

KEMET CORP  
Form 10-Q  
November 07, 2007

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549



# Form 10-Q

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the quarterly period ended September 30, 2007**

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**Commission File Number: 0-20289**

## **KEMET CORPORATION**

(Exact name of registrant as specified in its charter)

**DELAWARE**

(State or other jurisdiction of incorporation or organization)

**57-0923789**

(IRS Employer Identification No.)

**2835 KEMET WAY, SIMPSONVILLE, SOUTH CAROLINA 29681**

(Address of principal executive offices, zip code)

**(864) 963-6300**

(Registrant's telephone number, including area code)

Former name, former address and former fiscal year, if changed since last report: **N/A**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO





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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  X

Accelerated filer  O

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  No

Common Stock Outstanding at: September 30, 2007

<b>Title of Each Class</b>	<b>Number of Shares Outstanding</b>
Common Stock, \$.01 Par Value	83,974,762

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**PART 1 FINANCIAL INFORMATION****ITEM 1 Financial Statements****KEMET CORPORATION AND SUBSIDIARIES****Consolidated Balance Sheets****(Dollars in thousands except per share data)****(Unaudited)**

	September 30, 2007	March 31, 2007
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 164,861	\$ 212,202
Accounts receivable, net	138,660	108,830
Inventories:		
Raw materials and supplies	73,041	54,584
Work in process	62,687	51,810
Finished goods	35,492	47,474
Total inventories	171,220	153,868
Prepaid expenses and other current assets	5,788	6,816
Deferred income taxes	4,787	5,181
Total current assets	485,316	486,897
Noncurrent assets:		
Property and equipment, net of accumulated depreciation of \$688.0 million and \$682.6 million as of September 30, 2007 and March 31, 2007, respectively	374,458	349,174
Property held for sale	2,393	3,647
Investments in U.S. government marketable securities		45,767
Investments in affiliates	119	119
Goodwill	58,012	36,552
Intangible assets, net	17,267	14,260
Other assets	8,616	7,110
Non-current deferred income taxes	1,330	
Total noncurrent assets	462,195	456,629
Total assets	\$ 947,511	\$ 943,526
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Current portion of long-term debt	\$ 23,117	\$ 20,000
Accounts payable, trade	88,048	70,799
Accrued expenses	35,355	49,777
Income taxes payable	865	7,225
Total current liabilities	147,385	147,801
Noncurrent liabilities:		
Long-term debt, less current portion	224,848	238,744
Postretirement benefits and other noncurrent obligations	18,948	19,587
Deferred income taxes		1,636
Total noncurrent liabilities	243,796	259,967
Total liabilities	391,181	407,768
Stockholders equity:		

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Common stock, par value \$0.01, authorized 300,000,000 shares, issued 88,205,946 and 88,154,936 shares at September 30, 2007 and March 31, 2007, respectively	882	882
Additional paid-in capital	323,602	321,059
Retained earnings	242,853	228,118
Accumulated other comprehensive income	31,966	30,418
Treasury stock, at cost (4,231,184 and 4,403,048 shares at September 30, 2007 and March 31, 2007, respectively)	(42,973)	(44,719)
Total stockholders' equity	556,330	535,758
Total liabilities and stockholders' equity	\$ 947,511	\$ 943,526

See accompanying notes to consolidated financial statements.

**KEMET CORPORATION AND SUBSIDIARIES****Consolidated Statements of Operations****(Dollars in thousands except per share data)****(Unaudited)**

	<b>Three months ended September 30,</b>		<b>Six months ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Net sales	\$ 197,129	\$ 166,548	\$ 380,248	\$ 336,117
Operating costs and expenses:				
Cost of goods sold	159,397	132,443	302,939	265,157
Selling, general and administrative	20,212	21,245	42,019	45,165
Research and development	8,173	7,429	17,240	15,222
Restructuring charges	5,985	3,415	8,534	8,090
Total operating costs and expenses	193,767	164,532	370,732	333,634
Operating income	3,362	2,016	9,516	2,483
Other (income)/expense:				
Interest expense	2,085	1,283	4,685	2,731
Interest income	(1,356)	(702)	(3,217)	(1,563)
Other (income)/expense	(1,185)	194	(1,517)	(1,005)
Total other (income)/expense	(456)	775	(49)	163
Income before income taxes	3,818	1,241	9,565	2,320
Income tax (benefit)/expense	(267)	401	(1,577)	884
Income before minority interest	4,085	840	11,142	1,436
Minority interest	75		100	
Net income	\$ 4,010	\$ 840	\$ 11,042	\$ 1,436
Net income per share:				
Basic	\$ 0.05	\$ 0.01	\$ 0.13	\$ 0.02
Diluted	\$ 0.05	\$ 0.01	\$ 0.13	\$ 0.02
Weighted-average shares outstanding:				
Basic	83,953,130	87,018,384	83,921,418	87,007,111
Diluted	84,176,613	87,132,296	84,157,689	87,463,308

See accompanying notes to consolidated financial statements.

## KEMET CORPORATION AND SUBSIDIARIES

## Consolidated Statement of Cash Flows

(Dollars in thousands except per share data)

(Unaudited)

	Six months ended September 30,	
	2007	2006
<b>Operating activities:</b>		
Net income	\$ 11,042	\$ 1,436
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization, and asset impairment charges	25,952	20,373
Loss on disposal	94	8
Stock-based compensation	3,771	4,336
Change in operating assets	6,766	(24,373)
Change in operating liabilities	(45,876)	5,896
Net cash provided by operating activities	1,749	7,676
<b>Investing activities:</b>		
Proceeds from sale of short-term investments		4,902
Proceeds from sale of long-term investments	46,076	4,656
Additions to property and equipment	(24,920)	(12,540)
Business unit acquisition, net of cash received	(39,079)	(87,159)
Cash acquired in acquisitions	383	365
Other	15	74
Net cash used in investing activities	(17,525)	(89,702)
<b>Financing activities:</b>		
Payment on long-term debt	(31,734)	(20,000)
Proceeds from sale of common stock to Employee Savings Plan	387	327
Proceeds from exercise of stock options	130	946
Net cash used in financing activities	(31,217)	(18,727)
Net decrease in cash and cash equivalents	(46,993)	(100,753)
Effect of foreign currency fluctuation on cash	(348)	(12)
Cash and cash equivalents at beginning of period	212,202	163,778
Cash and cash equivalents at end of period	\$ 164,861	\$ 63,013

See accompanying notes to consolidated financial statements.

### **Note 1. Basis of Financial Statement Presentation**

The consolidated financial statements contained herein are unaudited and have been prepared from the books and records of KEMET Corporation and its Subsidiaries ( KEMET or the Company ). In the opinion of management, the consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the results for the interim periods. The consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all information and footnotes necessary for a complete presentation of financial position, results of operations, and cash flows in conformity with U.S. generally accepted accounting principles. Although the Company believes that the disclosures are adequate to make the information presented not misleading, it is suggested that these consolidated financial statements be read in conjunction with the audited financial statements and notes thereto included in the Company's fiscal year ended March 31, 2007, Form 10-K. Net sales and operating results for the three and six months ended September 30, 2007, are not necessarily indicative of the results to be expected for the full year. The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. In consolidation, all significant intercompany amounts and transactions have been eliminated.

### **Impact of Recently Issued Accounting Standards**

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN No. 48 ). FIN No. 48 supplements SFAS No. 109 by defining the confidence level that a tax position must meet in order to be recognized in the financial statements. On April 1, 2007, the Company adopted FIN No. 48. As a result of the adoption, the Company recorded a \$3.7 million increase to the opening retained earnings balance and a \$0.5 million reduction of goodwill. These adjustments represent the cumulative effect of adoption on prior periods. For additional information regarding these adjustments, refer to Note 10, Income Taxes.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 clarifies that fair value should be based on assumptions that market participants would use when pricing an asset or liability and establishes a fair value hierarchy of three levels that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data. SFAS No. 157 requires fair value measurements to be separately disclosed by level within the fair value hierarchy. The provisions of SFAS No. 157 are effective for fiscal years beginning after November 15, 2007. Generally, the provisions of this statement are to be applied prospectively. Certain situations, however, require retrospective application as of the beginning of the year of adoption through the recognition of a cumulative effect of accounting change. Such retrospective application is required for financial instruments, including derivatives and certain hybrid instruments with limitations on initial gains or losses under EITF Issue 02-3, Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities . The Company is currently evaluating the impact that SFAS No. 157 will have on its 2009 consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities . SFAS No. 159 permits companies to choose to measure certain financial instruments and other certain items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS No. 159 is effective for the Company beginning in the first quarter of fiscal year 2009. The Company is currently evaluating the impact that SFAS No. 159 will have on its 2009 consolidated financial statements.

### **Revenue Recognition**

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The Company recognizes revenue only when all of the following criteria are met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services have been rendered, (3) the seller's price to the buyer is fixed or determinable, and (4) collectibility is reasonably assured.

A portion of sales is related to products designed to meet customer specific requirements. These products typically have stricter tolerances making them useful to the specific customer requesting the product and to customers with similar or less stringent requirements. Products with customer specific requirements are tested and approved by the customer before the Company mass produces and ships the product. The Company recognizes revenue at shipment as the sales terms for products produced with customer specific requirements do not contain a final customer acceptance provision or other provisions that are unique and would otherwise allow the customer different acceptance rights.

A portion of sales is made to distributors under agreements allowing certain rights of return and price protection on unsold merchandise held by distributors. The Company's distributor policy includes inventory price protection and ship-from-stock and debit (SFSD) programs common in the industry. The price protection policy protects the value of the distributors' inventory in the event the Company reduces its published selling price to distributors. This program allows the distributor to debit the Company for the difference between KEMET's list price and the lower authorized price for specific parts. The Company establishes price protection reserves on specific parts residing in distributors' inventories in the period that the price protection is formally authorized by management.

The SFSD program provides a mechanism for the distributor to meet a competitive price after obtaining authorization from the local Company sales office. This program allows the distributor to ship its higher-priced inventory and debit the Company for the difference between KEMET's list price and the lower authorized price for that specific transaction. The Company establishes reserves for its SFSD program based primarily on actual inventory levels of certain distributor customers. The actual inventory levels at these distributors comprise 91% - 95% of the total global distributor inventory. The remaining 5% to 9% is estimated based on actual distributor inventory and current sales trends. Management analyzes historical SFSD activity to determine the SFSD exposure on the global distributor inventory at the balance sheet date. From time to time, the Company builds up inventory levels due to factors such as anticipated future demand exceeding capacity and when the Company moves manufacturing from one location to another location. When the distributors build up inventory levels, the estimation of the inventory at the distributors for the remaining 5% to 9% could be estimated at an incorrect amount. However, the Company believes that the difference between the estimate and the ultimate actual amount would be immaterial.

The establishment of these reserves is recognized as a component of the line item Net sales on the Consolidated Statements of Operations, while the associated reserves are included in the line item Accounts receivable on the Consolidated Balance Sheets.

The Company provides a limited warranty to its customers that the products meet certain specifications. The warranty period is generally limited to one year, and the Company's liability under the warranty is generally limited to a replacement of the product or refund of the purchase price of the product. Warranty costs as a percentage of Net sales were less than 1% for the year ended March 31, 2007, and for the six months ended September 30, 2007 and 2006. The Company recognizes warranty costs when identified.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates, assumptions, and judgments. Estimates and assumptions are based on historical data and other assumptions that management believes are reasonable in the circumstances. These estimates and assumptions affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements. In addition, they affect the reported amounts of revenues and expenses during the reporting period.

The Company's judgments are based on management's assessment as to the effect certain estimates, assumptions, or future trends or events may have on the financial condition and results of operations reported in KEMET's unaudited consolidated financial statements. It is important that readers of these unaudited financial statements understand that actual results could differ from these estimates, assumptions, and judgments.



**Note 2. Reconciliation of Basic Income Per Common Share**

In accordance with FASB Statement No. 128, *Earnings per Share*, the Company has included the following table presenting a reconciliation of basic EPS to diluted EPS fully displaying the effect of dilutive securities.

**Computation of Basic and Diluted Income Per Share**

(Dollars in thousands except per share data)

	Three months ended September 30,		Six months ended September 30,	
	2007	2006	2007	2006
<b>Numerator:</b>				
Net income	\$ 4,010	\$ 840	\$ 11,042	\$ 1,436
<b>Denominator:</b>				
<b>Weighted-average shares outstanding:</b>				
Basic	83,953,130	87,018,384	83,921,418	87,007,111
Assumed conversion of employee stock options	223,483	113,912	236,271	456,197
Diluted	84,176,613	87,132,296	84,157,689	87,463,308
<b>Net income per share:</b>				
Basic	\$ 0.05	\$ 0.01	\$ 0.13	\$ 0.02
Diluted	\$ 0.05	\$ 0.01	\$ 0.13	\$ 0.02

**Note 3. Derivatives and Hedging**

The Company uses certain derivative financial instruments to reduce exposures to volatility of foreign currencies.

*Hedging Foreign Currencies*

Certain operating expenses at the Company's Mexican facilities are paid in Mexican pesos. In order to hedge these forecasted cash flows, management purchases forward contracts to buy Mexican pesos for periods and amounts consistent with the related underlying cash flow exposures. These contracts are designated as hedges at inception and monitored for effectiveness on a routine basis. At September 30, 2007, the Company had outstanding forward exchange contracts that matured within approximately six months to purchase Mexican pesos with notional amounts of \$37.3 million. The fair value of these contracts totaled \$0.9 million at September 30, 2007, and they are recorded as derivative assets on the Consolidated Balance Sheets under Prepaid expenses and other current assets. During the next six months, it is estimated that approximately \$0.9 million of the unrealized gain on these contracts will be recorded to Cost of goods sold. This estimate is currently reflected in Accumulated other comprehensive income/(loss) (AOCI/(L)). The impact of the changes in fair values of these contracts resulted in AOCI/(L), net of taxes, of \$0.9 million and \$(0.2) million for the three month and six month periods ended September 30, 2007, respectively.

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Certain sales are made in Euros. In order to hedge these sales, management purchases forward contracts to sell Euros for periods in amounts not to exceed the underlying sales. These contracts are designated as hedges at inception and are monitored for effectiveness on a routine basis. At September 30, 2007, the Company had outstanding forward exchange contracts that mature within approximately six months to sell Euros with notional amounts of \$16.2 million. The fair value of these contracts total \$(0.9) million at September 30, 2007, and they are recorded as an offset to the Company's derivative Mexican peso asset on the Consolidated Balance Sheets under Prepaid expenses and other current assets. The impact of the changes in fair values of these contracts resulted in AOCI/(L), net of taxes of \$(0.1) million and \$(0.9) million for the three and six month periods ended September 30, 2007, respectively. There were no outstanding Euro hedges at March 31, 2007.

Changes in the derivatives' fair values are deferred and recorded as a component of AOCI/(L) until the underlying transaction is recorded. When the hedged item affects income, gains or losses are reclassified from AOCI/(L) to the Consolidated Statements of Operations as Cost of goods sold for forward exchange contracts to purchase Mexican pesos and sell Euros. Any ineffectiveness, if material, in the Company's hedging relationships is recognized immediately in the Consolidated Statements of Operations.

The Company formally documents all relationships between hedging instruments and hedged items, as well as risk management objectives and strategies for undertaking various hedge transactions.

**Note 4. Restructuring Charges**

In July 2003, KEMET announced the manufacturing relocation plan which consisted of reorganizing its operations around the world, resulting in the location of virtually all of its production in low-cost regions to be completed by the end of fiscal year 2008. This relocation allows KEMET access to key customers, key technical resources and knowledge, and low-cost resources. Costs related to this movement of manufacturing operations are shown as manufacturing relocation costs in the table below (dollars in thousands):

During the three and six months ended September 30, 2007 and 2006, the following highlights the restructuring charges recognized by the Company (dollars in thousands):

	Three months ended September 30,		Six months ended September 30,	
	2007	2006	2007	2006
Reduction in Force	\$ 3,315	\$ 1,414	\$ 4,529	\$ 1,515
Manufacturing moves	2,670	1,911	4,005	6,485
Asset impairments		90		90
Restructuring charges	\$ 5,985	\$ 3,415	\$ 8,534	\$ 8,090

A reconciliation of the beginning and ending liability balances for restructuring charges included in the liabilities section of the Consolidated Balance Sheets for the three and six months ended September 30, 2007 and 2006 is shown below (dollars in thousands):

	Three months ended September 30, 2007		Three months ended September 30, 2006		
	Personnel Reductions	Manufacturing Relocations	Personnel Reductions	Manufacturing Relocations	Termination of a Contract
Beginning of period	\$ 705	\$	\$ 1,994	\$	\$
Costs charged to expense	3,315	2,670	1,414	1,911	90
Costs paid or settled	(2,009)	(2,670)	(2,441)	(1,911)	(90)
End of period	\$ 2,011	\$	\$ 967	\$	\$

	Six months ended September 30, 2007		Six months ended September 30, 2006		
	Personnel Reductions	Manufacturing Relocations	Personnel Reductions	Manufacturing Relocations	Termination of a Contract
Beginning of period	\$ 941	\$	\$ 2,094	\$	\$
Costs charged to expense	4,529	4,004	1,515	6,485	90
Costs paid or settled	(3,459)	(4,004)	(2,642)	(6,485)	(90)
End of period	\$ 2,011	\$	\$ 967	\$	\$

Manufacturing relocation costs are expensed as actually incurred, therefore no liability is recorded in the Consolidated Balance Sheets for these costs. Costs charged to expense are aggregated in Restructuring charges in the Consolidated Statements of Operations.

*Personnel reductions* During the three months ended September 30, 2007, the Company recognized a charge of \$3.0 million for a reduction in force in the Evora, Portugal and Heidenheim, Germany facilities and \$0.3 million related to

the departure of a former senior executive. These reductions in force comprised 115 employees. In the first quarter of fiscal year 2008, the Company recorded a charge of \$1.2 million related to reductions in force in our Mexican plants. This includes approximately 300 employees in three plants in Mexico. During the three months ended September 30, 2006, the Company recognized a charge of \$1.4 million for reductions in force effecting 138 people in the United States, Mexico and Europe.

*Manufacturing relocations* During the six months ended September 30, 2007 and 2006, the Company incurred expenses of \$4.0 million and \$6.5 million, respectively. These costs are related to the manufacturing relocation plan. All costs are expensed as incurred.

**Note 5. Other Postretirement Benefit Plans**

The Company provides health care and life insurance benefits for certain retired employees who reach retirement age while working for the Company.

The components of the expense for postretirement medical and life insurance benefits are as follows (dollars in thousands):

	Three months ended September 30,		Six months ended September 30,	
	2007	2006	2007	2006
Service cost	\$ 21	\$ 139	\$ 42	\$ 278
Interest cost	241	407	482	814
Amortization of actuarial gain	(598)	(396)	(1,196)	(792)
Total net periodic benefits (income)/costs	\$ (336)	\$ 150	\$ (672)	\$ 300

The Company expects to make no contributions to fund plan assets in fiscal year 2008 as the Company's policy is to pay benefits as costs are incurred. However, the Company estimates its benefits payments in fiscal year 2008 will be approximately \$1.8 million. Management is responsible for determining the cost of benefits for this plan. Management considered a number of factors and consulted with an actuarial firm when determining this cost.

As of March 31, 2007, the Company implemented SFAS No. 158, *Employers' Accounting for Deferred Benefit Pension and Other Postretirement Plans* (SFAS No. 158). Under SFAS No. 158, the funded status of each pension and other post retirement benefit plan is required to be reported as an asset for overfunded plans or a liability for underfunded plans, replacing the accrued or prepaid asset currently recorded and reversing any amounts previously recorded with respect to any additional minimum pension liability. Accordingly, the Company reclassified its liability of \$23.4 million to AOCI as of March 31, 2007.

**Note 6. Investments**

At March 31, 2007, investments consisted of debt securities and an equity security of a privately-held company. The debt securities, which consisted of U.S. government marketable securities, were classified as available-for-sale securities, matured in one to three years, and were carried at fair market value with unrealized gains and losses recorded in AOCI on the Consolidated Balance Sheets.

During the quarter ended September 30, 2007, the Company sold 100% of its U.S. government marketable securities for \$46.1 million and reinvested the proceeds in its money market accounts. In connection with the sale, the Company realized a \$0.4 million loss which was previously recorded in AOCI.

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At September 30, 2007 and March 31, 2007, the Company determined that the remaining investment balance in its equity investment in Lamina Ceramics, Inc., approximated fair value.

A summary of the components and carrying values of investments on the Consolidated Balance Sheets is as follows (dollars in thousands):

	September 30, 2007 Fair Value	March 31, 2007 Fair Value	Unrealized Loss
U.S. government marketable securities:			
Long-term	\$	\$ 45,767	\$ (1,092)
Equity investments:			
Cost	119	119	
	\$ 119	\$ 45,886	\$ (1,092)

**Note 7. Supply Contracts**

The Company has a tantalum supply agreement with Cabot Corporation following the acquisition of the tantalum business unit of EPCOS on April 13, 2006. This contract concluded at the end of this quarter. The Company recorded an unfavorable contract provision liability due to the acquisition of the tantalum business unit of EPCOS on the opening balance sheet. A reconciliation of the beginning and ending balance included in Postretirement benefits and other noncurrent liabilities on the Consolidated Balance Sheets is as follows (dollars in thousands):

	<b>Inventory Supply Agreement</b>	
	<b>Six months ended September 30, 2007</b>	<b>Twelve months ended March 31, 2007</b>
Beginning of period	\$ 2,231	\$
Liability acquired		6,921
Costs paid or settled	(2,231)	(4,690)
End of period	\$	\$ 2,231

**Note 8. Accumulated Other Comprehensive Income**

Comprehensive income for the three and six months ended September 30, 2007 includes the following components (dollars in thousands):

	<b>Three Months Ended September 30,</b>		<b>Six Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Net income	\$ 4,010	\$ 840	\$ 11,042	\$ 1,436
Other comprehensive income, net of tax:				
Amortization of SFAS No. 158	(598)		(1,196)	
Currency forward contract gain/(loss)	(1,618)	2,059	(829)	1,459
Currency translation gain/(loss)	1,169	(243)	2,482	75
Unrealized securities gain		57		56
Unrealized investment income	1,197	1,090	1,091	651
Total net income and other comprehensive income	\$ 4,160	\$ 3,803	\$ 12,590	\$ 3,677

The components of Accumulated other comprehensive income on the Consolidated Balance Sheets are as follows (dollars in thousands):

	<b>September 30, 2007</b>	<b>March 31, 2007</b>
Currency forward contract income, net	\$ 24	\$ 854
Currency translation income	9,745	7,263
Unrealized investment loss		(1,092)
Effect of SFAS No. 158	22,197	23,393
Total accumulated other comprehensive income	\$ 31,966	\$ 30,418

**Note 9. Goodwill and Intangible Assets**

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The Company applies SFAS No. 141, Business Combinations, and SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 141 requires that the purchase method of accounting be used for all business combinations. SFAS No. 141 also specifies criteria that intangible assets acquired in a purchase method business combination must meet in order to be recognized and reported apart from goodwill. SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment.

In connection with SFAS No. 142, the Company performed impairment tests of its goodwill and other identifiable intangible assets including indefinite-lived trademarks, as well as patents and technology that have definite lives and will continue to be amortized.



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For purposes of determining the fair value of its trademarks, the Company utilizes a discounted cash flow model which considers the costs of royalties in the absence of trademarks owned by the Company. Based upon the Company's analysis of legal, regulatory, contractual, competitive and economic factors, the Company deemed that trademarks, which consist of the KEMET trade name and logo, have an indefinite useful life because they are expected to contribute to cash flows indefinitely.

The Company's goodwill is tested for impairment at least on an annual basis. The impairment test involves a comparison of the fair value of its reporting units as defined under SFAS No. 142, with carrying amounts. If the reporting unit's aggregated carrying amount exceeds its fair value, then an indication exists that the reporting unit's goodwill may be impaired. The impairment to be recognized is measured by the amount by which the carrying value of the reporting unit being measured exceeds its fair value, up to the total amount of its assets.

KEMET performs its impairment test during the first quarter of each fiscal year and when otherwise warranted. KEMET performed this impairment test in the quarters ended June 30, 2007 and 2006 and concluded that no goodwill impairment existed.

On April 24, 2007, the Company acquired the Evox Rifa Group Oyj, for a purchase price of approximately \$40.8 million, including approximately \$3.5 million for acquisition related costs. The acquisition included manufacturing operations as well as certain research and development, marketing, and sales functions in various locations, primarily within Europe. This acquisition increased goodwill by \$21.8 million and increased amortized intangibles by \$3.7 million.

On April 13, 2006, the Company acquired the tantalum business unit of EPCOS AG (EPCOS), for a purchase price of approximately \$105.7 million. The acquisition included the EPCOS tantalum capacitor manufacturing operation in Evora, Portugal as well as certain research and development, marketing, and sales functions in various locations, primarily within Europe. This acquisition increased goodwill by \$4.1 million and increased amortized intangibles by \$2.9 million.

The following chart highlights the Company's goodwill and intangible assets (dollars in thousands):

	September 30, 2007		March 31, 2007	
	Carrying Amount	Accumulated Amortization	Carrying Amount	Accumulated Amortization
<b><u>Unamortized Intangibles:</u></b>				
Goodwill	\$ 58,012		\$ 36,552	
Trademarks	7,617		7,617	
Unamortized intangibles	65,629		44,169	
<b><u>Amortized Intangibles:</u></b>				
Patents, trademarks and technology - 2-25 years	19,984	\$ 11,012	16,297	\$ 10,351
Other -3-10 years	1,726	1,048	1,725	1,028
Amortized intangibles	21,710	12,060	18,022	11,379
	\$ 87,339	\$ 12,060	\$ 62,191	\$ 11,379

The expected amortization expense for the fiscal years ending March 31, 2008, 2009, 2010, 2011 and 2012 is \$1,787, \$1,432, \$1,319, \$1,156, and \$1,100, respectively.

**Note 10. Income Taxes**

During the three months ended September 30, 2007, the net income tax benefit is comprised of a \$1.1 million income tax benefit from U.S. competent authority relief related to intercompany transfer pricing with the Company's Mexican subsidiary, \$0.7 million foreign income tax expense and minor federal and state income tax expense.

During the six months ended September 30, 2007, the Company recognized a \$2.5 million income tax benefit from the recognition of credits due to a change in Texas tax law and a \$1.1 million income tax benefit related to competent authority relief on a transfer pricing adjustment. In addition, the Company recognized \$1.8 million of foreign income tax expense and minor federal and state income tax expense.

During the three and six months ended September 30, 2006, the income tax expense is principally a result of profitable foreign subsidiaries.

The Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN No. 48 ), on April 1, 2007. As a result of the implementation of FIN No. 48, the Company recognized a decrease of \$4.2 million in the liability for unrecognized tax benefits, which was accounted for as a \$3.7 million increase to the April 1, 2007 balance of retained earnings and a \$0.5 million reduction of goodwill. As of the date of adoption, the Company had approximately \$5.7 million of unrecognized tax benefits, of which \$2.7 million if recognized would favorably affect the Company's effective tax rate. At September 30, 2007, the Company had approximately \$4.2 million of unrecognized tax benefits.

The Company files income tax returns in the U.S. and multiple foreign jurisdictions, including various state and local jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local tax examinations for years before fiscal year 2004 and is no longer subject to foreign income tax examinations by tax authorities for years before fiscal year 2002.

The Company recognizes potential accrued interest and penalties related to unrecognized tax benefits within its global operations in income tax expense. In conjunction with the adoption of FIN No. 48, the Company continued this practice and had approximately \$0.1 million of accrued interest and penalties at April 1, 2007, which is included as a component of income tax expense. During the three months ended September 30, 2007, the Company recognized approximately \$3.0 thousand in potential interest associated with uncertain tax positions. The Company also recognized a \$0.1 million benefit for the expiration of an uncertain tax position and related interest and penalties. To the extent interest and penalties are not assessed with respect to uncertain tax positions, amounts accrued will be reduced and reflected as a reduction of the overall income tax provision.

The Company anticipates that total unrecognized tax benefits will decrease by approximately \$0.8 million due to the settlement of foreign tax issues if resolved prior to September 30, 2008. Mexico has recently enacted tax reforms for 2008 which will impact the quarter ending December 31, 2007. The Company is currently evaluating the impact the new reforms will have on its results of operations and financial condition.

#### **Note 11. Segment and Geographic Information**

KEMET is organized into three distinct business groups: the Tantalum Business Group ( Tantalum ) the Ceramic Business Group ( Ceramic ) and the Film and Electrolytic Business Group ( Film and Electrolytic ). Each business group is responsible for the operations of certain manufacturing sites as well as all related research and development efforts. The sales and marketing functions are shared by the business groups and are allocated to each business group based on the business groups' respective manufacturing costs. In addition, all corporate costs are also allocated to the business groups based on the business groups' respective manufacturing costs. On April 24, 2007, KEMET acquired Evox Rifa Group Oyj ( Evox Rifa ). Accordingly, the results from the acquisition date through the end of the quarter have been included in Film and Electrolytic's results.

##### *Tantalum Business Group*

The Tantalum Business Group operates in six manufacturing sites in the United States, Mexico, China, and Portugal. This business group produces tantalum and aluminum capacitors. The business group also maintains a product innovation center in the United States and a research and development center in Heidenheim, Germany.

*Ceramic Business Group*

The Ceramic Business Unit operates in three manufacturing locations in Mexico and China. This business group produces ceramic capacitors. In addition, the business group also has a product innovation center in the United States.

*Film and Electrolytic Business Group*

The Film and Electrolytic Business Group operates in six manufacturing sites in Europe and Asia. This business group produces film, paper, and electrolytic capacitors. In addition, the business group also has a product innovation center in Sweden.

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The following table summarizes information about each group's net sales, operating income/(loss), depreciation and amortization and total assets (dollars in thousands):

	Three months ended September 30,		Six months ended September 30,	
	2007	2006	2007	2006
<b>Net sales:</b>				
Tantalum	\$ 108,263	\$ 109,160	\$ 213,596	\$ 220,118
Ceramic	58,978	57,388	114,036	115,999
Film & Electrolytic	29,888		52,616	
Total	\$ 197,129	\$ 166,548	\$ 380,248	\$ 336,117
<b>Operating income/(loss) (1):</b>				
Tantalum	\$ 2,183	\$ 1,462	\$ 8,571	\$ 3,572
Ceramic	(236)	554	(1,574)	(1,089)
Film & Electrolytic	1,415		2,519	
Total	\$ 3,362	\$ 2,016	\$ 9,516	\$ 2,483
<b>Depreciation/amortization expenses:</b>				
Tantalum	\$ 8,693	\$ 6,763	\$ 16,626	\$ 12,499
Ceramic	3,262	3,308	6,889	7,195
Film & Electrolytic	1,242		1,778	
Total	\$ 13,197	\$ 10,071	\$ 25,293	\$ 19,694

	September 30, 2007	March 31, 2007
<b>Total assets:</b>		
Tantalum	\$ 536,355	\$ 609,902
Ceramic	316,835	333,624
Film & Electrolytic	94,321	
Total	\$ 947,511	\$ 943,526

(1) Restructuring charges included in Operating income/(loss) were as follows:

	Three months ended September 30,		Six months ended September 30,	
	2007	2006	2007	2006
<b>Total restructuring:</b>				
Tantalum	\$ 4,877	\$ 2,358	\$ 6,744	\$ 5,163
Ceramic	1,108	1,057	1,790	2,927
Total	\$ 5,985	\$ 3,415	\$ 8,534	\$ 8,090

The Company manages its capital expenditures for long-lived assets on a consolidated basis; therefore, this information has been excluded on a reporting segment basis.

The following highlights the Company's net sales by geographic location:

	Three months ended September 30, (1)		Six months ended September,	
	2007	2006 (1)	2007	2006 (1)
United States	\$ 52,649	\$ 47,220	\$ 101,170	\$ 99,011
Hong Kong	28,206	30,121	55,284	57,324
China	24,720	16,121	43,349	34,493
Germany	20,747	15,925	36,284	27,369
Asia Pacific (2)	14,664	16,616	26,700	32,276
Singapore	10,246	10,390	18,853	23,512
Mexico	4,296	4,524	8,235	9,107
Other countries (2)	41,601	25,631	90,373	53,025
	\$ 197,129	\$ 166,548	\$ 380,248	\$ 336,117

(1) - Revenues are attributed to countries or regions based on the location of the customer. The Company sold \$27,705 and \$19,670 to two customers, each of which accounted for more than 10% of net sales in the fiscal quarter ended September 30, 2006. The Company did not have sales to any customer which accounted for more than 10% of net sales in the fiscal quarter ended September 30, 2007.

(2) - No country included in these captions exceeded 5% of consolidated net sales for the fiscal quarters ending September 30, 2007 and 2006.

## Note 12. Concentrations of Risks

### *Sales and Credit Risk*

The Company sells to customers located throughout the world. Credit evaluations of its customers' financial condition are performed periodically, and the Company generally does not require collateral from its customers. In October 2005, a customer of the Company filed for protection under Chapter 11 of the U.S. Bankruptcy Code. At the time of the filing, the Company had open trade receivables due from the customer of \$0.9 million. Accordingly, the Company has provided an allowance for doubtful accounts of \$0.3 million to account for any potential write-off of the open trade receivables. The Company will continue to monitor the situation during subsequent quarters to determine if additional amounts will be deemed to be uncollectible.

Electronics distributors are an important distribution channel in the electronics industry and accounted for approximately 54%, 58% and 52% of the Company's net sales in fiscal years 2007, 2006, and 2005, respectively. For the three months ended September 30, 2007, sales to electronics distributors accounted for approximately 47% of the Company's net sales. For the three months ended September 30, 2006, sales to electronics distributors accounted for approximately 50% of the Company's net sales. As a result of the Company's concentration of sales to electronics distributors, the Company may experience fluctuations in its operating results as electronics distributors experience fluctuations in end-market demand or adjust their inventory stocking levels.

At September 30, 2007 and March 31, 2007, no customer accounted for more than 10% of the Company's accounts receivable balance.

*Performance Bond and Bank Guarantee*

During April 2006 and in conjunction with a contractual provision in a commercial agreement, KEMET put in place a performance bond in the amount of EUR 2.5 million through a European bank. A corresponding interest-bearing deposit was placed with a European bank. The deposit is in KEMET's name and KEMET receives all interest earned by this deposit. However, the deposit is pledged to the European bank, and the bank can use the money should a valid claim be made against the bond. The bond is valid until March 31, 2008.

A guarantee was issued by a European bank on behalf of the Company in August 2006 in conjunction with the establishment of a Valued-Added Tax ( VAT ) registration in The Netherlands. The bank guarantee is in the amount of EUR 1.5 million. A corresponding interest-bearing deposit was placed with a European bank. The deposit is in KEMET s name and KEMET receives all interest earned by this deposit. However, this deposit is pledged to the European bank, and the bank can use these funds should a valid claim be made. The bank guarantee has no expiration date.

### *Employees*

As of September 30, 2007, KEMET had approximately 10,000 employees, of whom approximately 900 were located in the United States, 5,900 were located in Mexico, 2,000 in Asia, and 1,200 in Europe. The Company believes that its future success will depend in part on its ability to recruit, retain, and motivate qualified personnel at all levels of the Company. While none of its United States employees are unionized, the Company has approximately 4,900 hourly employees in Mexico represented by labor unions as required by Mexican law. The Company also has approximately 400 employees in Portugal represented by labor unions. The Company has not experienced any major work stoppages and considers its relations with its employees to be good. In addition, the Company s labor costs in Mexico, China, Indonesia, and various locations in Europe are denominated in local currencies, and a significant depreciation of the United States dollar against the local currencies would increase the Company s labor costs in these areas.

### **Note 13. Property Held for Sale**

As a result of moving manufacturing operations from the United States to lower cost facilities a certain manufacturing facility located in the United States is no longer in use and is held for sale according to SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets . The carrying value of the facility at September 30, 2007, was \$2.4 million and is separately presented in the Property held for sale line item on the Consolidated Balance Sheets. At September 30, 2007, the fair value is believed to approximate carrying value based on independent appraisals. The Company does not anticipate any remediation costs in selling the property. On a quarterly basis, management reviews this value for indications of impairment.

### **Note 14. Stock-based Compensation**

On April 1, 2006, the Company adopted SFAS No. 123(R), which requires the measurement and recognition of compensation expense, based on estimated fair values, for all share-based awards made to employees and directors, including stock options and restricted stock.

In adopting SFAS No. 123(R), the Company elected the modified prospective application transition method as of April 1, 2006, the first day of the Company s fiscal year 2007.

### **Employee Stock Options**



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At September 30, 2007, the Company had three option plans that reserved shares of common stock for issuance to executives and key employees: the 1992 Key Employee Stock Option Plan, the 1995 Executive Stock Plan, and the 2004 Long-Term Equity Incentive Plan. All of these plans were approved by the Company's shareholders. These plans authorized the grant of up to 8.1 million shares of the Company's common stock. The Company has no plans to purchase additional shares in conjunction with its employee stock option program in fiscal year 2008. Options issued under these plans vest in one to two years and expire ten years from the grant date.

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Employee stock option activity for the six months ended September 30, 2007 is as follows:

	Shares (in thousands)	Weighted- average Exercise Price	Weighted- average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in millions)
Outstanding at March 31, 2007	4,519	\$ 10.84		
Granted	3	7.64		
Exercised	(22)	5.96		
Forfeited	(17)	7.32		
Expired	(29)	13.07		
Outstanding at September 30, 2007	4,454	\$ 10.88	5.9	\$ 0.5
Exercisable at September 30, 2007	3,549	\$ 11.72	5.2	\$ 0.4

The Company measures the fair value of each employee stock option grant at the date of grant using a Black-Scholes option pricing model with the following assumptions

Assumptions:	Six months ended September 30,	
	2007	2006
Dividend yield	0%	0%
Expected volatility	43.5%	49.2%
Risk-free interest rate	4.3%	5.0%
Expected option lives in years	6.0	6.0

The dividend yield is based on a set dividend rate of 0.0% as the Company has not paid and does not anticipate paying dividends. The expected volatility is based on a six-year historical volatility of the Company's stock. The risk-free rate is based on the U.S. Treasury yield with a maturity commensurate with the expected term, which was six years for the six months ended September 30, 2007 and 2006, respectively. The six-year expected term is based on the safe harbor calculation which considers the weighted-average vesting, contractual term and two-year cliff vesting. The weighted-average grant-date fair value of options granted during the six months ended September 30, 2007 and 2006 was \$3.65 and \$3.21 per share, respectively. The compensation expense associated with these three stock option plans was approximately \$0.4 million and \$1.0 million for the three and six months ended September 30, 2007. The compensation expense associated with these three stock option plans was approximately \$0.5 million and \$0.9 million for the three and six months ended September 30, 2006. The expense was recorded as Selling, general and administrative expenses in the Consolidated Statements of Operations.

The total intrinsic value of options exercised during the six months ended September 30, 2007 and 2006 was \$0.04 million and \$0.2 million, respectively. Total unrecognized compensation cost related to non-vested options was \$1.4 million as of September 30, 2007. This cost is expected to be recognized over a weighted-average period of one year and six months. During the three months ended September 30, 2007, approximately 610,000 shares vested with a total fair value of approximately \$2.0 million.

### Restricted Stock

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Through September 30, 2007, the Company has issued approximately 178,000 shares of restricted stock to members of the Board of Directors and the Chief Executive Officer. Restricted stock granted to the Board of Directors vests in one year while

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restricted stock granted to the Chief Executive Officer vests immediately. The weighted-average contractual term on restricted stock is indefinite. Restricted stock activity for the six months ended September 30, 2007 is as follows:

	Shares (in thousands)	Weighted- average Issuance Price	Aggregate Intrinsic Value (in millions)
Outstanding at March 31, 2007	65	\$ 9.65	
Granted	113	8.21	
Exercised or repurchased			
Forfeited			
Expired			
Outstanding at September 30, 2007	178	\$ 8.82	\$ 1.4

The compensation expense associated with the restricted stock issued to the members of the Board of Directors was approximately \$0.03 million and \$0.07 million for the three and six months ended September 30, 2007. The compensation expense associated with the restricted stock issued to the Chief Executive Officer was approximately \$0.8 million for the six months ended September 30, 2007. The compensation expense associated with the restricted stock issued to the members of the Board of Directors was approximately \$0.03 million and \$0.09 million for the three and six months ended September 30, 2006. The compensation expense associated with the restricted stock issued to the Chief Executive Officer was approximately \$0.6 million for the six months ended September 30, 2006. The compensation expense was recorded as Selling, general and administrative expenses in the Consolidated Statements of Operations.

In connection with the grant of restricted stock to the Chief Executive Officer in the first quarter of 2006, the election was made by the Chief Executive Officer to satisfy the applicable Federal income tax withholding obligation arising from the grant of the restricted stock by a net share settlement, pursuant to which the Company withheld 12,500 shares of the restricted stock grant (out of the 50,000 shares granted) and used the deemed proceeds from those shares to pay the Federal income tax withholding. The net share settlement is deemed to be a repurchase by the Company of its equity securities.

### Executive Performance Stock Awards

Through September 30, 2007, the Company has issued 500,000 performance awards which will entitle the holder to receive shares of common stock if and when the stock price maintains certain thresholds as compared to prescribed stock prices. These awards are open ended until they vest and will have a ten-year life after vesting or will expire on the third year following retirement, whichever comes first. At September 30, 2007, none of these awards have vested due to the stock price not having reached the first exercise threshold. The weighted-average contractual term on performance stock awards is indefinite.

Performance stock award activity for the six months ended September 30, 2007 is as follows:

	Shares (in thousands)	Weighted- average Issuance Price
Outstanding at March 31, 2007	500	\$ 8.05

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Granted			
Exercised			
Forfeited			
Expired			
Outstanding at September 30, 2007	500	\$	8.05
Exercisable at September 30, 2007		\$	

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The Company measures the fair value of each performance stock award at the date of grant using the Monte Carlo option pricing model with the following assumptions:

Assumptions:	Six months ended September 30,	
	2007	2006
Dividend yield	0%	0%
Expected volatility	43.5%	49.2%
Risk-free interest rate	4.3%	4.5%
Expected option lives in years	6.0	6.0

The dividend yield is based on a set dividend rate of 0.0% as the Company has not paid and does not anticipate paying dividends. The expected volatility is based on a six-year historical volatility of the Company's stock. The risk-free interest rate is based on the U.S. Treasury yield with a maturity commensurate with the term, which was ten years for the six months ended September 30, 2007 and 2006, respectively. The weighted-average grant-date fair value of awards granted during the six months ended September 30, 2007 and 2006 was \$0.68 per share. The compensation expense associated with the performance stock was approximately \$2.8 million for the six months ending September 30, 2006.

### Performance Stock Awards

#### Fiscal Year 2007 Awards

Through September 30, 2007, the Company has issued 345,086 performance awards which will entitle the holders to receive 172,543 shares of common stock in May 2008 if certain performance measures are met as compared to a peer group index and to receive 172,543 shares if the Company met a prescribed two year earnings per share target. These awards vest on the measurement date of May 15, 2008, and can be achieved exclusively. The weighted-average contractual term on performance awards is indefinite. Performance award activity for the six months ended September 30, 2007 is as follows:

	Shares (in thousands)	Weighted- average Issuance Price
Outstanding at March 31, 2007	345	\$ 8.36
Granted		
Exercised		
Forfeited		
Expired		
Outstanding at September 30, 2007	345	\$ 8.36
Exercisable at September 30, 2007		\$

The Company measures the fair value of each peer company performance stock award at the date of grant using the Monte Carlo option pricing model with the following assumptions:

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Six months ended  
September 30, 2007

Assumptions:

Dividend yield	0%
Expected volatility	38.0%
Risk-free interest rate	4.3%
Expected option lives in years	0.5

The dividend yield is based on a set dividend rate of 0.0% as the Company has not paid and does not anticipate paying dividends. The expected volatility is based on a six-year historical volatility of the Company's stock. The risk-free interest rate is based on the U.S. Treasury yield with a maturity commensurate with the term, which was ten years for the six months ended September 30, 2007. The weighted-average grant-date fair value of performance awards granted during the fiscal year 2006 was \$1.62 per share.

The Company assessed the likelihood of meeting the earnings per share performance stock award and deemed that for the quarter ended September 30, 2007, the target will be achieved. The compensation costs of these awards will be expensed quarterly over the next two quarters ending March 31, 2008. The Company will continue to monitor the likelihood of whether the earnings per share target will be met and will adjust the compensation expense to match expectations.

The compensation expense associated with the performance awards was approximately \$0.6 million and \$1.3 million for the three and six month periods ending September 30, 2007 and was recorded as Selling, general and administrative expenses in the Consolidated Statements of Operations.

#### Fiscal Year 2008 Awards

Through September 30, 2007, the Company has issued 383,293 performance awards which will entitle the holders to receive 134,153 shares of common stock of the Company in May 2009 if certain performance measures are met as compared to a S&P 600 Smallcap index and to receive 249,140 shares of common stock of the Company if the Company meets a prescribed two year earnings per share target. These awards vest on the measurement date of May 15, 2009, and can be achieved exclusively. The weighted-average contractual term on performance awards is indefinite. Performance award activity for the six months ended September 30, 2007 is as follows:

	Shares (in thousands)	Weighted- average Issuance Price
Outstanding at March 31, 2007		\$
Granted	383	7.77
Exercised		
Forfeited		
Expired		
Outstanding at September 30, 2007	383	\$ 7.77
Exercisable at September 30, 2007		\$

The Company measures the fair value of each peer company performance stock award at the date of grant using the Monte Carlo option pricing model with the following assumptions:

	Six months ended September 30, 2007
Assumptions:	
Dividend yield	0%
Expected volatility	38.0%



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Risk-free interest rate	4.3%
Expected option lives in years	1.5

The dividend yield is based on a set dividend rate of 0.0% as the Company has not paid and does not anticipate paying dividends. The expected volatility is based on a six-year historical volatility of the Company's stock. The risk-free interest rate is based on the U.S. Treasury yield with a maturity commensurate with the term, which was ten years for the six months ended September 30, 2007.

The Company assessed the likelihood of meeting the earnings per share performance stock award and deemed that for the quarter ended September 30, 2007, the target will be achieved. The compensation costs of these awards will be expensed quarterly over the next six quarters ending March 31, 2009. The Company will continue to monitor the likelihood of whether the earnings per share target will be met and will adjust the compensation expense to match expectations.

The compensation expense associated with the performance awards was approximately \$0.3 million and \$0.7 million for the three and six month periods ending September 30, 2007 and was recorded as Selling, general and administrative expenses in the Consolidated Statements of Operations.

All options plans provide that options to purchase shares be supported by the Company's authorized but unissued common stock or treasury stock. All restricted stock and performance awards are also supported by the Company's authorized but unissued common stock or treasury stock. The prices of the options granted pursuant to these plans are not less than 100% of the value of the shares on the date of the grant.

In the Operating activities of the Consolidated Statements of Cash Flows, stock-based compensation expense was treated as an adjustment to Net income for the six months ended September 30, 2007. No tax benefit was realized from stock options exercised during the six months ended September 30, 2007.

#### **Note 15. Acquisitions**

##### ***Evox Rifa Group Oyj***

On April 24, 2007, pursuant to the terms of a Combination Agreement between KEMET Electronics Corporation ( KEMET Electronics ), a wholly owned subsidiary of KEMET Corporation, and Evox Rifa Group Oyj ( Evox Rifa ), the Company successfully purchased approximately 92.7% of Evox Rifa pursuant to a tender offer which commenced on March 12, 2007, and was completed on April 12, 2007. Evox Rifa had 178,156,018 shares outstanding at the time of the commencement of the tender offer. KEMET purchased approximately 165.2 million shares at a price of EUR 0.12 per share or approximately EUR 19.8 million (approximately \$27.0 million). KEMET announced at the time that it intended to acquire the remaining outstanding shares pursuant to a squeeze-out process. Following the settlement of the completion trades relating to the tender offer, Evox Rifa has become a subsidiary of KEMET. In September 2007, the Company completed the squeeze-out process and accordingly purchased the remaining outstanding shares of Evox Rifa for EUR 1.6 million (approximately \$2.2 million). This additional amount is considered part of the purchase price of the acquisition.

In addition, pursuant to the tender offer, KEMET offered to acquire all of the outstanding loan notes under the convertible capital loan issued by Evox Rifa for a consideration corresponding to the aggregate of the nominal amount per loan note of EUR 100 plus accrued interest up to and including the closing date of the tender offer. The outstanding amount of the loan notes and accrued interest at the time of the commencement of the tender offer totaled approximately EUR 5.9 million (approximately \$8.1 million). Holders of approximately 95.7% of the convertible capital loan notes issued by Evox Rifa tendered their loan notes pursuant to the tender offer and consequently, KEMET redeemed these notes as of April 24, 2007. In addition to the payment made for the shares and loan notes, KEMET assumed approximately EUR 19.2 million (approximately \$26.1 million) in outstanding indebtedness of Evox Rifa.

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The total purchase price for Evox Rifa was \$40.8 million which includes (dollars in millions):

Common stock purchases	\$	29.2
Purchase of convertible debt		8.1
Acquisition related costs		3.5
Total purchase price	\$	40.8

The Company is in the process of finalizing the purchase accounting, including the appraisal of the newly acquired assets. However, the Company does not believe that there will be a material difference in the amounts booked as of the date of this report.

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The purchase price was determined through arms-length negotiations between representatives of the Company and Evox Rifa.

The acquisition of Evox Rifa, included in operating results from the acquisition date, was accounted for using the purchase method of accounting and, accordingly, the purchase price was allocated to the assets purchased and liabilities assumed based upon their fair values at the date of the acquisition. The fair values of the assets acquired and the liabilities assumed were \$92.7 million and \$54.9 million, respectively. The allocation of the purchase price is based upon preliminary estimates of the fair value. The actual allocation of the purchase price may differ from the preliminary allocation due to refinements of the fair value of the net assets acquired. The excess of the purchase price over the fair values of the net asset acquired of \$21.8 million was recorded as goodwill. Approximately \$3.7 million has been allocated to intangible assets other than goodwill.

### Pro Forma Information:

The following presents the pro forma (unaudited) results for the three and six months ended September 30, 2007 and 2006, respectively assuming the acquisition of Evox Rifa had occurred on April 1, 2006 (dollars in thousands, except per share amounts):

	Three month period ended September 30,		Six month period ended September 30,	
	2007	2006	2007	2006
Net sales	\$ 197,129	\$ 194,944	\$ 387,303	\$ 393,298
Net income	\$ 4,010	\$ 1,291	\$ 8,920	\$ 874
Net income per share:				
Basic	\$ 0.05	\$ 0.01	\$ 0.11	\$ 0.01
Diluted	\$ 0.05	\$ 0.01	\$ 0.11	\$ 0.01

The above amounts for the three and six month periods ended September 30, 2007 and 2006 reflect adjustments for depreciation for the revalued properties, amortization of the intangibles acquired, a reduction in interest income for the cash used to purchase the business, a reduction in the interest expense on the convertible notes that KEMET purchased, and related tax effects for the aforementioned adjustments. These results also assume that KEMET owned 100.0% of Evox Rifa for each of the periods presented. The pro forma amounts do not include anticipated synergies from the acquisition.

The pro forma information, as presented above, is not necessarily indicative of the results which would have been obtained had the transaction occurred on April 1, 2006, nor is it necessarily indicative of the Company's future results.

In connection with the acquisition, the Company assumed the existing and outstanding debt, of approximately \$22.0 million at April 24, 2007. Since the acquisition, KEMET has repaid approximately \$12.4 million of this debt. At September 30, 2007, the remaining debt balance is \$9.6 million. The effective interest rates on these bank loans range from 2.5% to 8.3%. The maturity of the bank loans is as follows: within 12 months - \$2.1 million; 13-24 months - \$4.6 million; 25-36 months - \$0.8 million; 37-48 months - \$1.1 million; thereafter - \$1.0 million.

### *Tantalum Business of EPCOS AG*

In fiscal year 2007, the Company purchased the tantalum business of EPCOS AG, a German corporation ( EPCOS ) for a total purchase price of EUR 86.7 million (approximately \$105.7 million). The acquisition of the tantalum business unit of EPCOS, included in operating results from the acquisition date and as of the end of the transition date, was accounted for using the purchase method of accounting and, accordingly, the purchase price was allocated to the assets purchased and liabilities assumed based upon their fair values at the date of the acquisition. The fair values of the assets acquired and the liabilities assumed were \$137.8 million and \$42.5 million, respectively. The excess of the purchase price over the fair values of the net asset acquired of \$5.6 million was recorded as goodwill. Approximately \$2.9 million has been allocated to intangible assets other than goodwill.

The Company did not present pro forma information for the three months ended June 30, 2006 due to the consummation of the acquisition near the beginning of the Company's reporting period, and because the Company did not have access to the actual operating results for the thirteen day period beginning April 1, 2006.

In connection with the acquisition of the tantalum business unit of EPCOS, the Company became party to an agreement between EPCOS - Peces e Componentes Electronicos, S.A. (whose name was changed post-acquisition to KEMET Electronics Portugal, S.A. ( KEP )) and the Government of Portugal relating to certain investment contracts aimed to expand the manufacturing capacities of KEP. As a consequence, KEP has received non-interest bearing loans, two of which are outstanding as of September 30, 2007. Repayments are made in various installments, as noted below. Repayment of these loans is guaranteed by a bank. One of the loans matures on December 28, 2007 and the other loan matures on December 28, 2010. If KEP fulfills its obligations for the entire period under the investment contracts, the loans will be forgiven up to 60% of the outstanding amounts. The two obligations to be fulfilled by KEP include the hiring of a specified number of employees and the achievement of agreed-upon production levels. At September 30, 2007, the outstanding indebtedness was \$3.9 million.

#### **Note 16. Convertible Debt**

On November 1, 2006, KEMET Corporation ( the Company ) sold and issued \$160.0 million in convertible senior notes to qualified institutional buyers pursuant to Rule 144A of the Securities Act of 1933, as amended (the Notes ). The Notes are unsecured obligations and rank equally with the Company s existing and future unsubordinated and unsecured obligations and are junior to any of the Company s future secured obligations to the extent of the value of the collateral securing such obligations. In connection with the issuance and sale of the Notes, the Company entered into an indenture (the Indenture ) dated as of November 1, 2006, with Wilmington Trust Company as trustee.

In connection with the above referenced transaction, the Company also granted the initial purchasers a 30-day option to purchase up to \$15.0 million aggregate principal amount of additional Notes. The Initial Purchasers exercised this option on November 9, 2006, thereby resulting in the sale of an additional \$15.0 million aggregate principal amount of the Notes on November 13, 2006, resulting in a total of \$175.0 million aggregate principal amount of Notes outstanding.

The Notes bear interest at a rate of 2.25% per annum, payable in cash semi-annually in arrears on each May 15 and November 15 beginning May 15, 2007. The Notes are convertible into (i) cash in an amount equal to the lesser of the principal amount of the Notes and the conversion value of the Notes on the conversion date and (ii) cash or shares of the Company s common stock ( Common Stock ) or a combination of cash and shares of the Common Stock, at the Company s option, to the extent the conversion value at that time exceeds the principal amount of the Notes, at any time prior to the close of business on the business day immediately preceding the maturity date of the Notes, unless the Company has redeemed or purchased the Notes, subject to certain conditions. The conversion rate with respect to a Note is initially 103.0928 shares of Common Stock per \$1,000 principal amount of the Notes, which represents an initial conversion price of approximately \$9.70 per share, subject to adjustments. The holder may surrender the holder s Notes for conversion if any of the following conditions is satisfied:

During any fiscal quarter, the closing sale price of the Common Stock for at least 20 trading days in the period of 30 consecutive trading days ending on the last trading day of the preceding fiscal quarter exceeds 130% of the conversion price per share on such last trading day;

The Company has called the Notes for redemption;

The average of the trading prices of the Notes for any five consecutive trading day period is less than 98% of the average of the conversion values of the Notes during that period;

The Company makes certain significant distributions to the holders of the Common Stock; or

In connection with a transaction or event constituting a fundamental change.

The Company received net proceeds from the sale of the Notes of approximately \$170.2 million, after deducting discounts and estimated offering expenses of approximately \$4.8 million. Net proceeds from the sale were used to repurchase approximately 3.3 million shares of Common Stock at a cost of approximately \$24.9 million (concurrent with the initial closing of the Notes offering). Approximately \$4.4 million in debt issuance costs related to the Notes have been recorded as Other assets in the accompanying Consolidated Balance Sheets. Debt issuance costs are being amortized over a period of five years.

The terms of the Notes are governed by the Indenture. The Notes mature on November 15, 2026 unless earlier redeemed, repurchased or converted. The Company may redeem the Notes for cash, either in whole or in part, anytime after November 20, 2011 at a redemption price equal to 100% of the principal amount of the Notes to be redeemed plus accrued and unpaid interest, including additional interest, if any, up to but not including the date of redemption. In addition, holders of the Notes will have the right to require the Company to repurchase for cash all or a portion of their Notes on November 15, 2011, 2016 and 2021, at a repurchase price equal to 100% of the principal amount of the Notes to be repurchased plus accrued and unpaid interest, if any, in each case, up to but not including, the date of repurchase. The Notes are convertible into Common Stock at a rate equal to 30.95 shares per \$1,000 principal amount of the Notes (equal to an initial conversion price of approximately \$9.70 per share), subject to adjustment as described in the Indenture. Upon conversion, the Company will deliver for each \$1,000 principal amount of Notes, an amount consisting of cash equal to the lesser of \$1,000 and the conversion value (as defined in the Indenture) and, to the extent that the conversion value exceeds \$1,000, at the Company's election, cash or shares of Common Stock with respect to the remainder.

If the Company undergoes a fundamental change (as defined in the Indenture), holders of the Notes will have the right, subject to certain conditions, to require the Company to repurchase for cash all or a portion of their Notes at a repurchase price equal to 100% of the principal amount of the Notes to be repurchased plus accrued and unpaid interest, including contingent interest and additional amounts, if any.

The carrying amount of the Notes approximates fair value.

#### **Note 17 Subsequent Events**

##### *Acquisition of Arcotronics Italia S.p.A.*

On October 12, 2007, KEMET Corporation announced that its wholly owned subsidiary, KEMET Electronics Corporation (KEMET Electronics), had purchased all the outstanding shares of Arcotronics Italia S.p.A. (Arcotronics), from Blue Skye (Lux) S.à r.l. The acquisition includes seven manufacturing facilities located in Sasso Marconi, Monghidoro, and Vergato, Italy; Landsberg, Germany; Towchester, United Kingdom; Kyustendil, Bulgaria; and Anting-Shanghai, China.

KEMET Electronics paid EUR 17.5 million for 100% of the outstanding share capital of Arcotronics, assumed net financial debt of approximately EUR 100 million, and certain other liabilities of the company totaling approximately EUR 32 million.

In connection with the acquisition, the Company entered into a Senior Facility Agreement with UniCredit Banca d'Impresa S.p.A (UniCredit) whereby UniCredit agreed to lend to KEMET up to EUR 47,000,000. KEMET Electronics used a portion of this borrowing to repay outstanding indebtedness of Arcotronics, with the balance available for general corporate purposes. The material terms and conditions of the agreement are:

Maturity: 18 months less one day from the date of funding.

Interest Rate: Floating at three month EURIBOR plus 120 basis points.



Amortization: Bullet payment at maturity.

Structure: Unsecured.

The Company is in the process of finalizing the purchase accounting, including the appraisal of the newly acquired assets.

***Portuguese Investment Grants***

In October 2007, KEMET's legal entity in Portugal, received a payment of EUR 900 thousand from the Portuguese government in connection with an investment of capital made in Portugal. As part of the grant, and should KEMET Electronics Portugal, S.A., successfully meet at least 90% of its pre-established targets, up to 60% of the loan will be forgiven. KEMET Electronics Portugal, S.A. will initially record this as debt in October 2007 and will monitor the objectives on a quarterly basis.

## **ITEM 2. Management's Discussion and Analysis of Results of Operations and Financial Condition**

From time to time, information provided by the Company, including but not limited to statements in this report or other statements made by or on behalf of the Company, may contain forward-looking information within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities and Exchange Act of 1934. Such statements involve a number of risks and uncertainties. The Company's actual results could differ materially from those discussed in the forward-looking statements. The cautionary statements set forth in the Company's 2007 Annual Report under the heading Safe Harbor Statement identify important factors that could cause actual results to differ materially from those in any forward-looking statements made by or on behalf of the Company.

### ACCOUNTING POLICIES AND ESTIMATES

The following discussion and analysis of financial condition and results of operations are based on the Company's unaudited consolidated financial statements included herein. The Company's significant accounting policies are described in Note 1 to the consolidated financial statements in KEMET's annual report on Form 10-K for the year ended March 31, 2007. The Company's critical accounting policies are described under the caption Critical Accounting Policies in Item 7 of KEMET's annual report on Form 10-K for the year ended March 31, 2007.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates, assumptions, and judgments. Estimates and assumptions are based on historical data and other assumptions that management believes are reasonable in the circumstances. These estimates and assumptions affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements. In addition, they affect the reported amounts of revenues and expenses during the reporting period.

The Company's judgments are based on management's assessment as to the effect certain estimates, assumptions, or future trends or events may have on the financial condition and results of operations reported in KEMET's unaudited consolidated financial statements. It is important that readers of these unaudited financial statements understand that actual results could differ from these estimates, assumptions, and judgments.

#### **Overview**

KEMET is a leading manufacturer of the majority of capacitor types, including tantalum, multilayer ceramic, solid aluminum capacitors, and after the Evox Rifa acquisition on April 24, 2007, plastic film, paper and electrolytic capacitors. Capacitors are electronic components that store, filter, and regulate electrical energy and current flow and are one of the essential passive components used on circuit boards. Virtually all electronic applications and products contain capacitors, including communication systems, data processing equipment, personal computers, cellular phones, automotive electronic systems, military and aerospace systems, and consumer electronics.

The Company's business strategy is to generate revenues by being the preferred capacitor supplier to the world's most successful electronics original equipment manufacturers, electronics manufacturing services providers, and electronics distributors. The Company reaches these customers through a direct sales force, as well as a limited number of manufacturing representatives, that call on customer locations around the world.

The Company manufactures capacitors in the United States, Mexico, Portugal, China, Indonesia, U.K., Finland, and Sweden. Substantially all of the manufacturing in the United States has been relocated (see Manufacturing Relocation Plan ) to the Company's lower-cost manufacturing facilities in Mexico and China. Production that remains in the U.S. will focus primarily on early-stage manufacturing of new products and other specialty products for which customers are predominantly located in North America.

The market for all of the Company's capacitors is highly competitive. The capacitor industry is characterized by, among other factors, a long-term trend toward lower prices for capacitors, low transportation costs, and few import barriers. Competitive factors that influence the market for the Company's products include product quality, customer service, technical innovation, pricing, and timely delivery. The Company believes that it competes favorably on the basis of each of these factors.

## **Organization**

KEMET is organized into three distinct business groups: the Tantalum Business Group ( Tantalum ) the Ceramic Business Group ( Ceramic ) and the Film and Electrolytic Business Group ( Film and Electrolytic ). Each business group is responsible for the operations of certain manufacturing sites as well as all related research and development efforts. The sales and marketing functions are shared by each of the business groups and are allocated to the business groups. In addition, all corporate costs are also allocated to the business groups.

### *Tantalum Business Group*

The Tantalum Business Group operates in six manufacturing sites in the United States, Mexico, Portugal, and China. This business group produces tantalum and aluminum capacitors. The business unit also maintains a product innovation center in the United States, and a research and development center in Heidenheim, Germany. Sales of Tantalum products are made in all regions in the world.

### *Ceramic Business Group*

The Ceramic Business Group operates in three manufacturing sites in Mexico and China. This business group produces ceramic capacitors. In addition, the business group also has a product innovation center in the United States. Sales of Ceramic products are made in all regions of the world.

### *Film and Electrolytic Business Group*

The Film and Electrolytic Business Group operates in six manufacturing sites in Europe and Asia. This business group designs and manufactures plastic film, paper and electrolytic capacitors. In addition, the business group also has a product innovation center in the Sweden. Sales of Film and Electrolytic products are made in all regions of the world.

## **Business Strategy**

Our strategy is to use our position as a leading, high-quality manufacturer of capacitors to capitalize on the increasingly demanding requirements of our customers. Key elements of our strategy include:

**Ground all of our strategies and business decisions with a focus on both the short-term and long-term financial impact of a particular decision or strategy a profitable company is best able to effectively serve its customers and, in turn, its shareholders, partners and employees.**



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**Continue to be responsive to customers' needs and requirements and show them that their satisfaction is our number one priority by focusing on building products around their needs, giving decision making authority to customer facing personnel and providing purpose built systems and processes such as our Easy-To-Buy-From ( ETBF ) order entry system to make order entry and fulfillment easier, faster, more flexible and more reliable for our customers.**





**Leverage our technological competence to introduce new products in a timely and cost efficient manner and generate an increasing portion of our sales from new products to improve financial performance as well as to meet our customers' varied and evolving capacitor needs. During the second fiscal quarter 2008 the Tantalum Business Group released 25 new products of which 11 were first to market (which is a product not currently supplied by any competitor). In addition, the Ceramic Business Group introduced 21 new discrete products during the quarter.**



Continue to become the **The Capacitance Company** the supplier of choice for all capacitance needs including tantalum, ceramic, film, paper, electrolytic, and solid aluminum capacitors so our customers can reap the benefits of being able to satisfy their varied capacitor product needs through one supplier. While we believe we have the most complete line of capacitor technologies across these primary capacitor types, we intend to continue to research other capacitance technologies and solutions in order to remain at the forefront of this area.



**Pursue activities to maintain our position as a low-cost producer of capacitors with facilities close to our customers. These activities include shifting production to low-cost locations; reducing material and labor costs; developing cost-efficient manufacturing equipment and processes; designing manufacturing plants for efficient production; and reducing work-in-process (WIP) inventory by building products from start to finish in one factory.**

**Continue to evaluate and pursue strategic acquisition opportunities, some of which may be significant in size, that would enable us to enhance our competitive position and expand our market presence. Our objective is to acquire complementary capacitor and other related businesses, including those involved in other passive components that are synergistic with our customer base and provide opportunities to leverage our business model.**



Promote the KEMET brand globally by highlighting the high quality and high reliability of our products and our superior customer service. We intend to continue to implement Lean and Six Sigma methods to drive towards zero product defects so that quality remains a given in the minds of our customers.

#### **Manufacturing Relocation Plan (formerly known as Enhanced Strategic Plan of 2003)**

In July 2003, KEMET announced its manufacturing relocation plan (the plan) to enhance the Company's position as a global leader in passive electronic technologies. KEMET believed that there have been profound changes in the competitive landscape of the electronics industry over the past several years. The Company listened closely to its customers' description of their future directions, and aligned KEMET's future plans closely with their plans. Building on the Company's foundation of success in being the preferred supplier to the world's most successful electronics manufacturers and distributors, KEMET began adapting so as to continue to succeed in the new global environment.

To execute the plan, KEMET substantially reorganized its operations around the world. Several KEMET facilities were relocated based on access to key customers, access to key technical resources and knowledge, and availability of low-cost resources.

#### **KEMET's Global Presence**

##### *KEMET in the United States*

KEMET's corporate headquarters is in Greenville, South Carolina. Individual functions are evolving to support global activities in Asia, Europe, and the Americas, either from Greenville, South Carolina or through locations in appropriate parts of the world.

Commodity manufacturing currently in the United States has been substantially relocated to the Company's lower-cost manufacturing facilities in Mexico and China. There are two remaining moves currently underway which are scheduled to be completed by the end of fiscal year 2008. Production that remains in the United States will focus primarily on early-stage manufacturing of new products and other specialty products for which customers are predominantly located in North America.

To accelerate the pace of innovations, the KEMET Innovation Center was created. The primary objectives of the Innovation Center are to ensure the flow of new products and robust manufacturing processes that are expected to keep the Company at the forefront of its customers' product designs, while enabling these products to be transferred rapidly to the most appropriate KEMET manufacturing location in the world for low-cost, high-volume production. The main campus of the KEMET Innovation Center is located in Greenville, South Carolina.

##### *KEMET in Mexico*

Continue to evaluate and pursue strategic acquisition opportunities, some of which may be significant in size, that w



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KEMET believes its Mexican operations are among the most cost efficient in the world, and they will continue to be the Company's primary production facilities supporting North American and European customers. One of the strengths of KEMET Mexico is that it is truly a Mexican operation, including Mexican management and workers. These facilities will be responsible for maintaining KEMET's traditional excellence in quality, service, and delivery, while driving costs down. The facilities in Victoria and Matamoros will remain focused primarily on tantalum capacitors, and the facilities in Monterrey will continue to focus on ceramic capacitors.

### *KEMET in Asia Pacific*

In recent years, low production costs and proximity to large, growing markets have caused many of KEMET's key customers to relocate production facilities to Asia, particularly China. KEMET has a well-established sales and logistics network in Asia to support its customers' Asian operations. The Company's initial China production facilities in Suzhou near Shanghai commenced shipments in 2003. The Company began shipping products from its second production facility in Suzhou in 2005. Manufacturing operations in China will continue to grow, and KEMET anticipates that production capacity in China may be equivalent to Mexico in the future. Like KEMET Mexico, the vision for KEMET China is to be a Chinese operation, with Chinese management and workers, to help achieve KEMET's objective of being a global company. These facilities will be responsible for maintaining KEMET's traditional excellence in quality, service, and delivery, while accelerating cost-reduction efforts and supporting efforts to grow the Company's customer base in Asia. In connection with the Evox Rifa

acquisition completed on April 24, 2007, the Company has added another Chinese operation in Nantong, China as well as a manufacturing operation in Batam, Indonesia. These operations will continue to support the former Evox Rifa customer base in Asia with top quality film and electrolytic capacitors.

#### *KEMET in Europe*

As previously mentioned, the Company purchased the tantalum business unit of EPCOS AG on April 13, 2006, and also acquired Evox Rifa Group Oyj on April 24, 2007. These acquisitions have provided the Company with manufacturing operations in Europe. The Company now has manufacturing locations in Evora, Portugal; Suomussalmi, Finland; Granna, Sweden; and Weymouth, United Kingdom. In addition, the Company has research and development centers in Heidenheim, Germany and Farjestaden, Sweden. KEMET will maintain and enhance its strong European sales and customer service infrastructure, allowing KEMET to continue to meet the local preferences of European customers who remain an important focus for KEMET going forward.

#### *Global Sales and Logistics*

In recent years, it has become more complex to do business in the electronics industry. Market-leading electronics manufacturers have spread their facilities globally. The growth of the electronics manufacturing services (EMS) industry has resulted in a more challenging supply chain. New Asian electronics manufacturers are emerging rapidly. The most successful business models in the electronics industry are based on tightly integrated supply chain logistics to drive down costs. KEMET's direct salaried force worldwide and a well-developed global logistics infrastructure distinguishes it in the marketplace and will remain a hallmark of KEMET in meeting the needs of its global customers.

#### **Employees**

As of September 30, 2007, KEMET had approximately 10,000 employees, of whom approximately 900 were located in the United States, 5,900 were located in Mexico, 2,000 in Asia, and 1,200 in Europe. The Company believes that its future success will depend in part on its ability to recruit, retain, and motivate qualified personnel at all levels of the Company. While none of its United States employees are unionized, the Company has approximately 4,900 hourly employees in Mexico represented by labor unions as required by Mexican law. The Company also has approximately 400 employees in Portugal represented by labor unions. The Company has not experienced any major work stoppages and considers its relations with its employees to be good. In addition, the Company's labor costs in Mexico, China, Indonesia, and various locations in Europe are denominated in local currencies, and a significant depreciation of the United States dollar against the local currencies would increase the Company's labor costs in these areas.

#### **CONSOLIDATED RESULTS OF OPERATIONS**

##### *Recent Trend in Average Selling Prices*

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Average selling prices for the September 2007 quarter, adjusted for changes in product mix, were down approximately 4% as compared to average selling prices for the June 2007 quarter.

### *Comparison of the Three-Month Period Ended September 30, 2007, with the Three-Month Period Ended September 30, 2006*

#### *Net Sales*

Net sales for the three months ended September 30, 2007, increased 18.4% to \$197.1 million as compared to the same period last year, with 15.2% or \$29.9 million being contributed by the newly acquired Evox Rifa Group Oyj ( Evox Rifa ). The increase in net sales was attributable to an increase in sales volumes to Asia. Unit volumes in the three-month period ended September 30, 2007 increased 12.0% as compared to the same period last year. Mix-adjusted average selling prices for the September 2007 quarter increased approximately 3.0% compared to mix-adjusted average selling prices for the September 2006 quarter.

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By region, 30% of net sales for the three months ended September 30, 2007, were to customers in North America and South America ( Americas ), 39% were to Asia and Pacific Rim ( APAC ), and 31% were to Europe, Middle East and Africa ( EMEA ). For the three months ended September 30, 2006, 32% of net sales were to customers in the Americas, 44% were to APAC, and 24% were to EMEA.

By channel, 47% of net sales for the three months ended September 30, 2007, were to distribution customers, 21% were to Electronic Manufacturing Services customers, and 32% were to Original Equipment Manufacturing customers. For the three months ended September 30, 2006, 50% of net sales were to distribution customers, 25% were to Electronic Manufacturing Services customers, and 25% were to Original Equipment Manufacturing customers.

### *Cost of Sales*

Cost of sales for the three months ended September 30, 2007, was \$159.4 million, or 80.9% of net sales, as compared to \$132.4 million, or 79.5% of net sales, for the same period last year. The increase in cost of sales as a percentage of sales was due to a less favorable product mix partially offset by the Company's cost reduction efforts, to a lesser extent. The Company has continued to experience higher costs in two of its raw materials, palladium and silver. Silver is used by both the Tantalum and Ceramic Business Groups while palladium is used exclusively in the Ceramic Business Group.

### *Selling, General and Administrative Expenses*

Selling, general and administrative ( SG&A ) expenses for the three months ended September 30, 2007, were \$20.2 million, or 10.3% of net sales, as compared to \$21.2 million, or 12.8% of net sales for the same period last year. The SG&A expenses for the three months ended September 30, 2007 include \$3.7 million or 12.4% of net sales related to Evox Rifa. Taking into account the additional expenses associated with Evox Rifa, the decrease quarter over quarter was due primarily to a \$4.6 million decrease in core SG&A expense offset by an increase of SFAS No. 123(R) Share-Based Costs of \$0.9 million and another \$0.5 million for Evox Rifa integration costs.

### *Research and Development Expenses*

Research and development ( R&D ) expenses for the three months ended September 30, 2007, were \$8.2 million, or 4.1% of net sales, as compared to \$7.4 million, or 4.5% of net sales for the same period last year. The R&D expenses for the three months ended September 30, 2007 include \$0.6 million or 2.0% of net sales related to newly acquired Evox Rifa business. The continuing level of R&D expenses reflects the Company's efforts to be the The Capacitance Company. During the quarter, the Company introduced approximately 46 new products of which 11 were first to market.

### *Special Charges*

The Company reports a measure entitled Special Charges. These charges are considered items outside of normal operations, and it is the intent of KEMET to provide an alternative depiction of its operating results. Since some of the items are not considered restructuring charges as defined

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by U.S. generally accepted accounting principles, the Company has provided the breakout of U.S. generally accepted accounting principles restructuring charges and those other charges and adjustments separately.

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A summary of the special charges recognized in the quarters ended September 30, 2007 and 2006 is as follows (dollars in millions):

	Three months ended September 30,	
	2007	2006
Reductions in workforce	\$ 3.3	\$ 1.4
Manufacturing relocation costs	2.7	1.9
Restructuring charges (1)	6.0	3.4
Impact of SFAS No. 123(R) Share-Based Payment		0.5
Acquisitions integration costs	0.6	5.3
Total special charges	\$ 6.6	\$ 9.2

(1) **Restructuring charges** These costs are included as a separate line item on the Consolidated Statements of Operations.

Manufacturing relocation costs are expensed as actually incurred; therefore no liability is recorded in the Consolidated Balance Sheets for these costs. Costs charged to expense are aggregated in the Consolidated Statements of Operations line, Restructuring charges.

*Reductions in workforce* During the three months ended September 30, 2007, the Company had reductions in workforce programs in Portugal, and Germany and a reduction in force of a senior executive. For the three months ended September 30, 2006, the Company recognized a charge of \$1.4 million for a reduction in force in United States, Mexico, and Europe.

*Manufacturing relocations* During the three months ended September 30, 2007 and 2006, the Company incurred expenses of \$2.7 million and \$1.9 million, respectively. These costs are related to the plan. All costs are expensed as incurred.

*Acquisitions integration costs* As part of the Company's recent acquisitions, the Company has and will continue to incur costs to integrate the new businesses into KEMET. In April 2007, KEMET acquired Evox Rifa. In connection with this acquisition and the Company's efforts to integrate Evox Rifa into KEMET, the Company incurred \$0.6 million of costs during the second fiscal quarter of 2008. During fiscal year 2007, KEMET completed the acquisition of the tantalum business of EPCOS AG (EPCOS) on April 13, 2006. During the second quarter of fiscal year 2007, the Company recorded charges of \$5.3 million related to the acquisition which are included in Selling, general and administrative on the Consolidated Statements of Operations. As of March 31, 2007, all integration costs associated with the tantalum business of EPCOS had been incurred.

*Impact of SFAS No. 123(R) Share-Based Payment* In fiscal year 2007, the Company implemented SFAS No. 123(R) Share-Based Payment. During the three month period ended September 30, 2006, the Company recognized a charge of \$0.5 million relating to the cost recognition of issued stock options.

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*Operating Income*

Operating income for the three months ended September 30, 2007, was \$3.4 million, compared to an operating income of \$2.0 million for the quarter ended September 30, 2006. The improvement in the operating income was primarily due to higher sales volumes, lower selling, general and administration costs, partially offset by higher research and development costs. Each of these is discussed above.

*Other Income and Expense*

Interest income was higher in the three months ended September 30, 2007 versus the comparable period in the prior year primarily due to the Company's higher overall cash position created by the Company's newly issued convertible debt offering in November 2006. This also increased the amount of interest expense recorded during the three month period ended September 30, 2007 as compared to the previous year. In addition, additional interest expense was incurred in connection with the acquired debt of Evox Rifa. Other (income)/expense increased in the three months ended September 30, 2007 versus the comparable period of the preceding year due primarily to foreign currency transaction gains in the three-month period ended September 30, 2007.

*Income Taxes*

The income tax benefit totaled \$0.3 million for the three months ended September 30, 2007, compared to an income tax expense of \$0.4 million for the three months ended September 30, 2006. The net income tax benefit is comprised of a \$1.1 million income tax benefit from U.S. competent authority relief related to intercompany transfer pricing with the Company's Mexican subsidiary, \$0.7 million foreign income tax expense and minor federal and state income tax expense.

Management evaluates its tax assets and liabilities on a periodic basis and adjusts these balances on a timely basis as appropriate, based on certain estimates and assumptions and sufficient future taxable income to utilize its deferred tax benefits. If these estimates and related assumptions change in the future, the Company may be required to increase the value of the deferred tax liability, resulting in additional income tax expense.

***Comparison of the Six-Month Period Ended September 30, 2007, with the Six-Month Period Ended September 30, 2006***

*Net Sales*

Net sales for the six months ended September 30, 2007, increased 13.1% to \$380.2 million as compared to the same period last year, with 13.8% or \$52.6 million being contributed by the newly acquired Evox Rifa Group Oyj ( Evox Rifa ). The increase in net sales was attributable to an increase in sales volumes to Asia. Unit volumes in the six-month period ended September 30, 2007 decreased 2.0% as compared to the same period last year. Mix-adjusted average selling prices for the six months ended September 30, 2007 increased approximately 14.0% compared to mix-adjusted average selling prices for the six months ended September 30, 2006.

*Cost of Sales*

Cost of sales for the six months ended September 30, 2007, was \$302.9 million, or 79.7% of net sales, as compared to \$265.2 million, or 78.9% of net sales, for the same period last year. The increase in cost of sales as a percentage of sales was due to a less favorable product mix partially offset by the Company's cost reduction efforts. The Company has, however, continued to experience higher costs in two of its raw materials, palladium and silver. Silver is used by both the Tantalum and Ceramic Business Groups while palladium is used exclusively in the Ceramic Business Group.

*Selling, General and Administrative Expenses*

Selling, general and administrative ( SG&A ) expenses for the six months ended September 30, 2007, were \$42.0 million, or 11.0% of net sales, as compared to \$45.2 million, or 13.4% of net sales for the same period last year. The SG&A expenses for the six months ended September 30, 2007 include \$6.8 million or 12.9% of net sales related to Evox Rifa. Taking into account the additional expenses associated with Evox Rifa, the decrease for the six months ended September 30, 2007 was due primarily to lower SFAS No. 123(R) Share-Based Costs of \$0.6 million and another \$0.7 million decrease in core SG&A expenses.

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*Research and Development Expenses*

Research and development ( R&D ) expenses for the six months ended September 30, 2007, were \$17.2 million, or 4.5% of net sales, as compared to \$15.2 million, or 4.5% of net sales for the same period last year. The R&D expenses for the three months ended September 30, 2007 include \$1.1 million or 2.1% of net sales related to newly acquired Evox Rifa business. The continuing level of R&D expenses reflects the Company s efforts to be the The Capacitance Company. During the six months ended September 30, 2007, the Company introduced approximately 846 new products of which 56 were first to market.

*Special Charges*

The Company reports a measure entitled Special Charges. These charges are considered items outside of normal operations, and it is the intent of KEMET to provide an alternative depiction of its operating results. Since some of the items are not considered restructuring charges as defined by U.S. generally accepted accounting principles, the Company has provided the breakout of U.S. generally accepted accounting principles restructuring charges and those other charges and adjustments separately.

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A summary of the special charges recognized for the six months ended September 30, 2007 and 2006 is as follows (dollars in millions):

	Six months ended September 30,	
	2007	2006
Manufacturing relocation costs	\$ 4.0	\$ 6.5
Personnel reduction cost	4.5	1.5
Asset impairment		0.1
Restructuring charges (1)	8.5	8.1
Business unit integration	0.8	8.0
Impact of SFAS No. 123(R) Share-Based Payment		4.3
Write-off related to the acquisition		0.2
<b>Total special charges</b>	<b>\$ 9.3</b>	<b>\$ 20.6</b>

(1) **Restructuring charges** These costs are included as a separate line item on the Consolidated Statements of Operations.

Manufacturing relocation costs are expensed as actually incurred; therefore no liability is recorded in the Consolidated Balance Sheets for these costs. Costs charged to expense are aggregated in the Consolidated Statements of Operations line, Restructuring charges.

*Reductions in workforce* During the six months ended September 30, 2007, the Company had reductions in workforce programs in Portugal, and Germany and a reduction in force of a senior executive. For the six months ended September 30, 2006, the Company recognized a charge of \$1.5 million for a reduction in force in Europe.

*Manufacturing relocations* During the six months ended September 30, 2007 and 2006, the Company incurred expenses of \$4.0 million and \$6.5 million, respectively. These costs are related to the plan. All costs are expensed as incurred.

*Acquisitions integration costs* As part of the Company's recent acquisitions, the Company has and will continue to incur costs to integrate the new businesses into KEMET. In April 2007, KEMET acquired Evox Rifa. In connection with this acquisition and the Company's efforts to integrate Evox Rifa into KEMET, the Company incurred \$0.8 million of costs during the second fiscal quarter of 2008. During fiscal year 2007, KEMET completed the acquisition of the tantalum business of EPCOS AG (EPCOS) on April 13, 2006. During the six months ended September 30 2006, the Company recorded charges of \$8 million related to the acquisition which are included in Selling, general and administrative on the Consolidated Statements of Operations. As of March 31, 2007, all integration costs associated with the tantalum business of EPCOS had been incurred.

*Impact of SFAS No. 123(R) Share-Based Payment* In fiscal year 2007, the Company implemented SFAS No. 123(R) Share-Based Payment. During the six month period ended September 30, 2006, the Company recognized a charge of

Continue to evaluate and pursue strategic acquisition opportunities, some of which may be significant in size, that w

\$4.3 million relating to the cost recognition of issued stock options.

*Operating Income*

Operating income for the six months ended September 30, 2007, was \$9.5 million, compared to an operating income of \$2.5 million for the six months ended September 30, 2006. The improvement in the operating income was primarily due to higher sales volumes, lower restructuring charges, and lower selling, general and administrative expenses, partially offset by higher research and development expenses. Each of these is discussed above.

*Other Income and Expense*

Interest income was higher in the six months ended September 30, 2007 versus the comparable period in the prior year primarily due to the Company's higher overall cash position created by the Company's newly issued convertible debt offering in November 2006. This also increased the amount of interest expense recorded during the six month period ended September 30, 2007 as compared to the previous year. In addition, additional interest expense was incurred in connection

with the acquired debt of Evox Rifa. Other (income)/expense increased in the six months ended September 30, 2007 versus the comparable period of the preceding year due primarily to a foreign currency transaction gain in the six month period ended September 30, 2007.

#### *Income Taxes*

The income tax benefit totaled \$1.6 million for the six months ended September 30, 2007, compared to an income tax expense of \$0.9 million for the six months ended September 30, 2006. The net income tax benefit is comprised of a \$1.1 million income tax benefit from U.S. competent authority relief related to intercompany transfer pricing with the Company's Mexican subsidiary, a \$2.5 million income tax benefit from the recognition of tax credits due to a change in Texas tax law, \$1.8 million foreign income tax expense and minor federal and state income tax expense.

Management evaluates its tax assets and liabilities on a periodic basis and adjusts these balances on a timely basis as appropriate, based on certain estimates and assumptions and sufficient future taxable income to utilize its deferred tax benefits. If these estimates and related assumptions change in the future, the Company may be required to increase the value of the deferred tax liability, resulting in additional income tax expense.

#### ***Business Groups Comparison of Three-Month Period Ended September 30, 2007, with the Three-Month Period Ended September 30, 2006***

##### ***Tantalum Business Group***

The following presents the summarized results of the Tantalum business group (dollars in millions):

	<b>Three months ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
Net sales	\$ 108.3	\$ 109.2
Operating income	\$ 2.2	\$ 1.5

##### *Net sales*

Unit sales volumes for the three months ended September 30, 2007 were up 34.0% as compared to the same period last year. Average selling prices decreased 6.6% for the September 30, 2007 quarter versus the September 30, 2006 quarter. Volumes for tantalum products continue to be very strong in Asia, representing 43.6% of net sales.

##### *Operating income*

Continue to evaluate and pursue strategic acquisition opportunities, some of which may be significant in size, that w

Operating income was favorably impacted by improvements in material costs and lower restructuring charges in first fiscal quarter 2007 versus first fiscal quarter 2006. As previously stated, selling, general and administrative expenses are allocated to the business groups. The explanations for changes in those costs can be found above.

***Ceramic Business Group***

The following presents the summarized results of the Ceramic business group (dollars in millions):

	Three months ended September 30,			
	2007		2006	
Net sales	\$	59.0	\$	57.4
Operating income/(loss)	\$	(0.2)	\$	0.6

*Net sales*

Unit sales volumes for the three months ended September 30, 2007 increased 9.8% as compared to the same period last year. Average selling prices decreased 8.0% from the quarter ended September 30, 2007 as compared to the same quarter last year.

*Operating income/(loss)*

The Ceramic Business Group incurred a loss during the three months ended September 30, 2007 as compared to net income in the same period in the prior year, despite higher sales, due to a higher percentage of sales to Asia and a shift in product mix, and higher restructuring charges. As previously stated, selling, general and administrative expenses are allocated to the business units. The explanations for changes in those costs can be found above.

***Film and Electrolytic Business Group***

As previously discussed, the Company acquired Evox Rifa in April 2007. In conjunction with this acquisition, the Company determined that the new business was a separate segment and accordingly, is presenting the results for the three months ended September 30, 2007. Comparative numbers are not shown; however, the Company did prepare pro-forma information in the notes to the financial statements.

The following presents the summarized results of the Film and Electrolytic business group (dollars in millions):

	<b>Three months ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
Net sales	\$ 29.9	\$
Operating income	\$ 1.4	\$

***Business Groups Comparison of Six-Month Period Ended September 30, 2007, with the Six-Month Period Ended September 30, 2006***

***Tantalum Business Group***

The following presents the summarized results of the Tantalum business group (dollars in millions):

	<b>Six months ended September 30,</b>	
	<b>2007</b>	<b>2006</b>

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Net sales	\$	213.6	\$	220.1
Operating income	\$	8.6	\$	3.6

*Net sales*

Unit sales volumes for the six months ended September 30, 2007 were up 30.0% as compared to the same period last year. Average selling prices decreased 6.7% for the six months ended September 30, 2007 versus the six months ended September 30, 2006. Volumes for tantalum products continue to be very strong in Asia, representing 43.7% of total net sales.

*Operating income*

Operating income was favorably impacted by improvements in material costs and lower restructuring charges in first fiscal quarter 2007 versus first fiscal quarter 2006. As previously stated, selling, general and administrative expenses are allocated to the business units. The explanations for changes in those costs can be found above.

***Ceramic Business Group***

The following presents the summarized results of the Ceramic business group (dollars in millions):

	<b>Six months ended September 30,</b>			
	<b>2007</b>		<b>2006</b>	
Net sales	\$	114.0	\$	116.0
Operating loss	\$	(1.6)	\$	(1.1)

***Net sales***

Unit sales volumes for the six months ended September 30, 2007 decreased 4.4% as compared to the same period last year. Average selling prices increased 2.8% from the six months ended September 30, 2007 as compared to the same six month period last year.

***Operating income/( loss)***

Operating loss was higher in the six months ended September 30, 2007, as compared to the same period in 2006 due to a higher percentage of sales to Asia and shift in product mix. As previously stated, selling, general and administrative expenses are allocated to the business groups. The explanations for changes in those expenses can be found above.

***Film and Electrolytic Business Group***

As previously discussed, the Company acquired Evox Rifa in April 2007. In conjunction with this acquisition, the Company determined that the new business was a separate segment and accordingly, is presenting the results for the six months ended September 30, 2007. Comparative numbers are not shown; however, the Company did prepare pro-forma information in the notes to the financial statements.

The following presents the summarized results of the Film and Electrolytic business group (dollars in millions):

	<b>Six months ended September 30,</b>			
	<b>2007</b>		<b>2006</b>	
Net sales	\$	52.6	\$	
Operating income	\$	2.5	\$	

**Liquidity and Capital Resources**

Continue to evaluate and pursue strategic acquisition opportunities, some of which may be significant in size, that w



The Company's liquidity needs arise from working capital requirements, capital expenditures, and principal and interest payments on its indebtedness. The Company intends to satisfy its liquidity requirements primarily with existing cash and cash equivalents and cash provided by operations. The overall decrease in liquidity is primarily due to the aforementioned acquisition of Evox Rifa. Additional information regarding the acquisition may be obtained from Note 15 to the Notes to Consolidated Financial Statements in this document.

*Cash from Operating Activities*

Cash flows from operating activities for the six months ended September 30, 2007, provided \$1.7 million as compared to \$7.7 million in the same period of the prior year. The current period increase in operating cash was primarily due to net income of \$11.0 million, non-cash depreciation and amortization of \$26.0 million, and non-cash charges relating to stock-based compensation expense of \$3.8 million and a decrease in inventories. Offsetting these increases in operating cash were decreases in accrued expenses and income taxes.

*Cash from Investing Activities*

Cash flows from investing activities for the six months ended September 30, 2007, used \$17.5 million compared to using \$89.7 million in the same period of the prior year. The Company used \$39.1 million in cash to complete the purchase of

Evox Rifa. In addition, the Company had capital expenditures of \$24.9 million. Offsetting these decreases in investing activities were proceeds of \$46.1 million from the sale of long-term investments.

*Cash from Financing Activities*

Cash flows from financing activities for the six months ended September 30, 2007, used \$31.2 million as compared to \$18.7 million used in the same period in the prior year. This decrease in cash is due to the annual \$20 million principal payment associated with the Company's Senior Notes as well as the repayment of \$11.7 million of the acquired Evox Rifa debt. The Company was in compliance with the covenants under its Senior Note agreement as of the most recent reporting period.

The Company's principal source of net operating cash is from the sale of capacitors. Management believes cash generated from operations together with available cash and investments provides the Company the financial resources needed to meet general business requirements for the next twelve months, including capital expenditures and working capital requirements.

**Commitments**

As of September 30, 2007, the Company had contractual obligations in the form of non-cancelable operating leases, and debt, including interest payments, as follows (dollars in thousands):

	Fiscal years ended March 31,							Total
	Remainder of 2008	2009	2010	2011	2012	Thereafter		
Operating leases	\$ 1,254	\$ 2,223	\$ 1,449	\$ 857	\$ 347	\$ 562	\$ 6,692	
Debt	3,134	26,115	22,330	21,878	772	175,213	249,442	
Interest payments	4,623	7,756	6,241	4,793	4,045	61,074	88,532	
	\$ 9,011	\$ 36,094	\$ 30,020	\$ 27,528	\$ 5,164	\$ 236,849	\$ 344,666	

**Impact of Recently Issued Accounting Standards**

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. FIN No. 48 supplements SFAS No. 109 by defining the confidence level that a tax position must meet in order to be recognized in the financial statements. On April 1, 2007, the Company adopted FIN No. 48. As a result of the adoption, the Company recorded a \$3.7 million increase to the opening retained earnings balance and a \$0.5 million reduction of goodwill. These adjustments represent the cumulative effect of adoption on prior periods. For additional information regarding these adjustments, refer to Note 10, *Income Taxes* to the consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 clarifies that fair value should be based on assumptions that market participants would use when pricing an asset or liability and establishes a fair value hierarchy of three levels that prioritizes the

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information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data. SFAS No. 157 requires fair value measurements to be separately disclosed by level within the fair value hierarchy. The provisions of SFAS No. 157 are effective for fiscal years beginning after November 15, 2007. Generally, the provisions of this statement are to be applied prospectively. Certain situations, however, require retrospective application as of the beginning of the year of adoption through the recognition of a cumulative effect of accounting change. Such retrospective application is required for financial instruments, including derivatives and certain hybrid instruments with limitations on initial gains or losses under EITF Issue 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*. The Company is currently evaluating the impact that SFAS No. 157 will have on its 2009 consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 permits companies to choose to measure certain financial instruments and other certain items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS No. 159 is effective for the Company beginning in the first quarter of fiscal year 2009. The Company is currently evaluating the impact that SFAS No. 159 will have on its 2009 consolidated financial statements.

### **ITEM 3. Quantitative and Qualitative Disclosures About Market Risk**

Market risk disclosure included in the Company's fiscal year ended March 31, 2007, Form 10-K, Part II, Item 7 A, is still applicable and updated through September 30, 2007.

### **ITEM 4. Controls and Procedures**

(a). The Company's management evaluated, with the participation of the Chief Executive Officer and the Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures as of September 30, 2007. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective as of September 30, 2007, which is the end of the period covered by this report.

(b). During the second quarter of fiscal year 2008, there were no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **ITEM 1. Legal Proceedings**

Other than as reported in the Company's fiscal year ended March 31, 2007, Form 10-K under the caption Item 3. Legal Proceedings, the Company is not currently a party to any material pending legal proceedings other than routine litigation incidental to the business of the Company. The ultimate legal and financial liability of the Company with respect to such litigation cannot be estimated with any certainty. However, in the opinion of management, based on its examination of these matters and its experience to date, the ultimate outcome of these legal proceedings, net of liabilities already accrued in the Consolidated Balance Sheets and expected insurance proceeds, is not expected to have a material adverse effect on the Company's consolidated financial position, although the resolution in any reporting period of one or more of these matters could have a significant impact on the Company's results of operations and cash flows for that period.

### **ITEM 1A. Risk Factors**

The risk factors discussed in the Company's fiscal year ended March 31, 2007 Form 10-K, Part I, Item 1A have been updated and are disclosed below.

*Cyclical changes in the electronics industry could result in significant fluctuations in demand for our products, reducing our profitability.*

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Our products are used in the electronics industry, which is a highly cyclical industry. The demand for capacitors tends to reflect the demand for products in the electronics markets. Our customers' requirements for our capacitors fluctuate as a result of changes in general economic activity or other general economic events beyond our control and other factors that affect the demand for their products. During periods of increasing demand for their products, they typically seek to increase their inventory of our products to avoid production bottlenecks. When demand for their products peaks and begins to decline, they may rapidly decrease orders for our products while they use up accumulated inventory. Business cycles vary somewhat in different geographical regions, such as Asia, and within customer industries. We are also vulnerable to general economic events beyond our control and our sales and profits may suffer in periods of weak demand.

*We must consistently reduce the total costs of our products to combat the impact of downward price trends.*

Our industry is intensely competitive and prices for existing products tend to decrease steadily over their life cycle. There is substantial and continuing pressure from customers to reduce the total cost of using our parts. To remain competitive, we must achieve continuous cost reductions through process and product improvements.

We must also be in a position to minimize our customers' shipping and inventory financing costs and to meet their other goals for rationalization of supply and production. Our growth and the profit margins of our products will suffer if our competitors are more successful in reducing the total cost to customers of their products than we are. We must also continue

to introduce new products that offer performance advantages over our existing products and can thereby achieve premium prices, offsetting the price declines in our older products.

***An increase in the cost of our principal raw materials could adversely affect profitability.***

The principal raw materials used in the manufacture of our products are tantalum powder, palladium and silver. These materials are considered commodities and are subject to price volatility. Tantalum powder is primarily purchased under annual contracts, while palladium and silver are primarily purchased on the spot and forward markets, depending on market conditions. For example, if we believe that palladium and silver prices are likely to rise, we may purchase a significant amount of our annual requirements on a forward delivery basis. While the financial impact of these decisions are short-term in nature given that we are not currently party to any long-term supply agreements, they could impact our financial performance from period to period given that we do not hedge any of our raw material exposure and we are not likely to be able to pass on to our customers any fluctuations in our raw material costs. Additionally, any delays in obtaining raw materials for our products could hinder our ability to manufacture our products, negatively impacting our competitive position and our relationships with our customers.

Presently three suppliers process tantalum ore into capacitor-grade tantalum powder. Our management believes that the tantalum we require has generally been available in sufficient quantities to meet our requirements and that there are a sufficient number of tantalum processors relative to foreseeable demand. However, the limited number of tantalum powder suppliers could lead to increases in tantalum prices that we may not be able to pass on to our customers. In fiscal year 2001, for instance, the increase in demand for tantalum capacitors led to tight supplies of tantalum raw material and some tantalum powders resulting in prices increasing from under \$50 per pound early in calendar 2000 to over \$300 per pound in calendar 2001. The average price of tantalum raw material at September 30, 2007 was over \$180 per pound.

Palladium is presently found primarily in South Africa and Russia. Although the palladium we require has generally been available in sufficient quantities, the limited number of palladium suppliers could lead to significant price fluctuations. For instance, in fiscal year 2001 the price of palladium fluctuated between \$554 and \$1,090 per troy ounce. Such price increases and our inability to pass such increases on to our customers could have an adverse effect on profitability.

Silver has generally been available in sufficient quantities, and we believe there are a sufficient number of suppliers from which we can purchase our silver requirements. An increase in the price of silver that we were not able to pass on to our customers, however, could have an adverse affect on our profitability.

***We face intense competition in our business.***

The capacitor business is highly competitive worldwide, with low transportation costs and few import barriers. Competition is based on factors such as product quality and reliability, availability, customer service, timely delivery and price. The industry has become increasingly concentrated and globalized in recent years, and our primary U.S. and non-U.S. competitors, some of which are larger than we are, have significant financial resources. The greater financial resources or the lower amount of debt of such competitors may enable them to commit larger amounts of capital in response to changing market conditions. Some competitors may also have the ability to use profits from their other operations to subsidize losses sustained in their businesses with which we compete. Certain competitors may also develop product or service innovations that could put us at a disadvantage.

Continue to evaluate and pursue strategic acquisition opportunities, some of which may be significant in size, that w

*We manufacture many of our capacitors in various international locations and future political or regulatory changes in any of these regions could adversely affect our profitability.*

Although we have not experienced significant problems conducting operations in various international locations, our international operations are subject to a number of special risks, in addition to the same risks as our domestic business, including currency exchange rate fluctuations, differing protections of intellectual property, trade barriers, labor unrest, exchange controls, regional economic uncertainty, differing (and possibly more stringent) labor regulation, risk of governmental expropriation, domestic and foreign customs and tariffs, current and changing regulatory regimes, differences in the availability and terms of financing, political instability and potential increases in taxes. These factors could impact our production capability or adversely affect our results of operations or financial condition.

***We may not be able to successfully integrate current or future acquisitions with our operations or identify attractive acquisition opportunities in the future.***

Because the markets and industries in which we operate are highly competitive, and due to the inherent uncertainties associated with the integration of acquired companies, we may not be able to integrate current or future acquisitions without encountering difficulties including, without limitation, the loss of key employees and customers, the disruption of the ongoing businesses and possible inconsistencies in standards, controls and procedures. In addition, we may not be able to achieve the expected cost synergies from our purchase of current or future acquisition and we may incur higher than anticipated integration or restructuring costs associated with it. Our business strategy includes growth through select acquisitions of other businesses. However, acquisition opportunities may not be available and may not be attractively priced because of competition or other factors. In addition, we may be unable to fund an acquisition opportunity. Even if we are able to make acquisitions, we may be unable to successfully integrate such acquisitions into our existing operations and operational difficulties or diminished financial performance may result or a disproportionate amount of management's attention may be diverted. Even if we are successful in integrating any future acquisitions, we may not derive the benefits, such as operational, costs or administrative synergies, that we expected.

***Losing the services of our executive officers or our other highly qualified and experienced employees or our inability to continue to attract and retain additional qualified personnel could harm our business.***

Our success depends upon the continued contributions of our executive officers and certain other employees, many of whom have many years of experience with KEMET and would be extremely difficult to replace. We must also attract and retain experienced and highly skilled engineering, sales and marketing and managerial personnel. Competition for qualified personnel is intense in our industry, and we may not be successful in hiring and retaining these people. If we lose the services of our executive officers or our other highly qualified and experienced employees, or cannot attract and retain other qualified personnel, our business could suffer through less effective management due to loss of accumulated knowledge of our business or through less successful products due to a reduced ability to design, manufacture and market our products.

***Environmental laws and regulations could limit our ability to operate as we are currently operating and could result in additional costs.***

We are subject to a variety of U.S. federal, state and local, as well as foreign, environmental laws and regulations relating, among other things, to wastewater discharge, air emissions, handling of hazardous materials, disposal of solid and hazardous wastes, and remediation of soil and groundwater contamination. We use a number of chemicals or similar substances, and generate wastes, that are classified as hazardous. We require environmental permits to conduct many of our operations. Violations of environmental laws and regulations could result in substantial fines, penalties, and other sanctions. Changes in environmental laws or regulations (or in their enforcement) affecting or limiting, for example, our chemical uses, certain of our manufacturing processes, or our disposal practices, could restrict our ability to operate as we are currently operating, impose additional costs or otherwise cause delays in the delivery of our products to our customers, thereby damaging our relationships with them. In addition, we may experience releases of certain chemicals or discover existing contamination, which could cause us to incur material cleanup costs or other damages.

***We must continue to develop innovative products to maintain our relationships with our customers and to offset potential price erosion in older products.***

Continue to evaluate and pursue strategic acquisition opportunities, some of which may be significant in size, that w



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While most of the fundamental technologies used in the passive components industry have been available for a long time, the market is nonetheless typified by rapid changes in product designs and technological advances allowing for better performance, smaller size and/or lower cost. New applications are frequently found for existing technologies, and new technologies occasionally replace existing technologies for some applications or open up new business opportunities in other areas of application. We believe that successful innovation is critical for maintaining profitability in the face of potential erosion of selling prices for existing products and to ensure the flow of new products and robust manufacturing processes that will keep us at the forefront of our customers' product designs. Non-customized commodity products are especially vulnerable to price pressure, but customized products have also experienced price pressure in recent years. Developing and marketing new products requires start-up costs that may not be recouped if these products or production techniques are not successful. There are numerous risks inherent in product development, including the risks that we will be unable to anticipate the direction of technological change or that we will be unable to develop and market new products and applications in a timely fashion to satisfy customer demands. If this occurs, we could lose customers and experience adverse effects on our results of operations.

*We may not achieve the expected benefits of our manufacturing relocation plan or other restructuring plans we have or may adopt in the future.*

In July 2003, we announced our manufacturing relocation plan to improve our position as a global leader in passive electronic technologies. Pursuant to the plan, we reorganized our operations around the world. Several of our facilities were relocated based on access to key customers, access to key technical resources and knowledge, and availability of low-cost resources. We have also undertaken several other restructuring actions over the last several years to reduce our costs and to make our operations more efficient. We anticipate two remaining moves associated with the manufacturing relocation plan, which are scheduled to be completed by the end of fiscal year 2008, and also expect additional actions related to our acquisition of the EPCOS tantalum business unit. To the extent we are unsuccessful in realizing the goals of any or all of these initiatives, we will not be able to achieve our anticipated operating results. Additionally, to the extent we embark on additional restructuring or repositioning programs, such initiatives may be unsuccessful and we may not achieve the expected benefits therefrom, though it is likely we would incur additional costs.

## ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

Period	Total Number of Shares Purchased (1)	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs (2)
April 2007	87,500	\$ 9.76		2,600,000
May 2007		\$		2,600,000
June 2007	50,000	\$ 7.86		2,600,000
Total	137,500			

(1) - As part of the compensation package to the Chief Executive, the Board of Directors authorized two 50,000 blocks of restricted common stock of the Company to be granted. 50,000 shares were issued in both April and June, respectively. Last year in the first quarter, 50,000 shares of the Company's stock was authorized to be issued to the Chief Executive Officer. In connection with this grant of restricted shares of common stock of the Company to the Chief Executive Officer, an election was made by the Chief Executive Officer to satisfy the applicable Federal income tax withholding obligation arising from the grant of the restricted shares through a net share settlement, pursuant to which the Company withheld 12,500 shares of the restricted stock grant (out of the 50,000 shares granted) and used the deemed proceeds from those shares to pay the Federal income tax withholding. The remaining shares of 37,500 were issued from treasury stock in April 2007.

(2) - The Board of Directors has previously authorized programs to purchase up to 8.0 million of its common stock on the open market. Through September 30, 2007, the Company had made purchases of 5.4 million shares for \$63.6 million. The Company does not intend to purchase any additional shares under this program. The deemed purchase price for these shares is identical to the deemed issue price for these shares on the date of their original grant.

## ITEM 3. Defaults Upon Senior Securities

None.

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**ITEM 4. Submission of Matters to a Vote of Security Holders**

The results of the Company's 2007 Annual Meeting of Stockholders were reported on the Company's Current Report on Form 8-K dated July 30, 2007.

**ITEM 5. Other Information**

None.

**ITEM 6. Exhibits**

Exhibit 31.1 Rule 13a-14(a)/15d-14(a) Certification - Principal Executive Officer.

Exhibit 31.2 Rule 13a-14(a)/15d-14(a) Certification - Principal Financial Officer.

Exhibit 32.1 Section 1350 Certifications - Principal Executive Officer.

Exhibit 32.2 Section 1350 Certifications - Principal Financial Officer.

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

Date: November 7, 2007

KEMET Corporation

/s/ DAVID E. GABLE

David E. Gable

*Executive Vice President and Chief Financial  
Officer*