CPI INTERNATIONAL, INC.
Form 10-Q
August 11, 2010
Table of Contents

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 July 2, 2010

or

.. 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	75-3142681
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

811 Hansen Way, Palo Alto, California 94303
(Address of Principal Executive Offices and Zip Code)
(650) 846-2900
(Registrant’s telephone number, including area code)
Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

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 ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ¨ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ 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: 16,809,805 shares of Common Stock, $0.01 par value, at August 5, 2010.

CPI INTERNATIONAL, INC.
and Subsidiaries

10-Q REPORT
INDEX

Table of Contents

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,” “predict,” “potential” or “continue,” the negative 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, risks associated with our pending merger with a subsidiary of Comtech Telecommunications Corp (including but not limited to the risk that the conditions to the consummation of the merger may not be fulfilled), competition in our end markets; the impact of a general slowdown in the global economy; our significant amount of debt; changes or reductions in the United States defense budget; currency fluctuations; goodwill impairment considerations; customer cancellations of sales contracts; U.S. Government contracts laws and regulations; changes in technology; the impact of unexpected costs; the impact of environmental laws and regulations; and inability to obtain raw materials and components. 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 (including under Part II, Item 1A - Risk Factors) 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.

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

Part I: FINANCIAL INFORMATION

Item 1. Unaudited Condensed Consolidated Financial Statements

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data – unaudited)

	July 2, 2010	October 2, 2009
Assets		
Current Assets:		
Cash and cash equivalents	$ 47,183	$ 26,152
Restricted cash	1,040	1,561
Accounts receivable, net	43,433	45,145
Inventories	78,407	66,996
Deferred tax assets	10,485	8,652
Prepaid and other current assets	4,321	6,700
Total current assets	184,869	155,206
Property, plant, and equipment, net	54,650	57,912
Deferred debt issue costs, net	2,607	3,609
Intangible assets, net	73,218	75,430
Goodwill	162,225	162,225
Other long-term assets	3,786	3,872
Total assets	$ 481,355	$ 458,254
Liabilities and stockholders' equity		
Current Liabilities:		
Accounts payable	$ 21,164	$ 22,665
Accrued expenses	27,955	19,015
Product warranty	4,830	3,845
Income taxes payable	3,608	4,305
Deferred income taxes	328	-
Advance payments from customers	12,899	12,996
Total current liabilities	70,784	62,826
Deferred income taxes, non-current	23,997	24,726
Long-term debt	194,931	194,922
Other long-term liabilities	2,009	2,227
Total liabilities	291,721	284,701
Commitments and contingencies		
Stockholders' equity		
Common stock ($0.01 par value, 90,000 shares authorized; 17,016 and 16,807 shares issued; 16,810 and 16,601 shares outstanding)	170	168

Additional paid-in capital	79,257	75,630
Accumulated other comprehensive income	506	598
Retained earnings	112,501	99,957
Treasury stock, at cost (206 shares)	(2,800)	(2,800)
Total stockholders’ equity	189,634	173,553
Total liabilities and stockholders' equity	$ 481,355	$ 458,254

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

CONDENSED CONSOLIDATED
STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
(In thousands, except per share data – unaudited)

	Three Months Ended		Nine Months Ended	
	July 2, 2010	July 3, 2009	July 2, 2010	July 3, 2009
Sales	$ 93,876	$ 82,520	$ 264,995	$ 241,569
Cost of sales	64,953	58,236	185,910	175,603
Gross profit	28,923	24,284	79,085	65,966
Operating costs and expenses:				
Research and development	3,542	2,731	9,287	8,071
Selling and marketing	5,178	4,762	15,392	14,552
General and administrative	6,373	5,073	18,560	15,537
Amortization of acquisition-related intangible assets	688	691	2,062	2,076
Merger expenses	3,589	-	3,800	-
Total operating costs and expenses	19,370	13,257	49,101	40,236
Operating income	9,553	11,027	29,984	25,730
Interest expense, net	3,780	4,204	11,516	12,965
Gain on debt extinguishment	-	(51)	-	(248)
Income before income taxes	5,773	6,874	18,468	13,013
Income tax expense (benefit)	1,562	3,004	5,924	(2,201)
Net income	$ 4,211	$ 3,870	$ 12,544	$ 15,214
Other comprehensive income, net of tax				
Net unrealized (loss) gain on cash flow hedges and minimum pension liability adjustment	(1,096)	3,346	(92)	84
Comprehensive income	$ 3,115	$ 7,216	$ 12,452	$ 15,298
Earnings per common share - Basic	$ 0.25	$ 0.23	$ 0.75	$ 0.92
Earnings per common share - Diluted	$ 0.23	$ 0.22	$ 0.69	$ 0.86
Shares used to compute earnings per common share - Basic	16,631	16,362	16,534	16,316
Shares used to compute earnings per common share - Diluted	17,961	17,535	17,787	17,402

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands – unaudited)

	Nine Months Ended July 2, 2010	Nine Months Ended July 3, 2009
Cash flows from operating activities		
Net cash provided by operating activities	$ 22,516	$ 20,308
Cash flows from investing activities		
Capital expenditures	(2,824)	(2,349)
Payment of patent application fees	(36)	-
Net cash used in investing activities	(2,860)	(2,349)
Cash flows from financing activities		
Repayments of debt	-	(12,358)
Proceeds from issuance of common stock to employees	579	781
Proceeds from exercise of stock options	214	82
Excess tax benefit on stock option exercises	582	51
Net cash provided by (used in) financing activities	1,375	(11,444)
Net increase in cash and cash equivalents	21,031	6,515
Cash and cash equivalents at beginning of period	26,152	28,670
Cash and cash equivalents at end of period	$ 47,183	$ 35,185
Supplemental cash flow disclosures		
Cash paid for interest	$ 8,008	$ 9,742
Cash paid for income taxes, net of refunds	$ 8,069	$ 2,417

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(All tabular dollar amounts in thousands except share and per share amounts)

1. The Company and a Summary of its Significant Accounting Policies

The Company

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 direct and indirect subsidiaries on a consolidated basis.

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

Basis of Presentation and Consolidation

The Company’s fiscal year is the 52- or 53-week period that ends on the Friday nearest September 30. Fiscal years 2010 and 2009 comprise the 52-week periods ending October 1, 2010 and October 2, 2009, respectively. All period references are to the Company’s fiscal periods unless otherwise indicated.

The accompanying unaudited condensed consolidated financial statements of the Company as of July 2, 2010 and for the three and nine months ended July 2, 2010 are unaudited and reflect all normal recurring adjustments which are, in the opinion of management, necessary for the fair presentation of such financial statements. These unaudited condensed consolidated financial statements should be read in conjunction with the Company’s consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended October 2, 2009. The condensed consolidated balance sheet as of October 2, 2009 has been derived from the audited financial statements at that date. The results of operations and cash flows for the interim period ended July 2, 2010 are not necessarily indicative of results to be expected for the full year.

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances, transactions and stockholdings have been eliminated in consolidation.

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

Use of Estimates and Assumptions

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of sales and costs and expenses during the reporting period. On an ongoing basis, the Company evaluates its estimates, including those related to revenue recognition; inventory valuation; provision for product warranty; business combinations; recoverability and valuation of recorded amounts of long-lived assets and identifiable intangible assets, including goodwill; recognition and measurement of share-based compensation; and recognition and measurement of current and deferred income tax assets and liabilities. The Company bases its estimates on various factors and information, which may include, but are not limited to, history and prior experience, experience of other enterprises in the same industry, new related events, current economic conditions and information from third-party professionals that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

2. Recently Issued Accounting Standards

In the first quarter of fiscal year 2010, the Company adopted provisions of Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 820, “Fair Value Measurements and Disclosures,” that specified the way in which fair value measurements should be made for non-financial assets and non-financial liabilities that are not measured and recorded at fair value on a recurring basis, and specified additional disclosures related to these fair value measurements. The adoption of this new standard did not have an impact on the Company’s consolidated results of operations, financial position or cash flows.

In June 2008, the FASB issued an update to ASC 260, “Earnings Per Share,” which addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share under the two-class method. The update to ASC 260 requires unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) to be treated as participating securities and to be included in the computation of earnings per share pursuant to the two-class method. This guidance under ASC 260 was effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. All prior-period earnings per share data presented shall be adjusted retrospectively. The Company adopted the provisions of this guidance under ASC 260 effective October 3, 2009 and has included the required disclosures in Note 10 to the unaudited condensed consolidated financial statements. The adoption of this guidance did not have a material impact on the Company’s computation of earnings per share.

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

In October 2008, the FASB issued guidance codified under ASC 715, “Compensation—Retirement Benefits,” which requires that an employer disclose the following information about the fair value of plan assets: (1) the level within the fair value hierarchy in which fair value measurements of plan assets fall; (2) information about the inputs and valuation techniques used to measure the fair value of plan assets; and (3) a reconciliation of beginning and ending balances for fair value measurements of plan assets using significant unobservable inputs. At initial adoption, application of this guidance would not be required for earlier periods that are presented for comparative purposes. The Company adopted the provisions of this guidance under ASC 715 effective October 3, 2009. The adoption did not have an impact on the Company’s consolidated results of operations, financial position or cash flows.

In April 2009, the FASB released an amendment to ASC 805, “Business Combinations,” which requires an acquirer to recognize at fair value, at the acquisition date, an asset acquired or a liability assumed that arises from a contingency if the acquisition date fair value of that asset or liability can be determined during the measurement period. If the acquisition date fair value cannot be determined during the measurement period, an asset or liability shall be recognized at the acquisition date if (1) information available before the end of the measurement period indicates that it is probable that an asset existed or that a liability had been incurred at the acquisition date, and (2) the amount of the asset or liability can be reasonably estimated. The Company adopted the provisions of the guidance under ASC 805 and its amendment effective October 3, 2009. The impact of the adoption will depend on the nature of acquisitions completed in the future.

In August 2009, the FASB issued ASU 2009-05, “Measuring Liabilities at Fair Value,” an update to ASC 820. This update provides amendments to reduce potential ambiguity in financial reporting when measuring the fair value of liabilities. Among other provisions, this update provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more of the valuation techniques described in ASU 2009-05. The Company adopted the provisions of this guidance under ASU 2009-05 effective October 3, 2009. The adoption did not have an impact on the Company’s consolidated results of operations, financial position or cash flows.

In October 2009, the FASB issued ASU 2009-13, “Revenue Recognition (Topic 605): Multiple Deliverable Revenue Arrangements – A Consensus of the FASB Emerging Issues Task Force.” This update provides application guidance on whether multiple deliverables exist, how the deliverables should be separated and how the consideration should be allocated to one or more units of accounting. This update eliminates the residual method of allocation for multiple-deliverable revenue arrangements, and requires that arrangement consideration be allocated at the inception of an arrangement to all deliverables using the relative selling price method. The selling price used for each deliverable will be based on vendor-specific objective evidence, if available, third-party evidence if vendor-specific objective evidence is not available, or estimated selling price if neither vendor-specific or third-party evidence is available. Additionally, ASU 2009-13 expands the disclosure requirements related to a vendor’s multiple-deliverable revenue arrangements. ASU 2009-13 is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010 and early adoption is permitted. The Company is currently evaluating the potential impact that this update may have on its consolidated results of operations, financial position or cash flows but does not expect it will have a material effect.

- 9 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

In September 2009, the FASB issued ASU 2009-14, “Certain Revenue Arrangements That Include Software Elements,” which is included in the ASC 985, “Software.” ASU 2009-14 amends previous software revenue recognition to exclude (a) non-software components of tangible products and (b) software components of tangible products that are sold, licensed, or leased with tangible products when the software components and non-software components of the tangible product function together to deliver the tangible product’s essential functionality. ASU 2009-14 is effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010 and shall be applied on a prospective basis. Earlier application is permitted as of the beginning of an entity’s fiscal year. The Company is currently evaluating the potential impact that this update may have on its consolidated results of operations, financial position or cash flows but does not expect it will have a material effect.

In December 2009, the FASB issued ASU 2009-17, “Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities,” as a further clarification ASC 810-10, “Consolidation of Variable Interest Entities.” ASU 2009-17, upon adoption, requires the use of a qualitative analysis to determine the primary beneficiary of a variable interest entity (“VIE”), amends the guidance for determining if an entity is a VIE and enhances the disclosure requirements regarding an enterprise’s involvement with a VIE. ASU 2009-17 is effective as of the beginning of a company’s first fiscal year beginning after November 15, 2009. Since the Company does not currently have variable interest entities, this update is expected to have no impact on its consolidated results of operations, financial position or cash flows.

In January 2010, the FASB issued ASU 2010-06, “Fair Value Measurements and Disclosures: Improving Disclosures About Fair Value Measurements.” This update requires reporting entities to make new disclosures about recurring or nonrecurring fair-value measurements including significant transfers into and out of Level 1 and Level 2 fair-value measurements and information on purchases, sales, issuances, and settlements on a gross basis in the reconciliation of Level 3 fair-value measurements. ASU 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009, except for Level 3 reconciliation disclosures which are effective for annual periods beginning after December 15, 2010. The Company adopted the provisions of this guidance under ASU 2009-06, except for Level 3 reconciliation disclosures, effective January 2, 2010. As this guidance is disclosure-related, it did not have an impact on the Company’s consolidated results of operations, financial position or cash flows.

In February 2010, the FASB issued ASU 2010-08, "Technical Corrections to Various Topics." This update eliminates inconsistencies and outdated provisions in U.S. generally accepted accounting principles (“GAAP”) and provides needed clarification on others. Amendments within ASU 2010-08 that may be applicable to the Company are effective as of the first reporting period beginning after February 2, 2010, the date this ASU was issued. The Company adopted the provisions of this guidance under ASU 2010-08 effective April 3, 2010 with no material impact on its consolidated results of operations, financial position or cash flows.

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

In February 2010, the FASB issued ASU 2010-09, "Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements." This update retracts the requirement to disclose the date through which subsequent events have been evaluated and whether that date is the date the financial statements were issued or were available to be issued. ASU 2010-09 was effective immediately after its issuance and has been adopted by the Company with no material impact on its consolidated results of operations, financial position or cash flows.

In April 2010, the FASB issued ASU 2010-17, "Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition." ASU 2010-17 provides guidance on applying the milestone method to milestone payments for achieving specified performance measures when those payments are related to uncertain future events. The scope of ASU 2010-17 is limited to transactions involving research or development. This update further states that the milestone method is not the only acceptable method of revenue recognition for milestone payments. Accordingly, entities can make an accounting policy election to recognize arrangement consideration received for achieving specified performance measures during the period in which the milestones are achieved, provided certain criteria are met. An entity's policy for recognizing deliverable consideration or unit of accounting consideration contingent upon achievement of a milestone shall be applied consistently to similar deliverables or units of accounting. ASU 2010-17 is effective on a prospective basis for milestones achieved in interim and fiscal years beginning after June 15, 2010. Early adoption is permitted. The Company is currently evaluating the potential impact that this update may have on its consolidated results of operations, financial position or cash flows but does not expect it will have a material effect.

3. Supplemental Balance Sheet Information

Accounts Receivable: Accounts receivable are stated net of allowance for doubtful accounts as follows:

	July 2, 2010	October 2, 2009
Accounts receivable	$ 43,522	$ 45,240
Less: Allowance for doubtful accounts	(89)	(95)
Accounts receivable, net	$ 43,433	$ 45,145

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

Inventories: The following table provides details of inventories:

	July 2, 2010	October 2, 2009
Raw material and parts	$ 43,933	$ 38,205
Work in process	24,855	20,542
Finished goods	9,619	8,249
	$ 78,407	$ 66,996

Reserve for loss contracts: The following table summarizes the activity related to reserves for loss contracts:

	Nine Months Ended	
	July 2, 2010	July 3, 2009
Balance at beginning of period	$ 4,068	$ 1,928
Provision for loss contracts, charged to cost of sales	2,886	2,696
Credit to cost of sales upon revenue recognition	(3,347)	(1,522)
Balance at end of period	$ 3,607	$ 3,102

Reserve for loss contracts are reported in the condensed consolidated balance sheet in the following accounts:

	July 2, 2010	July 3, 2009
Inventories	$ 3,468	$ 3,092
Accrued expenses	139	10
	$ 3,607	$ 3,102

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

	Nine Months Ended	
	July 2, 2010	July 3, 2009
Beginning accrued warranty	$ 3,845	$ 4,159
Actual costs of warranty claims	(4,087)	(3,347)

Estimates for product warranty, charged to cost of sales		5,072		2,990
Ending accrued warranty	$	4,830	$	3,802

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

Accumulated Other Comprehensive Income: The following table provides the components of accumulated other comprehensive income in the condensed consolidated balance sheets:

	July 2, 2010	October 2, 2009
Unrealized gain on cash flow hedges, net of tax	$ 742	$ 828
Unrealized actuarial loss and prior service credit for pension liability, net of tax	(236)	(230)
	$ 506	$ 598

4. Definitive Merger Agreement with Comtech

On May 10, 2010, the Company announced the signing of a definitive merger agreement with Comtech Telecommunications Corporation (“Comtech”) under which Comtech agreed to acquire the Company in a merger in which Company stockholders would receive a combination of cash and stock in exchange for their Company shares. The ultimate amount of consideration that a Company stockholder will receive for each Company share will be equal to a combination of $9.00 in cash plus a fraction of a share of Comtech common stock equal to $8.10 divided by the average closing price of Comtech common stock over a specified period of time prior to closing, provided that the fraction shall not be greater than 0.2382 nor less than 0.2132. Based on the August 2, 2010 market closing price of Comtech stock of $21.79, the fraction was equal to 0.2382 and was currently valued at $5.19 per share of Company stock.

The transaction is subject to customary closing conditions, including, among others, adoption of the merger agreement by the Company’s stockholders, regulatory approvals, absence of any law or order prohibiting the transaction, effectiveness of the registration statement for the shares of Comtech common stock to be issued in the merger and the listing of such shares on Nasdaq, accuracy of certain representations and warranties and material compliance with covenants, and the absence of any material adverse effect (as defined) with respect to the Company or Comtech. On August 2, 2010, the Company and Comtech received a request for additional information and documents—often referred to as a second request—from the Department of Justice in connection with the proposed merger. The Company and Comtech are working to respond to the second request.

The merger agreement contains certain termination rights for both the Company and Comtech and further provides that, upon termination of the merger agreement, under specified circumstances, the Company will be required to pay Comtech a termination fee of up to $15 million.

For the three and nine months ended July 2, 2010, the Company has incurred transaction costs relating to the proposed merger in the amount of $3.6 million and $3.8 million, respectively. Such non-recurring transaction costs were comprised of fees for investment bankers, attorneys and other professional services rendered in connection with the proposed merger.

- 13 -

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

5. Fair Value Measurements

FASB ASC 825 establishes a framework for measuring fair value and expands disclosures about fair value measurements by establishing a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The three levels of the fair value hierarchy under ASC 825 are described as follows:

Level 1	Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.
Level 2	Inputs reflect quoted prices for identical assets or liabilities in markets that are not active; quoted prices for similar assets or liabilities in active markets; inputs other than quoted prices that are observable for the asset or the liability; or inputs that are derived principally from or corroborated by observable market data by correlation or other means.
Level 3	Unobservable inputs reflecting the Company’s own assumptions incorporated in valuation techniques used to determine fair value. These assumptions are required to be consistent with market participant assumptions that are reasonably available.

Fair value is the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date and in the principal or most advantageous market for that asset or liability. The fair value should be calculated based on assumptions that market participants would use in pricing the asset or liability, not on assumptions specific to the entity. In addition, the fair value of liabilities should include consideration of non-performance risk, including the Company’s own credit risk.

The Company’s non-financial assets (including goodwill, intangible assets and long-lived assets) and liabilities are measured at fair value on a non-recurring basis; that is, the assets and liabilities are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances such as when they are deemed to be other-than-temporarily impaired. The fair values of these non-financial assets and liabilities are determined based on valuation techniques using the best information available, and may include quoted market prices, market comparables, and discounted cash flow projections. During the three and nine months ended July 2, 2010, no fair value adjustments or material fair value measurements were required for the Company’s non-financial assets or liabilities.

The Company measures certain financial assets and liabilities at fair value on a recurring basis, including cash equivalents, restricted cash, available-for-sale securities and derivative instruments. As of July 2, 2010, financial assets utilizing Level 1 inputs included cash equivalents, such as money market and overnight U.S. Government securities and available-for-sale securities, such as mutual funds. Financial assets and liabilities utilizing Level 2 inputs included foreign currency derivatives and interest rate swap derivatives. The Company does not have any financial assets or liabilities requiring the use of Level 3 inputs.

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

The following tables set forth financial instruments carried at fair value within the ASC 825 hierarchy:

		Fair Value Measurements at July 2, 2010 Using		
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Money market and overnight U.S. Government securities1	$ 41,650	$ 41,650	$ -	$ -
Mutual funds2	153	153	-	-
Foreign exchange forward derivatives3	659	-	659	-
Total assets at fair value	$ 42,462	$ 41,803	$ 659	-
Liabilities:				
Foreign exchange forward derivatives4	20		20	
Interest rate swap derivative4	$ 1,109	$ -	$ 1,109	$ -
Total liabilities at fair value	$ 1,129	$ -	$ 1,129	$ -

1 The money market and overnight U.S. Government securities are classified as part of cash and cash equivalents and restricted cash in the condensed consolidated balance sheet.
2 The mutual funds are classified as part of other long-term assets in the condensed consolidated balance sheet.
3 The foreign currency derivatives are classified as part of prepaid and other current assets in the condensed consolidated balance sheet.
4 The foreign currency and interest rate swap derivatives are classified as part of accrued expenses in the condensed consolidated balance sheet.

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

		Fair Value Measurements at October 2, 2009 Using		
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Money market and overnight U.S. Government securities1	$ 22,464	$ 22,464	$ -	$ -
Mutual funds2	152	152	-	-
Foreign exchange forward derivatives3	3,467	-	3,467	-
Total assets at fair value	$ 26,083	$ 22,616	$ 3,467	-
Liabilities:				
Interest rate swap derivative4	$ 2,323	$ -	$ 2,323	$ -
Total liabilities at fair value	$ 2,323	$ -	$ 2,323	$ -

1 The money market and overnight U.S. Government securities are classified as part of cash and cash equivalents and restricted cash in the condensed consolidated balance sheet.
2 The mutual funds are classified as part of other long-term assets in the condensed consolidated balance sheet.
3 The foreign currency derivatives are classified as part of prepaid and other current assets in the condensed consolidated balance sheet.
4 The interest rate swap derivatives are classified as part of accrued expenses and other long-term liabilities in the condensed consolidated balance sheet.

Investments Other Than Derivatives

In general and where applicable, the Company uses quoted prices in active markets for identical assets or liabilities to determine fair value. This pricing methodology applies to the Company’s Level 1 investments, such as money market securities, U.S. Government securities and mutual funds.

If quoted prices in active markets for identical assets or liabilities are not available to determine fair value, then the Company would use quoted prices for similar assets and liabilities or inputs other than the quoted prices that are observable either directly or indirectly. These investments would be included in Level 2.

Derivatives

The Company executes foreign exchange forward contracts to purchase Canadian dollars and holds a pay-fixed receive-variable interest rate swap contract, all executed in the retail market with its relationship banks. To determine the most appropriate value, the Company uses an in-exchange valuation premise which considers the assumptions that market participants would use in pricing the derivatives. The Company has elected to use the income approach and uses observable (Level 2) market expectations at the measurement date and standard valuation techniques to convert future amounts to a single present amount. Level 2 inputs for derivative valuations are midmarket quoted prices for similar assets or liabilities in active markets and inputs other than quoted prices that are observable for the asset or liability.

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

Key inputs for currency derivatives are spot rates, forward rates, interest rates and credit derivative rates. The spot rate for the Canadian dollar is the same spot rate used for all balance sheet translations at the measurement date. Forward premiums/discounts and interest rates are interpolated from commonly quoted intervals. Once valued, each forward is identified as either an asset or liability. Assets are further discounted using counterparty annual credit default rates, and liabilities are valued using the Company's credit as reflected in the spread paid over LIBOR on the term loan under the Company's senior credit facilities.

Key inputs for valuing the interest rate swap are the cash rates used for the short term (under 3 months), futures rates for up to three years and LIBOR swap rates for periods beyond. These inputs are used to derive variable resets for the swap as well as to discount future fixed and variable cash flows to present value at the measurement date. A credit spread is used to further discount each net cash flow using, for assets, counterparty credit default rates and, for liabilities, the Company's credit spread over LIBOR on the term loan under the Company's senior credit facilities.

See Note 6 for further information regarding the Company's derivative instruments.

Other Financial Instruments

The Company's other financial instruments include cash, restricted cash, accounts receivable, accounts payable and long-term debt. Except for long-term debt, the carrying value of these financial instruments approximates fair values because of their relatively short maturity.

The fair values of the Company's long-term debt were estimated using quoted market prices where available. For long-term debt not actively traded, fair values were estimated using discounted cash flow analyses, based on the Company's current estimated incremental borrowing rates for similar types of borrowing arrangements. The estimated fair value of the Company's long-term debt as of July 2, 2010 and October 2, 2009 was $192.2 million and $188.5 million, respectively, compared to the carrying value of $194.9 million.

6. Derivative Instruments and Hedging Activities

Foreign Exchange Forward Contracts: Although the majority of the Company's revenue and expense activities are transacted in U.S. dollars, the Company does transact business in foreign countries. The Company's primary foreign currency cash flows are in Canada and several European countries. In an effort to reduce its foreign currency exposure to Canadian dollar denominated expenses, the Company enters into Canadian dollar forward contracts to hedge the Canadian dollar denominated costs for its manufacturing operation in Canada. The Company does not engage in currency speculation.

Table of Contents

The Company's Canadian dollar forward contracts in effect as of July 2, 2010 have durations of 8 to 15 months. These contracts are designated as cash flow hedges and are considered highly effective, as defined by FASB ASC 815. Unrealized gains and losses from foreign exchange forward contracts are included in accumulated other comprehensive income in the condensed consolidated balance sheets. At July 2, 2010, the unrealized gain, net of tax of $0.7 million, was $1.4 million. The Company anticipates recognizing the entire unrealized gain or loss in operating earnings within the next four fiscal quarters. 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 expenses in the condensed consolidated statements of income. The time value was not material for the three and nine months ended July 2, 2010 and July 3, 2009. If the transaction being hedged fails to occur, or if a portion of any derivative is ineffective, then the Company immediately recognizes the gain or loss on the associated financial instrument in general and administrative expenses in the condensed consolidated statements of income. The gain recognized in general and administrative expenses due to hedge ineffectiveness for the three and nine months ended July 2, 2010 was zero and $0.1 million, respectively. No ineffective amounts were recognized due to hedge ineffectiveness for the three and nine months ended July 3, 2009.

As of July 2, 2010, the Company had entered into Canadian dollar forward contracts for approximately $19.2 million (Canadian dollars), or approximately 58% of estimated Canadian dollar denominated expenses for July 2010 through March 2011, at an average rate of approximately 0.92 U.S. dollars to Canadian dollars.

Interest Rate Contracts: The Company also uses derivative instruments in order to manage interest costs and risk associated with its long-term debt. During fiscal year 2007, the Company entered into an interest rate swap contract (the "2007 Swap") to receive three-month USD-LIBOR-BBA (British Bankers' Association) interest and pay 4.77% fixed rate interest. Net interest positions are settled quarterly. The Company has structured the 2007 Swap with decreasing notional amounts such that it is less than the balance of its term loan under its senior credit facilities. The notional value of the 2007 Swap was $35.0 million at July 2, 2010 and represented approximately 53% of the aggregate term loan balance. The Swap agreement is effective through June 30, 2011. Under the provisions of ASC 815, this arrangement was initially designated and qualified as an effective cash flow hedge of interest rate risk related to the term loan, which permitted recording the fair value of the 2007 Swap and corresponding unrealized gain or loss to accumulated other comprehensive income in the condensed consolidated balance sheets. At July 2, 2010, the unrealized loss, net of tax of $0.4 million, was $0.7 million. The interest rate swap gain or loss is included in the assessment of hedge effectiveness. Gains and losses representing hedge ineffectiveness are immediately recognized in interest expense, net, in the condensed consolidated statements of income.

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

The following table summarizes the fair value of derivative instruments designated as cash flow hedges at July 2, 2010 and October 2, 2009:

	Asset Derivatives			Liability Derivatives		
		Fair Value			Fair Value	
	Balance Sheet Location	July 2, 2010	October 2, 2009	Balance Sheet Location	July2, 2010	October 2, 2009
Derivatives designated as hedging instruments						
Interest rate contracts				Accrued expenses	$ (1,109)	$ (1,766)
Interest rate contracts				Other long-term liabilities	-	(557)
Forward contracts	Prepaid and other current assets	$ 659	$ 3,467	Accrued expenses	(20)	
Total derivatives designated as hedging instruments		$ 659	$ 3,467		$ (1,129)	$ (2,323)

As of July 2, 2010 and October 2, 2009, all of the Company’s derivative instruments were classified as hedging instruments in accordance with ASC 815.

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

The following table summarizes the effect of derivative instruments on the condensed consolidated statements of income and comprehensive income for the three and nine months ended July 2, 2010 and July 3, 2009:

Derivatives in Cash Flow Hedging Relationships	Amount of (Loss) Gain Recognized in OCI on Derivative (Effective Portion)		Location of (Loss) Gain Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of (Loss) Gain Reclassified from Accumulated OCI into Income (Effective Portion)		Location of (Loss) Gain Recognized in Income on Derivative (Ineffective and Excluded Portion)	Amount of (Loss) Gain Recognized in Income on Derivative (Ineffective and Excluded Portion)	
	Three Months Ended			Three Months Ended			Three Months Ended	
	July 2, 2010	July 3, 2009		July 2, 2010	July 3, 2009		July 2, 2010	July 3, 2009
Interest rate contracts	$ (33)	$ (302)	Interest expense, net	$ (443)	$ (528)	Interest expense, net	$ (9)	$ (12)
Forward contracts	(667)	3,591	Cost of sales	149	(62)	General and administrative(a)	3	(60)
			Research and development	65	(33)			
			Selling and marketing	94	(101)			
			General and administrative	69	(121)			
Total	$ (700)	$ 3,289		$ 1,064	$ (2,045)		$ (6)	$ (72)

(a) The amount of gain recognized in income during the three months ended July 2, 2010 represents a $3 loss related to the amount excluded from the assessment of hedge effectiveness. The amount of loss recognized in income during the three months ended July 3, 2009 represents a $64 loss related to the amount excluded from the assessment of hedge effectiveness, net of $4 gain related to the ineffective portion of the hedging relationships.

	Nine Months Ended			Nine Months Ended			Nine Months Ended	
	July 2, 2010	July 3, 2009		July 2, 2010	July 3, 2009		July 2, 2010	July 3, 2009
Interest rate contracts	$ (281)	$ (1,889)	Interest expense, net	$ (1,495)	$ (1,228)	Interest expense, net	$ (28)	$ (40)

Forward contracts	888	(2,791)	Cost of sales	1805	(3,167)	General and administrative(b)	51	(285)
			Research and development	307	(176)			
			Selling and marketing	134	(96)			
			General and administrative	185	(289)			
Total	$ 607	$ (4,680)		$ 936	$ (4,956)		$ 23	$ (325)

(b) The amount of gain recognized in income during the nine months ended July 2, 2010 represents a $62 gain related to the ineffective portion of the hedging relationships, net of a $11 loss related to the amount excluded from the assessment of hedge effectiveness. The amount of loss recognized in income during the nine months ended July 3, 2009 represents a $286 loss related to the amount excluded from the assessment of hedge effectiveness, net of a $1 gain related to the ineffective portion of the hedging relationships.

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

As a result of the use of derivative instruments, the Company is exposed to the risk that counterparties to derivative contracts will fail to meet their contractual obligations. The Company does not hold collateral or other security from its counterparties supporting its derivative instruments. To mitigate the counterparty credit risk, the Company has a policy of only entering into contracts with carefully selected major financial institutions based upon their credit ratings and other factors. The Company regularly reviews its credit exposure balances as well as the creditworthiness of its counterparties.

When the Company's derivatives are in a net asset position, such as the case with the majority of the Company's forward foreign exchange contract derivatives at July 2, 2010, the Company is exposed to credit loss from nonperformance by the counterparty. If the counterparty fails to perform, credit risk with such counterparty is equal to the extent of the fair value gain in the derivative. At July 2, 2010, the Company's interest rate contract derivative was in a liability position, and the Company, therefore, was not exposed to the interest rate contract counterparty credit risk.

7. Commitments and Contingencies

Leases: The Company is committed to minimum rentals under non-cancelable operating lease agreements, primarily for land and facility space, that expire on various dates through 2050. Certain of the leases provide for escalating lease payments. Future minimum lease payments for all non-cancelable operating lease agreements at July 2, 2010 were as follows:

Fiscal Year	Operating Leases
2010 (remaining three months)	$ 482
2011	1,324
2012	1,125
2013	633
2014	420
Thereafter	2,634
	$ 6,618

Real estate taxes, insurance, and maintenance are also obligations of the Company. Rental expense under non-cancelable operating leases amounted to $0.6 million and $1.8 million for the three and nine months ended July 2, 2010, respectively, and $0.6 million and $2.0 million for the corresponding periods of fiscal year 2009. Assets subject to capital leases at July 2, 2010 and October 2, 2009 were not material.

Guarantees: The Company has restricted cash of $1.0 million and $1.6 million as of July 2, 2010 and October 2, 2009, respectively, consisting primarily of bank guarantees from customer advance payments to the Company's international subsidiaries. The bank guarantees become unrestricted cash when performance under the sales or supply contract is complete.

Table of Contents

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

Purchase commitments: As of July 2, 2010, the Company had the following known purchase commitments, which include primarily future purchases for inventory-related items under various purchase arrangements as well as other obligations in the ordinary course of business that the Company cannot cancel or where it would be required to pay a termination fee in the event of cancellation:

Fiscal Year	Purchase Contracts
2010 (remaining nine months)	$ 20,253
2011	9,710
2012	166
2013	37
2014	25
	$ 30,191

Contingent Earnout Consideration: Under the terms of the purchase agreement for the acquisition of Malibu Research, Inc. (“Malibu”) in August 2007, in addition to the $20.5 million of net cash consideration paid for the acquisition, the Company could have also been required to pay a potential earnout to the former stockholders of Malibu of up to $14.0 million based on the achievement of certain financial objectives over the three years following the acquisition, ending July 2, 2010 (“Financial Earnout”). Based on financial performance through July 2, 2010, no Financial Earnout was earned for any of the three earnout periods.

In addition, the Company could have also been required to pay a discretionary earnout of up to $1.0 million to the former stockholders of Malibu contingent upon achievement of certain succession planning goals by June 30, 2010. However, the Company has determined that such goals were not attained and, as a result, no discretionary earnout was ultimately paid.

Merger Expense Commitment: For services rendered in connection with the merger agreement with Comtech, the Company has agreed to pay J.P. Morgan Securities, Inc. (“J.P. Morgan”) a fee estimated to be approximately $5.0 million, of which $1.4 million has been accrued (accrued expenses) and $3.6 million will become payable only if the proposed merger is consummated. The Company has also agreed to reimburse J.P. Morgan for certain expenses incurred in connection with its services, including the fees and disbursements of counsel, and will indemnify J.P. Morgan against certain liabilities, including liabilities arising under the federal securities laws.

Contingencies: From time to time, the Company may be subject to claims that arise in the ordinary course of business. Except as noted below, in the opinion of management, all such matters involve amounts that would not have a material adverse effect on the Company's consolidated financial position if unfavorably resolved.

On July 1, 2010, a putative stockholder class action complaint was filed against the Company, the members of the Company’s board of directors, and Comtech. The lawsuit concerns the proposed merger between the Company and Comtech, and generally asserts claims alleging, among other things, that each member of the Company’s board of directors breached his fiduciary duties by agreeing to the terms of the proposed merger and by failing to provide stockholders with allegedly material information related to the proposed merger, and that Comtech aided and abetted the breaches of fiduciary duty allegedly committed by the members of the Company’s board of directors. The lawsuit seeks, among other things, class action certification and monetary relief. On July 28, 2010, the plaintiff filed an amended complaint, making

CPI INTERNATIONAL, INC.
and Subsidiaries

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

generally the same claims against the same defendants, and seeking the same relief. In addition, the amended complaint generally alleges that the consideration to be paid to the Company's stockholders under the terms of the proposed merger is inadequate. The Company believes all claims asserted in the lawsuit to be without merit.

During fiscal year 2009, the Company received a notice from a customer purporting to terminate a sales contract due to alleged nonperformance. In April 2010, the Company received another notice from the customer claiming additional cost incurred due to the alleged nonperformance. The Company plans to contest this matter vigorously. The Company recorded certain costs in fiscal year 2008 as a result of the termination; however, at this time, the Company cannot estimate the range of any further possible loss or gain with respect to this matter or whether an unfavorable resolution of this matter would have a material adverse effect on the Company's consolidated results of operations and cash flows.

8. Stock-based Compensation Plans

Stock Options: The following table summarizes the status of the Company's stock option awards as of July 2, 2010 and October 2, 2009 and changes during the nine months ended July 2, 2010 under the Company's stock option plans:

	Oustanding Options				Exercisable Options			
	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Balance at October 2, 2009	3,382,763	$ 6.38	4.95	$ 20,362	2,845,996	$ 4.73	4.43	$ 20,227
Granted	108,000	9.66						
Exercised	(122,795)	1.75						
Forfeited or cancelled	(17,125)	16.42						