factors over time could result in an impairment charge.

A prolonged general economic downturn and, specifically, a prolonged downturn in the defense, communications or medical markets, or technological changes, as well as other market factors could intensify competitive pricing pressure, create an imbalance of industry supply and demand, or otherwise diminish volumes or profits. Such events, combined with changes in interest rates, could adversely affect our estimates of future net cash flows to be generated by our long-lived assets. Consequently, it is possible that our future operating results could be materially and adversely affected by any impairment charges related to the recoverability of our long-lived assets.

Accounting for stock-based compensation

We account for stock-based compensation in accordance with SFAS No. 123 (revised 2004) or 123(R), "Share-Based Payment." Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period, which is generally the vesting period.

The fair value of each time-based option award is estimated on the date of grant using the Black-Scholes model. The fair value of each market performance-based (or combination of market performance- and time-based) option, restricted stock and restricted stock unit award is estimated on the date of grant using the Monte Carlo simulation technique in a risk-neutral framework. The Black-Scholes and the Monte Carlo simulation valuation models were developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable and require the input of subjective assumptions, including the expected stock price volatility and estimated option life. For purposes of these valuation models, no dividends have been assumed.

In accordance with SFAS No. 123R, prior to becoming a public entity in April 2006, we used the minimum value method to determine a calculated value, rather than a fair value, of share awards. Under the minimum value method, stock price volatility was assumed to be zero. The estimated fair value (or calculated value, as applicable) of our stock-based awards, less expected forfeitures, is amortized over the awards' vesting period on a straight-line basis for awards granted after the adoption of SFAS No. 123R. Since our common stock has not been publicly traded for a sufficient time period, the expected volatility is based on expected volatilities of similar companies that have a longer history of being publicly traded or a blend of our expected volatility based on available historical data and those of similar companies. The risk-free rates are based on the U.S. Treasury yield in effect at the time of the grant. Since our historical data is limited, the expected life of options granted is based on the simplified method for plain vanilla options in accordance with Securities and Exchange Commission ("SEC") Staff Accounting Bulletin ("SAB") No. 107. In December 2007, the SEC issued SAB No. 110, an amendment of SAB No. 107. SAB No. 110 states that the staff will continue to accept, under certain circumstances, the continued use of the simplified method beyond December 31,

2007. Accordingly, we will continue to use the simplified method until we have enough historical experience to provide a reasonable estimate of expected term. For the three and six months ended April 3, 2009, we recognized \$0.7 million and \$1.3 million, respectively, in stock-based compensation expense. For the three and six months ended March 28, 2008, we recognized \$0.6 million and \$1.0 million, respectively, in stock-based compensation expense.

- 63 -

Table of Contents

Income taxes

We must make certain estimates and judgments in determining income tax expense for financial statement purposes. These estimates and judgments occur in the calculation of tax credits, tax benefits and deductions and in the calculation of certain tax assets and liabilities, which arise from differences in the timing of recognition of revenue and expense for tax and financial statement purposes. Significant changes to these estimates may result in an increase or decrease to our tax provision in a subsequent period.

We must assess the likelihood that we will be able to recover our deferred tax assets. If recovery is not more likely than not, we must increase our provision for taxes by recording a valuation allowance against the deferred tax assets that we estimate will not ultimately be recoverable. We believe that all of the deferred tax assets recorded on our consolidated balance sheets will ultimately be recovered. However, should there be a change in our ability to recover our deferred tax assets, our tax provision would increase in the period in which we determined that the recovery was not more likely than not.

In addition, the calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations. In the first quarter of fiscal year 2008, we adopted FASB Interpretation (“FIN”) No. 48 and related guidance. See Note 9 to consolidated condensed financial statements of this Form 10-Q for further discussion. FIN No. 48 requires that we recognize liabilities for uncertain tax positions based on the two-step process prescribed within the interpretation. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step requires us to estimate and measure the tax benefit as the largest amount that is more than 50% likely of being realized upon ultimate settlement. It is inherently difficult and subjective to estimate such amounts, as this requires us to determine the probability of various possible outcomes. We reevaluate these uncertain tax positions on a quarterly basis. This evaluation is based on factors including, but not limited to, changes in facts or circumstances, changes in tax law, effectively settled issues under audit, and new audit activity. Such a change in recognition or measurement would result in the recognition of a tax benefit or an additional charge to the tax provision.

- 64 -

[Table of Contents](#)

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We do not use market risk sensitive instruments for trading or speculative purposes.

Interest rate risk

Our exposure to market risk for changes in interest rates relates primarily to our long-term debt. As of April 3, 2009, we had fixed rate senior subordinated notes of \$122.0 million due in 2012, bearing interest at 8% per year and variable rate debt consisting of \$12.0 million floating rate senior notes due in 2015 and a \$84.0 million term loan under our amended and restated senior credit facilities due in 2014. Our variable rate debt is subject to changes in the prime rate and the LIBOR rate.

We use derivative instruments from time to time in order to manage interest costs and risk associated with our long-term debt. On September 21, 2007, we entered into an interest rate swap contract to receive three-month USD-LIBOR-BBA (British Bankers' Association) interest and pay 4.77% fixed rate interest. Net interest positions are settled quarterly. We have structured the swap with decreasing notional amounts such that it is less than the balance of the term loan. The notional value of the swap was \$60.0 million at April 3, 2009 and represented approximately 71% of the aggregate term loan balance. The swap agreement is effective through June 30, 2011. Under the provisions of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, this arrangement was initially designated and qualified as an effective cash flow hedge of interest rate risk related to the term loan under our senior credit facilities which permitted recording the fair value of the swap and corresponding unrealized gain or loss to accumulated other comprehensive income in the consolidated balance sheets. The interest rate swap gain or loss is included in the assessment of hedge effectiveness. At April 3, 2009, the fair value of the short-term and long-term portions of the 2007 Swap was a liability of \$1.8 million (accrued expenses) and \$1.0 million (other long-term liabilities), respectively. At April 3, 2009, the unrealized loss, net of tax, on the swap was \$1.8 million.

We performed a sensitivity analysis to assess the potential loss in future earnings that a 10% increase in the variable portion of interest rates over a one-year period would have on our floating rate senior notes and term loan under our senior credit facilities. The impact was determined based on the hypothetical change from the end of period market rates over a period of one year and results in an immaterial increase in future interest expense.

Foreign currency exchange risk

Although the majority of our revenue and expense activities are transacted in U.S. dollars, we do transact business in foreign countries. Our primary foreign currency cash flows are in Canada and several European countries. In an effort to reduce our foreign currency exposure to Canadian dollar denominated expenses, we enter into Canadian dollar forward contracts to hedge the Canadian dollar denominated costs for our manufacturing operation in Canada. Our Canadian dollar forward contracts are designated as a cash flow hedge and are considered highly effective, as defined by SFAS No. 133. The unrealized gains and losses from foreign exchange forward contracts are included in "accumulated other comprehensive income" in the consolidated balance sheets. If the transaction being hedged fails to occur, or if a portion of any derivative is ineffective, then we promptly recognize the gain or loss on the associated financial instrument in the consolidated statements of operations. No ineffective amounts were recognized due to anticipated transactions failing to occur in the three and six months ended April 3, 2009.

Table of Contents

As of April 3, 2009, we had entered into Canadian dollar forward contracts for approximately \$50.6 million (Canadian dollars), or approximately 87% of our estimated Canadian dollar denominated expenses for April 2009 through June 2010, at an average rate of approximately \$0.87 U.S. dollar to Canadian dollar. We estimate the impact of a 1 cent change in the U.S. dollar to Canadian dollar exchange rate (without giving effect to our Canadian dollar forward contracts) to be approximately \$0.3 million annually to our net income or approximately 2 cents to basic and diluted earnings per share.

Net income for the three and six months ended April 3, 2009 includes a recognized loss of \$1.9 million and \$2.2 million, respectively, from foreign currency forward contracts. At April 3, 2009, the fair value of foreign currency forward contracts was a short-term liability of \$3.9 million (accrued expenses), a short-term asset of \$0.1 million (prepaid and other current assets), and a long-term asset of \$0.1 million, and the unrealized loss, net of tax, was \$3.0 million.

Item 4. Controls and Procedures

Management, including our principal executive officer and principal financial officer, has evaluated, as of the end of the period covered by this report, the effectiveness of the design and operation of our disclosure controls and procedures with respect to the information generated for use in this report. Based upon, and as of the date of that evaluation, the principal executive officer and principal financial officer concluded that the disclosure controls and procedures were effective to provide reasonable assurances that information required to be disclosed in the reports filed or submitted under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

There have been no changes in our internal control over financial reporting that occurred during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

- 66 -

[Table of Contents](#)

Part II: OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

For a discussion of risk factors, see "Part I. Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended October 3, 2008. There have been no material changes from the risk factors disclosed in the "Risk Factors" section of our 2008 Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

At an Annual Meeting of Stockholders held on February 24, 2009, the following proposals were presented for a vote of the stockholders of the Company:

Proposal No. 1: The election of the following two directors to serve for a three-year term ending at the 2012 Annual Meeting of Stockholders and until their respective successors are duly elected and qualified.

| Nominee | For Votes | Withheld Votes |
|-------------------|------------|----------------|
| O. Joe Caldarelli | 14,918,464 | 869,070 |
| Michael F. Finley | 14,487,532 | 1,730,934 |

The term of office for the following directors continued after the Annual Meeting: Michael Targoff, Jeffrey P. Hughes, Stephen R. Larson and William P. Rutledge.

Proposal No. 2: The approval of amendments to the Company's 2006 Equity and Performance Incentive Plan, as amended (the "2006 Plan"), to increase by 1,400,000 the maximum number of shares of the Company's common stock that may be issued or subject to awards under the 2006 Plan and to provide that future share-based awards (other than option and stock appreciation right awards) made under the 2006 Plan will count as two shares for purposes of determining whether the cap on the total number of shares issuable under the 2006 Plan has been exceeded.

| Votes | Shares |
|---------|------------|
| For | 11,037,657 |
| Against | 4,356,422 |

| | |
|---------|-------|
| Abstain | 1,945 |
|---------|-------|

- 67 -

Table of Contents

Proposal No. 3: The approval of the “performance-based” compensation provisions of the 2006 Plan to comply with the requirements of Section 162(m) of the Internal Revenue Code of 1986, as amended.

| Votes | Shares |
|---------|------------|
| For | 12,082,110 |
| Against | 3,311,347 |
| Abstain | 2,567 |

Proposal No. 4: The ratification of the appointment of KPMG LLP as the Company’s independent registered public accounting firm for fiscal year 2009.

| Votes | Shares |
|---------|------------|
| For | 15,701,112 |
| Against | 81,157 |
| Abstain | 4,665 |

Item 5. Other Information

None.

- 68 -

[Table of Contents](#)

Item 6. Exhibits

| No. | Description |
|------|--|
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-15(e) and Rule 15d-15(e), promulgated under the Securities Exchange Act of 1934, as amended. |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-15(e) and Rule 15d-15(e), promulgated under the Securities Exchange Act of 1934, as amended. |
| 32.1 | Certifications of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certifications of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

- 69 -

[Table of Contents](#)

SIGNATURES

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

CPI INTERNATIONAL, INC.

Dated: May 13, 2009

/s/ JOEL A. LITTMAN
Joel A. Littman
Chief Financial Officer, Treasurer and Secretary
(Duly Authorized Officer and Chief Financial Officer)

- 70 -
