

CPI INTERNATIONAL, INC.
Form 10-Q
February 09, 2011
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UNITED STATES
SECURITIES AND EXCHANGE

COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2010

or

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

For the transition period from _____ to _____

Commission file number: 000-51928

CPI INTERNATIONAL, INC.
(Exact Name of Registrant as Specified in Its Charter)

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

811 Hansen Way, Palo Alto, California 94303
(Address of Principal Executive Offices and Zip Code)

(650) 846-2900

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since
last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was

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

Yes No

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

Yes No

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding for each of the registrant’s classes of Common Stock, as of the latest practicable date: 16,854,595 shares of Common Stock, \$0.01 par value, at February 1, 2011.

CPI INTERNATIONAL, INC.
and Subsidiaries

10-Q REPORT
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Cautionary Statements Regarding Forward-Looking Statements

This document contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, that relate to future events or our future financial performance. In some cases, readers can identify forward-looking statements by terminology such as “may,” “will,” “should,” “expect,” “plan,” “anticipate,” “believe,” “estimate,” “predict,” “potential” or “continue,” the negative or other comparable terminology. These statements are only predictions. Actual events or results may differ materially.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we nor any other person assumes responsibility for the accuracy and completeness of the forward-looking statements. Forward-looking statements are subject to known and unknown risks and uncertainties, which could cause actual results to differ materially from the results projected, expected or implied by the forward-looking statements. These risk factors include, without limitation, risks associated with our pending merger agreement with an affiliate of The Veritas Capital Fund IV, L.P. (including the risk that the merger may not be consummated); competition in our end markets; our significant amount of debt and our ability to refinance our debt; changes or reductions in the United States defense budget; currency fluctuations; goodwill impairment considerations; customer cancellations of sales contracts; U.S. Government contracts; export restrictions and other laws and regulations; international laws; changes in technology; the impact of unexpected costs; the impact of a general slowdown in the global economy; the impact of environmental laws and regulations; and inability to obtain raw materials and components. All written and oral forward-looking statements made in connection with this report that are attributable to us or persons acting on our behalf are expressly qualified in their entirety by the foregoing risk factors and other cautionary statements included herein and in our other filings with the Securities and Exchange Commission (“SEC”). We are under no duty to update any of the forward-looking statements after the date of this report to conform such statements to actual results or to changes in our expectations.

The information in this report is not a complete description of our business or the risks and uncertainties associated with an investment in our securities. You should carefully consider the various risks and uncertainties that impact our business and the other information in this report and in our other filings with the SEC before you decide to invest in our securities or to maintain or increase your investment.

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and Subsidiaries

Part I: FINANCIAL INFORMATION

Item 1. Unaudited Condensed Consolidated Financial Statements

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

| | December 31, 2010 | October 1, 2010 |
|--|----------------------|--------------------|
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 59,907 | \$ 42,829 |
| Restricted cash | 3,060 | 1,804 |
| Accounts receivable, net | 39,423 | 45,707 |
| Inventories | 78,445 | 75,208 |
| Deferred tax assets | 11,887 | 11,030 |
| Prepaid and other current assets | 6,112 | 6,459 |
| Total current assets | 198,834 | 183,037 |
| Property, plant, and equipment, net | 52,550 | 54,259 |
| Deferred debt issue costs, net | 1,344 | 1,604 |
| Intangible assets, net | 71,730 | 72,474 |
| Goodwill | 162,225 | 162,225 |
| Other long-term assets | 5,465 | 4,677 |
| Total assets | \$ 492,148 | \$ 478,276 |
| Liabilities and stockholders' equity | | |
| Current Liabilities: | | |
| Current portion of long-term debt | \$ 66,000 | \$ 66,000 |
| Accounts payable | 22,195 | 24,290 |
| Accrued expenses | 29,837 | 23,653 |
| Product warranty | 5,418 | 5,101 |
| Income taxes payable | 3,522 | 5,022 |
| Advance payments from customers | 21,766 | 14,218 |
| Total current liabilities | 148,738 | 138,284 |
| Deferred income taxes | 21,542 | 21,707 |
| Long-term debt, less current portion | 128,937 | 128,934 |
| Other long-term liabilities | 5,451 | 5,411 |
| Total liabilities | 304,668 | 294,336 |
| Commitments and contingencies | | |
| Stockholders' equity | | |
| Common stock (\$0.01 par value, 90,000 shares authorized; 17,059 and 17,020 shares issued; 16,852 and 16,813 shares outstanding) | 171 | 170 |
| Additional paid-in capital | 81,235 | 80,015 |
| Accumulated other comprehensive loss | (44) | (141) |

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| | | |
|--|------------|------------|
| Retained earnings | 108,918 | 106,696 |
| Treasury stock, at cost (206 shares) | (2,800) | (2,800) |
| Total stockholders' equity | 187,480 | 183,940 |
| Total liabilities and stockholders' equity | \$ 492,148 | \$ 478,276 |

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

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

| | Quarter Ended | |
|--|---------------|------------|
| | December | January 1, |
| | 31, | 2010 |
| | 2010 | 2010 |
| Sales | \$ 89,020 | \$ 82,767 |
| Cost of sales | 64,099 | 59,327 |
| Gross profit | 24,921 | 23,440 |
| Operating costs and expenses: | | |
| Research and development | 3,130 | 2,556 |
| Selling and marketing | 5,244 | 5,040 |
| General and administrative | 6,316 | 5,525 |
| Amortization of acquisition-related intangible assets | 686 | 687 |
| Strategic alternative transaction expenses | 2,657 | - |
| Total operating costs and expenses | 18,033 | 13,808 |
| Operating income | 6,888 | 9,632 |
| Interest expense, net | 3,711 | 3,881 |
| Income before income taxes | 3,177 | 5,751 |
| Income tax expense | 955 | 1,910 |
| Net income | \$ 2,222 | \$ 3,841 |
| Other comprehensive income, net of tax | | |
| Net unrealized gain on cash flow hedges and minimum pension liability adjustment | 97 | 844 |
| Comprehensive income | \$ 2,319 | \$ 4,685 |
| Earnings per common share - Basic | \$ 0.13 | \$ 0.23 |
| Earnings per common share - Diluted | \$ 0.12 | \$ 0.21 |
| Shares used to compute earnings per common share - Basic | 16,695 | 16,452 |
| Shares used to compute earnings per common share - Diluted | 18,076 | 17,630 |

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

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

| | Quarter Ended | |
|--|---------------|------------|
| | December | January 1, |
| | 31, | 2010 |
| | 2010 | 2010 |
| Cash flows from operating activities | | |
| Net cash provided by operating activities | \$ 17,487 | \$ 9,564 |
| Cash flows from investing activities | | |
| Capital expenditures | (447) | (811) |
| Payment of patent application fees | (6) | - |
| Net cash used in investing activities | (453) | (811) |
| Cash flows from financing activities | | |
| Payment for Senior Credit Facilities agreement amendment (Note 6) | (379) | - |
| Proceeds from issuance of common stock to employees | 217 | 189 |
| Proceeds from exercise of stock options | 136 | 14 |
| Excess tax benefit on stock option exercises | 70 | 2 |
| Net cash provided by financing activities | 44 | 205 |
| Net increase in cash and cash equivalents | 17,078 | 8,958 |
| Cash and cash equivalents at beginning of period | 42,829 | 26,152 |
| Cash and cash equivalents at end of period | \$ 59,907 | \$ 35,110 |
| Supplemental cash flow disclosures | | |
| Cash paid for interest | \$ 800 | \$ 1,054 |
| Cash paid for income taxes, net of refunds | \$ 3,284 | \$ 2,273 |

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

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and Subsidiaries

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

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

The Company

Unless the context otherwise requires, “CPI International” means CPI International, Inc., and “CPI” means Communications & Power Industries, Inc. CPI is a direct subsidiary of CPI International. CPI International is a holding company with no operations of its own. The term “the Company” refers to CPI International and its direct and indirect subsidiaries on a consolidated basis.

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

Liquidity: The Company has historically financed, and intends to continue to finance, its capital and working capital requirements including debt service and internal growth, through a combination of cash flows from its operations and borrowings under its senior credit facilities. In addition, the Company is party to a merger agreement, as described in further details in Note 4, with Catalyst Acquisition, Inc., a wholly owned subsidiary of CPI International Acquisition, Inc. (formerly Catalyst Holdings, Inc.). Catalyst Acquisition, Inc. and CPI International Acquisition, Inc. are affiliates of The Veritas Capital Fund IV, L.P. (the “Veritas Fund”). If the merger closes, the Company expects to receive financing proceeds as a result of an equity contribution from the Veritas Fund and certain of its affiliates and net proceeds from the offering of senior notes and borrowings under the new term loan facility expected to be entered into by CPI International Acquisition, Inc. at the closing of the current pending merger.

If the merger closes, the Company believes that the financial resources from the refinancing taking place in connection with the merger, its cash on hand, and expected cash flows from operations will be sufficient to meet its business requirements, including capital expenditures and working capital requirements for the next 12 months, and to repay the \$66.0 million outstanding under its senior credit facility term loan scheduled to come due on August 1, 2011, as well as the \$117.0 million of its outstanding 8% senior subordinated notes and the \$12.0 million of its outstanding floating rate senior notes prior to their scheduled maturity dates. It is anticipated that the amounts outstanding under the Company's existing senior credit facility term loan and under its currently outstanding notes will be repaid in connection with the merger.

Basis of Presentation and Consolidation

The Company's fiscal year is the 52- or 53-week period that ends on the Friday nearest September 30. Fiscal years 2011 and 2010 comprised the 52-week periods ending September 30, 2011 and October 1, 2010, respectively. The first quarters of both fiscal years 2011 and 2010 include 13 weeks. All period references are to the Company's fiscal periods unless otherwise indicated.

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

The accompanying unaudited condensed consolidated financial statements of the Company as of December 31, 2010 and for the first quarter of fiscal years 2011 and 2010 are unaudited and reflect all normal recurring adjustments which are, in the opinion of management, necessary for the fair presentation of such financial statements. These unaudited condensed consolidated financial statements should be read in conjunction with the Company's consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended October 1, 2010. The condensed consolidated balance sheet as of October 1, 2010 has been derived from the audited financial statements at that date. The results of operations and cash flows for the interim period ended December 31, 2010 are not necessarily indicative of results to be expected for the full year. Should the merger noted above and discussed in note 4 be completed, the Company anticipates the transaction will be accounted for as a business combination and result in a change in basis of its balance sheet as of the merger date. Such accounting will result in significant changes to the Company's balance sheet and income statement in future periods including recording all assets and liabilities at fair value as of the merger date, recognition of additional goodwill and, in periods after the merger, increased amortization of intangible assets which will reduce net income.

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

Use of Estimates and Assumptions

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

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

2. Recently Issued Accounting Standards

In October 2009, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2009-13, “Revenue Recognition (Topic 605): Multiple Deliverable Revenue Arrangements – A Consensus of the FASB Emerging Issues Task Force.” This update provides application guidance on whether multiple deliverables exist, how the deliverables should be separated and how the consideration should be allocated to one or more units of accounting. This update eliminates the residual method of allocation for multiple-deliverable revenue arrangements, and requires that arrangement consideration be allocated at the inception of an arrangement to all deliverables. The selling price used for each deliverable will be based on vendor-specific objective evidence (“VSOE”), if available, third-party evidence (“TPE”) if VSOE is not available, or estimated selling price if neither VSOE or TPE is available. Additionally, ASU 2009-13 expands the disclosure requirements related to a vendor’s multiple-deliverable revenue arrangements. The Company adopted the provisions of this guidance under ASU 2009-13 effective October 2, 2010. The adoption did not have a material impact on the Company’s consolidated results of operations, financial position or cash flows.

In September 2009, the FASB issued ASU 2009-14, “Certain Revenue Arrangements That Include Software Elements,” which is included in the Accounting Standards Codification (“ASC”) Topic 985, “Software.” ASU 2009-14 amends previous software revenue recognition to exclude (a) non-software components of tangible products and (b) software components of tangible products that are sold, licensed, or leased with tangible products when the software components and non-software components of the tangible product function together to deliver the tangible product’s essential functionality. The Company adopted the provisions of this update under ASU 2009-14 effective October 2, 2010. The adoption did not have a material impact on the Company’s consolidated results of operations, financial position or cash flows.

In December 2009, the FASB issued ASU 2009-17, “Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities,” as a further clarification to ASC 810-10, “Consolidation of Variable Interest Entities.” ASU 2009-17, upon adoption, requires the use of a qualitative analysis to determine the primary beneficiary of a variable interest entity (“VIE”), amends the guidance for determining if an entity is a VIE and enhances the disclosure requirements regarding an enterprise’s involvement with a VIE. The Company adopted the provisions of this update under ASU 2009-17 effective October 2, 2010. Since the Company does not currently have variable interest entities, this update did not have an impact on the Company’s consolidated results of operations, financial position or cash flows.

In January 2010, the FASB issued ASU 2010-06, “Fair Value Measurements and Disclosures: Improving Disclosures About Fair Value Measurements.” This update requires reporting entities to make new disclosures about recurring or nonrecurring fair-value measurements including significant transfers into and out of Level 1 and Level 2 fair-value measurements and information on purchases, sales, issuances, and settlements on a gross basis in the reconciliation of Level 3 fair-value measurements. The Company adopted the provisions of this guidance under ASU 2009-06, except for Level 3 reconciliation disclosures, effective January 2, 2010 with no impact on the Company’s consolidated results of operations, financial position or cash flows. The level 3 reconciliation disclosures are effective for annual periods beginning after December 15, 2010, and for interim periods within those fiscal years. As the level 3 reconciliation is also disclosure-related, its adoption is not expected to have an impact on the Company’s consolidated results of operations, financial position or cash flows.

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

In April 2010, the FASB issued ASU 2010-17, “Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition.” ASU 2010-17 provides guidance on applying the milestone method to milestone payments for achieving specified performance measures when those payments are related to uncertain future events. The scope of ASU 2010-17 is limited to transactions involving research or development. This update further states that the milestone method is not the only acceptable method of revenue recognition for milestone payments. Accordingly, entities can make an accounting policy election to recognize arrangement consideration received for achieving specified performance measures during the period in which the milestones are achieved, provided certain criteria are met. An entity’s policy for recognizing deliverable consideration or unit of accounting consideration contingent upon achievement of a milestone shall be applied consistently to similar deliverables or units of accounting. The Company adopted the provisions of this update under ASU 2010-17 effective October 2, 2010. The adoption did not have a material impact on the Company’s consolidated results of operations, financial position or cash flows.

In December 2010, the FASB issued ASU 2010-28, “Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts.” ASU 2010-28 modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity must consider whether there are any adverse qualitative factors indicating an impairment may exist. ASU 2010-28 is effective for fiscal years, and interim periods within those years, beginning December 15, 2010. The adoption of this ASU is not expected to have a material impact on the Company’s consolidated results of operations, financial position or cash flows.

In December 2010, the FASB issued ASU 2010-29, “Business Combinations (Topic 805): Disclosure of Supplementary Pro Forma Information for Business Combinations.” ASU 2010-29 requires that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. This ASU also expands the supplemental pro forma adjustments to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. ASU 2010-29 is effective prospectively for business combinations for which the acquisition date is on or after the first annual reporting period beginning on or after December 15, 2010. As this ASU is disclosure-related, it is not expected to have a material impact on the Company’s consolidated results of operations, financial position or cash flows.

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

3. Supplemental Balance Sheet Information

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

| | December | |
|---------------------------------------|-------------|--------------------|
| | 31, 2010 | October 1, 2010 |
| Accounts receivable | \$ 39,498 | \$ 45,819 |
| Less: Allowance for doubtful accounts | (75) | (112) |
| Accounts receivable, net | \$ 39,423 | \$ 45,707 |

Inventories: The following table provides details of inventories:

| | December | |
|------------------------|-------------|--------------------|
| | 31, 2010 | October 1, 2010 |
| Raw material and parts | \$ 44,039 | \$ 42,167 |
| Work in process | 25,803 | 24,531 |
| Finished goods | 8,603 | 8,510 |
| | \$ 78,445 | \$ 75,208 |

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

| | Quarter Ended | |
|--|-------------------------|--------------------|
| | December 31, 2010 | January 1, 2010 |
| Balance at beginning of period | \$ 3,737 | \$ 4,068 |
| Provision for loss contracts, charged to cost of sales | 1,594 | 1,111 |
| Credit to cost of sales upon revenue recognition | (426) | (668) |
| Balance at end of period | \$ 4,905 | \$ 4,511 |

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

| | December | |
|------------------|-------------|--------------------|
| | 31, 2010 | January 1, 2010 |
| Inventories | \$ 4,018 | \$ 4,391 |
| Accrued expenses | 887 | 120 |
| | \$ 4,905 | \$ 4,511 |

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

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

| | Quarter Ended | |
|--|-------------------------|--------------------|
| | December 31, 2010 | January 1, 2010 |
| Beginning accrued warranty | \$ 5,101 | \$ 3,845 |
| Actual costs of warranty claims | (1,334) | (1,170) |
| Estimates for product warranty, charged to cost of sales | 1,651 | 1,286 |
| Ending accrued warranty | \$ 5,418 | \$ 3,961 |

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

| | December | |
|--|-------------|--------------------|
| | 31, 2010 | October 1, 2010 |
| Unrealized gain on cash flow hedges, net of tax | \$ 272 | \$ 175 |
| Unrealized actuarial loss and prior service credit for pension liability, net of tax | (316) | (316) |
| | \$ (44) | \$ (141) |

4. Merger Agreement

The Company entered into an Agreement and Plan of Merger dated as of November 24, 2010 ("Merger Agreement") with Catalyst Acquisition, Inc. ("Merger Sub"), an indirect wholly owned subsidiary of CPI International Acquisition, Inc. (formerly Catalyst Holdings, Inc.). CPI International Acquisition, Inc. is an indirect wholly owned subsidiary of CPI International Holding Corp. ("Parent"). Parent, Merger Sub and CPI International Acquisition, Inc. are affiliates of the Veritas Fund.

The Merger Agreement contemplates that Merger Sub will be merged with and into the Company, with the Company surviving as a wholly-owned subsidiary of Parent (the "Merger"), and each outstanding share of the Company's common stock will be converted in the Merger into the right to receive \$19.50 per share in cash.

The Company has made customary representations, warranties and covenants in the Merger Agreement, including (i) its agreement, subject to certain exceptions, to conduct business in the ordinary course and not to engage in certain activities between the execution of the Merger Agreement and the consummation of the merger and (ii) its agreement to not solicit or knowingly encourage alternative transactions or, subject to certain exceptions, enter into discussions concerning, or provide information in connection with, alternative transactions.

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

The completion of the Merger is subject to certain conditions, including, among others, (i) the adoption of the Merger Agreement by the Company's stockholders, (ii) the absence of certain legal impediments to the consummation of the merger, (iii) the expiration or termination of the applicable waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, and certain approvals under foreign anti-competition laws, (iv) subject to certain materiality exceptions, the accuracy of the representations and warranties made by Parent and the Company, respectively, and (v) compliance by Parent and the Company with the respective obligations under the Merger Agreement. The completion of the Merger is not subject to a financing condition. However, generally, Parent will not be required to close the merger until completion of a marketing period set forth in the Merger Agreement.

The Merger Agreement contains typical mutual termination rights, including termination by mutual agreement of the parties, for any final and nonappealable order or law enjoining or prohibiting or making illegal the Merger or for failure to obtain the Company's stockholder approval. In addition, either party may terminate the Merger Agreement if the Merger is not consummated by April 15, 2011. In addition, the Merger Agreement may be terminated by Parent in the event that the Company's board of directors changes its recommendation. The Company may terminate the Merger Agreement in order to enter into a superior acquisition proposal. The Company may also terminate the Merger agreement if all of the conditions precedent to Parent's obligation to close have been satisfied or waived (other than conditions that by their terms are to be satisfied at the closing) and Parent does not complete the closing by the required date.

The Company has agreed to pay a termination fee upon termination of the merger agreement if, among other things, (i) Parent terminates the merger agreement due to a recommendation change by the Company's board of directors, (ii) either party terminates the merger agreement because of the failure to obtain stockholder approval and before termination, the Company's board of directors changes its recommendation, or (iii) the Company terminates the merger agreement to enter into a superior acquisition proposal. If the merger agreement is terminated in connection with a superior acquisition proposal, then the termination fee payable by the Company is \$13 million. A termination by Parent following a change of recommendation resulting from certain events, circumstances or developments unknown or not understood as of the date of the merger agreement results in a termination fee of \$15 million. In addition, if the termination by Parent following a change in recommendation resulting from certain events, circumstances or developments unknown or not understood as of the date of the merger agreement occurs after the stockholder meeting to approve the merger agreement and the stockholders fail to approve the merger agreement, the Company will also be required to reimburse up to \$2.5 million of Parent's fees and expenses.

If the Company terminates the merger agreement under certain circumstances (including Parent's failure to consummate the merger by the required date following satisfaction or waiver of all conditions precedent to Parent's obligation to close (other than conditions that by their terms are to be satisfied at the closing)), Parent must pay the Company a termination fee of \$22.5 million; provided that this termination fee will be increased to \$27.5 million if Parent has committed willful breach of the merger agreement.

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Other Merger-Related Transactions

In connection with the Merger, Communications & Power Industries, Inc. has offered to purchase all \$117.0 million aggregate principal amount of its existing outstanding 8% Senior Subordinated Notes due 2012 (the “8% Notes”), and CPII has offered to purchase all \$12.0 million aggregate principal amount of its existing outstanding Floating Rate Senior Notes due 2015 (the “FR Notes”) pursuant to tender offers and related consent solicitations. The outstanding consents required to approve the proposed amendments to the indenture governing the 8% Notes and the FR Notes have been received. Any 8% Notes not tendered will be redeemed according to the terms of the indenture governing the 8% Notes. All holders of the FR Notes have validly tendered their notes and consents.

At the closing of the Merger, the Company expects to refinance its existing senior credit facility. Parent has received an equity commitment letter from the Veritas Fund pursuant to which the Veritas Fund has committed to invest, or have its affiliates invest, up to \$220.0 million, plus certain additional amounts, solely for the purpose of purchasing equity securities of an indirect parent of CPI International Acquisition, Inc. in order to provide a portion of the financing required for the Merger and the other transactions contemplated by the Merger Agreement. Actual funding from the Veritas Fund and its affiliates will depend on, among other things, the amount of the Company’s cash balances at the Merger closing date.

In addition, the remainder of the funding for the Merger, the associated refinancing of the Company's debt and fees and expenses is expected to come from a \$215.0 million aggregate principal amount note offering by Parent and a new credit facility for Parent consisting of a \$150.0 million six-year term loan facility and a \$30.0 million five-year revolving credit facility.

Strategic Alternative Transaction Expenses

The Company incurred during the first quarter of fiscal year 2011 non-recurring transaction costs, reported as “strategic alternative transaction expenses” in the condensed consolidated statement of income and comprehensive income, in the amount of \$2.7 million. Such transaction expenses comprised fees for investment bankers, attorneys and other professional services rendered in connection with the sale of the Company, including the Merger.

5. Financial Instruments

The Company’s non-financial assets (including goodwill, intangible assets, inventories and long-lived assets) and liabilities are measured at fair value on a non-recurring basis; that is, the assets and liabilities are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances such as when they are deemed to be other-than-temporarily impaired. The fair values of these non-financial assets and liabilities are determined based on valuation techniques using the best information available, and may include quoted market prices, market comparables, and discounted cash flow projections. An impairment charge is recorded when the cost exceeds its fair value and this condition is determined to be other-than-temporary. During the first quarter of fiscal years 2011 and 2010, no fair value adjustments or material fair value measurements were required for the Company’s non-financial assets or liabilities.

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The Company measures certain financial assets and liabilities at fair value on a recurring basis, including cash equivalents, restricted cash, available-for-sale securities and derivative instruments. As of December 31, 2010, financial assets utilizing Level 1 inputs included cash equivalents, such as money market and overnight U.S. Government securities and available-for-sale securities, such as mutual funds. Financial assets and liabilities utilizing Level 2 inputs included foreign currency derivatives and interest rate swap derivatives. The Company does not have any financial assets or liabilities requiring the use of Level 3 inputs.

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

| | Total | Fair Value Measurements at December 31, 2010 Using | | |
|--|------------------|--|---|---|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets: | | | | |
| Money market and overnight U.S. Government securities ¹ | \$ 46,401 | \$ 46,401 | \$ - | \$ - |
| Mutual funds ² | 185 | 185 | - | - |
| Foreign exchange forward derivatives ³ | 739 | - | 739 | - |
| Total assets at fair value | \$ 47,325 | \$ 46,586 | \$ 739 | - |
| Liabilities: | | | | |
| Interest rate swap derivative ⁴ | \$ 493 | \$ - | \$ 493 | \$ - |
| Total liabilities at fair value | \$ 493 | \$ - | \$ 493 | \$ - |

¹ The money market and overnight U.S. Government securities are classified as part of cash and cash equivalents and restricted cash in the condensed consolidated balance sheet.

² The mutual funds are classified as part of other long-term assets in the condensed consolidated balance sheet.

³ The foreign currency derivatives are classified as part of prepaid and other current assets in the condensed consolidated balance sheet.

⁴ The interest rate swap derivatives are classified as part of accrued expenses in the condensed consolidated balance sheet.

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| | Total | Fair Value Measurements at October 1, 2010 Using | | |
|---|------------------|--|---|--|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets: | | | | |
| Money market and overnight U.S. Government securities ¹ | \$ 36,420 | \$ 36,420 | \$ - | \$ - |
| Mutual funds ² | 171 | 171 | - | - |
| Foreign exchange forward derivatives ³ | 437 | - | 437 | - |
| Total assets at fair value | \$ 37,028 | \$ 36,591 | \$ 437 | - |
| Liabilities: | | | | |
| Interest rate swap derivative ⁴ | \$ 816 | \$ - | \$ 816 | \$ - |
| Total liabilities at fair value | \$ 816 | \$ - | \$ 816 | \$ - |

¹ The money market and overnight U.S. Government securities are classified as part of cash and cash equivalents and restricted cash in the condensed consolidated balance sheet.

² The mutual funds are classified as part of other long-term assets in the condensed consolidated balance sheet.

³ The foreign currency derivatives are classified as part of prepaid and other current assets in the condensed consolidated balance sheet.

⁴ The interest rate swap derivatives are classified as part of accrued expenses in the condensed consolidated balance sheet.

Investments Other Than Derivatives

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

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

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Derivatives

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

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

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

See Note 7 for further information regarding the Company's derivative instruments.

Other Financial Instruments

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

The fair values of the Company's long-term debt were estimated using quoted market prices where available. For long-term debt not actively traded, fair values were estimated using discounted cash flow analyses, based on the Company's current estimated incremental borrowing rates for similar types of borrowing arrangements. The estimated fair value of the Company's long-term debt as of December 31, 2010 and October 1, 2010 was \$194.0 million and \$192.6 million, respectively, compared to the carrying value of \$194.9 million as of both dates.

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6. Senior Credit Facilities Agreement Amendment

In November 2010, Communications & Power Industries entered into Amendment and Waiver No. 1 (the "Amendment") to its Senior Credit Facilities. The Senior Credit Facilities will mature and become due and payable on August 1, 2011 if CPI does not refinance or repay its 8% Senior Subordinated Notes prior to such date. The Amendment effects several technical changes to the Senior Credit Facilities including, among other items: (1) as a result of the potential maturity of the credit agreement on August 1, 2011, Communications & Power Industries is not currently permitted to have letters of credit under the credit agreement which extend beyond July 27, 2011; the Amendment permits Communications & Power Industries to obtain letters of credit outside the credit agreement (including depositing cash with the issuing banks to secure its obligations under those letters of credit) provided that the total amount of letters of credit that Communications & Power Industries may have outstanding at any time shall not exceed \$10 million in the aggregate; (2) the Amendment clarifies that entering into a merger agreement and an associated voting agreement would not trigger defaults under the credit agreement. The Company paid \$0.4 million for the Senior Credit Facilities agreement amendment. This amount is included in deferred debt issue costs, net in the condensed consolidated balance sheet as of December 31, 2010.

7. Derivative Instruments and Hedging Activities

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

The Company's Canadian dollar forward contracts in effect as of December 31, 2010 have durations of 3 to 12 months. These contracts are designated as a cash flow hedge and are considered highly effective, as defined by FASB ASC 815, "Derivatives and Hedging." Unrealized gains and losses from foreign exchange forward contracts are included in accumulated other comprehensive income in the condensed consolidated balance sheets. At December 31, 2010, the unrealized gain, net of tax of \$0.3 million, was \$0.6 million. The Company anticipates recognizing the entire unrealized gain or loss in operating earnings within the next four fiscal quarters. Changes in the fair value of foreign currency forward contracts due to changes in time value are excluded from the assessment of effectiveness and are immediately recognized in general and administrative expenses in the consolidated statements of income. The time value was not material for the first quarter of fiscal years 2011 and 2010. If the transaction being hedged fails to occur, or if a portion of any derivative is ineffective, then the Company immediately recognizes the gain or loss on the associated financial instrument in general and administrative in the consolidated statements of income. No ineffective amounts were recognized due to hedge ineffectiveness in the first quarter of fiscal year 2011. The gain recognized in general and administrative due to hedge ineffectiveness was insignificant for the first quarter of fiscal year 2010.

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As of December 31, 2010, the Company had entered into Canadian dollar forward contracts for approximately \$18.9 million (Canadian dollars), or approximately 53% of estimated Canadian dollar denominated expenses for January 2011 through September 2011, at an average rate of approximately 0.96 U.S. dollar to Canadian dollar.

Interest Rate Contracts: The Company also uses derivative instruments in order to manage interest costs and risk associated with its long-term debt. During fiscal year 2007, the Company entered into an interest rate swap contract (the "2007 Swap") to receive three-month USD-LIBOR-BBA (British Bankers' Association) interest and pay 4.77% fixed rate interest. Net interest positions are settled quarterly. The Company has structured the 2007 Swap with decreasing notional amounts such that it is less than the balance of its term loan under its senior credit facilities. The notional value of the 2007 Swap was \$25.0 million at December 31, 2010 and represented approximately 38% of the aggregate term loan balance. The Swap agreement is effective through June 30, 2011. Under the provisions of ASC 815, this arrangement was initially designated and qualified as an effective cash flow hedge of interest rate risk related to the term loan, which permitted recording the fair value of the 2007 Swap and corresponding unrealized gain or loss to accumulated other comprehensive income in the consolidated balance sheets. At December 31, 2010, the unrealized loss, net of tax of \$0.2 million, was \$0.3 million. The interest rate swap gain or loss is included in the assessment of hedge effectiveness. Gains and losses representing hedge ineffectiveness are immediately recognized in interest expense, net in the consolidated statements of income.

See Note 5, Financial Instruments, for further information regarding the Company's derivative instruments.

The following table summarizes the fair value of derivative instruments designated as cash flow hedges at December 31, 2010 and October 1, 2010:

| | Asset Derivatives | | | Liability Derivatives | | |
|--|--|-------------------------|-----------------------|---------------------------|-------------------------|-----------------------|
| | Balance Sheet Location | Fair Value | | Balance Sheet Location | Fair Value | |
| | | December 31, 2010 | October 1, 2010 | | December 31, 2010 | October 1, 2010 |
| Derivatives designated as hedging instruments | | | | | | |
| Interest rate contracts | | | | Accrued expenses | \$ 493 | \$ 816 |
| Forward contracts | Prepaid and other current assets | \$ 739 | \$ 437 | | | |
| Total derivatives designated as hedging instruments | | \$ 739 | \$ 437 | | \$ 493 | \$ 816 |

As of December 31, 2010 and October 1, 2010, all of the Company's derivative instruments were classified as hedging instruments under ASC 815.

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The following table summarizes the effect of derivative instruments on the condensed consolidated statements of income and comprehensive income for the first quarter of fiscal years 2011 and 2010:

| Derivatives in Cash Flow Hedging Relationships | Amount of Gain (Loss) Recognized in OCI on Derivative (Effective Portion) Three Months Ended | | Location of (Loss) Gain Reclassified from Accumulated OCI into Income (Effective Portion) | Amount of (Loss) Gain Reclassified from Accumulated OCI into Income (Effective Portion) Three Months Ended | | Location of (Loss) Gain Recognized in Income on Derivative (Ineffective and Excluded Portion) | Amount of (Loss) Gain Recognized in Income on Derivative (Ineffective and Excluded Portion) Three Months Ended | |
|---|---|---------------|---|--|------------------|--|---|----------------|
| | December | January | | December | January | | December | January |
| | 31, 2010 | 1, 2010 | | 31, 2010 | 1, 2010 | | 31, 2010 | 1, 2010 |
| Interest rate contracts | \$ 46 | \$ (84) | Interest expense, net | \$ (277) | \$ (550) | Interest expense, net | \$ (5) | \$ (10) |
| Forward contracts | 507 | 752 | Cost of sales | 504 | (75) | General and administrative(a) | 33 | 2 |
| | | | Research and development | 51 | 39 | | | |
| | | | Selling and marketing | 22 | 17 | | | |
| | | | General and administrative | 30 | 22 | | | |
| Total | \$ 553 | \$ 668 | | \$ 330 | \$ (547) | | \$ (28) | \$ (8) |

(a) The amount of gain recognized in income during the first quarter of fiscal year 2011 represents a \$33 gain related to the amount excluded from the assessment of hedge effectiveness. The amount of gain recognized in income during the first quarter of fiscal year 2010 represents a \$5 gain related to the ineffective portion of the hedging relationships, net of a \$3 loss related to the amount excluded from the assessment of hedge effectiveness.

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

When the Company's derivatives are in a net asset position, such as the case with the Company's forward foreign exchange contract derivatives at December 31, 2010, the Company is exposed to credit loss from nonperformance by the counterparty. If the counterparty fails to perform, credit risk with such counterparty is equal to the extent of the fair value gain in the derivative. At December 31, 2010, the Company's interest rate contract derivatives were in a liability position, and the Company, therefore, was not exposed to the interest rate contract counterparty credit risk.

8. Commitments and Contingencies

Leases: The Company is committed to minimum rentals under non-cancelable operating lease agreements, primarily for land and facility space, that expire on various dates through 2050. Certain of the leases provide for escalating lease payments. Future minimum lease payments for all non-cancelable operating lease agreements at December 31, 2010 were as follows:

| Fiscal Year | Operating Leases |
|------------------------------|---------------------|
| 2011 (remaining nine months) | \$ 1,173 |
| 2012 | 1,301 |
| 2013 | 882 |
| 2014 | 467 |
| 2015 | 287 |
| Thereafter | 2,375 |
| | \$ 6,485 |

Real estate taxes, insurance, and maintenance are also obligations of the Company. Rental expense under non-cancelable operating leases amounted to \$0.7 million for the first quarter of fiscal years 2011 and 2010. Assets subject to capital leases at December 31, 2010 and October 1, 2010 were not material.

Guarantees: The Company has restricted cash of \$3.1 million and \$1.8 million as of December 31, 2010 and October 1, 2010, respectively, consisting of bank guarantees from customer advance payments to the Company's international subsidiaries and cash collateral for certain performance bonds. The bank guarantees become unrestricted cash when performance under the sales or supply contract is complete. The cash collateral for the performance bonds will become unrestricted cash when the performance bonds expire.

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Purchase commitments: As of December 31, 2010, the Company had the following known purchase commitments, which include primarily future purchases for inventory-related items under various purchase arrangements as well as other obligations in the ordinary course of business that the Company cannot cancel or where it would be required to pay a termination fee in the event of cancellation:

| Fiscal Year | Purchase Contracts |
|------------------------------|-----------------------|
| 2011 (remaining nine months) | \$ 29,674 |
| 2012 | 2,482 |
| 2013 | - |
| 2014 | - |
| 2015 | - |
| | \$ 32,156 |

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

On July 1, 2010, a putative stockholder class action complaint was filed against the Company, the members of the Company's board of directors, and Comtech Telecommunications Corp. ("Comtech") in the Superior Court of the State of California in and for the County of Santa Clara, entitled Continuum Capital v. Michael Targoff, et al. (Case No. 110CV175940). The lawsuit concerned the proposed merger between the Company and Comtech, and generally asserted claims alleging, among other things, that each member of the Company's board of directors breached his fiduciary duties by agreeing to the terms of the previously proposed merger and by failing to provide stockholders with allegedly material information related to the proposed merger, and that Comtech aided and abetted the breaches of fiduciary duty allegedly committed by the members of the Company's board of directors. The lawsuit sought, among other things, class action certification and monetary relief. On July 28, 2010, the plaintiff filed an amended complaint, making generally the same claims against the same defendants, and seeking the same relief. In addition, the amended complaint generally alleged that the consideration that would have been paid to the Company's stockholders under the terms of the proposed merger was inadequate. On September 7, 2010, the Company terminated the Comtech sale agreement. On November 24, 2010, as described in Note 4, the Company entered into an agreement and plan of merger with Merger Sub and CPI International Acquisition, Inc. (formerly Catalyst Holdings, Inc.), which are affiliates of the Veritas Fund. On December 15, 2010, the plaintiff filed a second amended complaint, which removed Comtech as a defendant, added allegations related to the Merger and to the Veritas Fund, and added a claim for attorneys' fees. On December 23, 2010, after the Company filed its preliminary proxy statement relating to a special meeting in connection with the approval of the Merger, the plaintiff filed a third amended complaint, adding allegations related to the disclosures in the preliminary proxy statement. The third amended complaint seeks, among other things, class action certification and monetary relief.

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The Company believes the action is without merit; however, to avoid the cost and uncertainty of litigation and to complete the proposed merger without delay, the defendants have entered into a Memorandum of Understanding concerning settlement. The settlement and any attorneys' fees award are subject to Court approval. Pursuant to the Memorandum of Understanding, among other things, the defendants will receive a release of claims and the plaintiff will dismiss the third amended complaint with prejudice in exchange for, among other agreements, an agreement by the Company to make certain additional disclosures concerning the Merger, which disclosures have been included in a definitive proxy statement mailed to stockholders on or about January 12, 2011. The Memorandum of Understanding also provides that, upon Court approval and dismissal of the action, the Company, its insurers or its successor in interest will cause to be paid to the plaintiff's counsel approximately \$0.6 million in full settlement of any claim for attorneys' fees and all expenses. The Company expects \$0.4 million of this payment to be borne by its insurance carrier. The \$0.6 million full settlement and the \$0.4 million insurance reimbursement are included in accrued liabilities and prepaid and other current assets, respectively, in the condensed consolidated balance sheet as of December 31, 2010.

During fiscal year 2009, the Company received a notice from a customer purporting to terminate a sales contract due to alleged nonperformance. In April and June 2010, the Company received notices from the customer claiming additional cost incurred due to the alleged nonperformance. The customer has initiated arbitration and filed a claim for damages of approximately \$2.1 million. The Company has filed a counterclaim for damages of approximately \$0.8 million. The Company plans to contest this matter vigorously. At this time, the Company believes that any loss or gain with respect to this matter will not have a material effect on its consolidated results of operations and cash flows.

All legal costs are expensed as incurred.

9. Stock-based Compensation Plans

Stock Options: The following table summarizes the status of the Company's stock option awards as of December 31, 2010 and October 1, 2010 and of changes during the first quarter of fiscal year 2011 under the Company's stock option plans:

| | Outstanding Options | | | | Exercisable Options | | | |
|----------------------------|---------------------|---------------------------------|---|---------------------------|---------------------|---------------------------------|---|---------------------------|
| | Number of Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value | Number of Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value |
| Balance at October 1, 2010 | | | | | | | | |
| Granted | 108,000 | 19.33 | | | | | | |
| Exercised | (17,657) | 7.72 | | | | | | |
| Forfeited or cancelled | - | - | | | | | | |
| | 3,437,535 | \$ 7.00 | 4.18 | \$ 42,462 | 3,081,368 | \$ 6.06 | 3.72 | \$ 40,960 |

Balance at
December 31,
2010

The aggregate intrinsic value in the preceding table represents the total intrinsic value, based on the Company's closing stock price of \$19.35 as of December 31, 2010, which would have been received by the option holders had all option holders exercised their options and sold the shares received upon such exercises as of that date. As of December 31, 2010, approximately 3.1 million exercisable options were in-the-money.

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During the first quarter of fiscal year 2011, cash received from option exercises was approximately \$0.1 million, and the total intrinsic value of options exercised was \$0.2 million. During the first quarter of fiscal year 2010, cash received from option exercises was approximately \$13,500, and the total intrinsic value of options exercised was \$21,697. As of December 31, 2010, there was approximately \$2.5 million of total unrecognized compensation costs related to nonvested stock options, which is expected to be recognized over a weighted-average vesting period of 1.9 years.

Stock Purchase Plan: Employees purchased approximately 13,000 shares in the first quarter of fiscal year 2011 for \$0.2 million and approximately 17,000 shares in the first quarter of fiscal year 2010 for \$0.2 million under the 2006 Employee Stock Purchase Plan (the "2006 ESPP"). As of December 31, 2010, there were no unrecognized compensation costs related to rights to acquire stock under the Company's stock purchase plan.

Restricted Stock and Restricted Stock Units: There were 425,266 and 310,341 shares outstanding of nonvested restricted stock and restricted stock units granted to directors and employees as of December 31, 2010 and October 1, 2010, respectively. The restricted stock and restricted stock units generally vest over periods of one to four years. Upon vesting, each restricted stock unit will automatically convert into one share of common stock of CPI International.

A summary of the status of the Company's nonvested restricted stock and restricted stock unit awards as of December 31, 2010 and October 1, 2010 and of changes during the first quarter of fiscal year 2011 is presented below:

| | Number of Shares | Weighted-Average Grant-Date Fair Value Per Share |
|--------------------------------|---------------------|--|
| Nonvested at October 1, 2010 | 310,341 | \$ 10.51 |
| Granted | 138,700 | \$ 19.33 |
| Vested | (23,775) | \$ 15.18 |
| Forfeited | - | \$ - |
| Nonvested at December 31, 2010 | 425,266 | \$ 13.13 |

During the first quarter of fiscal year 2011, the Company granted 102,700 restricted stock units with time vesting criteria to certain of its non-executive employees and 36,000 restricted stock units with performance vesting criteria to its executive officers. The performance conditions are based on the achievement of specified EBITDA (earnings before net interest expense, provision for income taxes and depreciation and amortization) levels over a period of four years.

Aggregate intrinsic value of the nonvested restricted stock and restricted stock unit awards at December 31, 2010 and October 1, 2010 was \$8.2 million and \$4.4 million, respectively. As of December 31, 2010, there was \$4.6 million of unrecognized compensation costs related to restricted stock and restricted stock unit awards. The unrecognized compensation cost is expected to be recognized over a weighted average period of 3.2 years.

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

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Valuation and Expense Information

Stock Options. The fair value of the Company's stock options granted during the first quarter of fiscal years 2011 and 2010 was estimated on the date of grant using the Black-Scholes model with the following assumptions:

| | Quarter Ended | |
|--------------------------|-------------------------|--------------------|
| | December 31, 2010 | January 1, 2010 |
| Expected term (in years) | 8.14 | 7.79 |
| Expected volatility | 60.91 % | 60.50 % |
| Risk-free rate | 2.57 % | 3.00 % |
| Dividend yield | 0 % | 0 % |

The weighted-average grant-date fair value of all the options granted during the first quarter of fiscal years 2011 and 2010 was \$12.65 and \$6.25 per share, respectively.

Stock Purchase Plan. Based on the 15% discount received by the employees, the weighted-average fair value of shares issued under the 2006 ESPP was \$2.90 and \$1.99 per share during the first quarter of fiscal years 2011 and 2010, respectively.

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

The weighted-average estimated fair value of all restricted stock and restricted stock units granted during the first quarter of fiscal years 2011 and 2010 was \$19.33 and \$9.66 per share, respectively.

As stock-based compensation expense recognized in the condensed consolidated statements of income and comprehensive income for the first quarter of fiscal years 2011 and 2010 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. FASB ASC 718, "Compensation—Stock Compensation," requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

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

The following table summarizes stock-based compensation expense for the first quarter of fiscal years 2011 and 2010, which was allocated as follows:

| | Quarter Ended | |
|--|----------------------|--------------------|
| | December 31, 2010 | January 1, 2010 |
| Share-based compensation cost recognized in the income statement by caption: | | |
| Cost of sales | \$ 152 | \$ 133 |
| Research and development | 55 | 49 |
| Selling and marketing | 77 | 73 |
| General and administrative | 506 | 475 |
| | \$ 790 | \$ 730 |
| Share-based compensation cost capitalized in inventory | \$ 163 | \$ 141 |
| Share-based compensation cost remaining in inventory at end of period | \$ 108 | \$ 94 |
| Share-based compensation expense by type of award: | | |
| Stock options | \$ 428 | \$ 456 |
| Restricted stock and units | 327 | 241 |
| Stock purchase plan | 35 | 33 |
| | \$ 790 | \$ 730 |

The tax benefit realized from option exercises and restricted stock vesting totaled approximately \$0.2 million and \$0.1 million during the first quarter of fiscal years 2011 and 2010, respectively.

Effect of the Pending Merger on Stock Options, Restricted Stock and Restricted Stock Units

Pursuant to the Company's pending merger with Merger Sub described in Note 4, subject to certain exceptions described below, unvested options to purchase the Company's common stock will become fully vested immediately prior to the effective time of the merger ("Effective Time"), and at (or, in the case of certain option holders, immediately after) the Effective Time, outstanding unexercised stock options will be cancelled in exchange for a cash payment in an amount equal to the product of (x) the number of shares subject to the option and (y) the excess, if any, of (A) \$19.50 over (B) the exercise price per share subject to the option, less any applicable taxes. Subject to certain exceptions described below, each share of the Company's restricted stock and each of the Company's restricted stock unit outstanding immediately prior to the Effective Time will vest in full and entitle the holder to receive \$19.50 in cash, less applicable taxes. With respect to options and restricted stock units granted in the first quarter of fiscal year 2011, only 25% of such options and restricted stock units will become vested upon the closing of the merger and the remaining 75% will be cancelled. The Company will account for the acceleration of vesting of stock options, restricted stock and restricted stock units in conjunction with a business combination in accordance with ASC 718.

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

10. Income Taxes

The income tax expense of \$1.0 million and \$1.9 million for the first quarter of fiscal years 2011 and 2010, respectively, reflect estimated federal, foreign and state taxes. The effective tax rate for the first quarter of fiscal year 2011 was 30% and diverged from the combined federal and state statutory tax rate primarily because of Canadian foreign tax credits and a \$0.2 million fiscal year 2010 discrete R&D tax benefit. The discrete benefit was a result of the retroactive extension of the R&D tax credit to calendar year 2010 through the enactment of the Tax Relief, Unemployment Insurance Authorization and Job Creation Act of 2010, signed into law on December 17, 2010. The effective tax rate for the first quarter of fiscal year 2010 was 33% and diverged from the combined federal and state statutory rate primarily because of Canadian foreign tax credits and a \$0.3 million discrete tax benefit resulting from reduced Canadian deferred tax liabilities due to a reduction in the Ontario, Canada corporate tax rate effective December 15, 2009.

Consistent with FASB ASC 805, "Business Combinations," acquisition-related costs have been charged to expense in the period when the related services are rendered, although these costs may not be immediately deductible for tax purposes. For income tax reporting purposes, the company recorded a \$1.1 million income tax benefit and deferred tax asset for all \$2.7 million of strategic alternative expenses that were incurred in the first quarter of fiscal year 2011 without assuming that a business combination will ultimately occur. If the anticipated Merger is consummated, it may be determined that a portion of or all of the strategic alternative expenses are not deductible which would result in a charge to income tax expense upon consummation of the Merger.

The Company files a U.S. federal income tax return and state income tax returns in California, Massachusetts and several other U.S. states. The Company also files income tax returns in Canada and other foreign jurisdictions. In most of these jurisdictions, fiscal years 2006 to 2009 remain open to examination by the various taxing authorities. The Company has not been audited for U.S. federal income tax matters. The Company has income tax audits in progress in Canada and in several international jurisdictions in which it operates. The years under examination by the Canadian tax authorities are fiscal years 2001 and 2002. The total unrecognized tax benefit, which excludes any related interest accruals, was \$6.8 million as of December 31, 2010. Of the total unrecognized tax benefit balance, \$6.3 million of unrecognized tax benefits would reduce the effective tax rate if recognized as of December 31, 2010. Estimated interest and penalties related to the underpayment of income taxes are classified as a component of tax expense in the condensed consolidated statement of income and comprehensive income and totaled approximately \$0.1 million for the first quarter of fiscal year 2011. Accrued interest and penalties, net of interest benefits accrued on receivables anticipated as a result of the change in the U.S.-Canada treaty, were approximately \$0.9 million as of December 31, 2010. The Company has minimal penalties accrued in income tax expense.

The Company believes that it is reasonably possible that, in the next 12 months, the amount of unrecognized tax benefits related to the resolution of federal, state and foreign matters could be reduced by \$2.9 million as audits close, statutes expire and tax payments are made. Any prospective adjustments to the Company's unrecognized tax benefits will be recorded as an increase or decrease to income tax expense and cause a corresponding change to the Company's effective tax rate. Accordingly, the Company's effective tax rate could fluctuate materially from period to period.

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

11. Earnings Per Share

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

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

| | Quarter Ended | |
|---|-------------------------|--------------------|
| | December 31, 2010 | January 1, 2010 |
| Basic Earnings per Share | | |
| Net income | \$ 2,222 | \$ 3,841 |
| Income allocated to participating securities | (46) | (57) |
| Net income available to common shareholders | \$ 2,176 | \$ 3,784 |
| Basic weighted average common shares outstanding | 16,695 | 16,452 |
| Net income per common share - Basic | \$ 0.13 | \$ 0.23 |
| Diluted Earnings per Share | | |
| Net income | \$ 2,222 | \$ 3,841 |
| Income allocated to participating securities | (42) | (57) |
| Net income available to common shareholders | \$ 2,180 | \$ 3,784 |
| Basic weighted average common shares outstanding | 16,695 | 16,452 |
| Effect of dilutive stock options | 1,381 | 1,178 |
| Diluted weighted averages common shares outstanding | 18,076 | 17,630 |
| Net income per common share - Diluted | \$ 0.12 | \$ 0.21 |

The calculation of diluted net income per share excludes all anti-dilutive shares from stock options. For the first quarter of fiscal years 2011 and 2010, the number of anti-dilutive stock options, as calculated based on the weighted average closing price of the Company's common stock for the periods, was approximately 0.5 million and 0.9 million shares, respectively.

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

12. Segments, Geographic and Customer Information

The Company's reportable segments are VED and satcom equipment. The VED segment develops, manufactures and distributes high-power/high-frequency microwave and radio frequency signal components. The satcom equipment segment manufactures and supplies high-power amplifiers and networks for satellite communication uplink, electronic warfare and industrial applications. Segment information reported below is consistent with the manner in which it is reviewed and evaluated by the Company's chief operating decision maker ("CODM"), its chief executive officer, and is based on the nature of the Company's operations and products offered to customers.

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

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

| | Quarter Ended | |
|--------------------------------|---------------|------------|
| | December | January 1, |
| | 31, | 2010 |
| | 2010 | 2010 |
| Sales from external customers | | |
| VED | \$ 62,863 | \$ 59,077 |
| Satcom equipment | 20,731 | 20,127 |
| Other | 5,426 | 3,563 |
| | \$ 89,020 | \$ 82,767 |
| Intersegment product transfers | | |
| VED | \$ 5,807 | \$ 6,113 |
| Satcom equipment | 36 | - |
| | \$ 5,843 | \$ 6,113 |
| EBITDA | | |
| VED | \$ 13,976 | \$ 12,719 |
| Satcom equipment | 2,008 | 2,728 |
| Other | (6,273) | (3,080) |
| | \$ 9,711 | \$ 12,367 |

EBITDA is the measure used by the CODM to evaluate segment profit or loss. EBITDA represents earnings before net interest expense, provision for income taxes and depreciation and amortization. The Company believes that EBITDA is a more meaningful representation of segment operating performance for leveraged businesses like its own and therefore uses this metric as its internal measure of profitability. For the reasons listed below, the Company believes EBITDA provides investors better understanding of the Company's financial performance in connection with their analysis of the Company's business:

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

the Company's Senior Credit Facilities contain a covenant that requires the Company to maintain a senior secured leverage ratio that contains EBITDA as a component, and the Company's management team uses EBITDA to monitor compliance with this covenant;

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

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

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

Other companies may define EBITDA differently and, as a result, the Company's measure of EBITDA may not be directly comparable to EBITDA of other companies. Although the Company uses EBITDA as a financial measure to assess the performance of its business, the use of EBITDA is limited because it does not include certain material costs, such as interest and taxes, necessary to operate the Company's business. When analyzing the Company's performance, EBITDA should be considered in addition to, and not as a substitute for or superior to, operating income, net income, cash flows from operating activities or other statements of income or statements of cash flows data prepared in accordance with U.S. generally accepted accounting principles ("GAAP"). Operating income by the Company's reportable segments was as follows:

| | Quarter Ended | |
|------------------|-------------------------|--------------------|
| | December 31, 2010 | January 1, 2010 |
| Operating income | | |
| VED | \$ 12,425 | \$ 11,232 |
| Satcom equipment | 1,827 | 2,549 |
| Other | (7,364) | (4,149) |
| | \$ 6,888 | \$ 9,632 |

The following table reconciles net income to EBITDA:

| | Quarter Ended | |
|------------|-------------------------|--------------------|
| | December 31, 2010 | January 1, 2010 |
| Net income | \$ 2,222 | \$ 3,841 |

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| | | |
|-------------------------------|----------|-----------|
| Depreciation and amortization | 2,823 | 2,735 |
| Interest expense, net | 3,711 | 3,881 |
| Income tax expense | 955 | 1,910 |
| EBITDA | \$ 9,711 | \$ 12,367 |

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

13. Supplemental Guarantors Condensed Consolidating Financial Information (Unaudited)

Issued on January 23, 2004, CPI's 8% Senior Subordinated Notes due 2012 ("8% Notes"), the current balance of which is \$117.0 million, are guaranteed by CPI International and all of CPI's domestic subsidiaries. Separate financial statements of the guarantors are not presented because (i) the guarantors are wholly owned and have fully and unconditionally guaranteed the 8% Notes on a joint and several basis and (ii) the Company's management has determined that such separate financial statements are not material to investors. Instead, presented below are the consolidating financial statements of: (a) the parent, CPI International, (b) the issuer, CPI, (c) the guarantor subsidiaries (all of the domestic subsidiaries), (d) the non-guarantor subsidiaries, (e) the consolidating elimination entries, and (f) the consolidated totals. The accompanying consolidating financial information should be read in connection with the condensed consolidated financial statements of CPI International.

Investments in subsidiaries are accounted for based on the equity method. The principal elimination entries eliminate investments in subsidiaries, intercompany balances, intercompany transactions and intercompany sales.

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CONDENSED CONSOLIDATING BALANCE SHEET

As of December 31, 2010

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|---|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Assets | | | | | | |
| Cash and cash equivalents | \$ 186 | \$ 37,462 | \$ 1,602 | \$ 20,657 | \$ - | \$ 59,907 |
| Restricted cash | - | 1,293 | 1,676 | 91 | - | 3,060 |
| Accounts receivable, net | - | 17,193 | 8,539 | 13,691 | - | 39,423 |
| Inventories | - | 45,704 | 11,484 | 21,901 | (644) | 78,445 |
| Deferred tax assets | - | 11,727 | 2 | 158 | - | 11,887 |
| Intercompany receivable | - | 3,193 | 10,952 | 12,121 | (26,266) | - |
| Prepaid and other current assets | 582 | 4,218 | 389 | 923 | - | 6,112 |
| Total current assets | 768 | 120,790 | 34,644 | 69,542 | (26,910) | 198,834 |
| Property, plant and equipment, net | - | 37,504 | 2,824 | 12,222 | - | 52,550 |
| Deferred debt issue costs, net | 274 | 1,070 | - | - | - | 1,344 |
| Intangible assets, net | - | 52,630 | 12,791 | 6,309 | - | 71,730 |
| Goodwill | - | 93,307 | 20,973 | 47,945 | - | 162,225 |
| Other long-term assets | - | 5,397 | 68 | - | - | 5,465 |
| Investment in subsidiaries | 230,910 | 122,547 | - | - | (353,457) | - |
| Total assets | \$ 231,952 | \$ 433,245 | \$ 71,300 | \$ 136,018 | \$ (380,367) | \$ 492,148 |
| Liabilities and stockholders' equity | | | | | | |
| Current portion of long-term debt | | | | | | |
| | \$- | \$66,000 | \$- | \$ - | \$ - | \$ 66,000 |
| Accounts payable | 1 | 10,255 | 1,705 | 10,234 | - | 22,195 |
| Accrued expenses | 3,555 | 17,831 | 3,436 | 5,015 | - | 29,837 |
| Product warranty | - | 2,688 | 1,034 | 1,696 | - | 5,418 |
| Income taxes payable | - | 586 | 136 | 2,800 | - | 3,522 |
| Advance payments from customers | - | 9,399 | 5,907 | 6,460 | - | 21,766 |
| Intercompany payable | 26,266 | - | - | - | (26,266) | - |
| Total current liabilities | 29,822 | 106,759 | 12,218 | 26,205 | (26,266) | 148,738 |
| Deferred income taxes | - | 17,540 | - | 4,002 | - | 21,542 |
| Long-term debt, less current portion | 11,937 | 117,000 | - | - | - | 128,937 |
| Other long-term liabilities | 2,713 | 2,113 | - | 625 | - | 5,451 |
| Total liabilities | 44,472 | 243,412 | 12,218 | 30,832 | (26,266) | 304,668 |
| Common stock | 171 | - | - | - | - | 171 |
| Parent investment | - | 48,312 | 43,167 | 59,318 | (150,797) | - |

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| | | | | | | |
|--|-----------|-----------|----------|------------|---------------|------------|
| Additional paid-in capital | 81,235 | - | - | (8,211) | 8,211 | 81,235 |
| Accumulated other comprehensive loss | (44) | (44) | - | (187) | 231 | (44) |
| Retained earnings | 108,918 | 141,565 | 15,915 | 54,266 | (211,746) | 108,918 |
| Treasury stock | (2,800) | - | - | - | - | (2,800) |
| Total stockholders' equity | 187,480 | 189,833 | 59,082 | 105,186 | (354,101) | 187,480 |
| Total liabilities and stockholders' equity | \$231,952 | \$433,245 | \$71,300 | \$ 136,018 | \$ (380,367) | \$ 492,148 |

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

CONDENSED CONSOLIDATING BALANCE SHEET

As of October 1, 2010

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|---|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Assets | | | | | | |
| Cash and cash equivalents | \$34 | \$29,397 | \$905 | \$ 12,493 | \$ - | \$ 42,829 |
| Restricted cash | - | - | 1,710 | 94 | - | 1,804 |
| Accounts receivable, net | - | 20,107 | 10,225 | 15,375 | - | 45,707 |
| Inventories | - | 43,502 | 11,312 | 21,070 | (676) | 75,208 |
| Deferred tax assets | - | 10,945 | 2 | 83 | - | 11,030 |
| Intercompany receivable | - | 1,261 | 8,399 | 16,677 | (26,337) | - |
| Prepaid and other current assets | - | 4,666 | 466 | 1,327 | - | 6,459 |
| Total current assets | 34 | 109,878 | 33,019 | 67,119 | (27,013) | 183,037 |
| Property, plant and equipment, net | - | 38,877 | 2,901 | 12,481 | - | 54,259 |
| Deferred debt issue costs, net | 288 | 1,316 | - | - | - | 1,604 |
| Intangible assets, net | - | 53,082 | 12,932 | 6,460 | - | 72,474 |
| Goodwill | - | 93,307 | 20,973 | 47,945 | - | 162,225 |
| Other long-term assets | - | 4,548 | 129 | - | - | 4,677 |
| Investment in subsidiaries | 226,142 | 120,475 | - | - | (346,617) | - |
| Total assets | \$226,464 | \$421,483 | \$69,954 | \$ 134,005 | \$ (373,630) | \$ 478,276 |
| Liabilities and stockholders' equity | | | | | | |
| Current portion of long-term debt | | | | | | |
| | \$- | \$66,000 | \$- | \$ - | \$ - | \$ 66,000 |
| Accounts payable | 1 | 11,294 | 2,267 | 10,728 | - | 24,290 |
| Accrued expenses | 1,539 | 14,651 | 2,248 | 5,215 | - | 23,653 |
| Product warranty | - | 2,548 | 901 | 1,652 | - | 5,101 |
| Income taxes payable | - | 586 | 113 | 4,323 | - | 5,022 |
| Advance payments from customers | - | 4,803 | 5,450 | 3,965 | - | 14,218 |
| Intercompany payable | 26,337 | - | - | - | (26,337) | - |
| Total current liabilities | 27,877 | 99,882 | 10,979 | 25,883 | (26,337) | 138,284 |
| Deferred income taxes | - | 17,644 | - | 4,063 | - | 21,707 |
| Long-term debt, less current portion | | | | | | |
| | 11,934 | 117,000 | - | - | - | 128,934 |
| Other long-term liabilities | 2,713 | 1,892 | - | 806 | - | 5,411 |
| Total liabilities | 42,524 | 236,418 | 10,979 | 30,752 | (26,337) | 294,336 |
| Common stock | 170 | - | - | - | - | 170 |
| Parent investment | - | 46,868 | 43,167 | 59,180 | (149,215) | - |

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| | | | | | | |
|---|-----------|-----------|----------|------------|---------------|------------|
| Additional paid-in capital | 80,015 | - | - | (8,211) | 8,211 | 80,015 |
| Accumulated other comprehensive (loss) gain | (141) | (141) | - | 84 | 57 | (141) |
| Retained earnings | 106,696 | 138,338 | 15,808 | 52,200 | (206,346) | 106,696 |
| Treasury stock | (2,800) | - | - | - | - | (2,800) |
| Total stockholders' equity | 183,940 | 185,065 | 58,975 | 103,253 | (347,293) | 183,940 |
| Total liabilities and stockholders' equity | \$226,464 | \$421,483 | \$69,954 | \$ 134,005 | \$ (373,630) | \$ 478,276 |

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

CONDENSED CONSOLIDATING STATEMENT OF INCOME

For the Three Months Ended December 31, 2010

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|--|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Sales | \$ - | \$ 51,702 | \$ 17,695 | \$ 38,356 | \$ (18,733) | \$ 89,020 |
| Cost of sales | - | 38,664 | 14,922 | 29,278 | (18,765) | 64,099 |
| Gross profit | - | 13,038 | 2,773 | 9,078 | 32 | 24,921 |
| Operating costs and expenses: | | | | | | |
| Research and development | - | 831 | - | 2,299 | - | 3,130 |
| Selling and marketing | - | 1,882 | 1,100 | 2,262 | - | 5,244 |
| General and administrative | - | 3,232 | 1,360 | 1,724 | - | 6,316 |
| Amortization of acquisition-related intangible assets | - | 389 | 146 | 151 | - | 686 |
| Strategic alternative transaction expenses | 1,412 | 1,245 | - | - | - | 2,657 |
| Total operating costs and expenses | 1,412 | 7,579 | 2,606 | 6,436 | - | 18,033 |
| Operating (loss) income | (1,412) | 5,459 | 167 | 2,642 | 32 | 6,888 |
| Interest expense (income), net | 208 | 3,506 | - | (3) | - | 3,711 |
| (Loss) income before income tax expense and equity in income of subsidiaries | (1,620) | 1,953 | 167 | 2,645 | 32 | 3,177 |
| Income tax (benefit) expense | (615) | 931 | 60 | 579 | - | 955 |
| Equity in income of subsidiaries | 3,227 | 2,205 | - | - | (5,432) | - |
| Net income | \$ 2,222 | \$ 3,227 | \$ 107 | \$ 2,066 | \$ (5,400) | \$ 2,222 |

CONDENSED CONSOLIDATING STATEMENT OF INCOME

For the Three Months Ended January 1, 2010

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|-------------------------------|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Sales | \$ - | \$ 47,936 | \$ 17,419 | \$ 37,119 | \$ (19,707) | \$ 82,767 |
| Cost of sales | - | 36,880 | 14,783 | 27,389 | (19,725) | 59,327 |
| Gross profit | - | 11,056 | 2,636 | 9,730 | 18 | 23,440 |
| Operating costs and expenses: | | | | | | |

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| | | | | | | |
|--|----------|----------|--------|----------|-------------|----------|
| Research and development | - | 557 | 20 | 1,979 | - | 2,556 |
| Selling and marketing | - | 1,593 | 1,173 | 2,274 | - | 5,040 |
| General and administrative | 1 | 3,323 | 987 | 1,214 | - | 5,525 |
| Amortization of acquisition-related intangible assets | - | 390 | 146 | 151 | - | 687 |
| Total operating costs and expenses | 1 | 5,863 | 2,326 | 5,618 | - | 13,808 |
| Operating income | (1) | 5,193 | 310 | 4,112 | 18 | 9,632 |
| Interest expense, net | 216 | 3,638 | (1) | 28 | - | 3,881 |
| (Loss) income before income tax expense and equity in income of subsidiaries | (217) | 1,555 | 311 | 4,084 | 18 | 5,751 |
| Income tax (benefit) expense | (82) | 1,348 | 101 | 543 | - | 1,910 |
| Equity in income of subsidiaries | 3,976 | 3,769 | - | - | (7,745) | - |
| Net income | \$ 3,841 | \$ 3,976 | \$ 210 | \$ 3,541 | \$ (7,727) | \$ 3,841 |

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

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

For the Three Months Ended December 31, 2010

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|--|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Cash flows from operating activities | | | | | | |
| Net cash (used in) provided by operating activities | \$ (201) | \$ 8,712 | \$ 755 | \$ 8,221 | \$ - | \$ 17,487 |
| Cash flows from investing activities | | | | | | |
| Capital expenditures | - | (338) | (52) | (57) | - | (447) |
| Payment of patent application fees | - | - | (6) | - | - | (6) |
| Net cash used in investing activities | - | (338) | (58) | (57) | - | (453) |
| Cash flows from financing activities | | | | | | |
| Payment for Senior Credit Facilities agreement amendment | - | (379) | - | - | - | (379) |
| Proceeds from issuance of common stock to employees | 217 | - | - | - | - | 217 |
| Proceeds from exercise of stock options | 136 | - | - | - | - | 136 |
| Excess tax benefit on stock option exercises | - | 70 | - | - | - | 70 |
| Net cash provided by (used in) financing activities | 353 | (309) | - | - | - | 44 |
| Net increase in cash and cash equivalents | 152 | 8,065 | 697 | 8,164 | - | 17,078 |
| Cash and cash equivalents at beginning of period | 34 | 29,397 | 905 | 12,493 | - | 42,829 |
| Cash and cash equivalents at end of period | \$ 186 | \$ 37,462 | \$ 1,602 | \$ 20,657 | \$ - | \$ 59,907 |

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS
For the Three Months Ended January 1, 2010

| | Parent (CPI Int'l) | Issuer (CPI) | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Consolidating Eliminations | Consolidated Total |
|---|-----------------------|-----------------|---------------------------|-------------------------------|-------------------------------|-----------------------|
| Cash flows from operating activities | | | | | | |
| Net cash (used in) provided by operating activities | \$ (131) | \$ 3,972 | \$ 187 | \$ 5,536 | \$ - | \$ 9,564 |
| Cash flows from investing activities | | | | | | |
| Capital expenditures | - | (616) | (101) | (94) | - | (811) |
| Net cash used in investing activities | - | (616) | (101) | (94) | - | (811) |
| Cash flows from financing activities | | | | | | |
| Proceeds from issuance of common stock to employees | 189 | - | - | - | - | 189 |
| Proceeds from exercise of stock options | 14 | - | - | - | - | 14 |
| Excess tax benefit on stock option exercises | - | 2 | - | - | - | 2 |
| Net cash provided by financing activities | 203 | 2 | - | - | - | 205 |
| Net increase in cash and cash equivalents | 72 | 3,358 | 86 | 5,442 | - | 8,958 |
| Cash and cash equivalents at beginning of period | 10 | 15,055 | 759 | 10,328 | - | 26,152 |
| Cash and cash equivalents at end of period | \$ 82 | \$ 18,413 | \$ 845 | \$ 15,770 | \$ - | \$ 35,110 |

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

Our fiscal years are the 52- or 53-week periods that end on the Friday nearest September 30. Fiscal years 2011 and 2010 comprised the 52-week periods ending September 30, 2011 and October 1, 2010, respectively. The first quarters of both fiscal years 2011 and 2010 include 13 weeks. The following discussion should be read in conjunction with the accompanying unaudited condensed consolidated financial statements, and the notes thereto, of CPI International, Inc.

Overview

CPI International, headquartered in Palo Alto, California, is the parent company of Communications & Power Industries, a provider of microwave, radio frequency, power and control solutions for critical defense, communications, medical, scientific and other applications. Communications & Power Industries develops, manufactures and distributes products used to generate, amplify, transmit and receive high-power/high-frequency microwave and radio frequency signals and/or provide power and control for various applications. End-use applications of these systems include the transmission of radar signals for navigation and location; transmission of deception signals for electronic countermeasures; transmission and amplification of voice, data and video signals for broadcasting, Internet and other types of commercial and military communications; providing power and control for medical diagnostic imaging; and generating microwave energy for radiation therapy in the treatment of cancer and for various industrial and scientific applications.

Unless the context otherwise requires, "CPI International" means CPI International, Inc., and "CPI" means Communications & Power Industries, Inc. CPI is a direct subsidiary of CPI International. CPI International is a holding company with no operations of its own. The terms "we," "us," "our" and the "Company" refer to CPI International and its direct and indirect subsidiaries on a consolidated basis.

Merger Agreement

We entered into an Agreement and Plan of Merger dated as of November 24, 2010 ("Merger Agreement") with CPI International Acquisition, Inc. (formerly Catalyst Holdings, Inc.) ("Parent") and Catalyst Acquisition, Inc. ("Merger Sub"), an indirect wholly owned subsidiary of CPI International Acquisition, Inc. CPI International Acquisition, Inc. is an indirect wholly owned subsidiary of The Veritas Capital Fund IV, L.P. (the "Veritas Fund"). The Merger Agreement contemplates that Merger Sub will be merged with and into CPI International, Inc., with CPI International, Inc. surviving as a wholly-owned subsidiary of Parent (the "Merger"), and, subject to certain exceptions, each outstanding share of our common stock will be converted in the Merger into the right to receive \$19.50 per share in cash. The Merger Agreement is subject to CPI stockholder approval, and is also subject to a number of customary regulatory and other closing conditions. The Merger Agreement is not subject to any financing conditions. See Note 4 to the accompanying unaudited condensed consolidated financial statements for more information regarding the Merger Agreement.

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Orders

We sell our products into five end markets: defense (radar and electronic warfare), medical, communications, industrial and scientific.

Our customer sales contracts are recorded as orders when we accept written customer purchase orders or contracts. Customer purchase orders with an undefined delivery schedule, or blanket purchase orders, are not reported as orders until the delivery date is determined. Our government sales contracts are not reported as orders until we have been notified that the contract has been funded. Total orders for a fiscal period represent the total dollar amount of customer orders recorded by us during the fiscal period, reduced by the dollar amount of any order cancellations or terminations during the fiscal period.

Our orders by market for the first quarter of fiscal years 2011 and 2010 are summarized as follows (dollars in millions):

| | December 31, 2010 | | January 1, 2010 | | Increase (Decrease) | | |
|------------------------------|-------------------|-------------|-----------------|-------------|---------------------|---------|---|
| | Amount | % of Orders | Amount | % of Orders | Amount | Percent | |
| Radar and Electronic Warfare | \$45.3 | 46 % | \$33.5 | 36 % | \$11.8 | 35 | % |
| Medical | 13.6 | 14 | 15.6 | 17 | (2.0) | (13) |) |
| Communications | 30.0 | 30 | 35.1 | 38 | (5.1) | (15) |) |
| Industrial | 5.5 | 5 | 3.8 | 4 | 1.7 | 45 | |
| Scientific | 4.7 | 5 | 4.7 | 5 | - | 0 | |
| Total | \$99.1 | 100 % | \$92.7 | 100 % | \$6.4 | 7 | % |

Orders of \$99.1 million for the first quarter of fiscal year 2011 were \$6.4 million, or approximately 7%, higher than orders of \$92.7 million for the first quarter of fiscal year 2010. Explanations for the order increase or decrease by market for the first quarter of fiscal year 2011 compared to the first quarter of fiscal year 2010 are as follows:

- **Radar and Electronic Warfare:** The majority of our products in the radar and electronic warfare markets are for domestic and international defense and government end uses. Orders in these markets are primarily comprised of many orders of less than \$3.0 million by product or program, and the timing of these orders may vary from year to year. On a combined basis, orders for the radar and electronic warfare markets increased approximately 35% from an aggregate of \$33.5 million in the first quarter of fiscal year 2010 to an aggregate of \$45.3 million in the first quarter of fiscal year 2011. The increase in orders for these combined markets resulted primarily from an increase in demand for products to support a counter-improvised explosive device (“counter-IED”) program and the Aegis weapons system. These increases were partially offset by decreases in orders to support various weather radar programs due to the timing of those programs.
- **Medical:** Orders for our medical products consist of orders for medical imaging applications, such as x-ray imaging, magnetic resonance imaging (“MRI”) and positron emission tomography (“PET”) applications, and for radiation therapy applications for the treatment of cancer. The 13% decrease in medical orders resulted primarily from a decrease in demand for products to support MRI applications, largely due to the typically irregular timing and size of orders to support those applications. Demand for products to support x-ray imaging applications also decreased due to the receipt of a large order in the first quarter of fiscal year 2010 that did not repeat in the first quarter of fiscal year 2011. These decreases were partially offset by an increase in orders to support radiation therapy applications.

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- **Communications:** Orders for our communications products consist of orders for commercial communications applications and military communications applications. The 15% decrease in communications orders was due, in part, to a decrease in orders for military communications applications and other communications applications as a result of the timing of various programs. Over the long term, we expect our participation in military communications programs to continue to grow. These decreases were partially offset by an increase in demand for products to support satellite broadcast applications for commercial communications.
- **Industrial:** Orders in the industrial market are cyclical and are generally tied to the state of the economy. The \$1.7 million increase in industrial orders was due to the receipt of a development order for a nuclear magnetic resonance program, an increase in demand for products used in instrumentation applications due to program timing and an overall increase in demand for products to support various other industrial activities.
- **Scientific:** Orders in the scientific market are historically one-time projects and can fluctuate significantly from period to period. However, in the first quarter of fiscal year 2011, the orders level in the scientific market was essentially unchanged in comparison to the first quarter of fiscal year 2010.

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

Backlog

As of December 31, 2010, we had an order backlog of \$252.4 million compared to an order backlog of \$236.6 million as of January 1, 2010. Because our orders for government end-use products generally have much longer delivery terms than our orders for commercial business (which require quicker turn-around), our backlog is primarily composed of government end-use orders.

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

Results of Operations

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

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

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Three Months Ended December 31, 2010 Compared to Three Months Ended January 1, 2010

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

| | Quarter Ended | | | | | Increase (Decrease) Amount |
|--|-------------------|---------------|-----------------|---------------|-----------|----------------------------------|
| | December 31, 2010 | | January 1, 2010 | | % | |
| | Amount | % of Sales | Amount | % of Sales | | |
| Sales | \$ 89.0 | 100.0 % | \$ 82.8 | 100.0 % | \$ 6.2 | |
| Cost of sales | 64.1 | 72.0 | 59.3 | 71.6 | 4.8 | |
| Gross profit | 24.9 | 28.0 | 23.4 | 28.3 | 1.5 | |
| Research and development | 3.1 | 3.5 | 2.6 | 3.1 | 0.5 | |
| Selling and marketing | 5.2 | 5.8 | 5.0 | 6.0 | 0.2 | |
| General and administrative | 6.3 | 7.1 | 5.5 | 6.6 | 0.8 | |
| Amortization of acquisition-related intangibles | 0.7 | 0.8 | 0.7 | 0.8 | - | |
| Strategic alternative transaction expenses | 2.7 | 3.0 | - | - | 2.7 | |
| Operating income | 6.9 | 7.8 | 9.6 | 11.6 | (2.7) | |
| Interest expense, net | 3.7 | 4.2 | 3.9 | 4.7 | (0.2) | |
| Income before taxes | 3.2 | 3.6 | 5.8 | 7.0 | (2.6) | |
| Income tax expense | 1.0 | 1.1 | 1.9 | 2.3 | (0.9) | |
| Net income | \$ 2.2 | 2.5 % | \$ 3.8 | 4.6 % | \$ (1.6) | |
| Other Data: | | | | | | |
| EBITDA (a) | \$ 9.7 | 10.9 % | \$ 12.4 | 15.0 % | \$ (2.7) | |

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

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

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

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

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

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

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

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

For a reconciliation of Net Income to EBITDA, see Note 12 of the accompanying unaudited condensed consolidated financial statements.

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Sales: : Our sales by market for the first quarter of fiscal years 2011 and 2010 are summarized as follows (dollars in millions):

| | Quarter Ended | | | | | | Increase (Decrease) | |
|------------------------------|-------------------|------------|-----------------|------------|---------|---------|---------------------|---------|
| | December 31, 2010 | | January 1, 2010 | | Amount | Percent | Amount | Percent |
| | Amount | % of Sales | Amount | % of Sales | | | | |
| Radar and Electronic Warfare | \$31.7 | 36 | % \$28.2 | 34 | % \$3.5 | 12 | % | |
| Medical | 17.0 | 19 | 19.4 | 23 | (2.4) | (12) | | |
| Communications | 30.6 | 34 | 28.7 | 35 | 1.9 | 7 | | |
| Industrial | 5.4 | 6 | 5.2 | 6 | 0.2 | 4 | | |
| Scientific | 4.3 | 5 | 1.3 | 2 | 3.0 | 231 | | |
| Total | \$89.0 | 100 | % \$82.8 | 100 | % \$6.2 | 7 | % | |

Sales of \$89.0 million for the first quarter of fiscal year 2011 were \$6.2 million, or approximately 7%, higher than sales of \$82.8 million for the first quarter of fiscal year 2010. Explanations for the sales increase or decrease by market for the first quarter of fiscal year 2011 as compared to the first quarter of fiscal year 2010 are as follows:

- **Radar and Electronic Warfare:** The majority of our products in the radar and electronic warfare markets are for domestic and international defense and government end uses. The timing of orders receipts and subsequent shipments in these markets may vary from year to year. On a combined basis, sales for these two markets increased 12% from an aggregate of \$28.2 million in the first quarter of fiscal year 2010 to an aggregate of \$31.7 million in the first quarter of fiscal year 2011. This increase was due to an increase in demand for products to support the Aegis weapons system, several electronic warfare systems and a counter-IED program.
- **Medical:** Sales of our medical products consist of sales for medical imaging applications, such as x-ray imaging, MRI and PET applications, and for radiation therapy applications for the treatment of cancer. The 12% decrease in sales of our medical products in the first quarter of fiscal year 2011 was primarily due to a decrease in sales of products to support MRI applications, largely because of the typically irregular timing and size of orders to support those applications. Sales of products to support x-ray imaging applications also decreased, primarily as a result of the timing of various x-ray imaging programs.
- **Communications:** Sales of our communications products consist of sales for commercial communications applications and military communications applications. The 7% increase in sales in the communications market was primarily due to increases in sales of products to support military communications applications, particularly tactical common data link (“TCDL”) products for intelligence, surveillance and reconnaissance (“ISR”) applications. Over the long term, we expect our participation in military communications programs to continue to grow. In commercial communications, sales of products to support satellite broadband applications increased while sales of products to support other direct-to-home broadcast applications decreased.
- **Industrial:** Sales in the industrial market are cyclical and are generally tied to the state of the economy. The \$0.2 million increase in sales of industrial products in the first quarter of fiscal year 2011 was primarily due to increases in sales to support semiconductor wafer fabrication applications.

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- **Scientific:** Sales in the scientific market are historically one-time projects and can fluctuate significantly from period to period. The \$3.0 million increase in scientific sales was primarily the result of increased sales for a fusion research program and various other scientific development programs.

Gross Profit. Gross profit was \$24.9 million, or 28.0% of sales, for the first quarter of fiscal year 2011 as compared to \$23.4 million, or 28.3% of sales, for the first quarter of fiscal year 2010. The \$1.5 million increase in gross profit for the first quarter of fiscal year 2011 as compared to the first quarter of fiscal year 2010 was primarily due to higher shipment volume in the first quarter of fiscal year 2011.

Research and Development. Research and development expenses were \$3.1 million, or 3.5% of sales, for the first quarter of fiscal year 2011, a \$0.5 million increase from \$2.6 million, or 3.1% of sales, for the first quarter of fiscal year 2010. The increase in research and development for the first quarter of fiscal year 2011 compared to the first quarter of fiscal year 2010 was primarily due to increased investment for the development of communication amplifiers for commercial and military applications and the solid state and vacuum electron devices used in these amplifiers, and development of vacuum electron devices for the scientific and medical markets.

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

| | Quarter Ended | |
|--|---------------|------------|
| | December | January 1, |
| | 31, | 2010 |
| | 2010 | 2010 |
| Company sponsored | \$ 3.1 | \$ 2.6 |
| Customer sponsored, charged to cost of sales | 3.7 | 3.7 |
| | \$ 6.8 | \$ 6.3 |

Selling and Marketing. Selling and marketing expenses were \$5.2 million, or 5.8% of sales, for the first quarter of fiscal year 2011, and \$5.0 million, or 6.0% of sales, for the first quarter of fiscal year 2010. There was no significant change in selling and marketing expenses for the first fiscal quarters of 2010 and 2011.

General and Administrative. General and administrative expenses were \$6.3 million, or 7.1% of sales, for the first quarter of fiscal year 2011, a \$0.8 million increase from the \$5.5 million, or 6.6% of sales, for the first quarter of fiscal year 2010. The increase in general and administrative expenses in the first quarter of fiscal year 2011 was primarily due to a \$0.5 million loss contingency expense accrual for a customer contract termination and \$0.2 million for the unfavorable impact from foreign currency translation.

Amortization of Acquisition-Related Intangibles. Amortization of acquisition-related intangibles consists of purchase accounting charges for technology and other intangible assets. Amortization of acquisition-related intangibles was \$0.7 million for the first quarter of fiscal years 2011 and 2010.

Strategic Alternative expense. Merger expenses of \$2.7 million for the first quarter of fiscal year 2011 comprised non-recurring transaction costs, such as fees for investment bankers, attorneys and other professional services, rendered in connection with the pending sale of the company.

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Interest Expense, net (“Interest Expense”). Interest Expense was \$3.7 million, or 4.2% of sales, for the first quarter of fiscal year 2011, a \$0.2 million decrease from the \$3.9 million, or 4.7% of sales, for the first quarter of fiscal year 2010. The reduction in interest expense for the first quarter of fiscal year 2011 was primarily due to lower interest rates on our variable rate debt agreements over the past year, as debt levels remained unchanged.

Income Tax Expense (Benefit). We recorded an income tax expense of \$1.0 million for the first quarter of fiscal year 2011 and an income tax expense of \$1.9 million for the first quarter of fiscal year 2010. The effective income tax rate for the first quarter of fiscal years 2011 and 2010 was 30% and 33%, respectively. The lower effective income tax rate in fiscal year 2011 is primarily due to higher U.S. research and development tax credits, an increase in the U.S. domestic manufacturing deduction and an increase in Canadian foreign tax credits. As a result of the enactment of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, effective December 17, 2010, the first quarter of fiscal year 2011 includes a \$0.2 million discrete tax benefit due to the retroactive reinstatement of the research and development tax credit to calendar year 2010.

Net Income. Net income was \$2.2 million, or 2.5% of sales, for the first quarter of fiscal year 2011 as compared to \$3.8 million, or 4.6% of sales, in the first quarter of fiscal year 2010. The \$1.6 million decrease in net income in the first quarter of fiscal year 2011 as compared to the first quarter of fiscal year 2010 was primarily due to \$2.7 million of strategic alternative expenses in the first quarter of fiscal year 2011, net of income tax benefits of \$1.1 million. The \$6.2 million increase in shipment volume and \$1.5 million increase in gross profit during the first quarter of fiscal year 2011 was partially offset by higher spending on research and development and the loss contingency accrual for a fiscal year 2009 terminated sales contract.

EBITDA. EBITDA was \$9.7 million, or 10.9% of sales, for the first quarter of fiscal year 2011 as compared to \$12.4 million, or 15.0% of sales, for the first quarter of fiscal year 2010. The \$2.7 million decrease in EBITDA in the first quarter of fiscal year 2011 as compared to the first quarter of fiscal year 2010 was due primarily to \$2.7 million of strategic alternative expenses in the first quarter of fiscal year 2011. The \$6.2 million increase in shipment volume and \$1.5 million increase in gross profit during the first quarter of fiscal year 2011 was partially offset by higher spending on research and development and the loss contingency accrual for a fiscal year 2009 terminated sales contract.

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Liquidity and Capital Resources

Overview

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

If our current pending merger with Catalyst Acquisition, Inc. (as described above under the heading “Merger Agreement”) closes, we expect to receive funding through an equity contribution from the Veritas Fund and certain of its affiliates and net proceeds from the public offering of senior notes and borrowings under the new senior credit facilities expected to be entered into by CPI International Acquisition, Inc. See Note 4 to the accompanying unaudited condensed consolidated financial statements for more details. We believe that if the merger closes, the financial resources from the merger, our cash on hand, and expected cash flows from operations will be sufficient to meet our business requirements, including capital expenditures and working capital requirements for the next 12 months, and to repay the \$66.0 million outstanding under our senior credit facilities scheduled to come due on August 1, 2011, as well as the \$117.0 million of our outstanding 8% senior subordinated notes and the \$12.0 million of our outstanding floating rate senior notes prior to their scheduled maturity dates in connection with the merger. It is anticipated that the amounts outstanding under our existing senior credit facility term loan and under its currently outstanding notes will be repaid in connection with the merger.

If the pending merger with Catalyst Acquisition is not consummated and our existing debt is not repaid, we intend to seek replacement refinancing and repay the \$66.0 million outstanding under our senior credit facility term loan scheduled to come due on August 1, 2011, as well as the \$117.0 million of our outstanding 8% senior subordinated notes, on or prior to their due dates in 2011. While we believe that, based on our cash flow from operations and past history, we will be successful in obtaining the replacement financing necessary to repay our debt scheduled to mature in 2011, there are no assurances that such refinancing will be successful. If we are unable to refinance our senior credit facilities, we will need to seek to implement other alternatives such as issuing common stock or securities convertible into common stock to repay our indebtedness. If implemented, these actions could negatively impact our business or dilute our existing stockholders.

Cash and Working Capital

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

| | December 31, 2010 | October 1, 2010 |
|---------------------------|-------------------------|--------------------|
| Cash and cash equivalents | \$ 59.9 | \$ 42.8 |
| Working capital | \$ 50.1 | \$ 44.8 |

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We invest cash balances in excess of operating requirements in overnight U.S. Government securities and money market accounts. In addition to the above cash and cash equivalents, we have restricted cash of \$3.1 million as of December 31, 2010, consisting of bank guarantees from customer advance payments to our international subsidiaries and cash collateral for certain performance bonds. The bank guarantees become unrestricted cash when performance under the sales contract is complete. The cash collateral for the performance bonds will become unrestricted cash when the performance bonds expire.

The significant factors underlying the net increase in cash and cash equivalents during the first quarter of fiscal year 2011 were the net cash provided by our operating activities of \$17.5 million and proceeds and tax benefits of \$0.4 million from employee stock purchases and exercise of stock options, partially offset by capital expenditures of \$0.4 million and the payment for amendment to our senior credit facilities of \$0.4 million.

As of December 31, 2010 and October 1, 2010, we had \$195.0 million in total principal amount of debt outstanding. As of December 31, 2010, we had borrowing availability of \$55.5 million under the revolver under our senior credit facilities.

In December 2010, our European subsidiary entered into a \$2.0 million bank guarantee facility to be used for issuance of bank guarantees for advanced payments from customers and for securing certain of our obligations in projects under customer contracts. No guarantees were outstanding under such facility at December 31, 2010.

As more fully described below, our most significant debt covenant compliance requirement is maintaining a secured leverage ratio of 3.75:1. Our current secured leverage ratio is approximately 0.10:1.

Historical Operating, Investing and Financing Activities

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

| | Quarter Ended | |
|---|-------------------------|--------------------|
| | December 31, 2010 | January 1, 2010 |
| Net cash provided by operating activities | \$ 17.5 | \$ 9.6 |
| Net cash used in investing activities | (0.4) | (0.8) |
| Net cash provided by financing activities | - | 0.2 |
| Net increase in cash and cash equivalents | \$ 17.1 | \$ 9.0 |

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Operating Activities

During the first quarter of fiscal years 2011 and 2010, we funded our operating activities through cash generated internally. Cash provided by operating activities is net income adjusted for certain non-cash items and changes to working capital items.

Net cash provided by operating activities of \$17.5 million in the first quarter of fiscal year 2011 was attributable to net income of \$2.2 million, depreciation, amortization and other non-cash charges of \$2.5 million and net cash provided by working capital of \$12.8 million. The primary working capital sources of cash in the first quarter of fiscal year 2011 were an increase in advance payments from customers, an increase in accrued expenses and a decrease in accounts receivable. Advanced payments from customers increased due to an increase in certain sales orders, which allow for billings at the beginning of the contract term. Accrued expense increased due to expenses incurred in connection with the pending Merger Agreement that remained unpaid as of December 31, 2010 and due to the timing of interest payments on our debt. Accounts receivable decreased due to a decline in sales for the first quarter of fiscal year 2011 as compared to the immediately preceding quarter and due to improvement in collection efficiency. The aforementioned working capital sources of cash were partially offset by an increase in inventories, a decrease in accounts payable, an increase in restricted cash and a decrease in net income tax payable. The increase in inventories resulted from increased inventory purchases to support increased orders and the sales level anticipated for the remaining quarters of fiscal year 2011. Accounts payable decreased mainly due to timing of payments to trade vendors. Restricted cash increased due to cash collateral obtained for certain performance bonds. The decrease in income tax payable, net, primarily reflects lower taxable income compared to the immediately preceding quarter and tax payments made during the quarter.

Net cash provided by operating activities of \$9.6 million in the first quarter of fiscal year 2010 was attributable to net income of \$3.8 million, depreciation, amortization and other non-cash charges of \$4.5 million and net cash provided by working capital of \$1.3 million. The primary working capital sources of cash in the first quarter of fiscal year 2010 were a decrease in accounts receivable and an increase in accrued expenses. The decrease in accounts receivable resulted primarily from the decreased sales volume during the first quarter of fiscal year 2010 as compared to the fourth quarter of fiscal year 2009, while the increase in accrued expenses was primarily due to an increase in interest payable related to the timing of interest payments on our debt. The aforementioned working capital sources of cash were partially offset by an increase in inventories and a decrease in accounts payable. The increase in inventories resulted from increased purchases in anticipation of higher sales volume for the remaining quarters of fiscal year 2010. Accounts payable decreased mainly due to timing of payments to trade vendors.

Investing Activities

Investing activities for the first quarter of fiscal years 2011 and 2010 comprised \$0.4 million and \$0.8 million, respectively, of capital expenditures.

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Financing Activities

Net cash provided by financing activities for the first quarter of fiscal year 2011 consisted of proceeds and tax benefits from employee stock purchases and exercise of stock options with an aggregate total of \$0.4 million, offset by the payment of fees and expenses for an amendment to our senior credit facilities of \$0.4 million.

Net cash provided by financing activities for the first quarter of fiscal year 2010 was attributable to \$0.2 million in proceeds from employee stock purchases.

If the leverage ratio under our amended and restated senior credit facilities exceeds 3.5:1 at the end of any fiscal year, then we are required to make an annual prepayment within 90 days after the end of the fiscal year based on a calculation of excess cash flow, as defined in the senior credit facilities, multiplied by a factor of 50%, less any optional prepayments made during the fiscal year. There was no excess cash flow payment due for fiscal year 2010, and therefore, no excess cash flow payment was made in the first quarter of fiscal year 2011.

Contractual Obligations

The following table summarizes our significant contractual obligations as of December 31, 2010 and the effect that such obligations are expected to have on our liquidity and cash flows in future periods (in thousands):

| | Total | Fiscal Year | | | |
|------------------------------|-----------|---------------------------------------|----------------|----------------|------------|
| | | 2011 (remaining nine months) | 2012 - 2013 | 2014 - 2015 | Thereafter |
| Operating leases | \$6,485 | \$1,173 | \$2,183 | \$754 | \$2,375 |
| Purchase commitments | 32,156 | 29,674 | 2,482 | - | - |
| Debt obligations | 195,000 | 66,000 | 117,000 | 12,000 | - |
| Interest on debt obligations | 14,473 | 8,916 | 4,547 | 1,010 | - |
| Uncertain tax positions | 7,322 | 3,262 | 4,060 | - | - |
| Total cash obligations | \$255,436 | \$109,025 | \$130,272 | \$13,764 | \$2,375 |
| Standby letters of credit | \$4,544 | \$4,544 | | | |

The amounts for debt obligations and interest on debt obligations assume (1) that the respective debt instruments will be outstanding until their scheduled maturity dates, except for the term loan under our senior credit facilities, which is assumed to mature on the earlier date of August 1, 2011 as prescribed in the senior credit facilities agreement, (2) that interest rates in effect on December 31, 2010 remain constant for future periods, and (3) a debt level based on mandatory repayments according to the contractual amortization schedule.

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

As of December 31, 2010, there were no material changes to our other contractual obligations from what we disclosed in our Annual Report on Form 10-K for the fiscal year ended October 1 2010. See also Note 8 of the accompanying unaudited condensed consolidated financial statements for details on certain of our commitments and contingencies.

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Capital Expenditures

Our continuing operations typically do not have large recurring capital expenditure requirements. Capital expenditures are generally made to replace existing assets, increase productivity, facilitate cost reductions or meet regulatory requirements. Total capital expenditures for the first quarter of fiscal year 2011 were \$0.4 million. Total capital expenditures for fiscal year 2011 are expected to be approximately \$5.0 to \$6.0 million.

Recent Accounting Pronouncements

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

Critical Accounting Policies and Estimates

Our Critical Accounting Policies and Estimates have not changed from those reported in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Form 10-K for the fiscal year ended October 1, 2010.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

Interest rate risk

Our exposure to market risk for changes in interest rates relates primarily to our long-term debt. As of December 31, 2010, we had fixed rate senior subordinated notes of \$117.0 million due in 2012, bearing interest at 8% per year, variable rate debt consisting of \$12.0 million floating rate senior notes due in 2015, and a \$66.0 million term loan under our senior credit facilities due in 2014. Our variable rate debt is subject to changes in the prime rate and the LIBOR rate. As of December 31, 2010, the variable interest rate on the floating rate senior notes and on the term loan under the senior credit facilities, including the impact of our interest rate swap contract described below, was 6.43% and 6.77%, respectively.

We use derivative instruments from time to time in order to manage interest costs and risk associated with our long-term debt. In September 2007, we entered into an interest rate swap contract to receive three-month USD-LIBOR-BBA (British Bankers' Association) interest and pay 4.77% fixed rate interest. Net interest positions are settled quarterly. We have structured the swap with decreasing notional amounts such that it is less than the balance of the term loan. The notional value of the swap was \$25.0 million at December 31, 2010 and represented approximately 38% of the aggregate term loan balance. The swap agreement is effective through June 30, 2011. Under the provisions of Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 815, "Derivatives and Hedging," this arrangement was initially designated and qualified as an effective cash flow hedge of interest rate risk related to the term loan under our senior credit facilities which permitted recording the fair value of the swap and corresponding unrealized gain or loss to accumulated other comprehensive income in the condensed consolidated balance sheets. The interest rate swap gain or loss is included in the assessment of hedge effectiveness. At December 31, 2010, the fair value of the swap was a short-term liability of \$0.5 million (accrued expenses).

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

Foreign currency exchange risk

Although the majority of our revenue and expense activities are transacted in U.S. dollars, we do transact business in foreign countries. Our primary foreign currency cash flows are in Canada and several European countries. In an effort to reduce our foreign currency exposure to Canadian dollar denominated expenses, we enter into Canadian dollar forward contracts to hedge the Canadian dollar denominated costs for our manufacturing operation in Canada. Our Canadian dollar forward contracts are designated as a cash flow hedge and are considered highly effective, as defined by FASB ASC 815, "Derivatives and Hedging." The unrealized gains and losses from foreign exchange forward contracts are included in accumulated other comprehensive income in the condensed consolidated balance sheets. If the transaction being hedged fails to occur, or if a portion of any derivative is ineffective, then we promptly recognize the gain or loss on the associated financial instrument in general and administrative in the condensed consolidated statements of income. No ineffective amounts were recognized due to hedge ineffectiveness in the first quarter of fiscal year 2011. The gain recognized in general and administrative due to hedge ineffectiveness was insignificant for the first quarter of fiscal year 2010.

As of December 31, 2010, we had entered into Canadian dollar forward contracts for approximately \$18.9 million (Canadian dollars), or approximately 53% of our estimated Canadian dollar denominated expenses for January 2011 through September 2011, at an average rate of approximately \$0.96 U.S. dollar to Canadian dollar. We estimate the impact of a 1 cent change in the U.S. dollar to Canadian dollar exchange rate (without giving effect to our Canadian dollar forward contracts) to be approximately \$0.3 million annually to our net income or approximately 2 cents annually to basic and diluted earnings per share.

At December 31, 2010, the fair value of foreign currency forward contracts was a short-term asset of \$0.7 million (prepaid and other current assets).

Item 4. Controls and Procedures

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

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

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Part II: OTHER INFORMATION

Item 1. Legal Proceedings

On July 1, 2010, a putative stockholder class action complaint was filed against CPI International, the directors of CPI International and Comtech Telecommunications, Corp., a Delaware corporation (“Comtech”), in the Superior Court of the State of California in and for the County of Santa Clara entitled Continuum Capital v. Michael Targoff, et al. (Case No. 110CV175940). The lawsuit concerned the proposed merger between us and Comtech, and generally asserted claims alleging, among other things, that each member of our board of directors breached his fiduciary duties by agreeing to the terms of the previously proposed merger and by failing to provide stockholders with allegedly material information related to the proposed merger, and that Comtech aided and abetted the breaches of fiduciary duty allegedly committed by the members of our board of directors. The lawsuit sought, among other things, class action certification and monetary relief. On July 28, 2010, the plaintiff filed an amended complaint, making generally the same claims against the same defendants, and seeking the same relief. In addition, the amended complaint generally alleged that the consideration that would have been paid to our stockholders under the terms of the proposed merger was inadequate. On September 7, 2010, we terminated the Comtech sale agreement.

On November 24, 2010, we entered into an agreement and plan of merger with Catalyst Acquisition, Inc., an indirect wholly owned subsidiary of CPI International Acquisition, Inc. (formerly Catalyst Holdings, Inc.). CPI International Acquisition, Inc. is an indirect wholly owned subsidiary of The Veritas Capital Fund IV, L.P. (the "Veritas Fund").

On December 15, 2010, the plaintiff filed a second amended complaint, which removed Comtech as a defendant, added allegations related to the current pending merger and to the Veritas Fund, and added a claim for attorneys' fees. On December 23, 2010, after we filed our preliminary proxy statement relating to a special meeting in connection with the approval of the current pending merger, the plaintiff filed a third amended complaint, adding allegations related to the disclosures in the preliminary proxy statement. The third amended complaint seeks, among other things, class action certification and monetary relief.

We believe the action is without merit; however, to avoid the cost and uncertainty of litigation and to complete the proposed merger without delay, the defendants have entered into a Memorandum of Understanding concerning settlement. The settlement and any attorneys' fees award are subject to Court approval. Pursuant to the Memorandum of Understanding, among other things, the defendants will receive a release of claims and the plaintiff will dismiss the third amended complaint with prejudice in exchange for, among other agreements, our agreement to make certain additional disclosures concerning the current pending merger, which disclosures have been included in a definitive proxy statement we filed on January 11, 2011. The Memorandum of Understanding also provides that, upon Court approval and dismissal of the action, we, our insurers or our successor in interest will cause to be paid to the plaintiff's counsel approximately \$0.6 million in full settlement of any claim for attorneys' fees and all expenses. We expect \$0.4 million of this payment to be borne by our insurance carrier.

Item 1A. Risk Factors

For a discussion of risk factors, see “Part I. Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended October 1, 2010. There have been no material changes from the risk factors disclosed in the “Risk Factors” section of our 2010 Form 10-K.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. (Removed and Reserved)

Item 5. Other Information

None.

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Item 6. Exhibits

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

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SIGNATURES

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

CPI INTERNATIONAL, INC.

Dated: February 9, 2011

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

