

HEXCEL CORP /DE/
Form 10-Q
November 07, 2007

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

x

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

For the Quarter Ended September 30, 2007

or

o

**Transition Report Pursuant to Section 13 or 15 (d) of the
Securities Exchange Act of 1934**

For the transition period from to

Commission File Number 1-8472

Hexcel Corporation

(Exact name of registrant as specified in its charter)

Delaware
(State of Incorporation)

94-1109521
(I.R.S. Employer Identification No.)

**Two Stamford Plaza
281 Tresser Boulevard
Stamford, Connecticut 06901-3238**
(Address of principal executive offices and zip code)

Registrant's telephone number, including area code: **(203) 969-0666**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes **x** No **o**

Edgar Filing: HEXCEL CORP /DE/ - Form 10-Q

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

Large Accelerated Filer ☒ Accelerated Filer ☐ Non-Accelerated Filer ☐

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

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

Class
COMMON STOCK

Outstanding at November 2, 2007
95,589,883

HEXCEL CORPORATION AND SUBSIDIARIES

INDEX

| | Page |
|---|-------------|
| <u>PART I.</u> | |
| <u>FINANCIAL INFORMATION</u> | |
| <u>ITEM 1.</u> | |
| <u>Condensed Consolidated Financial Statements (Unaudited)</u> | |
| <u>Condensed Consolidated Balance Sheets September 30, 2007 and December 31, 2006</u> | 2 |
| <u>Condensed Consolidated Statements of Operations The Quarters and Nine-Months Ended September 30, 2007 and 2006</u> | 3 |
| <u>Condensed Consolidated Statements of Cash Flows The Nine-Months Ended September 30, 2007 and 2006</u> | 4 |
| <u>Notes to Condensed Consolidated Financial Statements</u> | 5 |
| <u>ITEM 2.</u> | |
| <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 20 |
| <u>ITEM 3.</u> | |
| <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 29 |
| <u>ITEM 4.</u> | |
| <u>Controls and Procedures</u> | 31 |
| <u>PART II.</u> | |
| <u>OTHER INFORMATION</u> | |
| <u>ITEM 1.</u> | |
| <u>Legal Proceedings</u> | 32 |
| <u>ITEM 1A.</u> | |
| <u>Risk Factors</u> | 33 |
| <u>ITEM 2.</u> | |
| <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 33 |
| <u>ITEM 6.</u> | |
| <u>Exhibits and Reports on Form 8-K</u> | 34 |
| <u>SIGNATURE</u> | 35 |

PART I. FINANCIAL INFORMATION

ITEM 1. Condensed Consolidated Financial Statements (Unaudited)

Hexcel Corporation and Subsidiaries

Condensed Consolidated Balance Sheets

| | | (Unaudited) | |
|---|----|---------------|--------------|
| | | September 30, | December 31, |
| | | 2007 | 2006 |
| (In millions, except per share data) | | | |
| Assets | | | |
| Current assets: | | | |
| Cash and cash equivalents | \$ | 31.4 | \$ 25.7 |
| Accounts receivable, net | | 185.0 | 169.8 |
| Inventories, net | | 179.0 | 150.8 |
| Prepaid expenses and other current assets | | 39.1 | 35.4 |
| Assets of discontinued operations | | | 44.1 |
| Total current assets | | 434.5 | 425.8 |
| Property, plant and equipment | | 805.3 | 750.3 |
| Less accumulated depreciation | | (405.5) | (403.8) |
| Net property, plant and equipment | | 399.8 | 346.5 |
| Goodwill and intangible assets | | 59.3 | 58.5 |
| Investments in affiliated companies | | 16.6 | 11.1 |
| Deferred tax assets | | 94.1 | 103.0 |
| Other assets | | 16.0 | 22.3 |
| Assets of discontinued operations | | | 47.3 |
| Total assets | \$ | 1,020.3 | \$ 1,014.5 |
| Liabilities and Stockholders' Equity | | | |
| Current liabilities: | | | |
| Notes payable and current maturities of capital lease obligations | \$ | 1.8 | \$ 2.5 |
| Accounts payable | | 103.4 | 96.0 |
| Accrued liabilities | | 126.1 | 105.6 |
| Liabilities of discontinued operations | | | 15.2 |
| Total current liabilities | | 231.3 | 219.3 |
| Long-term notes payable and capital lease obligations | | 322.8 | 409.8 |
| Other non-current liabilities | | 81.9 | 80.8 |
| Liabilities of discontinued operations | | | 3.0 |
| Total liabilities | | 636.0 | 712.9 |
| Stockholders' equity: | | | |
| Preferred stock, no par value, 20.0 shares authorized, no shares issued or outstanding | | | |
| Common stock, \$0.01 par value, 200.0 shares authorized, 97.0 shares issued at September 30, 2007 and 95.5 shares issued at December 31, 2006 | | 1.0 | 1.0 |
| Additional paid-in capital | | 506.8 | 479.3 |
| Accumulated deficit | | (109.2) | (157.1) |
| Accumulated other comprehensive income (loss) | | 7.5 | (1.8) |
| | | 406.1 | 321.4 |

Edgar Filing: HEXCEL CORP /DE/ - Form 10-Q

Less Treasury stock, at cost, 1.8 shares at September 30, 2007 and 1.7 shares at December 31,

| | | |
|--|------------|------------|
| 2006 | (21.8) | (19.8) |
| Total stockholders' equity | 384.3 | 301.6 |
| Total liabilities and stockholders' equity | \$ 1,020.3 | \$ 1,014.5 |

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

Hexcel Corporation and Subsidiaries
Condensed Consolidated Statements of Operations

| (In millions, except per share data) | (Unaudited) | | | |
|---|-----------------------------|----------|---------------------------------|----------|
| | Quarter Ended September 30, | | Nine Months Ended September 30, | |
| | 2007 | 2006 | 2007 | 2006 |
| Net sales | \$ 281.1 | \$ 252.3 | \$ 853.4 | \$ 786.6 |
| Cost of sales | 214.2 | 195.0 | 644.6 | 597.2 |
| Gross margin | 66.9 | 57.3 | 208.8 | 189.4 |
| Selling, general and administrative expenses | 26.4 | 26.1 | 84.8 | 80.1 |
| Research and technology expenses | 7.7 | 6.8 | 25.7 | 21.7 |
| Business consolidation and restructuring expenses | 2.6 | 0.5 | 4.1 | 1.7 |
| Operating income | 30.2 | 23.9 | 94.2 | 85.9 |
| Interest expense, net | 5.3 | 5.7 | 16.9 | 18.5 |
| Non-operating expense | 0.5 | | 1.0 | |
| Income from continuing operations before income taxes, equity in earnings and discontinued operations | 24.4 | 18.2 | 76.3 | 67.4 |
| Provision for income taxes | 7.2 | 4.0 | 29.1 | 23.4 |
| Income from continuing operations before equity in earnings and discontinued operations | 17.2 | 14.2 | 47.2 | 44.0 |
| Equity in earnings of affiliated companies, net of tax | 0.9 | 1.0 | 3.2 | 3.2 |
| Net income from continuing operations | 18.1 | 15.2 | 50.4 | 47.2 |
| Income (loss) from discontinued operations, net of tax | 1.6 | 0.5 | (5.3) | 0.6 |
| Gain (loss) on sale of discontinued operations, net of tax | (2.4) | | 4.4 | |
| Net income | \$ 17.3 | \$ 15.7 | \$ 49.5 | \$ 47.8 |
| Basic net income (loss) per common share: | | | | |
| Continuing operations | \$ 0.19 | \$ 0.16 | \$ 0.53 | \$ 0.50 |
| Discontinued operations | (0.01) | 0.01 | (0.01) | 0.01 |
| Net income | \$ 0.18 | \$ 0.17 | \$ 0.52 | \$ 0.51 |
| Diluted net income (loss) per common share: | | | | |
| Continuing operations | \$ 0.19 | \$ 0.16 | \$ 0.52 | \$ 0.50 |
| Discontinued operations | (0.01) | | (0.01) | |
| Net income | \$ 0.18 | \$ 0.16 | \$ 0.51 | \$ 0.50 |
| Weighted average common shares outstanding: | | | | |
| Basic | 94.9 | 93.7 | 94.4 | 93.3 |
| Diluted | 96.7 | 95.2 | 96.2 | 95.4 |

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

Hexcel Corporation and Subsidiaries

Condensed Consolidated Statements of Cash Flows

| (In millions) | (Unaudited) Nine Months Ended September 30, | |
|---|--|---------|
| | 2007 | 2006 |
| Cash flows from operating activities | | |
| Net income | \$ 49.5 | \$ 47.8 |
| Income (loss) from discontinued operations, net of tax | (0.9) | 0.6 |
| Net income from continuing operations | 50.4 | 47.2 |
| Reconciliation to net cash provided by operating activities: | | |
| Depreciation and amortization | 29.8 | 27.5 |
| Amortization of debt discount and deferred financing costs | 1.4 | 1.3 |
| Deferred income taxes | 20.5 | 12.9 |
| Business consolidation and restructuring expenses | 4.1 | 1.7 |
| Business consolidation and restructuring payments | (11.2) | (2.3) |
| Equity in earnings of affiliated companies | (3.2) | (3.2) |
| Dividends from affiliated companies | | 1.3 |
| Stock-based compensation | 8.1 | 6.9 |
| Excess tax benefits on stock-based compensation | (6.3) | (6.2) |
| Accelerated amortization of deferred financing costs | 1.0 | |
| Changes in assets and liabilities: | | |
| Increase in accounts receivable | (7.2) | (20.0) |
| Increase in inventories | (22.3) | (9.4) |
| Increase in prepaid expenses and other current assets | (1.3) | (0.5) |
| Decrease in accounts payable and accrued liabilities | (8.4) | (10.7) |
| Other net | 2.1 | 4.4 |
| Net cash provided by operating activities | 57.5 | 50.9 |
| Cash flows from investing activities | | |
| Capital expenditures and deposits for property purchases, net | (71.5) | (81.8) |
| Net proceeds from sale of discontinued operations | 84.0 | |
| Investment in affiliated companies | (2.0) | |
| Net cash provided by (used for) investing activities | 10.5 | (81.8) |
| Cash flows from financing activities | | |
| Proceeds from senior secured credit facility revolver, net | | 11.5 |
| Repayments of senior secured credit facility term B loan | (87.9) | (0.9) |
| Repayments on capital lease obligations and other debt, net | (0.1) | 0.9 |
| Activity under stock plans, including excess tax benefits on stock-based compensation | 17.1 | 10.7 |
| Net cash (used for) provided by financing activities | (70.9) | 22.2 |
| Net cash provided by operating activities, discontinued operations | 7.9 | 1.5 |
| Net cash used for investing activities, discontinued operations | (1.8) | (0.5) |
| Effect of exchange rate changes on cash and cash equivalents | 2.5 | (0.4) |
| Net increase (decrease) in cash and cash equivalents | 5.7 | (8.0) |
| Cash and cash equivalents at beginning of period | 25.7 | 21.0 |
| Cash and cash equivalents at end of period | \$ 31.4 | \$ 13.0 |

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

HEXCEL CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1 Significant Accounting Policies

In these notes, the terms Hexcel , we, us, or our mean Hexcel Corporation and subsidiary companies.

The accompanying condensed consolidated financial statements represent the consolidation of Hexcel. Refer to Note 1 to the consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2006 for a discussion of our significant accounting policies. The significant accounting policies included below are provided as a clarification to Note 1 to the consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2006.

Revenue Recognition

Product sales are recognized when all significant contractual obligations have been satisfied and collection of the resulting receivable is reasonably assured, which is generally at the time of shipment. Revenue is recognized on bill and hold arrangements only when the following criteria are met: risk of ownership has passed to the buyer, a fixed written commitment has been provided by the buyer, the goods are complete and ready for shipment and segregated from inventory, no performance obligations remain and a schedule for delivery of the goods has been established. Revenues derived from design, installation and support services are recognized when the service is provided. We accrue for sales returns and allowances based on its historical experience at the time of sale.

Property, Plant and Equipment

Property, plant and equipment, including capitalized interest applicable to major project expenditures, are recorded at cost. Asset and accumulated depreciation accounts are relieved for dispositions, with resulting gains or losses reflected in earnings. Depreciation of plant and equipment is provided using the straight-line method over the estimated useful lives of the various assets. The estimated useful lives range from 10 to 40 years for buildings and improvements and from 3 to 20 years for machinery and equipment. Repairs and maintenance are expensed as incurred, while major replacements and betterments are capitalized and depreciated over the remaining useful life of the related asset.

Basis of Presentation

Edgar Filing: HEXCEL CORP /DE/ - Form 10-Q

The accompanying condensed consolidated financial statements have been prepared from the unaudited records of Hexcel pursuant to rules and regulations of the Securities and Exchange Commission (SEC) and in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information. Certain information and footnote disclosures normally included in financial statements have been omitted pursuant to rules and regulations of the SEC.

In the opinion of management, the condensed consolidated financial statements include all normal recurring adjustments necessary for a fair presentation of financial position, results of operations and cash flows for the interim periods presented. The condensed consolidated balance sheet as of December 31, 2006 was derived from the audited 2006 consolidated balance sheet. Interim results are not necessarily indicative of results expected for any other interim period or for the full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis and the financial statements and notes thereto included in the Hexcel Corporation's 2006 Annual Report on Form 10-K.

Certain prior period amounts in the condensed consolidated financial statements and accompanying notes have been reclassified to conform to the 2007 presentation.

New Accounting Standards

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* including an amendment of FASB Statement No. 115 (*FAS 159*). FAS 159 permits an entity to measure certain financial assets and financial liabilities at fair value. The Statement's objective is to improve financial reporting by allowing entities to mitigate volatility in reported earnings caused by the measurement of related assets and liabilities using different attributes, without having to apply complex hedge accounting provisions. Entities that elect the fair value option will report unrealized gains and losses in earnings at each subsequent reporting date. The new Statement establishes presentation and disclosure requirements to help financial statement users understand the effect of the entity's election on its earnings, but does not eliminate disclosure requirements of other accounting standards. FAS 159 is effective for fiscal years beginning after November 15, 2007 (as of January 1, 2008 for calendar year companies). We are currently in the process of evaluating the effects of the adoption of FAS 159 on our consolidated results of operations, cash flows, and financial position.

In September 2006, the FASB finalized Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (*FAS 157*), which will become effective in 2008. This Statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements; however, it does not require any new fair value measurements. The provisions of FAS 157 will be applied prospectively to fair value measurements and disclosures in our condensed consolidated financial statements beginning in the first quarter of 2008. We are currently evaluating the impact of FAS 157 on our results of operations, cash flows, and financial position.

Note 2 Discontinued Operations

EBGI

Edgar Filing: HEXCEL CORP /DE/ - Form 10-Q

On August 6, 2007, we completed the sale of the U.S. electronics, ballistics and general industrial product lines (EBGI) portion of our reinforcements business. Net cash proceeds from the sale were \$58.5 million (after related expenses), resulting in a net after-tax loss of \$2.1 million. Included within the loss on sale is an after-tax curtailment gain of \$1.1 million, representing the unrecognized prior service cost on the EBGI Postretirement Health Care Plan as of August 6, 2007. The sale of EBGI included the sale of the design, manufacturing, and selling activities and the related property, plant and equipment and working capital. The sale includes up to \$12.5 million of additional payments contingent upon future sales of the Ballistics product line. Any additional payments will be recorded as income when earned. In accordance with the provisions of FAS 144, the EBGI business, including the net after-tax loss on sale, has been reported as a discontinued operation in our accompanying condensed consolidated financial statements.

Edgar Filing: HEXCEL CORP /DE/ - Form 10-Q

Revenues associated with the EBGI business were \$16.8 million and \$108.7 million for the quarter and nine-months ended September 30, 2007, respectively, and were \$30.9 million and \$107.3 million for the quarter and nine-months ended September 30, 2006, respectively. During the second quarter of 2007, Hexcel established a pre-tax reserve of \$15 million (\$9.7 million after-tax) relating to the previously disclosed investigation by the U.S. Department of Justice into the use of allegedly defective Zylon fiber in ballistic vests purchased under U.S. government funded programs. On October 29, 2007 we entered into a settlement agreement for the reserved amount of \$15 million, which we paid on November 5, 2007. Pre-tax loss associated with the discontinued operation was \$2.5 million and \$13.3 million (including a pre-tax loss on the sale of the business of \$3.3 million) for the quarter and nine-months ended September 30, 2007, and break-even and \$1.6 million for the quarter and nine-months ended September 30, 2006, respectively.

Edgar Filing: HEXCEL CORP /DE/ - Form 10-Q

The following is a summary of the EBGi net assets sold as initially determined at December 31, 2006 and finally reported on the closing date of August 6, 2007:

Edgar Filing: HEXCEL CORP /DE/ - Form 10-Q

| (In millions) | August 6, 2007 | December 31, 2006 |
|---|---------------------------|------------------------------|
| Accounts receivable, net | \$ 13.8 | \$ 11.7 |
| Inventories, net | 19.9 | 20.6 |
| Prepaid expenses and other current assets | | 1.3 |
| Net property, plant and equipment | 22.9 | 23.9 |
| Goodwill | 17.3 | 17.5 |
| Total assets | 73.9 | 75.0 |
| Accounts payable | 9.7 | 8.0 |
| Other accrued liabilities | 1.9 | 1.0 |
| Other non-current liabilities | | 1.6 |
| Total liabilities | 11.6 | 10.6 |
| Net assets of discontinued operations | \$ 62.3 | \$ 64.4 |

Architectural Business

On February 28, 2007, we completed the sale of our European Architectural business. The Architectural business sold included the design, manufacturing and selling activities and the related property, plant and equipment and working capital. Net cash proceeds from the sale were \$25.0 million, resulting in a net after-tax gain of \$6.5 million, including a loss of \$0.3 recorded in the third quarter of 2007. In accordance with the provisions of FAS 144, the operations of the Architectural business, including the net after-tax gain on the sale, has been reported as a discontinued operation in our accompanying condensed consolidated financial statements.

Revenues associated with the Architectural business were \$4.4 million for the quarter ended March 31, 2007 and \$6.0 million and \$18.2 million for the quarter and nine-months ended September 30, 2006, respectively. Pre-tax income associated with the

discontinued operation was \$10.8 million (including a pre-tax gain on the sale of the business of \$10.5 million) for the nine-months ended September 30, 2007 and \$0.8 million and \$2.4 million for the quarter and nine-months ended September 30, 2006, respectively.

The following is a summary of the net assets sold relating to the Architectural business as initially determined at December 31, 2006 and finally reported on the closing date of February 28, 2007:

| (In millions) | February 28, 2007 | December 31, 2006 |
|---|----------------------|----------------------|
| Cash and cash equivalents | \$ 1.0 | \$ 3.9 |
| Accounts receivable, net | 5.1 | 6.2 |
| Inventories, net | 6.7 | 0.4 |
| Prepaid expenses and other current assets | 0.1 | 5.4 |
| Net property, plant and equipment | 5.7 | 0.3 |
| Goodwill | 0.2 | 0.2 |
| Deferred tax assets | | |
| Total assets | 18.8 | 16.4 |
| Accounts payable | 4.3 | 4.3 |
| Other accrued liabilities | 1.4 | 1.9 |
| Other non-current liabilities | 0.6 | 1.4 |
| Total liabilities | 6.3 | 7.6 |
| Net assets of discontinued operations | \$ 12.5 | \$ 8.8 |

Note 3 Stock-Based Compensation

Stock-based compensation expense was \$1.4 million and \$1.6 million for the quarters ended September 30, 2007 and 2006, respectively. Stock-based compensation expense was \$8.1 million and \$6.9 million for the nine-months ended September 30, 2007 and 2006, respectively. Stock-based compensation expense capitalized for the quarters and nine-months ended September 30, 2007 and 2006 was not material. During the nine-month periods ended September 30, 2007 and 2006, cash received from stock option exercises and employee stock purchases was \$12.6 million and \$7.6 million, respectively. We used \$1.8 million and \$3.3 million in cash related to the shares withheld to satisfy employee tax obligations for restricted stock units (RSUs) and performance accelerated restricted stock units (PARs) converted during the nine-month period ended September 30, 2007 and 2006, respectively. We realized excess tax benefits of \$6.3 million and \$6.2 million in connection with stock options exercised, and RSUs and PARs converted during the nine-month period ended September 30, 2007 and 2006, respectively.

Restricted Stock Units

The following activity occurred with respect to our outstanding restricted stock units and performance restricted stock units during the quarter and nine-months ended September 30, 2007:

| (In millions, except share data) | Number of Units | Weighted Avg. Grant Date |
|----------------------------------|--------------------|-----------------------------|
|----------------------------------|--------------------|-----------------------------|

| | Fair Value per Unit | |
|---|---------------------|-------|
| Restricted Stock Units: | | |
| Nonvested balance at December 31, 2006 | 0.3 \$ | 16.73 |
| Granted | 0.2 \$ | 18.71 |
| Vested | (0.1) \$ | 13.79 |
| Forfeited | | |
| Nonvested balance at June 30, 2007 | 0.4 \$ | 18.20 |
| Granted | | |
| Vested | | |
| Forfeited | | |
| Nonvested balance at September 30, 2007 | 0.4 \$ | 18.33 |

| (In millions, except share data) | Number of Units | Weighted Avg. Grant Date Fair Value per Unit |
|--|--------------------|--|
| Performance Restricted Stock Units (PRSUs): | | |
| Nonvested balance at December 31, 2006 | 0.1 | \$ 21.97 |
| Granted | 0.1 | \$ 18.17 |
| Vested | | |
| Forfeited | | |
| Nonvested balance at June 30, 2007 | 0.2 | \$ 19.35 |
| Granted | | |
| Vested | | |
| Forfeited | | |
| Nonvested balance at September 30, 2007 | 0.2 | \$ 19.32 |

As of September 30, 2007, there was total unrecognized compensation cost related to nonvested RSUs and PRSUs of \$5.7 million, which is expected to be recognized generally over the remaining vesting period ranging from one year to three years.

Stock Options

A summary of nonqualified stock option activity under our stock compensation plan for the nine-month period ended September 30, 2007 is as follows:

| (In millions, except share data) | Number of Options | Weighted- Average Exercise Price | Weighted-Average Remaining Contractual Life (in years) | Aggregate Intrinsic Value |
|-----------------------------------|----------------------|--|---|------------------------------|
| Outstanding at December 31, 2006 | 5.2 | \$ 9.40 | 5.15 | \$ 41.3 |
| Options granted | 0.4 | \$ 18.37 | | |
| Options exercised | (1.3) | \$ 9.38 | | |
| Options expired or forfeited | (0.1) | \$ 18.27 | | |
| Outstanding at September 30, 2007 | 4.2 | \$ 10.14 | 5.07 | \$ 52.7 |
| Exercisable at September 30, 2007 | 3.4 | \$ 8.31 | | \$ 48.5 |

The total intrinsic value of options exercised during the quarter and nine-month period ended September 30, 2007 was \$9.5 million and \$17.7 million, respectively. As of September 30, 2007, there was total unrecognized compensation cost related to nonvested stock options of \$3.0 million, which is expected to be recognized generally over the remaining vesting period ranging from one year to three years.

Valuation Assumptions in Estimating Fair Value

We estimated the fair value of stock options at the grant date using the Black Scholes option pricing model with the following assumptions:

Nine-Months Ended September 30,

Edgar Filing: HEXCEL CORP /DE/ - Form 10-Q

| | 2007 | 2006 |
|--|---------|----------|
| Risk-free interest rate | 4.84% | 4.50% |
| Expected option life (in years) Executive | 5.97 | 5.90 |
| Expected option life (in years) Non-Executive | 5.24 | 5.43 |
| Dividend yield | % | % |
| Volatility | 40.94% | 46.44% |
| Weighted-average fair value per option granted | \$ 8.41 | \$ 10.87 |

Retirement Provisions

Employees who terminate employment other than for cause (as defined in the relevant employee option agreement), and who meet the definition of retirement in the relevant employee option agreement (age 65 or age 55 with 5 or more years of service with the Company), will continue to have their options vest in accordance with the vesting schedule set in the option agreement. Similar retirement provisions also apply to RSUs and PRSUs. RSUs are deemed to be vested when an employee reaches their defined retirement age. PRSUs differ from RSUs as an employee who is retirement eligible is only entitled to a pro-rata portion of their shares based on the portion of the performance period elapsed prior to retirement; however, if employed at the end of the performance period they are entitled to the entire grant. As a result of these provisions, under the terms of SFAS 123(R), we have accelerated the recognition of the compensation expense for any employee who received a grant in 2007, or 2006 and who met the above definition

of retirement eligibility, or who will meet the definition during the vesting period. This results in the majority of stock-based compensation expense being recognized in the quarter which the grant occurs.

Shares Authorized for Grant

As of September 30, 2007, an aggregate of 3.4 million shares were authorized for future grant under our stock plan, which covers stock options, RSUs, PRSUs and PARS.

Employee Stock Purchase Plan (ESPP)

In addition, we maintain an ESPP, under which eligible employees may contribute up to 10% of their base earnings toward the quarterly purchase of our common stock at a purchase price equal to 85% of the fair market value of the common stock on the purchase date. As of September 30, 2007, the number of shares of common stock reserved for future issuances under the ESPP was 0.2 million.

Note 4 Inventories, net

| (In millions) | September 30, 2007 | | December 31, 2006 | |
|------------------------|-----------------------|-------|----------------------|-------|
| Raw materials | \$ | 79.3 | \$ | 72.3 |
| Work in progress | | 44.4 | | 36.8 |
| Finished goods | | 55.3 | | 41.7 |
| Total inventories, net | \$ | 179.0 | \$ | 150.8 |

Note 5 Retirement and Other Postretirement Benefit Plans

We maintain qualified and nonqualified defined benefit retirement plans covering certain current and former U.S. and European employees, retirement savings plans covering eligible U.S. employees and certain postretirement health care and life insurance benefit plans covering eligible U.S. retirees. We also participate in a union sponsored multi-employer pension plan covering certain U.S. employees with union affiliations. In December 2006, our Board of Directors voted to terminate the U.S. qualified defined benefit plan as of April 1, 2007, subject to appropriate regulatory approval. As final termination of the U.S. qualified plan is expected to occur in the next twelve months, we have classified all liabilities of the plan as current. Refer to our 2006 Annual Report on Form 10-K for further information regarding these plans.

-

Defined Benefit Retirement Plans

Net Periodic Benefit Costs

Edgar Filing: HEXCEL CORP /DE/ - Form 10-Q

Net periodic benefit costs of our defined benefit retirement plans for the quarters and nine-months ended September 30, 2007 and 2006 were as follows:

| (In millions) | Quarter Ended September 30, | | Nine Months Ended September 30, | |
|--|-----------------------------|--------|---------------------------------|--------|
| | 2007 | 2006 | 2007 | 2006 |
| <i>U.S. Defined Benefit Retirement Plans</i> | | | | |
| Service cost | \$ 0.3 | \$ 0.3 | \$ 0.8 | \$ 0.9 |
| Interest cost | 0.5 | 0.5 | 1.5 | 1.5 |
| Expected return on plan assets | (0.2) | (0.3) | (0.6) | (0.9) |
| Net amortization and deferral | 0.4 | 0.3 | 1.2 | 0.9 |
| Sub-total | 1.0 | 0.8 | 2.9 | 2.4 |
| Curtailment and settlement loss | 0.4 | 0.2 | 1.2 | 0.7 |
| Net periodic benefit cost | \$ 1.4 | \$ 1.0 | \$ 4.1 | \$ 3.1 |
| <i>European Defined Benefit Retirement Plans</i> | | | | |
| Service cost | \$ 1.0 | \$ 0.9 | \$ 2.8 | \$ 2.6 |
| Interest cost | 1.7 | 1.4 | 5.1 | 4.2 |
| Expected return on plan assets | (1.9) | (1.6) | (5.7) | (4.6) |
| Net amortization and deferral | 0.2 | 0.3 | 0.6 | 0.7 |
| Sub-total | 1.0 | 1.0 | 2.8 | 2.9 |
| Curtailment and settlement loss | | | | |
| Net periodic benefit cost | \$ 1.0 | \$ 1.0 | \$ 2.8 | \$ 2.9 |

Contributions

We contributed \$0.7 million and \$0.2 million to our U.S. qualified and nonqualified defined benefit retirement plans during the third quarters of 2007 and 2006, respectively. Contributions were \$2.7 million and \$1.9 million for the nine-months ended September 30, 2007 and 2006, respectively. We expect to contribute at the minimum funding amount required in 2007, fund lump-sum payments and possibly fund the entire plan obligation by December 31, 2007, if the U.S. qualified plan's termination is approved by the appropriate regulatory authorities during 2007. Absent final plan termination in 2007, we plan to contribute approximately \$3 million during 2007 to our U.S. qualified pension plan to fund expected lump sum payments. Upon final termination of the U.S. qualified plan, we estimate that the final cash settlement contribution will be in the range of \$10 million to \$11 million and that we will record a pre-tax loss of approximately \$12 million related to the unrecognized actuarial loss. The termination will also result in the Company reducing its net periodic benefit cost by approximately \$2 million per year.

We generally fund our U.S. nonqualified defined benefit retirement plans when benefit payments are incurred. Under the provisions of these non-qualified plans, we expect to contribute \$0.3 million in 2007 to cover unfunded benefits. We contributed \$2.6 million to our U.S. defined benefits retirement plans during the 2006 fiscal year. Accrued benefit costs for the U.S. defined benefit retirement plans as of September 30, 2007 were \$21.9 million, of which \$9.3 million is included within accrued liabilities and \$12.6 million is included within other non-current liabilities. Accrued benefit costs for the U.S. defined benefit retirement plans as of December 31, 2006 were \$22.9 million, of which \$0.3 million is included within accrued liabilities and \$22.6 million is included within other non-current liabilities.

In addition, we contributed \$0.7 million and \$0.9 million to our European defined benefit retirement plans in the third quarters of 2007 and 2006, respectively. Total contributions were \$2.1 million and \$2.6 million for the nine-months ended September 30, 2007 and 2006, respectively. Meeting governing requirements, we plan to contribute approximately \$2.6 million during 2007 to our European plans. We contributed \$2.6 million to our European plans during the 2006 fiscal year. Accrued benefit costs for the European defined benefit retirement plans as of September 30, 2007 were \$38.3 million, of which \$1.2 million is included within accrued liabilities and \$37.1 million is included within other non-current liabilities. Accrued benefit costs for the European defined benefit retirement plans as of December 31, 2006 were \$37.6 million, of which \$0.6 million is included within accrued liabilities and \$37.0 million is included within other non-current liabilities.

Postretirement Health Care and Life Insurance Benefit Plans

-

Net Periodic Postretirement Benefit Costs

Net periodic benefit costs of our postretirement health care and life insurance benefit plans were \$0.1 million, consisting of interest costs for the third quarter of 2007. For both the nine-month periods ended September 30, 2007 and 2006, net periodic postretirement benefit costs were \$0.4 million.

Contributions

In connection with our postretirement plans, we contributed \$0.1 million and \$0.3 million during the third quarters of 2007 and 2006, respectively, and \$0.7 million and \$0.8 million during the nine-months ended September 30, 2007 and 2006, respectively. We periodically fund

Edgar Filing: HEXCEL CORP /DE/ - Form 10-Q

our postretirement plans to pay covered expenses as they are incurred. Under the provisions of these post retirement plans, we expect to contribute approximately \$1.0 million in 2007 to cover unfunded benefits. We contributed \$1.0 million to our postretirement plans during the 2006 fiscal year. Accrued benefit costs for the postretirement plans as of September 30, 2007 were \$12.4 million, of which \$0.6 million is included within accrued liabilities and \$11.8 million is included within other non-current liabilities. Accrued benefit costs for the postretirement plans as of December 31, 2006 were \$11.5 million, of which \$0.6 million is included within accrued liabilities and \$10.9 million is included within other non-current liabilities.

Note 6 - Business Consolidation and Restructuring Programs

The aggregate business consolidation and restructuring liabilities as of September 30, 2007 and December 31, 2006, and activity for the quarter and nine-months ended September 30, 2007, consisted of the following:

| (In millions) | Employee Severance | Facility & Equipment | Total |
|---|-----------------------|-------------------------|---------------|
| Balance as of December 31, 2006 | \$ 10.7 | \$ 0.3 | \$ 11.0 |
| Business consolidation and restructuring expenses: | | | |
| Current period expenses | 0.8 | 1.6 | 2.4 |
| Change in estimated expenses | (0.8) | | (0.8) |
| Net business consolidation and restructuring expenses | | 1.6 | 1.6 |
| Cash expenditures | (6.9) | (1.7) | (8.6) |
| Currency translation adjustments | 0.1 | | 0.1 |
| Balance as of June 30, 2007 | \$ 3.9 | \$ 0.2 | \$ 4.1 |
| Business consolidation and restructuring expenses | 0.9 | 1.7 | 2.6 |
| Cash expenditures | (1.0) | (1.6) | (2.6) |
| Currency translation adjustments | 0.1 | | 0.1 |
| Balance as of September 30, 2007 | \$ 3.9 | \$ 0.3 | \$ 4.2 |

December 2006 Program

In December 2006, we announced that an organizational realignment process had begun to reorganize ourselves into a single business as well as address stranded costs resulting from divestitures associated with our portfolio realignment. In connection with this action, we incurred severance and relocation expenses. We expect this program will be substantially completed by December 31, 2007.

Business consolidation and restructuring liabilities as of September 30, 2007 and December 31, 2006, and activity for the December 2006 program for the quarter and nine-months ended September 30, 2007, consisted of the following:

| (In millions) | Employee Severance | Facility & Equipment | Total |
|---|-----------------------|-------------------------|--------|
| Balance as of December 31, 2006 | \$ 7.0 | \$ | \$ 7.0 |
| Business consolidation and restructuring expenses | | | |
| Current period expenses | 0.9 | | 0.9 |
| Change in estimated expenses | (0.3) | | (0.3) |
| Net business consolidation and restructuring expenses | 0.6 | | 0.6 |
| Cash expenditures | (5.3) | | (5.3) |
| Currency translation adjustments | 0.1 | | 0.1 |
| Balance as of June 30, 2007 | \$ 2.4 | \$ | \$ 2.4 |
| Business consolidation and restructuring expenses | 0.9 | | 0.9 |
| Cash expenditures | (0.8) | | (0.8) |
| Currency translation adjustments | 0.1 | | 0.1 |
| Balance as of September 30, 2007 | 2.6 | | 2.6 |

Livermore Program

In the first quarter of 2004, we announced our intent to consolidate the activities of our Livermore, California facility into other facilities, principally the Salt Lake City, Utah plant. During the quarter and nine-months ended September 30, 2007, we recognized \$1.4 million and \$2.9 million of expense, respectively, associated with the facility closures and consolidation activities that were expensed as incurred. During the quarter and nine-months ended September 30, 2007, we made cash payments of \$1.5 and \$4.3 million, respectively, related to employee severance and facility closures and consolidation activities. The plant ceased operations on March 31, 2007. The Livermore facility has now been dismantled and the site is being remediated as part of the preparation for the sale of the property, with the related costs being expensed as incurred. As of September 30, 2007, the accrued balance related to this program of \$0.4 million is for severance obligations and is adequate for the estimated future requirements related to the program.

November 2001 Program

In November 2001, we announced a program to restructure business operations as a result of reductions in commercial aircraft production rates and due to depressed business conditions in the electronics market. There was minimal activity in the program during the quarter and the year as this program is substantially complete. During the nine-months ended September 30, 2007, we made cash payments of \$0.2 million, related to employee severance and lease obligations. We also reduced our estimate of future severance obligations under the program by \$0.5 million for the nine-months ended September 30, 2007. As of September 30, 2007, the accrued balances related to this program are for future severance obligations of \$0.9 million and lease payments of \$0.3 million that will continue into 2009 and are adequate for the estimated future

requirements related to the program.

Note 7 - Notes Payable and Capital Lease Obligations

| (In millions) | September 30, 2007 | December 31, 2006 |
|--|-------------------------------|------------------------------|
| Senior secured credit facility - revolver due 2010 | \$ | \$ |
| Senior secured credit facility - term B loan due 2012 | 95.7 | 183.6 |
| European credit and overdraft facilities | 0.5 | 0.3 |
| 6.75% senior subordinated notes due 2015 | 225.0 | 225.0 |
| Total notes payable | 321.2 | 408.9 |
| Capital lease obligations | 3.4 | 3.4 |
| Total notes payable and capital lease obligations | \$ 324.6 | \$ 412.3 |
| Notes payable and current maturities of long-term liabilities | \$ 1.8 | \$ 2.5 |
| Long-term notes payable and capital lease obligations, less current maturities | 322.8 | 409.8 |
| Total notes payable and capital lease obligations | \$ 324.6 | \$ 412.3 |

Senior Secured Credit Facility

Term loan borrowings under the Senior Secured Credit Facility bear interest at a floating rate based on the agent's defined prime rate plus a margin that can vary from 0.50% to 0.75% or LIBOR plus a margin that can vary from 1.50% to 1.75%, while revolving loan borrowings under the Senior Secured Credit Facility bear interest at a floating rate based on either the agent's defined prime rate plus a margin that can vary from 0.25% to 1.00%, or LIBOR plus a margin that can vary from 1.25% to 2.00%. The margin in effect for a borrowing at any given time depends on our consolidated leverage ratio. The weighted average interest rate for the actual borrowings on the Senior Secured Credit Facility was 7.11% and 7.08% for the quarter and nine-months ended September 30, 2007, respectively. Borrowings made under the LIBOR option during the nine-months ended September 30, 2007 were made at interest rates ranging from 6.81% to 7.31%.

The Senior Secured Credit Facility was entered into by and among Hexcel Corporation and certain lenders. In connection with the Senior Secured Credit Facility, two of our U.S. subsidiaries, Clark-Schwebel Holding Corp. and Hexcel Reinforcements Corp. (the Guarantors), entered into a Subsidiary Guaranty under which they guaranteed the obligations of Hexcel Corporation under the Senior Secured Credit Facility. In addition, Hexcel Corporation and the Guarantors entered into a Security Agreement in which Hexcel Corporation and the Guarantors pledged certain assets as security for the Senior Secured Credit Facility. The assets pledged include, among other things, the receivables, inventory, property, plant and equipment and intellectual property of Hexcel Corporation and the Guarantors, and 65% of the share capital of Hexcel's Danish subsidiary and first-tier U.K. subsidiary.

In accordance with the terms of the Senior Secured Credit Facility, we are required to maintain a minimum interest coverage ratio of 4.00 (based on the ratio of EBITDA, as defined in the credit agreement, to interest expense) and may not exceed a maximum leverage ratio of 3.25 (based on the ratio of total debt to EBITDA) throughout the term of the Senior Secured Credit Facility. The Senior Secured Credit Facility also contains limitations on, among other things, incurring debt, granting liens, making investments, making restricted payments (including dividends), making capital expenditures, entering into transactions with affiliates and prepaying subordinated debt. In addition, the Senior Secured Credit Facility contains other terms and conditions such as customary representations and warranties, additional covenants and customary events of default.

The Senior Secured Credit Facility permits us to issue letters of credit up to an aggregate amount of \$40.0 million. Any outstanding letters of credit reduce the amount available for borrowing under the revolving loan. As of September 30, 2007, we had issued letters of credit totaling \$7.7 million under the Senior Secured Credit Facility. The Company had no letters of credit outstanding outside the Senior Secured Credit Facility as of September 30, 2007. Total undrawn availability under the Senior Secured Credit Facility as of September 30, 2007 was \$117.3 million.

6.75% Senior Subordinated Notes, due 2015

The senior subordinated notes are unsecured senior subordinated obligations of Hexcel Corporation. Interest accrues at the rate of 6.75% per annum and is payable semi-annually in arrears on February 1 and August 1, beginning on August 1, 2005. The senior subordinated notes mature on February 1, 2015. We may not redeem the senior subordinated notes prior to February 1, 2010, except that we may use the net proceeds from one or more equity offerings at any time prior to February 1, 2008 to redeem up to 35% of the aggregate principal amount of the notes at 106.75% of the principal amount, plus accrued and unpaid interest. We will have the option to redeem all or a portion of the senior subordinated notes at any time during the one-year period beginning February 1, 2010 at 103.375% of principal plus accrued and unpaid interest. This percentage decreases to 102.25% for the one-year period beginning February 1, 2011, to 101.125% for the one-year period beginning February 1, 2012 and to 100.0% any time on or after February 1, 2013. In the event of a change of control (as defined in the indenture), we are generally required to make an offer to all note holders to purchase all outstanding senior subordinated notes at 101% of the principal amount plus accrued and unpaid interest.

The indenture contains various customary covenants including, but not limited to, restrictions on incurring debt, making restricted

payments (including dividends), the use of proceeds from certain asset dispositions, entering into transactions with affiliates, and merging or selling all or substantially all of our assets. The indenture also contains many other customary terms and conditions, including customary events of default, some of which are subject to grace and notice periods.

European Credit and Overdraft Facilities

In addition to the Senior Secured Credit Facility, certain of our European subsidiaries have access to limited credit and overdraft facilities provided by various local banks. These credit and overdraft facilities are primarily uncommitted facilities that are terminable at the discretion of the lenders. The aggregate maturities of the European credit and overdraft facilities are classified as current, as they are repayable on demand. The Company had \$0.5 million outstanding under overdraft facilities as of September 30, 2007.

Note 8 Non-Operating Expense

During the first and third quarters of 2007, we made mandatory principal prepayments on the term loan portion of our Senior Secured Credit Facility of \$35.4 million and \$51.4, respectively, with the net proceeds received from asset sales. The asset sales related to the December 2006 sale of our 50% interest in TechFab (a joint venture of our former Reinforcements business unit), the February 2007 sale of our European Architectural business and the August 2007 sale of our EBGi business. As a result of the prepayment and early retirement of debt, we have recorded a loss resulting from the accelerated write-off of deferred financing costs of \$0.5 million and \$1.0 million, for the quarter and nine-months ended September 30, 2007, respectively.

Note 9 Income Taxes

On January 1, 2007 we adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). As a result of the implementation of FIN 48, the Company recognized a \$0.9 million increase in the liability for unrecognized tax benefits. This increase in liability resulted in an increase to the January 1, 2007 accumulated deficit balance in the amount of \$1.6 million, a decrease in deferred tax liabilities of \$1.0 million, and an increase in accrued interest of \$1.7 million. The amount of unrecognized tax benefits at January 1, 2007 is \$15.3 million of which \$12.1 million would impact our effective tax rate, if recognized. In addition, we recognize interest accrued related to unrecognized tax benefits as a component of interest expense and penalties as a component of income tax expense in the condensed consolidated statements of operations. As of January 1, 2007, we had recorded a liability of \$2.9 million for the payment of interest.

We are subject to taxation in the U.S. and various states and foreign jurisdictions. The U.S. federal statute of limitations remains open for prior years, however the U.S. tax returns have been audited through 2003. Foreign and U.S. state jurisdictions have statutes of limitations generally ranging from 3 to 5 years. Years still open to examination by foreign tax authorities in major jurisdictions include Austria (2002 onward), Belgium (2004 onward), France (2004 onward), Spain (2002 onward) and UK (2005 onward). We are currently under examination in various U.S. state and foreign jurisdictions.

As of January 1, 2007, we had uncertain tax positions for which it is reasonably possible that amounts of unrecognized tax benefits could significantly change over the next year. These uncertain tax positions relate to our tax returns from 2002 onward, some of which are currently under examination by certain European taxing authorities. We are unable to provide an estimate of possible change to the unrecognized tax benefits related to these tax positions.

We expect that the amount of unrecognized tax benefits will continue to change in the next twelve months as a result of ongoing tax deductions, the resolutions of audits and the passing of the statute of limitations. During the third quarter of 2007, the Company favourably settled an income tax audit in one of its international locations. As a result of this settlement, the company reversed certain tax reserves related to the audit, which had been previously established under FIN 48.

| (In millions) | Unrecognized Tax Benefits |
|--|------------------------------|
| Balance as of January 1, 2007 | \$ 15.3 |
| Additions based on tax positions related to the current year | 2.6 |
| Reductions for tax positions in prior years | (1.1) |
| Balance as of September 30, 2007 | \$ 16.8 |

Note 10 - Net Income per Common Share

| (In millions, except per share data) | | Quarter Ended September 30, | | Nine Months Ended September 30, | |
|---|----|-----------------------------|---------|---------------------------------|---------|
| | | 2007 | 2006 | 2007 | 2006 |
| Basic net income per common share: | | | | | |
| Net income from continuing operations | \$ | 18.1 | \$ 15.2 | \$ 50.4 | \$ 47.2 |
| Income (loss) from discontinued operations | | (0.8) | 0.5 | (0.9) | 0.6 |
| Net income | \$ | 17.3 | \$ 15.7 | \$ 49.5 | \$ 47.8 |
| Weighted average common shares outstanding | | 94.9 | 93.7 | 94.4 | 93.3 |
| Net income from continuing operations per common share | \$ | 0.19 | \$ 0.16 | \$ 0.53 | \$ 0.50 |
| Income (loss) from discontinued operations per common share | | (0.01) | 0.01 | (0.01) | 0.01 |
| Basic net income per common share | \$ | 0.18 | \$ 0.17 | \$ 0.52 | \$ 0.51 |
| Diluted net income (loss) per common share: | | | | | |
| Net income from continuing operations | \$ | 18.1 | \$ 15.2 | \$ 50.4 | \$ 47.2 |
| Income (loss) from discontinued operations | | (0.8) | 0.5 | (0.9) | 0.6 |
| Net income | \$ | 17.3 | \$ 15.7 | \$ 49.5 | \$ 47.8 |
| Weighted average common shares outstanding Basic | | 94.9 | 93.7 | 94.4 | 93.3 |
| <i>Plus incremental shares from assumed conversions:</i> | | | | | |
| Restricted stock units | | 0.3 | 0.2 | 0.4 | 0.4 |
| Stock options | | 1.5 | 1.3 | 1.4 | 1.7 |
| Weighted average common shares outstanding Dilutive | | 96.7 | 95.2 | 96.2 | 95.4 |
| Net income from continuing operations per common share | \$ | 0.19 | \$ 0.16 | \$ 0.52 | \$ 0.50 |
| Income (loss) from discontinued operations per common share | | (0.01) | | (0.01) | |
| Diluted net income per common share | \$ | 0.18 | \$ 0.16 | \$ 0.51 | \$ 0.50 |

Total shares underlying stock options of 0.3 million and 0.7 million were excluded from the computation of diluted net income per share for the quarter and nine-months ended September 30, 2007, respectively, as they were anti-dilutive.

Note 11 - Comprehensive Income

Comprehensive income represents net income and other gains and losses affecting stockholders' equity that are not reflected in the condensed consolidated statements of operations. The components of comprehensive income for the quarters and nine-months ended September 30, 2007 and 2006 were as follows:

Edgar Filing: HEXCEL CORP /DE/ - Form 10-Q

| (In millions) | Quarter Ended September 30, | | Nine-Months Ended September 30, | |
|---|-----------------------------|---------|---------------------------------|---------|
| | 2007 | 2006 | 2007 | 2006 |
| Net income from continuing operations | \$ 18.1 | \$ 15.2 | \$ 50.4 | \$ 47.2 |
| Currency translation adjustments | 5.6 | 3.9 | 9.2 | 13.9 |
| Minimum pension obligation | (0.6) | | (0.2) | (0.2) |
| Net unrealized gains on financial instruments | 0.6 | 0.1 | 0.1 | 6.0 |
| Comprehensive income from continuing operations | \$ 23.7 | \$ 19.2 | \$ 59.5 | \$ 66.9 |

Note 12 - Derivative Financial Instruments

Cross-Currency Interest Rate Swap Agreement

Edgar Filing: HEXCEL CORP /DE/ - Form 10-Q

In 2003, we entered into a cross-currency interest rate swap agreement, which effectively exchanges a loan of 12.5 million Euros at a fixed rate of 7% for a loan with a notional amount of \$13.5 million at a fixed rate of 6.02% over the term of the agreement expiring December 1, 2007. We entered into this agreement to effectively hedge interest and principal payments relating to an inter-company loan denominated in Euros. The balance of the loan at September 30, 2007, after scheduled amortization, was 4.5 million Euros. The fair value and carrying amount of this swap agreement was a liability of \$1.6 million at September 30, 2007. During the quarters and nine-months ended September 30, 2007 and 2006, hedge ineffectiveness was immaterial. An immaterial net decrease for the quarter and nine-months ended September 30, 2007 was recognized as a component of accumulated comprehensive loss. Over

the next twelve months, unrealized losses of \$0.1 million recorded in accumulated other comprehensive loss relating to this agreement are expected to be reclassified into earnings.

In September 2006, we entered into a cross-currency interest rate swap agreement to hedge a portion of our net Euro investment in Hexcel France SA. To the extent it is effective, gains and losses are recorded as an offset in the cumulative translation account, the same account in which translation gains and losses on the investment in Hexcel France SA are recorded. All other changes, including any difference in current interest, are excluded from the assessment of effectiveness and are thereby included in operating income as a component of interest expense. The impact to interest expense for the quarter and nine-months ended September 30, 2007 was a reduction of \$0.3 million and \$0.7 million, respectively. This agreement has a notional value of \$63.4 million, a term of five years, and is scheduled to mature on September 20, 2011. We receive interest in U.S. dollars quarterly and pay interest in Euros on the same day. U.S. interest is based on the three month LIBOR rate. Euro interest is based on the three month EURIBOR. The fair value of the swap at September 30, 2007 and December 31, 2006 was a liability of \$8.2 million and \$2.7 million, respectively.

Foreign Currency Forward Exchange Contracts

Edgar Filing: HEXCEL CORP /DE/ - Form 10-Q

A number of our European subsidiaries are exposed to the impact of exchange rate volatility between the U.S. dollar and the subsidiaries functional currencies, being either the Euro or the British Pound Sterling. We entered into contracts to exchange U.S. dollars for Euros and British Pound Sterling through June 2009. The aggregate notional amount of these contracts was \$56.0 million at September 30, 2007. The purpose of these contracts is to hedge a portion of the forecasted transactions of European subsidiaries under long-term sales contracts with certain customers. These contracts are expected to provide us with a more balanced matching of future cash receipts and expenditures by currency, thereby reducing our exposure to fluctuations in currency exchange rates. For the quarters and nine-months ended September 30, 2007 and 2006, hedge ineffectiveness was immaterial.

The activity in accumulated other comprehensive income (loss) related to foreign currency forward exchange contracts for the quarters and nine-months ended September 30, 2007 and 2006 was as follows:

| (In millions) | Quarter Ended September 30, | | Nine Months Ended September 30, | |
|--|-----------------------------|--------|---------------------------------|----------|
| | 2007 | 2006 | 2007 | 2006 |
| Unrealized gains (losses) at beginning of period | \$ 3.3 | \$ 2.2 | \$ 3.9 | \$ (2.3) |
| (Gains) Losses reclassified to net sales | (0.8) | (0.3) | (2.5) | 0.4 |
| Increase in fair value | 1.5 | 0.4 | 2.6 | 4.2 |
| Unrealized gains at end of period | \$ 4.0 | \$ 2.3 | \$ 4.0 | \$ 2.3 |

As of September 30, 2007, unrealized gains recorded in accumulated other comprehensive income, net of tax, total \$4.0 million, of which \$2.8 million are expected to be reclassified into earnings over the next twelve months as the hedged sales are recorded.

Note 13 Investments in Affiliated Companies

As of September 30, 2007, we have equity ownership investments in two Asian joint ventures. In connection therewith, we have considered the accounting and disclosure requirements of FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities*, and believe that these investments would be considered variable interest entities. However, we also believe that we are not the primary beneficiary of such entities, and therefore, are not required to consolidate these entities.

BHA Aero Composite Parts Co., Ltd.

In 1999, Hexcel, Boeing International Holdings, Ltd. (Boeing International) and China Aviation Industry Corporation I (AVIC) formed a joint venture, BHA Aero Composite Parts Co., Ltd. (BHA Aero). This joint venture is located in Tianjin, China, and manufactures composite parts for secondary structures and interior applications for commercial aircraft. Summary information related to our investment in BHA Aero follows:

| (In millions) | As of September 30, | |
|-----------------------------|---------------------|---------|
| | 2007 | 2006 |
| Equity ownership | 40.48 % | 40.48 % |
| Last twelve months revenues | \$ 32.1 | \$ 24.7 |
| Equity investment balance | \$ 7.5 | \$ 5.9 |
| Accounts receivable balance | \$ 2.1 | \$ 2.3 |

On January 26, 2005, BHA Aero completed the refinancing of its bank debt, which resulted in a new five year bank term loan agreement supported by a pledge of BHA Aero's fixed assets and guarantees from Boeing and AVIC. As part of the refinancing, we agreed to reimburse Boeing and AVIC for a proportionate share of the losses they would incur if their guarantees of the new bank loan

were to be called, up to a limit of \$6.1 million. Our reimbursement agreement with Boeing and AVIC relating to the BHA Aero joint venture meets the definition of a guarantee in accordance with the provisions of FASB Interpretation No. 45, *Guarantors Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, (FIN 45). Accordingly, we recorded a \$0.5 million liability, and a corresponding increase in our investment in BHA Aero, during the first quarter of 2005 based upon the estimated fair value of the guarantee. Apart from outstanding accounts receivable balances, our investment in this venture, and our agreement to reimburse Boeing and AVIC for a proportionate share of the losses they would incur if their guarantees of the new bank loan were to be called, we have no other significant exposures to loss related to BHA Aero.

Asian Composites Manufacturing Sdn. Bhd.

In 1999, we formed another joint venture, Asian Composites Manufacturing Sdn. Bhd. (Asian Composites), with Boeing Worldwide Operations Limited, Sime Link Sdn. Bhd., and Malaysia Helicopter Services Bhd. (now known as Naluri Berhad), to manufacture composite parts for secondary structures for commercial aircraft. Our initial ownership interest in this joint venture, which is located in Alor Setar, Malaysia, was 25%.

In November 2006, Hexcel, Boeing Worldwide Operations Limited and Sime Link Sdn. Bhd. entered into an agreement to purchase Naluri Corporation Berhad's equity interest in Asian Composites, which will increase each respective equity ownership interest in this joint venture to 33.33%. We paid \$2.1 million in cash to purchase this additional equity interest when the transaction was completed on February 8, 2007.

Apart from any outstanding accounts receivable and our investment in this joint venture, we have no other significant exposures to loss related to Asian Composites. Summary information related to our investment in Asian Composites follows:

| (In millions) | Quarter Ended September 30, | |
|------------------------------|--------------------------------|---------|
| | 2007 | 2006 |
| Equity ownership | 33.33% | 25.00% |
| Last twelve months' revenues | \$ 29.3 | \$ 23.6 |
| Equity investment balance | \$ 8.6 | \$ 4.5 |
| Accounts receivable balance | \$ 1.4 | \$ 1.3 |

Note 14 - Segment Information

The financial results for our operating segments are prepared using a management approach, which is consistent with the basis and manner in which we internally segregate financial information for the purpose of assisting in making internal operating decisions. We evaluate the performance of our operating segments based on operating income, and generally account for intersegment sales based on arm's length prices. Corporate and certain other expenses are not allocated to the operating segments, except to the extent that the expense can be directly attributable to the business segment.

Edgar Filing: HEXCEL CORP /DE/ - Form 10-Q

Effective January 1, 2007, we revised our operating segments to reflect our strategic and operational realignment and to focus on advanced structural materials. We have eliminated our three former global business units and consolidated all our composites related activities into a single organization. Based upon our review of Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information*, we have concluded that we will now report two operating segments, Composite Materials and Engineered Products. The EBGI Reinforcements segment was reclassified as discontinued operations as of June 30, 2007 (see footnote 2).

In addition to the product line-based segmentation of our business, we also monitor sales into our principal end markets as a means to understanding demand for our products. Therefore, for each operating segment, we have also reported disaggregated sales by end market.

Edgar Filing: HEXCEL CORP /DE/ - Form 10-Q

Financial information for our business segments for the quarters and nine-months ended September 30, 2007 and 2006 is as follows:

| (In millions) | Composite Materials | Engineered Products | Unaudited Corporate & Other | Total |
|--|---------------------|---------------------|--------------------------------|----------|
| Third Quarter 2007 | | | | |
| Net sales to external customers: | | | | |
| Commercial aerospace | \$ 110.0 | \$ 42.8 | \$ | \$ 152.8 |
| Industrial | 67.6 | 0.3 | | 67.9 |
| Space and defense | 46.4 | 14.0 | | 60.4 |
| Net sales to external customers | 224.0 | 57.1 | | 281.1 |
| Intersegment sales | 7.6 | 0.4 | (8.0) | |
| Total sales | 231.6 | 57.5 | (8.0) | 281.1 |
| Operating income | 33.9 | 4.9 | (8.6) | 30.2 |
| Depreciation and amortization | 9.2 | 1.0 | | 10.2 |
| Business consolidation and restructuring expenses | 1.9 | 0.7 | | 2.6 |
| Stock-based compensation expense | 0.6 | 0.2 | 0.6 | 1.4 |
| Capital expenditures and deposits for property purchases | 23.5 | 1.5 | 0.3 | 25.3 |
| Third Quarter 2006 | | | | |
| Net sales to external customers: | | | | |
| Commercial aerospace | \$ 98.0 | \$ 34.0 | \$ | \$ 132.0 |
| Industrial | 66.0 | 1.1 | | 67.1 |
| Space and defense | 40.6 | 12.6 | | 53.2 |
| Net sales to external customers | 204.6 | 47.7 | | 252.3 |
| Intersegment sales | 7.2 | 0.3 | (7.5) | |
| Total sales | 211.8 | 48.0 | (7.5) | 252.3 |
| Operating income | 29.6 | 4.7 | (10.4) | 23.9 |
| Depreciation and amortization | 8.1 | 0.9 | | 9.0 |
| Business consolidation and restructuring expenses | 0.5 | | | 0.5 |
| Stock-based compensation expense | 0.5 | 0.1 | 1.0 | 1.6 |
| Capital expenditures and deposits for property purchases | 28.9 | 1.9 | 0.7 | 31.5 |
| Nine-Months Ended September 30, 2007 | | | | |
| Net sales to external customers: | | | | |
| Commercial aerospace | \$ 324.8 | \$ 126.7 | \$ | \$ 451.5 |
| Industrial | | | | |