MKS INSTRUMENTS INC
Form 10-Q
August 04, 2006

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-Q

(MARK ONE)

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

For the quarterly period ended June 30, 2006

or

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

For the transition period from _______________ to _______________

Commission file number 0-23621

MKS INSTRUMENTS, INC.
(Exact name of registrant as specified in its charter)

Massachusetts	04-2277512
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
90 Industrial Way, Wilmington, Massachusetts	01887
(Address of principal executive offices)	*(Zip Code)*
Registrant s telephone number, including area code	(978) 284-4000

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 þ No o

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. (Check one):

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

Number of shares outstanding of the issuer s common stock as of July 28, 2006: 56,213,216

Table of Contents

MKS INSTRUMENTS, INC.
FORM 10-Q
INDEX

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

MKS INSTRUMENTS, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	June 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 187,297	$ 220,573
Short-term investments	50,109	72,046
Trade accounts receivable, net	118,623	82,610
Inventories	127,379	98,242
Deferred income taxes	16,269	15,165
Other current assets	13,198	10,511
Total current assets	512,875	499,147
Property, plant and equipment, net	79,916	78,726
Long-term investments	2,366	857
Goodwill	322,676	255,243
Acquired intangible assets, net	50,917	27,422
Other assets	2,955	2,345
Total assets	$ 971,705	$ 863,740
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Short-term borrowings	$ 23,579	$ 16,966
Current portion of long-term debt		1,429
Current portion of capital lease obligations	838	491
Accounts payable	38,699	27,955
Accrued compensation	21,237	13,583
Income taxes payable	9,038	9,564
Other accrued expenses	27,131	19,099
Total current liabilities	120,522	89,087
Long-term debt	5,000	5,238
Long-term portion of capital lease obligations	1,144	914
Deferred income taxes	10,495	2,153
Other liabilities	4,388	3,505
Commitments and contingencies (Note 10)		
Stockholders equity:		
Preferred Stock, $0.01 par value, 2,000,000 shares authorized; none issued and outstanding		
	113	113

Common Stock, no par value, 200,000,000 shares authorized; 56,193,875 and 54,397,267 issued and outstanding at June 30, 2006 and December 31, 2005, respectively				
Additional paid-in capital		665,221		639,152
Retained earnings		156,451		116,642
Accumulated other comprehensive income		8,371		6,936
Total stockholders equity		830,156		762,843
Total liabilities and stockholders equity	$	971,705	$	863,740

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

3

Table of Contents

MKS INSTRUMENTS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net sales	$ 198,351	$ 130,193	$ 377,412	$ 257,600
Cost of sales	111,850	78,407	217,166	156,452
Gross profit	86,501	51,786	160,246	101,148
Research and development	17,663	14,689	33,720	29,238
Selling, general and administrative	30,300	23,040	60,065	46,889
Amortization of acquired intangible assets	4,086	3,693	9,340	7,383
Purchase of in-process technology			800	
Restructuring charges				454
Income from operations	34,452	10,364	56,321	17,184
Interest expense	228	251	431	425
Interest income	2,162	1,599	3,795	2,871
Income before income taxes	36,386	11,712	59,685	19,630
Provision for income taxes	12,012	1,934	19,876	4,394
Net income	$ 24,374	$ 9,778	$ 39,809	$ 15,236
Net income per share:				
Basic	$ 0.44	$ 0.18	$ 0.72	$ 0.28
Diluted	$ 0.44	$ 0.18	$ 0.72	$ 0.28
Weighted average common shares outstanding:				
Basic	55,338	53,975	54,999	53,926
Diluted	55,907	54,451	55,588	54,422

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

MKS INSTRUMENTS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(Unaudited)

	Six Months Ended June 30, 2006	2005
Cash flows from operating activities:		
Net income	$ 39,809	$ 15,236
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	15,882	13,426
Stock-based compensation	5,980	
Tax benefit from stock-based compensation	3,865	553
Excess tax benefit from stock-based compensation	(3,803)	
Other	829	(521)
Changes in operating assets and liabilities, net of the effect of businesses acquired:		
Trade accounts receivable	(28,351)	3,119
Inventories	(23,999)	1,899
Other current assets	(517)	(992)
Accrued expenses and other current liabilities	11,596	(2,057)
Accounts payable	4,427	897
Income taxes payable	(2,924)	228
Net cash provided by operating activities	22,794	31,788
Cash flows from investing activities:		
Acquisitions of businesses, net of cash acquired	(96,672)	
Purchases of short-term and long-term available for sale investments	(45,064)	(118,962)
Maturities and sales of short-term and long-term available for sale investments	65,280	104,648
Purchases of property, plant and equipment	(4,210)	(4,904)
Other	(756)	648
Net cash used in investing activities	(81,422)	(18,570)
Cash flows from financing activities:		
Proceeds from short-term borrowings	42,417	43,913
Payments on short-term borrowings	(36,357)	(42,497)
Principal payments on long-term debt and capital lease obligations	(1,933)	(1,430)
Proceeds from exercise of stock options and employee stock purchase plan	16,560	2,249
Excess tax benefit from stock-based compensation	3,803	
Net cash provided by financing activities	24,490	2,235
Effect of exchange rate changes on cash and cash equivalents	862	(2,548)

Increase (decrease) in cash and cash equivalents	(33,276)	12,905
Cash and cash equivalents at beginning of period	220,573	138,389
Cash and cash equivalents at end of period	$ 187,297	$ 151,294
Supplemental cash flow disclosure:		
Income taxes paid	$ 17,858	$ 5,321

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

MKS INSTRUMENTS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Tables in thousands, except share and per share data, or as otherwise noted)

1) Basis of Presentation

The terms MKS and the Company refer to MKS Instruments, Inc. and its subsidiaries. The interim financial data as of June 30, 2006 and for the three and six months ended June 30, 2006 and 2005 is unaudited; however, in the opinion of MKS, the interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The unaudited consolidated financial statements presented herein have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and note disclosures required by generally accepted accounting principles. The consolidated financial statements should be read in conjunction with the December 31, 2005 audited consolidated financial statements and notes thereto included in the MKS Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 16, 2006.

The preparation of these consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, management evaluates its estimates and judgments, including those related to revenue recognition, accounts receivable, inventory, intangible assets, goodwill, other long-lived assets, income taxes, deferred tax valuation allowance, stock-based compensation and investments. Management bases its estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Certain amounts in prior periods have been reclassified to be consistent with current period classifications.

2) Stock-Based Compensation

Effect of Adoption of SFAS 123R, Share-Based Payment

Prior to January 1, 2006, the Company accounted for stock-based awards to employees using the intrinsic value method as prescribed by Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations (APB 25). Accordingly, no compensation expense was recorded for options issued to employees in fixed amounts with fixed exercise prices at least equal to the fair market value of the Company s common stock at the date of grant. The Company had adopted the disclosure-only provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure, (SFAS 123).

On January 7, 2005, the Company accelerated the vesting of outstanding stock options granted to employees and officers with an exercise price of $23.00 per share or greater. As a result of this action, options to purchase approximately 1.6 million shares of the Company s common stock became exercisable on January 7, 2005. No compensation expense was recorded in the Company s consolidated statements of operations for the three and six months ended June 30, 2005 related to this action as these options had no intrinsic value on January 7, 2005. For purposes of the SFAS 123 proforma calculation below, the expense related to the options that were accelerated was $16,886,000, net of tax, for the three months ended March 31, 2005 and the six months ended June 30, 2005, respectively. The reason that the Company accelerated the vesting of the identified stock options was to reduce the Company s compensation expense in periods subsequent to the adoption of SFAS 123R, Share-Based Payment (SFAS 123R).

As of January 1, 2006, the Company adopted SFAS 123R using the modified prospective method. SFAS 123R requires companies to recognize compensation cost for all stock-based awards based upon the grant-date fair value of those awards and to recognize the expense over the requisite service period for awards expected to vest. Using the modified prospective method of adopting SFAS 123R, MKS began recognizing compensation expense for equity-based awards granted after January 1, 2006 plus unvested awards granted prior to January 1, 2006. Under this method of implementation, prior periods were not restated.

MKS INSTRUMENTS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Tables in thousands, except share and per share data, or as otherwise noted)

The Company recognized the full impact of its share-based payment plans in the consolidated statements of operations for the three and six months ended June 30, 2006 under SFAS 123R and did not capitalize any such costs on the consolidated balance sheets, as such costs that qualified for capitalization were not material. The following table reflects the effect of recording stock-based compensation for the three and six months ended June 30, 2006 in accordance with SFAS 123R:

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Stock-based compensation expense by type of award:		
Employee stock options	$ 1,999	$ 3,966
Restricted stock	1,151	1,678
Employee stock purchase plan	164	336
Total stock-based compensation	3,314	5,980
Tax effect on stock-based compensation	(1,182)	(2,117)
Net effect on net income	$ 2,132	$ 3,863
Effect on earnings per share:		
Basic	$ 0.04	$ 0.07
Diluted	$ 0.04	$ 0.07

Valuation Assumptions

In connection with the adoption of SFAS 123R, the Company reassessed its valuation technique and related assumptions. The Company determines the fair value of restricted stock based on the number of shares granted and the closing market price of the Company s common stock on the date of the award, and estimates the fair value of stock options and employee stock purchase rights using the Black-Scholes valuation model, which is consistent with our valuation techniques previously utilized for options in footnote disclosures required under SFAS 123. Such values are recognized as expense on a straight-line basis over the requisite service periods, net of estimated forfeitures. The estimation of stock-based awards that will ultimately vest requires significant judgment. We consider many factors when estimating expected forfeitures, including types of awards and historical experience. Actual results, and future changes in estimates, may differ substantially from our current estimates.

The fair values of options and employee stock purchase rights at the date of grant were estimated using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Stock option plans:				
Expected life (years)	5.0	3.2	5.0	3.3
Risk-free interest rate	5.0%	3.9%	4.9%	3.8%
Expected volatility	52.0%	55.0%	51.9%	55.0%
Dividend yield	0.0%	0.0%	0.0%	0.0%
Employee stock purchase rights:				

Expected life (years)	0.5	0.5	0.5	0.5
Risk-free interest rate	4.6%	2.4%	4.4%	2.4%
Expected volatility	34.3%	55.0%	34.2%	55.0%
Dividend yield	0.0%	0.0%	0.0%	0.0%

Expected volatilities are based on a combination of implied and historical volatilities of our common stock; the expected life represents the weighted average period of time that options granted are expected to be outstanding giving consideration to vesting schedules and our historical exercise patterns; and the risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for periods corresponding with the expected life of the option.

Table of Contents

MKS INSTRUMENTS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Tables in thousands, except share and per share data, or as otherwise noted)

Prior to the adoption of SFAS 123R

The following table illustrates the effect on net income and net income per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee awards.

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income as reported	$ 9,778	$ 15,236
Deduct: Total stock-based employee compensation expense determined under the fair-value-based method for all awards, net of tax	(1,533)	(20,423)
Pro forma net income (loss)	$ 8,245	$ (5,187)
Basic net income (loss) per share:		
As reported	$ 0.18	$ 0.28
Pro forma	$ 0.15	$ (0.10)
Diluted net income (loss) per share:		
As reported	$ 0.18	$ 0.28
Pro forma	$ 0.15	$ (0.10)

Equity Incentive Plans

The Company s equity incentive plans (the Plans) are intended to attract and retain employees and to provide an incentive for them to assist the Company to achieve long-range performance goals and to enable them to participate in the long-term growth of the Company. Employees may be granted restricted stock and restricted stock units (collectively, restricted stock), options to purchase shares of the Company s stock and other equity incentives under the Plans. In addition, certain of the Plans provide for the automatic grant of stock options to non-employee directors and permit the grant of equity-based awards to consultants. Under the Plans, stock options generally have a vesting period of 25% after one year and 6.25% per quarter thereafter, are exercisable for a period not to exceed 10 years from the date of grant and are granted at prices equal to 100% of the fair market value of our common stock at the grant date. Generally, options granted to non-employee directors, under the Plans, vest at the earliest of (1) the next annual meeting, (2) 13 months from the date of grant, or (3) the effective date of an acquisition. Restricted stock awards generally vest three years from the date of grant. At June 30, 2006, there were 6,161,818 shares authorized for issuance and 4,999,678 shares available for future grants of the Company s common stock under the Plans.

The Company also has two Employee Stock Purchase Plans (ESPPs) for the United States and international employees, respectively, which enable the Company s employees to purchase MKS common stock. As of June 30, 2006, there were 1,500,000 shares authorized for issuance and 664,013 shares reserved for future issuance under the ESPPs.

Stock Option and Restricted Stock Activity

	Options Outstanding	Restricted Stock

	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Grant Date Fair Value
Outstanding options/non-vested restricted stock at December 31, 2004	10,023,717	$ 20.25		
Granted	316,500	$ 16.93		
Exercised options/vested restricted stock	(382,211)	$ 10.70		
Forfeited or expired	(498,735)	$ 23.34		
Outstanding options/non-vested restricted stock at December 31, 2005	9,459,271	$ 20.36		
Granted	82,000	$ 23.64	702,490	$ 22.06
Exercised options/vested restricted stock	(1,149,013)	$ 13.45	(416)	$ 22.43
Forfeited or expired	(183,710)	$ 24.58	(10,600)	$ 22.42
Outstanding options/non-vested restricted stock at June 30, 2006	8,208,548	$ 21.26	691,474	$ 22.06

MKS INSTRUMENTS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Tables in thousands, except share and per share data, or as otherwise noted)

The fair value of stock options and restricted stock awards that vested during the six months ended June 30, 2006 and 2005 was approximately $4,320,000 and $3,288,000, respectively. As of June 30, 2006, the unrecognized compensation cost related to non-vested stock options and the unrecognized compensation cost related to restricted stock was approximately $10,984,000 and $13,363,000, respectively, and will be recognized over an estimated weighted average amortization period of 1.9 years and 2.6 years, respectively.

The following table summarizes information with respect to options outstanding and exercisable under the Plans at June 30, 2006:

	Options Outstanding				Options Exercisable		
	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (In Years)	Aggregate Intrinsic Value (in thousands)	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value (in thousands)
$4.43 - $8.92	280,013	$ 6.07	1.71	$ 3,935	280,013	$ 6.07	$ 3,935
$10.86 - $19.00	3,389,852	$ 15.88	6.71	14,360	2,203,448	$ 16.23	8,576
$19.18 - $29.50	3,659,233	$ 24.79	5.92	22	3,564,011	$ 24.83	16
$29.93 - $61.50	879,450	$ 32.14	5.48		879,450	$ 32.14	
$4.43 - $61.50	8,208,548	$ 21.26	6.06	$ 18,317	6,926,922	$ 21.45	$ 12,527

The weighted average remaining contractual life of options exercisable was 5.68 years at June 30, 2006.

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on the Company s closing stock price of $20.12 as of June 30, 2006, which would have been received by the option holders had all option holders exercised their options as of that date. The total number of in-the-money options exercisable as of June 30, 2006 was 2,609,469.

The weighted average grant date fair value of options granted during the six months ended June 30, 2006 and June 30, 2005, as determined under SFAS 123R and SFAS 123, was $12.00 and $6.95 per share, respectively. The total intrinsic value of options exercised during the six month period ended June 30, 2006 and June 30, 2005 was approximately $10,871,000 and $1,434,000, respectively.

The total cash received from employees as a result of employee stock option exercises during the six months ended June 30, 2006 and June 30, 2005 was approximately $15,459,000 and $1,191,000, respectively. In connection with these exercises, the net tax benefits realized by the Company for the six months ended June 30, 2006 and June 30, 2005 was approximately $3,865,000 and $553,000, respectively.

The Company settles employee stock option exercises with newly issued common shares.

3) Acquisitions

On January 3, 2006, the Company completed its acquisition of Ion Systems, Inc. (Ion), a leading provider of electrostatic management solutions located in Alameda, California, pursuant to an Agreement and Plan of Merger dated November 25, 2005. Ion s ionization technology controls electrostatic charge to reduce process contamination and improve yields, which complements the Company s process monitoring and control technologies. The aggregate purchase price consisted of $68,073,000 in cash, net of $5,056,000 in cash acquired, and $807,000 in acquisition related costs.

Table of Contents

MKS INSTRUMENTS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Tables in thousands, except share and per share data, or as otherwise noted)

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of the acquisition. The purchase price allocation is preliminary, pending the final determination of fair values of intangible assets and certain assumed assets and liabilities:

Current assets	$ 16,191
Intangible assets	25,800
Other assets	3,322
Goodwill	45,264
Total assets acquired	90,577
Current liabilities	(7,243)
Deferred tax liability	(9,398)
Total liabilities assumed	(16,641)
Total purchase price including acquisition costs	$ 73,936

The goodwill and other intangible assets associated with the acquisition are not deductible for tax purposes. Of the $25,800,000 of acquired intangible assets, the following table reflects the allocation of the acquired intangible assets and related estimates of useful lives:

Customer relationships	$ 12,200	8-year useful life
Current developed technology	9,900	6-year useful life
Tradenames	2,300	8-year useful life
Order backlog	1,000	3 months
In-process research and development	400	
	$ 25,800	

This transaction resulted in an amount of purchase price that exceeded the estimated fair values of tangible and intangible assets, which was allocated to goodwill. The Company believes that the amount of goodwill relative to identifiable intangible assets relates to several factors including: (1) potential buyer-specific synergies related to market opportunities for a combined product offering and (2) potential to leverage the Company s sales force and intellectual property to attract new customers and revenue.

On January 3, 2006, the Company completed its acquisition of Umetrics, AB (Umetrics), a leader in multivariate data analysis and modeling software located in Umea, Sweden, pursuant to a Sale and Purchase Agreement dated December 15, 2005. Umetrics multivariate data analysis and modeling software converts process data into useable information for yield improvement when linked with the Company s open and modular platform of process sensors and data collection, integration, data storage, and visualization capabilities. The purchase price consisted of $27,400,000 in cash, net of $2,602,000 in cash acquired, and $392,000 in acquisition related costs.

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of the acquisition. The purchase price allocation is preliminary, pending the final determination of fair values of intangible assets and certain assumed assets and liabilities:

Current assets	$ 4,243

Intangible assets	7,650
Other assets	400
Goodwill	22,060
Total assets acquired	34,353
Current liabilities	(1,929)
Deferred tax liability	(2,030)
Total liabilities assumed	(3,959)
Total purchase price including acquisition costs	$ 30,394

MKS INSTRUMENTS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Tables in thousands, except share and per share data, or as otherwise noted)

The goodwill and other intangible assets associated with the acquisition are not deductible for tax purposes. Of the $7,650,000 of acquired intangible assets, the following table reflects the allocation of the acquired intangible assets and related estimates of useful lives:

Customer relationships	$ 2,300	8-year useful life
Current developed technology	4,150	4-6-year useful life
Tradenames	800	8-year useful life
In-process research and development	400	
	$ 7,650	

This transaction resulted in an amount of purchase price that exceeded the estimated fair values of tangible and intangible assets, which was allocated to goodwill. The Company believes that the amount of goodwill relative to identifiable intangible assets relates to several factors including: (1) being a provider of multivariate software technology which will be increasingly important to solution providers for semiconductor and other industrial customers and (2) enhanced ability to combine Umetrics software products with MKS traditional hardware products.

Ion s ionization technology and Umetrics multivariate data analysis technology both complement our process control and monitoring technologies and will support the Company s mission to improve process performance and productivity.

The results of these acquisitions were included in the Company s consolidated operations beginning in January 2006. The pro forma consolidated statements reflecting the operating results of Ion and Umetrics, had they been acquired as of January 1, 2005, would not differ materially from the operating results of the Company as reported for the three and six months ended June 30, 2005.

4) Goodwill and Intangible Assets

Intangible Assets

Acquired amortizable intangible assets consisted of the following as of June 30, 2006:

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Completed technology	$ 86,663	$ (57,682)	$ 28,981
Customer relationships	21,140	(5,817)	15,323
Patents, trademarks, tradenames and other	16,495	(9,882)	6,613
	$ 124,298	$ (73,381)	$ 50,917

Acquired amortizable intangible assets consisted of the following as of December 31, 2005:

	Gross Carrying	Accumulated	Net Carrying

	Amount	Amortization	Amount
Completed technology	$ 72,421	$ (51,520)	$ 20,901
Customer relationships	6,640	(4,481)	2,159
Patents, trademarks, tradenames and other	12,395	(8,033)	4,362
	$ 91,456	$ (64,034)	$ 27,422

Table of Contents

MKS INSTRUMENTS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Tables in thousands, except share and per share data, or as otherwise noted)

Aggregate amortization expense related to acquired intangibles for the three and six months ended June 30, 2006 was $4,093,000 and $9,347,000, respectively. Aggregate amortization expense related to acquired intangibles for the three and six months ended June 30, 2005 was $3,693,000 and $7,383,000, respectively. Estimated amortization expense related to acquired intangibles for the remainder of 2006 and in total for the year is $8,049,000 and $17,396,000, respectively. Estimated amortization expense for 2007 and for each of the three succeeding fiscal years is as follows:

Year	Amount
2007	$ 15,713
2008	7,973
2009	5,788
2010	4,695

Goodwill

The changes in the carrying amount of goodwill during the six months ended June, 2006 were as follows:

Balance at December 31, 2005	$ 255,243
Goodwill acquired during 2006	67,324
Foreign currency translation	109
	$ 322,676

The change in the carrying amount of goodwill during the six months ended June 30, 2005 was not material.

5) Net Income Per Share

The following table sets forth the computation of basic and diluted net income per share:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Numerator				
Net income	$ 24,374	$ 9,778	$ 39,809	$ 15,236
Denominator				
Shares used in net income per common share basic	55,338	53,975	54,999	53,926
Effect of dilutive securities:				
Stock options, restricted stock and employee stock purchase plan	569	476	589	496
Shares used in net income per common share diluted	55,907	54,451	55,588	54,422
Net income per common share				
Basic	$ 0.44	$ 0.18	$ 0.72	$ 0.28
Diluted	$ 0.44	$ 0.18	$ 0.72	$ 0.28

For purposes of computing diluted net income per common share, 4,783,409 and 4,745,550 outstanding options and non-vested restricted stock for the three and six months ended June 30, 2006, respectively, and 7,112,404 and 7,138,214 outstanding options and non-vested restricted stock for the three and six months ended June 30, 2005, respectively, were excluded from the calculation, as their inclusion would be anti-dilutive. There were options to purchase approximately 8,208,548 and 9,855,786 shares of the Company s common stock outstanding as of June 30, 2006 and 2005, respectively.

MKS INSTRUMENTS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Tables in thousands, except share and per share data, or as otherwise noted)

6) Inventories

Inventories consist of the following:

	June 30, 2006	December 31, 2005
Raw material	$ 63,870	$ 48,235
Work in process	22,102	18,283
Finished goods	41,407	31,724
	$ 127,379	$ 98,242

7) Stockholders Equity

Comprehensive Income

Components of comprehensive income were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net income	$ 24,374	$ 9,778	$ 39,809	$ 15,236
Other comprehensive income (loss):				
Changes in value of financial instruments designated as cash flow hedges net of taxes of $0 and $452 for the three months ended June 30, respectively, and net of tax benefit of $271 and net of tax of $967 for the six months ended June 30, respectively)		756	(452)	1,612
Foreign currency translation adjustment	960	(3,251)	1,830	(5,329)
Unrealized gain (loss) on investments net of taxes of $1 and $15 for the three months ended June 30, respectively, and net of tax of $34 and net of tax benefit of $23 for the six months ended June 30, respectively)	3	24	57	(38)
Other comprehensive income (loss)	963	(2,471)	1,435	(3,775)
Total comprehensive income	$ 25,337	$ 7,307	$ 41,244	$ 11,481

8) Income Taxes

The Company records income taxes using the asset and liability method. Deferred income tax assets and liabilities are recognized for the future tax consequences attributable to differences between the consolidated financial statement carrying amounts of existing assets and liabilities and their respective income tax bases, and operating loss and tax credit carryforwards. The Company evaluates the realizability of its net deferred tax assets and assesses the need for a valuation allowance on a quarterly basis. The future benefit to be derived from its deferred tax assets is dependent upon its ability to generate sufficient future taxable income to realize the assets. The Company records a valuation allowance to reduce its net deferred tax assets to the amount that may be more likely than not to be realized. To the extent the Company establishes a valuation allowance, an expense will be recorded within the provision for income taxes line on the consolidated statements of operations.

At June 30, 2006, the Company continued to maintain a valuation allowance for certain state tax credits for which it is more likely than not that they will not be realized.

The Company s effective tax rate for the quarter ending June 30, 2006 was 33.0%. The effective tax rate is less than the statutory tax rate primarily due to the profits of the Company s international subsidiaries being taxed at rates lower than the U.S. statutory tax rate.

Through June 30, 2006, the Company had not provided deferred income taxes on the undistributed earnings of its foreign subsidiaries because such earnings were intended to be permanently reinvested outside the U.S. Determination of the potential deferred income tax liability on these undistributed earnings is not practicable because such liability, if any, is dependent on circumstances existing if and when remittance occurs. At June 30, 2006, the Company had $110,249,368 of undistributed earnings in its foreign subsidiaries.

MKS INSTRUMENTS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Tables in thousands, except share and per share data, or as otherwise noted)

On November 10, 2005, the FASB issued FASB Staff Position No. FAS 123(R)-3 Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards. The Company has elected to adopt the alternative transition method provided in the FASB Staff Position for calculating the tax effects of stock-based compensation pursuant to SFAS 123R. The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and consolidated statements of cash flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123R.

In the normal course of business, the Company and its subsidiaries are examined by various tax authorities, including the Internal Revenue Service (IRS). Any such examination could result in an unfavorable settlement of any particular issue and may require the use of cash. Unfavorable or favorable resolution of any such examination could result in an increase or a reduction, respectively, to our effective tax rate in the quarter of resolution. Although the Company believes that its tax positions are consistent with applicable U.S. federal and state and international laws, certain tax reserves are maintained at June 30, 2006 should these positions be challenged by the applicable tax authority and additional tax assessed on audit.

The Israeli Development Authority is currently conducting a review of the tax holiday granted to the Company for our manufacturing operations in Israel. We expect that this review may be completed within the next twelve months. Resolution of this issue could result in an increase or a reduction to our effective tax rate in future periods.

During the second quarter of 2005, the IRS completed its examination of the Company s tax returns for the tax years 1999 through 2002. As a result of this examination, the Company recorded a benefit to income tax expense of $1,901,000 and a $576,000 reduction of goodwill related to a previous acquisition.

9) Geographic, Product and Significant Customer Information

The Company operates in one segment for the development, manufacturing, sales and servicing of products that measure, control, power and monitor critical parameters of advanced manufacturing processes. The Company s chief decision-maker reviews consolidated operating results to make decisions about allocating resources and assessing performance for the entire Company.

Information about the Company s operations in different geographic regions is presented in the tables below. Net sales to unaffiliated customers are based on the location in which the sale originated. Transfers between geographic areas are at negotiated transfer prices and have been eliminated from consolidated net sales.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Geographic net sales				
United States	$ 133,376	$ 81,226	$ 258,509	$ 159,143
Japan	23,947	21,134	46,105	42,196
Europe	17,339	13,009	31,871	27,906
Asia	23,689	14,824	40,927	28,355
	$ 198,351	$ 130,193	$ 377,412	$ 257,600

	June 30, 2006	December 31, 2005
Long-lived assets:		
United States	$ 69,000	$ 66,588
Japan	5,531	5,679
Europe	3,587	4,311
Asia	4,753	4,493
	$ 82,871	$ 81,071

Table of Contents

MKS INSTRUMENTS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Tables in thousands, except share and per share data, or as otherwise noted)

The Company groups its products into three product groups. Net sales for these product groups are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Instruments and Control Systems	$ 94,316	$ 58,439	$ 178,224	$ 119,289
Power and Reactive Gas Products	83,645	55,276	160,229	107,635
Vacuum Products	20,390	16,478	38,959	30,676
	$ 198,351	$ 130,193	$ 377,412	$ 257,600

The Company had one customer comprising 22% of net sales for the three months ended June 30, 2006 and two customers comprising 22% and 10%, respectively, of net sales for the six months ended June 30, 2006. The Company had one customer comprising 16% and 16%, respectively, and one customer comprising 10% and 10%, respectively, of net sales for the three and six months ended June 30, 2005.

10) Commitments and Contingencies

On November 3, 1999, On-Line Technologies, Inc. (On-Line), which was acquired by MKS in 2001, brought suit in federal district court in Connecticut against Perkin-Elmer, Inc. and certain other defendants (Perkin-Elmer) for infringement of On-Line s patent related to its FTIR spectrometer product and related claims. The suit sought injunctive relief and damages for infringement. Perkin-Elmer filed a counterclaim seeking invalidity of the patent, costs and attorneys fees, and in June 2002, filed a motion for summary judgment. In April 2003, the court granted the motion and dismissed the case. MKS appealed this decision to the federal circuit court of appeals, which, on October 13, 2004, reversed the lower court s dismissal of certain claims in the case. Accordingly, the case has been remanded to the United States District Court in Connecticut for further proceedings on the merits of the remaining claims. On March 11, 2005, Perkin-Elmer submitted to the court a stipulation agreeing that they have infringed a specified claim of On-Line s patent. Perkin-Elmer also filed a motion for summary judgment that such patent claim is invalid, but that motion was denied on March 23, 2006. Perkin-Elmer then filed a motion for reconsideration of that decision, which motion is currently pending. The case is currently scheduled for trial beginning on October 16, 2006.

The Company is subject to other legal proceedings and claims, which have arisen in the ordinary course of business.

In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the Company s results of operations, financial condition or cash flows.

11) Restructuring Charges

During the three months ended March 31, 2005, the Company initiated a restructuring plan related to its Berlin, Germany location. This consolidation of activities included the reduction of 16 employees. The total restructuring charge related to this consolidation was $454,000, which consisted of $251,000 related to the repayment of a government grant and $203,000 in severance costs.

12) Product Warranties

The Company provides for the estimated costs to fulfill customer warranty obligations upon the recognition of the related revenue. While the Company engages in extensive product quality programs and processes, including actively monitoring and evaluating the quality of its component suppliers, the Company s warranty obligation is affected by product failure rates, utilization levels, material usage, and supplier warranties on parts delivered to the Company. Should actual product failure rates, utilization levels, material usage, or supplier warranties on parts differ from the Company s estimates, revisions to the estimated warranty liability would be required.

MKS INSTRUMENTS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(Tables in thousands, except share and per share data, or as otherwise noted)

Product warranty activities for the six months ended June 30 were as follows:

	2006	2005
Balance at the beginning of the year	$ 7,766	$ 7,601
Fair value of warranty liabilities acquired during the period	612	
Provisions for product warranties during the period	7,299	3,368
Direct charges to the warranty liability during the period	(4,606)	(3,807)
Balance at June 30	$ 11,071	$ 7,162

13) Recently Issued Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued Financial Accounting Standards Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes. FIN 48 clarifies the accounting for uncertainty in income tax positions taken or expected to be taken in tax returns that effect amounts reported in a company s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 establishes a threshold condition that a tax position must meet for any part of the benefit of that position to be recognized in the financial statements. FIN 48 also provides guidance concerning derecognition, measurement, classification, interest and penalties and disclosure of tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently analyzing the effects of FIN 48.

MKS INSTRUMENTS, INC.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

We believe that this Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. When used herein, the words believes, anticipates, plans, expects, estimates and similar expressions are intended to identify forward-looking statements. These forward-looking statements reflect management s current opinions and are subject to certain risks and uncertainties that could cause results to differ materially from those stated or implied. We assume no obligation to update this information. Risks and uncertainties include, but are not limited to, those discussed in the section in this Report entitled Risk Factors.

Overview

We are a leading worldwide provider of instruments, components, subsystems and process control solutions that measure, control, power and monitor critical parameters of semiconductor and other advanced manufacturing processes.

We are managed as one operating segment which is organized around three product groups: Instruments and Control Systems, Power and Reactive Gas Products, and Vacuum Products. Our products are derived from our core competencies in pressure measurement and control, materials delivery, gas and thin-film composition analysis, electrostatic charge control, control and information management, power and reactive gas generation and vacuum technology. Our products are used to manufacture semiconductors and thin film coatings for diverse markets such as flat panel displays, optical and magnetic storage media, architectural glass, and electro-optical products. We also provide technologies for other markets, including the medical imaging equipment market.

Our customers include semiconductor capital equipment manufacturers, semiconductor device manufacturers, industrial and biopharmaceutical manufacturing companies, medical equipment manufacturers and university, government and industrial research laboratories. For the six months ended June 30, 2006 and the full year ended December 31, 2005, we estimate that approximately 73% and 71% of our net sales, respectively, were to semiconductor capital equipment manufacturers and semiconductor device manufacturers. We expect that sales to the semiconductor capital equipment manufacturers and semiconductor device manufacturers will continue to account for a substantial majority of our sales.

During the fourth quarter of 2005 and continuing through the second quarter of 2006, we experienced significant increases in customer orders, which caused our sales for the first two quarters of 2006 to increase significantly from 2005 quarterly levels. We currently expect that our third quarter 2006 sales could be at a similar level to our second quarter 2006 sales. However, the semiconductor capital equipment industry is subject to rapid demand shifts, which are difficult to predict, and we are uncertain how long these sales levels may be maintained or the timing or extent of any future downturn or upturn in the semiconductor capital equipment industry.

A portion of our sales is to operations in international markets. For the six months ended June 30, 2006 and full year ended December 31, 2005, international sales accounted for approximately 32% and 37% of net sales, respectively.

On January 3, 2006, we completed our acquisition of Ion Systems, Inc. (Ion), a leading provider of electrostatic management solutions located in Alameda, California, pursuant to an Agreement and Plan of Merger dated November 25, 2005. Ion s ionization technology controls electrostatic charges to reduce process contamination and improve yields, which complements our process monitoring and control technologies. The aggregate purchase price consisted of $68.1 million in cash, net of $5.0 million in cash acquired, and $0.8 million in acquisition related costs.

Additionally, on January 3, 2006, we completed our acquisition of Umetrics, AB (Umetrics), a leader in multivariate data analysis and modeling software located in Umea, Sweden, pursuant to a Sale and Purchase Agreement dated December 15, 2005. Umetrics multivariate data analysis and modeling software converts process data into useable information for yield improvement, when linked with our open and modular platform of process sensors and data collection, integration, data storage, and visualization capabilities. The purchase price consisted of $27.4 million in cash, net of $2.6 million in cash acquired, and $0.4 million in acquisition related costs.

Table of Contents

Critical Accounting Policies and Estimates

The preparation of our consolidated financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions and estimates that affect the amounts reported. Management believes that other than the adoption of Statement of Financial Accounting Standards No. 123R, Share-Based Payment (SFAS 123R), there have been no significant changes in our critical accounting policies since December 31, 2005. See the discussion of critical accounting policies in our Annual Report on Form 10-K for the year ended December 31, 2005.

Stock-Based Compensation Expense

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS 123R, using the modified prospective transition method, and therefore have not restated prior periods results. Under this method we recognize compensation expense for all equity-based awards granted after January 1, 2006 as well as awards granted prior to but not yet vested as of January 1, 2006, in accordance with SFAS 123R. Under the fair value recognition provisions of SFAS 123R, we recognize stock-based compensation net of an estimated forfeiture rate and only recognize compensation cost for those shares expected to vest on a straight-line basis over the requisite service period of the award. The adoption of this standard reduced our net income by $2.1 million and $3.9 million, respectively, for the three and six months ended June 30, 2006. Prior to SFAS 123R adoption, we accounted for share-based payments under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and accordingly, generally recognized compensation expense only when we granted options with a discounted exercise price.

Determining the appropriate fair value model and calculating the fair value of share-based payment awards require the input of highly subjective assumptions, including the expected life of the share-based payment awards and stock price volatility. Management determined that blended volatility, a combination of historical and implied volatility, is more reflective of market conditions and a better indicator of expected volatility than historical or implied volatility. Therefore, expected volatility for the three and six months ended June 30, 2006 was based on a blended volatility. The assumptions used in calculating the fair value of share-based payment awards represent management s best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change and we use different assumptions, our stock-based compensation expense could be materially different in the future. In addition, we are required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period. See Note 2 to the consolidated financial statements for a further discussion on stock-based compensation.

Results of Operations

The following table sets forth for the periods indicated the percentage of total net sales of certain line items included in MKS consolidated statements of operations data.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	56.4	60.2	57.5	60.7
Gross profit	43.6	39.8	42.5	39.3
Research and development	8.9	11.3	8.9	11.4
Selling, general and administrative	15.3	17.7	15.9	18.2
Amortization of acquired intangible assets	2.0	2.8	2.5	2.9
Purchase of in-process technology			0.3	
Restructuring, asset impairment and other charges				0.2
Income from operations	17.4	8.0	14.9	6.6

Interest income, net	1.0	1.0	0.9	1.0
Income before income taxes	18.4	9.0	15.8	7.6
Provision for income taxes	6.1	1.5	5.3	1.7
Net income	12.3%	7.5%	10.5%	5.9%

Table of Contents

Net Sales (dollars in millions)

	Three Months Ended June 30,			Six Months Ended June 30,		
	2006	2005	% Change	2006	2005	% Change
Net sales	$ 198.4	$ 130.2	52.4%	$ 377.4	$ 257.6	46.5%

Net sales increased $68.2 million during the three month period ended June 30, 2006 mainly due to an increase in worldwide demand from our semiconductor capital equipment manufacturer and semiconductor device manufacturer customers, which increased $52.3 million or 57.3% compared to the same period for the prior year. During the first quarter of 2006, we acquired Ion and Umetrics. These acquisitions increased our net sales by approximately $11.5 million for the three month period ended June 30, 2006 compared to the same period in the prior year. International net sales were $65.0 million for the three months ended June 30, 2006 or 32.8% of net sales compared to $49.0 million for the same period of 2005 or 37.6% of net sales.

Net sales increased $119.8 million during the six month period ended June 30, 2006 mainly due to an increase in worldwide demand from our semiconductor capital equipment manufacturer and semiconductor device manufacturer customers, which increased $91.2 million or 49.8% compared to the same period for the prior year. During the first quarter of 2006, we acquired Ion and Umetrics. These acquisitions increased our net sales by approximately $21.6 million for the six month period ended June 30, 2006 compared to the same period in the prior year. International net sales were $118.9 million for the six months ended June 30, 2006 or 31.5% of net sales compared to $98.5 million for the same period of 2005 or 38.2% of net sales.

Gross Profit

&n