CABOT MICROELECTRONICS CORP
Form 10-Q
May 08, 2015
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended

MARCH 31, 2015

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 000-30205

CABOT MICROELECTRONICS CORPORATION
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| DELAWARE | 36-4324765 |
| (State of Incorporation) | (I.R.S. Employer Identification No.) |

| | |
|---|---|
| 870 NORTH COMMONS DRIVE | 60504 |
| AURORA, ILLINOIS | (Zip Code) |
| (Address of principal executive offices) | |

Registrant's telephone number, including area code: (630) 375-6631

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 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 (Section 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 definitions of “large accelerated filer,” “accelerated filer” and smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

YES NO

As of April 30, 2015, the Company had 24,719,693 shares of Common Stock, par value $0.001 per share, outstanding.

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CABOT MICROELECTRONICS CORPORATION

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PART I. FINANCIAL INFORMATION
ITEM 1.

CABOT MICROELECTRONICS CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited and in thousands, except per share amounts)

| | Three Months Ended March 31, | | Six Months Ended March 31, | |
|---|---|---|---|---|
| | 2015 | 2014 | 2015 | 2014 |
| Revenue | $104,858 | $99,456 | $216,792 | $199,971 |
| Cost of goods sold | 50,182 | 52,931 | 105,142 | 105,732 |
| Gross profit | 54,676 | 46,525 | 111,650 | 94,239 |
| Operating expenses: | | | | |
| Research, development and technical | 15,131 | 14,364 | 30,149 | 28,935 |
| Selling and marketing | 5,777 | 6,471 | 13,416 | 13,178 |
| General and administrative | 14,296 | 11,076 | 26,047 | 21,802 |
| Total operating expenses | 35,204 | 31,911 | 69,612 | 63,915 |
| Operating income | 19,472 | 14,614 | 42,038 | 30,324 |
| Interest expense | 1,059 | 843 | 1,965 | 1,715 |
| Other income (expense), net | (332) | 103 | 725 | 720 |
| Income before income taxes | 18,081 | 13,874 | 40,798 | 29,329 |
| Provision for income taxes | 4,270 | 3,779 | 7,071 | 7,926 |
| Net income | $13,811 | $10,095 | $33,727 | $21,403 |
| Basic earnings per share | $0.57 | $0.42 | $1.40 | $0.89 |
| Weighted average basic shares outstanding | 24,057 | 23,982 | 23,845 | 23,775 |
| Diluted earnings per share | $0.55 | $0.40 | $1.36 | $0.86 |
| Weighted average diluted shares outstanding | 24,693 | 24,897 | 24,582 | 24,749 |

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

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CABOT MICROELECTRONICS CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited and in thousands)

| | Three Months Ended March 31, | | Six Months Ended March 31, | |
|---|---|---|---|---|
| | 2015 | 2014 | 2015 | 2014 |
| Net income | $13,811 | $10,095 | $33,727 | $21,403 |
| Other comprehensive income (loss), net of tax: | | | | |
| Foreign currency translation adjustments | 48 | (452) | (8,284) | (5,212) |
| Net unrealized losses on cash flow hedges | (443) | - | (612) | - |
| Unrealized gain on investments | - | - | - | 151 |
| Other comprehensive income (loss), net of tax | (395) | (452) | (8,896) | (5,061) |
| Comprehensive income | $13,416 | $9,643 | $24,831 | $16,342 |

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

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CABOT MICROELECTRONICS CORPORATION
CONSOLIDATED BALANCE SHEETS
(Unaudited and in thousands, except share amounts)

| | March 31, 2015 | September 30, 2014 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $333,651 | $284,155 |
| Accounts receivable, less allowance for doubtful accounts of $1,260 at March 31, 2015, and $1,392 at September 30, 2014 | 55,812 | 60,693 |
| Inventories, net | 64,273 | 64,979 |
| Prepaid expenses and other current assets | 21,761 | 10,645 |
| Deferred income taxes | 8,050 | 7,521 |
| Total current assets | 483,547 | 427,993 |
| | | |
| Property, plant and equipment, net | 94,508 | 100,821 |
| Goodwill | 42,289 | 43,245 |
| Other intangible assets, net | 5,878 | 7,163 |
| Deferred income taxes | 7,537 | 11,353 |
| Other long-term assets | 10,683 | 10,592 |
| Total assets | $644,442 | $601,167 |
| | | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | $16,019 | $15,304 |
| Accrued expenses, income taxes payable and other current liabilities | 31,615 | 31,394 |
| Current portion of long-term debt | 8,750 | 8,750 |
| Total current liabilities | 56,384 | 55,448 |
| | | |
| Long-term debt, net of current portion | 159,688 | 164,063 |
| Deferred income taxes | 294 | 510 |
| Other long-term liabilities | 9,727 | 9,144 |
| Total liabilities | 226,093 | 229,165 |
| | | |
| Commitments and contingencies (Note 9) | | |
| Stockholders' equity: | | |
| Common Stock: Authorized: 200,000,000 shares, $0.001 par value; Issued: 33,484,891 shares at March 31, 2015, and 31,927,601 shares at September 30, 2014 | 33 | 32 |
| Capital in excess of par value of common stock | 486,017 | 437,266 |
| Retained earnings | 261,669 | 227,942 |
| Accumulated other comprehensive income | 359 | 9,255 |
| Treasury stock at cost, 8,721,971 shares at March 31, 2015, and 8,142,687 shares at September 30, 2014 | (329,729) | (302,493) |
| Total stockholders' equity | 418,349 | 372,002 |
| | | |
| Total liabilities and stockholders' equity | $644,442 | $601,167 |

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

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CABOT MICROELECTRONICS CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited and amounts in thousands)

| | Six Months Ended March 31, 2015 | 2014 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $33,727 | $21,403 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 9,303 | 9,908 |
| Provision for doubtful accounts | (40) | (219) |
| Share-based compensation expense | 8,706 | 7,791 |
| Deferred income tax expense | 4,966 | 1,437 |
| Non-cash foreign exchange loss | 531 | 45 |
| Gain on disposal of property, plant and equipment | (100) | (38) |
| Impairment of long-lived assets | - | 2,144 |
| Other | (802) | (294) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 2,747 | 773 |
| Inventories | (1,688) | (8,920) |
| Prepaid expenses and other assets | (11,480) | (3,339) |
| Accounts payable | 1,374 | (1,603) |
| Accrued expenses, income taxes payable and other liabilities | 1,426 | (14,665) |
| Net cash provided by operating activities | 48,670 | 14,423 |
| | | |
| Cash flows from investing activities: | | |
| Additions to property, plant and equipment | (5,317) | (7,340) |
| Proceeds from the sale of property, plant and equipment | 175 | 160 |
| Proceeds from the sale of investments | - | 2,130 |
| Other investing activities | - | 1,062 |
| Net cash used in investing activities | (5,142) | (3,988) |
| | | |
| Cash flows from financing activities: | | |
| Repayment of long-term debt | (4,375) | (4,375) |
| Repurchases of common stock | (27,236) | (30,072) |
| Net proceeds from issuance of stock | 33,630 | 35,908 |
| Tax benefits associated with share-based compensation expense | 6,113 | 2,246 |
| Net cash provided by financing activities | 8,132 | 3,707 |
| | | |
| Effect of exchange rate changes on cash | (2,164) | (1,024) |
| Increase in cash and cash equivalents | 49,496 | 13,118 |
| Cash and cash equivalents at beginning of period | 284,155 | 226,029 |
| Cash and cash equivalents at end of period | $333,651 | $239,147 |
| | | |
| Supplemental disclosure of non-cash investing and financing activities: | | |
| Purchases of property, plant and equipment in accrued liabilities and accounts payable at the end of the period | $1,149 | $697 |
| Issuance of restricted stock | 9,924 | 7,785 |

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

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CABOT MICROELECTRONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited and in thousands, except share and per share amounts)

## 1. BACKGROUND AND BASIS OF PRESENTATION

Cabot Microelectronics Corporation ("Cabot Microelectronics", "the Company", "us", "we" or "our") supplies high-performance polishing slurries and pads used in the manufacture of advanced integrated circuit (IC) devices within the semiconductor industry, in a process called chemical mechanical planarization (CMP). CMP is a polishing process used by IC device manufacturers to planarize or flatten many of the multiple layers of material that are deposited upon silicon wafers in the production of advanced ICs. Our products play a critical role in the production of advanced IC devices, thereby enabling our customers to produce smaller, faster and more complex IC devices with fewer defects. We develop, produce and sell CMP slurries for polishing many of the conducting and insulating materials used in IC devices, and also for polishing the disk substrates and magnetic heads used in hard disk drives. We also develop, manufacture and sell CMP polishing pads, which are used in conjunction with slurries in the CMP process. We also pursue other demanding surface modification applications through our Engineered Surface Finishes (ESF) business where we believe we can leverage our expertise in CMP consumables for the semiconductor industry to develop products for demanding polishing applications in other industries. For additional information, refer to Part 1, Item 1, “Business”, in our Annual Report on Form 10-K for the fiscal year ended September 30, 2014.

The unaudited consolidated financial statements have been prepared by Cabot Microelectronics Corporation pursuant to the rules of the Securities and Exchange Commission (SEC) and accounting principles generally accepted in the United States of America. In the opinion of management, these unaudited consolidated financial statements include all adjustments, consisting of only normal recurring adjustments, necessary for the fair presentation of Cabot Microelectronics’ financial position as of March 31, 2015, cash flows for the six months ended March 31, 2015, and March 31, 2014, and results of operations for the three and six months ended March 31, 2015, and March 31, 2014. The consolidated balance sheet as of September 30, 2014 was derived from audited annual financial statements, but does not contain all of the footnote disclosures from the annual financial statements. The results of operations for the three and six months ended March 31, 2015 may not be indicative of results to be expected for future periods, including the fiscal year ending September 30, 2015. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto included in Cabot Microelectronics’ Annual Report on Form 10-K for the fiscal year ended September 30, 2014.

In conjunction with our financial statement revision, which was discussed in our Annual Report on Form 10-K for the fiscal year ended September 30, 2014, we have reclassified $459 between prepaid expense and income taxes payable within the cash flow from operating activities section of the Consolidated Statement of Cash Flows for the period ended March 31, 2014. The consolidated financial statements include the accounts of Cabot Microelectronics and its subsidiaries. All intercompany transactions and balances between the companies have been eliminated as of March 31, 2015.

## 2. FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair value is defined as the price that would be received from the sale of an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The FASB established a three-level hierarchy for disclosure based on the extent and level of judgment used to estimate fair value. Level 1 inputs consist of valuations based on quoted market prices in active markets for identical assets or liabilities. Level 2 inputs consist of valuations based on quoted prices for similar assets or liabilities, quoted prices for identical assets or liabilities in an inactive market, or other observable inputs.  Level 3 inputs consist of valuations based on unobservable inputs that are supported by little or no market activity.

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The following table presents financial instruments, other than long-term debt, that we measured at fair value on a recurring basis at March 31, 2015 and September 30, 2014. See Note 7 for a detailed discussion of our long-term debt. We have classified the following assets and liabilities in accordance with the fair value hierarchy set forth in the applicable standards. In instances where the inputs used to measure the fair value of an asset fall into more than one level of the hierarchy, we have classified them based on the lowest level input that is significant to the determination of the fair value.

| March 31, 2015 | Level 1 | Level 2 | Level 3 | Total Fair Value |
|---|---|---|---|---|
| Assets: | | | | |
| Cash and cash equivalents | $333,651 | $- | $ - | $333,651 |
| Other long-term investments | 1,851 | | | 1,851 |
| Derivative financial instruments | - | 121 | - | 121 |
| Total assets | $335,502 | $121 | $ - | $335,623 |
| | | | | |
| Liabilities: | | | | |
| Derivative financial instruments | - | 985 | - | 985 |
| Total liabilities | $- | $985 | $ - | $985 |

| September 30, 2014 | Level 1 | Level 2 | Level 3 | Total Fair Value |
|---|---|---|---|---|
| Assets: | | | | |
| Cash and cash equivalents | $284,155 | $- | $ - | $284,155 |
| Other long-term investments | 1,654 | | | 1,654 |
| Derivative financial instruments | - | 100 | - | 100 |
| Total assets | $285,809 | $100 | $ - | $285,909 |
| | | | | |
| Liabilities: | | | | |
| Derivative financial instruments | - | 270 | - | 270 |
| Total liabilities | $- | $270 | $ - | $270 |

Our cash and cash equivalents consist of various bank accounts used to support our operations and investments in institutional money-market funds which are traded in active markets. The other long-term investments are included in other long-term assets on our Consolidated Balance Sheet. Our other long-term investments represent the fair value of investments under the Cabot Microelectronics Supplemental Employee Retirement Plan (SERP), which is a nonqualified supplemental savings plan. The fair value of the investments is determined through quoted market prices within actively traded markets. Although the investments are allocated to individual participants and investment decisions are made solely by those participants, the SERP is a nonqualified plan. Consequently, the Company owns the assets and the related offsetting liability for disbursement until such time a participant makes a qualifying withdrawal. The long-term asset was adjusted to $1,851 in the second quarter of fiscal 2015 to reflect its fair value as of March 31, 2015.

Our derivative financial instruments include forward foreign exchange contracts and interest rate swaps. In the first quarter of fiscal 2015, we entered into floating-to-fixed interest rate swap agreements to hedge the variability in LIBOR-based interest payments on a portion of our outstanding variable rate debt. These interest rate swaps represent our primary use of derivative financial instruments. The fair value of our derivative instruments is estimated using standard valuation models using market-based observable inputs over the contractual term, including one-month LIBOR-based yield curves, among others. We consider the risk of nonperformance, including counterparty credit risk, in the calculation of the fair value of derivative financial instruments. See Note 8 of this Form 10-Q for more information on our use of derivative financial instruments.

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3. INVENTORIES, NET

Inventories, net consisted of the following:

| | March 31, 2015 | September 30, 2014 |
|---|---|---|
| Raw materials | $35,311 | $ 37,009 |
| Work in process | 5,663 | 4,505 |
| Finished goods | 23,299 | 23,465 |
| Total | $64,273 | $ 64,979 |

4. GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill was $42,289 as of March 31, 2015, and $43,245 as of September 30, 2014. The decrease in goodwill was due to foreign exchange fluctuations of the New Taiwan dollar.

The components of other intangible assets are as follows:

| | March 31, 2015 | | September 30, 2014 | |
|---|---|---|---|---|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Other intangible assets subject to amortization: | | | | |
| Product technology | $8,201 | $ 7,159 | $8,278 | $ 6,750 |
| Acquired patents and licenses | 8,270 | 7,689 | 8,270 | 7,534 |
| Trade secrets and know-how | 2,550 | 2,550 | 2,550 | 2,550 |
| Customer relationships, distribution rights and other | 11,920 | 8,855 | 12,193 | 8,484 |
| Total other intangible assets subject to amortization | 30,941 | 26,253 | 31,291 | 25,318 |
| Total other intangible assets not subject to amortization* | 1,190 | | 1,190 | |
| Total other intangible assets | $32,131 | $ 26,253 | $32,481 | $ 25,318 |

* Total other intangible assets not subject to amortization consist primarily of trade names.

Amortization expense on our other intangible assets was $582 and $1,175 for the three and six months ended March 31, 2015, respectively. Amortization expense on our other intangible assets was $613 and $1,269 for the three and six months ended March 31, 2014, respectively. Estimated future amortization expense for the five succeeding fiscal years is as follows:

| Fiscal Year | Estimated Amortization Expense |
|---|---|

| | | |
|---|---|---|
| Remainder of 2015 | $ | 1,172 |
| 2016 | | 1,939 |
| 2017 | | 1,118 |
| 2018 | | 441 |
| 2019 | | 11 |

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Goodwill and indefinite-lived intangible assets are tested for impairment annually in the fourth quarter of the fiscal year or more frequently if indicators of potential impairment exist, using a fair-value-based approach. The recoverability of goodwill is measured at the reporting unit level, which is defined as either an operating segment or one level below an operating segment. An entity has the option to assess the fair value of a reporting unit either using a qualitative analysis ("step zero") or a discounted cash flow analysis ("step one"). Similarly, an entity has the option to use a step zero or a step one approach to determine the recoverability of indefinite-lived intangible assets. In fiscal 2014, we chose to use a step one analysis for both goodwill impairment and for indefinite-lived intangible asset impairment.

We completed our annual impairment test during our fourth quarter of fiscal 2014 and concluded that no impairment existed. There were no indicators of potential impairment during the six months ended March 31, 2015, so it was not necessary to perform an impairment review for goodwill and indefinite-lived intangible assets during the quarter. There have been no cumulative impairment charges recorded on the goodwill for any of our reporting units.

5. OTHER LONG-TERM ASSETS

Other long-term assets consisted of the following:

| | March 31, 2015 | September 30, 2014 |
|---|---|---|
| Auction rate securities (ARS) | $5,895 | $ 5,895 |
| Other long-term assets | 2,937 | 3,043 |
| Other long-term investments | 1,851 | 1,654 |
| Total | $10,683 | $ 10,592 |

We classify our ARS investments as held-to-maturity and have recorded them at cost. Our ARS investments at March 31, 2015 consisted of two tax exempt municipal debt securities with a total par value of $5,895, both of which have maturities greater than ten years. The ARS market began to experience illiquidity in early 2008, and this illiquidity continues. Despite this lack of liquidity, there have been no defaults in payment of the underlying securities and interest income on these holdings continues to be received on scheduled interest payment dates. Our ARS, when purchased, were issued by A-rated municipalities. Although the credit ratings of both municipalities have been downgraded since our original investment, one of the ARS is credit enhanced with bond insurance, and the other has become an obligation of the bond insurer. Both ARS currently carry a credit rating of AA- by Standard & Poor's.

The fair value of our ARS, determined using level 2 fair value inputs, was $5,317 as of March 31, 2015. We have classified our ARS as held-to-maturity based on our intention and ability to hold the securities until maturity. We believe the gross unrecognized loss of $578 is due to the illiquidity in the ARS market, rather than to credit loss. We will continue to monitor our ARS for impairment indicators, which may require us to record an impairment charge that is deemed other-than-temporary. In November 2011, the municipality that issued one of our ARS filed for bankruptcy protection. As a result of the approval of the municipality's reorganization plan, and our voting elections, we received 65% of the par value outstanding, or $2,113, during the quarter ended December 31, 2013, and we reversed the $234 temporary impairment that we previously recorded.

Other long-term assets are comprised of the long-term portion of prepaid unamortized debt costs as well as miscellaneous deposits and prepayments on contracts extending beyond the next 12 months.  As discussed in Note 2, we recorded a long-term asset and a corresponding long-term liability of $1,851 representing the fair value of our SERP investments as of March 31, 2015.

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6. ACCRUED EXPENSES, INCOME TAXES PAYABLE AND OTHER CURRENT LIABILITIES

Accrued expenses, income taxes payable and other current liabilities consisted of the following:

| | March 31, 2015 | September 30, 2014 |
|---|---|---|
| Accrued compensation | $17,915 | $ 16,980 |
| Goods and services received, not yet invoiced | 1,968 | 3,167 |
| Deferred revenue and customer advances | 489 | 1,223 |
| Warranty accrual | 238 | 246 |
| Income taxes payable | 5,376 | 5,448 |
| Taxes, other than income taxes | 1,778 | 1,182 |
| Other accrued expenses | 3,851 | 3,148 |
| Total | $31,615 | $ 31,394 |

Accrued compensation at March 31, 2015 includes $1,377 for severance payments to be made to three executive officers who resigned from their positions.

7. DEBT

On February 13, 2012, we entered into a credit agreement (the “Credit Agreement”) among the Company, as Borrower, Bank of America, N.A., as administrative agent, swing line lender and an L/C issuer, Bank of America Merrill Lynch and J.P. Morgan Securities LLC, as joint lead arrangers and joint book managers, JPMorgan Chase Bank, N.A., as syndication agent, and Wells Fargo Bank, N.A. as documentation agent.  The Credit Agreement provided us with a $175,000 term loan (the “Term Loan”), which we drew on February 27, 2012 to fund approximately half of the special cash dividend we paid to our stockholders on March 1, 2012, and a $100,000 revolving credit facility (the “Revolving Credit Facility”), which has never been drawn, with sub-limits for multicurrency borrowings, letters of credit and swing-line loans.  The Term Loan and the Revolving Credit Facility are referred to as the “Credit Facilities.”  On June 27, 2014, we entered into an amendment (the “Amendment”) to the Credit Agreement, which (i) increased term loan commitments by $17,500, from $157,500 to $175,000, the same level as the original amount under the Credit Agreement at its inception in 2012; (ii) increased the uncommitted accordion feature on the Revolving Credit Facility from $75,000 to $100,000; (iii) extended the expiration date of the Credit Facilities from February 13, 2017 to June 27, 2019; (iv) relaxed the consolidated leverage ratio financial covenant; and (v) revised certain pricing terms and other terms within the Credit Agreement.  On June 27, 2014, we drew the $17,500 of increased term loan commitments, bringing the total outstanding commitments under the Term Loan to $175,000.

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Borrowings under the amended Credit Facilities (other than in respect of swing-line loans) bear interest at a rate per annum equal to the “Applicable Rate” (as defined below) plus, at our option, either (1) a LIBOR rate determined by reference to the cost of funds for deposits in the relevant currency for the interest period relevant to such borrowing or (2) the “Base Rate”, which is the highest of (x) the prime rate of Bank of America, N.A., (y) the federal funds rate plus 1/2 of 1.00% and (z) the one-month LIBOR rate plus 1.00%. The current Applicable Rate for borrowings under the Credit Facilities is 1.50% with respect to LIBOR borrowings and 0.25% with respect to Base Rate borrowings, with such Applicable Rate subject to adjustment based on our consolidated leverage ratio. Swing-line loans bear interest at the Base Rate plus the Applicable Rate for Base Rate loans under the Revolving Credit Facility. In addition to paying interest on outstanding principal under the Credit Agreement, we pay a commitment fee to the lenders under the Revolving Credit Facility in respect of the unutilized commitments thereunder. The fee ranges from 0.20% to 0.30%, based on our consolidated leverage ratio. Interest expense and commitment fees are paid according to the relevant interest period and no less frequently than at the end of each calendar quarter. We paid $2,658 in arrangement fees, upfront fees and administration fees in February 2012 and we paid an additional $550 in upfront fees and arrangement fees in June 2014, of which $397 remains in prepaid expenses and other current assets and $1,271 remains in other long-term assets on our Consolidated Balance Sheet as of March 31, 2015. We also pay letter of credit fees as necessary. The Term Loan has periodic scheduled repayments; however, we may voluntarily prepay the Credit Facilities without premium or penalty, subject to customary “breakage” fees and reemployment costs in the case of LIBOR borrowings. All obligations under the Credit Agreement are guaranteed by certain of our existing and future direct and indirect domestic subsidiaries. The obligations under the Credit Agreement and guarantees of those obligations are secured, subject to certain exceptions, by first priority liens and security interests in the assets of the Company and certain of its domestic subsidiaries.

In the first quarter of fiscal 2015, we entered into interest rate swap agreements that have the economic effect of converting fifty percent of our variable rate debt into fixed rate debt at a weighted average fixed rate of 1.5% plus the Applicable Rate defined above. See Notes 2 and 8 for additional information on the interest rate swap agreements.

The Credit Agreement contains covenants that restrict the ability of the Company and its subsidiaries to take certain actions, including, among other things and subject to certain significant exceptions: creating liens, incurring indebtedness, making investments, engaging in mergers, selling property, paying dividends or amending organizational documents. The Credit Agreement requires us to comply with certain financial ratio maintenance covenants. These include a maximum consolidated leverage ratio of 3.00 to 1.00 through December 31, 2015 and a minimum consolidated fixed charge coverage ratio of 1.25 to 1.00. The maximum consolidated leverage ratio will decrease to 2.75 to 1.00 from January 1, 2016 through the expiration of the Credit Agreement. As of March 31, 2015, our consolidated leverage ratio was 1.47 to 1.00 and our consolidated fixed charge coverage ratio was 7.41 to 1.00. The Credit Agreement also contains customary affirmative covenants and events of default. We believe we are in compliance with these covenants.

At March 31, 2015, the fair value of the Term Loan, using level 2 inputs, approximates its carrying value of $168,438 as the loan bears a floating market rate of interest. As of March 31, 2015, $8,750 of the debt outstanding is classified as short-term.

Principal repayments of the Term Loan are generally made on the last calendar day of each quarter if that day is considered to be a business day. As of March 31, 2015, scheduled principal repayments of the Term Loan were as follows:

| Fiscal Year | Principal Repayments |
|---|---|
| Remainder of 2015 | $ 4,375 |

| | |
|---|---|
| 2016 | 8,750 |
| 2017 | 7,656 |
| 2018 | 14,219 |
| 2019 | 133,438 |
| Total | $ 168,438 |

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8. DERIVATIVE FINANCIAL INSTRUMENTS

We are exposed to various market risks, including risks associated with interest rates and foreign currency exchange rates. We enter into certain derivative transactions to mitigate the volatility associated with these exposures. We have policies in place that define acceptable instrument types we may enter into and we have established controls to limit our market risk exposure. We do not use derivative financial instruments for trading or speculative purposes. In addition, all derivatives, whether designated in hedging relationships or not, are required to be recorded on the balance sheet at fair value on a gross basis.

Cash Flow Hedges – Interest Rate Swap Agreements

In the first quarter of fiscal 2015, we entered into floating-to-fixed interest rate swap agreements to hedge the variability in LIBOR-based interest payments on $86,406 of our outstanding variable rate debt. The notional amount of the swaps decreases each quarter by an amount in proportion to our scheduled quarterly principal payment of debt. The notional value of the swaps was $84,219 as of March 31, 2015, and the swaps are scheduled to expire on June 27, 2019.

We have designated these swap agreements as cash flow hedges pursuant to ASC 815, "Derivatives and Hedging". As cash flow hedges, unrealized gains are recognized as assets and unrealized losses are recognized as liabilities. Unrealized gains and losses are designated as effective or ineffective based on a comparison of the changes in fair value of the interest rate swaps and changes in fair value of the underlying exposures being hedged. The effective portion is recorded as a component of accumulated other comprehensive income or loss, while the ineffective portion is recorded as a component of interest expense. Changes in the method by which we pay interest from one-month LIBOR to another rate of interest could create ineffectiveness in the swaps, and result in amounts being reclassified from other comprehensive income into net income. Hedge effectiveness is tested quarterly to determine if hedge treatment is appropriate.

Foreign Currency Contracts Not Designated as Hedges

Periodically we enter into forward foreign exchange contracts in an effort to mitigate the risks associated with currency fluctuations on certain foreign currency balance sheet exposures. Our foreign exchange contracts do not qualify for hedge accounting; therefore, the gains and losses resulting from the impact of currency exchange rate movements on our forward foreign exchange contracts are recognized as other income or expense in the accompanying consolidated income statements in the period in which the exchange rates change. As of March 31, 2015 and September 30, 2014, respectively, the notional amounts of the forward contracts we held to purchase U.S. dollars in exchange for other international currencies were $2,130 and $4,695, respectively, and the notional amounts of forward contracts we held to sell U.S. dollars in exchange for other international currencies were $25,240 and $18,425, respectively.

The fair value of our derivative instruments included in the Consolidated Balance Sheet, which was determined using level 2 inputs, was as follows:

| | Asset Derivatives | | Liability Derivatives | |
|---|---|---|---|---|
| Balance Sheet Location | March 31, 2015 | September 30, 2014 | March 31, 2015 | September 30, 2014 |

| | | | | | |
|---|---|---|---|---|---|
| Derivatives designated as hedging instruments | | | | | |
| Interest rate swap contracts | Other noncurrent assets | $11 | $ - | $- | $ - |
| | Accrued expenses and other current liabilities | $- | $ - | $950 | $ - |
| | Other long-term liabilities | $- | $ - | $11 | $ - |
| Derivatives not designated as hedging instruments | | | | | |
| Foreign exchange contracts | Prepaid expenses and other current assets | $110 | $ 100 | $- | $ - |
| | Accrued expenses and other current liabilities | $- | $ - | $24 | $ 270 |

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The following table summarizes the effect of our derivative instruments on our Consolidated Statement of Income for the three and six months ended March 31, 2015 and 2014:

| | | Gain (Loss) Recognized in Statement of Income | | | |
|---|---|---|---|---|---|
| | | Three Months Ended | | Six Months Ended | |
| Statement of Income Location | | March 31, 2015 | March 31, 2014 | March 31, 2015 | March 31, 2014 |
| Derivatives not designated as hedging instruments | | | | | |
| Foreign exchange contracts | Other income (expense), net | $(344) | $ 55 | $(1,680) | $(337) |

The interest rate swap agreements were deemed to be effective since inception, so there was no impact on our Consolidated Statement of Income.  We recorded a $612 unrealized loss, net of tax, in accumulated comprehensive income during the six months ended March 31, 2015 for these interest rate swaps.  During the next 12 months, we expect approximately $961 to be reclassified from accumulated other comprehensive income into interest expense related to our interest rate swaps as the fixed interest rate on our interest rate swaps is expected to be higher than the variable interest rate on our outstanding debt.

9. COMMITMENTS AND CONTINGENCIES

LEGAL PROCEEDINGS

While we are not involved in any legal proceedings that we believe will have a material impact on our consolidated financial position, results of operations or cash flows, we periodically become a party to legal proceedings in the ordinary course of business.

Refer to Note 16 of “Notes to the Consolidated Financial Statements” in Item 8 of Part II of our Annual Report on Form 10-K for the fiscal year ended September 30, 2014, for additional information regarding commitments and contingencies.

PRODUCT WARRANTIES

We maintain a warranty reserve that reflects management’s best estimate of the cost to replace product that does not meet our specifications and customers’ performance requirements, and costs related to such replacement.  The warranty reserve is based upon a historical product replacement rate, adjusted for any specific known conditions or circumstances.  Additions and deductions to the warranty reserve are recorded in cost of goods sold.  Our warranty reserve activity during the first six months of fiscal 2015 was as follows:

| | |
|---|---|
| Balance as of September 30, 2014 | $246 |
| Reserve for product warranty during the reporting period | 317 |
| Settlement of warranty | (325) |
| Balance as of March 31, 2015 | $238 |

PURCHASE OBLIGATIONS

Purchase obligations include our take-or-pay arrangements with suppliers, and purchase orders and other obligations entered into in the normal course of business regarding the purchase of goods and services. We operate under a fumed silica supply agreement with Cabot Corporation, our former parent company which is not a related party, which requires us to purchase certain minimum quantities of fumed silica each year of the agreement, and to pay a shortfall if we purchase less than the minimum. The agreement became effective as of January 1, 2013 with an initial term of four years. As of March 31, 2015, purchase obligations include $61,088 of contractual commitments related to our Cabot Corporation supply agreement for fumed silica.

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POSTRETIREMENT OBLIGATIONS IN FOREIGN JURISDICTIONS

We have unfunded defined benefit plans covering employees in certain foreign jurisdictions as required by local law. Benefit costs, consisting primarily of service costs, are recorded as fringe benefit expense under cost of goods sold and operating expenses in our Consolidated Statements of Income. The projected benefit obligations and accumulated benefit obligations under all such unfunded plans are updated annually during the fourth quarter of the fiscal year. Benefit payments under all such unfunded plans to be paid over the next 10 years are expected to be immaterial. For more information regarding these plans, refer to Note 16 of "Notes to the Consolidated Financial Statements" included in Item 8 of Part II of our Annual Report on Form 10-K for the fiscal year ended September 30, 2014.

10. ACCUMULATED OTHER COMPREHENSIVE INCOME

The components of accumulated other comprehensive income (AOCI), including the reclassification adjustments for items that are reclassified from AOCI to net income, are shown below:

| | Foreign Currency Translation Adjustment | Unrealized Gain (Loss) on Cash Flow Hedges | Pension and Other Postretirement Liabilities | Unrealized Gain (Loss) on Marketable Securities | Accumulated Other Comprehensive Income |
|---|---|---|---|---|---|
| Balance September 30, 2014 | $ 10,115 | $ - | $ (860) | $ - | $ 9,255 |
| Increase (decrease) in OCI | (10,074) | (1,339) | - | - | (11,413) |
| Reclassifications | - | 389 | - | - | 389 |
| Income tax benefit (expense) | 1,790 | 338 | - | - | 2,128 |
| Balance March 31, 2015 | $ 1,831 | $ (612) | $ (860) | $ - | $ 359 |

| | Foreign Currency Translation Adjustment | Unrealized Gain (Loss) on Cash Flow Hedges | Pension and Other Postretirement Liabilities | Unrealized Gain (Loss) on Marketable Securities | Accumulated Other Comprehensive Income |
|---|---|---|---|---|---|
| Balance September 30, 2013 | $ 18,251 | $ - | $ (664) | $ (151) | $ 17,436 |
| Increase (decrease) in OCI | (5,874) | - | - | 234 | (5,640) |
| Reclassifications | - | - | - | - | - |
| Income tax benefit (expense) | 662 | - | - | (83) | 579 |
| Balance March 31, 2014 | $ 13,039 | $ - | $ (664) | $ - | $ 12,375 |

Changes in our pension and postretirement liabilities are not material on a quarterly basis, so we record the annual change in accumulated other comprehensive income in the fourth quarter of our fiscal year.

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11. SHARE-BASED COMPENSATION PLANS

We issue share-based awards under the following programs: our Cabot Microelectronics Corporation 2012 Omnibus Incentive Plan (OIP); our Cabot Microelectronics Corporation 2007 Employee Stock Purchase Plan, as Amended and Restated January 1, 2010 (ESPP); and pursuant to the OIP, our Directors' Deferred Compensation Plan, as amended September 23, 2008 (DDCP), and our 2001 Executive Officer Deposit Share Program (DSP). Prior to March 2012, when our stockholders approved the OIP, we issued share-based payments under our Second Amended and Restated Cabot Microelectronics Corporation 2000 Equity Incentive Plan, as amended and restated September 23, 2008 (EIP); our ESPP, and, pursuant to the EIP, the DDCP and DSP. For additional information regarding these programs, refer to Note 11 of "Notes to the Consolidated Financial Statements" included in Item 8 of Part II of our Annual Report on Form 10-K for the fiscal year ended September 30, 2014. Other than the ESPP, all share-based payments granted beginning March 6, 2012 are made from the OIP, and the EIP is no longer available for any awards.

We record share-based compensation expense for all share-based awards, including stock option grants, restricted stock and restricted stock unit awards and employee stock purchase plan purchases. We calculate share-based compensation expense using the straight-line approach based on awards ultimately expected to vest, which requires the use of an estimated forfeiture rate. Our estimated forfeiture rate is primarily based on historical experience, but may be revised in future periods if actual forfeitures differ from the estimate. We use the Black-Scholes option-pricing model to estimate the grant date fair value of our stock options and employee stock purchase plan purchases. This model requires the input of highly subjective assumptions, including the price volatility of the underlying stock, the expected term of our stock options and the risk-free interest rate. We estimate the expected volatility of our stock options based on a combination of our stock's historical volatility and the implied volatilities from actively-traded options on our stock. We calculate the expected term of our stock options using historical stock option exercise data, and we add a slight premium to this expected term for employees who meet the definition of retirement eligible pursuant to their grants during the contractual term of the grant. The risk-free interest rate is derived from the U.S. Treasury yield curve in effect at the time of grant.

Share-based compensation expense for the three and six months ended March 31, 2015, and 2014, was as follows:

| | Three Months Ended March 31, | | Six Months Ended March 31, | |
|---|---|---|---|---|
| | 2015 | 2014 | 2015 | 2014 |
| Cost of goods sold | $463 | $449 | $961 | $929 |
| Research, development and technical | 384 | 352 | 799 | 718 |
| Selling and marketing | 248 | 307 | 568 | 660 |
| General and administrative | 4,204 | 3,317 | 6,378 | 5,484 |
| Total share-based compensation expense | 5,299 | | | |