

CPI INTERNATIONAL, INC.
Form 10-Q
May 12, 2010
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UNITED STATES
SECURITIES AND EXCHANGE

COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended April 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 (I.R.S. Employer Identification No.)
Incorporation or Organization)

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

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

Yes 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 | <input type="checkbox"/> | Accelerated filer | <input checked="" type="checkbox"/> |
| Non-accelerated filer (Do not check if a smaller reporting company) | <input type="checkbox"/> | Smaller reporting company | <input type="checkbox"/> |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes No

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: 16,744,721 shares of Common Stock, \$0.01 par value, at May 3, 2010.

CPI INTERNATIONAL, INC.
and Subsidiaries

10-Q REPORT
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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.

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and Subsidiaries

Part I: FINANCIAL INFORMATION

Item 1. Unaudited Condensed Consolidated Financial Statements

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

| | April 2, 2010 | October 2, 2009 |
|--|-------------------|--------------------|
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 36,529 | \$ 26,152 |
| Restricted cash | 994 | 1,561 |
| Accounts receivable, net | 39,432 | 45,145 |
| Inventories | 79,379 | 66,996 |
| Deferred tax assets | 8,674 | 8,652 |
| Prepaid and other current assets | 6,868 | 6,700 |
| Total current assets | 171,876 | 155,206 |
| Property, plant, and equipment, net | 55,741 | 57,912 |
| Deferred debt issue costs, net | 2,949 | 3,609 |
| Intangible assets, net | 73,964 | 75,430 |
| Goodwill | 162,225 | 162,225 |
| Other long-term assets | 3,820 | 3,872 |
| Total assets | \$ 470,575 | \$ 458,254 |
| Liabilities and stockholders' equity | | |
| Current Liabilities: | | |
| Accounts payable | \$ 23,828 | \$ 22,665 |
| Accrued expenses | 20,281 | 19,015 |
| Product warranty | 4,615 | 3,845 |
| Income taxes payable | 2,993 | 4,305 |
| Deferred income taxes | 332 | - |
| Advance payments from customers | 12,013 | 12,996 |
| Total current liabilities | 64,062 | 62,826 |
| Deferred income taxes, non-current | 24,279 | 24,726 |
| Long-term debt, less current portion | 194,928 | 194,922 |
| Other long-term liabilities | 2,241 | 2,227 |
| Total liabilities | 285,510 | 284,701 |
| Commitments and contingencies | | |
| Stockholders' equity | | |
| Common stock (\$0.01 par value, 90,000 shares authorized; 16,927 and 16,807 shares issued; 16,721 and 16,601 shares outstanding) | 169 | 168 |

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| | | |
|--|------------|------------|
| Additional paid-in capital | 77,804 | 75,630 |
| Accumulated other comprehensive income | 1,602 | 598 |
| Retained earnings | 108,290 | 99,957 |
| Treasury stock, at cost (206 shares) | (2,800) | (2,800) |
| Total stockholders' equity | 185,065 | 173,553 |
| Total liabilities and stockholders' equity | \$ 470,575 | \$ 458,254 |

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

Table of ContentsCPI INTERNATIONAL, INC.
and SubsidiariesCONDENSED CONSOLIDATED
STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
(In thousands, except per share data – unaudited)

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|------------------|------------------|------------------|
| | April 2, 2010 | April 3, 2009 | April 2, 2010 | April 3, 2009 |
| Sales | \$ 88,352 | \$ 81,903 | \$ 171,119 | \$ 159,049 |
| Cost of sales | 61,630 | 60,137 | 120,957 | 117,367 |
| Gross profit | 26,722 | 21,766 | 50,162 | 41,682 |
| Operating costs and expenses: | | | | |
| Research and development | 3,189 | 3,157 | 5,745 | 5,340 |
| Selling and marketing | 5,174 | 4,801 | 10,214 | 9,790 |
| General and administrative | 6,873 | 5,240 | 12,398 | 10,464 |
| Amortization of acquisition-related intangible assets | 687 | 691 | 1,374 | 1,385 |
| Total operating costs and expenses | 15,923 | 13,889 | 29,731 | 26,979 |
| Operating income | 10,799 | 7,877 | 20,431 | 14,703 |
| Interest expense, net | 3,855 | 4,306 | 7,736 | 8,761 |
| Gain on debt extinguishment | - | (197) | - | (197) |
| Income before income taxes | 6,944 | 3,768 | 12,695 | 6,139 |
| Income tax expense (benefit) | 2,452 | 79 | 4,362 | (5,205) |
| Net income | \$ 4,492 | \$ 3,689 | \$ 8,333 | \$ 11,344 |
| Other comprehensive income, net of tax | | | | |
| Net unrealized gain (loss) on cash flow hedges and minimum pension liability adjustment | 160 | 617 | 1,004 | (3,262) |
| Comprehensive income | \$ 4,652 | \$ 4,306 | \$ 9,337 | \$ 8,082 |
| Earnings per common share - Basic | \$ 0.27 | \$ 0.22 | \$ 0.50 | \$ 0.69 |
| Earnings per common share - Diluted | \$ 0.25 | \$ 0.21 | \$ 0.46 | \$ 0.65 |
| Shares used to compute earnings per common share - Basic | 16,520 | 16,317 | 16,486 | 16,293 |
| Shares used to compute earnings per common share - Diluted | 17,769 | 17,309 | 17,700 | 17,336 |

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

Table of ContentsCPI INTERNATIONAL, INC.
and SubsidiariesCONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands – unaudited)

| | Six Months Ended | |
|--|------------------|------------------|
| | April 2, 2010 | April 3, 2009 |
| Cash flows from operating activities | | |
| Net cash provided by operating activities | \$ 11,548 | \$ 7,865 |
| Cash flows from investing activities | | |
| Capital expenditures | (1,835) | (1,818) |
| Payment of patent application fees | (33) | - |
| Net cash used in investing activities | (1,868) | (1,818) |
| Cash flows from financing activities | | |
| Repayments of debt | - | (7,495) |
| Proceeds from issuance of common stock to employees | 374 | 605 |
| Proceeds from exercise of stock options | 99 | 36 |
| Excess tax benefit on stock option exercises | 224 | - |
| Net cash provided by (used in) financing activities | 697 | (6,854) |
| Net increase (decrease) in cash and cash equivalents | 10,377 | (807) |
| Cash and cash equivalents at beginning of period | 26,152 | 28,670 |
| Cash and cash equivalents at end of period | \$ 36,529 | \$ 27,863 |
| Supplemental cash flow disclosures | | |
| Cash paid for interest | \$ 7,092 | \$ 8,323 |
| Cash paid for income taxes, net of refunds | \$ 6,000 | \$ 2,270 |

The accompanying notes are an integral part of these unaudited 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. 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 April 2, 2010 and for the three and six months ended April 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 April 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.

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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 a significant 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 9 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.

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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 June 2009, the FASB issued Accounting Standards Update ("ASU") 2009-16, an update to ASC 860, "Transfers and Servicing," related to accounting for transfers of financial assets. ASU 2009-16 was issued to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. ASU 2009-16 is effective for the first annual reporting period that begins after November 15, 2009. The application of this guidance will only apply and be effective should the Company transfer financial assets on or after October 2, 2010. The adoption of ASU 2009-16 is not expected to have a material effect on the Company's consolidated results of operations, financial position or cash flows.

In August 2009, the FASB issued ASU 2009-05, 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.

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

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.

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 for the Company as of January 2, 2010. Since the Company does not currently have variable interest entities, this update had 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 only disclosure-related, it did not have an impact on the Company's consolidated results of operations, financial position or cash flows.

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

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 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 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 financial 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 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:

| | April 2, 2010 | October 2, 2009 |
|--|------------------|-----------------------|
| Accounts receivable | \$ 39,542 | \$ 45,240 |
| Less: Allowance for doubtful accounts | (110) | (95) |
| Accounts receivable, net | \$ 39,432 | \$ 45,145 |

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

Inventories: The following table provides details of inventories:

| | April 2, 2010 | October 2, 2009 |
|------------------------|------------------|-----------------------|
| Raw material and parts | \$ 43,349 | \$ 38,205 |
| Work in process | 26,171 | 20,542 |
| Finished goods | 9,859 | 8,249 |
| | \$ 79,379 | \$ 66,996 |

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

| | Six Months Ended April 2, 2010 | April 3, 2009 |
|--|--------------------------------------|------------------|
| Balance at beginning of period | \$ 4,068 | \$ 1,928 |
| Provision for loss contracts, charged to cost of sales | 1,854 | 1,454 |
| Credit to cost of sales upon revenue recognition | (1,371) | (1,101) |
| Balance at end of period | \$ 4,551 | \$ 2,281 |

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

| | April 2, 2010 | April 3, 2009 |
|------------------|------------------|------------------|
| Inventories | \$ 4,267 | \$ 2,273 |
| Accrued expenses | 284 | 8 |
| | \$ 4,551 | \$ 2,281 |

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

| | Six Months Ended April 2, 2010 | April 3, 2009 |
|---------------------------------|--------------------------------------|------------------|
| Beginning accrued warranty | \$ 3,845 | \$ 4,159 |
| Actual costs of warranty claims | (2,788) | (2,192) |

| | | |
|--|----------|----------|
| Estimates for product warranty, charged to cost of sales | 3,558 | 2,014 |
| Ending accrued warranty | \$ 4,615 | \$ 3,981 |

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(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:

| | April 2, 2010 | October 2, 2009 |
|--|------------------|--------------------|
| Unrealized gain on cash flow hedges, net of tax | \$ 1,838 | \$ 828 |
| Unrealized actuarial loss and prior service credit for pension liability, net of tax | (236) | (230) |
| | \$ 1,602 | \$ 598 |

4. Financial Instruments

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 six months ended April 2, 2010, no fair value adjustments or material fair value measurements were required for the Company's non-financial assets or liabilities.

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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 April 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.

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

| | Total | Fair Value Measurements at April 2, 2010 Using | | |
|---|------------------|--|---|--|
| | | 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 securities ¹ | \$ 32,981 | \$ 32,981 | \$ - | \$ - |
| Mutual funds ² | 172 | 172 | - | - |
| Foreign exchange forward derivatives ³ | 2,757 | - | 2,757 | - |
| Total assets at fair value | \$ 35,910 | \$ 33,153 | \$ 2,757 | - |
| Liabilities: | | | | |
| Interest rate swap derivative ⁴ | \$ 1,519 | \$ - | \$ 1,519 | \$ - |
| Total liabilities at fair value | \$ 1,519 | \$ - | \$ 1,519 | \$ - |

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.

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| | Total | Fair Value Measurements at October 2, 2009 Using | | |
|---|------------------|--|---|--|
| | | 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 securities ¹ | \$ 22,464 | \$ 22,464 | \$ - | \$ - |
| Mutual funds ² | 152 | 152 | - | - |
| Foreign exchange forward derivatives ³ | 3,467 | - | 3,467 | - |
| Total assets at fair value | \$ 26,083 | \$ 22,616 | \$ 3,467 | - |
| Liabilities: | | | | |
| Interest rate swap derivative ⁴ | \$ 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.

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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 5 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 April 2, 2010 and October 2, 2009 was \$192.3 million and \$188.5 million, respectively, compared to the carrying value of \$194.9 million.

5. 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.

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The Company's Canadian dollar forward contracts in effect as of April 2, 2010 have durations of 8 to 16 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 April 2, 2010, the unrealized gain, net of tax of \$1.5 million, was \$2.8 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 six months ended April 2, 2010 and April 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 was \$0.1 million for the three and six months ended April 2, 2010. No ineffective amounts were recognized due to hedge ineffectiveness for the three and six months ended April 3, 2009.

As of April 2, 2010, the Company had entered into Canadian dollar forward contracts for approximately \$25.9 million (Canadian dollars), or approximately 75% of estimated Canadian dollar denominated expenses for April 2010 through December 2010, at an average rate of approximately 0.88 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 \$40.0 million at April 2, 2010 and represented approximately 61% 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 April 2, 2010, the unrealized loss, net of tax of \$0.6 million, was \$0.9 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.

See Note 4, Financial Instruments, for further information regarding the Company's derivative instruments.

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

| | Asset Derivatives | | | Liability Derivatives | | |
|---|----------------------------------|---------------|-----------------|-----------------------------|---------------|-----------------|
| | Balance Sheet Location | April 2, 2010 | October 2, 2009 | Balance Sheet Location | April 2, 2010 | October 2, 2009 |
| Derivatives designated as hedging instruments | | | | | | |
| Interest rate contracts | | | | Accrued expenses | \$ (1,356) | \$ (1,766) |
| Interest rate contracts | | | | Other long-term liabilities | (163) | (557) |
| Forward contracts | Prepaid and other current assets | \$ 2,757 | \$ 3,467 | | | |
| Total derivatives designated as hedging instruments | | \$ 2,757 | \$ 3,467 | | \$ (1,519) | \$ (2,323) |

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

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The following table summarizes the effect of derivative instruments on the condensed consolidated statements of income and comprehensive income for the three and six months ended April 2, 2010 and April 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 April 2, 2010 | Three Months Ended April 3, 2009 | | Three Months Ended April 2, 2010 | Three Months Ended April 3, 2009 | | April 2, 2010 | April 3, 2009 |
| Interest rate contracts | \$ (164) | \$ (197) | Interest expense, net | \$ (502) | \$ (531) | Interest expense, net | \$ (9) | \$ (13) |
| Forward contracts | 803 | (1,153) | Cost of sales | 681 | (1,670) | General and administrative(a) | 46 | (35) |
| | | | Research and development | 119 | (73) | | | |
| | | | Selling and marketing | 52 | (41) | | | |
| | | | General and administrative | 69 | (121) | | | |
| Total | \$ 639 | \$ (1,350) | | \$ 419 | \$ (2,436) | | \$ 37 | \$ (48) |

(a) The amount of gain recognized in income during the three months ended April 2, 2010 represents a \$57 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 three months ended April 3, 2009 represents \$35 related to the amount excluded from the assessment of hedge effectiveness.

| Interest rate contracts | Six Months Ended | | Interest expense, net | Six Months Ended | | Interest expense, net | Six Months Ended | |
|-------------------------|------------------|---------------|-----------------------|------------------|---------------|-----------------------|------------------|---------------|
| | April 2, 2010 | April 3, 2009 | | April 2, 2010 | April 3, 2009 | | April 2, 2010 | April 3, 2009 |
| Interest rate contracts | \$ (248) | \$ (1,587) | Interest expense, net | \$ (1,052) | \$ (700) | Interest expense, net | \$ (19) | \$ (28) |

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| | | | | | | | |
|-------------------|----------|-------------|----------------------------|-----------|-------------|---------------------------------|-----------|
| Forward contracts | 1,555 | (6,382) | Cost of sales | 606 | (1,846) | General and administrative(b)48 | (225) |
| | | | Research and development | 158 | (114) | | |
| | | | Selling and marketing | 69 | (63) | | |
| | | | General and administrative | 91 | (188) | | |
| Total | \$ 1,307 | \$ (7,969) | | \$ (128) | \$ (2,911) | \$ 29 | \$ (253) |

(b) The amount of gain recognized in income during the six months ended April 2, 2010 represents a \$62 gain related to the ineffective portion of the hedging relationships, net of a \$14 loss related to the amount excluded from the assessment of hedge effectiveness. The amount of loss recognized in income during the six months ended April 3, 2009 represents a \$3 related to the ineffective portion of the hedging relationships and \$222 related to the amount excluded from the assessment of hedge effectiveness.

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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.

In addition, the Company's interest rate swap contract is subject to an International Swaps and Derivatives Association, Inc. Master Agreement ("ISDA Master Agreement"). The ISDA Master Agreement allows for the aggregation of the market exposures and termination of all transactions between the Company and its counterparties in the event a default (as defined in the ISDA Master Agreement) occurs in respect of either party.

When the Company's derivatives are in a net asset position, such as the case with the Company's forward foreign exchange contract derivatives at April 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 April 2, 2010, the Company's interest rate contract derivatives were in a liability position, and the Company, therefore, was not exposed to the interest rate contract counterparty credit risk.

6. 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 April 2, 2010 were as follows:

| Fiscal Year | Operating Leases |
|-----------------------------|---------------------|
| 2010 (remaining six months) | \$ 942 |
| 2011 | 901 |
| 2012 | 739 |
| 2013 | 575 |
| 2014 | 422 |
| Thereafter | 2,633 |
| | \$ 6,212 |

Real estate taxes, insurance, and maintenance are also obligations of the Company. Rental expense under non-cancelable operating leases amounted to \$0.5 million and \$1.2 for the three and six months ended April 2, 2010, respectively, and \$0.6 million and \$1.3 for the corresponding periods of fiscal year 2009. Assets subject to capital leases at April 2, 2010 and October 2, 2009 were not material.

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Guarantees: The Company has restricted cash of \$1.0 million and \$1.6 million as of April 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.

Purchase commitments: As of April 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 six months) | \$ 26,084 |
| 2011 | 6,403 |
| 2012 | 214 |
| 2013 | - |
| 2014 | - |
| | \$ 32,701 |

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 also be required to pay a potential earnout to the former stockholders of Malibu of up to \$7.7 million, which is primarily contingent upon the achievement of certain financial objectives over the three years following the acquisition ("Financial Earnout"). In addition, a discretionary earnout of up to \$1.0 million contingent upon achievement of certain succession planning goals by June 30, 2010 may apply. As of April 2, 2010, the Company has not accrued any of these contingent earnout amounts as achievement of the objectives and goals has not occurred. Any earnout consideration paid based on financial performance will be recorded as additional goodwill. Any discretionary succession earnout consideration paid will be recorded as general and administrative expense. No earnout was earned for the first and second earnout periods, therefore, the maximum potential Financial Earnout that could be earned over the 3 years following the acquisition has been reduced from the original potential total of \$14.0 million to \$7.7 million based on the performance in the first and second earnout periods. Based on its current financial forecasts for Malibu, the Company expects that no earnout will ultimately be payable for the third earnout period.

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.

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.

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7. Stock-based Compensation Plans

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

| | Outstanding 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 | (51,625) | 1.91 | | | | | | |
| Forfeited or cancelled | (13,000) | 16.51 | | | | | | |
| Balance at April 2, 2010 | 3,426,138 | \$ 6.51 | 4.66 | \$ 24,972 | 2,908,929 | \$ 5.20 | 4.10 | \$ 24,268 |

The aggregate intrinsic value in the preceding table represents the total intrinsic value, based on the Company's closing stock price of \$13.09 as of April 2, 2010, which would have been received by the option holders had all option holders exercised their options and sold the shares received upon such exercises as of that date. As of April 2, 2010, approximately 2.5 million exercisable options were in-the-money.

During the three and six months ended April 2, 2010, cash received from option exercises was approximately \$0.1 million, and the total intrinsic value of options exercised was \$0.5 million and \$0.6 million, respectively. During the three and six months ended April 3, 2009, cash received from option exercises was \$29,411 and \$36,003, respectively, and the total intrinsic value of options exercised was \$20,896 and \$27,900, respectively. As of April 2, 2010, there was approximately \$2.5 million of total unrecognized compensation costs related to nonvested stock options, which is expected to be recognized over a weighted-average vesting period of 1.4 years.

Stock Purchase Plan: Employees purchased 16,704 shares for \$0.2 million and 33,465 shares for \$0.4 million in the three and six months ended April 2, 2010, respectively, and 22,481 shares for \$0.2 million and 70,851 shares for \$0.6 million for the corresponding periods of fiscal year 2009 under the 2006 Employee Stock Purchase Plan (the "2006 ESPP"). As of April 3, 2009, there were no unrecognized compensation costs related to rights to acquire stock under the 2006 ESPP.

Restricted Stock and Restricted Stock Units: There were 315,841 and 218,298 shares outstanding of nonvested restricted stock and restricted stock units granted to directors and employees as of April 2, 2010 and October 2, 2009, respectively. The restricted stock and restricted stock units generally vest over periods of one to four years. Upon

vesting, each restricted stock unit will automatically convert into one share of common stock of CPI International.

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A summary of the status of the Company's nonvested restricted stock and restricted stock unit awards as of April 2, 2010 and October 2, 2009 and of changes during the first six months of fiscal year 2010 is presented below:

| | Number of Shares | Weighted-Average Grant-Date Fair Value Per Share |
|---------------------------------|---------------------|---|
| Nonvested at October 2, 2009 | 218,298 | \$ 11.27 |
| Granted | 163,307 | \$ 10.04 |
| Vested | (61,414) | \$ 12.12 |
| Forfeited | (4,350) | \$ 10.49 |
| Nonvested at April 2, 2010 | 315,841 | \$ 10.48 |

During the first quarter of fiscal year 2010, the Company granted 104,800 restricted stock units with time vesting criteria to certain of its non-executive employees and 36,000 restricted stock units with performance vesting criteria to its officers.

During the second quarter of fiscal year 2010, the Company granted certain members of its board of directors a total of 22,507 shares of restricted stock which will vest within the following three years.

Aggregate intrinsic value of the nonvested restricted stock and restricted stock unit awards at April 2, 2010 and October 2, 2009 was \$4.1 million and \$2.5 million, respectively. As of April 2, 2010, there was \$2.9 million of unrecognized compensation costs related to restricted stock and restricted stock unit awards. The unrecognized compensation cost is expected to be recognized over a weighted average period of 2.0 years.

The Company settles stock option exercises, restricted stock awards and restricted stock units with newly issued common shares.

Valuation and Expense Information

The fair value of the Company's time-based option awards is estimated on the date of grant using the Black-Scholes model. The fair value of each market performance-based (or combination of market performance- and time-based) option, restricted stock and restricted stock unit awards is estimated on the date of grant using the Monte Carlo simulation technique in a risk-neutral framework.

Stock Options. Assumptions used in the Black-Scholes model to estimate the fair value of time-based option grants during the six months ended April 2, 2010 (specifically, the first quarter of fiscal year 2010) are presented below.

| | |
|--------------------------|---------|
| Expected term (in years) | 7.79 |
| Expected volatility | 60.50 % |

| | | |
|----------------|------|---|
| Risk-free rate | 3.00 | % |
| Dividend yield | 0 | % |

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There were no time-based options granted during the three months ended April 2, 2010 nor during the three and six months ended April 3, 2009.

Assumptions used in the Monte Carlo simulation model to estimate the fair value of time- and market performance-based options granted during the six months ended April 3, 2009 (specifically, the first quarter of fiscal year 2009) are presented below.

| | |
|-----------------------------|---------|
| Contractual term (in years) | 10.00 |
| Expected volatility | 51.50 % |
| Risk-free rate | 3.53 % |
| Dividend yield | 0 % |

There were no time- and market performance-based options granted during the three and six months ended April 2, 2010 nor during the three months ended April 3, 2009.

The weighted-average grant-date fair value of all the options granted during the six months ended April 2, 2010 and April 3, 2009 was \$6.25 and \$5.61 per share, respectively.

Stock Purchase Plan. Based on the 15% discount received by the employees, the weighted-average fair value of shares issued under the 2006 ESPP was \$1.96 and \$1.97 per share during the three and six months ended April 2, 2010, respectively, and \$1.43 and \$1.50 per share for the corresponding periods of fiscal year 2009.

Restricted Stock and Restricted Stock Units. The fair value of each time-based restricted stock and restricted stock unit award and of each performance-based restricted stock unit award is calculated using the market price of the Company's common stock on the date of grant. The fair value of each performance-based restricted stock unit award assumes that the relevant performance criteria will be met and the target payout level will be achieved. Compensation cost is adjusted for subsequent changes in the outcome of performance-related conditions until the award vests.

Assumptions used in the Monte Carlo simulation model to estimate the fair value of time- and market performance-based restricted stock and restricted stock units granted during the six months ended April 3, 2009 (specifically, the first quarter of fiscal year 2009) are presented below.

| | |
|---------------------|---------|
| Expected volatility | 51.50 % |
| Risk-free rate | 3.54 % |
| Dividend yield | 0 % |

There were no time- and market performance-based restricted stock and restricted stock units granted during the three and six months ended April 2, 2010 nor during the three months ended April 3, 2009.

The weighted-average estimated fair value of all restricted stock and restricted stock units granted during the three and six months ended April 2, 2010 was \$12.44 and \$10.04, respectively. The weighted-average estimated fair value of all restricted stock and restricted stock units granted was \$7.85 and \$8.87 per share during the corresponding periods of

fiscal year 2009.

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As stock-based compensation expense recognized in the condensed consolidated statements of income and comprehensive income for the three and six months ended April 2, 2010 and for the corresponding periods of fiscal year 2009 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. FASB ASC 718, "Compensation—Stock Compensation," requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The following table summarizes stock-based compensation expense for the three and six months ended April 2, 2010 and April 3, 2009, which was allocated as follows:

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|------------------|------------------|------------------|
| | April 2, 2010 | April 3, 2009 | April 2, 2010 | April 3, 2009 |
| Share-based compensation cost recognized in the income statement by caption: | | | | |
| Cost of sales | \$ 147 | \$ 127 | \$ 280 | \$ 244 |
| Research and development | 61 | 45 | 110 | 87 |
| Selling and marketing | 67 | 73 | 140 | 141 |
| General and administrative | 513 | 456 | 988 | 850 |
| | \$ 788 | \$ 701 | \$ 1,518 | \$ 1,322 |
| Share-based compensation cost capitalized in inventory | | | | |
| | \$ 150 | \$ 129 | \$ 291 | \$ 253 |
| Share-based compensation cost remaining in inventory at end of period | | | | |
| | \$ 97 | \$ 85 | \$ 97 | \$ 85 |
| Share-based compensation expense by type of award: | | | | |
| Stock options | \$ 459 | \$ 454 | \$ 915 | \$ 872 |
| Restricted stock and units | 296 | 216 | 537 | 384 |
| Stock purchase plan | 33 | 31 | 66 | 66 |
| | \$ 788 | \$ 701 | \$ 1,518 | \$ 1,322 |

The tax benefit realized from option exercises and restricted stock vesting totaled approximately \$0.3 million and \$0.4 million during the three and six months ended April 2, 2010, respectively. The tax benefit realized from option exercises and restricted stock vesting totaled approximately \$29,000 and \$88,000 during the three and six months ended April 3, 2009, respectively.

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

8. Income Taxes

Income tax expense of \$4.4 million for the six months ended April 2, 2010 and income tax benefit of \$5.2 million for the six months ended April 3, 2009 reflect estimated federal, foreign and state taxes. The effective tax rate for the six months ended April 2, 2010 was 34.4%. The effective tax rate for the six months ended April 3, 2009 was a negative 85% and diverged from the federal and state statutory rate primarily due to several significant discrete tax benefits: (1) \$5.1 million relating to the Company's position with regard to an outstanding audit by the Canada Revenue Agency ("CRA"), (2) \$0.7 million related to certain provisions of the California Budget Act of 2008 signed on February 20, 2009, which will allow a taxpayer to elect an alternative method to attribute taxable income to California for tax years beginning on or after January 1, 2011 and (3) \$0.9 million for adjustments to Canadian deferred tax accounts.

The \$0.9 million adjustment to Canadian deferred tax accounts includes a \$0.6 million tax benefit to reflect the reduction to Canadian corporate income tax rates and a \$0.3 million tax benefit to correct the computation of certain deferred tax accounts. The \$0.6 million adjustment should have been recorded in the first quarter of fiscal year 2008 rather than in the first quarter of fiscal year 2009 and the \$0.3 million adjustment should have been recorded in several prior year financial results. These adjustments are deemed immaterial to the Company's results of operations and financial condition in the affected periods.

The Company files U.S. federal income tax returns, as well as income tax returns in California and other U.S. states, Canada and other foreign jurisdictions. Generally, fiscal years 2005 to 2008 remain open to examination by the various taxing jurisdictions. The Company has not been audited for U.S. federal income tax matters. The Company has income tax audits in progress in Canada and in several international jurisdictions in which it operates. The years under examination by the Canadian taxing authorities are fiscal years 2001 and 2002.

The total unrecognized tax benefit, which excludes any related interest accruals, was \$3.4 million as of April 2, 2010. Of the total unrecognized tax benefit balance, \$2.5 million of unrecognized tax benefits would reduce the effective tax rate if recognized as of April 2, 2010. Estimated interest and penalties related to the underpayment of income taxes are classified as a component of tax expense in the condensed consolidated statement of income and comprehensive income and totaled approximately \$0.1 million for the six months ended April 2, 2010. Accrued interest and penalties, net of interest benefits accrued on receivables anticipated as a result of the change in the U.S.-Canada treaty, were approximately \$0.7 million as of April 2, 2010. The Company had minimal penalties accrued in income tax expense.

The Company believes that it is reasonably possible that, in the next 12 months, the amount of unrecognized tax benefits related to the resolution of federal, state and foreign matters could be reduced by \$2.7 million as audits close, statutes expire and tax payments are made. Any prospective adjustments to the Company's unrecognized tax benefits will be recorded as an increase or decrease to income tax expense and cause a corresponding change to the Company's effective tax rate. Accordingly, the Company's effective tax rate could fluctuate materially from period to period.

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9. Earnings Per Share

Earnings per share is computed using the two-class method, which is an earnings allocation method for computing earnings per share that treats a participating security as having rights to earnings that would otherwise have been available to common stockholders. Certain of the Company's stock-based compensation awards pay nonforfeitable dividends to the participants during the vesting period and, as such, are deemed participating securities. Basic earnings per share are computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding that are increased for additional shares that would be outstanding if potentially dilutive non-participating securities were converted to common shares, pursuant to the treasury stock method.

Earnings per share for the respective periods were calculated as follows (amounts and shares in thousands, except per share data):

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|------------------|------------------|------------------|
| | April 2, 2010 | April 3, 2009 | April 2, 2010 | April 3, 2009 |
| Basic Earnings per Share | | | | |
| Net income | \$ 4,492 | \$ 3,689 | \$ 8,333 | \$ 11,344 |
| Income allocated to participating securities | (87) | (51) | (144) | (123) |
| Net income available to common shareholders | \$ 4,405 | \$ 3,638 | \$ 8,189 | \$ 11,221 |
| Basic weighted average common shares outstanding | 16,520 | 16,317 | 16,486 | 16,293 |
| Net income per common share - Basic | \$ 0.27 | \$ 0.22 | \$ 0.50 | \$ 0.69 |
| Diluted Earnings per Share | | | | |
| Net income | \$ 4,492 | \$ 3,689 | \$ 8,333 | \$ 11,344 |
| Income allocated to participating securities | (81) | (48) | (134) | (116) |
| Net income available to common shareholders | \$ 4,411 | \$ 3,641 | \$ 8,199 | \$ 11,228 |
| Basic weighted average common shares outstanding | 16,520 | 16,317 | 16,486 | 16,293 |
| Effect of dilutive stock options | 1,249 | 992 | 1,214 | 1,043 |
| Diluted weighted average common shares outstanding | 17,769 | 17,309 | 17,700 | 17,336 |

| | | | | |
|---------------------------------------|---------|---------|---------|---------|
| Net income per common share - Diluted | \$ 0.25 | \$ 0.21 | \$ 0.46 | \$ 0.65 |
|---------------------------------------|---------|---------|---------|---------|

1 Restated in accordance with ASC 260.

The calculation of diluted net income per share excludes all anti-dilutive shares from stock options. For the three and six months ended April 2, 2010, the number of anti-dilutive shares, as calculated based on the weighted average price of the Company's common stock for the periods, was approximately 0.9 million shares. For the three and six months ended April 3, 2009, the number of anti-dilutive shares, as calculated based on the weighted average price of the Company's common stock for the periods, was approximately 1.0 million shares.

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10. 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 ("CODM"), its chief executive officer, and is based on the nature of the Company's operations and products offered to customers.

Amounts not reported as VED or satcom equipment are reported as Other. In accordance with quantitative and qualitative guidelines established by FASB ASC 280, "Segment Reporting," Other includes the activities of the Company's Malibu division and unallocated corporate expenses, such as business combination-related expenses, share-based compensation expense and certain non-recurring or unusual expenses. The Malibu division is a designer, manufacturer and integrator of advanced antenna systems for radar, radar simulators and telemetry systems, as well as for data links used in ground, airborne, unmanned aerial vehicles ("UAVs") and shipboard systems.

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

| | Three Months Ended | | Six Months Ended | |
|---------------------------------------|--------------------|------------------|------------------|------------------|
| | April 2, 2010 | April 3, 2009 | April 2, 2010 | April 3, 2009 |
| Sales to external customers | | | | |
| VED | \$ 65,228 | \$ 62,069 | \$ 124,305 | \$ 117,697 |
| Satcom equipment | 20,918 | 16,174 | 41,045 | 33,625 |
| Other | 2,206 | 3,660 | 5,769 | 7,727 |
| | \$ 88,352 | \$ 81,903 | \$ 171,119 | \$ 159,049 |
| Intersegment product transfers | | | | |
| VED | \$ 6,291 | \$ 4,422 | \$ 12,404 | \$ 9,787 |
| Satcom equipment | 1 | - | 1 | 9 |
| | \$ 6,292 | \$ 4,422 | \$ 12,405 | \$ 9,796 |
| EBITDA | | | | |
| VED | \$ 17,399 | \$ 11,850 | \$ 30,118 | \$ 22,201 |
| Satcom equipment | 1,990 | 682 | 4,718 | 2,045 |
| Other | (5,840) | (1,779) | (8,920) | (3,969) |
| | \$ 13,549 | \$ 10,753 | \$ 25,916 | \$ 20,277 |

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EBITDA is the measure used by the CODM to evaluate segment profit or loss. EBITDA represents earnings before net interest expense, provision for income taxes and depreciation and amortization. The Company believes that EBITDA is a more meaningful representation of segment operating performance for leveraged businesses like its own and therefore uses this metric as its internal measure of profitability. For the reasons listed below, the Company believes EBITDA provides investors better understanding of 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 Company's Senior Credit Facilities contain a covenant that requires the Company to maintain a senior secured leverage ratio that contains EBITDA as a component, and the Company's management team uses EBITDA to monitor compliance with this covenant;

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 or superior to, operating income, net income, cash flows from operating activities or other statements of income or statements of cash flows data prepared in accordance with U.S. GAAP. Operating income by the Company's reportable segments was as follows:

| | Three Months Ended | | Six Months Ended | |
|------------------|--------------------|------------------|------------------|------------------|
| | April 2, 2010 | April 3, 2009 | April 2, 2010 | April 3, 2009 |
| Operating income | | | | |
| VED | \$ 15,903 | \$ 10,417 | \$ 27,135 | \$ 19,340 |
| Satcom equipment | 1,812 | 502 | 4,361 | 1,674 |
| Other | (6,916) | (3,042) | (11,065) | (6,311) |

| | | | |
|-----------|----------|-----------|-----------|
| \$ 10,799 | \$ 7,877 | \$ 20,431 | \$ 14,703 |
|-----------|----------|-----------|-----------|

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The following table reconciles net income to EBITDA:

| | Three Months Ended | | Six Months Ended | |
|----------------------------------|--------------------|------------------|------------------|------------------|
| | April 2, 2010 | April 3, 2009 | April 2, 2010 | April 3, 2009 |
| Net income | \$ 4,492 | \$ 3,689 | \$ 8,333 | \$ 11,344 |
| Depreciation and amortization | 2,750 | 2,679 | 5,485 | 5,377 |
| Interest expense, net | 3,855 | 4,306 | 7,736 | 8,761 |
| Income tax expense (benefit) | 2,452 | 79 | 4,362 | (5,205) |
| EBITDA | \$ 13,549 | \$ 10,753 | \$ 25,916 | \$ 20,277 |

11. Subsequent Event

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 May 7, 2010 market closing price of Comtech stock of \$31.06, the fraction was equal to 0.2382 and was currently valued at \$7.40 per share of Company stock.

Except as otherwise agreed with certain Company executives after the date hereof, (i) immediately prior to the effective time of the merger, unvested options to purchase the Company’s common stock will become fully vested, and (ii) holders of unexercised Company stock options outstanding immediately prior to the effective time will be entitled to receive a cash payment in an amount equal to the product of (x) the number of Company shares subject to the option and (y) the excess, if any, of (A) \$9.00 in cash plus a cash amount equal to the product of the number of shares of Comtech common stock issuable in respect of each share of Company common stock in the merger multiplied by the average price of Comtech’s shares over a specified period prior to the effective time of the merger over (B) the exercise price per share subject to the option, less any applicable taxes. Except as otherwise agreed with certain Company executives after the date hereof, each share of Company restricted stock and each Company restricted stock unit outstanding immediately prior to the closing will vest in full and, as of the effective time of the merger, entitle the holder to receive \$9.00 in cash plus a cash amount equal to the product of the number of shares of Comtech common stock issuable in respect of each share of Company common stock in the merger multiplied by the average price of Comtech’s shares over a specified period prior to the effective time of the merger, less applicable taxes.

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. 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.

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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.

12. Supplemental Guarantors Condensed Consolidating Financial Information (Unaudited)

Issued on January 23, 2004, CPI's 8% Senior Subordinated Notes due 2012 ("8% Notes"), the current balance of which is \$117.0 million, 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, 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.

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CONDENSED CONSOLIDATING BALANCE SHEET

As of April 2, 2010

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|---|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Assets | | | | | | |
| Current assets: | | | | | | |
| Cash and cash equivalents | \$ 360 | \$ 24,592 | \$ 911 | \$ 10,666 | \$ - | \$ 36,529 |
| Restricted cash | - | - | 904 | 90 | - | 994 |
| Accounts receivable, net | - | 16,931 | 7,703 | 14,798 | - | 39,432 |
| Inventories | - | 48,676 | 10,061 | 21,322 | (680) | 79,379 |
| Deferred tax assets | - | 8,656 | 2 | 16 | - | 8,674 |
| Intercompany receivable | - | 7,826 | 9,957 | 8,449 | (26,232) | - |
| Prepaid and other current assets | 32 | 5,323 | 659 | 854 | - | 6,868 |
| Total current assets | 392 | 112,004 | 30,197 | 56,195 | (26,912) | 171,876 |
| Property, plant and equipment, net | - | 40,283 | 2,949 | 12,509 | - | 55,741 |
| Deferred debt issue costs, net | 316 | 2,633 | - | - | - | 2,949 |
| Intangible assets, net | - | 53,986 | 13,217 | 6,761 | - | 73,964 |
| Goodwill | - | 93,307 | 20,973 | 47,945 | - | 162,225 |
| Other long-term assets | - | 3,593 | 227 | - | - | 3,820 |
| Intercompany notes receivable | - | 1,035 | - | - | (1,035) | - |
| Investment in subsidiaries | 222,645 | 113,854 | - | - | (336,499) | - |
| Total assets | \$ 223,353 | \$ 420,695 | \$ 67,563 | \$ 123,410 | \$ (364,446) | \$ 470,575 |
| Liabilities and stockholders' equity | | | | | | |
| Current liabilities: | | | | | | |
| Accounts payable | \$ 1 | \$ 12,132 | \$ 2,079 | \$ 9,616 | \$ - | \$ 23,828 |
| Accrued expenses | 127 | 14,204 | 1,860 | 4,090 | - | 20,281 |
| Product warranty | - | 2,402 | 707 | 1,506 | - | 4,615 |
| Income taxes payable | - | 620 | 154 | 2,219 | - | 2,993 |
| Deferred income taxes | - | - | - | 332 | - | 332 |
| | - | 4,946 | 4,487 | 2,580 | - | 12,013 |

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| | | | | | | |
|--|------------|------------|-----------|------------|---------------|------------|
| Advance payments from customers | | | | | | |
| Intercompany payable | 26,232 | - | - | - | (26,232) | - |
| Total current liabilities | 26,360 | 34,304 | 9,287 | 20,343 | (26,232) | 64,062 |
| Deferred income taxes, non-current | - | 20,279 | - | 4,000 | - | 24,279 |
| Intercompany notes payable | - | - | - | 1,035 | (1,035) | - |
| Long-term debt, less current portion | 11,928 | 183,000 | - | - | - | 194,928 |
| Other long-term liabilities | - | 1,544 | 36 | 661 | - | 2,241 |
| Total liabilities | 38,288 | 239,127 | 9,323 | 26,039 | (27,267) | 285,510 |
| Common stock | 169 | - | - | - | - | 169 |
| Parent investment | - | 53,709 | 43,167 | 58,921 | (155,797) | - |
| Additional paid-in capital | 77,804 | - | - | (8,211) | 8,211 | 77,804 |
| Accumulated other comprehensive income | 1,602 | 1,602 | - | 803 | (2,405) | 1,602 |
| Retained earnings | 108,290 | 126,257 | 15,073 | 45,858 | (187,188) | 108,290 |
| Treasury stock, at cost | (2,800) | - | - | - | - | (2,800) |
| Total stockholders' equity | 185,065 | 181,568 | 58,240 | 97,371 | (337,179) | 185,065 |
| Total liabilities and stockholders' equity | \$ 223,353 | \$ 420,695 | \$ 67,563 | \$ 123,410 | \$ (364,446) | \$ 470,575 |

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

CONDENSED CONSOLIDATING BALANCE SHEET

As of October 2, 2009

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|---|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Assets | | | | | | |
| Cash and cash equivalents | \$ 10 | \$ 15,055 | \$ 759 | \$ 10,328 | \$ - | \$ 26,152 |
| Restricted cash | - | - | 1,467 | 94 | - | 1,561 |
| Accounts receivable, net | - | 18,456 | 12,581 | 14,108 | - | 45,145 |
| Inventories | - | 41,877 | 7,622 | 18,117 | (620) | 66,996 |
| Deferred tax assets | - | 8,494 | 2 | 156 | - | 8,652 |
| Intercompany receivable | - | 9,033 | 6,751 | 10,534 | (26,318) | - |
| Prepaid and other current assets | - | 5,396 | 475 | 829 | - | 6,700 |
| Total current assets | 10 | 98,311 | 29,657 | 54,166 | (26,938) | 155,206 |
| Property, plant and equipment, net | - | 42,048 | 3,001 | 12,863 | - | 57,912 |
| Deferred debt issue costs, net | 344 | 3,265 | - | - | - | 3,609 |
| Intangible assets, net | - | 54,891 | 13,477 | 7,062 | - | 75,430 |
| Goodwill | - | 93,307 | 20,973 | 47,945 | - | 162,225 |
| Other long-term assets | - | 3,645 | 227 | - | - | 3,872 |
| Intercompany notes receivable | - | 1,035 | - | - | (1,035) | - |
| Investment in subsidiaries | 211,575 | 114,416 | - | - | (325,991) | - |
| Total assets | \$ 211,929 | \$ 410,918 | \$ 67,335 | \$ 122,036 | \$ (353,964) | \$ 458,254 |
| Liabilities and stockholders' equity | | | | | | |
| Accounts payable | \$ (1) | \$ 11,100 | \$ 2,730 | \$ 8,836 | \$ - | \$ 22,665 |
| Accrued expenses | 137 | 13,293 | 1,634 | 3,951 | - | 19,015 |
| Product warranty | - | 1,893 | 452 | 1,500 | - | 3,845 |
| Income taxes payable | - | 1,683 | 151 | 2,471 | - | 4,305 |
| Advance payments from customers | - | 7,389 | 4,368 | 1,239 | - | 12,996 |
| Intercompany payable | 26,318 | - | - | - | (26,318) | - |
| | 26,454 | 35,358 | 9,335 | 17,997 | (26,318) | 62,826 |

| | | | | | | |
|---|------------|------------|-----------|------------|---------------|------------|
| Total current liabilities | | | | | | |
| Deferred income taxes, non-current | - | 20,342 | - | 4,384 | - | 24,726 |
| Intercompany notes payable | - | - | - | 1,035 | (1,035) | - |
| Long-term debt, less current portion | 11,922 | 183,000 | - | - | - | 194,922 |
| Other long-term liabilities | - | 1,720 | 36 | 471 | - | 2,227 |
| Total liabilities | 38,376 | 240,420 | 9,371 | 23,887 | (27,353) | 284,701 |
| Common stock | 168 | - | - | - | - | 168 |
| Parent investment | - | 52,241 | 43,167 | 58,615 | (154,023) | - |
| Additional paid-in capital | 75,630 | - | - | (211) | 211 | 75,630 |
| Accumulated other comprehensive gain (loss) | 598 | 598 | - | (223) | (375) | 598 |
| Retained earnings | 99,957 | 117,659 | 14,797 | 39,968 | (172,424) | 99,957 |
| Treasury stock | (2,800) | - | - | - | - | (2,800) |
| Total stockholders' equity | 173,553 | 170,498 | 57,964 | 98,149 | (326,611) | 173,553 |
| Total liabilities and stockholders' equity | \$ 211,929 | \$ 410,918 | \$ 67,335 | \$ 122,036 | \$ (353,964) | \$ 458,254 |

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

CONDENSED CONSOLIDATING STATEMENT OF INCOME

For the Three Months Ended April 2, 2010

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|--|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Sales | \$ - | \$ 53,320 | \$ 17,957 | \$ 37,011 | \$ (19,936) | \$ 88,352 |
| Cost of sales | - | 38,287 | 15,471 | 27,730 | (19,858) | 61,630 |
| Gross profit | - | 15,033 | 2,486 | 9,281 | (78) | 26,722 |
| Operating costs and expenses: | | | | | | |
| Research and development | - | 877 | 47 | 2,265 | - | 3,189 |
| Selling and marketing | - | 1,806 | 1,174 | 2,194 | - | 5,174 |
| General and administrative | - | 4,297 | 952 | 1,624 | - | 6,873 |
| Amortization of acquisition-related intangible assets | - | 390 | 147 | 150 | - | 687 |
| Total operating costs and expenses | - | 7,370 | 2,320 | 6,233 | - | 15,923 |
| Operating income | - | 7,663 | 166 | 3,048 | (78) | 10,799 |
| Interest expense, net | 209 | 3,621 | (1) | 26 | - | 3,855 |
| (Loss) income before income tax expense and equity in income of subsidiaries | (209) | 4,042 | 167 | 3,022 | (78) | 6,944 |
| Income tax (benefit) expense | (79) | 1,757 | 101 | 673 | - | 2,452 |
| Equity in income of subsidiaries | 4,622 | 2,337 | - | - | (6,959) | - |
| Net income | \$ 4,492 | \$ 4,622 | \$ 66 | \$ 2,349 | \$ (7,037) | \$ 4,492 |

CONDENSED CONSOLIDATING STATEMENT OF INCOME

For the Three Months Ended April 3, 2009

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|-------------------------------|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Sales | \$ - | \$ 52,641 | \$ 17,077 | \$ 30,510 | \$ (18,325) | \$ 81,903 |
| Cost of sales | - | 39,798 | 14,124 | 24,538 | (18,323) | 60,137 |
| Gross profit | - | 12,843 | 2,953 | 5,972 | (2) | 21,766 |
| Operating costs and expenses: | | | | | | |
| Research and development | - | 1,074 | 3 | 2,080 | - | 3,157 |

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| | | | | | | |
|--|----------|----------|--------|----------|-------------|----------|
| Selling and marketing | - | 1,820 | 988 | 1,993 | - | 4,801 |
| General and administrative | - | 4,221 | 1,131 | (112) | - | 5,240 |
| Amortization of acquisition-related intangible assets | - | 390 | 151 | 150 | - | 691 |
| Total operating costs and expenses | - | 7,505 | 2,273 | 4,111 | - | 13,889 |
| Operating income | - | 5,338 | 680 | 1,861 | (2) | 7,877 |
| Interest expense (income), net | 253 | 4,045 | (3) | 11 | - | 4,306 |
| Gain on debt extinguishment | - | (197) | - | - | - | (197) |
| (Loss) income before income tax expense and equity in income of subsidiaries | (253) | 1,490 | 683 | 1,850 | (2) | 3,768 |
| Income tax (benefit) expense | (98) | (251) | 271 | 157 | - | 79 |
| Equity in income of subsidiaries | 3,844 | 2,103 | - | - | (5,947) | - |
| Net income | \$ 3,689 | \$ 3,844 | \$ 412 | \$ 1,693 | \$ (5,949) | \$ 3,689 |

Table of ContentsCPI INTERNATIONAL, INC.
and SubsidiariesNOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

CONDENSED CONSOLIDATING STATEMENT OF INCOME

For the Six Months Ended April 2, 2010

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|--|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Sales | \$ - | \$ 101,256 | \$ 35,375 | \$ 74,130 | \$ (39,642) | \$ 171,119 |
| Cost of sales | - | 75,167 | 30,253 | 55,119 | (39,582) | 120,957 |
| Gross profit | - | 26,089 | 5,122 | 19,011 | (60) | 50,162 |
| Operating costs and expenses: | | | | | | |
| Research and development | - | 1,434 | 67 | 4,244 | - | 5,745 |
| Selling and marketing | - | 3,399 | 2,347 | 4,468 | - | 10,214 |
| General and administrative | 1 | 7,620 | 1,939 | 2,838 | - | 12,398 |
| Amortization of acquisition-related intangible assets | - | 780 | 293 | 301 | - | 1,374 |
| Total operating costs and expenses | 1 | 13,233 | 4,646 | 11,851 | - | 29,731 |
| Operating (loss) income | (1) | 12,856 | 476 | 7,160 | (60) | 20,431 |
| Interest expense (income), net | 425 | 7,259 | (2) | 54 | - | 7,736 |
| (Loss) income before income tax expense and equity in income of subsidiaries | (426) | 5,597 | 478 | 7,106 | (60) | 12,695 |
| Income tax (benefit) expense | (161) | 3,105 | 202 | 1,216 | - | 4,362 |
| Equity in income of subsidiaries | 8,598 | 6,106 | - | - | (14,704) | - |
| Net income | \$ 8,333 | \$ 8,598 | \$ 276 | \$ 5,890 | \$ (14,764) | \$ 8,333 |

CONDENSED CONSOLIDATING STATEMENT OF INCOME

For the Six Months Ended April 3, 2009

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|---------------|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Sales | \$ - | \$ 98,856 | \$ 36,784 | \$ 62,233 | \$ (38,824) | \$ 159,049 |
| Cost of sales | - | 76,065 | 30,737 | 49,311 | (38,746) | 117,367 |
| Gross profit | - | 22,791 | 6,047 | 12,922 | (78) | 41,682 |

Operating costs and expenses:

| | | | | | | |
|--|-----------|-----------|--------|----------|--------------|-----------|
| Research and development | - | 1,758 | 3 | 3,579 | - | 5,340 |
| Selling and marketing | - | 3,562 | 2,235 | 3,993 | - | 9,790 |
| General and administrative | - | 7,951 | 2,154 | 359 | - | 10,464 |
| Amortization of acquisition-related intangible assets | - | 780 | 304 | 301 | - | 1,385 |
| Total operating costs and expenses | - | 14,051 | 4,696 | 8,232 | - | 26,979 |
| Operating income | - | 8,740 | 1,351 | 4,690 | (78) | 14,703 |
| Interest expense (income), net | 531 | 8,198 | (8) | 40 | - | 8,761 |
| Gain on debt extinguishment | - | (197) | - | - | - | (197) |
| (Loss) income before income tax expense and equity in income of subsidiaries | (531) | 739 | 1,359 | 4,650 | (78) | 6,139 |
| Income tax (benefit) expense | (203) | (4,085) | 386 | (1,303) | - | (5,205) |
| Equity in income of subsidiaries | 11,672 | 6,848 | - | - | (18,520) | - |
| Net income | \$ 11,344 | \$ 11,672 | \$ 973 | \$ 5,953 | \$ (18,598) | \$ 11,344 |

Table of ContentsCPI INTERNATIONAL, INC.
and SubsidiariesNOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tabular dollar amounts in thousands except share and per share amounts)

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

For the Six Months Ended April 2, 2010

| | 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 | \$ (453) | \$ 11,045 | \$ 353 | \$ 603 | \$ - | \$ 11,548 |
| Cash flows from investing activities | | | | | | |
| Capital expenditures | - | (1,402) | (168) | (265) | - | (1,835) |
| Payment of patent application fees | - | - | (33) | - | - | (33) |
| Net cash used in investing activities | - | (1,402) | (201) | (265) | - | (1,868) |
| Cash flows from financing activities | | | | | | |
| Proceeds from issuance of common stock to employees | 374 | - | - | - | - | 374 |
| Proceeds from exercise of stock options | 99 | - | - | - | - | 99 |
| Excess tax benefit on stock option exercises | - | 224 | - | - | - | 224 |
| Intercompany dividends | 330 | (330) | - | - | - | - |
| Net cash provided by (used in) financing activities | 803 | (106) | - | - | - | 697 |
| Net increase in cash and cash equivalents | 350 | 9,537 | 152 | 338 | - | 10,377 |
| Cash and cash equivalents at beginning of period | 10 | 15,055 | 759 | 10,328 | - | 26,152 |
| Cash and cash equivalents at end of period | \$ 360 | \$ 24,592 | \$ 911 | \$ 10,666 | \$ - | \$ 36,529 |

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

For the Six Months Ended April 3, 2009

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| | 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 | \$ (1,092) | \$ 8,429 | \$ 227 | \$ 301 | \$ - | \$ 7,865 |
| Cash flows from investing activities | | | | | | |
| Capital expenditures | - | (1,679) | (112) | (27) | - | (1,818) |
| Net cash used in investing activities | - | (1,679) | (112) | (27) | - | (1,818) |
| Cash flows from financing activities | | | | | | |
| Repayments of debt | - | (7,495) | - | - | - | (7,495) |
| Proceeds from issuance of common stock to employees | 605 | - | - | - | - | 605 |
| Proceeds from exercise of stock options | 36 | - | - | - | - | 36 |
| Intercompany dividends / debt | 396 | (8,396) | - | 8,000 | - | - |
| Net cash provided by (used in) financing activities | 1,037 | (15,891) | - | 8,000 | - | (6,854) |
| Net (decrease) increase in cash and cash equivalents | (55) | (9,141) | 115 | 8,274 | - | (807) |
| Cash and cash equivalents at beginning of period | 84 | 26,272 | 493 | 1,821 | - | 28,670 |
| Cash and cash equivalents at end of period | \$ 29 | \$ 17,131 | \$ 608 | \$ 10,095 | \$ - | \$ 27,863 |

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

Our fiscal years are the 52- or 53-week periods that end on the Friday nearest September 30. Fiscal years 2010 and 2009 comprise the 52-week period ending October 1, 2010 and October 2, 2009, respectively. The following discussion should be read in conjunction with the accompanying unaudited condensed consolidated financial statements, and the notes thereto, of CPI International, Inc.

Overview

CPI International, headquartered in Palo Alto, California, is the parent company of Communications & Power Industries, a provider of microwave, radio frequency, power and control solutions for critical defense, communications, medical, scientific and other applications. Communications & Power Industries develops, manufactures and distributes products used to generate, amplify, transmit and receive 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 commercial and military 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.

Orders

We sell our products into five end markets: defense (radar and 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 six months ended April 2, 2010 and April 3, 2009 are summarized as follows (dollars in millions):

| | Six Months Ended | | | | (Decrease) | |
|---------------------------------|------------------|----------------|---------------|----------------|------------|---------|
| | April 2, 2010 | | April 3, 2009 | | Increase | |
| | Amount | % of Orders | Amount | % of Orders | Amount | Percent |
| Radar and Electronic Warfare | \$ 65.7 | 35 % | \$ 75.6 | 41 % | \$ (9.9) | (13) % |
| Medical | 41.8 | 23 | 39.7 | 22 | 2.1 | 5 |
| Communications | 59.0 | 32 | 54.8 | 30 | 4.2 | 8 |

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| | | | | | | |
|------------|----------|-------|----------|-------|--------|------|
| Industrial | 10.4 | 6 | 11.1 | 6 | (0.7) | (7) |
| Scientific | 8.2 | 4 | 1.3 | 1 | 6.9 | 530 |
| Total | \$ 185.1 | 100 % | \$ 182.5 | 100 % | \$ 2.6 | 1 % |

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Orders of \$185.1 million for the six months ended April 2, 2010 were \$2.6 million, or approximately 1%, higher than orders of \$182.5 million for the six months ended April 3, 2009. Explanations for the order increase or decrease by market for the first six months of fiscal year 2010 compared to the first six months of fiscal year 2009 are as follows:

- **Radar and Electronic Warfare:** The majority of our products in the radar and electronic warfare markets are for domestic and international defense and government end uses. Orders in these markets are characterized by many smaller orders in the \$0.5 million to \$3.0 million range by product or program, and the timing of these orders may vary from year to year. On a combined basis, orders for the radar and electronic warfare markets decreased approximately 13% from an aggregate of \$75.6 million in the first six months of fiscal year 2009 to an aggregate of \$65.7 million in the first six months of fiscal year 2010. The decrease in orders for these combined markets was primarily due to the timing of large orders to support two foreign radar programs, as well as the timing of orders for the HAWK missile system. In the first six months of fiscal 2009, we received \$4.2 million in orders for a foreign radar development program and \$4.1 million in orders for a different foreign radar program; these large orders were not expected to, and did not, repeat in the first six months of fiscal 2010.
- **Medical:** Orders for our medical products consist of orders for medical imaging applications, such as x-ray imaging, magnetic resonance imaging (“MRI”) and positron emission tomography (“PET”) applications, and for radiation therapy applications for the treatment of cancer. The 5% increase in medical orders resulted from an increase in demand for products to support MRI applications, and was partially offset by a decrease in orders of products to support radiation therapy and x-ray imaging applications. In fiscal year 2009, orders to support radiation therapy applications were higher than the historical average, while sales of these products remained at normal levels.
- **Communications:** Orders for our communications products consist of orders for commercial communications applications and military communications applications. The 8% increase in communications orders was primarily due to increases in orders to support commercial communications applications, such as fixed satellite broadcast and commercial radio broadcast applications. These increases were partially offset by a decrease in orders for the Warfighter Information Network – Tactical (WIN-T) military communications program, for which we received an approximately \$13 million order in the first six months of fiscal year 2009; this order was not expected to, and did not, repeat in the first six months of fiscal year 2010. Demand for products to support other military communications programs increased during the most recent period. Military communications is a relatively new sector of the overall communications market for us, and, with the exception of the WIN-T program, is characterized by numerous programs that are relatively modest in size and for which the timing may vary from year to year. Over the long-term, we expect our participation in military communications programs to continue to grow.
- **Industrial:** Orders in the industrial market are cyclical and are generally tied to the state of the economy. The \$0.7 million decrease in industrial orders was primarily due to the timing of orders for products used in cargo screening and instrumentation applications. This decrease was partially offset by an increase in demand for products to support semiconductor manufacturing applications.

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- Scientific: Orders in the scientific market are historically one-time projects and can fluctuate significantly from period to period. The \$6.9 million increase in scientific orders was primarily the result of the receipt of orders for products to support fusion research and scientific accelerators at domestic laboratories.

Incoming order levels can fluctuate significantly on a quarterly or annual basis, and a particular quarter's or year's order rate may not be indicative of future order levels. In addition, our sales are highly dependent upon manufacturing scheduling and performance and, accordingly, it is not possible to accurately predict when orders will be recognized as sales.

Backlog

As of April 2, 2010, we had an order backlog of \$240.7 million compared to an order backlog of \$225.4 million as of April 3, 2009. Because our orders for government end-use products generally have much longer delivery terms than our orders for commercial business (which require quicker turn-around), our backlog is primarily composed of government orders.

Backlog represents the cumulative balance, at a given point in time, of recorded customer sales orders that have not yet been shipped or recognized as sales. Backlog is increased when an order is received, and backlog is decreased when we recognize sales. We believe that backlog and orders information is helpful to investors because this information may be indicative of future sales results. Although backlog consists of firm orders for which goods and services are yet to be provided, customers can, and sometimes do, terminate or modify these orders. However, historically the amount of modifications and terminations has not been material compared to total contract volume.

Results of Operations

We derive our revenue primarily from the sale of microwave and radio frequency products, including high-power microwave amplifiers, satellite communications amplifiers, medical x-ray imaging subsystems and other related products. Our products generally have selling prices ranging from \$2,000 to \$200,000, with certain limited products priced up to \$1,000,000.

Cost of goods sold generally includes costs for raw materials, manufacturing costs, including allocation of overhead and other indirect costs, charges for reserves for excess and obsolete inventory, warranty claims and losses on fixed price contracts. Operating expenses generally consist of research and development, selling and marketing and general and administrative expenses.

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Three Months Ended April 2, 2010 Compared to Three Months Ended April 3, 2009

The following table sets forth our historical results of operations for each of the periods indicated (dollars in millions):

| | Three Months Ended April 2, 2010 | | Three Months Ended April 3, 2009 | | Increase (Decrease) |
|---|-------------------------------------|---------------|-------------------------------------|---------------|------------------------|
| | Amount | % of Sales | Amount | % of Sales | Amount |
| Sales | \$ 88.4 | 100.0 % | \$ 81.9 | 100.0 % | \$ 6.5 |
| Cost of sales | 61.6 | 69.7 | 60.1 | 73.4 | 1.5 |
| Gross profit | 26.7 | 30.2 | 21.8 | 26.6 | 4.9 |
| Research and development | 3.2 | 3.6 | 3.2 | 3.9 | - |
| Selling and marketing | 5.2 | 5.9 | 4.8 | 5.9 | 0.4 |
| General and administrative | 6.9 | 7.8 | 5.2 | 6.3 | 1.7 |
| Amortization of acquisition-related intangibles | 0.7 | 0.8 | 0.7 | 0.9 | - |
| Operating income | 10.8 | 12.2 | 7.9 | 9.6 | 2.9 |
| Interest expense, net | 3.9 | 4.4 | 4.3 | 5.3 | (0.4) |
| Gain on debt extinguishment | - | - | (0.2) | (0.2) | 0.2 |
| Income before taxes | 6.9 | 7.8 | 3.8 | 4.6 | 3.1 |
| Income tax expense | 2.5 | 2.8 | 0.1 | 0.1 | 2.4 |
| Net income | \$ 4.5 | 5.1 % | \$ 3.7 | 4.5 % | \$ 0.8 |
| Other Data: | | | | | |
| EBITDA (a) | \$ 13.5 | 15.3 % | \$ 10.8 | 13.2 % | \$ 2.7 |

Note: Totals may not equal the sum of the components due to independent rounding. Percentages are calculated based on rounded dollar amounts presented.

(a) EBITDA represents earnings before net interest expense, provision for income taxes and depreciation and amortization. For the reasons listed below, we believe that U.S. generally accepted accounting principles (“GAAP”) based financial

information for leveraged businesses such as ours should be supplemented by EBITDA so that investors better understand our financial performance in connection with their analysis of our business:

EBITDA is a component of the measures used by our board of directors and management team to evaluate our operating performance;

Our senior credit facilities contain a covenant that requires us to maintain a senior secured leverage ratio that contains EBITDA as a component, and our management team uses EBITDA to monitor compliance with this covenant;

EBITDA is a component of the measures used by our management team to make day-to-day operating decisions;

EBITDA facilitates comparisons between our operating results and those of competitors with different capital structures and, therefore, is a component of the measures used by the management to facilitate internal comparisons to competitors' results and our industry in general; and

the payment of management bonuses is contingent upon, among other things, the satisfaction by us of certain targets that contain EBITDA as a component.

Other companies may define EBITDA differently and, as a result, our measure of EBITDA may not be directly comparable to EBITDA of other companies. Although we use EBITDA as a financial measure to assess the performance of our business, the use of EBITDA is limited because it does not include certain material costs, such as interest and taxes, necessary to operate our business. When analyzing our performance, EBITDA should be considered in addition to, and not as a substitute for or superior to, net income, cash flows from operating activities or other statements of income or statements of cash flows data prepared in accordance with GAAP.

For a reconciliation of Net Income to EBITDA, see Note 10 of the accompanying unaudited condensed consolidated financial statements.

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Sales: Our sales by market for the three months ended April 2, 2010 and April 3, 2009 are summarized as follows (dollars in millions):

| | Three Months Ended | | | | (Decrease) | |
|------------------------------|--------------------|------------|---------------|------------|------------|---------|
| | April 2, 2010 | | April 3, 2009 | | Increase | |
| | Amount | % of Sales | Amount | % of Sales | Amount | Percent |
| Radar and Electronic Warfare | \$ 33.2 | 37 % | \$ 34.3 | 42 % | \$ (1.1) | (3) % |
| Medical | 17.5 | 20 | 15.6 | 19 | 1.9 | 12 |
| Communications | 29.1 | 33 | 25.3 | 31 | 3.8 | 15 |
| Industrial | 5.3 | 6 | 4.4 | 5 | 0.9 | 20 |
| Scientific | 3.3 | 4 | 2.3 | 3 | 1.0 | 45 |
| Total | \$ 88.4 | 100 % | \$ 81.9 | 100 % | \$ 6.5 | 8 % |

Sales of \$88.4 million for the three months ended April 2, 2010 were \$6.5 million, or approximately 8%, higher than sales of \$81.9 million for the three months ended April 3, 2009. Explanations for the sales increase or decrease by market for the second quarter of fiscal year 2010 as compared to the second quarter of fiscal year 2009 are as follows:

- **Radar and Electronic Warfare:** The majority of our products in the radar and electronic warfare markets are for domestic and international defense and government end uses. The timing of orders receipts and subsequent shipments in these markets may vary from year to year. On a combined basis, sales for these two markets decreased approximately 3% from an aggregate of \$34.3 million in the three months ended April 3, 2009 to an aggregate of \$33.2 million in the three months ended April 2, 2010. This decrease was primarily due to the periodic timing of certain domestic radar programs, and was partially offset by increased sales for certain domestic electronic warfare programs.
- **Medical:** Sales of our medical products consist of sales for medical imaging applications, such as x-ray imaging, MRI and PET applications, and for radiation therapy applications for the treatment of cancer. The 12% increase in sales of our medical products in the three months ended April 2, 2010 was due to increased sales of products to support MRI and radiation therapy applications.
- **Communications:** Sales of our communications products consist of sales for commercial communications applications and military communications applications. The 15% increase in sales in the communications market was due to increases in sales to support a variety of military communications applications, including the WIN-T program, as well as increases in sales to support commercial communications applications, particularly fixed satellite broadcast applications. Military communications is a relatively new sector of the overall communications market for us, and, with the exception of the WIN-T program, is characterized by numerous programs that are relatively modest in size and for which the timing may vary from year to year. Over the long-term, we expect our participation in military communications programs to continue to grow.
- **Industrial:** Sales in the industrial market are cyclical and are generally tied to the state of the economy. The \$0.9 million increase in sales of industrial products in the most recent period was primarily due to increased sales to support semiconductor manufacturing and instrumentation applications.

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- Scientific: Sales in the scientific market are historically one-time projects and can fluctuate significantly from period to period. The \$1.0 million increase in scientific sales was primarily the result of increased sales for a foreign fusion research program.

Gross Profit. Gross profit was \$26.7 million, or 30.2% of sales, for the three months ended April 2, 2010 as compared to \$21.8 million, or 26.6% of sales, for the three months ended April 3, 2009. The \$4.9 million increase in gross profit in the three months ended April 2, 2010 as compared to the three months ended April 3, 2009 was primarily due to higher shipments and improved operating efficiencies from the higher shipment volume, partially offset by an increase in expenses from the elimination of certain employee cost reduction initiatives in the three months ended April 2, 2010.

Research and Development. Research and development expenses were \$3.2 million, or 3.6% of sales, for the three months ended April 2, 2010, and \$3.2 million, or 3.9% of sales, for the three months ended April 3, 2009. Total spending on research and development, including customer-sponsored research and development, was as follows (in millions):

| | Three Months Ended | |
|---|--------------------|------------------|
| | April 2, 2010 | April 3, 2009 |
| Company sponsored | \$ 3.2 | \$ 3.2 |
| Customer sponsored, charged to cost of sales | 4.0 | 4.1 |
| | \$ 7.2 | \$ 7.3 |

Selling and Marketing. Selling and marketing expenses were \$5.2 million, or 5.9% of sales, for the three months ended April 2, 2010, a \$0.4 million increase from the \$4.8 million, or 5.9% of sales, for the three months ended April 3, 2009. The increase in selling and marketing expenses in the three months ended April 2, 2010 was primarily due to higher foreign expenses from unfavorable currency translation and increased sales commissions for third party sales representatives.

General and Administrative. General and administrative expenses were \$6.9 million, or 7.8% of sales, for the three months ended April 2, 2010, a \$1.7 million increase from the \$5.2 million, or 6.3% of sales, for the three months ended April 3, 2009. The increase in general and administrative expenses in the three months ended April 2, 2010 was primarily due to unfavorable currency translation, higher consulting fees for tax and legal services, and higher management incentive accruals as a result of improved operating performance.

Amortization of Acquisition-related Intangibles. Amortization of acquisition-related intangibles consists of purchase accounting charges for technology and other intangible assets. Amortization of acquisition-related intangibles was \$0.7 million for the second quarter of fiscal years 2010 and 2009.

Interest Expense, net ("Interest Expense"). Interest Expense was \$3.9 million, or 4.4% of sales, for the three months ended April 2, 2010, a \$0.4 million decrease from the \$4.3 million, or 5.3% of sales, for the three months ended April 3, 2009. The reduction in interest expense for the three months ended April 2, 2010 was primarily due to repayments of debt over the past year, which resulted in lower outstanding debt obligations during the three months ended April 2, 2010 compared to the three months ended April 3, 2009.

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Gain on Debt Extinguishment. The gain on debt extinguishment of \$0.2 million in the three months ended April 3, 2009 resulted from the repurchase of \$3.0 million of our 8% senior subordinated notes at a discount of \$0.3 million, or 8.5% of par value, partially offset by a \$0.1 million non-cash write-off of deferred debt issue costs.

Income Tax Expense. We recorded an income tax expense of \$2.5 million for the three months ended April 2, 2010 and income tax expense of \$0.1 million for the three months ended April 3, 2009.

Income tax expense for the three months ended April 3, 2009 included a discrete tax benefit of approximately \$0.7 million that was related to certain provisions of the California Budget Act of 2008 signed on February 20, 2009, which will allow a taxpayer to elect an alternative method to attribute taxable income to California for tax years beginning on or after January 1, 2011. We also recorded a discrete tax benefit of \$0.3 million relating to the correction of an immaterial error in the computation of certain deferred tax accounts that should have been recorded in several prior year financial results.

Net Income. Net income was \$4.5 million, or 5.1% of sales, in the three months ended April 2, 2010 as compared to \$3.7 million, or 4.5% of sales, in the three months ended April 3, 2009. The \$0.8 million increase in net income in the three months ended April 2, 2010 as compared to the three months ended April 3, 2009 was primarily due to higher shipment volume and the favorable impact of Canadian dollar hedges in the three months ended April 2, 2010, partially offset by unfavorable currency translation. In addition, the \$1.0 million in discrete income tax benefits in the three months ended April 3, 2009 did not repeat in the three months ended April 2, 2010.

EBITDA. EBITDA was \$13.5 million, or 15.3% of sales, for the three months ended April 2, 2010 as compared to \$10.8 million, or 13.2% of sales, for the three months ended April 3, 2009. The \$2.7 million increase in EBITDA in the three months ended April 2, 2010 as compared to the three months ended April 3, 2009 was primarily due to higher shipment volume and the favorable impact of Canadian dollar hedges in the three months ended April 2, 2010, partially offset by unfavorable currency translation.

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Six Months Ended April 2, 2010 Compared to Six Months Ended April 3, 2009

The following table sets forth our historical results of operations for each of the periods indicated (dollars in millions):

| | Six Months Ended | | | | Increase (Decrease) Amount |
|--|------------------|---------------|---------------|---------------|----------------------------------|
| | April 2, 2010 | | April 3, 2009 | | |
| | Amount | % of Sales | Amount | % of Sales | |
| Sales | \$ 171.1 | 100.0 % | \$ 159.0 | 100.0 % | \$ 12.1 |
| Cost of sales | 121.0 | 70.7 | 117.4 | 73.8 | 3.6 |
| Gross profit | 50.2 | 29.3 | 41.7 | 26.2 | 8.5 |
| Research and development | 5.7 | 3.3 | 5.3 | 3.3 | 0.4 |
| Selling and marketing | 10.2 | 6.0 | 9.8 | 6.2 | 0.4 |
| General and administrative | 12.4 | 7.2 | 10.5 | 6.6 | 1.9 |
| Amortization of acquisition- related intangibles | 1.4 | 0.8 | 1.4 | 0.9 | - |
| Operating income | 20.4 | 11.9 | 14.7 | 9.2 | 5.7 |
| Interest expense, net | 7.7 | 4.5 | 8.8 | 5.5 | (1.1) |
| Gain on debt extinguishment | - | - | (0.2) | (0.1) | 0.2 |
| Income before taxes | 12.7 | 7.4 | 6.1 | 3.8 | 6.6 |
| Income tax expense (benefit) | 4.4 | 2.6 | (5.2) | (3.3) | 9.6 |
| Net income | \$ 8.3 | 4.9 % | \$ 11.3 | 7.1 % | \$ (3.0) |
| Other Data: | | | | | |
| EBITDA (a) | \$ 25.9 | 15.1 % | \$ 20.3 | 12.8 % | \$ 5.6 |

Note: Totals may not equal the sum of the components due to independent rounding. Percentages are calculated based on rounded dollar amounts presented.

- (a) EBITDA represents earnings before net interest expense, provision for income taxes and depreciation and amortization. For the reasons listed below, we believe that U.S. generally accepted accounting principles (“GAAP”) based financial information for leveraged businesses such as ours should be supplemented by EBITDA so that investors better understand our financial performance in connection with their analysis of our business:

EBITDA is a component of the measures used by our board of directors and management team to evaluate our operating performance;

our senior credit facilities contain a covenant that requires us to maintain a senior secured leverage ratio that contains EBITDA as a component, and our management team uses EBITDA to monitor compliance with this covenant;

EBITDA is a component of the measures used by our management team to make day-to-day operating decisions;

EBITDA facilitates comparisons between our operating results and those of competitors with different capital structures and, therefore, is a component of the measures used by the management to facilitate internal comparisons to competitors' results and our industry in general; and

the payment of management bonuses is contingent upon, among other things, the satisfaction by us of certain targets that contain EBITDA as a component.

Other companies may define EBITDA differently and, as a result, our measure of EBITDA may not be directly comparable to EBITDA of other companies. Although we use EBITDA as a financial measure to assess the performance of our business, the use of EBITDA is limited because it does not include certain material costs, such as interest and taxes, necessary to operate our business. When analyzing our performance, EBITDA should be considered in addition to, and not as a substitute for or superior to, net income, cash flows from operating activities or other statements of income or statements of cash flows data prepared in accordance with GAAP.

For a reconciliation of Net Income to EBITDA, see Note 10 of the accompanying unaudited condensed consolidated financial statements.

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Sales. Our sales by market for the six months ended April 2, 2010 and April 3, 2009 are summarized as follows (dollars in millions):

| | Six Months Ended | | | | (Decrease) | |
|------------------------------|------------------|------------|---------------|------------|------------|---------|
| | April 2, 2010 | | April 3, 2009 | | Increase | |
| | Amount | % of Sales | Amount | % of Sales | Amount | Percent |
| Radar and Electronic Warfare | \$ 61.5 | 36 % | \$ 62.3 | 39 % | \$ (0.8) | (1) % |
| Medical | 36.8 | 21 | 31.4 | 20 | 5.4 | 17 |
| Communications | 57.8 | 34 | 51.5 | 32 | 6.3 | 12 |
| Industrial | 10.4 | 6 | 9.8 | 6 | 0.6 | 6 |
| Scientific | 4.6 | 3 | 4.0 | 3 | 0.6 | 15 |
| Total | \$ 171.1 | 100 % | \$ 159.0 | 100 % | \$ 12.1 | 8 % |

Sales of \$171.1 million for the six months ended April 2, 2010 were \$12.1 million, or 8%, higher than sales of \$159.0 million for the six months ended April 3, 2009. Explanations for the sales increase or decrease by market are as follows:

- **Radar and Electronic Warfare:** The majority of our sales in the radar and electronic warfare markets are for products for domestic and international defense and government end uses. The timing of the receipt of orders and subsequent shipments in these markets may vary from year to year. On a combined basis, sales for these markets were essentially unchanged at \$61.5 million in the six months ended April 2, 2010 as compared to \$62.3 million in the six months ended April 3, 2009.
- **Medical:** Sales of our medical products consist of sales for medical imaging applications, such as x-ray imaging, MRI and PET applications, and for radiation therapy applications for the treatment of cancer. The 17% increase in sales of our medical products was primarily due to increased sales to support MRI applications.
- **Communications:** The 12% increase in sales in the communications market was primarily attributable to increases in sales to support a variety of military communications applications, including the WIN-T program. Sales to support commercial communications applications, particularly fixed satellite broadcast applications, increased as well. Military communications is a relatively new sector of the overall communications market for us, and, with the exception of the WIN-T program, is characterized by numerous programs that are relatively modest in size and for which the timing may vary from year to year. Over the long term, we expect our participation in military communications programs to continue to grow.
- **Industrial:** Sales in the industrial market are cyclical and are generally tied to the state of the economy. The \$0.6 million increase in industrial sales was consistent with a general improvement in business conditions across the industrial market.
- **Scientific:** Sales in the scientific market are historically one-time projects and can fluctuate significantly from period to period. The \$0.6 million increase in scientific sales was primarily the result of increased sales for a foreign fusion research program.

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Gross Profit. Gross profit was \$50.2 million, or 29.3% of sales, for the six months ended April 2, 2010, an \$8.5 million increase from \$41.7 million, or 26.2% of sales, in the six months ended April 3, 2009. The increase in gross profit for the six months ended April 2, 2010 as compared to the six months ended April 3, 2009 was primarily due to higher shipments and improved operating efficiencies from the higher shipment volume, partially offset by an increase in expenses from the elimination of certain employee cost reduction initiatives in the six months ended April 2, 2010.

Research and Development. Research and development expenses were \$5.7 million, or 3.3% of sales, for the six months ended April 2, 2010, a \$0.4 million increase from \$5.3 million, or 3.3% of sales, for the six months ended April 3, 2009. The increase in research and development for the six months ended April 2, 2010 was primarily due to development efforts on broadband communication products for commercial and military applications.

Total spending on research and development, including customer-sponsored research and development, was as follows (in millions):

| | Six Months Ended | |
|---|------------------|------------------|
| | April 2, 2010 | April 3, 2009 |
| Company sponsored | \$ 5.7 | \$ 5.3 |
| Customer sponsored, charged to cost of sales | 7.7 | 7.3 |
| | \$ 13.4 | \$ 12.6 |

Selling and Marketing. Selling and marketing expenses were \$10.2 million, or 6.0% of sales, for the six months ended April 2, 2010, a \$0.4 million increase from the \$9.8 million, or 6.2% of sales, for the six months ended April 3, 2009. The increase in selling and marketing expenses in the six months ended April 2, 2010 was primarily due to higher foreign expenses from unfavorable currency translation and increased sales commissions for third party sales representatives.

General and Administrative. General and administrative expenses were \$12.4 million, or 7.2% of sales, for the six months ended April 2, 2010, a \$1.9 million increase from the \$10.5 million, or 6.6% of sales, for the six months ended April 3, 2009. The increase in general and administrative expenses in the six months ended April 2, 2010 was primarily due to unfavorable currency translation, higher consulting fees for tax and legal services and higher management incentive accruals as a result of improved operating performance.

Amortization of Acquisition-related Intangibles. Amortization of acquisition-related intangibles consists of purchase accounting charges for technology and other intangible assets. Amortization of acquisition-related intangibles was \$1.4 million for the six months ended April 2, 2010 and the six months ended April 3, 2009.

Interest Expense, Net ("Interest Expense"). Interest Expense of \$7.7 million for the six months ended April 2, 2010 was \$1.1 million lower than interest expense of \$8.8 million for the six months ended April 3, 2009. The reduction in interest expense for the six months ended April 2, 2010 was primarily due to repayments of debt over the past year which resulted in lower interest expense during the six months ended April 2, 2010 as compared to the six months ended April 3, 2009.

Gain on Debt Extinguishment. The gain on debt extinguishment of \$0.2 million in the six months ended April 3, 2009 resulted from the repurchase of \$3.0 million of our 8% senior subordinated notes at a discount of \$0.3 million, or 8.5% of par value, partially offset by a \$0.1 million non-cash write-off of deferred debt issue costs.

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Income Tax (Benefit) Expense. We recorded an income tax expense of \$4.4 million for the six months ended April 2, 2010 and an income tax benefit of \$5.2 million for the six months ended April 3, 2009. Our estimated effective income tax rate for fiscal year 2010 is expected to be approximately 36%.

The six months ended April 3, 2009 included several significant discrete tax benefits: (1) \$5.1 million related to an outstanding audit by the Canada Revenue Agency (“CRA”), (2) \$0.7 million related to certain provisions of the California Budget Act of 2008, signed on February 20, 2009, which will allow a taxpayer to elect an alternative method to attribute taxable income to California for tax years beginning on or after January 1, 2011, and (3) \$0.9 million for adjustments to Canadian deferred tax accounts.

In December 2008, a new tax treaty protocol between Canada and the U.S. became effective. The new treaty requires mandatory arbitration for the resolution of double taxation disputes not settled through the competent authority process. As a result of this new treaty, our tax position on an outstanding audit by the CRA has become more favorable, and we reduced our tax contingency reserve in Canada by \$3.0 million, and established an income tax receivable and recognized an income tax benefit in the U.S. for \$2.8 million; this tax benefit was partially offset by a related increase in deferred tax liabilities of \$0.7 million.

The \$0.9 million adjustment to Canadian deferred tax accounts included a \$0.6 million tax benefit to reflect the reduction to Canadian corporate income tax rates, and a \$0.3 million tax benefit to correct the computation of certain deferred tax accounts. The \$0.6 million adjustment should have been recorded in the first quarter of fiscal year 2008 rather than in the three months ended April 3, 2009, and the \$0.3 adjustment million should have been recorded in several prior year’s financial results. These adjustments are deemed immaterial to our results of operations and financial condition for all affected periods.

Net Income. Net income was \$8.3 million, or 4.9% of sales, in the six months ended April 2, 2010 as compared to \$11.3 million, or 7.1% of sales, in the six months ended April 3, 2009. The decrease in net income in the six months ended April 2, 2010 as compared to the six months ended April 3, 2009 was primarily due to discrete income tax benefits that were recorded in the six months ended April 3, 2009. Excluding discrete income tax benefits that were recorded in the six months ended April 3, 2009, the higher net income in the six months ended April 2, 2010 was primarily due to higher shipment volume and the favorable impact of Canadian dollar hedges in the six months ended April 2, 2010, partially offset by unfavorable currency translation.

EBITDA. EBITDA was \$25.9 million, or 15.1% of sales, for the six months ended April 2, 2010 as compared to \$20.3 million, or 12.8% of sales, for the six months ended April 3, 2009. The \$5.6 million increase in EBITDA for the six months ended April 2, 2010 as compared to the corresponding period of fiscal year 2009 was due primarily to higher shipment volume and the favorable impact of Canadian dollar hedges in the six months ended April 2, 2010, partially offset by unfavorable currency translation.

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Liquidity and Capital Resources

Overview

Our liquidity is affected by many factors, some of which are based on normal ongoing operations of our business and others that are related to uncertainties in the markets in which we compete and other global economic factors. We have historically financed, and intend to continue to finance, our capital and working capital requirements including debt service and internal growth, through a combination of cash flows from our operations and borrowings under our senior credit facilities. Our primary uses of cash are cost of sales, operating expenses, debt service and capital expenditures.

We believe that we have the financial resources to meet our business requirements, including capital expenditures and working capital requirements, for the next 12 months.

Cash and Working Capital

The following summarizes our cash and cash equivalents and working capital (in millions):

| | April 2, 2010 | October 2, 2009 |
|---------------------------|------------------|-----------------------|
| Cash and cash equivalents | \$ 36.5 | \$ 26.2 |
| Working capital | \$ 107.8 | \$ 92.4 |

We invest cash balances in excess of operating requirements in overnight U.S. Government securities and money market accounts. In addition to the above cash and cash equivalents, we have restricted cash of \$1.0 million as of April 2, 2010, consisting primarily of bank guarantees from customer advance payments to our international subsidiaries. The bank guarantees become unrestricted cash when performance under the sales contract is complete.

The significant factors underlying the net increase in cash and cash equivalents during the six months ended April 2, 2010 were the net cash provided by our operating activities of \$11.5 million and proceeds and tax benefits of \$0.7 million from employee stock purchases and stock exercises, partially offset by capital expenditures of \$1.8 million.

As of April 2, 2010 and October 2, 2009, we had \$195.0 million in total principal amount of debt outstanding. As of April 2, 2010, we had borrowing availability of \$54.9 million under the revolver under our senior credit facilities.

As more fully described below, our most significant debt covenant compliance requirement is maintaining a secured leverage ratio of 3.75:1. Our current secured leverage ratio is approximately 0.50:1. Our senior credit facilities will mature in the fourth quarter of fiscal year 2011 unless we refinance our 8% senior subordinated notes due 2012 prior to July 31, 2011.

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Historical Operating, Investing and Financing Activities

In summary, our cash flows were as follows (in millions):

| | Six Months Ended | |
|--|------------------|------------------|
| | April 2, 2010 | April 3, 2009 |
| Net cash provided by operating activities | \$ 11.5 | \$ 7.9 |
| Net cash used in investing activities | (1.8) | (1.8) |
| Net cash provided by (used in) financing activities | 0.7 | (6.9) |
| Net increase (decrease) in cash and cash equivalents | \$ 10.4 | \$ (0.8) |

Operating Activities

During the six months ended April 2, 2010 and April 3, 2009, we funded our operating activities through cash generated internally. Cash provided by operating activities is net income adjusted for certain non-cash items and changes to working capital items.

Net cash provided by operating activities of \$11.5 million in the six months ended April 2, 2010 was attributable to net income of \$8.3 million, depreciation, amortization and other non-cash charges of \$8.4 million, partially offset by net cash used in working capital of \$5.2 million. The primary working capital uses of cash in the first two quarters of fiscal year 2010 were an increase in inventories and a decrease in income tax payable. The increase in inventories resulted primarily from increased inventory purchases to support increased orders and the higher sales level anticipated for the remaining quarters of fiscal year 2010. The decrease in income tax payable was primarily due to payments and lower taxable income for the second quarter of fiscal year 2010 as compared to that for the fourth quarter of fiscal year 2009. The aforementioned uses of working capital were partially offset by a decrease in accounts receivable due to the timing of billings and improved cash collections, an increase in accrued liabilities due to increased payroll and paid-time off accruals and an increase in accounts payable due to timing of payments of vendor invoices and the increase in inventory purchases.

Net cash provided by operating activities of \$7.9 million in the six months ended April 3, 2009 was attributable to net income of \$11.3 million, depreciation, amortization and other non-cash charges of \$5.9 million, partially offset by \$9.3 million net cash used for working capital. The primary working capital uses of cash in the six months ended April 3, 2009 were decreases in accrued expenses and income tax payable and an increase in inventories. The decrease in accrued expenses related primarily to the timing of payroll and employee vacations, combined with lower incentive compensation and timing of interest payments on debt. Income tax payable decreased primarily due to the reduction in our contingency reserve for a Canada tax assessment. Inventories increased due to selective increases of certain work-in-progress and finished goods to meet anticipated customer delivery requirements. These uses of cash were partially offset by a decrease in accounts receivable resulting primarily from decreased sales.

Investing Activities

Investing activities for the six months ended April 2, 2010 and April 3, 2009 comprised mainly \$1.8 million of capital expenditures.

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Financing Activities

Net cash provided by financing activities for the six months ended April 2, 2010 was attributable to \$0.4 million in proceeds from employee stock purchases and \$0.3 million in proceeds and tax benefit from employee stock option exercises.

Net cash used in financing activities for the six months ended April 3, 2009 consisted primarily of senior term loan repayment of \$4.75 million and senior subordinated notes repurchase of \$3.0 million partially offset by \$0.6 million in proceeds from employee stock purchases and \$0.3 million discount from the repurchase of our senior subordinated notes.

If the leverage ratio under our amended and restated senior credit facilities exceeds 3.5:1 at the end of any fiscal year, then we are required to make an annual prepayment within 90 days after the end of the fiscal year based on a calculation of excess cash flow, as defined in the senior credit facilities, multiplied by a factor of 50%, less any optional prepayments made during the fiscal year. There was no excess cash flow payment due for fiscal year 2009, and therefore, no excess cash flow payment was made in the six months ended April 2, 2010.

Contractual Obligations

The following table summarizes our significant contractual obligations as of April 2, 2010 and the effect that such obligations are expected to have on our liquidity and cash flows in future periods (in thousands):

| | Fiscal Year | | | | |
|------------------------------|-------------|--------------------------------------|----------------|----------------|------------|
| | Total | 2010 (remaining six months) | 2011 - 2012 | 2013 - 2014 | Thereafter |
| Operating leases | \$ 6,212 | \$ 942 | \$1,640 | \$997 | \$ 2,633 |
| Purchase commitments | 32,701 | 26,084 | 6,617 | - | - |
| Debt obligations | 195,000 | - | 183,000 | - | 12,000 |
| Interest on debt obligations | 24,373 | 6,751 | 15,932 | 1,452 | 238 |
| Uncertain tax positions | 2,736 | 2,736 | - | - | - |
| Total cash obligations | \$ 261,022 | \$ 36,513 | \$207,189 | \$2,449 | \$ 14,871 |
| Standby letters of credit | \$ 5,124 | \$ 5,124 | | | |

The amounts for debt obligations and interest on debt obligations assume (1) that the respective debt instruments will be outstanding until their scheduled maturity dates, except for the term loan under our senior credit facilities, which is assumed to mature on the earlier date of August 1, 2011 as prescribed in the senior credit facilities agreement, (2) that interest rates in effect on April 2, 2010 remain constant for future periods, and (3) a debt level based on mandatory repayments according to the contractual amortization schedule.

The expected timing of payment amounts of the obligations in the above table is estimated based on current information; timing of payments and actual amounts paid may be different.

As of April 2, 2010, there were no material changes to our other contractual obligations from what we disclosed in our Annual Report on Form 10-K for the fiscal year ended October 2, 2009. See also Note 6 of the accompanying unaudited condensed consolidated financial statements for details on certain of our commitments and contingencies.

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Capital Expenditures

Our continuing operations typically do not have large recurring capital expenditure requirements. Capital expenditures are generally made to replace existing assets, increase productivity, facilitate cost reductions or meet regulatory requirements. Total capital expenditures for the six months ended April 2, 2010 were \$1.8 million. Total capital expenditures for fiscal year 2010 are expected to be approximately \$4.0 to \$5.0 million.

Recent Accounting Pronouncements

See Note 2 to the accompanying unaudited condensed consolidated financial statements for information regarding the effect of new accounting pronouncements on our financial statements.

Critical Accounting Policies and Estimates

Our Critical Accounting Policies and Estimates have not changed from those reported in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Form 10-K for the fiscal year ended October 2, 2009.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We do not use market risk sensitive instruments for trading or speculative purposes.

Interest rate risk

Our exposure to market risk for changes in interest rates relates primarily to our long-term debt. As of April 2, 2010, we had fixed rate senior subordinated notes of \$117.0 million due in 2012, bearing interest at 8% per year, variable rate debt consisting of \$12.0 million floating rate senior notes due in 2015, and a \$66.0 million term loan under our senior credit facilities due in 2014. Our variable rate debt is subject to changes in the prime rate and the LIBOR rate.

We use derivative instruments from time to time in order to manage interest costs and risk associated with our long-term debt. In September 2007, we entered into an interest rate swap contract to receive three-month USD-LIBOR-BBA (British Bankers' Association) interest and pay 4.77% fixed rate interest. Net interest positions are settled quarterly. We have structured the swap with decreasing notional amounts such that it is less than the balance of the term loan. The notional value of the swap was \$40.0 million at April 2, 2010 and represented approximately 61% of the aggregate term loan balance. The swap agreement is effective through June 30, 2011. Under the provisions of Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 815, "Derivatives and Hedging," this arrangement was initially designated and qualified as an effective cash flow hedge of interest rate risk related to the term loan under our senior credit facilities which permitted recording the fair value of the swap and corresponding unrealized gain or loss to accumulated other comprehensive income in the condensed consolidated balance sheets. The interest rate swap gain or loss is included in the assessment of hedge effectiveness. At April 2, 2010, the fair value of the short-term and long-term portions of the swap was a liability of \$1.4 million (accrued expenses) and \$0.2 million (other long-term liabilities), respectively.

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We performed a sensitivity analysis to assess the potential loss in future earnings that a 10% increase in the variable portion of interest rates over a one-year period would have on our floating rate senior notes and term loan under our senior credit facilities. The impact was determined based on the hypothetical change from the end of period market rates over a period of one year and would result in an immaterial increase in future interest expense.

Foreign currency exchange risk

Although the majority of our revenue and expense activities are transacted in U.S. dollars, we do transact business in foreign countries. Our primary foreign currency cash flows are in Canada and several European countries. In an effort to reduce our foreign currency exposure to Canadian dollar denominated expenses, we enter into Canadian dollar forward contracts to hedge the Canadian dollar denominated costs for our manufacturing operation in Canada. Our Canadian dollar forward contracts are designated as a cash flow hedge and are considered highly effective, as defined by FASB ASC 815. The unrealized gains and losses from foreign exchange forward contracts are included in accumulated other comprehensive income in the consolidated balance sheets. If the transaction being hedged fails to occur, or if a portion of any derivative is ineffective, then we promptly recognize the gain or loss on the associated financial instrument in general and administrative in the condensed consolidated statements of income. The gain recognized in general and administrative due to hedge ineffectiveness was \$0.1 million for the three and six months ended April 2, 2010. No ineffective amounts were recognized due to hedge ineffectiveness for the three and six months ended April 3, 2009.

As of April 2, 2010, we had entered into Canadian dollar forward contracts for approximately \$25.9 million (Canadian dollars), or approximately 75% of our estimated Canadian dollar denominated expenses for April 2010 through December 2010, at an average rate of approximately \$0.88 U.S. dollar to Canadian dollar. We estimate the impact of a 1 cent change in the U.S. dollar to Canadian dollar exchange rate (without giving effect to our Canadian dollar forward contracts) to be approximately \$0.3 million annually to our net income or approximately 2 cents annually to basic and diluted earnings per common share.

At April 2, 2010, the fair value of foreign currency forward contracts was a short-term asset of \$2.8 million (prepaid and other current assets).

Item 4. Controls and Procedures

Management, including our principal executive officer and principal financial officer, has evaluated, as of the end of the period covered by this report, the effectiveness of the design and operation of our disclosure controls and procedures with respect to the information generated for use in this report. Based upon, and as of the date of that evaluation, the principal executive officer and principal financial officer concluded that the disclosure controls and procedures were effective to provide reasonable assurances that information required to be disclosed in the reports filed or submitted under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

There have been no changes in our internal control over financial reporting that occurred during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II: OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended October 2, 2009, except for the additional risk factor below.

On May 8, 2010, we entered into an Agreement and Plan of Merger with Comtech Telecommunications Corp. (“Comtech”) providing for Comtech to acquire the Company in a merger for a purchase price consisting of a mix of cash and Comtech common stock. The Company and its stockholders are exposed to several risks relating to the planned merger between the Company and Comtech, including the following: There have been no material changes to the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended October 2, 2009, except for the additional risk factor below.

- We and Comtech may be unable to obtain the regulatory approvals or satisfy other closing conditions required to complete the merger. Failure to complete the merger could negatively impact our stock price and our future business and financial results.
- Although we and Comtech expect that the merger will result in benefits to the combined company, the combined company may not realize those benefits because of various challenges.
- The price of Comtech common stock may decline, which would decrease the value of the total merger consideration to be received by our stockholders in the merger.
 - The merger agreement limits our ability to pursue alternatives to the merger.
- The merger agreement imposes customary restrictions on the conduct of our business outside of the ordinary course prior to the closing of the transaction or the termination of the merger agreement, which may also adversely affect our ability to manage our operations effectively in light of changes in economic or market conditions or to execute our business strategy and meet our financial goals.
- The pendency of the proposed merger, whether or not consummated, may result in a diversion of management’s attention from day-to-day operations, a loss of key personnel, and a disruption of our operations. The announcement and pendency of the proposed transaction may also affect our relationships with third parties.
- Under certain circumstances, we may be required under the merger agreement to pay Comtech a termination fee of up to \$15 million.
- Certain of our directors and executive officers have interests in the merger that may be different from, or in addition to, the interests of our stockholders.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

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Item 4. (Removed and Reserved)

Item 5. Other Information

Submission of Matters to a Vote of Security Holders. At an Annual Meeting of Stockholders held on February 23, 2010, the following proposals were presented for a vote of the stockholders of the Company:

Proposal No. 1: The election of the following two directors to serve for a three-year term ending at the 2013 Annual Meeting of Stockholders and until their respective successors are duly elected and qualified.

| Nominee | For Votes | Withheld Votes |
|-------------------|------------|----------------|
| Jeffrey P. Hughes | 13,474,329 | 2,161,866 |
| Stephen R. Larson | 15,621,984 | 14,211 |

The term of office for the following directors continued after the Annual Meeting: Michael Targoff, O. Joe Caldarelli, Michael F. Finley and William P. Rutledge.

Proposal No. 2: The ratification of the appointment of KPMG LLP as the Company's independent registered public accounting firm for fiscal year 2010.

| Votes | Shares |
|---------|------------|
| For | 15,972,150 |
| Against | 112,729 |
| Abstain | 1,689 |

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Item 6. Exhibits

| No. | Description |
|------|--|
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-15(e) and Rule 15d-15(e), promulgated under the Securities Exchange Act of 1934, as amended. |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-15(e) and Rule 15d-15(e), promulgated under the Securities Exchange Act of 1934, as amended. |
| 32.1 | Certifications of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certifications of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CPI INTERNATIONAL, INC.

Dated: May 12, 2010

/s/ JOEL A. LITTMAN
Joel A. Littman
Chief Financial Officer, Treasurer and Secretary
(Duly Authorized Officer and Chief Financial Officer)

