Cabot Microelectronics Corporation

2006 Second Fiscal Quarter Earnings Report

April 27, 2006

Good morning, 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 second quarter of fiscal 2006, which ended March 31. 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 first quarter of fiscal 2006 ended December 31, 2005, and Form 10-K for the fiscal year ended September 30, 2005. We assume no obligation to update any of this forward-looking information.

I will now turn the call over to Bill Noglows.

Thanks, Barbara. Good morning everyone.

This morning we reported results for our second fiscal quarter, which we believe reflect the continued strength in the semiconductor industry that we experienced during our prior two fiscal quarters. However, as expected, our financial results this quarter include the significant impact of our transition to selling directly to customers in Taiwan rather than through a distributor. As we anticipated, during the transition period, our distributor sold its remaining inventory of our products to customers and we built inventory needed to serve these customers directly, with a resulting short-term interruption in our sales during the second quarter.

We first announced our plans to transition to direct sales in Taiwan last August, and we have discussed this transition and its anticipated effects on our second quarter financial results in our last two earnings calls. The impact of this important initiative should come as no surprise. We believe that the strategic benefits of dealing directly with customers rather than through third parties are compelling, and this transition is consistent with our strategic initiative of getting closer to our customers.

I'm happy to say our team executed this transition smoothly, and at this date the change appears to have been seamless to our customers, which is just the way we intended it. As we have discussed in the past, over the last several years we have converted from distributor sales to direct sales in a number of different geographies. Our last significant transition was in June of 2003 when we began selling directly to customers in Europe and Southeast Asia. What made our change in Taiwan so important was the sheer scale of business that we do there. Given that last year approximately 35 percent of our sales were to our distributor in Taiwan and China, and since the vast majority of these sales were for customers in Taiwan, it was imperative that we execute this change flawlessly, and again, early indications are that it has gone very well.

Our revenue this quarter was 67.4 million dollars, and we believe this was between ten and eleven million dollars lower than it would have been without the impact of the direct sales transition. Even without this effect, we did see some softening of demand versus the prior quarter. This is consistent with Bill Johnson's comments during our last earnings call when we noted that orders appeared somewhat lower to date in January, after a December quarter that ended very strong in terms of revenue, and following two consecutive quarters of revenue growth in excess of 10 percent. This slight softening may also reflect normal seasonality effects within the semiconductor industry.

I want to be clear that the sequential reduction in revenue that we experienced during our second fiscal quarter was due to the direct sales transition and possibly some seasonality or modest softening of demand – it did not relate to any material loss of business in any of our application areas.

Putting aside sales to customers in Taiwan to eliminate the effects of the direct sales transition there, and taking a somewhat longer view, we see that year over year our sales were up nearly 22 percent, with still higher growth rates in a number of important geographies in the Asia Pacific region. For example, our sales in China this quarter were up almost 100 percent versus the same quarter last year; our sales to customers in Korea were up almost 50 percent; and sales into Southeast Asia were up around 25 percent.

We think our financial results for the second fiscal quarter reflect overall healthy conditions in the semiconductor industry. End demand appears generally strong and chip inventory levels have trended within a range that industry experts would describe as "normal", although recently some have expressed concerns about rising chip inventories in certain areas. A number of experts are forecasting a solid second half of the calendar year, and expectations for the foundries in Asia, which are important customers for us, are generally upbeat. Visibility beyond that timeframe is more limited.

We have typically characterized demand for our products as driven by wafer starts at technologies of 250 nanometers and smaller, because this is the portion of the semiconductor industry that uses CMP technology. Currently, this represents slightly more than half of overall semiconductor output. But since data on wafer starts by technology node is reported on a 3 month lag, we do not find this metric particularly useful for forecasting. However, another metric to which we are beginning to pay closer attention because we think it represents a 3 to 6 month leading indicator for demand for CMP materials, is silicon wafer shipments to the fabs. Based on actual and forecast wafer shipments, it appears that demand for CMP materials should be steady in the June quarter and growing in the September and December quarters. So overall, we see a pretty healthy nearterm CMP industry outlook.

As I've often discussed on these calls, we are executing on two parallel growth strategies for Cabot Microelectronics. The first strategy is to continue to strengthen and grow our CMP business, including slurries and pads. This broad strategy occupies most of our corporate mind share. In parallel with this effort, we are pursuing a second growth strategy through our Engineered Surface Finishes initiative, or ESF, through which we are leveraging our expertise in chemical mechanical polishing solutions for semiconductors into other demanding polishing applications beyond this industry.

We're excited about our current position as well as our future prospects in our core CMP business. We strive to find innovative ways to meet our customers' needs, and we believe we achieved a number of accomplishments this quarter, which I'll mention briefly here and we can discuss more during the Q and A session:

During the quarter we continued work to further improve our product line and supply position in slurries for all applications. We recently commercialized two new products for tungsten polishing and are near final on a third, and we earned significant new wins for tungsten applications with two big memory players.

We have begun to work with a number of customers on supply arrangements that could provide a combination of several of our products to meet the multiple needs of our customers. Through this approach we think we can leverage our broad and deep portfolio of CMP products and services to bring greater value to our customers.

We increased the number of customers to whom we are sampling our polishing pads, based on encouraging feedback from the initial group of customers who have helped us evaluate them. We believe that 2 or 3 customers are close to selecting our pad for their commercial polishing applications.

During our second fiscal quarter we also continued preparations for the opening of our Taiwan Technical Service Center. This new facility is designed to provide copper slurry formulation capability for our customers in Taiwan, acting as an extension of our Asia Pacific Technology Center in Japan.

Finally, we won a number of supplier awards and distinctions from several important customers. We believe these are further evidence that our ongoing efforts to work ever more closely with our customers are making tangible progress.

Clearly there is a lot of energy around our core CMP business, in both slurries and pads. We are excited about the capabilities we bring to our customers -- our robust product portfolio and product development pipeline, our substantial technology infrastructure and technical team, and our unmatched manufacturing and supply chain infrastructure. We think these capabilities and our continued execution of our strategies uniquely position us to be able to meet our customers' requirements in the years to come.

We are also making progress on our second growth strategy through our ESF initiative. We are focused on precision polishing applications in optics, optoelectronics, compound semiconductors, health care, displays and precision metal finishing, and we are excited by the opportunities we are seeing there. We expect to grow this business through a combination of both internal organic technical development and acquisitions of business positions, technologies and channels to market.

We continue to leverage our recent acquisition of the assets of Surface Finishes Company, which is providing greater visibility into high performance polishing markets that we had not previously served. We are also continuing to look for other interesting acquisition opportunities that can complement our internal efforts. We believe that acquisitions to fulfill our ESF growth initiative, as well as to grow our core CMP business, can be productive uses of capital to which we have access by virtue of our strong balance sheet and business model.

Our approach is to manage our business for the long term. Within our core CMP business, developing relationships with customers and building their trust and confidence, developing new products and qualifying these with customers take time. Often it may be difficult to see measurable progress month to month, quarter to quarter, or even over several quarters. Despite this, we believe we have the discipline and the resources to take the steps necessary to strengthen our position for the long term. Let me offer three recent examples in our core CMP business of where we have incurred costs in the near-term in exchange for long term benefits:

First is our direct sales transition in Taiwan. As we have discussed, we anticipate clear strategic and economic benefits of working directly with our customers that far outweigh the short term effects on our second quarter financial results.

A second example is moving our data storage business to Singapore. We have built business capability in Singapore to better serve the data storage industry and position ourselves as the preferred supplier to a number of important customers in the region. This should provide attractive long term benefits relative to the short term incremental costs.

The third example is building research and development capability closer to our customers through our Asia Pacific Technology Center in Japan, and our new Taiwan Technical Service Center. Research and development requires significant investment in people and equipment which can raise costs in the near term. But as these investments become productive and integrated with the rest of our global activities, we believe there will be substantial long term benefits.

Finally, beyond the core CMP business, our ESF growth initiative is another example of near term investing for long term benefit. Developing a new business is challenging and takes time and patience. But we are willing to invest in the commercial and technical resources and capabilities we need to grow our Engineered Surface Finishes business because we believe in the long term potential value of this initiative.

Now I'll turn the call over to Bill Johnson to review our business results, and then we will take your questions.

Thanks, Bill.

Our revenue for the second quarter of fiscal 2006 was $67.4 million. Bill discussed at length our second quarter direct sales transition in Taiwan, which we believe decreased our revenue this quarter by between ten and eleven million dollars. The impact of this transition on the quarter makes comparison of financial results for this period with other periods more difficult. For example, revenue this quarter was down by $14.0 million or 17.3 percent versus the prior quarter, but it was only down by around 4 percent absent the impact of the direct sales transition. We believe this 4 percent sequential reduction may reflect some normal seasonality, and a modest correction from our very strong first fiscal quarter.

Year over year our revenue was up by 4.5 percent from $64.5 million in the same quarter last year, even including the impact of the direct sales transition. Absent this effect, our revenue was up around 21 percent versus the same quarter last year.

Primarily due to the effects of the direct sales transition, all of our CMP slurry products recorded sequential revenue reductions.

Another indication of the difficulty in comparing sequential quarters given the impact of the direct sales transition is that revenue from our slurries for copper polishing applications, including barrier, decreased by 32.6 percent sequentially this quarter. The direct sales transition obviously had a huge impact on our copper revenue – sales of our slurry products in Taiwan are heavily foundry-oriented, and the big reduction in copper sales this quarter reflects the significant amount of copper slurry we sell for advanced logic applications in Taiwan. Consequently, copper slurries represented only 16.3 percent of our total revenue for the quarter. I want to reiterate Bill's earlier comments, specifically with respect to copper slurries – the sequential reduction in our revenue from copper slurries was due to the direct sales transition. We did not lose any material copper business this quarter.

Our average selling price for the quarter decreased by 2.5 percent compared with last quarter. Selected price reductions accounted for around two thirds of this total impact, and a lower priced product mix represented around one third of the effect.

Gross profit this quarter represented 46.8 percent of revenue, down a bit from 47.2 percent last quarter and up from 46.2 percent in the year ago quarter. Gross profit as a percentage of revenue decreased marginally this quarter due to lower pricing, partially offset by benefits of a higher margin mix of products.

Now I'll turn to operating expenses, which include research, development and technical, selling and marketing, and general and administrative costs. Operating expenses of $24.6 million decreased by half a million dollars sequentially and were $3.2 million higher than in the same quarter last year. The sequential decrease was primarily due to lower costs for cleanroom materials for our research and development activities, along with lower professional fees, partially offset by higher travel costs.

A year-over-year comparison of operating expenses is difficult to make due to the effect of accounting rules that required us to begin expensing stock options this fiscal year. Mainly due to this non-cash expense, operating expenses increased by 15.1 percent year-over-year. Pre-tax stock option expense was $2.5 million this quarter, of which $2.3 million was classified in operating expenses.

Net income for the quarter was $5.4 million, down from $9.6 million last quarter, mainly due to the effects of the direct sales transition. Net income this quarter was only approximately seven hundred thousand dollars lower than the $6.1 million we reported in the same quarter last year, even including the significant impact of the direct sales transition and the new $1.7 million after tax effect of stock option expensing.

The weighted average number of shares outstanding on a diluted basis this quarter was 24.2 million. This was slightly lower than in the prior quarter due to $4.0 million of stock purchases under our share repurchase program.

Diluted earnings per share were 22 cents this quarter, including 7 cents of stock option expense. EPS was down from 39 cents in the previous quarter. During our last earnings conference call we estimated that EPS in the second quarter would be reduced by around 17 cents per share due to effects of the direct sales transition. Our 22 cents in earnings per share this quarter includes this 17 cent adverse transitional effect, so except for this planned impact our EPS this quarter was consistent with our performance last quarter, despite the somewhat softer revenue we mentioned earlier.

In the same quarter a year ago EPS was 25 cents, or 3 cents higher than this quarter. Remember that the year ago quarter did not include the 17 cent effect of the direct sales transition or the 7 cents of stock option expense we recorded this quarter.

Turning now to cash and balance sheet related items, capital additions for the quarter were $5.3 million. This included investments to commercialize new copper and pad products, tools and equipment for our cleanrooms and to support our Engineered Surface Finishes growth initiative, investment in our new Taiwan Technical Service Center and costs associated with moving our data storage business to Singapore. Depreciation and amortization expense was $5.0 million for the quarter.

We ended the quarter with $173.7 million in cash and short term investments, $5.0 million lower than last quarter. Cash flow this quarter reflects a $7.7 million increase in working capital, mainly due to higher inventories required to support direct sales in Taiwan. Our cash flow also reflects the $4.0 million of share repurchases that I mentioned earlier.

I'll conclude my remarks with a few comments on our nearterm outlook.

Our guidance on gross margin for our third fiscal quarter remains at 48 percent of revenue, plus or minus 2 percentage points. This has been our guidance since our April earnings conference call in 2004. For the last five quarters we have operated in the lower half of this guidance range, due in part to pricing pressure – partially from competitive activity and partially from pricing actions we have initiated as we price our products to maintain or grow our supply position within the industry. And we expect this pricing pressure to continue. In the recent past we have achieved productivity improvements which have helped offset the effects of price reductions on gross margin. Although we have likely captured much of the low hanging fruit in this area, we expect to achieve further productivity improvements in the future. We will also continue to introduce new, higher margin products that can help offset pricing pressure. Beyond this pricing pressure on margin, we have described our efforts to grow our company through our ESF initiative, including through acquisitions, which will take us into new polishing applications and business models that may not support gross margins at our historical levels. We have also described our interest in growing our core CMP business, including through acquisition. Our focus is on top line as well as bottom line growth, and based on the choices we make we may achieve this at the expense of some gross margin, when expressed as a percentage of revenue.

As you know, we don't provide guidance on revenue, but as we look at business activity through the month to date in April, we see somewhat softer demand than we saw in January and February of this year, in terms of orders that we expect to ship by the end of the month. (Since March was the key transitional month in our change to direct sales in Taiwan, March is not an appropriate comparator.) The softness that we are seeing in April may reflect some residual effects of our direct sales transition. Obviously we will monitor closely sales activity through the rest of the period. 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.

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!