Cabot Microelectronics Corporation

2005 Third Fiscal Quarter Earnings Report

July 28, 2005

Good morning, with me today is Bill Noglows, Chairman and CEO of the company, to host this earnings conference call for the third quarter of fiscal 2005, which ended June 30.

This morning we reported results for our third fiscal quarter of 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 4381279. 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 second quarter of fiscal 2005 ended March 31, 2005, and Form 10-K for the fiscal year ended September 30, 2004. We assume no obligation to update any of this forward-looking information.

This morning Bill and I are conducting this call without David Li, our Director of Investor Relations, who many of you have interacted with over the last year and a half. David was recently promoted to run one of our business areas. I'd like to thank Dave for his contributions to our investor relations function, and wish him success in his new role. We have an ongoing search for Dave's replacement, and I hope to announce a new Director of Investor Relations soon.

I will now turn the call over to Bill Noglows.

Thanks, Bill. Good morning to all of you.

This morning we announced financial results for our third quarter of fiscal 2005 that we believe reflect a "bottoming" of the semiconductor industry downcycle that has affected a significant portion of the semiconductor industry recently, and which has negatively impacted results thus far in fiscal 2005. Our revenue this quarter was up slightly following two consecutive quarters of sequentially lower revenues during which we saw certain customers reduce production to correct excess inventories of some semiconductor devices. Industry experts indicate that inventory correction appears to be complete and have predicted that the semiconductor industry will turn up during the second half of the calendar year. For example, industry analysts have increased forecast growth in semiconductor industry revenue from 2004 to 2005 to between 4 and 8 percent. Total wafer shipments are now expected to grow 5 percent in the third calendar quarter. A number of notable semiconductor manufacturers have shown strength in their quarterly financial results. Forecasts for PC shipments in 2005 have increased sharply in the last month. Finally, foundries are forecasting 8 to 10 percent growth in wafer shipments for the third calendar quarter, and some product lead times have increased. Since demand for our products is primarily based on wafer starts at sub-quarter micron technology, an upturn in semiconductor industry activity should drive growth for us in the coming quarters.

Over the past two years we have been executing on our three principal strategies – Technology Leadership, Operations Excellence and Getting Closer to our Customers. During our last conference call I discussed our progress on our Technology Leadership initiative, with particular attention paid to our revitalized product development pipeline, as well as our progress on our Operations Excellence initiative, specifically with regard to productivity and yield improvements we are capturing through our Six Sigma initiative. We're excited about our progress and ongoing execution in both of these key areas. This morning I would like to focus our discussion on the substantial progress we are making on our third principal strategy – Getting Closer to our Customers.

We have discussed previously that the CMP industry has begun to mature, technology has begun fragmenting and becoming more complex, and customers are requiring more customized CMP solutions. Shrinking feature sizes continue to make slurry product quality, consistency and performance more important. Given these trends, along with intensifying competition in CMP, it is imperative that we work more closely and collaboratively with our customers to continue to maintain and enhance our leadership in this increasingly demanding technology. I believe that our customers are enthusiastic about our execution on this initiative. As we partner with our customers on joint development activities, we are openly sharing far more information about our technology and know-how, demonstrating greater commercial flexibility in customer supply arrangements, and making our world-class technical and commercial staffs as accessible to our customers as their needs require.

Let me describe several tangible examples of progress we are making in Getting Closer to our Customers.

During our third fiscal quarter we earned supplier quality awards from three important customers. In one case we were selected number 1 out of nearly 200 suppliers, and in another we were rated in the top one percent out of 1500 suppliers. Beyond these three specific awards, we are also consistently earning significantly higher ratings when our customers audit our operations and grade us on their supplier scorecards.

In our data storage business, we are moving the portion of our business that serves the rigid disk market to Singapore to be closer to the hard disk drive customer base that is concentrated in Southeast Asia. This will include establishing manufacturing operations there, as well as relocating our related commercial and technical teams. We believe that over 60 percent of the global manufacturing capacity for the hard disk drive industry is located in Southeast Asia, and that we can serve customers more efficiently, more responsively and at lower cost by moving closer to their manufacturing and development centers.

During our third fiscal quarter we reached agreement with two important customers in Asia on long term supply arrangements for CMP slurries, bringing to four the number of these arrangements we have entered into with significant Asian customers over the past three quarters. The arrangements cover a range of technology nodes and relate to copper, tungsten and dielectric applications. In the past, long term supply arrangements have been relatively rare in the CMP industry. We believe our progress in gaining these long term commitments from our customers underscores the closer relationships we are developing with these customers, as well as the high quality of our products, services and supply chain.

Our Asia Pacific Technology Center continues on track to open for operation in October of this year. We expect that having this fully capable technology development facility in the Asia Pacific region will allow us to better extend our strong technical capability and know-how to our customers there, while significantly improving our response time as well as providing the ability to work closely with our regional customers on unique and customized CMP solutions. Construction is well underway, and staffing is progressing as planned.

In previous conference calls we have discussed our efforts in Six Sigma, which have primarily focused on internal improvement activities, mainly in our manufacturing operations and in research and development. We are now extending our Six Sigma initiative to include joint projects with customers. We are currently sharing our Six Sigma capabilities and working on joint projects with two customers to help them improve quality and consistency in their manufacturing operations, which should translate into lower defectivity and higher yields for them. Other customers are expressing interest in this kind of collaboration. Working with customers on Six Sigma improvement projects represents a great example of how we can address our customers' needs for lower costs through a means other than simply reducing the price of our slurries.

Finally, in April of our third fiscal quarter we held our first CMP technology symposium in Austin, Texas. This event attracted 70 participants from a wide range of customers. We have received terrific feedback from this event, and are planning other similar events in Europe and Asia in September of this year.

In addition to all of these achievements and activities, during our third fiscal quarter we earned our third Process of Record, or POR, win for a 65 nanometer copper polishing application. We also earned our first two PORs for 45 nanometer technology – one each for copper and barrier applications, and we earned our third POR for Direct Shallow Trench Isolation, or DSTI.

We are delighted with the progress we are making in building ever stronger relationships with our customers and earning their greater trust and confidence in us, and we are eager to do more. I believe that no other competitor in the CMP slurry industry has the technical and operational capabilities to work with the broad range of customers that we do, across the full spectrum of applications and technology nodes.

Now I would like to update you on an exciting area of increasing emphasis for Cabot Microelectronics. You may recall that last October I talked about our emerging efforts in engineered surface finishes, through which we are translating our core technical expertise in CMP technology for the semiconductor industry, with which we modify surfaces at an atomic level, into a range of demanding surface modifications and polishing applications in other industries where shaping, enabling and enhancing the performance of surfaces is as critical to success as it is in the semiconductor industry. We have made real progress on our Engineered Surface Finishes, or ESF, initiative over the past several months, and as it continues to develop and expand, we continue to believe that ESF can provide additional growth and diversification opportunities for our company, while also complementing our leadership position in CMP technology for the semiconductor industry. A number of the areas that we are currently developing have natural adjacencies to our core CMP business and technology, and include applications in fields such as optics, optoelectronics, flat panel displays and metal finishing.

We believe our strong balance sheet and cash flow provide us the flexibility to both acquire business positions in a number of these areas as well as grow and develop organically, as appropriate to create value for our business and our customers. We intend to continue to provide periodic updates on our progress in this exciting area.

Now let me turn over the call to Bill Johnson for a more detailed review of our financial and business performance, after which we will open the call for your questions.

Thanks, Bill.

Our revenue for the third quarter of fiscal 2005 was $65.0 million, which was up 0.8 percent sequentially from the $64.5 million of revenue we reported last quarter, and down 15.5 percent from $76.9 million in the same period last year. Comparisons of our revenue and other financial metrics to the year ago quarter reflect the near record results of our strong third quarter of fiscal 2004 before the subsequent semiconductor industry downturn.

This quarter saw combined revenues for our tungsten and dielectric slurries increase by 3.7 percent, slurries for copper polishing applications decrease by 9.0 percent and data storage slurries increase by 3.1 percent.

Our average selling price for the quarter decreased by 2.8 percent compared to last quarter, primarily due to selected price reductions, along with the effect of the weaker Japanese yen versus the U.S. dollar on the approximately 15 percent of our revenue that is yen-denominated.

Gross profit for the quarter was $31.2 million, up 4.8 percent versus the prior quarter's $29.8 million, and down 20.0 percent from $39.0 million in the year ago quarter. Our gross profit expressed as a percentage of revenue was 48.0 percent, up from the 46.2 percent of revenue that we reported last quarter, down from 50.7 percent in the year ago quarter, and at the midpoint of our guidance range of 48 percent of revenue, plus or minus 2 percent.

Gross profit as a percentage of revenue increased largely due to the benefit of a higher valued product mix, partially offset by the effect of selected price reductions that I mentioned earlier. You are aware that product mix has historically been a significant driver of quarter-to-quarter changes in our gross profit margin since our three primary CMP applications – copper, tungsten and dielectrics -- have differing pricing and margin dynamics.

Now let me turn to operating expenses, which include research and development, selling and marketing, and general and administrative costs. Operating expenses totaled $20.6 million this quarter, down by 3.8 percent from the $21.4 million we reported last quarter, and approximately half a million dollars, or 2.6 percent, lower than in the comparable quarter last year. This quarter's lower operating costs reflect lower staffing related costs, including lower accruals for the company's annual bonus plan, partially offset by higher costs of cleanroom supplies for our research and development activities and higher professional fees, including fees associated with meeting the requirements of Sarbanes Oxley Section 404.

Operating income for the quarter was $10.6 million, up 26.9 percent from $8.4 million in the prior quarter and down 40.7 percent from $17.9 million in the same quarter a year ago. Operating income represented 16.3 percent of revenue this quarter, up from the 13.0 percent of revenue that we reported last quarter, and down from 23.2 percent in the year ago quarter.

Our effective income tax rate was 27.9 percent this quarter, and we expect our tax rate for the full fiscal year to be 31.0 percent.

Net income for the quarter was $8.3 million, up 37.7 percent from $6.1 million last quarter, and down 31.9 percent from $12.2 million in the same quarter last year.

The weighted average number of shares outstanding on a diluted basis was 24.6 million shares this quarter, slightly lower than in the prior quarter due to purchases of approximately 171 thousand shares of stock for roughly $5.0 million under our share repurchase program this quarter. To date we have purchased approximately 656 thousand shares for roughly $21.5 million at an average price of around $32.85 per share under the $25 million share repurchase program.

Diluted earnings per share for the quarter was 34 cents, up from the 25 cents per share we reported last quarter and down from 49 cents in the year-ago quarter.

Next I will address cash and balance sheet related items. Capital spending for the quarter was $4.0 million, mainly related to construction of the Asia Pacific Technology Center. We also made capital investments to expand manufacturing capacity, including production capacity for new products. Depreciation and amortization expense was $4.9 million for the quarter.

Our full year forecast for capital investments is now $30 million, down from our previous forecast of $33 million due to the lower than planned spending on the Asia Pacific Technology Center and for our quality improvement activities. We expect depreciation and amortization for full fiscal year 2005 to be $19 million.

We ended the quarter with $165.7 million in cash and short term investments, $2.0 million higher than last quarter. Cash flow this quarter reflects a $2.1 million increase in working capital, about half of which related to an increase in our inventory of abrasive particle, in conjunction with our ongoing raw material supply assurance strategy. Our Days of Sales Outstanding, or DSO's, in accounts receivable remained even with last quarter, and Days of Sales in Inventory increased slightly with the increased raw material inventory. Our cash flow also reflects the $5.0 million of share repurchases that I mentioned earlier. Total capital lease obligations are $6.8 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, decreased by 9.0 percent sequentially, and was down by 21.4 percent compared to the year ago quarter. Copper revenue represented 20.6 percent of our total revenue for the quarter, down from the 22.8 percent we reported last quarter.

The sequential reduction in copper revenue was due to lower sales to our largest customer, Marketech, which is a distributor in Taiwan and China. We believe Marketech increased its slurry inventory in our second fiscal quarter then returned its slurry inventory to a normal level in our third fiscal quarter, and so, purchased less of our slurry that quarter. In aggregate, sales of copper slurries to all of our other customers during our third fiscal quarter increased by 6.0 percent sequentially.

During our third fiscal quarter we reached agreement with an important customer on an exclusive long term arrangement to supply copper slurries for 130 and 90 nanometer technologies. This makes three long term supply arrangements we have entered into with customers for our copper products over the last three quarters, and as Bill mentioned earlier, we believe these arrangements are evidence of the growing confidence and trust in our company by our customers.

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.

Industry adoption of 90 nanometer technology for logic applications continues to progress. We hold 5 PORs for copper polishing and 1 POR for barrier polishing with 90 nanometer technology, both unchanged from last quarter. We have held our one POR for the 90 nanometer barrier application for several quarters; however, last quarter I inadvertently referred to our holding two PORs for 90 nanometer barrier technology.

At 65 nanometer technology, we now have three POR wins for copper polishing, up from two PORs that we reported last quarter, and one POR for barrier polishing, unchanged from last quarter. We recently made our first commercial sale of products for polishing 65 nanometer copper and barrier.

Beyond 65 nanometer technology, this quarter we earned our first two PORs for 45 nanometer technology, one each for copper and barrier polishing applications.

Now let me turn to our other slurry products. Revenue from our tungsten and dielectric CMP slurries taken together was up 3.7 percent sequentially, and down 15.6 percent compared to the year ago quarter.

We continue to have confidence in our technology leadership in slurries for tungsten applications, both with respect to our existing products as well as with new products in development. The two long term supply arrangements that we entered into with customers during our third fiscal quarter both include our tungsten slurries. Our new 6000 series product is now fully commercial and several customers are in advanced evaluations. And our new 7000 series products, still in development, are being broadly sampled for use with 65 nanometer technology and should also be extendable to 45 nanometers.

We see a promising future for our tungsten slurry products, given the growth outlook that we see for memory devices as well as the opportunity to convert a number of “homebrew” slurry users to our commercial slurry products. We are working with a number of customers that currently provide their own tungsten slurry who are now evaluating our products as potential replacements for their homebrew slurries. We believe that the strength of our technology and our outstanding product performance can provide compelling advantages to current home brewers.

Turning now to dielectric polishing applications, the two new long term supply arrangements we have discussed this morning also cover our dielectric slurry products. Our new 6000 series slurry was commercially launched in April, after extensive customer evaluation. Ongoing evaluations by a number of customers could lead to sales over the next several quarters. This product provides improved defectivity and a lower cost of ownership than our legacy products. Our new 8000 series slurry, which is still in development and targeted for advanced ILD applications, should be commercialized during the second half of the calendar year. We are also developing new products for advanced applications for 45 nanometer and 22 nanometer technologies.

Also within dielectrics, sales of our slurries for Direct Shallow Trench Isolation applications continue with our customers' ramp of 90 nanometer technology. We earned our third POR this quarter, up from the two we have reported previously, and our products are in evaluations with a number of other customers.

Finally, revenue from our data storage business increased by 3.1 percent sequentially. The data storage industry has demonstrated continued strength due to growing demand for hard disk drives in PC's and consumer electronic devices, even through a historically seasonally weak period.

This concludes our financial and business review. Now let me offer some comments on our near-term outlook.

You are aware that we do not provide guidance on revenue, but as we look at business activity through the month to date in July, orders for our products that we expect to ship by the end of the month are approximately even with orders during the same period in each of the three months of the June quarter. However, I would caution that the first four weeks of orders out of a quarter represent a limited window on quarterly results.

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

This concludes our formal comments