Cabot Microelectronics Corporation

2005 Second Fiscal Quarter Earnings Report

April 28, 2005

Good morning, with me today are Bill Noglows, Chairman and CEO, and Bill Johnson, Chief Financial Officer, to host this earnings conference call for the second quarter of fiscal 2005, which ended March 31.

This morning we reported results for our second quarter of fiscal 2005. A copy of our press release is available in the investor relations section of our website, cabotcmp.com, or by calling our investor relations office at 630 499-2600. Today's conference call is being recorded and access will be available for three weeks via telephone playback. The playback numbers are 800 642-1687 in the United States or 706 645-9291 internationally, and you will need access code 3993332. Playback will also be available via webcast for the next three weeks in the investor relations section of our website along with a script of this morning's formal comments.

I would like to remind you that our conversations today may include "forward-looking statements" that involve a number of risks, uncertainties and other factors that could cause actual results to differ materially from these forward-looking statements. These risk factors are discussed in our SEC filings, including our report filed on Form 10-Q for the first quarter of fiscal 2005 ended December 31, 2004, and Form 10-K for the fiscal year ended September 30, 2004. We assume no obligation to update any of this forward-looking information.

I will now turn the call over to Bill Noglows.

Thanks, Dave. Good morning to all of you.

This morning we announced disappointing financial results for our second quarter of fiscal 2005. We believe these results reflect a continuation of the difficult industry environment that we experienced during our first fiscal quarter. I will begin by sharing my thoughts on the current market environment, and then talk about my confidence in the strategic direction of our company, since I believe that our financial results generally reflect current industry conditions rather than specific company issues. Bill Johnson will follow with a more detailed summary of our financial and business performance.

You will recall that during our first fiscal quarter, which ended December 31 of 2004, we experienced a sharp sequential revenue reduction that we attributed primarily to a decrease in the production of certain semiconductor devices by a number of our customers, particularly the foundries, in an effort to correct an excess of finished goods inventory. Since demand for our products is primarily driven by wafer starts at sub quarter micron technologies, and since the foundries represent a very important part of our business, this downturn adversely impacted sales of our slurry products during our first fiscal quarter, particularly for tungsten and dielectric CMP applications.

During our second fiscal quarter we saw a continuation of this same industry environment, which resulted in a much smaller sequential revenue reduction --- but a reduction, nevertheless. A number of industry experts have commented that the inventory correction appears to be near complete, and they expect some recovery later this calendar year. As we look at our sales to date in the month of April, we are beginning to see some encouraging signs. Through the first four weeks of April, orders for our products are approximately 10 percent higher than average orders for the comparable periods during the five prior months, the recent period during which we experienced the downturn. However, I would caution that the first four weeks of sales represent only a limited window on results for the full quarter.

Despite what we see as a current soft market environment for CMP slurries, we believe that worldwide demand for electronic devices remains healthy and supports a positive outlook for semiconductors. For example, PC demand appears to remain strong, particularly in notebook computers, and although the communications sector has shown recent signs of slowing, the demand for consumer devices, including digital cameras, TV’s and personal media devices, seems to remain robust.

And notwithstanding our disappointing overall financial results for this quarter, I believe that our business prospects are brighter now than they have been for some time. To this point, let me highlight progress we have made in two specific areas - our product development pipeline and progress on Six Sigma within our Operations Excellence initiative.

I believe that our product development pipeline is in better shape now than it has been in many years. Each quarter we try to update you on progress on new products in each application area. Given the length of the product development cycle and the qualification time with customers, combined with our need to protect customer and competitive information, it is sometimes difficult to demonstrate clear progress when we look at specific development stage products only on a quarter-by-quarter basis. However, looking at the overall product development portfolio, we are excited about how we have refilled our pipeline.

We have dynamic new product offerings in all of our major application areas. Bill Johnson will discuss this in more detail in a few minutes, but in short, in dielectrics we have two new products in or near commercialization and a third in early stage development, that should offer significantly lower cost of ownership for our customers than our legacy products, as either "drop in" products with comparable or better performance at lower cost, or with a step change improvement in performance. Likewise, in tungsten we have two new products at or near commercialization that demonstrate significantly improved performance, that we believe will extend our clear leadership in this important application area. Finally, in copper we have earned a process of record win for another 90 nanometer copper polishing application, and we also received our first commercial orders for slurries for copper and barrier polishing for 65 nanometer technology.

We are excited about the prospects of all of these new products.

Looking at technology more broadly, in the past we have talked about the fragmentation of CMP technology for the most advanced applications, due to customers' varying needs which depend upon the specific materials and process integration schemes they utilize. But developing a completely customized solution for every customer would be cost-prohibitive, given the significant resources and time required for new product development and meeting our customers' continual drive to lower costs. Instead, our approach is to develop product platforms that can be "tuned" relatively easily for a particular customer's needs based on the films they use and their specific integration schemes. We are able to tune the slurries by dialing in the specific selectivity requirements for the films of interest by altering the respective amounts of a number of trace level chemical additives. For example, last quarter we talked about tunable slurries that we are developing for advanced barrier polishing applications, which we tune by adjusting the various removal rates and selectivity of copper to the tantalum barrier and the underlying dielectric. Another example is for advanced dielectric applications where we can control the removal rates and selectivity to oxide, nitride and polysilicon. For advanced tungsten applications we can similarly adjust removal rates and selectivity to tungsten, nitride and oxide.

We believe that this product platform development approach with removal rate and selectivity control represents a very cost-effective means of providing highly customized, value-added solutions for our customers for the most advanced applications.

As we look across the competitive arena of CMP slurries, we believe that no other company comes close to demonstrating the technology capabilities that we do across the application spectrum. Our revitalized product pipeline, including our range of tunable slurries, is evidence of that. And our new Asia Pacific Technology Center, which is scheduled to become operational in October of this year, will provide us with even greater global reach for our technology.

Beyond new product technology, I would like to briefly address progress on achieving Operations Excellence through our Six Sigma initiative. For our first fiscal quarter, we reported gross margin performance at 50.1 percent of revenue, slightly above the top end of our guidance range, and we discussed the associated improved product yields in our manufacturing process, which at the time we cautiously attributed to the early benefits of our Six Sigma initiative. As you know, we have broadly introduced Six Sigma across our company, and several of our first round Six Sigma projects have addressed reduced variability and improved quality in our production operations.

Although our gross margin performance for the second fiscal quarter was weaker than in our first, I am pleased that with respect to quality and manufacturing yield, in our second fiscal quarter we improved upon our solid first quarter results. This improvement in yield was masked by larger adverse effects that Bill Johnson will discuss further. Our higher yields this quarter are further evidence of progress on our Six Sigma initiative, and we are optimistic that there are additional improvements that we can continue to capture in our manufacturing operations as well as in all other business areas.

Further to this point, although our gross margin for this quarter was at the lower end of our guidance range of 48 percent of revenue, plus or minus 2 percent, our guidance remains unchanged. We expect the competitive pricing environment that we have discussed in the past will continue, but our future success at improving productivity through Six Sigma along with continual introduction of new, higher margin products will enable us to maintain gross margin within this guidance range.

Let me now turn the call over to Bill Johnson for a more detailed review of our financial and business performance, after which we will open the call for your questions. I will then make some closing comments.

Thanks, Bill. Good morning.

Our revenue for the second quarter of fiscal 2005 was $64.5 million, which was down 3.8 percent sequentially from the $67.1 million of revenue we reported last quarter, and down 12.3 percent from $73.5 million in the same period last year. As Bill discussed, we believe this sequential decline reflects continued softness in the semiconductor industry that we reported last quarter. This quarter saw combined revenues for our tungsten and dielectric slurries decrease by 5.2 percent, slurries for copper polishing applications increase by 2.0 percent and Data Storage slurries decrease by 6.2 percent.

Our average selling price for the quarter decreased by 1.1 percent compared to last quarter, primarily due to selected price reductions.

Gross profit for the quarter was $29.8 million, down 11.4 percent versus the prior quarter's $33.6 million, and down 17.6 percent from $36.1 million in the year ago quarter. Our gross profit expressed as a percentage of revenue was 46.2 percent, down from both the 50.1 percent of revenue that we reported last quarter and 49.2 percent in the year ago quarter, and as Bill mentioned, at the low end of our guidance range of 48 percent of revenue, plus or minus 2 percent.

Gross margin as a percentage of revenue was adversely impacted by a lower valued product mix, lower utilization of our manufacturing capacity and the impact of selected price reductions. Of these three factors, the lower valued product mix had the most profound effect, accounting for nearly two thirds of the overall sequential variance. As we have discussed in the past, our three primary CMP applications – copper, tungsten and dielectrics, have differing pricing and margin dynamics. However, despite the overall reduction in gross margin, as Bill mentioned earlier we continued to benefit this quarter from yield improvements in our manufacturing operations that we reported last quarter.

Now let me turn to operating expenses, which include research and development, selling and marketing, and general and administrative costs. Operating expenses totaled $21.4 million this quarter, up by 10.5 percent from the $19.4 million we reported last quarter, and approximately $100 thousand, or 0.3 percent, higher than in the comparable quarter last year. This quarter's higher operating costs reflect higher costs of cleanroom materials and laboratory supplies for our research and development activities, higher professional fees, including fees associated with meeting the requirements of Sarbanes Oxley Section 404, and higher staffing costs. Although up sequentially, our spending on operating costs this quarter is in line with our pattern of operating costs over the last 7 quarters, reflecting continued careful management of costs in this area. We expect a similar level of operating costs in our third fiscal quarter.

Operating income for the quarter was $8.4 million, down 41.3 percent from $14.2 million in the prior quarter and down 43.6 percent from $14.8 million in the same quarter a year ago. Operating income represented 13.0 percent of revenue this quarter, down from the 21.2 percent of revenue that we reported last quarter, and down from 20.1 percent in the year ago quarter.

Our effective income tax rate was 31.3 percent this quarter, and we expect our tax rate for the full fiscal year to be 32.5 percent.

Net income for the quarter was $6.1 million, down 38.4 percent from $9.8 million last quarter, and down 37.7 percent from $9.7 million in the same quarter last year.

The weighted average number of shares outstanding on a diluted basis was 24.7 million shares this quarter, slightly lower than in the prior quarter. Purchases of approximately 148 thousand shares of stock for roughly $4.8 million under our share repurchase program this quarter more than offset issuance of new shares due to exercise of approximately 125 thousand stock options related to our April, 2000 IPO, which were due to expire this month, as well as employee stock purchases under our Employee Stock Purchase Plan. Diluted earnings per share for the quarter was 25 cents, down from both the 40 cents per share we reported last quarter and 39 cents in the year-ago quarter.

Next I will address cash and balance sheet related items. Capital spending for the quarter was $6.4 million, mainly related to new equipment for our polishing cleanroom and metrology facility as well as construction of our new Asia Pacific Technology Center. We also made capital investments to expand manufacturing capacity, mainly for new products, and to support our quality efforts. Depreciation and amortization expense was $4.9 million for the quarter.

Our full year forecast for capital investments remains unchanged at $33 million, and we expect depreciation and amortization for the full fiscal year 2005 to be $19.6 million.

We ended the quarter with $163.7 million in cash and short term investments, $6.1 million lower than last quarter. Our Days of Sales Outstanding, or DSO's, in accounts receivable, as well as Days of Sales in Inventory remained even with last quarter. However, cash flow this quarter reflects an $8.9 million increase in working capital, primarily related to a reduction in payables associated with the specific timing of payments to a key raw material supplier in the ordinary course of business, and the timing as well as the statutory calculation method required for payment of estimated federal income taxes. Our cash flow also reflects the $4.8 million of share repurchases that I mentioned earlier. Total capital lease obligations were $7.0 million, and we have no long term debt outstanding.

Let me now provide additional commentary on the performance of our slurry product areas, beginning with copper. Revenue from our slurries for copper polishing applications, including barrier, increased by 2.0 percent sequentially, but was down by 7.1 percent compared to the year ago quarter. Copper revenue represented 22.8 percent of our total revenue for the quarter, up from the 21.5 percent we reported last quarter.

We believe that we continue to have a solid position in copper slurries for 130 nanometer technology, which remains the dominant node for copper polishing, and believe we have not experienced any material change in our competitive position at this node this quarter. We expect continued growth in 130 nanometer technology into calendar year 2006.

Industry adoption of 90 nanometer technology for logic applications continues to progress. We hold 5 POR's for 90 nanometer copper polishing, up from the 4 POR's we reported last quarter. And we hold 2 POR's for barrier polishing for 90 nanometer technology, unchanged from what we reported last quarter. In addition, we recently reached agreement with one important customer on a multi-year exclusive arrangement to supply copper slurries for 130 through 90 nanometer technologies. We are also continuing to work with a number of other customers as they prepare to adopt this new and demanding technology.

Beyond 130 and 90 nanometer technologies, we are working with several customers on solutions for polishing copper and barrier using 65 nanometer technology. We have two 65 nanometer process of record wins for copper polishing, both in conjunction with planned eCMP applications, unchanged from last quarter. We also have one POR for 65 nanometer barrier polishing, down from 2 POR's we reported last quarter. Since 65 nanometer technology is only in the very early stages of adoption we are not surprised that there may be some near term fluidity with respect to POR's at this node. As Bill mentioned, we recently received our first commercial order for products for polishing 65 nanometer copper and barrier.

Now let me turn to our other slurry products. Revenue from our tungsten and dielectric CMP slurries taken together was down 5.2 percent sequentially, and down 15.5 percent compared to the year ago quarter.

We believe we continue to have a strong technology position in slurries for tungsten applications, both with our existing products as well as with new products in development. Our new 6000 series product is now ready for commercial sale for 90 nanometer applications to supplement our existing offerings, and our new 7000 series product, still in development, is being broadly sampled for use with 65 nanometer technology; we expect this product will also be extendable to 45 nanometers. Given the strength in our existing products and the customer pull we are experiencing for our new products, we continue to have confidence in our technology leadership in tungsten slurries. Further, we see a promising future for these products, especially given the growth outlook that we see for memory devices.

For dielectric polishing applications, our new 6000 series CMP slurry is now being commercially launched, after extensive customer evaluation. It was formally introduced at an industry event yesterday under the Idiel tradename. This product provides improved defectivity, but more important, a lower cost of ownership than our legacy products, and it has received positive feedback from customers. We expect to commercialize our new 8000 series product, which is still in development and targeted for advanced ILD applications, during the second half of the calendar year.

Finally, sales of our slurries for Direct Shallow Trench Isolation applications continue with our customers' ramp of 90 nanometer technology, where we are the process of record with two customers and are in evaluations with a number of others.

Revenue from our data storage business decreased by 6.2 percent sequentially, following 2 quarters of strong growth.

This concludes our financial and business review. Now let me offer some comments on share based compensation expense, as well as our nearterm outlook.

Last quarter we discussed the anticipated impact on our company of the recent FASB pronouncement on share based compensation expense, FAS 123R, under which we will begin recognizing on our income statement expense related primarily to awards of stock options which have previously been disclosed on a pro forma basis in the footnotes to our financial statements. Last quarter we discussed our expected pre-tax share based compensation expense of $11 million for each of our fourth fiscal quarter of 2005 and for our full fiscal year 2006, based on the expected timing of implementation of FAS 123R. However, a recent SEC decision now delays the implementation of FAS 123R until our first quarter of fiscal 2006, so we no longer expect to recognize the $11 million pre-tax share based compensation expense that we previously estimated for our fiscal fourth quarter of 2005. However, we still expect approximately $11 million of pre-tax share based compensation expense for our full fiscal year 2006.

We intend to monitor the regulatory landscape for any further implementation issues, and will provide periodic updates as appropriate.

You are aware that we do not provide guidance on revenue, but as we discussed earlier, looking at business activity through the month to date in April, orders for our products are approximately 10 percent higher than average orders for the comparable periods during the prior five months, the recent period during which we experienced the downturn. However, again I would caution that the first four weeks of sales out of a quarter represent a limited window on quarterly results.

With respect to guidance on gross margin, as we discussed, our guidance remains unchanged at 48 percent of revenue, plus or minus 2 percent.

Now let's open the call to questions, after which Bill Noglows will close the call with a few final comments.

Thank you for your questions. Let me close with these summary comments.

The first half of fiscal year 2005 has been challenging and disappointing to us all, given the impact on our business of production downturns by a number of our customers. However, I am confident that our financial results for our second fiscal quarter primarily reflect industry conditions rather than company specific issues. I believe our company has embarked on a sound strategy, and we are executing well on our three key initiatives of Technology Leadership, Operations Excellence and Getting Closer to our Customers. We continue to believe that we are the clear leaders in CMP slurries, and our renewed commitment to technology, quality and customers is beginning to significantly reinforce and enhance this position. Our strong balance sheet and cash flow provide us the flexibility and capability to continue to make the investments that we believe will sustain our leadership well into the future, as well as allow for investment in new growth areas, which we are actively pursuing. Given our progress on our strategic initiatives, along with a future recovery of the semiconductor industry, which could occur later this calendar year based on predictions of some industry experts, we continue to believe that we are well-positioned for continued success.

I want to thank you all for your interest in Cabot Microelectronics, and I look forward to speaking with you again.