CPI HOLDCO INC
Form 10-Q
August 12, 2005

UNITED STATES
SECURITIES AND EXCHANGE
COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended July 1, 2005

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: 333-11386-04

CPI HOLDCO, 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 each 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 ý No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes o No ý

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: 4,275,566 shares of Common Stock, $.01 par value, at August 10, 2005.

CPI Holdco, 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 the future financial performance of CPI Holdco, Inc. (collectively, with its subsidiaries, the Company). 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 of such ter comparable terminology. These statements are only predictions. Actual events or results may differ materially.

Although the Company believes that the expectations reflected in the forward-looking statements are reasonable, the Company cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither the Company nor any other person assumes responsibility for the accuracy and completeness of the forward-looking statements. All written and oral forward-looking statements made in connection with this report that are attributable to the Company or persons acting on the Company s behalf are expressly qualified in their entirety by the risk factors, and other cautionary statements included herein and in the other filings with the Securities and Exchange Commission (SEC) made by the Company and its predecessor, Communications & Power Industries Holding Corporation. The Company is 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 the Company s expectations.

The information in this report is not a complete description of the Company s business or the risks and uncertainties associated with an investment in the Company s securities. You should carefully consider the various risks and uncertainties that impact the Company s business and the other information in this report and the Company s other filings with the SEC before you decide to invest in the Company or to maintain or increase your investment. Such risks and uncertainties include, but are not limited to, the following:

the Company s indebtedness is substantial;

the agreements and instruments governing the Company s debt have restrictions that could limit its flexibility in operating its business;

the Company s ability to generate the significant amount of cash needed to service its debt and to fund capital expenditures or other liquidity needs depends on many factors beyond its control;

the Company has had historical losses;

the Company may be unable to retain and/or recruit key management and other personnel;

the markets in which the Company sells its products are competitive;

the end markets in which the Company operates are subject to technological change;

a significant portion of the Company s sales is, and is expected to continue to be, from contracts with the U.S. Government;

the Company generates sales from contracts with foreign governments;

the Company s international operations subject it to social, political and economic risks of doing business in foreign countries;

the Company may not be successful in obtaining the necessary export licenses and technical assistance agreements to conduct operations abroad and the U.S. Congress may prevent proposed sales to foreign customers;

the Company s results of operations and financial condition may be adversely affected by increased or unexpected costs incurred by it on its contracts and sales orders;

environmental regulation and legislation, liabilities relating to contamination and changes in the Company s ability to recover under Varian Medical Systems Inc. s indemnity obligations could adversely affect its business;

the Company has only a limited ability to protect its intellectual property rights;

the Company s inability to obtain certain necessary raw materials and key components could disrupt the manufacture of its products and cause its financial condition and results of operations to suffer;

the relocation of the Company s San Carlos, California operating division to Palo Alto, California could result in disruption to the Company s operations;

the Company may not be able to timely comply with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002; and

the Company is controlled by affiliates of The Cypress Group L.L.C.

Any of the foregoing factors could cause the Company s business, results of operations, or financial condition to suffer, and actual results could differ materially from those expected.

CPI Holdco, Inc.

and Subsidiaries

INDEX

PART I: FINANCIAL INFORMATION

ITEM 1: UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

CPI Holdco, Inc.

and Subsidiaries

CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands-unaudited)

	July 1, 2005		October 1, 2004	
Assets				
Cash and cash equivalents	$	17,108	$	40,476
Restricted cash		2,019		2,279
Accounts receivable, net		48,391		35,914
Inventories		47,156		38,074
Deferred tax assets		12,535		12,285
Prepaids and other current assets		4,575		3,796
Total current assets		131,784		132,824
Property, plant and equipment, net		77,312		70,127
Debt issue costs, net		11,416		8,910
Intangible assets, net		78,554		78,481
Goodwill		145,462		139,614
Other long-term assets		1,853		1,251
Total assets	$	446,381	$	431,207
Liabilities and stockholders equity				
Current portion of long-term debt	$		$	3,944
Accounts payable		17,902		15,790
Accrued expenses		27,400		20,939
Product warranty		6,031		6,074
Income taxes payable		5,851		1,661
Advance payments from customers		8,007		12,031
Total current liabilities		65,191		60,439
Deferred income taxes		34,989		39,118
Advance payments from sale of San Carlos property		13,450		13,450
Long-term debt		284,218		210,606
Other long-term liabilities		84		
Total liabilities		397,932		323,613
Common stock		43		43
Additional paid-in capital		28,601		103,534
Accumulated other comprehensive income		1,041		1,369
Retained earnings		18,764		2,648
Net stockholders equity		48,449		107,594
Total liabilities and stockholders equity	$	446,381	$	431,207

See accompanying notes to the condensed consolidated financial statements.

CPI Holdco, Inc.

and Subsidiaries

CONDENSED CONSOLIDATED
STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
(in thousands - unaudited)

	13-Week Period Ended July 1, 2005	13-Week Period Ended July 2, 2004
Sales	$ 87,639	$ 72,345
Cost of sales	57,848	49,112
Amortization of acquisition-related inventory write-up		1,280
Gross profit	29,791	21,953
Operating costs and expenses:		
Research and development	1,899	1,869
Selling and marketing	4,744	3,856
General and administrative	5,789	5,011
Amortization of acquisition-related intangible assets	548	4,682
Acquired in-process research and development		(9,000)
Total operating costs and expenses	12,980	6,418
Operating income	16,811	15,535
Interest expense, net	5,697	3,822
Income before income taxes	11,114	11,713
Income tax expense	4,416	242
Net income	$ 6,698	$ 11,471
Other comprehensive income/(loss), net of tax:		
Net unrealized loss on cash flow hedges	(711)	(352)
Net Change	(711)	(352)
Comprehensive income	$ 5,987	$ 11,119

See accompanying notes to the condensed consolidated financial statements.

CPI Holdco, Inc.

and Subsidiaries

CONDENSED CONSOLIDATED
STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
(in thousands - unaudited)

	2005	Fiscal Year 2004	
	39-Week Period Ended July 1, 2005 (Successor)	January 23, 2004 to July 2, 2004 (Successor)	October 4, 2003 to January 22, 2004 (Predecessor)
Sales	$ 245,835	$ 137,986	$ 79,919
Cost of sales	162,912	90,919	56,189
Amortization of acquisition-related inventory write-up	351	5,500	
Gross profit	82,572	41,567	23,730
Operating costs and expenses:			
Research and development	5,205	3,333	2,200
Selling and marketing	13,397	6,994	4,352
General and administrative	15,664	8,523	6,033
Merger expenses			6,374
Amortization of acquisition-related intangible assets	6,940	8,078	
Acquired in-process research and development		2,500	
Total operating costs and expenses	41,206	29,428	18,959
Operating income	41,366	12,139	4,771
Interest expense, net	14,509	6,772	8,902
Income (loss) before income taxes	26,857	5,367	(4,131)
Income tax expense	10,741	729	439
Net income (loss)	16,116	4,638	(4,570)
Preferred dividends:			
Senior redeemable preferred stock			3,861
Junior preferred stock			2,382
Net income (loss) attributable to common stock	$ 16,116	$ 4,638	$ (10,813)
Other comprehensive income/(loss), net of tax:			
Net unrealized (loss)/gain on cash flow hedges	(328)	13	
Net change	(328)	13	
Comprehensive income (loss)	$ 15,788	$ 4,651	$ (10,813)

See accompanying notes to the condensed consolidated financial statements.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (in thousands) 25

CPI Holdco, Inc.

and Subsidiaries

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (in thousands - unaudited)

	2005 39-Week period ended July 1, 2005 (Successor)	Fiscal Year 2004 January 23, 2004 to July 2, 2004 (Successor)	Fiscal Year 2004 October 4, 2003 to January 22, 2004 (Predecessor)
OPERATING ACTIVITIES			
Net cash provided by operating activities	$ 15,283	$ 11,464	$ 8,213
INVESTING ACTIVITIES			
Expenses relating to sale of San Carlos property	(216)		
Purchase of Predecessor s net assets, net of cash acquired		(113,760)	
Purchase of Econco s net assets, net of cash acquired	(18,325)		
Purchases of property, plant and equipment	(8,867)	(1,222)	(459)
Other investing activities	(16)		
Net cash used in investing activities	(27,424)	(114,982)	(459)
FINANCING ACTIVITIES			
Retirement of debt and preferred stock:			
Senior subordinated notes		(74,000)	(26,000)
Senior redeemable preferred stock		(29,735)	
Junior preferred stock		(32,336)	
Dividends on senior preferred stock		(19,310)	
Mortgage financing		(17,500)	
Proceeds from/(payments for) the issuance of debt:			
Floating rate senior notes	79,200		
Senior subordinated notes		125,000	
Senior term loans		90,000	
Debt issue costs	(3,455)	(9,648)	
Proceeds from the repayment of Predecessor management loans		1,266	
Net proceeds from the issuance of common stock		98,075	
Repayments on senior term loan	(9,550)	(225)	
Stockholder distribution payments	(75,809)		
Payment of collateral on interest rate swap contract	(1,000)		
Other financing activities	(100)		
Net (repayments) proceeds from bank overdraft	(513)	2,150	(1,639)
Net cash (used in) provided by financing activities	(11,227)	133,737	(27,639)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(23,368)	30,219	(19,885)
Cash and cash equivalents at beginning of period	40,476		33,751
Cash and cash equivalents at end of period	$ 17,108	$ 30,219	$ 13,866
Supplemental Disclosures of Cash Flow Information			
Cash paid for interest	$ 8,160	$ 5,662	$ 1,637
Cash paid for taxes, net of refunds	$ 10,820	$ 168	$ 2,376
Supplemental Disclosures of Non-cash Investing and Financing Activities			
Dividends on senior preferred stock	$	$	$ 3,861

See accompanying notes to the condensed consolidated financial statements.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (in thousands - unaudited) 27

CPI Holdco, Inc.

and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Basis of Presentation

For periods ending prior to January 23, 2004, the accompanying condensed consolidated financial statements represent the consolidated results and financial position of Communications & Power Industries Holding Corporation (Holding or the Predecessor). On January 23, 2004, the Predecessor merged (the Merger) with CPI Merger Sub Corp. (Merger Sub), a wholly-owned subsidiary of CPI Holdco, Inc. (CPI Holdco or the Successor), a Delaware corporation formerly known as CPI Acquisition Corp., controlled by affiliates of The Cypress Group L.L.C. (Cypress) as more fully described in Note 3 Mergers . As a result of the Merger, the Predecessor became a wholly-owned subsidiary of CPI Holdco. The financial statements for periods subsequent to January 22, 2004 represent the condensed consolidated financial statements of CPI Holdco after giving effect to the Merger. References to the Company refer to the Predecessor prior to the Merger and the Successor post-Merger.

CPI Holdco s fiscal years are the 52- or 53-week periods that end on the Friday nearest September 30. The Successor s fiscal year did not change from that of the Predecessor. Fiscal year 2005 comprises the 52-week period ending September 30, 2005, and fiscal year 2004 comprised the 52-week period ended October 1, 2004.

Management believes that these unaudited interim condensed consolidated financial statements contain all adjustments, all of which are of a normal, recurring nature, necessary to present fairly the financial position of the Company and its results of operations and cash flows for the interim periods presented. The results for the interim periods reported are not necessarily indicative of the results for the complete fiscal year 2005. Certain information and footnote disclosures normally included in annual financial statements have been condensed or omitted and, accordingly, these financial statements should be read in conjunction with the financial statements and the notes thereto contained in the Company s Annual Report on Form 10-K for the fiscal year ended October 1, 2004.

There is currently no public market for CPI Holdco s common stock.

2. Stock-based Compensation

As allowed by Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, the Company applies the intrinsic value-based method of accounting prescribed by Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Under this method, compensation expense is recorded only if the quoted market price of the stock exceeded the exercise price at the measurement date. Since the Company s stock is not publicly traded and therefore does not have a quoted market price, the Company computes an estimated market price of its stock based on valuation techniques for determining the fair value of closely held stock. The exercise prices of all stock options issued by the Successor were at, or above, the estimated market price of the underlying stock at the date of issuance. The Company charges stock-based compensation expense against income under the caption General and administrative in the Condensed Consolidated Statements of Operations and Comprehensive Income.

In fiscal year 2005, stock-based compensation determined under the intrinsic value-based method was recorded for performance stock options that vest in fiscal years 2005 through 2008. Stock-based compensation expense is charged to income over the stock option vesting period that corresponds with the performance measurement period. Stock-based compensation expense is determined based on an estimate of the number of performance stock options expected to vest multiplied by the difference between a) the estimated market price of the stock at the performance measurement date and b) the option exercise price. The estimated market price at the performance measurement date was based on the fair value of CPI Holdco s common stock at the end of the most recent quarter. The Company expects to meet the performance targets for all outstanding performance stock options. Net income includes stock compensation expense of $0.4 million for the 13-week period ended July 1, 2005, $0.9 million for the 39-week period ended July 1, 2005 and $1.3 million for the period from October 4, 2003 to January 22, 2004.

During fiscal year 2003, the Predecessor issued stock options to employees that were subsequently determined to have been issued below the estimated market price of the stock on the date of grant. The compensation cost associated with the 2003 stock options was amortized as a charge against income on a straight-line basis over the four-year vesting period until the stock options became fully vested at the time of the Merger.

If compensation cost for the Company s stock-based compensation plan had been determined using the fair value-based method of accounting, then the Company s net income (loss) would have changed to the pro forma amounts indicated below (in thousands):

		13-Week Period ended July 1, 2005	13-Week Period ended July 2, 2004
Net income as reported		$ 6,698	$ 11,471
Add:	Stock-based compensation included in net income determined under intrinsic value-based method, net of tax	266	
Deduct:	Stock-based compensation determined under fair value-based method, net of tax	(339)	(77)
Pro forma net income		$ 6,625	$ 11,394

		2005	Fiscal Year 2004	
		39-Week Period ended July 1, 2005 (Successor)	January 23, 2004 to July 2, 2004 (Successor)	October 4, 2003 to January 22, 2004 (Predecessor)
Net income (loss) as reported		$ 16,116	$ 4,638	$ (4,570)
Add:	Stock-based compensation included in net income (loss) determined under intrinsic value-based method, net of tax	523		773
Deduct:	Stock-based compensation determined under fair value-based method, net of tax	(788)	(102)	(136)
Pro forma net income (loss)		$ 15,851	$ 4,536	$ (3,933)

3. Mergers

Cypress Merger

On January 23, 2004, CPI Holdco s wholly-owned subsidiary, Merger Sub, merged with and into Holding pursuant to the terms of the Agreement and Plan of Merger (the Merger Agreement), dated as of November 17, 2003, by and among Holding, CPI Holdco, Merger Sub and Green Equity Investors II, L.P., as the representative of the security holders of Holding, under which CPI Holdco, Merger Sub s parent corporation and a corporation controlled by affiliates of Cypress, agreed to acquire Holding. In the Merger, each share of Holding s common stock and stock options outstanding immediately prior to the Merger, other than a portion of stock options held by certain members of management (which were converted into options to purchase shares of CPI Holdco) and other than any shares of common stock owned by Holding or CPI Holdco, were converted into the right to receive a pro rata portion of the aggregate merger consideration of $131.7 million. In connection with the Merger, CPI Holdco received an equity contribution of $100.0 million before expenses from affiliates of Cypress in exchange for 4,251,122 shares of common stock of CPI Holdco. Members of management of Holding, as a result of rolling over their options to purchase common stock of Holding, received stock options to purchase 167,513 shares of common stock of CPI Holdco (Rollover Options). The estimated fair value of Rollover Options was $5.0 million and was accounted for as Merger purchase price as of January 23, 2004. Members of Holding management that were residents of Canada received 1,485 stock options to purchase shares of common stock of CPI Holdco as payment of Merger escrow proceeds in respect of their options to purchase shares of Holding.

In connection with the Merger, Holding and Communications & Power Industries, Inc. (CPI) refinanced all of their outstanding indebtedness. As part of the refinancing, CPI effected a covenant defeasance of $74.0 million outstanding aggregate principal amount of its 12% Senior Subordinated Notes (12% Notes) and redeemed the 12% Notes in full, each pursuant to the terms of the Indenture governing the 12% Notes. In addition, CPI terminated its credit facility, and Holding paid off all amounts owing under, and terminated, the loan agreement related to its San Carlos property. CPI also redeemed all of the outstanding shares of its 14% Junior Cumulative Preferred Stock and its Series B 14% Senior Redeemable Exchangeable Cumulative Preferred Stock.

The Merger transaction was accounted for using the purchase method of accounting as required by the SFAS No.141, Business Combinations . Accordingly, the assets acquired and liabilities assumed were recorded at fair value, and the excess of the purchase price over the fair value of the assets acquired was recorded as goodwill. The allocation of the purchase price to specific assets and liabilities was based, in part, upon independent appraisals and internal estimates of cash flow and recoverability. The following table summarizes the final allocation of fair value of the assets acquired and liabilities assumed at January 23, 2004 (in thousands):

Cash	$	13,866
Accounts receivable		29,587
Inventory, including $5.5 million of fair value write-up		43,608
Other current assets		3,241
Property, plant and equipment		70,079
Identifiable intangible assets		92,160
Acquired in-process research and development		2,500
Goodwill		139,614
Debt and preferred stock		(172,881)
Deferred tax liabilities, net		(33,169)
Other liabilities		(56,934)
Total	$	131,671

The $2.5 million of acquired in-process research and development represents the estimated fair value of acquired in-process research and development projects that had not yet reached technological feasibility on January 23, 2004 and had no alternative future use. Accordingly, this amount was written off at the Merger date. The value assigned to acquired in-process research and development is related to technology application projects involving development of Vacuum Electron Devices (VEDs) for communications, scientific and military applications and development of power supplies, x-ray generators and transmitters for industrial, medical and military applications.

The following unaudited pro forma summary presents information as if the Merger had taken place at the beginning of each period presented. The pro forma amounts include certain adjustments, including depreciation based on the allocated purchase price of property and equipment, amortization of finite-lived intangible assets acquired, interest expense and taxes. One-time charges for the inventory write-up, merger expenses, acquired in-process research and development and backlog amortization, net of applicable taxes, are excluded from the pro forma net income amounts (in thousands):

		13-Week period ended July 1, 2005		**13-Week period ended July 2, 2004**
Sales	$	87,639	$	72,345
Pro forma net income	$	6,698	$	5,564

		39-Week period ended July 1, 2005		**39-Week period ended July 2, 2004**
Sales	$	245,835	$	217,905
Pro forma net income	$	19,297	$	17,011

Corporate Reorganization

On March 12, 2004, Holding was merged with and into its wholly-owned subsidiary, CPI, with CPI as the surviving corporation (the Intercompany Merger). As a result of the Intercompany Merger, the corporate structure of the Company and its subsidiaries consists of one parent holding corporation, CPI Holdco, and all of the obligations of Holding existing prior to the Intercompany Merger became obligations of CPI.

4. Inventories

Inventories are stated at the lower of average cost or market (net realizable value). The main components of inventories were as follows (in thousands):

	July 1, 2005	October 1, 2004
Raw materials and parts	$ 29,279	$ 23,500
Work in process	10,995	10,067
Finished goods	6,882	4,507
Total	$ 47,156	$ 38,074

5. Product Warranty

The Company s products are generally warranted for a variety of periods, typically one to three years or a predetermined product usage life. The Company assesses the adequacy of its preexisting warranty liabilities and adjusts the balance based on actual experience and changes in future expectations. The following table reconciles the changes in the Company s accrued warranty (in thousands):

	13-Week Period ended July 1, 2005	13-Week Period ended July 2, 2004
Beginning accrued warranty	$ 5,666	$ 5,889
Cost of warranty claims	(1,355)	(1,421)
Accruals for product warranty	1,720	1,546
Ending accrued warranty	$ 6,031	$ 6,014

	Fiscal Year		
	2005	2004	
	39-Week Period ended July 1, 2005 (Successor)	January 23, 2004 to July 2, 2004 (Successor)	October 4, 2003 to January 22, 2004 (Predecessor)
Beginning accrued warranty	$ 6,074	$ 5,839	$ 5,401
Amount acquired from Econco	112		
Cost of warranty claims	(3,831)	(2,247)	(1,241)
Accruals for product warranty			