

PHOTRONICS INC  
Form 10-Q  
September 06, 2007

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**  
**For the quarterly period ended July 29, 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 0-15451**

**PHOTRONICS, INC.**

*(Exact name of registrant as specified in its charter)*

**Connecticut**  
*(State or other jurisdiction  
of incorporation or organization)*

**06-0854886**  
*(IRS Employer  
Identification Number)*

**15 Secor Road, Brookfield, Connecticut 06804**  
*(Address of principal executive offices and zip code)*

**(203) 775-9000**  
*(Registrant's telephone number, including area code)*

*Securities registered pursuant to Section 12(b) of the Act:* **None**

*Securities registered pursuant to Section 12(g) of the Act:* **Common Stock, \$0.01 par value per share**

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

Yes  No

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

Yes  No

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

Class	Outstanding at September 3, 2007
<b>Common Stock, \$0.01 par value</b>	<b>41,844,069 Shares</b>

-1-

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## Forward-Looking Information

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for forward-looking statements made by or on behalf of Photronics, Inc. (the "Company"). These statements are based on management's beliefs, as well as assumptions made by and information currently available to management. Forward-looking statements may be identified by words like "expect", "anticipate", "believe", "plan", "projects", and similar expressions. All forward-looking statements involve risks and uncertainties that are difficult to predict. In particular, any statement contained in this quarterly report on Form 10-Q, in press releases, written statements or other documents filed with the Securities and Exchange Commission, or in the Company's communications and discussions with investors and analysts in the normal course of business through meetings, phone calls and conference calls, regarding the consummation and benefits of future acquisitions, expectations with respect to future sales, financial performance, operating efficiencies and product expansion, are subject to known and unknown risks, uncertainties and contingencies, many of which are beyond the control of the Company. These factors may cause actual results, performance or achievements to differ materially from anticipated results, performances or achievements. Factors that might affect such forward-looking statements include, but are not limited to, overall economic and business conditions; the demand and receipt of orders for the Company's products; competitive factors in the industries and geographic markets in which the Company competes; changes in federal, state and international tax requirements (including tax rate changes, new tax laws and revised tax law interpretations); the Company's ability to place new equipment in service on a timely basis; interest rate fluctuations and other capital market conditions, including foreign currency rate fluctuations; economic and political conditions in international markets; the ability to obtain additional financings; the ability to achieve anticipated synergies and other cost savings in connection with acquisitions and productivity programs; uncertainties with respect to the integration and management of MP Mask Technology Center, LLC (MP Mask); delays in the construction and equipping of the planned nanofab fabrication facilities; the timing, impact and other uncertainties of future acquisitions; the seasonal and cyclical nature of the semiconductor and flat panel display industries; the availability of capital; management changes; damage or destruction to the Company's facilities by natural disasters, labor strikes, political unrest or terrorist activity; the ability to fully utilize its tools; the ability of the Company to receive desired yields, pricing, product mix, and market acceptance of its products; changes

in technology; and the ability of the Company to obtain necessary export licenses. Any forward-looking statements should be considered in light of these factors. Accordingly, there is no assurance that the Company's expectations will be realized. The Company does not assume responsibility for the accuracy and completeness of the forward-looking statements and does not assume an obligation to provide revisions to any forward-looking statements.

-2-

**PHOTRONICS, INC.  
AND SUBSIDIARIES**

**INDEX**

<b>PART I.</b>	<b>FINANCIAL INFORMATION</b>	<u>Page</u>
Item 1.	Condensed Consolidated Financial Statements	
	<u>Condensed Consolidated Balance Sheets at July 29, 2007 and October 29, 2006</u>	4
	<u>Condensed Consolidated Statements of Income for the Three and Nine Months Ended July 29, 2007 and July 30, 2006</u>	5
	<u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended July 29, 2007 and July 30, 2006</u>	6
	<u>Notes to Condensed Consolidated Financial Statements</u>	7
Item 2.	<u>Management's Discussion and Analysis of Results of Operations and Financial Condition</u>	15
Item 3.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	23
Item 4.	<u>Controls and Procedures</u>	24
<b>PART II.</b>	<b>OTHER INFORMATION</b>	
Item 1A.	<u>Risks Relating to the Company's Business</u>	24
Item 5.	<u>Other Information</u>	24
Item 6.	<u>Exhibits</u>	25

-3-

**PART I. FINANCIAL INFORMATION****Item 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****PHOTRONICS, INC. AND SUBSIDIARIES**

Condensed Consolidated Balance Sheets

*(in thousands, except per share amounts)**(unaudited)*

	<b>July 29, 2007</b>	<b>October 29, 2006</b>
	<u>          </u>	<u>          </u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$120,056	\$ 129,425
Short-term investments	25,182	69,899
Accounts receivable, net of allowance of \$4,740 in 2007 and \$4,471 in 2006	72,527	84,299
Inventories	16,630	19,209
Other current assets	11,790	16,055
	<u>          </u>	<u>          </u>
Total current assets	246,185	318,887
Property, plant and equipment, net	460,116	443,637
Goodwill	138,534	138,534
Investment in joint venture	65,646	64,365
Other intangibles, net	70,004	71,763
Other assets	6,857	8,497
	<u>          </u>	<u>          </u>
	\$987,342	\$1,045,683
	<u>          </u>	<u>          </u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Current portion of long-term borrowings	\$ 25,000	\$ 86,903
Accounts payable	65,962	53,907
Accrued liabilities	31,123	50,386
	<u>          </u>	<u>          </u>
Total current liabilities	122,085	191,196
Long-term borrowings	149,608	170,288
Deferred income taxes and other liabilities	16,509	23,920
	<u>          </u>	<u>          </u>
Total liabilities	288,202	385,404

Minority interest	48,914	45,997
Shareholders' equity:		
Preferred stock, \$0.01 par value, 2,000 shares authorized, none issued and outstanding	-	-
Common stock, \$0.01 par value, 150,000 shares authorized, 41,572 shares issued and outstanding at July 29, 2007 and 41,485 shares issued and outstanding at October 29, 2006	416	415
Additional paid-in capital	380,896	378,143
Retained earnings	226,813	202,652
Accumulated other comprehensive income	42,101	33,072
	<hr/>	<hr/>
Total shareholders' equity	650,226	614,282
	<hr/>	<hr/>
	\$987,342	\$1,045,683
	<hr/>	<hr/>

See accompanying notes to condensed consolidated financial statements.

-4-

**PHOTRONICS, INC. AND SUBSIDIARIES**  
Condensed Consolidated Statements of Income  
(in thousands, except per share amounts)  
(unaudited)

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>July 29, 2007</b>	<b>July 30, 2006</b>	<b>July 29, 2007</b>	<b>July 30, 2006</b>
	<hr/>	<hr/>	<hr/>	<hr/>
Net sales	\$104,301	\$108,160	\$319,908	\$339,579
Costs and expenses:				
Cost of sales	(80,595)	(75,256)	(240,344)	(228,685)
Selling, general and administrative	(16,039)	(15,524)	(46,922)	(46,438)
Research and development	(4,241)	(6,741)	(13,285)	(22,985)
Consolidation, restructuring and related charges	-	(1,790)	-	(13,216)

Gain on sale of facility	-	-	2,254	-
Operating income	3,426	8,849	21,611	28,255
Other income (expense), net				
Interest expense	(1,477)	(2,989)	(4,509)	(9,002)
Investment and other income, net	2,344	1,715	5,521	13,294
Income before income taxes and minority interest	4,293	7,575	22,623	32,547
Income tax (provision) benefit	(1,126)	(1,692)	3,962	(9,324)
Income before minority interest	3,167	5,883	26,585	23,223
Minority interest	(929)	(1,328)	(2,424)	(3,710)
Net income	\$2,238	\$ 4,555	\$24,161	\$ 19,513
Earnings per share:				
Basic	\$0.05	\$0.11	\$0.58	\$0.47
Diluted	\$0.05	\$0.11	\$0.53	\$0.45
Weighted average number of common shares outstanding:				
Basic	41,558	41,383	41,515	41,344
Diluted	41,864	41,735	51,355	51,036

*See accompanying notes to condensed consolidated financial statements.*

	<b>Nine Months Ended</b>	
	<b>July 29, 2007</b>	<b>July 30, 2006</b>
Cash flows from operating activities:		
Net income	\$24,161	\$19,513
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	72,234	67,594
Gain on sale of facility and other	(3,027)	-
Gain on sale of investments	(257)	-
Minority interest in income of consolidated subsidiaries	2,424	3,710
Consolidation, restructuring and related charges	-	13,216
Changes in assets and liabilities:		
Accounts receivable	15,330	(5,078)
Inventories	4,124	(597)
Other current assets	4,231	(4,514)
Accounts payable and other	(25,146)	(13,946)
Net cash provided by operating activities	<u>94,074</u>	<u>79,898</u>
Cash flows from investing activities:		
Purchases of property, plant and equipment	(56,951)	(83,441)
Acquisition of additional interest in PK Ltd.	-	(8,432)
Proceeds from the sale of short-term investments and other	48,253	78,697
Investment in joint venture, technology and supply agreements	(1,000)	(120,505)
Purchases of short-term investments	(5,465)	(64,983)
Proceeds from sale of facility and other	5,783	-
Net cash used in investing activities	<u>(9,380)</u>	<u>(198,664)</u>
Cash flows from financing activities:		
Repayments of long-term borrowings	(87,087)	(4,725)
Payment to Micron Technology, Inc.	(7,500)	-
Proceeds from long-term borrowings	3,369	12,218
Proceeds from issuance of common stock	631	1,172
Other	(1,485)	-
Net cash (used in) provided by financing activities	<u>(92,072)</u>	<u>8,665</u>
Effect of exchange rate changes on cash flows	<u>(1,991)</u>	<u>(709)</u>
Net decrease in cash and cash equivalents	(9,369)	(110,810)
Cash and cash equivalents at beginning of period	<u>129,425</u>	<u>196,049</u>
Cash and cash equivalents at end of period	<u>\$ 120,056</u>	<u>\$85,239</u>
Supplemental cash flow information:		
Change in accrual for purchases of property, plant and equipment	\$ 16,480	\$12,585

*See accompanying notes to condensed consolidated financial statements.*

-6-

## **PHOTRONICS, INC. AND SUBSIDIARIES**

Notes to Condensed Consolidated Financial Statements  
Three and Nine Months Ended July 29, 2007 and July 30, 2006  
*(in thousands, except per share amounts)*  
*(unaudited)*

### **NOTE 1 - BASIS OF FINANCIAL STATEMENT PRESENTATION**

Photronics, Inc. and its subsidiaries (the "Company" or "Photronics") is one of the world's leading manufacturers of photomasks, which are high precision photographic quartz plates containing microscopic images of electronic circuits. Photomasks are a key element in the manufacture of semiconductors and flat panel displays (FPD), and are used as masters to transfer circuit patterns onto semiconductor wafers and flat panel substrates during the fabrication of integrated circuits (IC) and a variety of FPD and, to a lesser extent, other types of electrical and optical components. The Company currently operates principally from ten manufacturing facilities, two of which are located in the United States, three in Europe, two in Taiwan, and one each in Korea, Singapore and China, which began production in the second quarter of the Company's fiscal 2007 year. The Company is also constructing an independent state-of-the-art nanofab facility (the "New NanoFab") in Boise, Idaho, under a build-to-suit lease agreement with Micron Technology, Inc. which is expected to be completed by the end of calendar year 2007.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with 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 accounting principles generally accepted in the United States of America for annual financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the interim period are not necessarily indicative of the results that may be expected for the fiscal year ending October 28, 2007. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended October 29, 2006.

### **NOTE 2 - COMPREHENSIVE INCOME**

The following table summarizes comprehensive income for the three and nine months ended July 29, 2007 and July 30, 2006:

<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
<b>July 29, 2007</b>	<b>July 30, 2006</b>	<b>July 29, 2007</b>	<b>July 30, 2006</b>



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Net income	\$2,238	\$4,555	\$24,161	\$19,513
Other comprehensive income:				
Change in unrealized net gains on investments, net of tax	13	522	(108)	(762)
Change in fair value of cash flow hedges	(330)	28	(1,703)	84
Foreign currency translation adjustments	4,281	(1,237)	10,840	19,437
	<u>3,964</u>	<u>(687)</u>	<u>9,029</u>	<u>18,759</u>
Total comprehensive income	<u>\$6,202</u>	<u>\$3,868</u>	<u>\$33,190</u>	<u>\$38,272</u>

-7-

**NOTE 3 - EARNINGS PER SHARE**

The calculation of basic and diluted earnings per share is presented below:

	<u>Three Months Ended</u>		<u>Nine Months Ended</u>	
	<u>July 29, 2007</u>	<u>July 30, 2006</u>	<u>July 29, 2007</u>	<u>July 30, 2006</u>
Net income	\$2,238	\$4,555	\$24,161	\$19,513
Effect of dilutive securities:				
Interest expense on convertible notes, net of related tax effect	-	-	3,301	3,301
Earnings for diluted earnings per share	<u>\$2,238</u>	<u>\$4,555</u>	<u>\$27,462</u>	<u>\$22,814</u>
Weighted average common shares computations:				
Weighted average common shares used for basic earnings per share	41,558	41,383	41,515	41,344
Effect of dilutive securities:				
Convertible notes	-	-	9,441	9,441
Employee stock options	306	352	399	251
Dilutive potential common shares	<u>306</u>	<u>352</u>	<u>9,840</u>	<u>9,692</u>

Weighted average common shares used for diluted earnings per share	41,864	41,735	51,355	51,036
Basic earnings per share	\$0.05	\$0.11	\$0.58	\$0.47
Diluted earnings per share	\$0.05	\$0.11	\$0.53	\$0.45

The effect of the potential conversion of some of the Company's convertible subordinated notes and the exercise of certain stock options has been antidilutive. The following table shows the amount of incremental shares outstanding that would have been added if the assumed conversion of convertible subordinated notes and stock options had been dilutive.

	Three Months Ended		Nine Months Ended	
	July 29, 2007	July 30, 2006	July 29, 2007	July 30, 2006
Convertible notes	9,441	11,795	405	2,354
Employee stock options	2,034	1,472	1,870	1,166
Total potentially dilutive shares excluded	11,475	13,267	2,275	3,520

#### NOTE 4 - INVESTMENTS

Short-term investments at July 29, 2007 and October 29, 2006 consist of available-for-sale fixed income and marketable equity securities. Long-term investments of \$392 at July 29, 2007 and \$706 at October 29, 2006 included in "Other Assets" primarily consist of available-for-sale equity securities, where fair values were determined based upon quoted market prices.

-8-

Available-for-sale investments at July 29, 2007 were as follows:

	Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Short-term debt investments:				
Auction rate securities	\$12,000	\$ -	\$ -	\$12,000
Foreign bond funds and other	12,915	267	-	13,182
Total short-term investments	24,915	267	-	25,182

Long-term equity investments	30	362	-	392
	<u>\$24,945</u>	<u>\$629</u>	<u>\$ -</u>	<u>\$25,574</u>

Available-for-sale investments at October 29, 2006 were as follows:

	<u>Cost Basis</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Fair Value</u>
Short-term debt investments:				
Auction rate securities	\$50,400	\$ -	\$ -	\$50,400
Foreign bond funds and other	19,479	125	(105)	19,499
Total short-term investments	<u>69,879</u>	<u>125</u>	<u>(105)</u>	<u>69,899</u>
Long-term equity investments	51	655	-	706
	<u>\$69,930</u>	<u>\$780</u>	<u>\$(105)</u>	<u>\$70,605</u>

In determining whether investment holdings are other than temporarily impaired, the Company considers the nature, cause, severity and duration of the impairment. The Company and its investment advisors used analyst reports, credit ratings or other items as part of its review. No investments were considered to be other than temporarily impaired as of July 29, 2007.

The maturities of available-for-sale short-term debt investments at July 29, 2007 were as follows:

	<u>Cost Basis</u>	<u>Estimated Fair Value</u>
Due in one year or less	\$12,915	\$13,182
Due after ten years	12,000	12,000
	<u>\$24,915</u>	<u>\$25,182</u>

In the nine month periods ended July 29, 2007 and July 30, 2006, the Company sold \$48.3 million and \$77.0 million, respectively, of short-term debt investments.

Gross realized gains and losses related to the Company's investments are as follows:

	<b>Nine Months Ended</b>	
	<b>July 29, 2007</b>	<b>July 30, 2006</b>
Gross realized gains	\$435	\$2,165
Gross realized losses	(87)	(148)
Net realized gains	<u>\$348</u>	<u>\$2,017</u>

#### **NOTE 5 - STOCK-BASED COMPENSATION PLANS**

In March 2007, shareholders of the Company approved a new stock-based compensation plan (the "Plan"), under which options, restricted stock, restricted stock units, stock appreciation rights, performance stock, performance units, and other awards based on, or related to shares of the Company's common stock may be granted from shares authorized but unissued, shares previously issued and reacquired by the Company or both. A maximum of three million shares of Common Stock may be issued under the Plan. Awards may be granted to Company officers, employees and directors, non-employee directors, consultants, advisors and independent contractors of the Company or a subsidiary of the Company. The Plan prohibits further awards from being issued under prior plans. The Plan is more fully described below. The Company incurred compensation cost under the plans for the three and nine months ended July 29, 2007 of \$0.8 million and \$2.3 million, respectively, as compared to \$0.6 million and \$1.3 million, respectively, for the comparable prior year periods. No compensation cost was capitalized as part of inventory, and no income tax benefit was recorded in those years. No equity awards were settled in cash during the periods presented.

#### **Stock Options**

Option awards generally vest in one to four years, and have a ten year contractual term. All incentive and non-qualified stock option grants must have an exercise price no less than the market value of the underlying common stock on the date of grant. The option and share awards provide for accelerated vesting if there is a change in control as defined in the Plan.

The fair value of option grants is determined with the closing price on the day of grant using the Black Scholes option pricing model. Expected volatility is based on the historical volatility of the Company's stock. The Company uses historical option exercise behavior and employee termination data to estimate option life, which represents the period of time that the options granted are expected to remain outstanding. The risk-free rate of return for the estimated life of the option is based on the U.S. treasury yield curve in effect at the time of grant. The weighted average assumptions used for the nine months ended July 29, 2007 and July 30, 2006 are as follows:

#### **Nine Months Ended**

	<b>July 29, 2007</b>	<b>July 30, 2006</b>
Volatility	52.8%	55.1%
Risk-free rate of return	4.5%	4.8%
Dividend yield	0.0%	0.0%
Weighted average life	4.6 years	4.5 years

-10-

A summary of option activity under the Plan as of July 29, 2007 follows:

<b>Options</b>	<b>Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Life</b>	<b>Aggregate Intrinsic Value</b>
Outstanding at July 29, 2007	2,403,997	\$18.70	6.6 years	\$222
Exercisable at July 29, 2007	1,807,837	\$19.33	5.9 years	\$213

During the nine months ending July 29, 2007, 52,750 shares were granted with a weighted-average grant-date fair value of \$7.31 per share. For the comparable period last year 682,700 shares were granted with a weighted-average grant-date fair value of \$8.52 per share. As of July 29, 2007, the total compensation cost for non-vested awards not yet recognized was approximately \$4.3 million. That cost is expected to be recognized over a weighted average amortization period of 1.8 years.

### Restricted Stock

The Company also grants restricted stock awards annually. The restrictions on these awards lapse over a service period that has ranged from less than one to eight years. During the nine months ending July 29, 2007, 36,500 shares were granted with a weighted-average grant-date fair value of \$14.11 per share. For the comparable period last year 285,000 shares were granted with a weighted-average grant-date fair value of \$16.59 per share. As of July 29, 2007, the total compensation cost for non-vested awards not yet recognized was approximately \$3.5 million. That cost is expected to be recognized over a weighted average amortization period of 3.3 years. A summary of the status of the Company's nonvested restricted shares as of July 29, 2007 follows:

<b>Weighted Average Remaining Contractual</b>	<b>Aggregate Intrinsic</b>
---	--------------------------------

<b>Restricted Stock</b>	<b>Shares</b>	<b>Life</b>	<b>Value</b>
Outstanding at July 29, 2007	243,751	7.3 years	\$3,447

**NOTE 6 - LEASE LIABILITIES RELATED TO RESTRUCTURING**

Since 2001, the Company has closed manufacturing facilities in North America and in Europe due in part to the migration of semiconductor manufacturing to Asia, excess capacity, competitive pricing pressures and weakened demand. Decisions regarding which facilities to close were based on sales volume projections, customer base and production qualifications. The Company continues to assess its global manufacturing strategy based on changes in market conditions. This ongoing assessment could result, in the future, in facilities closures, asset redeployment, workforce reductions, or the addition of increased manufacturing facilities, all of which would be predicated by market conditions and customer requirements.

In fiscal 2006, the Company recorded total restructuring charges of \$15.6 million primarily related to ceasing operations at its manufacturing and research and development facility in Austin, Texas. During the first quarter of 2007, the Company sold this facility for proceeds of \$5.0 million and realized a gain of \$2.3 million.

The following tables set forth the Company's restructuring reserves as of July 29, 2007 and July 30, 2006, respectively, and reflect the activity affecting the reserves for the three and nine months then ended. As of July 29, 2007, the remaining liability of \$1.8 million primarily represents non-cancelable lease obligations that are due under respective lease terms through 2009.

-11-

**Three Months Ended  
July 29, 2007**

	<b>April 29, 2007</b>	<b>Charges</b>	<b>Utilized</b>	<b>July 29, 2007</b>
Leases and other	\$2,019	\$ -	\$(196)	\$1,823

**Nine Months Ended  
July 29, 2007**

	<b>October 29, 2006</b>	<b>Charges</b>	<b>Utilized</b>	<b>July 29, 2007</b>
Leases and other	\$2,654	\$ -	\$(831)	\$1,823

The following tables set forth the Company's restructuring reserve as of July 30, 2006 and reflects the activity affecting the reserve for the three and nine months then ended:

	<b>Three Months Ended</b>			<b>July 30, 2006</b>
	<b>April 30, 2006</b>	<b>Charges</b>	<b>Utilized</b>	
Manufacturing capacity reduction and other	\$ 302	\$1,966	\$(1,967)	\$ 301
Workforce reductions	1,080	(176)	(604)	300
Leases and other	2,631	-	(246)	2,385
<b>Total</b>	<b>\$4,013</b>	<b>\$1,790</b>	<b>\$(2,817)</b>	<b>\$2,986</b>

	<b>Nine Months Ended</b>			<b>July 30, 2006</b>
	<b>October 30, 2005</b>	<b>Charges</b>	<b>Utilized</b>	
Manufacturing capacity reduction and other	\$ -	\$10,681	\$(10,681)	\$ -
Workforce reductions	-	1,080	(780)	300
Leases and other	2,245	1,455	(1,014)	2,686
<b>Total</b>	<b>\$2,245</b>	<b>\$13,216</b>	<b>\$(12,475)</b>	<b>\$2,986</b>

#### **NOTE 7 - GEOGRAPHIC INFORMATION**

The Company operates in a single industry segment as a manufacturer of photomasks, which are high precision quartz plates containing microscopic images of electronic circuits for use in the fabrication of semiconductors. The Company's net sales, operating income (loss) and identifiable assets by geographic area as of and for the three and

nine months ended July 29, 2007 and July 30, 2006 were as follows:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>July 29, 2007</b>	<b>July 30, 2006</b>	<b>July 29, 2007</b>	<b>July 30, 2006</b>
<b>Net sales</b>				
Asia	\$ 60,469	\$ 59,187	\$183,074	\$185,748
Europe	16,849	20,017	55,338	59,829
North America	26,983	28,956	81,496	94,002
	<b>\$104,301</b>	<b>\$108,160</b>	<b>\$319,908</b>	<b>\$339,579</b>
<b>Operating income (loss)</b>				
Asia	\$3,524	\$8,797	\$12,849	\$36,644
Europe	(148)	3,781	4,394	12,897
North America	832	(1,424)	4,383	(6,760)
Gain on sale of facility	-	-	2,254	-
Consolidation, restructuring and related charges	-	(1,790)	-	(13,216)
Stock-based compensation	(782)	(515)	(2,269)	(1,310)
	<b>\$3,426</b>	<b>\$8,849</b>	<b>\$21,611</b>	<b>\$28,255</b>
		<b>July 29, 2007</b>	<b>July 30, 2006</b>	
<b>Total identifiable assets</b>				
Asia		\$479,231	\$ 449,910	
Europe		111,776	112,400	
North America		396,335	456,425	
		<b>\$987,342</b>	<b>\$1,018,735</b>	

The Company is typically impacted during its first fiscal quarter by the North America and European holiday periods as some customers reduce their effective workdays and orders during this period.

#### NOTE 8 - INCOME TAXES

The income tax provision differs from the amount computed by applying the United States statutory rate of 35 percent to income before income taxes primarily due to the resolution and settlement of U.S. and foreign tax matters that were associated with uncertain tax positions in prior years. The income tax provision for the nine month period ended July 29, 2007 reflects a benefit for the resolution in the amount of \$7.4 million. In addition, the Company has



benefited from reduced tax rates in Korea and Taiwan, which have been offset by valuation allowances placed on deferred tax assets, primarily those generated by net operating loss carry forwards.

-13-

## NOTE 9 - LONG -TERM BORROWINGS

Long-term borrowings consist of the following:

	<u>July 29, 2007</u>	<u>October 29, 2006</u>
2.25% convertible subordinated notes due April 15, 2008	\$150,000	\$150,000
Unsecured foreign notes payable, bearing interest at a variable rate, as defined, due October 11, 2010	24,608	20,288
4.75% convertible subordinated notes, including fair value adjustment of \$(184) in 2006	-	86,903
	<u>174,608</u>	<u>257,191</u>
Less current portion	25,000	86,903
	<u>\$149,608</u>	<u>\$170,288</u>

On June 6, 2007, the Company entered into a credit agreement with a group of financial institutions that provides for a five-year, revolving credit facility (the "credit facility") with an aggregate commitment of \$125 million. In connection therewith, the Company has classified \$125 million of its \$150 million, 2.25% convertible subordinated notes due in April 2008 as long-term. On September 4, 2007, the aggregate commitment was increased to \$155 million. The applicable interest rate spread and facility fee vary based upon the Company's senior leverage ratio. Under the terms of the credit facility, the Company is subject to compliance with certain financial and other covenants. The credit facility is secured by a pledge of the Company's stock in certain of its subsidiaries. Borrowings under the credit facility bear interest at a LIBOR rate, as defined, plus 87 basis points. There were no borrowings under the credit facility as of July 29, 2007.

The 4.75% convertible subordinated notes were repaid at maturity on December 15, 2006. A related interest rate swap also matured on December 15, 2006 concurrent with the repayment of the related debt.

## NOTE 10 - COMMITMENTS AND CONTINGENCIES

At July 29, 2007, the Company had commitments outstanding of approximately \$205 million, primarily related to capital equipment for the planned U.S. nanofab facility and equipment in Korea, and for a build-to-suit capital lease through 2012 for the planned U.S. nanofab facility.

The Company is subject to various claims that arise in the ordinary course of business. The Company believes such claims, individually or in the aggregate, will not have a material adverse effect on the business of the Company.

#### **NOTE 11 - RECENT ACCOUNTING PRONOUNCEMENTS**

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities-Including an Amendment of FASB Statement No. 115." SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value, and is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The Company is currently evaluating the impact that the adoption of SFAS No. 159 will have on its consolidated financial statements.

In October 2006, the FASB issued SFAS No. 158, "Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)." SFAS No. 158 requires companies to recognize in its statement of financial condition the funded status of its defined benefit postretirement plans, measured as the difference between the fair value of the plan assets and the benefit obligation. SFAS No. 158 also requires an entity to recognize changes in the funded status of its defined benefit postretirement plan directly to

-14-

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accumulated other comprehensive income, net of tax, to the extent such changes are not recognized in earnings as components of periodic net benefit cost. SFAS No. 158 is effective for companies with fiscal years ending after December 15, 2006. The Company is currently evaluating SFAS No. 158, however it does not believe the impact of its adoption will be material to its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the impact, if any, that SFAS No. 157 may have on its consolidated financial statements.

In September 2006, the United States Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" (SAB No. 108). The Company early adopted SAB No. 108 during its quarter ended January 28, 2007, and its adoption did not have a material impact on its consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation Number 48 (FIN 48), "Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109." The interpretation contains a two step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. The provisions are effective as of the beginning of the Company's 2008 fiscal year. The Company is evaluating the impact, if any, this statement may have on its consolidated financial statements.

#### **Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION**

##### **Overview**

Management's discussion and analysis of the Company's financial condition, business results and outlook should be read in conjunction with its condensed consolidated financial statements and related notes. Various segments of this MD&A do contain forward-looking statements, all of which are presented based on current expectations and may be adversely affected by uncertainties and risk factors presented throughout this filing and the Company's Annual Report on Form 10-K for the fiscal 2006 year, leading actual results to materially differ from these expectations.

The Company sells substantially all of its photomasks to semiconductor designers and manufacturers, and manufacturers of flat panel displays (FPDs). Photomask technology is also being applied to the fabrication of other higher performance electronic products such as photonics, micro-electronic mechanical systems and certain nanotechnology applications. The Company's selling cycle is tightly interwoven with the development and release of new semiconductor designs and flat panel applications, particularly as it relates to the semiconductor industry's migration to more advanced design methodologies and fabrication processes. The Company believes that the demand for photomasks primarily depends on design activity rather than sales volumes from products produced using photomask technologies. Consequently, an increase in semiconductor or FPD sales does not necessarily result in a corresponding increase in photomask sales. In addition, the reduced use of customized integrated circuits (ICs), a reduction in design complexity or other changes in the technology or methods of manufacturing semiconductors or a slowdown in the introduction of new semiconductor or FPD designs could reduce demand for photomasks even if demand for semiconductors and FPDs increases. Advances in semiconductor and photomask design and semiconductor production methods could reduce the demand for photomasks. Historically, the semiconductor industry has been volatile, with sharp periodic downturns and slowdowns. These downturns have been characterized by, among other things, diminished product demand, excess production capacity and accelerated erosion of selling prices.

-15-

### Material Changes in Results of Operations Three and Nine Months ended July 29, 2007 versus July 30, 2006

The following table represents selected operating information expressed as a percentage of net sales:

	Three Months Ended		Nine Months Ended	
	July 29, 2007	July 30, 2006	July 29, 2007	July 30, 2006
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	(77.3)	(69.6)	(75.1)	(67.3)
Gross margin	22.7	30.4	24.9	32.7
Selling, general and administrative expenses	(15.3)	(14.4)	(14.7)	(13.7)
Research and development expenses	(4.1)	(6.2)	(4.1)	(6.8)
Consolidation, restructuring and related charges	-	(1.6)	-	(3.9)
Gain on sale of facility	-	-	0.7	-
Operating income	3.3	8.2	6.8	8.3
Other income (expense), net	0.8	(1.2)	0.3	1.3

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Income before income taxes and minority interest	4.1	7.0	7.1	9.6
Income tax benefit (provision)	(1.1)	(1.6)	1.2	(2.7)
Minority interest	(0.9)	(1.2)	(0.7)	(1.1)
Net income	2.1%	4.2%	7.6%	5.8%

All of the following tabular comparisons, unless otherwise indicated, are for the three months ended July 29, 2007 (Q3-07) and July 30, 2006 (Q3-06) and for the nine months ended July 29, 2007 (YTD-07) and July 30, 2006 (YTD-06) in millions of dollars:

**Net Sales**

	Three Months Ended			Nine Months Ended		
	Q3-07	Q3-06	Percent Change	YTD-07	YTD-06	Percent Change
IC	\$ 85.3	\$ 87.2	(2.1)%	\$259.2	\$264.6	(1.9)%
FPD	19.0	21.0	(9.7)	60.7	75.0	(19.4)
Total net sales	\$104.3	\$108.2	(3.6)%	\$319.9	\$339.6	(5.8)%

Net sales for Q3-07 decreased 3.6% to \$104.3 million as compared to \$108.2 million for Q3-06. The decrease is related to reduced sales of FPD photomasks of \$2.0 million associated with decreased average selling prices (ASPs) for high-end FPD photomasks; and reduced sales of IC photomasks of \$1.9 million as a result of a slight decline in ASPs, principally from mainstream products. High-end photomask applications, which typically have higher ASPs, include mask sets for FPD products using G6 and above technologies and IC products using 90 nanometer and below technologies. By geographic area, net sales in Q3-07 as compared to Q3-06 increased by \$1.3 million or 2.1% in Asia, and decreased by \$(2.0) million or (6.8)% in North America, and \$(3.2) million or (15.8)% in Europe. As a percent of total sales in Q3-07, sales were 58% in Asia, 26% in North America, and 16% in Europe.

-16-

For YTD-07, net sales decreased (5.8)% or \$(19.7) million of which \$(14.3) million of the decrease related to reduced sales of FPD photomasks and \$(5.4) million of reduced sales of IC photomasks, both of which were a result of decreased ASPs. The Company's quarterly revenues can be affected by the seasonal purchasing of its customers. The Company is typically impacted during its first quarter by the North American and European holiday periods as some customers reduce their effective workdays and orders during this period. Q1-07 had more than the usual customer shutdowns which resulted in reduced net sales.

**Gross Margin**

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	Three Months Ended			Nine Months Ended		
	Q3-07	Q3-06	Percent Change	YTD-07	YTD-06	Percent Change
Gross margin	\$23.7	\$32.9	(28.0)%	\$79.6	\$110.9	(28.0)%
Percentage of net sales	22.7%	30.4%		24.9%	32.7%	

Gross margin decreased to 22.7% in Q3-07 from 30.4% in Q2-06 as a result of decreased sales and the expanded manufacturing base in Asia including two greenfield facilities in Taiwan and China, and from reduced high-end sales and reduced ASPs. Gross margin decreased to 24.9% in YTD-07 from 32.7% in YTD-06 primarily due to decreased FPD ASPs and the Company's increased manufacturing base in Asia. The Company operates in a high fixed cost environment and to the extent that the Company's revenues and utilization increase or decrease, gross margin will generally be positively or negatively impacted. The gross margin percentage throughout the remainder of fiscal 2007 could be negatively impacted by increased depreciation expense associated with the Company's capital expenditures as the Company increases its fixed cost manufacturing base, principally in Asia.

*Selling, General and Administrative*

	Three Months Ended			Nine Months Ended		
	Q3-07	Q3-06	Percent Change	YTD-07	YTD-06	Percent Change
Selling, general and administrative expenses	\$16.0	\$15.5	3.3%	\$46.9	\$46.4	1.0%
Percentage of net sales	15.3%	14.4%		14.7%	13.7%	

Selling, general and administrative expenses increased \$0.5 million to \$16.0 million in Q3-07, compared with \$15.5 million in Q3-06. The increase was primarily a result of increased costs associated with starting up the Company's NanoFab in Boise, Idaho. Selling, general, and administrative expenses were \$46.9 million in YTD-07 and \$46.4 million in YTD-06. The Company's two new facilities in Taiwan and China became operational by Q2-07, and therefore certain costs related thereto are reported as cost of sales whereas prior to them becoming operational for production such costs were reported as selling, general and administrative expenses.

*Research and Development*

	Three Months Ended			Nine Months Ended		
	Q3-07	Q3-06	Percent Change	YTD-07	YTD-06	Percent Change
Research and development	\$4.2	\$6.7	(37.1)%	\$13.3	\$23.0	(42.2)%
Percentage of net sales	4.1%	6.2%		4.1%	6.8%	

Research and development expenses consist primarily of global development efforts relating to high-end process technologies for advanced sub wavelength reticle solutions for IC and FPD technologies. Research and development expenses decreased by \$2.5 million and \$9.7 million in Q3-07 and YTD-07, respectively, as compared to the same periods in the prior year, primarily as a result of reduced expenditures resulting from the 2006 closure of the Company's Austin, Texas research and development operations. Such reduced expenditures were partially offset by amortization expenses of the fair value of the agreement to license technology from Micron Technology, Inc.

### ***Gain on Sale of Facility***

In January of 2007, the Company sold its Austin, Texas manufacturing and research and development facility for proceeds of \$5.0 million and realized a gain of \$2.3 million.

### ***Consolidation, Restructuring and Related Charges***

In March 2006, the Company implemented a restructuring program to streamline its operating infrastructure in North America, including the closing of its Austin, Texas manufacturing facility and ceasing its Austin, Texas research and development activities. In connection therewith, the Company recorded restructure charges of \$1.8 million in Q3-06 and \$13.2 million in YTD-06, primarily comprised of facility and equipment impairments at the Austin facility.

### ***Other Income (Expense), Net***

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>Q3-07</b>	<b>Q3-06</b>	<b>YTD-07</b>	<b>YTD-06</b>
Interest expense	\$(1.5)	\$(3.0)	\$(4.5)	\$(9.0)
Investment and other income, net	2.4	1.7	5.5	13.3
Other income (expense), net	\$ 0.9	\$(1.3)	\$ 1.0	\$ 4.3

Interest expense in Q3-07 and YTD-07 decreased as compared to the same periods in the prior year, primarily as a result of the Company's redeeming the remaining outstanding balance of its \$87.1 million, 4.75% convertible subordinated notes in December, 2006. Investment and other income, net, for Q3-07 as compared to Q3-06, increased primarily as a result of increased foreign currency gains which more than offset decreased investment income associated with reduced investment balances. Investment and other income net, for YTD-07, decreased as compared to YTD-06, primarily due to reduced foreign currency gains and reduced investment income associated with reduced investment balances. Further, realized gains on the sales of investments and other assets were \$1.1 million YTD-07 as compared to \$3.0 million in YTD-06.

### ***Provision for Income Taxes***

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>Q3-07</b>	<b>Q3-06</b>	<b>YTD-07</b>	<b>YTD-06</b>
Income tax (provision) benefit	\$(1.1)	\$(1.7)	\$4.0	\$(9.3)
Effective income tax rate	(26.2)%	(22.3)%	17.5%	(28.6)%

The provision for income taxes for Q3-07 was \$1.1 million, compared to \$1.7 million for Q3-06. For YTD-07 the provision for income taxes was a benefit of \$4.0 million, compared to a provision of \$9.3 million for YTD-06. The effective rate for YTD-07 was a 17.5% benefit as compared to a 28.6% provision for YTD-06, primarily due to the benefit that was recorded for the resolution and settlement of U.S. and foreign tax matters that were associated with uncertain tax positions in prior years. In addition, the tax rate was impacted by taxes incurred on income generated in taxable jurisdictions that were partially offset by increased income generated in the U.S. where the Company did not record additional deferred tax benefits due to net operating loss carryforwards. The income tax benefit for the nine month period ended July 29, 2007 primarily resulted from benefits associated with the tax settlements.

-18-

The Company's operations have followed the migration of semiconductor industry fabrication to Asia, where the Company operates in countries where it is accorded favorable tax rates. The Company is accorded tax holidays in Taiwan, one of which expired in December 2006, and another which is expected to begin to expire in 2012. In addition, the Company has been accorded a tax holiday in China which is expected to expire in 2011. In Korea and Taiwan various tax credits have been utilized to reduce the Company's effective income tax rate.

#### ***Minority Interest in Consolidated Subsidiaries***

Minority interest expense decreased to \$0.9 million in Q3-07 as compared to \$1.3 million in Q3-06, and to \$2.4 million in YTD-07, as compared to \$3.7 million in YTD-06, primarily due to decreased net income of the Company's non-wholly owned subsidiary in Taiwan. The Company's ownership in its subsidiaries in Taiwan and Korea was approximately 58% and 99.7%, respectively, at July 29, 2007 and July 30, 2006.

#### **Liquidity and Capital Resources**

The Company's working capital was \$124.1 million at July 29, 2007 and \$127.7 million at October 29, 2006. At July 29, 2007, \$125 million of the Company's outstanding \$150 million, 2.25% convertible subordinated notes due in April of 2008, was reported as long-term in connection with \$125 million of credit available to the Company under a five-year, revolving credit facility agreement entered into on June 6, 2007 with a group of financial institutions. On September 4, 2007, the aggregate commitment was increased to \$150 million. Cash, cash equivalents and short-term investments decreased to \$145.2 million at July 29, 2007 as compared to \$199.3 million at October 29, 2006, primarily due to the redemption of \$87.1 million of the remaining outstanding balance of the Company's 4.75% convertible subordinated notes. Cash provided by operating activities increased to \$94.1 million for the nine months ended July 29, 2007, as compared to \$79.9 million for the nine months ended July 30, 2006, primarily due to increased net income compared to the same prior year period, and decreased accounts receivable associated with decreased sales compared to the same period in the prior year, and increased trade accounts payable, which were in part offset by decreases in accrued liabilities. Cash used in investing activities for the nine months ended July 29, 2007

was \$9.4 million, which is primarily comprised of \$48.3 million proceeds from the sales of investments less payments for capital expenditures of \$57.0 million. Cash used in financing activities of \$92.1 million primarily related to the Company redeeming its \$87.1 million outstanding 4.75% convertible subordinated notes.

The Company's commitments represent investments in the tooling of the new US Nano Fab facility in Boise, Idaho, additional manufacturing capacity, as well as advanced equipment for the production of high-end, more complex photomasks in Asia, principally Korea. At July 29, 2007, the Company had commitments outstanding of approximately \$205 million, primarily related to equipment for the planned U.S. nanofab facility and equipment in Korea, and for a build-to-suit capital lease through 2012 for the planned U.S. nanofab facility. The Company expects capital expenditures for fiscal 2007 to be approximately \$160 million to \$175 million. The Company will use its working capital and its credit facility to finance its capital expenditures. Photronics believes that its currently available resources, together with its capacity for growth, and its access to other debt and equity financing sources, are sufficient to satisfy its currently planned capital expenditures, as well as its anticipated working capital requirements for the foreseeable future. However, the Company cannot assure that additional sources of financing would be available to the Company on commercially favorable terms should the Company's capital requirements exceed cash available from operations and existing cash, short-term investments and its credit facility.

### **Stock-Based Compensation**

Total stock-based compensation expense for the three and nine months ended July 29, 2007 was \$0.8 million and \$2.3 million, respectively, as compared to \$0.6 million and \$1.3 million, respectively, for the comparable prior year periods, substantially all of which is in selling, general and administrative expenses. No compensation cost was capitalized as part of inventory, and no income tax benefit has been recorded. As of July 29, 2007 total unrecognized compensation cost of \$7.8 million is expected to be recognized over a weighted average amortization period of 2.4 years.

### **Business Outlook**

A majority of the Company's revenue growth has come from, and is expected to continue to come from, the Asian region as customers increase their use of manufacturing foundries located outside of North America and Europe. Additional revenue growth is also anticipated from North America and Europe as a result of utilizing technology licensed

-19-

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under the Company's technology license with Micron Technology, Inc. The Company's Korean and Taiwanese operations are non-wholly owned subsidiaries; therefore a portion of earnings generated at each location is allocated to the minority shareholders.

The Company continues to assess its global manufacturing strategy based on changes in market conditions. In addition to the restructuring plan implemented in the second quarter of 2006 relating to closing the Austin facility, this ongoing assessment could result in the future, in facilities closures, asset redeployment, workforce reductions, or the addition of increased manufacturing facilities, all of which would be based on market conditions and customer requirements.

The Company's future results of operations and the other forward-looking statements contained in this filing involve a number of risks and uncertainties. Various factors that have been discussed and a number of other factors could cause actual results to differ materially from the Company's expectations.



## **Application of Critical Accounting Procedures**

The Company's consolidated financial statements are based on the selection and application of significant accounting policies, which require management to make significant estimates and assumptions. The Company believes that the following are some of the more critical judgment areas in the application of the Company's accounting policies that affect its financial condition and results of operations.

### *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 amounts reported in them. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. The Company's estimates are based on the facts and circumstances available at the time; different reasonable estimates could have been used in the current period, and changes in the accounting estimates used are likely to occur from period to period, which may have a material impact on the presentation of the Company's financial condition and results of operations. Actual results reported by the Company may differ from such estimates. The Company reviews these estimates periodically and reflects the effect of revisions in the period that they are determined.

### *Derivative Instruments and Hedging Activities*

The Company records derivatives in the consolidated balance sheet as assets or liabilities, measured at fair value. Gains or losses resulting from changes in the values of those derivatives are reported in the consolidated statements of income or as accumulated other comprehensive income (loss), a separate component of shareholders' equity, depending on the use of the derivatives and whether they qualify for hedge accounting. In order to qualify for hedge accounting, the derivative must be highly effective in achieving offsetting changes in fair value or cash flows of the hedged items during the term of the hedge. The Company uses judgment in assessing the fair value of derivatives and related financial instruments, including assumptions utilized in derivative fair value models in areas such as projected interest rates and changes in the Company's stock price during the contract term.

### *Property, Plant and Equipment*

Property, plant and equipment are stated at cost less accumulated depreciation and amortization. Repairs and maintenance, as well as renewals and replacements of a routine nature are charged to operations as incurred, while those which improve or extend the lives of existing assets are capitalized. Upon sale or other disposition, the cost of the asset and accumulated depreciation are removed from the accounts, and any resulting gain or loss is reflected in operations.

Depreciation and amortization are computed on the straight-line method over the estimated useful lives of the related assets. Buildings and improvements are depreciated over 15 to 40 years, machinery and equipment over 3 to 10 years and furniture, fixtures and office equipment over 3 to 5 years. Leasehold improvements are amortized over the life of the lease or the estimated useful life of the improvement, whichever is less. Judgment and assumptions are used in establishing estimated useful lives and depreciation periods. The Company also uses judgment and assumptions as it periodically reviews property, plant and equipment for any potential impairment in carrying values whenever events such as a significant industry downturn, plant closures, technological obsolescence or other changes in circumstances indicate that their carrying amount may not be recoverable. Actual fair values may differ from estimated fair values.

### *Intangible Assets*

Intangible assets consist primarily of goodwill and other acquisition-related intangibles, and a technology license agreement and a supply agreement. These assets are stated at fair value as of the date acquired less accumulated amortization. Amortization is calculated on a straight-line basis or another method that more fairly represents the utilization of the assets. The future economic benefit of the carrying value of intangible assets is reviewed annually and the Company uses judgment whenever events or changes in circumstances indicate the carrying value of an intangible asset may not be recoverable based on discounted cash flows or market factors and an impairment loss would be recorded in the period so determined.

### *Impairment of Long-Lived Assets*

Long-lived assets and certain identifiable assets to be held and used are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Determination of recoverability is based on the Company's judgment and estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. Measurement of an impairment loss for long-lived assets and certain identifiable intangible assets that management expects to hold and use is based on the fair value of the asset. Long-lived assets and certain identifiable intangible assets to be disposed of are reported at the lower of carrying amount or fair value less costs to sell.

### *Investment in Joint Venture*

Investments in joint ventures over which the Company has the ability to exercise significant influence and that, in general, are at least 20 percent owned are stated at cost plus equity in undistributed net income (loss) of the joint venture. These investments are evaluated for impairment in accordance with the requirements of Accounting Principles Board (APB) Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock." An impairment loss would be recorded whenever a decline in value of an equity investment below its carrying amount is determined to be other than temporary. In judging "other than temporary," the Company would consider the length of time and extent to which the fair value of the investment has been less than the carrying amount of the equity company, the near-term and longer-term operating and financial prospects of the equity company, and its longer-term intent of retaining the investment in the equity company.

### *Income Taxes*

The income tax provision is computed on the basis of consolidated financial statement income or loss before income taxes. Deferred income taxes reflect the tax effects of differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. In the event the Company determines that future taxable income is not expected to be sufficient, the Company uses judgment and assumptions to determine if valuation allowances for deferred income tax assets are required by considering future market growth, forecasted operations, future taxable income, and the mix of earnings in the tax jurisdictions in which it operates in order to determine the need for a valuation allowance.

The Company considers income taxes in each of the tax jurisdictions in which it operates in order to determine its effective income tax rate. Current income tax exposure is identified along with assessing temporary differences resulting from differing treatment of items for tax and financial reporting purposes. These differences result in deferred tax assets and liabilities, which are included in the Company's consolidated balance sheets. The actual annual amount of taxable income in each tax jurisdiction may differ from the estimates used to compute the effective income tax rate during the first, second and third quarters. Additionally, the Company evaluates the recoverability of deferred income tax assets from future taxable income and establishes valuation allowances if recovery is deemed not likely. Accordingly, the income tax provision in the consolidated statements of income is impacted by changes in the valuation allowance. Significant management estimates and judgment are required in determining any valuation

allowance recorded against net deferred tax assets.

-21-

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### *Revenue Recognition*

The Company recognizes revenue when both title and risk of loss transfer to the customer. The Company makes estimates and assumptions and uses judgment relating to discounts and estimates for product return and warranties which are accrued and recognized at the time of sale.

Discounts - Sales discounts are negotiated with customers prior to billing and at the time of billing, sales invoices are prepared net of negotiated sales discounts.

Product Returns - Customer returns have historically been insignificant. However, the Company does record a liability for the insignificant amount of estimated sales returns based upon historical experience.

Warranties and Other Post Shipment Obligations - For a 30-day period, the Company warrants that items sold will conform to customer specification. However, the Company's liability is limited to repair or replacement of the photomasks at its sole option. The Company inspects photomasks for conformity to customer specifications prior to shipment. Accordingly, customer returns of items under warranty have historically been insignificant. However, the Company records a liability for the insignificant amount of estimated warranty returns based on historical experience. The Company's specific return policies include accepting returns for products with defects or products that have not been produced to precise customer specifications. At the time of shipment, a liability is established for these items.

Customer Acceptance - Customer acceptance occurs concurrently with the transfer of title and risk of loss based upon the applicable shipping and delivery terms.

### **Effect of New Accounting Standards**

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115." SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value, and is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The Company is currently evaluating the impact that the adoption of SFAS No. 159 will have on its consolidated financial statements.

In October 2006, the FASB issued SFAS No. 158, "Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)." SFAS No. 158 requires companies to recognize in its statement of financial condition the funded status of its defined benefit postretirement plans, measured as the difference between the fair value of the plan assets and the benefit obligation. SFAS No. 158 also requires an entity to recognize changes in the funded status of its defined benefit postretirement plan directly to accumulated other comprehensive income, net of tax, to the extent such changes are not recognized in earnings as components of periodic net benefit cost. SFAS No. 158 is effective for companies with fiscal years ending after December 15, 2006. The Company is currently evaluating SFAS No. 158, however it does not believe the impact of its adoption will be material to its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for

fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the impact, if any, that SFAS No. 157 may have on its consolidated financial statements.

In September 2006, the United States Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" (SAB No. 108). This SAB provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The Company early adopted SAB No. 108 during its quarter ended January 28, 2007, and its adoption did not have a material impact on its consolidated financial statements.

-22-

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In June 2006, the FASB issued FASB Interpretation Number 48 (FIN 48), "Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109." The interpretation contains a two step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. The provisions are effective as of the beginning of the Company's 2008 fiscal year. The Company is evaluating the impact, if any, this statement may have on its consolidated financial statements.

### **Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company records derivatives on the balance sheet as assets or liabilities, measured at fair value. The Company does not engage in derivative instruments for speculative purposes. Gains or losses resulting from changes in the values of those derivatives are reported in the statement of income, or as accumulated other comprehensive income (loss), a separate component of shareholders' equity, depending on the use of the derivatives and whether they qualify for hedge accounting. In order to qualify for hedge accounting, the derivative must be highly effective in achieving offsetting changes in fair value or cash flows of the hedged items during the term of the hedge. In general, the types of risks hedged are those relating to the variability of future cash flows caused by movements in foreign currency exchange rates. The Company documents its risk management strategy and hedge effectiveness at the inception of and during the term of each hedge.

#### **Foreign Currency Exchange Rate Risk**

The Company conducts business in several major international currencies through its worldwide operations and is subject to changes in foreign exchange rates of such currencies. Changes in exchange rates can positively or negatively affect the Company's sales, operating margins and retained earnings. The principal functional currencies of the Company's Asian subsidiaries are the Korean won, New Taiwan dollar and Singapore dollar. The principal functional currencies of the Company's European subsidiaries are the British pound and euro.

The Company attempts to minimize its risk to foreign currency transaction losses by producing its products in the same country in which the products are sold and thereby generating revenues and incurring expenses in the same currency and by managing its working capital. However, there can be no assurance that this approach will be successful, especially in the event of a significant adverse movement in the value of any foreign currencies against the U.S. dollar. In some instances, the Company may sell products in a currency other than the functional currency of the country where it was produced. The Company does not engage in purchasing forward exchange contracts for

speculative purposes.

The Company's primary net foreign currency exposures as of July 29, 2007 included the Korean won, Singapore dollar, New Taiwan dollar, euro, British pound and Chinese renminbi. As of July 29, 2007, a 10% adverse movement in the value of these currencies against the U.S. dollar would have resulted in a net unrealized pre-tax loss of \$4.3 million. The Company does not believe that a 10% change in the exchange rates of other non-U.S. dollar currencies would have a material effect on its consolidated financial position, results of operations or cash flows.

In April, 2006, the Company's Korean subsidiary entered into a foreign currency rate swap contract. Under the terms of the contract, the Company has effectively converted a \$50 million interest bearing intercompany loan denominated in U.S. dollars to Korean won. This contract was initially scheduled to expire in December 2006, however, it has been extended to December 2007. The Company elected not to designate the foreign currency rate swap contract as a hedge which results in a market-to-market adjustment in the income statement.

In September, 2006, the Company entered into forward contracts to convert the fixed yen purchase price of certain equipment into fixed U.S. dollar amounts. In accordance with SFAS No. 133, "Accounting for Derivatives and Hedging Activities," hedges related to anticipated transactions are designated and documented at the inception of the respective hedges as cash flow and are evaluated for effectiveness. The Company records these derivative instruments in either other current assets or non current assets or accrued liabilities, depending on their net position, at fair value regardless of the purpose or intent for holding the instrument. Changes in the fair value of the derivative financial instrument are recognized in earnings or in shareholders equity as a component of accumulated other comprehensive income or loss depending on whether the derivative financial instrument qualifies for hedge accounting as defined by SFAS No. 133.

-23-

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## **Interest Rate Risk**

The majority of the Company's borrowings at July 29, 2007 were in the form of its convertible subordinated note, which bears interest at a fixed rate of 2.25%, and certain unsecured international notes payable which bear interest at rates between 6.57% and 6.93%. At July 29, 2007, the Company had approximately \$105 million in net variable rate financial instrument assets which were sensitive to interest rate risk. A 10% change in interest rates would not have a material effect on the Company's consolidated financial position, results of operations or cash flows.

## **Item 4. CONTROLS AND PROCEDURES**

### **Evaluation of Disclosure Controls and Procedures**

An evaluation was carried out under the supervision and with the participation of the Company's management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Act of 1934) as of July 29, 2007, the end of the period covered by this report. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of July 29, 2007, the end of the period covered by this report, the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms.

**Changes in Internal Control over Financial Reporting**

There was no change in the Company's internal control over financial reporting during the three months ended July 29, 2007 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1A. RISKS RELATING TO THE COMPANY'S BUSINESS**

There have been no material changes to risks relating to the Company's business as disclosed in Part 1, Item 1A of the Company's Form 10-K for the year ended October 29, 2006.

**Item 5. OTHER INFORMATION**

On August 23, 2007, Photronics Imaging Technologies (Shanghai) Co., Ltd. ("PITC") entered into an Amended and Restated RMB 186 million Credit Facility with JPMorgan Chase Bank (China) Company Limited, Shanghai Branch as Administrative Agent (the "Original Lender"). Pursuant to the Amended and Restated Credit Agreement, the Original Lender will retain a portion of, and will assign to the other lenders the remaining portion of the loans and commitments under the Amended and Restated Credit Agreement. This credit facility includes a term loan and a revolving credit loan totaling RMB 186,000 million, bearing interest based on the prevailing official PBOC (People's Bank of China) rate. As of August 23, 2007, RMB 186 million was outstanding under the Amended and Restated Credit Agreement and is due in 2010. PITC is subject to compliance with and maintenance of certain financial and other covenants.

On August 23, 2007, the Company entered into an Amended and Restated Guarantee Agreement relating to the RMB 186 million credit facility for PITC. Pursuant to the terms of the Amended and Restated Guarantee Agreement, the Company guaranteed PITC's obligations under the Amended and Restated Credit Agreement.

On September 4, 2007 the aggregate commitment of the Company's credit facility was increased to \$155 million as set forth in Note 9 to the condensed consolidated financial statements.

**Item 6. EXHIBITS**

(a) Exhibits

**Exhibit  
Number Description**

10.27 Credit Agreement dated as of August 6, 2007 among Photronics, Inc., the Foreign Subsidiary Borrowers Party hereto, the Lenders Party hereto, and JPMorgan Chase Bank, National Association as Administrative Agent and Collateral Agent; Citizens

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Bank of Massachusetts; HSBC Bank USA, National Association; and Citibank, N.A. as Co-Syndication Agents. JPMorgan Securities Inc. as Sole Book runner and Sole Lead Arranger.

- 10.28 Amended and Restated Agreement RMB 186,000,000 Credit Facility for Photronics Imaging Technologies (Shanghai) Co., Ltd. with JPMorgan Chase Bank (China) Company Limited, Shanghai Branch as Administrative Agent.
- 10.29 Amended and Restated Guarantee Agreement by Photronics, Inc. relating to RMB 186,000,000 Credit Facility for Photronics Imaging Technologies (Shanghai) Co., Ltd.
- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification 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 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**SIGNATURES**

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

Photronics, Inc.  
(Registrant)

By:           /s/ SEAN T. SMITH          

Sean T. Smith  
Senior Vice President  
Chief Financial Officer  
(Duly Authorized Officer and  
Principal Financial Officer)

Date: September 5, 2007