MANAGEMENT DISCUSSION SECTION

Operator: Great day, ladies and gentlemen and welcome to the ESI Fiscal 2011 Third Quarter Earnings Call. My name is Delma and I will be your coordinator for today's event. At this time, all participants are in a listen-only mode. We will facilitate a question-and-answer session towards the end of this presentation. [Operator Instructions]. As a reminder, this conference is being recorded for replay purposes.

I would now like to turn the presentation over to Mr. Brian Smith. Please go ahead.

Brian Smith, Investor Relations

Thank you, Delma and good afternoon, everyone. My name is Brian Smith, Director of Investor Relations for ESI. With me today are Nick Konidaris, our CEO and Paul Oldham, our Chief Financial Officer. This conference call will cover our fiscal 2011 third quarter results.

Before we go into the details of the call, I would like to remind you that some of what we say on this call will include forward-looking statements concerning customer orders, shipments revenue, gross margin, expenses and earnings. These statements are subject to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995.

These statements include a number of risks and uncertainties that are discussed in more detail in today's press release and our filings with the SEC. Actual results may differ materially from those forward-looking statements. This call also contains time-sensitive information that we believe to be accurate as of today, January 27, 2011 and which could change in the future. This call is the property of ESI.

Now, I will turn the call over to our CEO, Nick Konidaris.

Nick Konidaris, President and Chief Executive Officer

Thank you, Brian. Good afternoon, and welcome to our third quarter conference call. This was another growth quarter for ESI. Orders at $78 million were the highest in over four years. The macroenvironment appears to be improving and our end markets continue to be relatively healthy. Sequentially, we grew orders, sales, gross margins, operating margins, net income and operating cash flow. Revenues for the quarter were $67 million, up 13% from Q2. Non-GAAP earnings per share were $0.21. Paul will go into more detail around the financials in a moment.

We generated $78 million of orders compared to $70 million last quarter. The increase was driven by record orders for both our flex interconnect and our advanced micromachining products. Semiconductor bookings were down after two strong quarters for memory repair as two key DRAM customers absorbed capacity. Component test orders strengthened as demand for MLCCs continues to be strong.

Let me go through each business in turn. Revenues in our semiconductor business were $50 million, the highest in three years as we shipped the large orders placed during the September quarter. Orders were down sequentially especially in memory repair as we await the third large DRAM customer to begin adding repair capacity.

Given the recent decline in DRAM prices and increased capacity in the market, we expect demand from that customer could now take at least a couple more quarters. Still, we expect to see over $50 million memory orders this fiscal year and DRAM bit growth continues to be strong driven by PC sales, increased content per box and mobile applications.

We continue to make progress with our new model 9900 system for silicon wafer processing in 3D application. This quarter we received and shipped our first order to a foundry customer. In addition, we installed the system at our Japan demo center, where it will be under evaluation by multiple customers. Our LED Scribing business was soft in Q3. Growth for us will be driven by our push into the high brightness LED Scribing market, which will begin to happen in a quarter or two. Looking forward, in our semi business, we expect some choppiness to continue for the next several quarters. Longer-term, we expect this business to continue its recovery back to pre-recession levels.

Our Interconnect and Micro-Machining Group had another strong revenue quarter at $30 million. Over the last four quarters, IMG's revenue has totaled $127 million and we generated record orders this quarter, growing over 75% sequentially. Within IMG, our flex interconnect business had strong revenues and record orders, eclipsing the record it had achieved just the previous quarter. We received several multi-million dollar orders for our newest via drilling system, the model 5330xi. Looking forward, we expect this business to continue to perform well, driven by strong demand for consumer electronics products.

Our advanced micromachining business also had its best quarter ever for orders. Our flexible model 5900 micromachining system continues to prove its worth, leading to several large follow on orders from existing customers and applications.

We're pleased with our contribution to the success of our customers' products, which demonstrates our strategy of partnering with our customers to deliver breakthrough solutions. We see more growth opportunities ahead in this space.

Revenues in our Components Group were $8 million, down sequentially due to lower orders seen in Q2. Q3 orders rebounded however, up 50% sequentially reflecting solid customer demand for our component test systems. In addition, we received an order for our LED package test system from a Tier 1 LED manufacturer. We expect to ship this unit in Q1 of fiscal year '12.

Looking forward, we believe that the fundamental drivers for passive component demand remain healthy, especially demand for smartphones and other consumer electronics products. As such, customer demand in this business will remain solid and will be driven by timing of capacity additions. Plus our entry into packaged LED test should contribute to growth in our next fiscal year.

Turning now to the outlook for ESI. While overall business remains healthy, we expect to see some choppiness quarter to quarter based on timing of capacity absorption. Looking forward into next fiscal year, we will continue executing our growth strategy of investing and diversifying into high-growth markets and applications. For the year, we are targeting 15% to 25% revenue growth, driven by our entry into high brightness LED Scribing, LED package test, and 3D packaging applications for silicon wafers.

In the near term, we have strong backlog and customer activity is solid. In this environment, we expect revenues to increase to around $70 million in the fourth quarter and non-GAAP EPS between $0.20 and $0.24. Now I will turn call over to Paul, for a detailed discussion of our results for the third quarter.

Paul Oldham, Chief Financial Officer, Vice President of Administration, Corporate Secretary

Thank you, Nick, good afternoon, everyone. The following information includes results from our third-quarter fiscal 2011, which ended January 1st. To improve comparability, we're also providing earnings per share and related income statement results on a non-GAAP basis, excluding the impact of purchase accounting, equity compensation, restructuring expenses and non-recurring items.

Orders for the third quarter were $78 million, up 11% from the prior quarter and up 27% from a strong Q3 last year. As Nick mentioned, the sequential growth was driven mainly by record orders in interconnect to micromachining and higher orders in components. These increases were partially offset by lower orders in our semi group both in memory repair and LED Scribing.

Shipments in Q3 were $63 million compared to $65 million in Q2. Ending backlog increased by $14 million to $68 million with the mix of backlog shifting away from semiconductor and toward the other businesses. Deferred revenue decreased by approximately $4 million, due to new product shipments from Q2, recognized in revenue during Q3. Revenue for the third-quarter increased 13% sequentially to $67 million, driven primarily by strong shipments of our semiconductor products. Our book-to-bill ratio was 1.23 to 1.

Gross margin for the third quarter was 45% including approximately $540,000 in cost of goods sold for purchase accounting and equity compensation. On a non-GAAP basis, gross margin was 45.5%, up almost 100 basis points from last quarter, on a higher proportion of semiconductor sales.

GAAP operating expenses were $27.5 million, including $2 million of stock compensation and purchase accounting amortization. In addition, we recognized a charge of $1.3 million related to the arbitration ruling in a suit brought by the former CEO of the company who was terminated in 2003. Also we took an $800,000 charge relating to the transition of procurement and other manufacturing activity to Asia.

Excluding the impact of these items, Non-GAAP operating expenses were $23.4 million, up $600,000 from the prior quarter. The increased spending was largely due to the addition of PyroPhotonics, which we acquired late in the second quarter. However engineering expense were lower than expected due largely to the timing of project materials, which will increase in Q4. In addition, we saw some expenses shift to sales and marketing as our new products begin to transition from engineering into the channel.

Looking forward, we expect non-GAAP operating expenses to be between $24 million and $24.5 million in the fourth quarter due primarily to higher project spending and variable expenses. On a GAAP basis, operating income was $2.5 million compared to $700,000 last quarter, non-GAAP operating profit was $7.2 million or 11% of sales compared to $3.8 million or 6% of sales in the prior quarter.

Non-GAAP operating leverage was 44%. The higher operating income is the result of improved sales and better gross margins. Other expense offset interest income this quarter due primarily to foreign exchange losses in China and Korea.

In addition, subsequent to the end of the quarter, we sold an auction rate security for approximately $700,000, which have previously been written off. This gain will be recognized in Q4. Income tax expense for the quarter was $117,000 and effective tax rate of approximately 5%.

The lower expense this quarter was a result of timing of income between quarters and the catch-up benefit from the renewal of the R&D tax credit, which impacted the quarter favorably by about $0.03 per share. On a non-GAAP basis, our tax rate was approximately 18%.

Excluding the favorable impact of the R&D tax credit, our non-GAAP tax rate would have been approximately 30%. In the long-term, we expect our GAAP and non-GAAP tax rate to be in the low 30s. On a GAAP basis, third quarter net income was $2.4 million or $0.08 per diluted share. On a non-GAAP basis, net income was $5.9 million or $0.21 per diluted share compared to net income of $2.9 million or $0.10 per diluted share in the prior quarter.

Turning now to our balance sheet, cash and investments including restricted cash were $177 million, up $7 million from last quarter. Cash flow from operations was $8.4 million in the third quarter. Year-to-date operating cash flow is $21.3 million or 11.5% of sales. Inventories decreased by $3 million and inventory turns increased to 2.1 times.

We expect to see inventory to continue to decrease slightly and turns to improve as revenue increases. Accounts receivable decreased by $2 million to $45 million. DSO decreased by 10 days to 61 days largely due to timing of shipments earlier in the quarter and the decrease in deferred revenue.

Capital expenditures were approximately $1.8 million and depreciation and amortization excluding purchase accounting was $2.6 million.

Looking forward, the macroenvironment appears to have stabilized and overall, our markets are healthy driven by demand for consumer electronics and smartphones. However, we expect our orders to be choppy given normal cyclicality and timing of absorption of capacity over the next several quarters.

Based on current strength in our business, we expect revenues in the fourth quarter to increase to around $70 million. Gross margin is expected to be up slightly on higher production levels. As a result, we expect non-GAAP earnings excluding stock compensation, purchase accounting and other non-recurring items to be between $0.20 and $0.24 per share.

Now, I will turn the call back to Nick for a brief summary.

Nick Konidaris, President and Chief Executive Officer

To summarize, we completed a very successful quarter. The forecast is for growth to continue next quarter. Our markets are healthy, but cyclical. We are working diligently to execute our growth strategy and we expect to introduce several major new products, which we have announced in the coming quarters, which will expand our addressable market and our growth opportunities. This concludes our prepared remarks. We are ready for your questions. Delma?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from David Duley with Steelhead Securities. Please go ahead.

<Q – David Duley>: Congratulations on a nice quarter.

<A – Paul Oldham>: Thanks, Dave.

<Q – David Duley>: Hey, just one housekeeping, were there any 10% customers on the order front or the revenue front during the quarter?

<A – Paul Oldham>: Yes, there were two 10% customers on the quarter in revenues.

<Q – David Duley>: Could you let us know what the percentages were, although you don't want to know – let the customer names go, I understand that.

<A – Paul Oldham>: We typically don't talk about the percentages in the quarter. At the year end, we'll talk about the percentages of those.

<Q – David Duley>: Okay. And as far as we look at the sequential growth whatever the midpoint of your range is, how should we think about the drop rate to the margin line and the operating income line in this current – in the last quarter?

<A – Paul Oldham>: I think our guidance is relatively consistent with the drop rate of close to 40%, which is what we've guided to. We've seen that for the last couple of quarters, now and I would expect to see that as we go into the fourth quarter.

<Q – David Duley>: That's to the operating income line?

<A – Paul Oldham>: That's right. Remember that the tax benefited EPS this quarter by about $0.03. So on a non-GAAP basis if you normalize for the R&D tax credit it was about $0.18.

<Q – David Duley>: Okay. Final thing from me is could you just talk a little bit more about – you mentioned quickly that you shipped an LED tool into the marketplace and I'm – I apologize. I didn't hear which segment that was into. Could you talk about both your opportunities in the LED marketplace? Give us an update there. Thank you.

<A – Nick Konidaris>: Yes. We announced – we said that we received an order for the LED tester. We have not shipped that system. That system is going to ship in Q1 of our fiscal year '12. You may be confusing that with the fact that we shipped an order for the 9900 dicing system for 3D packaging. We shipped that order and we shipped that system this quarter, in fact. The opportunities in LED for us are summarized into primarily dicing for high brightness LED segment and testing of packaged LED devices – and testing for packaged LED devices. In addition to that we are discovering other smaller opportunities that for instance with doing – with new ways of contacting the LEDs to the packets that require some specialized V applications to eliminate wire bonding on LEDs and replace that with vias that are metal plated and the metal plate stub eventually connects to the outside world. But these are the opportunities in LED. All of them – as a market as we discussed in the investor conference – fluctuate in the neighborhood of about $150 million to $250 million as a sum of total opportunities for us. Market size.

<Q – David Duley>: And so you shipped a tester. Would we expect to ship something into the high brightness side of things on the dicing side?

<A – Nick Konidaris>: We expect to ship something. Yes, we did not ship again an LED tester, we shipped an order -

<Q – David Duley>: Yes.

<A – Nick Konidaris>: Yes, okay. But we have not shipped yet a scriber for high brightness. We are doing a lot of evaluation and expect to make our first shipment this quarter.

<Q – David Duley>: Great. Thank you.

<A – Nick Konidaris>: Thank you.

Operator: Your next question comes from Mark Miller with Noble Capital. Please go ahead.

<Q – Mark Miller>: Yes, good work on the quarter. I'm just wondering about your backlog as you shift away backlog from semi for a while. How does that imply in terms of the margins in your backlog? Are you going to get richer or is it going to get lighter?

<A – Paul Oldham>: Mark, as we mentioned with the strong shipments of semi this quarter, our backlog of semi has declined a little bit and that contributed to the better margins in this quarter. As we look forward, we don't see a large shift in mix impacting the quarter. The slightly higher revenues that we expect in Q4 will offset the mix impact and so we guided to slightly higher margins for Q4.

<Q – Mark Miller>: And your via drilling area, are you starting to see a real impact from 3D packaging and some of the thin silicon via work that's going on? Is that starting to drive you or is that coming?

<A – Nick Konidaris>: I think this is coming and it's coming in a number of applications. One application would be dicing thin wafers. Another application would be doing the interconnections from layers to layers through – with lasers doing through silicon vias, especially when the number of those vias is small. So these are the main applications for 3D and a lot of opportunities coming and we think that the 9900 is going to be a significant contributor in this opportunity that, again as we discussed during the last investor conference, is in the neighborhood of $100 million to $200 million.

<Q – Mark Miller>: And then finally, I missed your sales in the semiconductor and the Internet connect area for the quarter?

<A – Nick Konidaris>: I think it was 30, but let's double-check that.

<Q – Mark Miller>: Okay.

<A – Nick Konidaris>: $30 million? Yes, it was $30 million.

<Q – Mark Miller>: $30 million for semi and what about interconnect?

<A – Nick Konidaris>: $30 million also, right.

<Q – Mark Miller>: Oh, $30 million, $30 million and $8 million. Okay. Thank you.

Operator: Your next question comes from Tom Diffely with D. A. Davidson. Please go ahead.

<Q – Tom Diffely>: Yes, good afternoon. Just a quick verification. When you talked about the testing – the LED tester, you said the order was received but it's supposed to ship in the first quarter of next year – first fiscal quarter?

<A – Nick Konidaris>: Correct.

<Q – Tom Diffely>: Okay. And on the dicing of the high brightness, you expect the first order to come this quarter? And shipped at a future date?

<A – Nick Konidaris>: We expect both order and shipment this quarter.

<Q – Tom Diffely>: Okay. Great. All right. So on the micromachining business have you seen a broadening of the customer base at all or is it still fairly top heavy?

<A – Nick Konidaris>: It's really top heavy right now. It's primarily driven by capacity expansion, but at the same time we have a backlog of new applications that we're working and at the same time we hear noises about opportunities with other customers.

<Q – Tom Diffely>: Okay. And then when you look at the semi business, would you expect to start receiving an additional round of orders in the next quarter or two with some of the larger players?

<A – Nick Konidaris>: I think what's happening in the semi business is that the two customers that really drove those orders, memory repair, for this year are going to take some time to absorb the capacity, we're shipping the majority of that $50 million to those customers.

But we would expect in the next two quarters some orders from those customers but they aren't going to be at the rate that – in my opinion – that we saw in the previous quarter. There's of course the question about the third customer and because right now there is an imbalance between supply and demand, I think that we're going to see some delay of expectation – some delay of materializing orders from that third customer. But the fundamental demand remains strong, there is a temporary imbalance between supply and demand as it is demonstrated in the lowering of the prices for DRAM.

<Q – Tom Diffely>: Right. Okay. You haven't seen that delay get longer have you or is it just use up the old tools just hasn't been absorbed as fast as you thought initially?

<A – Nick Konidaris>: It's basically, when you have those things you try to economize as best as you can and people try to use the old tools as long as they can.

<Q – Tom Diffely>: Okay. And in the passive business that seems to be a fairly healthy end market right now. Does that continue just to be a lumpy business for you?

<A – Nick Konidaris>: We saw in Q2 a low number of orders. These orders have rebounded this past quarter. We expect the demand to continue being strong, especially driven by consumer products in computing and communications.

<Q – Tom Diffely>: Okay. And then finally when you look out the next year or so when some of these new products start to ramp, do you see any kind of margin impact either positive or negative when you get more of the dicing and the high brightness and the LED packaging and testing?

<A – Nick Konidaris>: Well, we're trying to have – to improve our margins everywhere we can. I think as a general rule, we have to say that newer products would perform better than existing products and I think that would be our expectation.
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<Q – Tom Diffely>: Okay. And then finally I guess any new news on the solar front? You said at some points you may tap into that market as well?

<A – Nick Konidaris>: That market is related to our acquisition of PyroPhotonics. That integration moved smoothly. PyroPhotonics is kind of silent in terms of the investor community because they are – all of their output is absorbed by our memory repair tool, but at the same time they're working on finishing their higher power PP lasers that is ideally suited for solar. And at the same time they're getting small orders that don't make the mark of being announced in an earnings call, but they are evaluation orders at solar customers.

<Q – Tom Diffely>: Okay, great. Thank you.

<A – Nick Konidaris>: Thank you.

Operator: [Operator Instructions]. Your next question comes from Mr. Mark Miller with Noble Capital. Please go ahead.

<Q – Mark Miller>: We're seeing photonics equipment firms starting to get real transaction. You mentioned LED. What about OLED? I mean are you seeing any impact there or you have anything planned on the OLED area?

<A – Nick Konidaris>: I think that we have a different activity – well, in terms of OLED from a point view of dicing or – in LED we're involved in dicing and testing. As far as OLED, which is in the LCD space, unless if I'm confused, you mean the LCD that is going to be OLED, is that your question, right?

<Q – Mark Miller>: Yes, yes.

<A – Nick Konidaris>: Yes. Over there I think over a period of time we're going to see opportunities as we develop glass processing solutions. We don't have anything to be announcing this year, this coming fiscal year but as we said in the earnings call, that would be a follow-on wave of new product introduction.

<Q – Mark Miller>: Okay. Just one other area that's been hot recently with some equipment people has been solar and I'm just wondering again any plans or results there?

<A – Nick Konidaris>: Yes. On solar we have – we are really focusing on thin film solar solutions that would be basically CIGS and Cad-Tel. Where we have, we believe a laser that can provide, for certain metal layers, a superior scribe that enhances the efficiency of the solar panel. That solution comes through these TP lasers that are being developed by the company that we acquired, called PyroPhotonics. PyroPhotonics is constantly sending evaluation units to major thin film solar manufacturers. The results are good and we expect that as these evaluations are completed and the product is being finished to see, at least at the laser level, orders from the solar business. Later on we do of course have the opportunity to integrate the laser with our own system, such system we do not have today but we're going to start with the lasers produced by PyroPhotonics.

<Q – Mark Miller>: So some orders are possible this year then. Or this calendar year, I should say?

<A – Nick Konidaris>: That's correct.

<Q – Mark Miller>: Thank you.

Operator: [Operator Instructions]. We have no further questions at this time. I would now like to turn the call over to Mr. Nick Konidaris for closing remarks. Please go ahead.

Nick Konidaris, President and Chief Executive Officer

In summary, we continue to execute our strategy which is all about growth. We do this by leading in the markets we currently serve and by leveraging our expertise into new and adjacent markets and applications.

Thank you very much for joining us. You are welcome to call Paul, Brian or me if you have further questions. This concludes our call, thanks for your interest in ESI.

Operator: Thank you for your participation in today's conference. This concludes today's presentation. You may now disconnect and have a wonderful day.