CARPENTER TECHNOLOGY CORP
Form 10-Q
February 01, 2008
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 10-Q

**(Mark One)**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the quarterly period ended December 31, 2007**

**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 1-5828**

# CARPENTER TECHNOLOGY CORPORATION

**(Exact name of Registrant as specified in its Charter)**

| | |
|---|---|
| **Delaware**<br>**(State or other jurisdiction of**<br>**incorporation or organization)** | **23-0458500**<br>**(I.R.S. Employer**<br>**Identification No.)** |
| **P.O. Box 14662**<br>**Reading, Pennsylvania**<br>**(Address of principal executive offices)** | **19610**<br>**(Zip Code)** |

**610-208-2000**

**(Registrant s telephone number, including area code)**

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

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

Large accelerated filer: x Accelerated filer: ¨ Non-accelerated filer: ¨

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock as of January 22, 2008.

| | |
|---|---|
| **Common stock, $5 par value**<br>**Class** | **48,230,883**<br>**Number of shares outstanding** |

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**FORM 10-Q**

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Items 3 and 4 of Part II are omitted because there is no information to report.

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**PART I**

**Item 1. Financial Statements**

**CARPENTER TECHNOLOGY CORPORATION**

**CONSOLIDATED BALANCE SHEETS**

**(Unaudited)**

(in millions, except share data)

| | December 31, 2007 | June 30, 2007 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 133.8 | $ 300.8 |
| Marketable securities | 327.6 | 372.7 |
| Accounts receivable, net | 204.1 | 303.2 |
| Inventories | 313.7 | 235.0 |
| Deferred income taxes | 17.6 | 13.3 |
| Other current assets | 21.9 | 30.7 |
| Assets of discontinued operations | 38.6 | |
| Total current assets | 1,057.3 | 1,255.7 |
| Property, plant and equipment, net | 534.1 | 537.4 |
| Prepaid pension cost | 137.4 | 132.4 |
| Goodwill | 40.2 | 46.4 |
| Trademarks and trade names, net | 18.7 | 19.2 |
| Other assets | 38.3 | 34.6 |
| Assets of discontinued operations | 22.9 | |
| Total assets | $ 1,848.9 | $ 2,025.7 |
| **LIABILITIES** | | |
| Current liabilities: | | |
| Accounts payable | $ 156.7 | $ 215.9 |
| Accrued liabilities | 109.7 | 117.1 |
| Current portion of long-term debt | 33.0 | 33.2 |
| Liabilities of discontinued operations | 13.5 | |
| Total current liabilities | 312.9 | 366.2 |
| Long-term debt, net of current portion | 300.0 | 299.5 |
| Accrued postretirement benefits | 87.0 | 90.9 |
| Deferred income taxes | 135.5 | 143.5 |
| Other liabilities | 76.3 | 57.9 |
| Liabilities of discontinued operations | 1.8 | |
| Total liabilities | 913.5 | 958.0 |
| Contingencies and commitments (see Note 8) | | |
| **STOCKHOLDERS EQUITY** | | |

| | | |
|---|---|---|
| Common stock authorized 100,000,000 shares; issued 54,600,342 at December 31, 2007 and 27,276,122 shares at June 30, 2007; outstanding 48,588,577 at December 31, 2007 and 26,121,771 at June 30, 2007 | 273.0 | 136.4 |
| Capital in excess of par value common stock | 197.1 | 328.0 |
| Reinvested earnings | 848.3 | 751.3 |
| Common stock in treasury (6,011,765 shares and 1,154,351 shares at December 31, 2007 and June 30, 2007, respectively), at cost | (292.6) | (65.7) |
| Accumulated other comprehensive loss | (90.4) | (82.3) |
| Total stockholders equity | 935.4 | 1,067.7 |
| Total liabilities and stockholders equity | $ 1,848.9 | $ 2,025.7 |

See accompanying notes to consolidated financial statements.

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**CARPENTER TECHNOLOGY CORPORATION**

**CONSOLIDATED STATEMENTS OF INCOME**

**(Unaudited)**

(in millions, except per share data)

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|---|---|---|---|
| | **2007** | **2006** | **2007** | **2006** |
| NET SALES | $ 446.4 | $ 420.8 | $ 897.7 | $ 800.8 |
| Cost of sales | 329.0 | 329.7 | 663.9 | 612.5 |
| Gross profit | 117.4 | 91.1 | 233.8 | 188.3 |
| Selling, general and administrative expenses | 36.9 | 32.1 | 70.4 | 60.7 |
| Operating income | 80.5 | 59.0 | 163.4 | 127.6 |
| Interest expense | 5.3 | 5.7 | 10.8 | 11.4 |
| Other income, net | (12.1) | (11.8) | (18.5) | (17.8) |
| Income before income taxes | 87.3 | 65.1 | 171.1 | 134.0 |
| Income tax expense | 29.6 | 19.5 | 57.5 | 40.1 |
| Income from continuing operations | 57.7 | 45.6 | 113.6 | 93.9 |
| Income from discontinued operations before income taxes | 2.7 | 3.6 | 5.4 | 7.8 |
| Income tax expense | 4.3 | 1.1 | 5.3 | 2.4 |
| (Loss) income from discontinued operations | (1.6) | 2.5 | 0.1 | 5.4 |
| NET INCOME | $ 56.1 | $ 48.1 | $ 113.7 | $ 99.3 |
| EARNINGS PER COMMON SHARE: | | | | |
| Basic: | | | | |
| Income from continuing operations | $ 1.18 | $ 0.89 | $ 2.28 | $ 1.82 |
| (Loss) income from discontinued operations | $ (.03) | $ 0.05 | $ | $ 0.11 |
| Net income | $ 1.15 | $ 0.94 | $ 2.28 | $ 1.93 |
| Diluted: | | | | |
| Income from continuing operations | $ 1.17 | $ 0.86 | $ 2.27 | $ 1.78 |
| (Loss) income from discontinued operations | $ (.03) | $ .05 | | $ 0.10 |
| Net income | $ 1.14 | $ 0.91 | $ 2.27 | $ 1.88 |

WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:

| | | | | |
|---|---|---|---|---|
| Basic | 48.7 | 51.2 | 49.9 | 51.1 |
| Diluted | 49.0 | 52.7 | 50.2 | 52.6 |
| Cash dividends per common share | $ 0.15 | $ 0.1125 | $ 0.30 | $ 0.225 |

See accompanying notes to consolidated financial statements.

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**CARPENTER TECHNOLOGY CORPORATION**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**(Unaudited)**

(in millions)

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|---|---|---|---|
| | **2007** | **2006** | **2007** | **2006** |
| Net income | $ 56.1 | $ 48.1 | $ 113.7 | $ 99.3 |
| Net gain (loss) on derivative instruments, net of tax (expense) benefits of $3.4, ($2.5), $7.1 and ($0.9), respectively | (5.4) | 4.2 | (11.2) | 1.5 |
| Benefit plan amortization, net of tax of $0.3 and $0.6, respectively | (0.4) | | (0.9) | |
| Pension curtailment, net of tax of ($0.1) and ($0.1), respectively | 0.2 | | 0.2 | |
| Foreign currency translation gain | 0.6 | 3.5 | 3.8 | 4.8 |
| Comprehensive income | $ 51.1 | $ 55.8 | $ 105.6 | $ 105.6 |

See accompanying notes to consolidated financial statements.

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**CARPENTER TECHNOLOGY CORPORATION**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(Unaudited)**

(in millions)

| | Six Months Ended December 31, 2007 | Six Months Ended December 31, 2006 |
|---|---|---|
| OPERATING ACTIVITIES: | | |
| Net income | $ 113.7 | $ 99.3 |
| Adjustments to reconcile net income to net cash provided from operating activities: | | |
| Depreciation and amortization | 25.1 | 23.8 |
| Deferred income taxes expense (benefit) | 1.2 | (7.2) |
| Net pension (income) expense | (1.2) | 2.4 |
| Net (gain) loss on disposals of property and equipment | (1.1) | 0.2 |
| Changes in working capital and other: | | |
| Accounts receivable | 86.4 | 17.9 |
| Inventories | (88.9) | (32.4) |
| Other current assets | (3.4) | (6.4) |
| Accounts payable | (55.2) | 40.4 |
| Accrued current liabilities | (15.5) | (34.5) |
| Other, net | 19.4 | 4.3 |
| Net cash provided from operating activities | 80.5 | 107.8 |
| INVESTING ACTIVITIES: | | |
| Purchases of property, equipment and software | (42.8) | (14.6) |
| Proceeds from disposals of property and equipment | 1.3 | 0.2 |
| Purchases of marketable securities | (287.3) | (412.1) |
| Proceeds from sales of marketable securities | 332.4 | 231.3 |
| Net cash provided from (used for) investing activities | 3.6 | (195.2) |
| FINANCING ACTIVITIES: | | |
| Payments on long-term debt | (0.1) | (0.1) |
| Dividends paid | (14.9) | (12.2) |
| Purchases of treasury stock | (225.8) | |
| Tax benefits on share-based compensation | 1.1 | 2.2 |
| Proceeds from common stock options exercised | 0.6 | 1.3 |
| Net cash used for financing activities | (239.1) | (8.8) |
| Effect of exchange rate changes on cash and cash equivalents | (3.6) | (3.6) |
| Effect of cash and cash equivalents classified as assets of discontinued operations | (8.4) | |
| DECREASE IN CASH AND CASH EQUIVALENTS | (167.0) | (99.8) |
| Cash and cash equivalents at beginning of period | 300.8 | 352.8 |
| Cash and cash equivalents at end of period | $ 133.8 | $ 253.0 |

See accompanying notes to consolidated financial statements.

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**CARPENTER TECHNOLOGY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Basis of Presentation**

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal and recurring adjustments, considered necessary for a fair presentation are reflected in the interim periods presented. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in Carpenter s annual report on Form 10-K for the year ended June 30, 2007. Operating results for the three and six months ended December 31, 2007 are not necessarily indicative of the operating results for any future period.

As used throughout this report, unless the context requires otherwise, the terms Carpenter , the Company , Registrant , Issuer , we and our re
Carpenter Technology Corporation.

**Stock Split**

On October 16, 2007, the Company announced that its Board of Directors approved a two-for-one split of the Company s common stock to be effected in the form of a stock dividend. The stock split was distributed on November 15, 2007 to stockholders of record at the close of business on November 6, 2007. All share and per share information has been retroactively adjusted and restated to reflect the impact of the split.

**Discontinued Operations and Assets Held for Sale**

During the second quarter of fiscal 2008, the Company announced plans to sell our ceramics operations, which is more fully discussed in Note 2. In accordance with Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the assets and liabilities of the ceramics operations as of December 31, 2007 have been segregated in our consolidated balance sheet and been classified as discontinued operations. The results of operations for our ceramics businesses have been classified as discontinued operations in the consolidated statements of income for all periods presented. Cash flows related to our ceramics operations have not been separately disclosed.

**Recent Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements ( SFAS 157 ), which establishes a framework for measuring the fair value of assets and liabilities. This framework is intended to provide increased consistency in how fair value determinations are made under various existing accounting standards that permit, or in some cases require, estimates of fair market value. SFAS 157 also expands financial statement disclosure requirements related to a company s use of fair value measurements, including the effect of such measures on earnings. The Company is required to adopt the provisions of SFAS 157 effective the first quarter of fiscal 2009. The Company is currently evaluating the provisions of SFAS 157.

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**CARPENTER TECHNOLOGY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

In February 2007, FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 ( SFAS 159 ). This Statement permits entities to choose to measure many financial instruments and certain other items at fair value and report unrealized gains and losses on these instruments in earnings. The Company is required to adopt the provisions of SFAS 159 effective for the first quarter of fiscal 2009. The Company is currently evaluating the provisions of SFAS 159.

During the quarter ended September 30, 2007, as required, the Company adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN 48 ). FIN 48 prescribes recognition and measurement standards for a tax position taken or expected to be taken in a tax return. The evaluation of a tax position in accordance with FIN 48 is a two step process. The first step is the determination of whether a tax position should be recognized in the financial statements. Under FIN 48, a tax position taken or expected to be taken in a tax return is to be recognized only if the Company determines that it is more-likely-than-not that the tax position will be sustained upon examination by the tax authorities based upon the technical merits of the position. In step two, for those tax positions which should be recognized, the measurement of a tax position is determined as being the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. FIN 48 was effective as of the beginning of the Company s 2008 fiscal year, with adoption treated as a cumulative-effect type reduction to beginning retained earnings of $1.8 million. Upon adoption of FIN 48, the Company made an accounting policy election to classify interest and penalties on estimated liabilities for uncertain tax positions as components of the provision for income taxes.

**2. Divestiture**

On December 21, 2007, the Company announced that we had entered into a definitive agreement to sell our ceramics operations to Morgan Crucible Company plc, a U.K. based advanced materials company. The ceramics operations consisted of our Certech and Carpenter Advanced Ceramics business units that have historically been included in our Engineered Products Operations business segment. The closing of the transaction is subject to the completion of certain customary governmental approvals and other contingencies and is expected to occur during the second half of fiscal 2008. The total expected pre-tax proceeds from the sale, subject to a working capital adjustment, are $147 million.

Differences between the tax basis and the financial reporting basis of investments in subsidiaries are referred to as outside basis differences. The Company has not previously recorded deferred taxes on outside basis differences in accordance with SFAS No. 109, Accounting for Income Taxes based on the following:

Outside basis differences related to an investment in foreign subsidiaries because the indefinite reversal criteria of APB No.23, Accounting for Income Taxes-Special Areas , were met

Outside basis differences related to an investment in domestic subsidiaries because the enterprise expected that the outside basis difference would reverse without tax effect.

According to the provisions of FASB Emerging Issues Task Force Issue No, 93-17, a company should record deferred taxes related to the outside basis differences when its expectations have changed and, in any event, no later than the date on which the business is classified as held for sale. Accordingly, upon signing a definitive agreement to sell the ceramics

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CARPENTER TECHNOLOGY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

operations in December 2007, and thus changing its expectations for the businesses to be divested, the Company is now required to record deferred taxes on the outside basis differences on the businesses to be divested, which resulted in a $3.3 million unfavorable tax adjustment recorded in the three months ended December 31, 2007. In addition, upon closing of the divestiture it is anticipated that the Company will recognize income taxes on the gain on the sale of the businesses as well as recognize certain foreign tax credits which can not be recorded until the divestiture is completed. The closing of the divestiture is expected in the second half of fiscal 2008.

The following table summarizes the components of discontinued operations:

| (in millions) | Three Months Ended December 31, 2007 | Three Months Ended December 31, 2006 | Six Months Ended December 31, 2007 | Six Months Ended December 31, 2006 |
|---|---|---|---|---|
| Net sales | $ 24.6 | $ 20.5 | $ 48.4 | $ 45.0 |
| Income before income taxes | $ 2.7 | $ 3.6 | $ 5.4 | $ 7.8 |
| Income tax expense | 4.3 | 1.1 | 5.3 | 2.4 |
| (Loss) income from discontinued operations | $ (1.6) | $ 2.5 | $ 0.1 | $ 5.4 |

The following table summarizes the significant classes of the assets and liabilities classified as discontinued operations in the accompanying consolidated balance sheets:

| (in millions) | December 31, 2007 |
|---|---|
| Assets: | |
| Cash and cash equivalents | $ 8.4 |
| Accounts receivable, net | 16.7 |
| Inventories | 10.4 |
| Other current assets | 3.1 |
| Total current assets of discontinued operations | $ 38.6 |
| Property, plant and equipment | $ 16.3 |
| Goodwill | 6.2 |
| Other assets | 0.4 |
| Total other assets of discontinued operations | $ 22.9 |
| Liabilities: | |
| Accounts payable | $ 4.3 |
| Accrued liabilities | 9.2 |
| Total current liabilities of discontinued operations | $ 13.5 |

| | | |
|---|---|---|
| Other liabilities of discontinued operations | $ | 1.8 |

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**CARPENTER TECHNOLOGY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**3. Earnings Per Common Share**

The calculations of basic and diluted earnings from continuing operations per common share for the three and six months ended December 31, 2007 and 2006 were as follows:

| (in millions, except per share data) | Three Months Ended December 31, 2007 | Three Months Ended December 31, 2006 | Six Months Ended December 31, 2007 | Six Months Ended December 31, 2006 |
|---|---|---|---|---|
| Basic: | | | | |
| Income from continuing operations | $ 57.7 | $ 45.6 | $ 113.6 | $ 93.9 |
| Dividends accrued on convertible preferred stock, net of tax benefits | | (0.4) | | (0.7) |
| Earnings from continuing operations available for common stockholders | $ 57.7 | $ 45.2 | $ 113.6 | $ 93.2 |
| Weighted average number of common shares outstanding | 48.7 | 51.2 | 49.9 | 51.1 |
| Basic earnings from continuing operations per common share | $ 1.18 | $ 0.89 | $ 2.28 | $ 1.82 |
| Diluted: | | | | |
| Income from continuing operations | $ 57.7 | $ 45.6 | $ 113.6 | $ 93.9 |
| Assumed shortfall between common and preferred dividend | | (0.2) | | (0.3) |
| Earnings from continuing operations available for common stockholders | $ 57.7 | $ 45.4 | $ 113.6 | $ 93.6 |
| Weighted average number of common shares outstanding | 48.7 | 51.2 | 49.9 | 51.1 |
| Assumed conversion of preferred shares | | 1.2 | | 1.2 |
| Effect of shares issuable under stock option plans | 0.3 | 0.4 | 0.3 | 0.3 |
| Adjusted weighted average common shares outstanding | 49.0 | 52.8 | 50.2 | 52.6 |
| Diluted earnings from continuing operations per common share | $ 1.17 | $ 0.86 | $ 2.27 | $ 1.78 |

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**CARPENTER TECHNOLOGY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**4. Investments in Marketable Securities**

The fair value of the Company s marketable securities is based on quoted market prices or estimates of fair value as of December 31, 2007 and June 30, 2007. The following is a summary of marketable securities, all of which are classified as available-for-sale as of December 31, 2007 and June 30, 2007:

December 31, 2007

| (in millions) | Municipal Bonds | Other | Total |
|---|---|---|---|
| Cost | $ 327.6 | $ | $ 327.6 |
| Unrealized losses | | | |
| Estimated fair value | $ 327.6 | $ | $ 327.6 |

June 30, 2007

| (in millions) | Municipal Bonds | Other | Total |
|---|---|---|---|
| Cost | $ 371.5 | $ 1.2 | $ 372.7 |
| Unrealized losses | | | |
| Estimated fair value | $ 371.5 | $ 1.2 | $ 372.7 |

The Company s marketable securities consisted of variable rate demand notes as well as auction rate securities. Variable rate demand notes and auction rate securities are variable rate bonds tied to short-term interest rates. Although the underlying bonds may have long-term stated maturities, the investments are generally priced and traded as short-term instruments due to the liquidity provided by short-term interest rate reset mechanisms. The Company classified the securities as current assets in the accompanying consolidated balance sheets because the Company believes the investments are available to fund current operations.

For the six months ended December 31, 2007 and 2006, proceeds from sales of these investments were $332.4 million and $231.3 million, respectively.

**5. Inventories**

Inventories consisted of the following components as of December 31, 2007 and June 30, 2007:

| (in millions) | December 31, 2007 | June 30, 2007 |
|---|---|---|
| Raw materials and supplies | $ 45.5 | $ 29.1 |
| Work in process | 185.3 | 138.3 |
| Finished and purchased products | 82.9 | 67.6 |

| | | |
|---|---|---|
| Total inventory | $ 313.7 | $ 235.0 |

Inventories are valued at the lower of cost or market. Cost for inventories is principally determined by the Last-In, First-Out ( LIFO ) method. The effect of using the LIFO methodology to value inventory, rather than FIFO, decreased cost of sales by $33.8 million and $48.3 million for the three and six months ended December 31, 2007, respectively and increased cost of sales by $53.0 million and $79.2 million for the three and six months ended December 31, 2006, respectively.

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**CARPENTER TECHNOLOGY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

### 6. Accrued Liabilities

Accrued liabilities consisted of the following as of December 31, 2007 and June 30, 2007:

| (in millions) | December 31, 2007 | June 30, 2007 |
|---|---|---|
| Compensation | $ 31.8 | $ 37.7 |
| Employee benefits | 30.2 | 30.0 |
| Derivative financial instruments | 16.0 | 2.1 |
| Interest | 5.5 | 5.5 |
| Income taxes | 3.2 | 19.9 |
| Taxes, other than income | 3.1 | 4.2 |
| Environmental costs | 2.0 | 1.5 |
| Deferred revenue | 1.4 | 2.1 |
| Professional services | 0.6 | 0.8 |
| Other | 15.9 | 13.3 |
| | $ 109.7 | $ 117.1 |

### 7. Pension and Other Postretirement Benefits

The components of the net periodic benefit cost related to Carpenter s pension and other postretirement benefits for the three and six months ended December 31, 2007 and 2006 were as follows:

| Three months ended December 31, (in millions) | Pension Plans 2007 | Pension Plans 2006 | Other Postretirement Plans 2007 | Other Postretirement Plans 2006 |
|---|---|---|---|---|
| Service cost | $ 4.7 | $ 4.3 | $ 0.6 | $ 0.6 |
| Interest cost | 12.2 | 11.6 | 2.9 | 2.7 |
| Expected return on plan assets | (18.6) | (16.8) | (1.9) | (1.5) |
| Amortization of net loss | 0.6 | 1.6 | 0.5 | 0.5 |
| Curtailment | 0.2 | | | |
| Amortization of prior service cost (benefit) | 0.2 | 0.2 | (1.9) | (2.0) |
| Net pension (income) expense | $ (0.7) | $ 0.9 | $ 0.2 | $ 0.3 |

| Six months ended December 31, (in millions) | Pension Plans 2007 | Pension Plans 2006 | Other Postretirement Plans 2007 | Other Postretirement Plans 2006 |
|---|---|---|---|---|
| Service cost | $ 9.4 | $ 8.6 | $ 1.2 | $ 1.2 |
| Interest cost | 24.4 | 23.2 | 5.8 | 5.4 |

| | | | | |
|---|---|---|---|---|
| Expected return on plan assets | (37.2) | (33.6) | (3.8) | (3.0) |
| Amortization of net loss | 1.2 | 3.2 | 1.0 | 1.0 |
| Curtailment | 0.2 | | | |
| Amortization of prior service cost (benefit) | 0.4 | 0.4 | (3.8) | (4.0) |
| Net pension (income) expense | $ (1.6) | $ 1.8 | $ 0.4 | $ 0.6 |

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**CARPENTER TECHNOLOGY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**8. Contingencies**

***Environmental***

Carpenter is subject to various federal, state, local and foreign environmental laws and regulations relating to pollution, protection of public health and the environment, natural resource damages and occupational safety and health. Although compliance with these laws and regulations may affect the costs of Carpenter s operations, compliance costs to date have not been material on an annual or periodic basis. Carpenter has environmental remediation liabilities at some of its owned operating facilities and has been designated as a potentially responsible party ( PRP ) with respect to certain third-party Superfund waste disposal sites and other third party owned sites. Additionally, Carpenter has been notified that it may be a PRP with respect to other Superfund sites as to which no proceedings have been instituted against Carpenter. Neither the exact amount of remediation costs nor the final method of their allocation among all designated PRPs at these Superfund sites has been determined. The liability for future environmental remediation costs is evaluated by management on a quarterly basis. Carpenter accrues amounts for environmental remediation costs that represent management s best estimate of the probable and reasonably estimable costs related to environmental remediation. There were no additional amounts accrued during the three and six months ended December 31, 2007 or 2006. The liability recorded for environmental remediation costs at Superfund sites, at other third party-owned sites and at Carpenter-owned current or former operating facilities remaining at December 31, 2007 was $5.2 million. The estimated range at December 31, 2007 of the reasonably possible future costs of remediation at Superfund sites, at other third party-owned sites and at Carpenter-owned current or former operating facilities is between $5.2 million and $8.7 million.

Estimates of the amount and timing of future costs of environmental remediation requirements are inherently imprecise because of the continuing evolution of environmental laws and regulatory requirements, the availability and application of technology, the identification of currently unknown remediation sites and the allocation of costs among the PRPs. Based upon information currently available, such future costs are not expected to have a material effect on Carpenter s financial position, results of operations or cash flows. However, such costs could be material to Carpenter s financial position, results of operations or cash flows in a particular future quarter or year.

***Guarantees/Indemnification Obligations***

In connection with the divestitures of several previously owned companies, Carpenter undertook certain indemnification obligations as part of the definitive agreements for sale of those businesses. The indemnification obligations relate to Carpenter s covenants, representations and warranties under the sale agreements, potential liability for operations of the businesses prior to the sale and other similar matters. The indemnification obligations are subject to conditions and limitations that are normal in agreements of this type. Further, certain of the indemnification obligations may be limited or barred by a monetary cap or a time limitation. However, other indemnifications are not subject to a monetary cap, therefore, we are unable to estimate the maximum potential future liability under the indemnity provisions of these agreements. The obligation to provide indemnification will normally arise only after the indemnified party makes a claim subject to review by Carpenter and in compliance with applicable procedures with respect to the method and timeliness of notice. Recourse may be available in limited situations against third parties from which Carpenter purchased the businesses. As of December 31, 2007 and June 30, 2007, we recorded a reserve of approximately $2.0 million related to these indemnifications.

**CARPENTER TECHNOLOGY CORPORATION**

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***Duty Drawback***

Historically, the Company has participated in a program offered by U.S. Customs and Border Protection ( U.S. Customs ) known as duty drawback. Under the program, the Company claimed a refund of import duties on items manufactured and exported to customers in foreign countries. Certain vendors of the Company prepared certificates authorizing the Company to claim duty drawback refunds against imported goods purportedly shipped by the vendor to the Company. Because of the complexity of the program, the Company engaged a licensed U.S. customs broker specializing in duty drawback claims. The customs broker was responsible for performing the administration of the process which included maintaining and collecting various forms of supporting evidence for each claim including collecting appropriate certificates from vendors, as well as preparing and submitting the refund claims.

The Company received notice from U.S. Customs that the Company was under investigation related to claims previously filed by the customs broker on the Company s behalf. The investigation alleged certain discrepancies and a lack of supporting documentation for the claims that had been filed by the broker. The Company initiated an internal review of the claims filed with U.S. Customs to determine the extent of claims that may have inadequate supporting documentation. The Company has also engaged a new licensed U.S. customs broker and suspended the filing of any new duty drawback claims until the investigation can be concluded. The Company intends to cooperate fully with U.S. Customs investigation of this matter.

As of the date of this filing, the Company s internal review is not complete due to the extensive amount of documentation which must be compiled and reviewed. Based on the initial results of the review to date, the Company recorded a charge of $4.6 million to Cost of Sales during the first quarter of fiscal 2008. This charge was determined in accordance with Statements of Financial Accounting Standards No. 5, Accounting for Contingencies, and represents the Company s current best estimate of probable loss. No additional charges were recorded in the second quarter of fiscal 2008. As a result of the Company s internal review, the Company has made payments of $0.7 million to U.S. Customs through December 31, 2007 related to the above contingency.

During the period the Company s customs broker was filing claims on the Company s behalf, July 2003 through December 2006, the Company applied for and received refund claims totaling $6.9 million. While the ultimate outcome of the U.S. Customs investigation and the Company s internal review is not yet known, based on current facts we believe that the reserve recorded of $4.2 million appears adequate.

***Other***

Carpenter is also defending various claims and legal actions, and is subject to contingencies that are common to its operations, including those pertaining to product claims, commercial disputes, employment actions, employee benefits, compliance with domestic and foreign laws, personal injury claims and tax issues. Carpenter provides for costs relating to these matters when a loss is probable and the amount of the loss is reasonably estimable. The effect of the outcome of these matters on Carpenter s future results of operations and liquidity cannot be predicted because any such effect depends on future results of operations and the amount and timing (both as to recording future charges to operations and cash expenditures) of the resolution of such matters. While it is not feasible to determine the outcome of these matters, management

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believes that the total ultimate liability will not have a material effect on Carpenter s financial position, results of operations or cash flows over the long-term. However, such costs could be material to Carpenter s financial position, results of operations or cash flows in a particular future quarter or year.

**9. Common Stock in Treasury**

In December 2007, the Company s Board of Directors authorized a new share repurchase program as a result of the completion of the purchases of the previously authorized $250.0 million share repurchase program. The new program authorizes the purchase of up to $250.0 million of the Company s outstanding common stock. According to the terms of the new share repurchase program, purchases will be funded with available cash and made from time to time in either the open market or through private transactions. The timing or amount of the shares to be repurchased cannot be assured. During the six months ended December 31, 2007, Carpenter purchased 3,683,903 of its common stock on the open market for $225.8 million.

The following is a summary of shares purchased during the six months ended December 31, 2007 under the respective share repurchase programs:

| Date Authorized by the Board of Directors | Total Authorized | Shares Purchased | Cost of Shares Purchased | Authorized Amount Remaining Available for Future Purchases as of December 31, 2007 |
|---|---|---|---|---|
| September 2006 | $ 250.0 | 3,622,870 | $ 221.2 | |
| December 2007 | $ 250.0 | 61,033 | 4.6 | $ 245.4 |
| | | 3,683,903 | $ 225.8 | $ 245.4 |

**10. Other Income**

Other income, net consisted of the following:

| (in millions) | Three Months Ended December 31, 2007 | Three Months Ended December 31, 2006 | Six Months Ended December 31, 2007 | Six Months Ended December 31, 2006 |
|---|---|---|---|---|
| Continued Dumping and Subsidy Offset Act receipt | $ (8.2) | $ (6.4) | $ (8.2) | $ (6.4) |
| Interest income | (4.5) | (5.1) | (10.3) | (10.4) |
| Increase in equity in minority interests of unconsolidated subsidiaries | (0.3) | (0.3) | (0.5) | (0.7) |
| Foreign exchange loss | 0.4 | 0.5 | 0.5 | 0.3 |

| | | | | |
|---|---|---|---|---|
| Other expense (income) | 0.5 | (0.5) | | (0.6) |
| | $ (12.1) | $ (11.8) | $ (18.5) | $ (17.8) |

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### 11. Income Taxes

The tax rate used for interim periods is the estimated annual effective consolidated tax rate, based on the current estimate of full year results, except that taxes related to specific events, if any, are recorded in the interim period in which they occur.

As required, the Company adopted FIN 48 on July 1, 2007 which resulted in the Company recognizing a $3.7 million increase in liabilities related to liabilities for unrecognized tax benefits, and a $1.9 million increase in deferred tax assets for tax positions for which the ultimate deductibility is highly certain, but for which there is uncertainty as to the timing of such deductibility. The net result of these recognized assets and liabilities was a reduction to beginning retained earnings of $1.8 million. The Company s total liabilities for unrecognized tax benefits at the date of adoption were $20.2 million, which included $1.8 million of accrued interest and penalties. For the three months ended December 31, 2007, the Company s income tax provision included $0.1 million of benefit for changes in uncertain tax positions taken in prior years. The Company anticipates that the amount of unrecognized tax benefits may change in the next twelve months. However, due to uncertainties in timing, it is not reasonably possible to estimate a range of possible change.

It is the Company s policy to classify interest and penalties recognized on underpayment of income taxes as income tax expense. For the six months ended December 31, 2007, we accrued interest of $0.4 million.

Including tax positions for which the Company determined that the tax position would not meet the more-likely-than-not recognition threshold upon examination by the taxing authorities based upon the technical merits of the position, the total estimated unrecognized tax benefit that, if recognized at December 31, 2007, would affect the Company s effective tax rate was approximately $9.2 million. At this time, the Company does not believe that it is reasonably possible that there will be a material change in the estimated unrecognized tax benefits within the next twelve months.

The Company, and/or one of its subsidiaries, files income tax returns in the U.S. Federal jurisdiction and in various states and foreign jurisdictions. A summary of tax years that remain subject to examination, by major tax jurisdiction, is as follows:

| **Jurisdiction** | **Earliest Year Open to Examination** |
|---|---|
| U.S. Federal | 2004 |
| States: | |
| Pennsylvania | 2003 |
| California | 2006 |
| Illinois | 2005 |
| Foreign: | |
| Belgium | 2004 |
| Mexico | 2002 |

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**12. Business Segments**

As a result of the Company s pending divestiture of the ceramics operations, we now have two continuing operations reportable business segments: Premium Alloys Operations and Advanced Metals Operations.

The Premium Alloys Operations ( PAO ) segment includes the manufacturing and distribution of high temperature and high strength metal alloys and stainless steels in the form of ingots, billets, large bars and hollows. Also, the PAO segment includes conversion processing of metal for other specialty metals companies. A significant portion of PAO sales are to customers in the aerospace and energy industries. Much of PAO sales are to forging companies that further shape, mill, and finish the metals into more specific dimensions. All such sales are made under the Carpenter brand name.

The Advanced Metals Operations ( AMO ) segment includes the manufacturing and distribution of high temperature and high strength metal alloys, stainless steels, and titanium in the form of small bars and rods, wire, narrow strip and powder. Products in this segment typically go through more finishing operations, such as rolling, turning, grinding, drawing, and atomization, than products in our PAO segment. Also, sales in the AMO segment are spread across many end-use markets, including the aerospace, industrial, consumer, automotive, and medical industries. AMO products are sold under the Carpenter, Dynamet, and Talley brand names.

Our consolidated total assets are managed as corporate-level assets and, therefore, are not allocated to the business segments. Only a portion of the expenses related to these assets, principally depreciation and amortization, is allocated to the individual business segments for inclusion in their respective measures of operating income.

The service cost component of Carpenter s net pension expense, which represents the estimated cost of future pension liabilities earned associated with active employees, is included in the operating income of the business segments. The residual net pension expense, which is comprised of the expected return on plan assets, interest costs on the projected benefit obligations of the plans, and amortization of actuarial gains and losses and prior service costs, is included under the heading Pension earnings, interest & deferrals .

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On a consolidated basis, Carpenter s sales were not materially dependent on a single customer or a small group of customers.

| (in millions) | Three Months Ended December 31, 2007 | 2006 | Six Months Ended December 31, 2007 | 2006 |
|---|---|---|---|---|
| Net sales: | | | | |
| Advanced Metals Operations | $ 313.4 | $ 311.5 | $ 635.7 | $ 601.8 |
| Premium Alloys Operations | 132.7 | 106.0 | 261.9 | 192.9 |
| Other | 3.6 | 3.8 | 6.8 | 7.3 |
| Intersegment | (3.3) | (0.5) | (6.7) | (1.2) |
| Consolidated net sales | $ 446.4 | $ 420.8 | $ 897.7 | $ 800.8 |
| Operating income: | | | | |
| Advanced Metals Operations | $ 44.5 | $ 41.3 | $ 93.4 | $ 82.0 |
| Premium Alloys Operations | 39.6 | 22.9 | 76.1 | 54.1 |
| Other | 1.0 | 1.1 | 1.7 | 2.0 |
| Corporate costs | (10.7) | (10.1) | (19.8) | (18.0) |
| Pension earnings, interest & deferrals | 6.0 | 3.6 | 12.0 | 7.2 |
| Intersegment | 0.1 | 0.2 | | 0.3 |
| Consolidated operating income | $ 80.5 | $ 59.0 | $ 163.4 | $ 127.6 |

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

**Background and General**

Carpenter is engaged in the manufacturing, fabrication, and distribution of specialty metals and engineered products. As a result of the pending divestiture of our ceramic operations discussed below, we now have two reportable business segments: Premium Alloys Operations and Advanced Metals Operations, which are discussed later below. As part of our overall business strategy, we expect to continue to seek and consider opportunities related to strategic divestitures, acquisitions, and collaborative arrangements.

Our discussions below in this Item 2 are based upon the more detailed discussions about our business, operations and financial condition included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2007, under Item 8 thereof. Our discussions here focus on our results during or as of the three and six month periods ended December 31, 2007 and the comparable periods of fiscal 2007 (the three and six month periods ended December 31, 2006), and, to the extent applicable, on material changes from information discussed in that Form 10-K or other important intervening developments or information since that time that have not previously been reported. These discussions should be read in conjunction with that Form 10-K for detailed background information.

**Impact of Raw Material Surcharges and Product Mix**

Increases in the cost of raw materials have impacted our operations over the past few years. We, and others in our industry, generally have been able to pass these cost increases on certain materials through to our customers using surcharges which are structured to recover increases in raw material costs. In the last several years, as raw material prices have escalated, surcharges have become an increasingly significant component of our net sales, which had a dilutive effect on our gross margin and operating margin percentages as described later in this discussion. Generally, the formula used to calculate the surcharge is based on prices quoted on the London Metal Exchange ( LME ) for the previous month for the respective raw materials, which creates a lag between the raw materials price change on the LME and our corresponding surcharges on sales. Except for the usually modest effect of the lag, the surcharge mechanism protects our net income on such sales.

We produce hundreds of grades of materials, with a wide range of pricing and profit levels depending on the grade. In addition, our product mix within a period is subject to the fluctuating order patterns of our customers as well as decisions we may make to participate in certain lower margin business in order to utilize available capacity. While we expect to see positive contribution from a more favorable product mix in our margin performance over time, the impact by period may fluctuate, and period-to-period comparisons may vary.

**Discontinued Operations**

On December 21, 2007, we announced that we had entered into a definitive agreement to sell our ceramics operations to Morgan Crucible Company plc, a U.K. based advanced materials company. The ceramics operations consisted of our Certech and Carpenter Advanced Ceramics business units that have historically been included in our Engineered Products Operations business segment. The closing of the transaction is subject to the completion of certain customary governmental approvals and other contingencies and is expected to occur during the third quarter of fiscal 2008. The total expected pre-tax proceeds from the sale, subject to a working capital adjustment, are $147 million.

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**Results of Operations   Three Months Ended December 31, 2007 vs. Three Months Ended December 31, 2006**

Unless specifically stated otherwise, all discussion of the results of operations reflect the Company s continuing operations.

**Operating Performance Overview**

For the fiscal quarter ended December 31, 2007, we reported net income of $57.7 million or $1.17 per diluted share. This was a 27 percent increase as compared with net income for the same period a year ago. Our results reflected strong growth in the energy end-use market coupled with increased international demand for our products.

**Net Sales**

Net sales for the three months ended December 31, 2007 were $446.4 million, which was a 6 percent increase over the same period a year ago. Adjusted for surcharge revenue, sales decreased 1 percent. Total volume declined by 9 percent during the fiscal quarter ended December 31, 2007 from the second quarter a year ago. Carpenter s Premium Alloys Operations generated a 15 percent increase in pounds shipped largely due to demand from the energy market. More than offsetting this increase was a 13 percent decline in pounds shipped by the Advanced Metals Operations partly due to lower priced stainless material sold through distributors.

Geographically, sales outside the United States increased 33 percent from a year ago to $152.0 million. International sales represented 34 percent of total sales for the three months ended December 31, 2007 compared to 27 percent for the three months ended December 31, 2006. The increase primarily reflected increased sales in Europe which benefited from growth with key customers in aerospace, strong demand from the energy market and higher sales to the automotive and consumer markets.

**Sales by End-Use Markets**

Our sales are to customers across a diversified list of end-use markets. The table below includes comparative information for the Company s estimated sales by end-use markets:

| ($ in millions) | Three Months Ended December 31, 2007 | Three Months Ended December 31, 2006 | $ Increase/ (decrease) | % Increase/ (decrease) |
|---|---|---|---|---|
| Aerospace | $ 171.4 | $ 160.9 | $ 10.5 | 7% |
| Industrial | 97.6 | 95.2 | 2.4 | 3 |
| Energy | 57.1 | 36.8 | 20.3 | 55 |
| Automotive | 48.8 | 54.6 | (5.8) | (11) |
| Consumer | 44.5 | 45.5 | (1.0) | (2) |
| Medical | 27.0 | 27.8 | (0.8) | (3) |
| Total net sales | $ 446.4 | $ 420.8 | $ 25.6 | 6% |

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The following table includes comparative information for the Company s estimated sales by end-use markets excluding surcharge revenues:

| ($ in millions) | Three Months Ended December 31, 2007 | 2006 | $ Increase/ (decrease) | % Increase/ (decrease) |
|---|---|---|---|---|
| Aerospace | $ 124.6 | $ 129.4 | $ (4.8) | (4)% |
| Industrial | 62.0 | 66.7 | (4.7) | (7) |
| Energy | 44.5 | 27.0 | 17.5 | 65 |
| Automotive | 34.5 | 38.6 | (4.1) | (11) |
| Consumer | 29.4 | 31.4 | (2.0) | (6) |
| Medical | 22.8 | 27.7 | (4.9) | (18) |
| Total net sales excluding surcharge revenues | $ 317.8 | $ 320.8 | $ (3.0) | (1)% |

Sales to the aerospace market increased 7 percent from the second quarter a year ago to $171.4 million. Excluding surcharge revenue, sales declined approximately 4 percent from the second quarter a year ago. Reduced sales of material used in the manufacture of fasteners and the loss of business with a key customer who is now sourcing some of its requirements internally from a recently acquired subsidiary have adversely impacted sales.

Industrial market sales increased 3 percent from the second quarter a year ago to $97.6 million. Adjusted for surcharge revenue, sales decreased approximately 7 percent. The decrease during the quarter ended December 31, 2007 reflected lower demand for material used in the manufacture of semiconductor equipment as well as valves and fittings.

Sales to the energy market of $57.1 million reflected a 55 percent increase from the second quarter of fiscal 2007. Excluding surcharge revenue, sales increased 65 percent from a year ago. Energy market sales were strong in both the oil and gas and power generation segments compared to the same quarter a year ago. The overall increase reflected strong demand for industrial gas turbines, particularly within the international market and continued acceptance of the Company s broad product portfolio of high-strength and corrosion-resistant materials.

Automotive and truck market sales decreased 11 percent from the second quarter a year ago to $48.8 million. Excluding surcharge revenue, sales decreased 11 percent. Lower domestic production and inventory supply chain adjustments contributed to the decline.

Sales to the consumer market decreased 2 percent to $44.5 million from a year ago. Adjusted for surcharge revenue, sales decreased 6 percent. Lower shipments to manufacturers serving the housing market were partially offset by higher sales to the electronics market.

Sales to the medical market decreased 3 percent to $27.0 million from a year ago. Adjusted for surcharge revenue, sales decreased 18 percent. An increase in pounds shipped was more than offset by an unfavorable shift in product mix and lower selling prices for titanium materials.

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**Sales by Product Class**

The table below includes comparative information for the Company s sales by major product class:

| | Three Months Ended December 31, | | $ | % |
|---|---|---|---|---|
| ($ in millions) | 2007 | 2006 | Increase / (Decrease) | Increase / (Decrease) |
| Special alloys | $ 238.5 | $ 196.3 | $ 42.2 | 21% |
| Stainless steels | 147.6 | 155.5 | (7.9) | (5) |
| Titanium products | 38.6 | 48.9 | (10.3) | (21) |
| Tools and other steels | 16.6 | 14.0 | 2.6 | 19 |
| Other materials | 5.1 | 6.1 | (1.0) | (16) |
| Total net sales | $ 446.4 | $ 420.8 | $ 25.6 | 6% |

The table below includes comparative information for the Company s sales by major product class excluding surcharge revenues:

| | Three Months Ended December 31, | | $ | % |
|---|---|---|---|---|
| ($ in millions) | 2007 | 2006 | Increase / (Decrease) | Increase / (Decrease) |
| Special alloys | $ 156.1 | $ 137.0 | $ 19.1 | 14% |
| Stainless steels | 102.1 | 115.3 | (13.2) | (11) |
| Titanium products | 38.6 | 48.9 | (10.3) | (21) |
| Tools and other steels | 15.9 | 13.5 | 2.4 | 18 |
| Other materials | 5.1 | 6.1&nbs | | |