CPI INTERNATIONAL, INC.
Form 10-Q
May 14, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 30, 2007

or

o 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 94303-1110
(650) 846-2900

(Address of Principal Executive Offices and Telephone Number,
Including Area Code)

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 required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

Yes o No x

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: 16,314,032 shares of Common Stock, $.01 par value, at April 30, 2007.

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and subsidiaries

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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, pred continue, the negative of such terms 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; our significant amount of debt; changes or reductions in the U.S. defense budget; U.S. government contracts laws and regulations; changes in technology; the impact of unexpected costs; inability to obtain raw materials and components; and currency fluctuations. 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.

PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data   unaudited)

	March 30, 2007	September 29, 2006
Assets		
Current Assets:		
Cash and cash equivalents	$ 27,605	$ 30,153
Restricted cash	1,937	1,746
Accounts receivable, net	47,293	43,628
Inventories	56,910	54,031
Deferred tax assets	11,560	11,520
Prepaid and other current assets	3,658	3,080
Total current assets	148,963	144,158
Property, plant, and equipment, net	65,978	63,851
Deferred debt issue costs, net	8,917	9,644
Intangible assets, net	74,268	75,489
Goodwill	147,271	147,489
Other long-term assets	558	1,128
Total assets	$ 445,955	$ 441,759
Liabilities and stockholders equity		
Current Liabilities:		
Current portion of long-term debt	$	$ 1,714
Accounts payable	20,629	19,101
Accrued expenses	23,312	23,269
Product warranty	5,525	5,958
Income taxes payable	6,050	10,693
Advance payments from customers	6,017	6,310
Total current liabilities	61,533	67,045
Deferred income taxes	29,613	29,933
Long-term debt, less current portion	241,808	245,067
Other long-term liabilities	60	41
Total liabilities	333,014	342,086
Commitments and contingencies		
Stockholders equity		
Common stock ($0.01 par value, 90,000,000 shares authorized; 4,275,566 shares issued and outstanding) authorized; 16,291,889 and 16,049,577 shares issued and outstanding)	163	160
Additional paid-in capital	67,371	65,295
Accumulated other comprehensive income	273	679
Retained earnings	45,134	33,539
Total stockholders equity	112,941	99,673
Total liabilities and stockholders equity	$ 445,955	$ 441,759

See accompanying notes to the condensed consolidated financial statements.

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

	Three Months Ended March 30, 2007	March 31, 2006	Six Months Ended March 30, 2007	March 31, 2006
Sales	$ 88,444	$ 86,929	$ 172,167	$ 169,308
Cost of sales	60,739	61,185	117,881	118,356
Gross profit	27,705	25,744	54,286	50,952
Operating costs and expenses:				
Research and development	2,352	1,941	4,243	3,851
Selling and marketing	4,799	4,680	9,628	9,704
General and administrative	5,846	4,676	10,250	11,978
Amortization of acquisition-related intangible assets	546	546	1,094	1,094
Net loss on disposition of fixed assets	40	143	58	208
Total operating costs and expenses	13,583	11,986	25,273	26,835
Operating income	14,122	13,758	29,013	24,117
Interest expense, net	5,275	6,400	10,614	12,464
Income before income taxes	8,847	7,358	18,399	11,653
Income tax expense	3,087	3,013	6,804	5,093
Net income	$ 5,760	$ 4,345	$ 11,595	$ 6,560
Other comprehensive income, net of tax				
Net unrealized loss on cash flow hedges	(17)	(306)	(406)	(489)
Comprehensive income	$ 5,743	$ 4,039	$ 11,189	$ 6,071
Earnings per share - Basic	$ 0.35	$ 0.33	$ 0.72	$ 0.50
Earnings per share - Diluted	$ 0.32	$ 0.29	$ 0.66	$ 0.44
Shares used to compute earnings per share - Basic	16,253,522	13,078,954	16,161,149	13,078,954
Shares used to compute earnings per share - Diluted	17,730,318	14,784,947	17,646,457	14,776,514

See accompanying notes to the condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands unaudited)

	Six Months Ended March 30, 2007	March 31, 2006
Cash flows from operating activities		
Net cash provided by (used in) operating activities	$ 6,299	$ (4,515)
Cash flows from investing activities		
Expenses relating to sale of San Carlos property		(4)
Capital expenditures	(5,347)	(5,817)
Capitalized expenses relating to potential business acquisition	(119)	
Net cash used in investing activities	(5,466)	(5,821)
Cash flows from financing activities		
Proceeds from issuance of debt		10,000
Repayments of debt	(5,000)	
Proceeds from issuance of common stock to employees	398	
Proceeds from exercise of stock options	542	
Payment of IPO financing costs		(1,374)
Stockholder distribution payments		(17,000)
Excess tax benefit on stock option exercises	679	
Net cash used in financing activities	(3,381)	(8,374)
Net decrease in cash and cash equivalents	(2,548)	(18,710)
Cash and cash equivalents at beginning of period	30,153	26,511
Cash and cash equivalents at end of period	$ 27,605	$ 7,801
Supplemental cash flow disclosures		
Cash paid for interest	$ 10,707	$ 12,378
Cash paid for taxes, net of refunds	$ 10,495	$ 4,607

See accompanying notes to the condensed consolidated financial statements.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(All tabular dollar amounts in thousands except share and per share amounts)

1. Organization and Basis of Presentation

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 subsidiaries on a consolidated basis.

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

The condensed consolidated financial statements include those of the Company and its subsidiaries. Significant intercompany balances, transactions, and stockholdings have been eliminated in consolidation.

The Company s fiscal year is the 52- or 53-week period that ends on the Friday nearest September 30. Fiscal year 2007 comprises the 52-week period ending September 28, 2007 and fiscal year 2006 comprised the 52-week period ended September 29, 2006. All period references are to the Company s fiscal periods unless otherwise indicated. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes included in the Company s Annual Report on Form 10-K for the year ended September 29, 2006.

On May 3, 2006, the Company completed the initial public offering of its common stock (see Note 4 for further disclosure).

2. Supplemental Balance Sheet Information

Accounts Receivable: Accounts receivable are stated net of allowances for doubtful accounts of $0.1 million and $0.5 million at March 30, 2007 and September 29, 2006, respectively.

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

	March 30, 2007	**September 29, 2006**
Raw material and parts	$ 37,058	$ 35,160
Work in process	12,375	10,481
Finished goods	7,477	8,390
	$ 56,910	$ 54,031

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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 March 30, 2007	March 31, 2006
Balance at beginning of period	$ 8,822	$ 8,655
Inventory provision, charged to cost of sales	540	473
Inventory write-offs	(218)	(151)
Balance at end of period	$ 9,144	$ 8,977

Reserve for loss contracts and cost in excess of market inventory: The following table summarizes the activity related to reserves for loss contracts and cost in excess of market inventory:

	Six Months Ended March 30, 2007	March 31, 2006
Balance at beginning of period	$ 1,702	$ 1,430
Provision for loss contracts and cost in excess of market inventory, charged to cost of sales	49	652
Credit to cost of sales upon revenue recognition	(453)	(629)
Balance at end of period	$ 1,298	$ 1,453

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

	Six Months Ended March 30, 2007	March 31, 2006
Beginning accrued warranty	$ 5,958	$ 6,359
Accruals for product warranty, charged to cost of sales	2,374	2,738
Cost of warranty claims	(2,807)	(2,679)
Ending accrued warranty	$ 5,525	$ 6,418

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

	March 30, 2007			September 29, 2006		
	Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
VED Core Technology	$ 30,700	$ (1,965)	$ 28,735	$ 30,700	$ (1,659)	$ 29,041
VED Application Technology	19,800	(2,526)	17,274	19,800	(2,130)	17,670
X-ray Generator and Satcom ApplicationTechnology	8,000	(1,708)	6,292	8,000	(1,441)	6,559
Customer backlog	17,450	(17,450)		17,450	(17,450)	
Land lease	11,810	(833)	10,977	11,810	(706)	11,104
Tradename	5,800		5,800	5,800		5,800
Customer list and programs	5,700	(565)	5,135	5,700	(451)	5,249
Noncompete agreement	110	(55)	55	110	(44)	66
	$ 99,370	$ (25,102)	$ 74,268	$ 99,370	$ (23,881)	$ 75,489

The estimated future amortization expense of purchased intangibles as of March 30, 2007, excluding the Company s unamortized tradename, is as follows:

Fiscal Year	Amount
2007 (remaining six months)	$ 1,223
2008	2,446
2009	2,446
2010	2,424
2011	2,424
Thereafter	57,505
	$ 68,468

Goodwill: The following table presents goodwill by reportable segment at March 30, 2007 and September 29, 2006:

	March 30, 2007	September 29, 2006
VED	$ 133,440	$ 133,637
Satcom Equipment	13,831	13,852
	$ 147,271	$ 147,489

The decrease in goodwill from September 29, 2006 to March 30, 2007 was due to an adjustment for tax benefits realized from the exercise of fully vested stock options that were acquired in a business combination.

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3. Long-Term Debt

Long-term debt comprises the following:

	March 30, 2007	September 29, 2006
Term loan, expiring 2010	$ 37,500	$ 42,500
8% Senior subordinated notes, due 2012	125,000	125,000
Floating rate senior notes, due 2015, net of issue discount of $692 and $719	79,308	79,281
	241,808	246,781
Less: Current portion		1,714
Long-term portion	$ 241,808	$ 245,067

Senior Credit Facility and Term Loan of CPI: In fiscal year 2004, CPI entered into a $130.0 million credit agreement, which was amended and restated on November 29, 2004, and further amended on February 16, 2005, April 13, 2005, and December 15, 2005 (the Senior Credit Facility). The Senior Credit Facility consists of a $40.0 million revolving commitment, with a sub-facility of $15.0 million for letters of credit and $5.0 million for swingline loans (Revolver), which expires on January 23, 2010, and a $90.0 million term loan (Term Loan), which expires on July 23, 2010. As of March 30, 2007, the Company had no outstanding borrowings under the Revolver and $37.5 million outstanding under the Term Loan, after taking into account a $5.0 million Term Loan repayment in December 2006 using available operating cash. The $5.0 million Term Loan repayment included a $1.7 million ECF (as defined below) payment, and an optional prepayment of $3.3 million. In December 2005, CPI borrowed $10.0 million on the Term Loan to pay a dividend to CPI International. CPI International used the proceeds of that dividend to pay a portion of the special cash dividend of $17.0 million to its stockholders. Upon certain specified conditions, including compliance on a pro forma basis with the covenants in the Senior Credit Facility, CPI may seek commitments for a new class of term loans, not to exceed $65.0 million. The Senior Credit Facility is guaranteed by CPI International and all of CPI s domestic subsidiaries and is secured by substantially all of their assets.

Any borrowings under the Revolver would currently bear interest at a rate equal to, at CPI s option, LIBOR plus 2.75% per annum, or the Alternate Base Rate (ABR) plus 1.75% per annum. Available borrowings under the Revolver are reduced by any amounts secured through letters of credit; at March 30, 2007, the Company had letters of credit commitments for $3.8 million. The Term Loan borrowings currently bear interest at a rate equal to, at CPI s option, LIBOR plus 2.25% per annum or the ABR plus 1.25% per annum, payable quarterly. The ABR is the greater of (a) the Prime Rate and (b) the Federal Funds Rate plus 0.50%. In addition to customary fronting and administrative fees under the Senior Credit Facility, CPI pays letter of credit participation fees equal to the applicable Revolver LIBOR margin per annum on the average daily amount of the letter of credit exposure, and a commitment fee of 0.50% per annum on the average daily unused amount of revolving commitment. As of March 30, 2007 (1) the Term Loan borrowing consisted of one tranche of $5.5 million and one tranche of $32.0 million with interest payable on April 12, 2007 and April 23, 2007, each at 7.6% per annum, and (2) a Revolving commitment of $3.8 million for letter of credit exposure, with letter of credit participation fees and fronting fees payable quarterly at a combined interest rate of 3.0% per annum.

The Senior Credit Facility requires 1.0% of the original Term Loan amount to be repaid annually in quarterly installments of 0.25% beginning June 30, 2004 and continuing for five years, with the remainder due in equal quarterly installments thereafter. CPI is required to prepay its outstanding loans, 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, (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 and (4) 50% of such proceeds received from issuances of common equity by, or equity contributions to, CPI International.

CPI is also required to make an annual prepayment within 90 days after the end of each fiscal year based on a calculation of Excess Cash Flow, as defined in the Senior Credit Facility (ECF), multiplied by a factor of 25%, 50% or 75% depending on the leverage ratio at the end of the fiscal year, less optional prepayments made during the fiscal year. On December 30, 2004, CPI made an ECF payment of $3.9 million. The ECF payment was applied pro rata, in accordance with the provisions of the Senior Credit Facility, against the remaining scheduled installments of Term Loan principal due up to, but not including, the September 30, 2009 scheduled principal installment. The Company made an ECF payment of $1.7 million for the fiscal year ended September 29, 2006 in December 2006 and there is no expected ECF payment due for fiscal year 2007, primarily because of the $3.3 million optional prepayment that was made in December 2006.

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. In March 2005, CPI made an optional prepayment of $5.7 million; in May 2006, CPI made additional optional prepayments of $47.5 million in the aggregate using proceeds from the initial public offering of CPI International s common stock (the IPO); and in December 2006, CPI made an additional prepayment of $3.3 million. The optional prepayments were applied pro rata, in accordance with the provisions of the Senior Credit Facility, against the remaining scheduled installments of Term Loan principal due up to June 30, 2009, with the balance applied to scheduled installment amounts on or after September 30, 2009, in direct order of maturity.

The Senior Credit Facility contains a number of covenants that, among other things, restrict, subject to certain exceptions, the ability of CPI International, CPI and CPI s domestic 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 prepayments relating to subordinated indebtedness; and amend or waive provisions of charter documents in a manner materially adverse to the lenders. CPI and CPI s subsidiaries must comply with: a minimum interest coverage ratio; a maximum total leverage ratio; a minimum fixed charge coverage ratio; and a maximum capital expenditures limitation, each calculated on a consolidated basis for CPI and CPI s subsidiaries. CPI International must also comply with a minimum interest coverage ratio, a minimum fixed charge coverage ratio and a maximum leverage ratio, each calculated on a consolidated basis for CPI International and its subsidiaries. As of March 30, 2007, CPI and CPI International were in compliance with all Senior Credit Facility financial covenants.

Subject in certain cases to applicable notice provisions and grace periods, events of default under the Senior Credit Facility include, among other things: failure to make payments when due; breaches of representations and warranties in the documents governing the Senior Credit Facility; non-compliance by CPI International, CPI and/or CPI s subsidiaries with certain covenants; failure by CPI International, CPI and/or CPI s subsidiaries to pay certain other indebtedness or to observe any other covenants or agreements that would allow acceleration of such indebtedness, collectively in excess of $5.0 million at any time; events of bankruptcy or insolvency of CPI International, CPI and/or CPI s subsidiaries; certain uninsured and unstayed judgments of $5.0 million or more against CPI International; impairment of the security interests in the collateral or the guarantees under the Senior Credit Facility; and a change in control, as defined in the documents governing the Senior Credit Facility.

8% Senior subordinated notes of CPI: In connection with a business combination on January 23, 2004, CPI issued $125.0 million in aggregate principal amount of its 8% Senior Subordinated Notes (the 8% Notes). 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 Facility. 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	
2008	104	%
2009	102	%
2010 and thereafter	100	%

At any time on or prior to February 1, 2008, the 8% Notes may also be redeemed or purchased (by CPI or any other person) in whole but not in part, at CPI s option, upon the occurrence of a change of control (as defined in the indenture governing the 8% Notes) at a price equal to 100% of the principal amount of the 8% Notes, plus a make-whole premium (as defined in the indenture governing the 8% Notes) to the redemption price on February 1, 2008, and accrued and unpaid interest, if any, to, the date of redemption or purchase. 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.

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 of CPI International: On February 22, 2005, CPI International issued $80.0 million in principal amount of its Floating Rate Senior Notes (FR Notes). The FR Notes were issued at a 1% discount. The proceeds from the issuance of FR Notes were used to make a distribution to stockholders of CPI International of approximately $75.8 million and to pay fees and expenses of approximately $3.5 million associated with the issuance of FR Notes. The FR Notes 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, 2007 is approximately 11.15% 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 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 CPI to satisfy its obligations under the FR Notes. The Senior Credit Facility and the indenture governing the 8% Notes restrict CPI s ability to make distributions to CPI International. The Senior Credit Facility prohibits CPI from making distributions to CPI International unless there is no default under the Senior Credit Facility and CPI International and CPI satisfy certain leverage ratios. 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.

At any time or from time to time CPI International, at its option, may redeem the 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	
2007	103	%
2008	102	%
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 March 30, 2007, maturities on long-term debt were as follows:

Fiscal Year	Term Loan	Floating Rate Senior Notes	8% Senior Subordinated Notes	Total
2007	$	$	$	$
2008				
2009				
2010	37,500			37,500
2011				
Thereafter		80,000	125,000	205,000
	$ 37,500	$ 80,000	$ 125,000	$ 242,500

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4. Stockholders Equity

Common and Preferred Stock: On April 7, 2006, the Company amended and restated its certificate of incorporation to provide for 90,000,000 authorized shares of common stock, par value $0.01 per share, and 10,000,000 authorized shares of preferred stock, par value $0.01 per share. The holder of each share of common stock has the right to one vote. The board of directors has the authority to issue the undesignated preferred stock in one or more series and to fix the rights, preferences, privileges and restrictions thereof. As of March 30, 2007 and September 29, 2006, there were no shares of preferred stock outstanding.

On April 7, 2006, in connection with the amendment and restatement of its certificate of incorporation, the Company also effected a 3.059-to-1 stock split of its outstanding shares of common stock as of such date. All share and per share amounts in the accompanying condensed consolidated financial statements and accompanying notes have been retroactively restated to reflect this stock split.

On May 3, 2006, the Company completed the IPO of its common stock. The Company sold 2,941,200 shares of common stock and the selling stockholders sold 4,117,670 shares, at an initial public offering price to the public of $18.00 per share, resulting in proceeds to the Company of approximately $47.3 million, net of IPO transaction costs of approximately $5.6 million. The Company used the net proceeds to repay $47.3 million of the Term Loan under the Senior Credit Facility.

5. Share-based Compensation Plans

The Company has four stock plans: the 2006 Equity and Performance Incentive Plan (the 2006 Plan), the 2006 Employee Stock Purchase Plan (the 2006 ESPP), the 2004 Stock Incentive Plan (the 2004 Plan) and the 2000 Stock Option Plan (the 2000 Plan).

2006 Plan: The 2006 Plan provides for an aggregate of up to 1,400,000 shares of CPI International s common stock to be available for awards, plus the number of shares subject to awards granted under the 2004 Plan and the 2000 Plan that are forfeited, expire or are cancelled after the effective date of the 2006 Plan. All of the Company s employees (including officers), directors, and consultants are eligible for awards under the 2006 Plan. The 2006 Plan is administered by the Compensation Committee of the Board of Directors (Compensation Committee) and awards may consist of options, stock appreciation rights, restricted stock, other stock unit awards, performance awards, dividend equivalents or any combination of the foregoing. The exercise price for stock options generally cannot be less than 100% of the fair market value of the shares on the date of grant.

2006 ESPP: The 2006 ESPP permits eligible employees to purchase common stock at a discounted price. An aggregate of 760,000 shares of common stock is reserved for issuance under this plan. The stock purchase plan is administered by the Compensation Committee. Employees participating in the plan may purchase stock for their accounts according to a price formula set by the Compensation Committee, as administrator, before the applicable offering period, which cannot exceed 24 months. The price per share will equal a fixed percentage (which may not be lower than 85%) of the fair market value of a share of common stock on the last day of the purchase period in the offering, or the lower of (1) a fixed percentage (not to be less than 85%) of the fair market value of a share of common stock on the date of commencement of participation in the offering and (2) a fixed percentage (not to be less than 85%) of the fair market value of a share of common stock on the date of purchase. The initial 2006 ESPP offering

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period began on July 1, 2006; the participants purchase price for CPI International, Inc. common stock will be 85% of the closing market price on the last trading day of each quarter.

2004 Plan: No further options are available for issuance under the 2004 Plan. The Company issued both time and performance stock option awards under the 2004 Plan. All stock option grants under the 2004 Plan were issued at exercise prices equal to or greater than the estimated market price of the Company s common stock at option grant date.

2000 Plan: No further options are available for issuance under the 2000 Plan. In accordance with the terms of the stock option agreements, the unvested stock options outstanding under the 2000 Plan became fully vested in February 2004 in connection with a business combination. The 2000 Plan option holders were offered the opportunity to either roll over their stock options from the predecessor company into options to purchase common stock of CPI International or exercise their stock options. Management elected to roll over options to purchase 912,613 shares of common stock at prices ranging from $0.20 to $0.74 per share.

Stock Options: A summary of the Company s stock option activity as of March 30, 2007, and changes during the six months then ended is presented below:

	Number of Shares	**Weighted-Average Exercise Price**	**Weighted-Average Remaining Contractual Term (Years)**	**Aggregate Intrinsic Value**
Outstanding at September 29, 2006	3,163,057	$ 4.51		
Granted	291,000	14.28		
Exercised	(206,949)	2.62		
Forfeited	(31,141)	10.03		
Outstanding at March 30, 2007	3,215,967	$ 5.47	7.05	$ 44,232
Vested and expected to vest at March 30, 2007	3,188,743	$ 5.41	7.04	$ 44,028
Exercisable at March 30, 2007	2,308,489	$ 3.00	6.48	$ 37,448

The grant date fair value of awards granted during the first six months of fiscal year 2007 was estimated as of the date of grant using the Black-Scholes options pricing model, assuming no expected dividends and the following ranges of assumptions:

Expected term (in years)	5.99	6.25
Expected volatility	49.33%	
Risk-free rate	4.56%	4.73%
Grant date fair value	$7.66	$9.07

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Since the Company s 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. The expected life of options granted is based on the simplified method for plain vanilla options in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 107. The risk-free rates are based on the U.S. Treasury yield in effect at the time of the grant.

Cash received from option exercises under all share-based payment arrangements during the first six months of fiscal year 2007 was $0.5 million. The total intrinsic value of options exercised was $2.7 million during the first six months of fiscal year 2007. There were no options granted or exercised during the first six months of fiscal year 2006.

As of March 30, 2007, there was approximately $4.2 million of total unrecognized compensation costs related to nonvested stock options, which is expected to be recognized over a weighted-average vesting period of 2.4 years.

Restricted Stock Awards: There were 11,466 and 9,999 shares of restricted stock granted to directors outstanding as of March 30, 2007 and September 29, 2006, respectively. The restricted stock awards vest over periods of one to three years and have a 10 year contractual life.

A summary of the status of the Company s nonvested restricted stock awards as of March 30, 2007, and changes during the six months then ended is presented below:

	Number of Shares	Weighted-Average Grant-Date Fair Value
Nonvested at September 29, 2006	9,999	$ 18.00
Granted	7,022	17.09
Vested	(5,555)	18.00
Forfeited		
Nonvested at March 30, 2007	11,466	$ 17.44

As of March 30, 2007, there was $0.2 million of total unrecognized compensation costs related to nonvested restricted stock awards, which is expected to be recognized over a weighted average vesting period of 1.6 years.

Share-Based Compensation Cost: There was no unrecognized compensation cost relating to stock options outstanding at the beginning of fiscal year 2006 and no stock options were granted during the first six months of fiscal year 2006. Therefore, there was no share-based compensation cost in the first six months of fiscal year 2006. Total share-based compensation cost for the Company s stock plans in the first six months of fiscal year 2007 comprise the following:

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	Six Months Ended March 30, 2007	
Share-based compensation cost recognized in the income statement by caption:		
Cost of sales	$	102
Research and development	26	
Selling and marketing	51	
General and administrative	314	
	$	493
Share-based compensation cost capitalized in inventory	$	107
Share-based compensation cost remaining in inventory at end of period	$	36
Share-based compensation expense by type of award:		
Stock options	$	435
Restricted stock	58	
	$	493

6. Derivative Financial Instruments

The Company uses forward exchange contracts to hedge the foreign currency exposure associated with forecasted manufacturing costs in Canada. As of March 30, 2007, CPI had outstanding forward contract commitments to purchase Canadian dollars for an aggregate U.S. notional amount of $21.5 million; the last forward contract expires on December 17, 2007. At March 30, 2007 and September 29, 2006, the fair value of foreign currency forward contracts was a net liability of $0.2 million and an asset of $0.1 million, respectively, and the unrealized (loss) gain was $(0.1) million and $8 thousand, net of related tax expense, respectively.

The Company s foreign currency forward contracts are designated as a cash flow hedge and are considered highly effective, as defined by Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities. The unrealized gains and losses from foreign exchange forward contracts are included in Accumulated other comprehensive income in the condensed consolidated balance sheets, and the Company anticipates recognizing the entire unrealized loss in operating earnings within the next twelve months. 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 in the condensed consolidated statements of operations. The time value was not material for first six months of fiscal years 2007 and 2006. 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 the condensed consolidated statements of operations. No ineffective amounts were recognized due to anticipated transactions failing to occur in the first six months of fiscal years 2007 and 2006. Realized gains and losses from foreign currency forward contracts are recognized in cost of sales and general and administrative in the condensed consolidated statements of operations. Net income in the first six months of fiscal year 2007 includes a recognized loss from foreign currency forward contracts of $0.1 million. Net income in the first six months of fiscal year 2006 includes a recognized gain from foreign currency forward contracts of $1.0 million.

In April 2005, the Company expanded its use of derivatives to hedge the interest rate exposure associated with the FR Notes. On April 15, 2005, the Company entered into an $80 million interest rate swap contract (the Swap) to receive variable rate 6-month LIBOR interest and pay 4.15% fixed rate interest, which when combined with the 5.75% margin, results in a fixed rate of 9.9% on the FR Notes through January 31, 2008. The Swap interest payments are made semi-annually, beginning with the first payment on February 1, 2006. The Swap matures on January 31, 2008. In fiscal year 2005, the Company deposited $1.0 million as collateral for the Swap; the amount of collateral fluctuates based on the fair value of the Swap. In fiscal year 2006, the Company received a $0.5 million refund of the Swap collateral. The Swap collateral remaining is reported as Prepaid and Other Current Assets in the accompanying condensed consolidated balance sheets as of March 30, 2007, and as Other Long-term Assets as of September 29, 2006. The unrealized gains and losses from the Swap are included in Accumulated other comprehensive income in the condensed consolidated balance sheets. The ineffective portion of the Swap was not significant, and the interest rate swap gain or loss are included in the assessment of hedge effectiveness. At March 30, 2007 and September 29, 2006, the fair value of the Swap was an asset of $0.7 million and $1.1 million, respectively, and the unrealized gain, net of related tax expense, was $0.4 million and $0.7 million, respectively.

7. Income Taxes

The Company s effective tax rate was approximately 37% and 44% for the first six months of fiscal year 2007 and 2006, respectively. The lower effective income tax rate in the first six months of fiscal year 2007 was primarily due to a change in filing position that was made in the third quarter of fiscal year 2006 as a result of foreign income tax planning activities, discrete tax benefits related to prior year foreign tax filings and lower effective income tax rates in the first six months of fiscal year 2007 in certain foreign jurisdictions primarily due to decreases in the Canadian statutory tax rates. The effective tax rate for the first six months of fiscal year 2006 included a $0.3 million charge attributable to the fourth quarter of fiscal year 2005 consisting of $0.5 million to correct the overstatement of tax benefits recorded in the fourth quarter of fiscal year 2005 for stock-based compensation expense that is not deductible for income tax purposes in a foreign tax jurisdiction, offset by reversal of a $0.2 million tax contingency reserve that was no longer required. Without the correction to the overstatement of tax benefits, the Company s effective tax rate for the first six months of fiscal year 2006 would have been approximately 41%.

8. Earnings Per Share

Basic earnings per share is computed using the weighted-average number of common shares outstanding during the period. Diluted earnings per share is 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 using the treasury stock method.

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

	Three Months Ended March 30, 2007	March 31, 2006	Six Months Ended March 30, 2007	March 31, 2006
Weighted average shares outstanding - Basic	16,253,522	13,078,954	16,161,149	13,078,954
Effect of dilutive stock options and restricted stock awards	1,476,796	1,705,993	1,485,308	1,697,560
Weighted average shares outstanding - Diluted	17,730,318	14,784,947	17,646,457	14,776,514

As further discussed in Note 4, on April 7, 2006, in connection with the amendment and restatement of its certificate of incorporation, the Company effected a 3.059-to-1 split of its outstanding shares of common stock as of such date. All share and per share amounts have been retroactively restated to reflect this stock split.

9. 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, its chief executive officer, and is based on the nature of the Company s operations and products offered to customers.

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

	Three Months Ended		**Six Months Ended**	
	March 30, 2007	**March 31, 2006**	**March 30, 2007**	**March 31, 2006**
Sales from external customers				
VED	$ 72,216	$ 69,597	$ 139,191	$ 132,793
Satcom equipment	16,228	17,332	32,976	36,515
	$ 88,444	$ 86,929	$ 172,167	$ 169,308
Intersegment product transfers				
VED	$ 4,582	$ 6,476	$ 9,705	$ 12,684
Satcom equipment	9	2	9	2
	$ 4,591	$ 6,478	$ 9,714	$ 12,686
EBITDA				
VED	$ 17,932	$ 17,396	$ 35,516	$ 33,461
Satcom equipment	1,121	1,961	2,618	4,852
Other	(2,743)	(3,304)	(4,739)	(9,745)
	$ 16,310	$ 16,053	$ 33,395	$ 28,568

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Amounts not reported as VED or satcom equipment are reported as other. Other consists primarily of corporate operating expenses and certain other expenses that are managed by the corporate organization, such as business combination-related expenses, share-based compensation expense, and certain non-recurring or unusual expenses. The first six months of fiscal year 2006 included non-recurring expenses for a special bonus of $3.25 million and expenses of $2.5 million related to the relocation of the Company s Eimac operations from its former San Carlos, California facility to its nearby Palo Alto, California and Mountain View, California facilities. The special bonus was paid to employees and directors (other than directors who are employees or affiliates of Cypress) to reward them for the increase in Company value.

EBITDA represents earnings before provision for income taxes, net interest expense and depreciation and amortization. For the reasons listed below, the Company believes that GAAP-based financial information for leveraged businesses such as the Company s business should be supplemented by EBITDA so that investors better understand 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;

- the Senior Credit Facility contains covenants that require the Company to maintain certain interest expense coverage and leverage ratios that contain EBITDA as a component, and the Company s management team uses EBITDA to monitor compliance with such covenants;

- 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 March 30, 2007	March 31, 2006	Six Months Ended March 30, 2007	March 31, 2006
Net income	$ 5,760	$ 4,345	$ 11,595	$ 6,560
Depreciation and amortization	2,188	2,295	4,382	4,451
Interest expense, net	5,275	6,400	10,614	12,464
Income tax expense	3,087	3,013	6,804	5,093
EBITDA	$ 16,310	$ 16,053	$ 33,395	$ 28,568

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

	Three Months Ended March 30, 2007	March 31, 2006	Six Months Ended March 30, 2007	March 31, 2006
United States	$ 52,577	$ 57,207	$ 102,081	$ 108,207
All foreign countries	35,867	29,722	70,086	61,101
Total sales	$ 88,444	$ 86,929	$ 172,167	$ 169,308

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

	March 30, 2007 Cost	Accumulated Depreciation and Amortization	Net Property, Plant and Equipment	September 29, 2006 Cost	Accumulated Depreciation and Amortization	Net Property, Plant and Equipment
United States	$ 66,154	$ (13,995)	$ 52,159	$ 64,527	$ (11,221)	$ 53,306
Canada	15,534	(1,763)	13,771	11,915	(1,440)	10,475
Other	175	(127)	48	177	(107)	70
Total	$ 81,863	$ (15,885)	$ 65,978	$ 76,619	$ (12,768)	$ 63,851

The United States Government is the only customer that accounted for 10% or more of the Company s consolidated sales in the first six months of fiscal years 2007 and 2006. Direct sales to the United States Government were $29.0 million and $27.8 million for first six months of fiscal years 2007 and 2006, respectively. Accounts receivable from this customer represented 14% of consolidated accounts receivable as of March 30, 2007 and September 29, 2006.

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

10. Sale of San Carlos Assets

In February 2003, the Company entered into an agreement to sell the land and close its facilities located in San Carlos, California to consolidate the Company s Eimac operations into the Company s existing facility in nearby Palo Alto, California. In September 2006, the sale was completed. The aggregate sales proceeds were $24.8 million, of which $11.3 million was received in September 2006 and $13.5 million was received as advance payments in fiscal 2004. The Company had total selling costs of

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$1.3 million related to the sale of the San Carlos property. The aggregate sales proceeds of $24.8 million less the related selling costs of $1.3 million, offset by the land and building s net book value of approximately $23.5 million, resulted in no gain or loss on the sale.

11. Special Cash Dividend

In December 2005, the Board of Directors declared and paid a special cash dividend to stockholders of $17.0 million. This dividend was paid using (a) the $10.0 million in net proceeds obtained from the additional borrowing under the Senior Credit Facility in connection with the December 2005 amendment thereto, and (b) available cash.

12. Recently Released Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation 48, Accounting for Income Tax Uncertainties (FIN 48). FIN 48 defines the threshold for recognizing the benefits of tax return positions in the financial statements as more-likely-than-not to be sustained by the taxing authority. The recently issued literature also provides guidance on the derecognition, measurement and classification of income tax uncertainties, along with any related interest and penalties. FIN 48 also includes guidance concerning accounting for income tax uncertainties in interim periods and increases the level of disclosures associated with any recorded income tax uncertainties. FIN 48 is effective for fiscal years beginning after December 15, 2006. Any differences between the amounts recognized in the statements of financial position prior to the adoption of FIN 48 and the amounts reported after adoption will be accounted for as a cumulative-effect adjustment recorded to the beginning balance of retained earnings. The Company will be required to adopt FIN 48 in fiscal year 2008 and is currently in the process of determining the impact, if any, of adopting the provisions of FIN 48 on its financial position, results of operations and liquidity.

In September 2006, the FASB issued 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. Early adoption, as of the beginning of an entity s fiscal year, is also permitted, provided interim financial statements have not yet been issued. The Company will be required to adopt SFAS No. 157 in fiscal year 2008 and is currently evaluating the potential impact, if any, that the adoption of SFAS No. 157 will have on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R), which requires an employer to recognize the overfunded or underfunded status of a defined benefit plan as an asset or liability in its condensed consolidated balance sheet. Under SFAS No. 158, actuarial gains and losses and prior service costs or credits that have not yet been recognized through earnings as net periodic benefit cost will be recognized in other comprehensive income, net of tax, until they are amortized as a component of net periodic benefit cost. SFAS No. 158 is effective as of the end of the fiscal year ending after December 15, 2006 and shall not be applied retrospectively. The Company will be required to adopt SFAS No. 158 in the fourth quarter of fiscal year 2007 and is currently evaluating the impact, if any, that the adoption of SFAS No. 158 will have on its consolidated financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB No. 108). SAB No. 108 provides guidance on how prior year misstatements should be considered when quantifying misstatements in the current year financial statements. SAB No. 108 requires registrants to quantify misstatements using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB No. 108 does not change the guidance in SAB No. 99, Materiality, when evaluating the materiality of misstatements. SAB No. 108 is effective for fiscal years ending after November 15, 2006. Upon initial application, SAB No. 108 permits a one-time cumulative effect adjustment to beginning retained earnings. The Company will be required to adopt SAB No. 108 in the fourth quarter of fiscal year 2007 and believes at this time that the adoption of SAB No. 108 will not have a material impact on its consolidated financial statements.

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 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 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 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 159 will be effective in the first quarter of fiscal year 2009. The Company is currently evaluating the impact that this statement will have on its consolidated financial statements.

13. Supplemental Guarantors Condensed Consolidating Financial Information (Unaudited)

On January 23, 2004, CPI issued $125.0 million of 8% Notes that 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 or 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.

CONDENSED CONSOLIDATING BALANCE SHEET

As of March 30, 2007

	Parent (CPI Int l)	Issuer (CPI)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Eliminations	Consolidated Total
Assets						
Cash and cash equivalents	$ 516	$ 25,113	$ 508	$ 1,468	$	$ 27,605
Restricted cash			1,160	777		1,937
Accounts receivable, net		24,103	8,048	15,142		47,293
Inventories		38,825	2,539	16,197	(651)	56,910
Deferred tax assets		10,954	3	865	(262)	11,560
Intercompany receivable		27,631	1,955		(29,586)	
Prepaid and other current assets	1,239	1,622	331	729	(263)	3,658
Total current assets	1,755	128,248	14,544	35,178	(30,762)	148,963
Property, plant and equipment, net		49,327	2,845	13,806		65,978
Deferred debt issue costs, net	3,010	5,907				8,917
Intangible assets, net		59,107	6,590	8,571		74,268
Goodwill		93,160	5,848	48,263		147,271
Other long-term assets		558				558
Intercompany notes receivable		1,035			(1,035)	
Investment in subsidiaries	219,037	61,789			(280,826)	
Total assets	$ 223,802	$ 399,131	$ 29,827	$ 105,818	$ (312,623)	$ 445,955
Liabilities and stockholders equity						
Accounts payable	$ 192	$ 12,535	$ 554	$ 7,348	$	$ 20,629
Accrued expenses	1,320	16,239	702	5,051		23,312
Product warranty		3,159	225	2,141		5,525
Deferred income taxes	262				(262)	
Income taxes payable			379	5,934	(263)	6,050
Advance payments from customers		2,865	1,519	1,633		6,017
Intercompany payable	28,396			1,190	(29,586)	
Total current liabilities	30,170	34,798	3,379	23,297	(30,111)	61,533
Deferred income taxes		23,813		5,800		29,613
Intercompany notes payable				1,035	(1,035)	
Long-term debt, less current portion	79,308	162,500				241,808
Other long-term liabilities		60				60
Total liabilities	109,478	221,171	3,379	30,132	(31,146)	333,014
Common stock	163					163
Parent investment		120,610	22,228	57,632	(200,470)	
Additional paid-in capital	67,371					67,371
Accumulated other comprehensive income	273	(154)		(95)	249	273
Retained earnings	46,517	57,504	4,220	18,149	(81,256)	45,134
Net stockholders equity	114,324	177,960	26,448	75,686	(281,477)	112,941
Total liabilities and stockholders equity	$ 223,802	$ 399,131	$ 29,827	$ 105,818	$ (312,623)	$ 445,955

13. Supplemental Guarantors Condensed Consolidating Financial Information (Unaudited)

CONDENSED CONSOLIDATING BALANCE SHEET

13. Supplemental Guarantors Condensed Consolidating Financial Information (Unaudited)

As of September 29, 2006

	Parent (CPI Int l)	Issuer (CPI)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Eliminations	Consolidated Total
Assets						
Cash and cash equivalents	$ 139	$ 28,299	$ 290	$ 1,425	$	$ 30,153
Restricted cash			941	805		1,746
Accounts receivable, net		22,642	7,132	13,854		43,628
Inventories		34,659	2,215	18,540	(1,383)	54,031
Deferred tax assets		10,703	3	814		11,520
Intercompany receivable		27,988	2,748		(30,736)	
Prepaid and other current assets	887	1,238	165	790		3,080
Total current assets	1,026	125,529	13,494	36,228	(32,119)	144,158
Property, plant and equipment, net		50,344	2,982	10,525		63,851
Deferred debt issue costs, net	3,123	6,521				9,644
Intangible assets, net		59,901	6,715	8,873		75,489
Goodwill		93,378	5,848	48,263		147,489
Other long-term assets	731	397				1,128
Intercompany notes receivable		1,035			(1,035)	
Investment in subsidiaries	204,778	55,247			(260,025)	
Total assets	$ 209,658	$ 392,352	$ 29,039	$ 103,889	$ (293,179)	$ 441,759
Liabilities and stockholders equity						
Current portion of long-term debt	$	$ 1,714	$	$	$	$ 1,714
Accounts payable	199	9,667	490	8,745		19,101
Accrued expenses	1,298	16,130	921	4,920		23,269
Product warranty		3,506	204	2,248		5,958
Income taxes payable		4,778	204	5,711		10,693
Advance payments from customers		3,451	909	1,950		6,310
Intercompany payable	27,744			2,992	(30,736)	
Total current liabilities	29,241	39,246	2,728	26,566	(30,736)	67,045
Deferred income taxes	447	23,578		5,908		29,933
Intercompany notes payable				1,035	(1,035)	
Long-term debt, less current portion	79,281	165,786				245,067
Other long-term liabilities		41				41
Total liabilities	108,969	228,651	2,728	33,509	(31,771)	342,086
Common stock	160					160
Parent investment		120,705	22,228	57,536	(200,469)	
Additional paid-in capital	65,295					65,295
Accumulated other comprehensive income	679	8		(23)	15	679
Retained earnings	34,555	42,988	4,083	12,867	(60,954)	33,539
Net stockholders equity	100,689	163,701	26,311	70,380	(261,408)	99,673
Total liabilities and stockholders equity	$ 209,658	$ 392,352	$ 29,039	$ 103,889	$ (293,179)	$ 441,759

13. Supplemental Guarantors Condensed Consolidating Financial Information (Unaudited)

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13. Supplemental Guarantors Condensed Consolidating Financial Information (Unaudited)

CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

13. Supplemental Guarantors Condensed Consolidating Financial Information (Unaudited)

	Parent (CPI Int l)	Issuer (CPI)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Eliminations	Consolidated Total
Sales	$	$ 56,666	$ 16,351	$ 34,143	$ (18,716)	$ 88,444
Cost of sales		40,211	13,642	26,255	(19,369)	60,739
Gross profit		16,455	2,709	7,888	653	27,705
Operating costs and expenses:						
Research and development		902		1,450		2,352
Selling and marketing		2,015	869	1,915		4,799
General and administrative		4,402	515	929		5,846
Amortization of acquisition-related intangible assets		334	62	150		546
Net loss on disposition of assets		17		23		40
Total operating costs and expenses		7,670	1,446	4,467		13,583
Operating income		8,785	1,263	3,421	653	14,122
Interest expense (income), net	2,072	3,328	(9)	(116)		5,275
(Loss) income before income tax expense and equity in income of subsidiaries	(2,072)	5,457	1,272	3,537	653	8,847
Income tax (benefit) expense	(787)	2,650	356	868		3,087
Equity in income of subsidiaries	7,045	4,238			(11,283)	
Net income	$ 5,760	$ 7,045	$ 916	$ 2,669	$ (10,630)	$ 5,760

CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

13. Supplemental Guarantors Condensed Consolidating Financial Information (Unaudited)

	Parent (CPI Int l)	Issuer (CPI)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Eliminations	Consolidated Total
Sales	$	$ 56,580	$ 16,101	$ 34,148	$ (19,900)	$ 86,929
Cost of sales		42,238	13,241	25,797	(20,091)	61,185
Gross profit		14,342	2,860	8,351	191	25,744
Operating costs and expenses:						
Research and development		842		1,099		1,941
Selling and marketing		1,933	974	1,773		4,680
General and administrative		1,784	435	2,457		4,676
Amortization of acquisition-related intangible assets		334	62	150		546
Net loss on disposition of assets		143				143
Total operating costs and expenses		5,036	1,471	5,479		11,986
Operating income		9,306	1,389	2,872	191	13,758
Interest expense (income), net	2,052	4,339	(4)	13		6,400
(Loss) income before income tax expense and equity in income of subsidiaries	(2,052)	4,967	1,393	2,859	191	7,358
Income tax (benefit) expense	(821)	2,539	390	905		3,013
Equity in income of subsidiaries	5,576	3,148			(8,724)	
Net income	$ 4,345	$ 5,576	$ 1,003	$ 1,954	$ (8,533)	$ 4,345

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13. Supplemental Guarantors Condensed Consolidating Financial Information (Unaudited)

CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

For the Six Months Ended March 30, 2007

	Parent (CPI Int l)	Issuer (CPI)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Eliminations	Consolidated Total
Sales	$	$ 108,031	$ 30,931	$ 68,686	$ (35,481)	$ 172,167
Cost of sales		75,706	25,707	52,681	(36,213)	117,881
Gross profit		32,325	5,224	16,005	732	54,286
Operating costs and expenses:						
Research and development		1,545		2,698		4,243
Selling and marketing		3,984	1,698	3,946		9,628
General and administrative		8,093	722	1,435		10,250
Amortization of acquisition-related intangible assets		668	125	301		1,094
Net loss on disposition of assets		17		41		58
Total operating costs and expenses		14,307	2,545	8,421		25,273
Operating income		18,018	2,679	7,584	732	29,013
Interest expense (income), net	4,120	6,619	(15)	(110)		10,614
(Loss) income before income tax expense and equity in income of subsidiaries	(4,120)	11,399	2,694	7,694	732	18,399
Income tax (benefit) expense	(1,566)	5,221	737	2,412		6,804
Equity in income of subsidiaries	14,149	7,971			(22,120)	
Net income	$ 11,595	$ 14,149	$ 1,957	$ 5,282	$ (21,388)	$ 11,595

CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

For the Six Months Ended March 31, 2006

	Parent (CPI Int l)	Issuer (CPI)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Eliminations	Consolidated Total
Sales	$	$ 108,583	$ 29,042	$ 68,956	$ (37,273)	$ 169,308
Cost of sales		80,526	23,942	51,266	(37,378)	118,356
Gross profit		28,057	5,100	17,690	105	50,952
Operating costs and expenses:						
Research and development		1,686		2,165		3,851
Selling and marketing		4,098	1,843	3,763		9,704
General and administrative		6,570	734	4,674		11,978
Amortization of acquisition-related intangible assets		668	125	301		1,094
Net loss on disposition of assets		172		36		208
Total operating costs and expenses		13,194	2,702	10,939		26,835
Operating income		14,863	2,398	6,751	105	24,117
Interest expense (income), net	4,100	8,346	(9)	27		12,464
(Loss) income before income tax expense and equity in income of subsidiaries	(4,100)	6,517	2,407	6,724	105	11,653
Income tax (benefit) expense	(1,640)	3,779	696	2,258		5,093
Equity in income of subsidiaries	9,020	6,282			(15,302)	
Net income	$ 6,560	$ 9,020	$ 1,711	$ 4,466	$ (15,197)	$ 6,560

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CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

For the Six Months Ended March 30, 2007

	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	$ (563)	$ 2,888	$ 239	$ 3,735	$	$ 6,299
Cash flows from investing activities						
Capital expenditures		(1,634)	(21)	(3,692)		(5,347)
Capitalized expenses relating to potential business acquisition		(119)				(119)
Net cash used in investing activities		(1,753)	(21)	(3,692)		(5,466)
Cash flows from financing activities						
Repayments of debt		(5,000)				(5,000)
Proceeds from issuance of common stock to employees	398					398
Proceeds from exercise of stock options	542					542
Excess tax benefit on stock option exercises		679				679
Net cash provided by (used in) financing activities	940	(4,321)				(3,381)
Net increase (decrease) in cash and cash equivalents	377	(3,186)	218	43		(2,548)
Cash and cash equivalents at beginning of period	139	28,299	290	1,425		30,153
Cash and cash equivalents at end of period	$ 516	$ 25,113	$ 508	$ 1,468	$	$ 27,605

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

For the Six Months Ended March 31, 2006

	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	$ (2,116)	$ (4,158)	$ 22	$ 1,737	$	$ (4,515)
Cash flows from investing activities						
Expenses relating to sale of San Carlos property		(4)				(4)
Capital expenditures		(5,009)	(79)	(729)		(5,817)
Net cash used in investing activities		(5,013)	(79)	(729)		(5,821)
Cash flows from financing activities						
Proceeds from issuance of debt		10,000				10,000
Payment of IPO financiing costs	(1,374)					(1,374)
Stockholder distribution payments	(17,000)					(17,000)
Intercompany dividends	20,459	(20,459)				
Net cash provided by (used in) financing activities	2,085	(10,459)				(8,374)
Net (decrease) increase in cash and cash equivalents	(31)	(19,630)	(57)	1,008		(18,710)
Cash and cash equivalents at beginning of period	33	25,528	323	627		26,511
Cash and cash equivalents at end of period	$ 2	$ 5,898	$ 266	$ 1,635	$	$ 7,801

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

13. Supplemental Guarantors Condensed Consolidating Financial Information (Unaudited)

Our fiscal years are the 52- or 53-week periods that end on the Friday nearest September 30. Fiscal year 2007 comprises the 52-week period ending September 28, 2007 and fiscal year 2006 comprised the 52-week period ended September 29, 2006. The following discussion should be read in conjunction with the accompanying 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, Inc., a leading provider of microwave, radio frequency, power and control solutions for critical defense, communications, medical, scientific and other applications. Communications & Power Industries, Inc. 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 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.

Eimac Relocation

We began the relocation of our Eimac operations (Eimac) from our former San Carlos, California facility to our nearby Palo Alto, California and Mountain View, California facilities during fiscal year 2005. On June 1, 2006, we made organizational changes and consolidated the operating activities of Eimac into our Microwave Power Products division, which also operates in our Palo Alto facility. The integration of Eimac into our Palo Alto operations was completed in January 2007.

As part of this relocation, Eimac experienced planned manufacturing disruptions stemming from the decommissioning of our production equipment in San Carlos and the required reconfiguration, installation and testing of that equipment prior to production readiness in Palo Alto. During fiscal year 2005, in anticipation of these planned disruptions, customers accelerated the placement of orders with Eimac. This order acceleration in fiscal year 2005, and the subsequent acceleration of product shipments, caused a reduction of customers demand requirements from Eimac during the first half of fiscal year 2006, particularly in our medical, communications and industrial markets.

The Eimac relocation negatively impacted Eimac orders and sales for the first six months of fiscal year 2006 as compared to the first six months of fiscal year 2007. During the first six months of fiscal year 2006, we incurred move related expenses and Eimac experienced unfavorable overhead absorption and manufacturing variances due to the reduction in sales volume and relocation disruptions. By the first quarter of fiscal year 2007, orders and sales rates for Eimac had recovered to near their historical levels.

Orders

We sell our products into six end markets: radar, 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.

Our orders by market for the first six months of fiscal years 2007 and 2006 are summarized as follows (dollars in millions):