Cabot Microelectronics Corporation

2006 Third Fiscal Quarter Earnings Report

July 27, 2006

Good morning everyone, this is Barbara Ven Horst, Director of Investor Relations for Cabot Microelectronics Corporation. With me today are Bill Noglows, Chairman and CEO, and Bill Johnson, Chief Financial Officer.

This morning we reported results for our third quarter of fiscal 2006, which ended June 30. 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 will be archived for four weeks on our website. The script of this morning's formal comments will also be available there.

Please remember that our discussions 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 second quarter of fiscal 2006 ended March 31, 2006, and Form 10-K for the fiscal year ended September 30, 2005. We assume no obligation to update any of this forward-looking information.

And now I will turn the call over to Bill Noglows.

Thanks, Barbara. Good morning everyone, and thank you for joining us today. It has been a busy 3 months for Cabot Microelectronics since our 2nd quarter conference call. Since then, we've reported several significant accomplishments which I will cover this morning. Most recent, of course, was our announcement this morning of our strong performance in the June quarter. In addition to this great news, we made a significant acquisition under our Engineered Surface Finishes growth initiative; we continued to make progress in our pads business; we recently reported that we've strengthened our competitive position with respect to intellectual property related to CMP slurry; and we were honored to host the President of the United States at our headquarters in Illinois. All in all, we believe it's been a great three months.

Let's take a look at each of these accomplishments, starting with our results for the June quarter. We reported record-setting revenue of $84.9 million, our highest quarterly revenue performance ever. We also broke a record in the volume of slurry we shipped to our customers around the world – both in total volume and in each of our IC application areas – including copper. Results were especially strong in Asia, which posted a 44 percent increase over the June 2005 quarter.

We believe our strong revenues this quarter are evidence of recent health in the overall semiconductor industry, as well as strength in demand for our products in all of our business areas. Generally, forecasters are predicting that this trend will continue through the end of calendar 2006. Opinion varies about the industry's prospects for calendar 2007, but from our perspective our business is well-positioned for ongoing success. We believe our strategic initiatives of technology leadership, operations excellence and getting closer to our customers are yielding tangible benefits.

During our last conference call, Bill Johnson and I spoke at length about our recent transition from using a third-party distributor in Taiwan to selling directly to our customers there. We had discussed this planned transition since August of last year and, as you know, we started selling direct on April 1st of this year. We're excited about the long-term benefits this transition affords us, but you will recall the significant short-term adverse financial effect it had on our results for the March quarter. With the transition now fully behind us, our customers appear pleased with our execution of this change and we are satisfied as well.

Demand for CMP slurries appears strong and Cabot Microelectronics' products -- both newly-introduced and legacy technologies -- are participating fully in what has been a healthy market. For example, a major memory player has begun converting from a competitor's products to our newly-commercialized tungsten and dielectric slurries across a range of technology nodes. A number of customers have chosen to replace their homebrew solutions with our tungsten slurries. In addition, we have made initial sales of a new copper barrier slurry for a pre-commercial 45 nm application.

We took an important step in pursuing our Engineered Surface Finishes initiative, or ESF as we refer to it. This growth strategy leverages our expertise in CMP technology for the semiconductor industry, including formulation, materials and polishing techniques, to address other demanding applications requiring nanoscale control of surface shape and finish.

On July 7th, we closed on the acquisition of the assets of QED Technologies, Incorporated, a leader in perfecting surfaces for the precision optics industry.

We believe the acquisition of QED is a great "next step" for our ESF initiative. The precision optics industry, estimated by some to be a multi-billion dollar market, is growing quickly. Demand for improved performance is causing manufacturers to move from traditional manual, artisan-based processing in favor of automated methods that provide predictable, repeatable, and consistent results with higher yields.

QED – a technology-driven company with about $12 million in annual revenues – develops and sells unique, patented polishing and metrology systems that can achieve these results. The systems enable optics manufacturers to polish larger areas with flat, curved or even aspherical geometries to a degree of accuracy and with a level of consistency that was not possible with more traditional manual methods. With more than 100 systems in operation worldwide, QED's technology is widely acknowledged as best-in-class for final figuring of the highest precision optics.

QED does for precision optics what Cabot Microelectronics does for semiconductors. Namely – achieving near-perfect finishes that enable enhanced performance, and doing so deterministically and with repeatability. Because QED is a leader in the transition to automated manufacturing of precision optics, it offers us both an excellent entry point into the precision optics market and access to important customers who are leading-edge optical system manufacturers. We believe combining QED's business with our expertise in CMP forms a strong foundation for growth. We expect the QED business will leverage our expertise in polishing chemistry and materials to enhance the development of consumables for optical processes, and that our global infrastructure will help accelerate QED's entry into new markets.

Our new pad offering is a key growth opportunity within our core CMP business and we continue to make progress there as well. We have made commercial sales to one customer; eight others are in various stages of qualification; and an even larger number are evaluating samples. We are scheduled to have additional manufacturing capacity on-line in the US in September and expect to add additional pad manufacturing capability in Taiwan by early calendar 2007. We believe our pads are a compelling offering in terms of value, performance and pad life and, to date, we are excited and pleased with customers' responses.

Our business is based on technology leadership. And as we've said in the past, our ability to continue to anticipate and meet our customers' requirements for leading edge technology is based on the significant investments we make in patent-protected research and development. A strong intellectual property portfolio is fundamental to our strategy and success, and, we believe, provides us with a significant competitive advantage. Continuing to expand our already substantial intellectual property portfolio and protecting our IP against misuse by others are two important elements of this strategy, and in this quarter we made notable achievements in both.

First, we acquired a number of patents and associated rights relating to CMP slurry technology from IBM, covering various applications such as copper, copper barrier, tungsten and dielectrics, among others, for $5 million. While the acquired patents are not likely to make an immediate contribution to revenue, we believe this transaction affords us a competitive edge. We believe the patents add a valuable complement to our existing technology and provide us with future product development opportunities. We are delighted to have completed this transaction with IBM, who was the pioneer in CMP technology and with whom we have had a productive and collaborative relationship as a valued customer since the early days of CMP.

Our second achievement in the IP arena was our successful protection of our tungsten technology against infringement by Cheil Industries. We had initiated a complaint in this matter before the United States International Trade Commission. The ITC granted our request to prevent this competitor from, among other things, importing any infringing products into the U.S. Our actions on this issue are consistent with our record of vigorously and proactively pursuing any parties that attempt to compromise our investments in R&D by infringing our intellectual property.

I'll wrap up with a few comments about one more exciting event for our company – a visit by the President of the United States, George W. Bush, to our headquarters here in Aurora. We were honored and proud to have been chosen by the White House as a company that exemplifies the technology leadership the President is advocating in his American Competitiveness Initiative. On July 7th, the President and Speaker of the House Dennis Hastert toured our cleanroom facility and research laboratories, and the President made a brief statement to the press on the initiative. We were delighted to have had the opportunity to introduce the President and the world to some of our world-class scientists and show off our best-in-class facilities.

Those are some of the highlights of the past three months. Now I'll ask Bill Johnson to review our business results in more detail, and then we will open the call for your questions. Bill?

Thanks, Bill, and good morning everyone.

Our revenue for the third quarter of fiscal 2006 was $84.9 million, which, as Bill mentioned, set a record for our company. Revenue was up by 26.0 percent versus the prior quarter. However, because that quarter included the significant impact of the transition to direct sales in Taiwan, sequential comparisons of some financial measures aren't very meaningful this quarter. What is meaningful is that our total revenue increased 30.6 percent year-over-year.

In addition to our total sales record, we achieved record sales in this quarter for both our Tungsten and Dielectric slurry businesses. Sales of our slurries for Copper polishing (including barrier) were at the second highest level ever.

Sales of Copper slurries represented 20.8 percent of our total revenue, and grew 61.3 percent sequentially and 32.0 percent versus the same quarter last year.

Tungsten slurries contributed 37.7 percent of total quarterly revenue, with revenue up 19.4 percent sequentially and 30.6 percent year over year.

Dielectric slurries provided 34.6 percent of revenue this quarter, with sales up 24.1 percent sequentially and up 37.2 percent compared with the year ago quarter.

Data Storage products represented 6.0 percent of our quarterly revenue; this revenue was up 5.5 percent sequentially, but down 0.6 percent year over year.

On a geographic basis, as Bill mentioned we continued to see particularly strong sales growth in Asia – year over year, our sales in China were up 73 percent, Korea increased 69 percent, South East Asia grew 50 percent and Taiwan rose 45 percent.

Our average selling price for slurry products increased by 4.9 percent compared with the March quarter. Around 60 percent of this increase is attributable to higher prices, driven by the transition to selling directly to customers in Taiwan. 35 percent of the increase was due to a higher-priced product mix and the rest was foreign exchange related. Because we now sell directly to customers in Taiwan and provide the value-add service that our distributor had previously provided, we keep a portion of the markup that our distributor charged its end customers. However, as we've discussed in the past, we are now responsible for some logistics costs that largely offset the higher prices.

Gross profit this quarter represented 47.6 percent of revenue, up 80 basis points from 46.8 percent last quarter, but down 40 basis points from 48.0 percent in the year ago quarter. Gross profit as a percentage of revenue increased this quarter primarily due to the benefits of higher manufacturing capacity utilization on the higher level of sales and higher pricing, largely offset though by higher costs, including logistics costs associated with selling direct in Taiwan.

Now I'll turn to operating expenses, which include research, development and technical, selling and marketing, and general and administrative costs. Operating expenses of $26.7 million increased by $2.1 million sequentially and were $6.1 million higher than in the same quarter last year. This sequential increase was mainly due to higher estimated accruals for our annual incentive program, greater usage of wafers and other laboratory supplies for our research and development efforts, and higher professional fees, including costs to enforce the company's intellectual property portfolio.

The year-over-year increase in operating expenses was primarily due to higher staffing costs. These include costs to support a number of the company's strategic initiatives, such as the Asia Pacific Technology Center, the Singapore Data Storage facility, and the Taiwan Technical Service Center. It also includes stock option expense. As you know, we began expensing stock options in the current fiscal year as required by new accounting rules. Pre-tax stock option expense was $2.6 million this quarter, of which $2.5 million was classified in operating expenses.

Net income for the quarter was $9.8 million, up by nearly 80 percent from the $5.4 million last quarter. Net income this quarter was 17.3 percent higher than the $8.3 million we reported in the same quarter last year, even with the $1.6 million after-tax effect of stock option expense.

The weighted average number of shares outstanding on a diluted basis this quarter was 24.2 million. This was essentially unchanged from the prior quarter. We did not purchase any stock in the June quarter under our share repurchase program because of our pending acquisition of QED.

Diluted earnings per share were 40 cents this quarter, including a 7 cent adverse effect of stock option expense. EPS was 18 cents higher than the previous quarter and 6 cents higher than we reported in the same quarter last year. Remember, we were not required to record stock option expense in the June quarter of 2005, so on a comparable basis we achieved significant EPS growth year over year.

Turning now to cash and balance sheet related items, capital additions for the quarter were $3.5 million. This included investments to commercialize our new pad product, as well as tools and equipment for our cleanrooms and laboratory facilities worldwide. In addition, as Bill mentioned, we invested $5 million to acquire the collection of CMP slurry patents from IBM. Depreciation and amortization expense was $5.2 million for the quarter.

We ended the quarter with $169.5 million in cash and short term investments, which was $4.2 million lower than last quarter. Cash flow reflects an $11.6 million increase in working capital, mainly due to a higher level of accounts receivable associated with our higher revenue this quarter.

I'll conclude my remarks with a few comments on our near-term outlook, starting with revenue.

As you know, we don't provide guidance on revenue. But in terms of the order pattern we have experienced month to date in July, we see generally steady demand for CMP slurries, comparable to what we experienced during our June quarter. As we caution on every earnings call, the first four weeks of orders out of a quarter represent only a limited window on full quarter results.

In addition to revenue from our CMP business, in our September quarter, we will begin recognizing revenue from our QED acquisition. In the last twelve months, QED generated approximately $12 million in revenue. Our expectation is that by working together, QED will become a growth vehicle for our company.

Our guidance on gross margin for our fourth fiscal quarter remains at 48 percent of revenue, plus or minus 2 percentage points.

Considering near-term operating expenses (again, research, development and technical, selling and marketing, general and administrative costs), we expect three factors will increase these costs in our September quarter. The first two relate to the QED acquisition.

In accordance with accounting rules, we expect to write off approximately $1 million in value associated with in-process research and development efforts related to an as-yet un-commercialized research project. We had previously disclosed an estimate of this one-time cost of approximately $2 million.

Second, we expect the run-rate of QED's operating expenses to be approximately $2.5 million per quarter.

And third, we expect to recognize approximately one half million dollars per quarter as we amortize the value of the IBM patents that we purchased.

So going forward, we expect – in aggregate – operating expenses will increase by approximately $3 million per quarter on an ongoing basis, with an incremental $1 million one-time expense in the September quarter.

Finally, our balance of cash and short term investments, which totaled nearly $170 million at June 30, should be lower in our September quarter due to the QED acquisition. We purchased the assets of QED in early July and paid $19 million in cash. As we previously reported, the total price could ultimately be up to $23.5 million, depending upon future performance under an earn-out arrangement.

Now I'll turn the call back to Barbara so we may prepare to take your questions. Thank you for your time this morning and your interest in Cabot Microelectronics. We look forward to the next opportunity to speak with you. Goodbye!