CABOT CORP
Form 10-Q
May 10, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended
March 31, 2007

or

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

For the transition period from to

Commission file number 1-5667

Cabot Corporation

(Exact name of registrant as specified in its charter)

Delaware (State of Incorporation)	**04-2271897** (I.R.S. Employer Identification No.)
Two Seaport Lane **Boston, Massachusetts** (Address of principal executive offices)	**02210-2019** (Zip Code)

Registrant s telephone number, including area code: **(617) 345-0100**

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, and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

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

Large accelerated filer 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 o No x

Indicate the number of shares outstanding of each of the issuer s classes of Common Stock, as of the latest practicable date.

As of May 3, 2007 the Company had 64,392,398 shares of Common Stock, par value $1 per share, outstanding.

CABOT CORPORATION

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Part I. Financial Information

Item 1. Financial Statements

CABOT CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

Three and Six Months Ended March 31, 2007 and 2006

UNAUDITED

	Three Months Ended March 31,		Six Months Ended March 31,	
	2007	2006	2007	2006
	(In millions, except per share amounts)			
Net sales and other operating revenues	$ 637	$ 627	$ 1,292	$ 1,214
Cost of sales	499	542	1,005	1,023
Gross profit	138	85	287	191
Selling and administrative expenses(1)	73	59	127	117
Research and technical expenses	17	14	32	27
Income from operations	48	12	128	47
Interest and dividend income	3	1	5	3
Interest expense	(9)	(7)	(18)	(13)
Other income (expense)	(1)	6	1	2
Income from operations before income taxes, equity in net income of affiliated companies and minority interest	41	12	116	39
Provision for income taxes	(11)	(1)	(30)	(5)
Equity in net income of affiliated companies, net of tax	3	4	6	7
Minority interest in net income, net of tax	(2)	(3)	(7)	(7)
Income from operations	31	12	85	34
Cumulative effect of a change in accounting principle, net of tax				2
Net income	31	12	85	36
Dividends on preferred stock, net of tax benefit	(1)		(1)	(1)
Net income available to common shares	$ 30	$ 12	$ 84	$ 35
Weighted-average common shares outstanding, in millions:				
Basic	61	60	61	60
Diluted	69	69	69	69
Income per common share:				
Basic:				
Income from operations	$ 0.49	$ 0.19	$ 1.37	$ 0.54
Cumulative effect of a change in accounting principle				0.04
Net income per share basic	$ 0.49	$ 0.19	$ 1.37	$ 0.58
Diluted:				
Income from operations	$ 0.45	$ 0.17	$ 1.24	$ 0.48
Cumulative effect of a change in accounting principle				0.04
Net income per share diluted	$ 0.45	$ 0.17	$ 1.24	$ 0.52
Dividends per common share	$ 0.18	$ 0.16	$ 0.36	$ 0.32

(1) Subsequent to the release of Cabot s earnings on April 25, 2007, the Company recorded a $10 million reserve in its March 31, 2007 consolidated financial statements based on settlement discussions with the plaintiffs in the carbon black antitrust litigation pending in the U.S. Federal District Court, as more fully described in Note K of this Form 10-Q and Cabot s Annual Report on Form 10-K for the fiscal year ended September 30, 2006.

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

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CABOT CORPORATION
CONSOLIDATED BALANCE SHEETS
ASSETS
UNAUDITED

	March 31, 2007 (In millions)	September 30, 2006
Current assets:		
Cash and cash equivalents	$ 246	$ 189
Short-term marketable securities	21	1
Accounts and notes receivable, net of reserve for doubtful accounts of $5 and $6	541	534
Inventories:		
Raw materials	137	131
Work in process	99	109
Finished goods	149	139
Other	43	41
Total inventories	428	420
Prepaid expenses and other current assets	78	75
Deferred income taxes	34	36
Total current assets	1,348	1,255
Investments:		
Equity affiliates	59	59
Long-term marketable securities and cost investments	2	3
Total investments	61	62
Property, plant and equipment	2,616	2,531
Accumulated depreciation and amortization	(1,657)	(1,567)
Net property, plant and equipment	959	964
Other assets:		
Goodwill	33	31
Intangible assets, net of accumulated amortization of $10 and $10	4	5
Assets held for rent	42	40
Deferred income taxes	97	100
Other assets	79	77
Total other assets	255	253
Total assets	$ 2,623	$ 2,534

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

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CABOT CORPORATION

CONSOLIDATED BALANCE SHEETS (Continued)

LIABILITIES & STOCKHOLDERS EQUITY

UNAUDITED

	March 31, 2007	September 30, 2006
	(In millions, except share and per share amounts)	
Current liabilities:		
Notes payable to banks	$ 69	$ 58
Accounts payable and accrued liabilities	387	384
Income taxes payable	34	27
Deferred income taxes	2	2
Current portion of long-term debt	18	34
Total current liabilities	510	505
Long-term debt	442	459
Deferred income taxes	19	20
Other liabilities	291	286
Commitments and contingencies (Note G)		
Minority interest	68	68
Stockholders equity:		
Preferred stock: Authorized: 2,000,000 shares of $1 par value Series B ESOP Convertible Preferred Stock 7.75% Cumulative, Authorized: 200,000 shares Issued: 50,580 and 55,895 shares Outstanding: 33,419 and 38,734 shares (aggregate redemption value of $33 and $39 at $1,000 per share)	50	56
Less cost of 17,161 shares of preferred treasury stock	(38)	(38)
Common stock:		
Authorized: 200,000,000 shares of $1 par value Issued: 64,506,134 and 63,579,040 shares Outstanding: 64,361,188 and 63,432,651 shares	65	64
Less cost of 144,946 and 146,389 shares of common treasury stock	(5)	(5)
Additional paid-in capital	29	7
Retained earnings	1,221	1,160
Deferred employee benefits	(36)	(38)
Notes receivable for restricted stock	(19)	(20)
Accumulated other comprehensive income	26	10
Total stockholders equity	1,293	1,196
Total liabilities and stockholders equity	$ 2,623	$ 2,534

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

CABOT CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

Six Months Ended March 31, 2007 and 2006

UNAUDITED

	2007	2006
	(In millions)	
Cash Flows from Operating Activities:		
Net income	$ 85	$ 36
Adjustments to reconcile net income to cash provided by (used in) operating activities:		
Depreciation and amortization	70	61
Deferred tax provision		(5)
Cumulative effect of a change in accounting principle		(2)
Equity in income of affiliated companies	(6)	(4)
Minority interest income	7	8
Non-cash compensation	13	15
Other non-cash items	(1)	2
Changes in assets and liabilities net of acquisitions and the effect of consolidation of equity affiliates:		
Accounts and notes receivable	8	(42)
Inventories	(3)	1
Prepaid expenses and other current assets		4
Accounts payable and accrued liabilities	(9)	(21)
Income taxes payable	5	(11)
Other liabilities	(4)	(17)
Other	8	(3)
Cash provided by operating activities	173	22
Cash Flows from Investing Activities:		
Additions to property, plant and equipment	(49)	(101)
Acquisition of interest in equity affiliate		(19)
Proceeds from sales of property, plant and equipment	2	6
Increase in assets held for rent	(2)	(1)
Purchases of marketable securities	(59)	(20)
Proceeds from maturity of marketable securities	39	57
Cash used in investing activities	(69)	(78)
Cash Flows from Financing Activities:		
Borrowings under financing arrangements	18	8
Repayments under financing arrangements	(9)	(3)
Repayments of long-term debt	(37)	(31)
Proceeds from long-term debt	4	26
Increase in notes payable to banks, net	2	18
Repayments of debt related to Cabot Japan KK		(18)
Proceeds from cash contribution received from minority interest shareholders		2
Proceeds from sales of common stock	8	6
Purchases of common stock	(4)	
Cash dividends paid to minority interest stockholders	(9)	(5)
Cash dividends paid to stockholders	(24)	(21)
Cash used in financing activities	(51)	(18)
Effect of exchange rate changes on cash	4	(4)
Increase (decrease) in cash and cash equivalents	57	(78)
Cash and cash equivalents at beginning of period	189	181
Cash and cash equivalents at end of period	$ 246	$ 103

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

CABOT CORPORATION

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

Six Months Ended March 31, 2007

(In millions, except shares in thousands)

UNAUDITED

	Preferred Stock, Net of Treasury Stock Shares	Cost	Common Stock, Net of Treasury Stock Shares	Cost	Additional Paid-in Capital	Retained Earnings	Deferred Employee Benefits	Notes Receivable for Restricted Stock	Accumulated Other Comprehensive Income	Total Stockholders Equity	Total Comprehensive Income
Balance at September 30, 2006	39	$ 18	63,433	$ 59	$ 7	$ 1,160	$ (38)	$ (20)	$ 10	$ 1,196	
Net income						85					$ 85
Foreign currency translation adjustment									13		13
Change in unrealized loss on derivative instruments									3		3
Other comprehensive income											16
Comprehensive income										101	$ 101
Common dividends paid						(23)				(23)	
Issuance of stock under employee compensation plans, net of forfeitures			240		8					8	
Amortization of share-based compensation					13					13	
Purchase and retirement of common and treasury stock			(90)		(4)					(4)	
Preferred stock conversion	(6)	(6)	778	1	5						
Preferred dividends paid to Employee Stock Ownership Plan, net of tax benefit						(1)				(1)	
Principal payment by Employee Stock Ownership Plan under guaranteed loan							2			2	
Notes receivable for restricted stock payments and forfeitures								1		1	
Balance at March 31, 2007	33	$ 12	64,361	$ 60	$ 29	$ 1,221	$ (36)	$ (19)	$ 26	$ 1,293	

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

CABOT CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2007
UNAUDITED

A. Basis of Presentation

The consolidated financial statements include the accounts of Cabot Corporation and its majority-owned and controlled U.S. and non-U.S. subsidiaries (Cabot or the Company). Intercompany transactions have been eliminated.

The unaudited consolidated financial statements have been prepared in accordance with the requirements of Form 10-Q and consequently do not include all disclosures required by Form 10-K. Additional information may be obtained by referring to Cabot s Annual Report on Form 10-K for the fiscal year ended September 30, 2006 (2006 10-K).

The financial information submitted herewith is unaudited and reflects all adjustments which are, in the opinion of management, necessary to provide a fair statement of the results for the interim periods ended March 31, 2007 and 2006. All such adjustments are of a normal recurring nature. The results for interim periods are not necessarily indicative of the results to be expected for the fiscal year.

Certain amounts in the fiscal 2006 cash flow presentation have been reclassified to conform to the fiscal 2007 cash flow presentation as follows:

	Six Months Ended March 31, 2006 As previously reported	As reclassified
Cash flows from operating activities		
Minority interest income	$	$ 8
Other non-cash items	12	2
Total	$12	$10
Cash flows from financing activities		
Borrowings under financing arrangements	$	$ 8
Repayments under financing arrangements		(3)
Increase in notes payable to banks, net	23	18
Proceeds from cash contribution received from minority interest shareholders		2
Total	$ 23	$ 25

B. Significant Accounting Policies

Revenue Recognition

Cabot derives most of its revenues from the sale of rubber blacks, performance products, fumed metal oxides, tantalum and related products, and from the rental and sale of cesium formate. Revenue from product sales is typically recognized when the product is shipped, and title and risk of loss have passed to the customer. Revenue from the rental of cesium formate is recognized throughout the rental period based on the contracted rental terms. Customers are also billed and revenue is recognized, typically at the end of the job, for cesium formate product that is not returned. Other operating revenues, which represent less than ten percent of total revenues, include tolling, servicing and royalties for licensed technology.

CABOT CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2007
UNAUDITED

Cabot s revenue recognition policies are in compliance with Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition, which establishes criteria that must be satisfied before revenue is realized or realizable and earned. Cabot recognizes revenue when persuasive evidence of a sales arrangement exists, delivery has occurred, the sales price is fixed or determinable and collectibility is probable. Cabot generally is able to ensure that products meet customer specifications prior to shipment. If the Company is unable to determine that the product has met the specified objective criteria prior to shipment, the revenue is deferred until product acceptance has occurred. Certain customer contracts contain price protection clauses that provide for the potential reduction in past or future sales prices. Cabot analyzes these contract provisions to determine if an obligation related to these clauses exists and records revenue net of any estimated price protection commitments.

The Company offers certain of its customers cash discounts and volume rebates as sales incentives. The discounts and volume rebates are recorded as a reduction of sales at the time revenue is recognized based on historical experience. Rebates are estimated and recorded based primarily on historical experience and contractual obligations. Cabot reviews its estimates for discounts and volume rebates, and the assumptions underlying the estimates are modified to reflect changes in facts and circumstances as appropriate.

Shipping and handling charges related to sales transactions are recorded as sales revenue when billed to customers or included in the sales price in accordance with Emerging Issues Task Force (EITF) 00-10, Accounting for Shipping and Handling Fees and Costs. Shipping and handling costs are included in cost of sales.

Accounts and notes receivable as of March 31, 2007 and September 30, 2006 primarily include trade accounts receivable which arise in the normal course of business of $518 million and $508 million, respectively; income taxes receivable of $14 million and $19 million, respectively; and the current portion of notes receivable of $14 million and $13 million, respectively. Trade receivables are recorded at the invoiced amount and do not bear interest. Trade receivables in China may be settled with the receipt of bank issued non-interest bearing notes. The China notes taken in settlement of trade receivables totaled 110 million RMB ($14 million) and 100 million RMB ($13 million) as of March 31, 2007 and September 30, 2006, respectively, and are included in accounts and notes receivable. Cabot periodically sells a portion of the China notes taken in settlement of trade receivables at a discount. These transactions are accounted for as sales under the provisions of FAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 140). The difference between the proceeds from the sale and the carrying value of the receivables is recognized as a loss on the sale of receivables and is included in other income (expense) in the accompanying consolidated statements of income.

Cabot maintains allowances for doubtful accounts based on an assessment of the collectibility of specific customer accounts, the aging of accounts receivable and other economic information on both a historical and prospective basis. Customer account balances are charged against the allowance when it is probable the receivable will not be recovered. Changes in the allowance during the three and six months ended March 31, 2007 and 2006 were not material. There is no off-balance sheet credit exposure related to customer receivable balances.

CABOT CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2007
UNAUDITED

Financial Instruments

Cabot s financial instruments consist primarily of cash and cash equivalents, short-term and long-term debt, and derivative instruments. The carrying values of Cabot s financial instruments approximate fair value with the exception of long-term debt, which is generally recorded at face value, except for a portion that has been designated with a derivative instrument as subject to a fair value hedge. The fair values of derivative instruments are based on quoted market prices. Derivative financial instruments are used to manage certain of Cabot s foreign currency and interest rate exposures, which exist as part of the Company s on-going business operations. Cabot does not enter into financial instruments for speculative purposes, nor does Cabot hold or issue any financial instruments for trading purposes. Derivative financial instruments are accounted for in accordance with FAS No. 133, Accounting for Derivative Instruments and Hedging Activities , as amended by FAS No. 138, Accounting for Derivative Instruments and Hedging Activites and related interpretations (FAS 133), and are measured and recorded at fair value on the balance sheet. Cabot formally documents the relationships between hedging instruments and hedged items, as well as its risk management objective.

Hedge accounting is followed for derivatives that have been designated and qualify as fair value, cash flow or net investment hedges. For fair value hedges, the Company records in the current period earnings (i) changes in the fair value of highly effective derivatives and (ii) changes in the fair value of the hedged liabilities that are attributable to the hedged risks. For cash flow hedges, changes in the fair value of the effective portion of the derivatives gains or losses are reported in other comprehensive income, and changes in the fair value of the ineffective portion are reported in current period earnings. For net investment hedges, changes in the fair value of the effective portion of the derivatives gains or losses are reported as foreign currency translation gains or losses in other comprehensive income, while changes in the ineffective portion are reported in current period earnings. The gains or losses on derivative instruments reported in other comprehensive income are reclassified to earnings in the period in which earnings are affected by the underlying item. From time to time, the Company may enter into certain derivative instruments that may not be designated as hedges under FAS 133. Although these derivatives are not designated as hedges, Cabot believes that such instruments are closely correlated with the underlying exposure, thus managing the associated risk. The gains or losses from changes in the fair value of derivative instruments that are not designated as hedges are recognized in current period earnings.

CABOT CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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C. Share-Based Compensation

The Company recognized the full impact of its share-based compensation plans in the consolidated statements of income for the three and six months ended March 31, 2007 and 2006 under FAS No. 123 (R), Share-Based Payments (FAS 123 (R)), and did not capitalize any such costs on the consolidated balance sheets, as such costs that qualified for capitalization were not material. The following table presents share-based compensation expenses included in the accompanying consolidated statements of income:

	Three months ended March 31		Six months ended March 31	
	2007	2006	2007	2006
	(Dollars in millions)			
Cost of sales	$ 2	$ 3	$ 4	$ 5
Selling and administrative	4	4	8	7
Research and technical			1	1
Share-based compensation expense before tax	$ 6	$ 7	$ 13	$ 13

D. Goodwill and Other Intangible Assets

The carrying amount of goodwill attributable to each reportable segment with goodwill balances and the changes in those balances during the six months ended March 31, 2007 are as follows:

	Carbon Black Business	Metal Oxides Business	Total
	(Dollars in millions)		
Balance at September 30, 2006	$ 21	$ 10	$ 31
Foreign currency translation adjustment	1	1	2
Balance at March 31, 2007	$ 22	$ 11	$ 33

Cabot does not have any indefinite-lived intangible assets. At March 31, 2007 and September 30, 2006, Cabot had $4 million and $5 million of finite-lived intangible assets, respectively. Intangible assets are amortized over their estimated useful lives, which range from two to fifteen years, with a weighted average period of ten years. Amortization relative to these intangibles is expected to aggregate to less than $1 million per year over the next five years.

CABOT CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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E. Employee Benefit Plans

Net periodic defined benefit pension and other postretirement benefit costs include the following:

	Three Months Ended March 31							
	2007		2006		2007		2006	
	Pension Benefits				Postretirement Benefits			
	U.S.	Foreign	U.S.	Foreign	U.S.	Foreign	U.S.	Foreign
	(Dollars in millions)							
Service cost	$ 1	$ 2	$ 1	$ 2	$	$	$ 1	$
Interest cost	2	3	1	3	2		2	
Expected gain on plan assets	(3)	(2)	(2)	(3)				
Recognized loss				1				
Amortization of prior service cost					(1)			
Net periodic benefit cost	$	$ 3	$	$ 3	$ 1	$	$ 3	$

	Six Months Ended March 31							
	2007		2006		2007		2006	
	Pension Benefits				Postretirement Benefits			
	U.S.	Foreign	U.S.	Foreign	U.S.	Foreign	U.S.	Foreign
	(Dollars in millions)							
Service cost	$ 2	$ 3	$ 3	$ 3	$ 1	$	$ 2	$
Interest cost	4	6	3	5	3		3	
Expected gain on plan assets	(5)	(5)	(5)	(5)				
Recognized loss		1		2			1	
Amortization of prior service cost					(1)			
Net periodic benefit cost	$ 1	$ 5	$ 1	$ 5	$ 3	$	$ 6	$

F. Restructuring

Cost Reduction Initiatives

In September 2006, Cabot announced a restructuring plan principally to reduce the fundamental cost structure of the carbon black product lines. These initiatives include streamlining the Company s sales, manufacturing, technical service and certain functional groups through a workforce reduction. Implementation began in September 2006 and has been substantially completed. The total number of employees impacted by the cost reductions was approximately 130 people, with the majority having left the Company by September 30, 2006. Termination and related benefits costs associated with this restructuring have been recorded in accordance with FAS No. 112, Employers Accounting for Postemployment Benefits (FAS 112) or FAS No. 146, Accounting for the Costs Associated with Exit or Disposal Activities (FAS 146), as appropriate. Accordingly, in some instances, charges attributable to these programs were deferred until fiscal 2007. During the second quarter of fiscal 2007 the Company recorded $2 million of charges related to these initiatives. Cabot has recorded all material charges associated with this restructuring and expects to make cash payments of approximately $4 million during the remainder of fiscal 2007.

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CABOT CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2007
UNAUDITED

Details of this restructuring activity and the reserve during the three months ended March 31, 2007 are as follows:

	Severance And Employee Benefits (Dollars in millions)
Reserve at December 31, 2006	$ 6
Charges	2
Cash Paid	(4)
Reserve at March 31, 2007	$ 4

Details of this restructuring activity and the reserve during the six months ended March 31, 2007 are as follows:

	Severance And Employee Benefits (Dollars in millions)
Reserve at September 30, 2006	$ 9
Charges	4
Cash Paid	(9)
Reserve at March 31, 2007	$ 4

Altona Restructuring

In October 2004, Cabot initiated a plan to shut down its Altona, Australia carbon black manufacturing facility due to an indication by Cabot s raw materials supplier that it would cease supply in September 2005, as well as the decline of the carbon black business in Australia. Production at this facility ceased on October 3, 2005. Through March 31, 2007, Cabot has recorded charges associated with this restructuring of approximately $28 million, which is expected to be partly offset by gains on the sale of the land on which the facility was formerly located. The sale of the land is expected to occur during fiscal 2007 and has not yet been reflected in the consolidated statement of income. No further material charges are expected related to this restructuring. All charges associated with this restructuring initiative are related to the Carbon Black Business. Cabot has recorded all of these charges in the consolidated statements of income since October 2004. The Company has $1 million of reserves remaining which is expected to be paid during fiscal 2007 in connection with the final remediation and restoration of the property.

As of March 31, 2007, the reserve balances for the cost reduction initiatives and the Altona restructuring are included in accrued expenses in the accompanying consolidated balance sheets.

CABOT CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2007
UNAUDITED

G. Commitments and Contingencies

Purchase Commitments

Cabot has entered into long-term purchase agreements for various key raw materials in the Carbon Black, Metal Oxides and Supermetals Businesses. The table below includes all of the Company s long-term purchase commitments, including those under new raw material supply agreements entered into during the second quarter of fiscal 2007:

	(Dollars in millions)
2007	$ 240
2008	257
2009	145
2010	105
2011	94
Thereafter	702
Total future purchase commitments	$ 1,543

Contingencies

Cabot is a defendant or potentially responsible party in various lawsuits and environmental proceedings wherein substantial amounts are claimed or at issue.

Environmental Liabilities

As of March 31, 2007 and September 30, 2006, Cabot had approximately $12 million and $13 million, respectively, reserved for environmental matters primarily related to divested businesses. These reserves represent Cabot s best estimate of its share of costs likely to be incurred at those sites where costs are reasonably estimable based on its analysis of the extent of clean up required, alternative clean up methods available, abilities of other responsible parties to contribute and its interpretation of laws and regulations applicable to each site. At March 31, 2007, $4 million of the $12 million reserved for the environmental matters are recognized on a discounted basis and are being accreted up to the undiscounted liability through interest expense over the expected cash flow period. Cash payments related to these liabilities were $2 million for both the three and six months ended March 31, 2007.

CABOT CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2007
UNAUDITED

Cabot has been a defendant in an action in the federal court in Pennsylvania brought by two farmers who claimed damage to their farms over a multi-year period, allegedly associated with emissions from Cabot s Boyertown, Pennsylvania facility. In March 2007, Cabot and the plaintiffs reached a resolution, which is reflected in the Company s financial results for the second quarter of fiscal 2007, that resulted in the case being dismissed, subject to the parties finalizing a formal settlement agreement. The formal settlement agreement is expected to be completed during the third quarter of fiscal year 2007.

Respirator Liabilities

Cabot has exposure in connection with a safety respiratory products business that a subsidiary acquired from American Optical Corporation (AO) in an April 1990 asset purchase transaction. The subsidiary manufactured respirators under the AO brand and disposed of that business in July 1995. In connection with its acquisition of the business, the subsidiary agreed, in certain circumstances, to assume a portion of AO s liabilities, including costs of legal fees together with amounts paid in settlements and judgments, allocable to AO respiratory products used prior to the 1990 purchase by the Cabot subsidiary. As more fully described in the Company s 2006 10-K, Cabot s respirator liabilities involve claims for personal injury, including asbestosis and silicosis, allegedly resulting from the use of AO respirators that are alleged to have been negligently designed or labeled. As of March 31, 2007, there were approximately 56,000 claimants in pending cases asserting claims against AO in connection with respiratory products. In the third quarter of fiscal year 2003, Cabot recorded a reserve to cover the Company s expected share of liability for existing and future respirator liability claims. The book value of the reserve is being accreted up to the undiscounted liability through interest expense over the expected cash flow period, which is through 2049, and, at March 31, 2007, is approximately $18 million (or $28 million on an undiscounted basis). Cash payments related to this liability were less than $1 million for both the three and six months ended March 31, 2007.

Carbon Black Antitrust Litigation

Cabot, Phelps Dodge Corporation, Colombian Chemicals Co., Degussa Engineered Carbons, LP, Degussa AG, and Degussa Corporation (the Degussa entities referred to as the Degussa Defendants and all defendants referred to collectively as the Defendants) are named Defendants in an antitrust lawsuit pending in federal district court, as more fully described in the Company s 2006 10-K. Cabot and the other Defendants are also the named defendants in antitrust lawsuits pending in several state courts. The plaintiffs in the federal case allege that the Defendants conspired to fix, raise, maintain or stabilize prices for carbon black sold in the United States during a specified period, and the plaintiffs in the state cases assert violations under the applicable state laws for conduct that is similar to what is alleged in the federal case. Cabot believes it has valid defenses to all of these claims and will continue to assert them vigorously. In June 2006, the Defendants in the federal action filed a motion for summary judgment. Arguments on the motion were heard in October 2006, but the court has not issued a decision. In November 2006, the plaintiffs filed a pleading seeking the federal court s approval of a settlement with the Degussa Defendants. In pleadings filed with the court, the plaintiffs estimated their total damages (subject to trebling) to be approximately $100 million. In March 2007, the federal court approved a settlement with the Degussa Defendants. Based on recent settlement discussions with the plaintiffs in the federal action,

CABOT CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
March 31, 2007
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the Company recorded a reserve of $10 million associated with the federal action in its March 31, 2007 consolidated financial statements.

Beryllium Claims

Cabot is a party to several pending actions in connection with its discontinued beryllium operations. Cabot entered the beryllium industry through an acquisition in 1978. The Company ceased manufacturing beryllium products at one of the acquired facilities in 1979, and the balance of its former beryllium business was sold to NGK Metals, Inc. in 1986. As more fully described in the Company s 2006 10-K, the actions are pending in several state and federal courts, and involve claims for personal injury, medical monitoring and product liability resulting from alleged contact with beryllium in various ways. In two of the personal injury cases pending in the Pennsylvania State Court of Common Pleas, in March 2007, the court entered an order requiring the parties to participate in mediation. The same court also entered an order requiring final pretrial conferences to be held between November 2007 and February 2008 in all of the currently pending Pennsylvania state court personal injury and medical monitoring cases. Cabot believes it has valid defenses to all of the beryllium actions and will continue to assert them vigorously. In addition, there is a contractual indemnification obligation running from NGK to Cabot in connection with many of the pending beryllium matters.

Other Matters

In September 2005, AVX Corporation filed a lawsuit in the Massachusetts Superior Court alleging that Cabot has improperly administered the supply agreement entered into between the Company and AVX in 2001 (the 2001 Supply Agreement). In particular, AVX claims that Cabot has not provided all of the price relief due to AVX pursuant to most-favored nation (MFN) pricing provisions in the 2001 Supply Agreement. Discovery in the case is on-going, but to date AVX has claimed that it is owed an additional $28 million in MFN credit. In early April 2007, Cabot and AVX filed cross-motions for summary judgment on two key disputed issues in the litigation. A hearing on the motions took place on May 1, 2007. Cabot believes it has valid defenses to all of AVX s claims against the Company and will continue to assert them vigorously.

The Company has various other lawsuits, claims and contingent liabilities arising in the ordinary course of its business, including a number of claims asserting premises liability for asbestos exposure, related to its divested businesses. In Cabot s opinion, although final disposition of some or all of these other suits and claims may impact the Company s consolidated financial statements in a particular period, they should not, in the aggregate, have a material adverse effect on the Company s consolidated financial position.

Guarantee Agreements

Cabot has provided certain indemnities pursuant to which it may be required to make payments to an indemnified party in connection with certain transactions and agreements. In connection with certain acquisitions and divestitures, Cabot has provided routine indemnities with respect to such matters as environmental, tax, insurance, product and employee liabilities. In connection with various other agreements, including service and supply agreements, Cabot may provide routine indemnities for certain

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contingencies and routine warranties. Cabot is unable to estimate the maximum potential liability for these types of indemnities as a maximum obligation is not explicitly stated in most cases and the amounts, if any, are dependent upon the outcome of future contingent events, the nature and likelihood of which cannot be reasonably estimated. The duration of the indemnities varies, and in many cases is indefinite. Cabot has not recorded any liability for these indemnities in the consolidated financial statements, except as otherwise disclosed above under Contingencies.

H. Earnings Per Share

Basic and diluted earnings per share (EPS) were calculated as follows:

	Three Months Ended March 31		Six Months Ended March 31	
	2007	2006	2007	2006
	(Dollars in millions, except per share amounts)			
Basic EPS:				
Income available to common shares (numerator)	$ 30	$ 12	$ 84	$ 35
Weighted average common shares outstanding	64	63	64	63
Less: contingently issuable shares(1)	(3)	(3)	(3)	(3)
Adjusted weighted average common shares (denominator)	61	60	61	60
Basic EPS	$ 0.49	$ 0.19	$ 1.37	$ 0.58
Diluted EPS:				
Income available to common shares	$ 30	$ 12	$ 84	$ 35
Dividends on preferred stock, net of tax benefit(2)	1		1	1
Income available to common shares plus assumed conversions (numerator)	$ 31	$ 12	$ 85	$ 36
Adjusted weighted average common shares outstanding	61	60	61	60
Effect of dilutive securities:(2)				
Assumed conversion of preferred stock	6	6	6	6
Common shares issuable(3)(4)	2	3	2	3
Adjusted weighted average shares (denominator)	69	69	69	69
Diluted EPS	$ 0.45	$ 0.17	$ 1.24	$ 0.52

(1) Represents outstanding restricted stock issued under Cabot s equity incentive plans.

(2) Represents dividends paid on preferred stock, which would not be paid on the common stock issued upon conversion of preferred stock.

(3) Represents incremental shares for the assumed vesting of outstanding restricted stock and exercise of stock options outstanding under Cabot s equity incentive plans.

(4) For the three and six months ended March 31, 2006 and 2007, there were no options to purchase shares of common stock excluded in the calculation of diluted earnings per share.

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I. Financial Information by Segment

Cabot is organized into four reportable segments: the Carbon Black Business, the Metal Oxides Business, the Supermetals Business, and the Specialty Fluids Business. The following table provides financial information by segment for the three and six months ended March 31, 2007 and 2006:

	Carbon Black (Dollars in millions)	Metal Oxides	Supermetals	Specialty Fluids	Segment Total	Unallocated and Other(1)	Consolidated Total
Three months ended March 31, 2007							
Net sales and other operating revenues(2)	$ 493	$ 68	$ 53	$ 10	$ 624	$ 13	$ 637
Income (loss) before taxes(3)	$ 57	$ 10	$ (2)	$ 3	$ 68	$ (27)	$ 41
Three months ended March 31, 2006							
Net sales and other operating revenues(2)	$ 476	$ 62	$ 67	$ 11	$ 616	$ 11	$ 627
Income (loss) before taxes(3)	$ 26	$ 5	$ 12	$ 4	$ 47	$ (35)	$ 12
Six months ended March 31, 2007							
Net sales and other operating revenues(2)	$ 978	$ 133	$ 130	$ 26	$ 1,267	$ 25	$ 1,292
Income (loss) before taxes(3)	$ 111	$ 19	$ 14	$ 11	$ 155	$ (39)	$ 116
Six months ended March 31, 2006							
Net sales and other operating revenues(2)	$ 895	$ 119	$ 160	$ 21	$ 1,195	$ 19	$ 1,214
Income (loss) before taxes(3)	$ 47	$ 7	$ 23	$ 8	$ 85	$ (46)	$ 39

(1) Unallocated and Other includes certain items and eliminations that are not allocated to the operating segments. Management does not consider these items necessary for an understanding of the operating results of these segments and such amounts are excluded in the segment reporting to the Chief Operating Decision Maker.

(2) Net sales and other operating revenues for the Carbon Black Business include 100% of sales from one equity affiliate, which is eliminated through Unallocated and Other. Unallocated and Other also includes royalties paid by equity affiliates and external shipping and handling fees:

	Three Months Ended March 31 2007 (Dollars in millions)	2006	Six Months Ended March 31 2007	2006
Equity affiliate sales	$ (9)	$ (9)	$ (18)	$ (17)
Royalties paid by equity affiliates	4	3	7	5
Shipping and handling fees and other	18	17	36	31
Total	$ 13	$ 11	$ 25	$ 19

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(3) Income (loss) before taxes for Unallocated and Other includes:

	Three Months Ended March 31		Six Months Ended March 31	
	2007	2006	2007	2006
	(Dollars in millions)			
Interest expense	$ (9)	$ (7)	$ (18)	$ (13)
Certain items and other expense, net(a)	(16)	(27)	(16)	(26)
Equity in net income of affiliated companies	(3)	(4)	(6)	(7)
Foreign currency transaction gains(b)	1	3	1	
Total	$ (27)	$ (35)	$ (39)	$ (46)

(a) Certain items and other expense, net, includes investment income, and certain other items that are not included in segment profit before taxes (PBT). Certain items for both the second quarter and the first six months of fiscal 2007 includes charges of $5 million for environmental reserves and a legal settlement, as well as a $10 million reserve related to the carbon black antitrust litigation. Additionally, certain items include $2 million and $5 million for restructuring initiatives as discussed in Note F for the second quarter and first six months of fiscal 2007, respectively. Certain items for the second quarter of fiscal 2006 include restructuring charges of $2 million, the $27 million Sons of Gwalia settlement payment and $2 million of cost reduction initiatives in the Supermetals Business. Certain items for the first six months of fiscal 2006 include $3 million for restructuring charges, $27 million related to the Sons of Gwalia settlement payment and $3 million of cost reduction initiatives in the Supermetals Business.

(b) Net of other foreign currency risk management activity.

The Carbon Black Business is primarily comprised of the rubber blacks, performance products and inkjet colorants product lines as well as the business development activities of Superior MicroPowders. The revenues from each of these product lines are as follows:

	Three Months Ended March 31		Six Months Ended March 31	
	2007	2006	2007	2006
	(Dollars in millions)			
Rubber blacks	$ 346	$ 346	$ 697	$ 644
Performance products	134	117	257	226
Inkjet colorants	13	12	23	23
Superior MicroPowders		1	1	2
Total Carbon Black Sales	$ 493	$ 476	$ 978	$ 895

The Metal Oxides Business is primarily comprised of the fumed metal oxides (including fumed silica and fumed alumina and dispersions thereof) and aerogel product lines. The revenues were primarily from the fumed metal oxides product line.

J. Newly Issued Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued FAS No. 157, Fair Value Measurements (FAS 157). FAS 157 provides guidance for using fair value to measure assets and liabilities and requires additional disclosure about the use of fair value measures, the information used to measure fair value, and the effect fair-value measurements have on earnings. The primary areas in which the Company utilizes fair value measures are valuing pension plan assets and liabilities, valuing hedge-

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related derivative financial instruments, allocating purchase price to the assets and liabilities of acquired companies, and evaluating long-term assets for potential impairment. FAS 157 does not require any new fair value measurements. FAS 157 is effective for the Company beginning October 1, 2008. The Company is evaluating the impact of FAS 157 on its consolidated financial statements.

In September 2006, the FASB issued FAS No. 158, Employer s Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R) (FAS 158). FAS 158 requires an employer to recognize the funded status of a benefit plan, measured as the difference between plan assets at fair value and the projected benefit obligation, in its statement of financial position. FAS 158 also requires an employer to measure defined benefit plan assets and obligations as of the date of the employer s fiscal year end. FAS 158 is effective for the Company for its fiscal year ending September 30, 2007. The Company is continuing to evaluate the impact of FAS 158 on its consolidated balance sheet.

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement 109 (FIN 48), which prescribes a comprehensive model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return, including a decision whether or not to file a return in a particular jurisdiction. Under this new guidance, the financial statements will reflect expected future tax consequences of such positions presuming the taxing authorities full knowledge of the position and all relevant facts, but without considering time values. This guidance also revises disclosure requirements and introduces a prescriptive, annual, tabular roll-forward of unrecognized tax benefits. FIN 48 is effective for annual periods beginning after December 15, 2006, which will be fiscal 2008 for Cabot. The Company is evaluating the impact of FIN 48 on its consolidated financial statements.

In February 2007, the FASB issued FAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115 (FAS 159). FAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. FAS 159 does not affect any existing accounting literature that requires certain assets and liabilities to be carried at fair value. FAS 159 is effective for fiscal years beginning after November 15, 2007, which will be fiscal 2009 for Cabot. The Company is evaluating the impact of FAS 159 on its consolidated financial statements.

K. Subsequent Event

Subsequent to the release of Cabot s earnings on April 25, 2007, the Company recorded a $10 million reserve in its March 31, 2007 consolidated financial statements based on settlement discussions with the plaintiffs in the carbon black antitrust litigation pending in the U.S. Federal District Court, as more fully described in Note G of this Form 10-Q and the 2006 10-K.

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

I. Critical Accounting Policies and Estimates

The preparation of our financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses and related disclosure of contingent assets and liabilities. We consider an accounting estimate to be critical to the financial statements if 1) the estimate is complex in nature or requires a high degree of judgment and 2) different estimates and assumptions were used, the result could have a material impact on the consolidated financial statements. On an ongoing basis, we evaluate our policies and estimates. We base our estimates on historical experience, current conditions and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The estimates that we believe are critical to the preparation of the Consolidated Financial Statements are presented below.

Revenue Recognition and Accounts Receivable

We derive most of our revenues from the sale of rubber blacks, performance products, fumed metal oxides, tantalum and related products and from the rental and sale of cesium formate. Revenue from product sales is typically recognized when the product is shipped and title and risk of loss have passed to the customer. Revenue from the rental of cesium formate is recognized throughout the rental period based on the contracted rental terms. Customers are also billed and revenue is recognized, typically at the end of the job, for cesium formate product that is not returned. Other operating revenues, which represent less than ten percent of total revenues, include tolling, servicing and royalties for licensed technology.

Our revenue recognition policies are in compliance with Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition , which establishes criteria that must be satisfied before revenue is realized or realizable and earned. We recognize revenue when persuasive evidence of a sales arrangement exists, delivery has occurred, the sales price is fixed or determinable and collectibility is probable. We generally are able to ensure that products meet customer specifications prior to shipment. If we are unable to determine that the product has met the specified objective criteria prior to shipment, the revenue is deferred until product acceptance has occurred.

Certain customer contracts contain price protection clauses that provide for the potential reduction in past or future sales prices. We analyze these contract provisions to determine if an obligation related to these clauses exists and record revenue net of any estimated price protection commitments.

We offer certain customers cash discounts and volume rebates as sales incentives. The discounts and volume rebates are recorded as a reduction of sales at the time revenue is recognized based on historical experience. Rebates are estimated and recorded based primarily on historical experience and contractual obligations. We review the estimates for discounts and volume rebates, and the assumptions underlying the estimates are modified to reflect changes in facts and circumstances as appropriate. This estimation process does introduce some uncertainty as to the amount of revenue we recognize. Refinements to the initial estimates can result in increases or decreases to revenue and thus directly impact our earnings and cash flows. Such changes in our estimates have not been material.

The allowance for doubtful accounts is based on our assessment of the collectibility of specific customer accounts, the aging of our accounts receivable and other economic information on both an historical and prospective basis. Additionally, we estimate sales returns based on historical trends in our customers product returns. While bad debt write-offs and product returns have not been significant historically, if there is a deterioration of a major customer s credit-worthiness, actual defaults are higher than our previous experience or actual returns do not reflect historical trends, our estimates of the recoverability of the amounts due to us would be refined which may reduce our earnings.

Inventory Valuation

The cost of most raw materials, work in process and finished goods inventories in the U.S. is determined by the last-in, first-out (LIFO) method. Had we used the first-in, first-out (FIFO) method instead of the LIFO method for such inventories the value of those inventories would have been $77 million and $76 million higher as of March 31, 2007 and September 30, 2006, respectively. The LIFO method of determining cost of inventory could lead, at times, to significant fluctuations on our gross margin. The cost of other U.S. and all non-U.S. inventories is determined using the average cost method or the FIFO method.

We review inventory for potential obsolescence periodically. In this review, we make assumptions about the future demand for and market value of the inventory and based on these assumptions estimate the amount of any obsolete, unmarketable or slow moving inventory. We write down our inventories for estimated obsolescence or unsaleable inventory by an amount equal to the difference between the cost of inventory and the estimated market value. In cases where the market value of inventories is below cost, the inventory is adjusted to its market value. Historically, such write-downs have not been significant. If actual market conditions are less favorable than those projected by management at the time of the assessment, however, additional inventory write-downs may be required, which could reduce our gross profit and our earnings.

Share-based Compensation

Since October 1, 2005, we have followed the methodology set forth in FAS No. 123 (R), Share-Based Payments (FAS 123 (R)), using the modified prospective approach to account for all of our stock-based awards. Historically, we have issued significantly more shares of restricted stock than stock options under our equity compensation plans. Restricted stock awards, whether accounted for under FAS 123 (R) or the previous standard, Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees , generally result in a charge to the statement of income. Accordingly, the impact of FAS 123 (R) on our comparative results over a period of years is not significant. The fair value of restricted stock is based on intrinsic value at the grant date and is recognized as expense over the service period, which generally represents the vesting period.

We use the Black-Scholes option-pricing model to calculate the fair value of stock options issued under our equity compensation plans. In determining the fair value of stock options, we make a variety of assumptions and estimates, including discount rates, forfeiture rates, volatility measures, expected yields and expected option lives. Changes to such assumptions and estimates can result in different fair values and could therefore reduce our earnings. Such changes would not impact our cash flows.

Goodwill and Other Intangible Assets

We perform an impairment test for goodwill at least annually (generally as of June 30) and when events or changes in business circumstances indicate that the carrying value may not be recoverable. To test whether an impairment exists, the fair value of the applicable reporting unit is estimated based on discounted cash flows. The calculation of fair value is sensitive to both the estimated future cash flows and the discount rate applied to those cash flows. The assumptions used to estimate the discounted cash flows are based on management s best estimates about selling prices, production and sales volume, costs, future growth rates, capital expenditures and market conditions over an estimate of the remaining operating period at the reporting unit. The discount rate is based on the weighted average cost of capital that is determined by evaluating the risk free rate of return, cost of debt and expected equity premiums. If an impairment exists, a loss to write down the value of goodwill to its implied fair value is recorded. While this would have no direct impact on our cash flows, it would reduce our earnings.

We also have intangible assets that we amortize, which relate primarily to patents and other intellectual property. We review these intangibles for impairment when facts and/or circumstances indicate that the carrying value may not be recoverable. A write-down of such intangible assets would not directly impact our cash flows but would reduce our earnings.

Valuation of Long-Lived Assets

Our long-lived assets primarily include property, plant, equipment, long-term investments and assets held for rent. We review the carrying values of long-lived assets for impairment whenever events or changes in business circumstances indicate that the carrying amount of an asset may not be recoverable. Such circumstances would include, but are not limited to, a significant decrease in the market price of the long-lived asset, a significant adverse change in the way the asset is being used, a decline in the physical condition of the asset or a history of operating or cash flow losses associated with the use of the asset.

We make various estimates and assumptions when analyzing whether there is an impairment of our long-lived assets, excluding goodwill and long-term investments. These estimates and assumptions include determining which cash flows are directly related to the potentially impaired asset, the useful life of the asset over which the cash flows will occur, their amounts and the asset s residual value, if any. An asset impairment exists when the carrying value of the asset is not recoverable based on the undiscounted estimated cash flows expected from the asset. The impairment loss is determined by the excess of the asset s carrying value over its fair value. Our estimated cash flows reflect management s assumptions about selling prices, production and sales volumes, costs and market conditions over an estimate of the remaining useful life of the asset. While an impairment charge would have no direct impact on our cash flows, it would reduce our earnings.

The fair values of equity method investments are dependent on the financial performance of the entities in which the Company invests and the external factors inherent in the markets in which they operate. We consider these factors as well as the forecasted financial performance of the investment entities when assessing the potential impairment of these investments.

Financial Instruments

Our financial instruments consist primarily of cash and cash equivalents, short-term and long-term debt, and derivative instruments. The carrying values of our financial instruments approximate fair value with the exception of certain long-term debt, which is generally recorded at face value, except for a portion that has been designated with a derivative instrument. The fair values of our derivative instruments are based on quoted market prices. We use derivative financial instruments primarily for purposes of hedging exposures to fluctuations in interest rates and foreign currency exchange rates, which exist as part of our on-going business operations. We do not enter into contracts for speculative purposes, nor do we hold or issue any financial instruments for trading purposes. All derivatives are recognized on the balance sheet at fair value. The changes in the fair value of derivatives are recorded in either earnings or other comprehensive income, depending on whether the instrument is designated as part of a hedge transaction or is not designated as part of a hedge transaction and, if designated as part of a hedge transaction, the type of hedge transaction. The gains or losses on derivative instruments reported in other comprehensive income are reclassified to earnings in the period in which earnings are affected by the underlying hedged item. The ineffective portion of all hedges is recognized in earnings in the current period. In accordance with our risk management strategy, we may enter into certain derivative instruments that may not be designated as hedges for hedge accounting purposes. Although these derivatives are not designated as hedges, we believe that such instruments are closely correlated with the underlying exposure, thus managing the associated risk. We record in earnings the gains or losses from changes in the fair value of derivative instruments that are not designated as hedges.

Pensions and Other Postretirement Benefits

We maintain both defined benefit and defined contribution plans for our employees. In addition, we provide certain postretirement health care and life insurance benefits for our retired employees. Plan obligations and annual expense calculations are based on a number of key assumptions. The assumptions, which are specific for each of our U.S. and foreign plans, are related to both the assets we hold to fund our plans (where applicable) and the characteristics of the benefits that will ultimately be provided to our employees. Assumptions relative to our plan assets specifically involve the anticipated rates of return. Assumptions relative to our pension obligations are more varied; they include estimated discount rates, rates of compensation increases for employees, mortality, employee turnover and other related demographic data. Projected health care and life insurance obligations also rely on the above mentioned demographic assumptions and assumptions surrounding health care cost trends. We compute our recorded obligations in accordance with generally accepted accounting principles. Under such principles, if actual results differ from what is projected, the differences are generally accumulated and amortized over future periods and could therefore affect the recognized expense and recorded obligation in such future periods. However, cash flow requirements may be different from the amounts of expense that are recorded in the consolidated financial statements.

Asset Retirement Obligations

We account for asset retirement obligations in accordance with FAS No. 143, Accounting for Asset Retirement Obligations (FAS 143) and Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations (FIN 47). Pursuant to FAS No. 143, companies are required to estimate incremental costs for special handling, removal and disposal costs of materials that may or will give rise to conditional asset retirement obligations (AROs) and then discount the expected costs back to the current year using a credit adjusted risk free rate. FIN 47 clarified that ARO liabilities and costs must be recognized when the timing and/or settlement can be reasonably estimated. If it is unclear when, or if, an ARO will be triggered, companies are required to use probability weighting for possible timing scenarios to determine the amounts that should be recognized in the company s financial statements. The estimation of AROs is subject to a number of inherent uncertainties including: (a) the timing of when any ARO may be incurred, (b) the ability to accurately identify and reasonably estimate the costs of all materials that may require special handling or treatment, (c) the ability to assess the relative probability of different scenarios which could give rise to an ARO, and (d) other factors outside a company s control, including changes in regulations, costs and interest rates. AROs have not been recognized for certain of the Company s facilities because either the fair value cannot be reasonably estimated due to an indeterminable settlement date of the obligation, or the Company currently does not have a legal obligation associated with the retirement of those facilities. As such, actual costs and the timing of such costs may vary significantly from the estimates, judgments, and probable scenarios considered by the Company, which could, in turn, reduce our earnings.

Litigation and Contingencies

We are involved in litigation in the ordinary course of business, including personal injury and environmental litigation. After consultation with counsel, as appropriate, we accrue a liability for litigation when it is probable that a liability has been incurred and the amount can be reasonably estimated. The estimated reserves are recorded based on our best estimate of the liability associated with such matters or the low end of the estimated range of liability if we are unable to identify a better estimate within that range. Our best estimate is determined through the evaluation of various information, including claims, settlement offers, demands by government agencies, estimates performed by independent third parties, identification of other responsible parties and an assessment of their ability to contribute and our prior experience. Litigation is highly uncertain and there is always the possibility of an unusual result in any particular case that may reduce our earnings and cash flows.

The most significant reserves that we have established are for environmental remediation, respirator litigation claims and a $10 million reserve related to the carbon black antitrust litigation described in Note K. As of March 31, 2007, we had $12 million reserved for various environmental matters. The amount accrued reflects our assumptions about remediation requirements at the contaminated sites, the nature of the remedies, the outcome of discussions with regulatory agencies and other potentially responsible parties at multi-party sites and the number and financial viability of other potentially responsible parties. A portion of the reserve for environmental matters is recognized on a discounted basis, which requires the use of an estimated discount rate and estimates of future cash flows associated with the liability. These liabilities can be affected by the availability of new information, changes in the assumptions on which the accruals are based, unanticipated government enforcement action or changes in applicable government laws and regulations, which could result in higher or lower costs.

As of March 31, 2007, we also had $18 million accrued for respirator liability claims. Our current estimate of the cost of our share of existing and future respirator liability claims is based on facts and circumstances existing at this time. Developments that could affect our estimate include, but are not limited to, (i) significant changes in the number of future claims, (ii) a continuation in the recent trend of dismissals without payment of pending silica and non-malignant asbestos claims that began in calendar 2006, (iii) significant changes in the average cost of resolving claims, (iv) significant changes in the legal costs of defending these claims, (v) changes in the nature of claims received, (vi) changes in the law and procedure applicable to these claims, (vii) the financial viability of other parties who contribute to the settlement of respirator claims, and (viii) a determination that our interpretation of the contractual obligations on which we have estimated our share of liability is inaccurate. While we believe the current best estimate is recorded, we cannot determine the impact of these potential developments on our current estimate of our share of liability for these existing and future claims. Accordingly, the actual amount of these liabilities for existing and future claims could be different than the reserved amount.

Income Taxes

Our business operations are global in nature, and we are subject to taxes in numerous jurisdictions. Tax laws and tax rates vary substantially in these jurisdictions and are subject to change given the political and economic climate in those countries. For example, our tax rate for 2007 assumes that a certain portion of our consolidated net income will be secured from China and that our tax holiday in China will continue until its stated expiration in 2014. Achievement of our estimated 2007 tax rate is dependent not only on our ability to continue to generate earnings in China but also the continuance of the tax holiday policy benefits for the Company from recently enacted China tax law changes. We file our tax returns in accordance with our interpretations of each jurisdiction s tax laws. At the beginning of each fiscal year we forecast our estimated annual income by jurisdiction so as to compute an effective tax rate to be applied to our consolidated interim results. This is adjusted as more information comes to our attention during the course of the year. In the event that actual results are significantly different from these estimates, our provision for income taxes could be significantly impacted. For example, a 1% change in the effective tax rate would change income tax expense for the six months ended March 31, 2007 by approximately $1 million.

As described above, significant judgment is required in determining our worldwide provision for income taxes and recording the related tax assets and liabilities. In the ordinary course of our business, there are operational decisions, transactions, facts and circumstances, and calculations in which the ultimate tax determination is not certain. Furthermore, our tax positions are periodically subject to challenge by taxing authorities throughout the world. Where appropriate, we reserve for tax matters when we believe that the likelihood of an incremental liability being incurred is probable in accordance with the provisions of FAS No. 5, Accounting for Contingencies (FAS 5) and FAS No. 109, Accounting for Income Taxes (FAS 109). Any significant impact as a result of changes in underlying facts, law, tax rates, tax audit, or review could lead to adjustments to our income tax expense, our effective tax rate, or our cash flow.

Additionally, in accordance with FAS 109 we have established valuation allowances against a variety of deferred tax assets, including net operating loss carryforwards, foreign tax credits, and other income tax credits. Valuation allowances take into consideration our ability to use these deferred tax assets and reduce the value of such items to the amount that is deemed more likely than not to be recoverable. Changes in our operations, domestically and internationally, could impact our ability to utilize these tax attributes in the future. The release of valuation allowances in periods when these tax attributes become realizable would reduce our effective tax rate.

Restructuring Activities

Our consolidated financial statements detail specific charges relating to restructuring activities as well as the actual spending that has occurred against the resulting accruals. Our restructuring charges are estimates based on our preliminary assessments of (1) severance benefits to be granted to employees which are based on known benefit formulas and identified job grades, (2) costs to abandon certain facilities and (3) asset impairments as discussed above under Valuation of Long-Lived Assets . Because these accruals are estimates, they are subject to change as a result of deviations from initial restructuring plans or subsequent information that may come to our attention. These deviations may lead to changes in estimates, which would then be reflected in our consolidated financial statements.

Significant Accounting Policies

We have other significant accounting policies that are discussed in Note A of the Notes to our Consolidated Financial Statements in our 2006 10-K. Certain of these policies include the use of estimates, but do not meet the definition of critical because they generally do not require estimates or judgments that are as difficult or subjective to measure. However, these policies are important to an understanding of the consolidated financial statements.

II. Results of Operations

Cabot is organized into four reportable segments: the Carbon Black Business, the Metal Oxides Business, the Supermetals Business, and the Specialty Fluids Business. The Carbon Black Business is comprised of the rubber blacks, performance products and inkjet colorants product lines as well as the business development activities of Cabot Superior MicroPowders. The Metal Oxides Business is comprised of the fumed metal oxides and aerogel product lines.

Overview

During the second quarter and first six months of 2007, we experienced strong volumes in our Carbon Black and Metal Oxides Businesses and expanded margins due principally to lower feedstock costs in our carbon black product lines. We were aided, on a net basis, by favorable foreign currency translation as the benefit on prices from the weakening U.S. dollar more than offset the unfavorable currency translation impact on costs.

The Supermetals Business had weaker performance in both periods with the continued transition from contracted to market based sales, which was completed in December 2006 with the expiration of our final significant long-term supply contract. In addition, the Business experienced increased costs which, when combined with these factors, led to a slight loss for the second quarter of 2007.

We experienced solid cash generation in both the second quarter and first six months of 2007 due to strong earnings.

Second Quarter and First Six Months Fiscal Year 2007 versus Second Quarter and First Six Months Fiscal Year 2006 Consolidated

Net Sales and Gross Profit

	Three Months Ended March 31		Six Months Ended March 31	
	2007	2006	2007	2006
	(Dollars in millions)			
Net sales and other operating revenues	$ 637	$ 627	$ 1,292	$ 1,214
Gross profit	138	85	287	191

The $10 million increase in net sales in the second quarter of 2007 from the same period in 2006 was due primarily to the positive impact of foreign currency translation ($23 million) and higher volumes ($15 million), partially offset by lower pricing and an unfavorable product mix ($22 million). Additionally, we experienced $4 million of revenue related to a subsidiary s transportation of feedstock for third parties during the second quarter of 2006 that did not recur in the same period in 2007. For the first six months of 2007, the $78 million increase in net sales when compared to the first six months of 2006 was driven by higher volumes ($38 million), the positive impact of foreign currency translation ($32 million) and higher pricing ($7 million).

Gross margin was 22% in the second quarter of 2007 compared to 14% in the same period in 2006. The $53 million increase in gross profit primarily resulted from higher volumes ($15 million), favorable foreign currency translation ($23 million) and lower carbon black raw material costs ($37 million), partially offset by lower pricing and an unfavorable product mix ($22 million). Additionally, $6 million of charges related to environmental reserves, a legal settlement and restructuring charges were recorded in the consolidated statement of income as cost of sales during the second quarter of 2007. The 2006 charges included $30 million related to a payment to the Sons of Gwalia to terminate a previously existing supply agreement, and restructuring and cost reduction initiatives. Gross margin was 22% for the first six months of 2007 compared to 16% for the same period in 2006. The $96 million increase in gross profit primarily resulted from higher volumes ($38 million), lower carbon black raw material costs ($32 million), and the positive impact of foreign currency translation ($32 million). Additionally, we experienced $15 million of revenue associated with a subsidiary s transportation of feedstock for third parties in the first six months of 2006 that did not recur in the same period of 2007.

Selling and Administrative Expenses

	Three Months Ended March 31		Six Months Ended March 31	
	2007	2006	2007	2006
	(Dollars in millions)			
Selling and administrative expenses	$ 73	$ 59	$ 127	$ 117

Selling and administrative expenses increased by $14 million in the second quarter of fiscal 2007 when compared to the second quarter of 2006 driven by increased costs associated with our new manufacturing capacity, higher variable compensation accruals and the timing of certain expenses, partially offset by cost reduction initiatives announced at the end of fiscal year 2006. Additionally, a $10 million reserve related to the carbon black antitrust litigation and $1 million of charges related to restructuring initiatives were recorded in the consolidated statement of income as selling and administrative expenses for the second quarter of 2007 compared to $2 million, for cost reduction initiatives in the second quarter of 2006. For the first six months of 2007, selling and administrative expenses were $10 million higher due to the aforementioned litigation reserve when compared to the same period in 2006.

Research and Technical Expenses

	Three Months Ended March 31 2007	2006	Six Months Ended March 31 2007	2006
	(Dollars in millions)			
Research and technical expenses	$ 17	$ 14	$ 32	$ 27

Research and technical expense increased by $3 million in the second quarter of 2007 and by $5 million in the first six months of 2007 when compared with the same periods of 2006. The increase in both periods was primarily the result of increased spending in our inkjet colorants and Superior MicroPowders product lines and work associated with new technology installed in conjunction with the expansion of capacity at our carbon black manufacturing facility in Brazil.

Interest Expense

	Three Months Ended March 31 2007	2006	Six Months Ended March 31 2007	2006
	(Dollars in millions)			
Interest expense	$ (9)	$ (7)	$ (18)	$ (13)

Interest expense for the second quarter of 2007 increased by $2 million compared to the second quarter of 2006 primarily due to foreign currency fluctuations on our interest paid in Euros. For the first six months of 2007, the $5 million increase in interest expense was primarily due to foreign currency fluctuations on our interest paid in Euros and lower interest expense in 2006, due to the capitalization of interest related to our new manufacturing facilities in China and expansion of our existing manufacturing facility in Brazil.

Other Income (Expense)

	Three Months Ended March 31 2007	2006	Six Months Ended March 31 2007	2006
	(Dollars in millions)			
Other income (expense)	$ (1)	$ 6	$ 1	$ 2

Other income (expense) for the second quarter of 2007 includes a $1 million charge related to the repatriation of funds through an unfavorable exchange transaction from one of our Venezuelan subsidiaries. The change in other income (expense) is primarily due to insurance proceeds received and a positive foreign currency impact during the second quarter of 2006, that did not recur in the same period of 2007.

Effective Tax Rate

Income tax expense for the second quarter and first six months of fiscal 2007 was $11 million and $30 million compared to $1 million and $5 million for the second quarter and first six months of 2006, respectively.

On a quarterly basis, the Company calculates an annual estimated effective tax rate and applies it to the income of the quarter before discrete items. The tax impact of discrete items is then added to arrive at the income tax expense for the quarter. Discrete items include unusual and infrequently occurring items such as the sale of a business and changes in previously estimated tax liabilities resulting from quarter events such as a tax law change or resolution of a tax dispute. In the second quarter of 2007, the effective tax rate was 27% before discrete items. The $11 million tax expense for the second quarter of 2007 includes a $4 million benefit related to the reserve for carbon black antitrust litigation and a $2 million charge related to the unfavorable resolution of a non-US tax case leading to an actual tax rate for net income of 28%. For the second quarter of 2006, the effective tax rate was 28% before discrete items. When the tax impact of the $27 million settlement payment to the Sons of Gwalia is included, the actual tax rate for net income was 6%.

The Company is currently under audit by the Internal Revenue Service for tax years 2003 and 2004 and is under audit in a number of jurisdictions outside of the U.S. It is likely that some of these audits will be resolved in fiscal 2007, which may impact our actual tax rate going forward. The Company expects its effective tax rate for 2007 to be between 26% and 28%, before discrete items.

Net Income

We reported net income for the second quarter and first six months of 2007 of $31 million ($0.45 per diluted common share) and $85 million ($1.24 per diluted common share), respectively, compared to net income of $12 million ($0.17 per diluted common share) and $36 million ($0.52 per diluted common share) in the same periods of 2006. The following earnings per share summary highlights the after-tax impact of certain items described below and the cumulative effect of a change in accounting principle from the implementation, in fiscal 2006, of the share-based compensation standard (FAS 123 (R)):

	Three Months Ended March 31		**Six Months Ended March 31**	
Amounts per Diluted Common Share	**2007**	**2006**	**2007**	**2006**
Certain items:				