PARTICIPANTS

Corporate Participants

Brian Smith – Director-Investor Relations
Nicholas Konidaris – President, Chief Executive Officer & Director
Paul Oldham – CFO, Secretary & Vice President-Administration

Other Participants

Tom Diffely – Analyst, D. A. Davidson & Co.
Jim Ricchiuti – Analyst, Needham & Co. LLC

MANAGEMENT DISCUSSION SECTION

Operator: Hello, ladies and gentlemen, and welcome to your ESI Fiscal 2013 Quarter One Earnings Conference Call hosted by Brian Smith. My name is Mariana and I will be your coordinator for this session. During this presentation, your lines remain on listen-only. [Operator Instructions]

Without any further ado, let me hand the conference over to Brian Smith. It's over to you Brian, please go ahead.

Brian Smith, Director-Investor Relations

Thank you, Mariana, 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 2013 first quarter result.

Before we go into the details of the call, I'd like to remind you that some of what we say on this call will include forward-looking statements concerning customer orders, shipments, revenue, gross margins, 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, July 25, 2012, 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.

Nicholas Konidaris, President, Chief Executive Officer & Director

Thank you, Brian. Good afternoon and welcome to our first quarter conference call. In our first quarter, we generated sequential sales and orders growth, kept our expense rate flat, secured new design wins, acquired the state-of-the-art laser company and generated over $11 million of operating cash.

Although several of our markets continue in overcapacity, we executed on the opportunities available in interconnect and microfabrication and made good progress on our growth initiatives. Revenues for the quarter were $59 million. Non-GAAP earnings per share were $0.06. Paul will go into more detail around the financials in a moment.

We generated $74 million of orders, up 5% from Q4. Once again, our interconnect and microfabrication business led the way. Well over half of the bookings came from this product group. We received several large orders for our advanced microfabrication products from new design wins as well as follow-on orders for existing applications. Flex interconnect orders were down after the record levels last quarter. Demand picked up for our component test products, while orders for our DRAM and LED systems remained at trough levels.

Let me discuss each business in turn. The interconnect and microfabrication group had revenue of $48 million, up about 50% from last quarter. Orders declined somewhat from last quarter, mainly due to lower flex interconnect orders coming off the record March quarter. The flex interconnect business continues to see robust customer activity, but it's absorbing the significant capacity order over the last two quarters. The key demand driver here continues to be smartphones and tablets, which use an increasing amount of flex circuitry to improve functionality, while taking up a little space as possible.

In advanced microfabrication, we received several large orders. Most exciting, our new design wins we secured this quarter, which produced not only large orders but could also result in significant follow-on business. This business has been our most dynamic, our most challenging and our most rewarding.

Its new design win opportunity is a chance for ESI to prove its unique capabilities in creating breakthrough solutions to solve our customers' most difficult challenges. And each challenge we meet, our organizational capabilities increase. Although lumpy, we believe the potential for growth in this space is very exciting. In addition, we shipped the majority of orders received last quarter for our new model 5950 printed circuit depaneling system. The 5950 is setting a new standard in PCB singulation.

Turning to our semiconductor business, revenues were $4 million, about half of the level from last quarter. The DRAM market remains in overcapacity and pricing continues to weigh down profitability. We saw virtually no demand from this market in Q1. We're cautious in our expectations from the DRAM space given the uncertainty in the industry and the declining rate of big growth being forecasted.

Our LED sapphire wafer scribing products show a slight increase in demand in Q1, but the LED market remained in its oversupply condition. LED manufacturers continue to invest in technologies to boost light output, but large capacity additions appear to be contingent on more end user adoption of LEDs for general lighting. Results so far give us confidence that our model 2600 utilizes the only proven technology today to scribe the most advanced high-brightness LED wafers. Our mission is to make the 2600 the tool of choice with meaningful capacity addition solution.

Our components group generated $8 million of revenues in the quarter, slightly above last quarter. Orders in Q1 more than doubled, the trough levels seen in Q4, driven by demand for the 3510 MLCC microchip tester.

This new state-of-the-art tool addresses the smaller sized capacitors, used primarily in smartphones and tablets. The other end products that utilize capacitors, namely PCs, televisions and automobiles, are not driving growth in this market. In LED test, the broad market continues to be in overcapacity. During this time, we're working to qualify our new model of 3800 in order to participate in the next round of investment driven by general lighting applications.

Finally, this quarter, we acquired EOLITE Systems, a designer and manufacturer of unique fiber lasers. The acquisition provides ESI direct access to differentiated higher-power fiber laser technology, which can be used in a broad set of microfabrication applications for customized solutions at lower cost.

Leading edge laser capability is key for ESI to meet the challenges in state-of-the-art materials processing. By combining the higher power amplification capabilities of EOLITE with a flexible pulse technology from our PyroPhotonics division, we strengthen our capability to provide innovative solutions to our customers.

Turning now to the outlook for ESI. This is our second straight quarter of orders over $70 million in a difficult market environment. We have executed well in winning new microfabrication designs and receiving large orders. Our products and solutions are leaders in their markets and we're capitalizing on those revenue opportunities available to us. As for the other markets, we would be well positioned for meaningful capacity investment [ph] reasons (07:48). Looking now to the second quarter, we expect revenues to be between $75 million and $80 million. Non-GAAP EPS is expected to be $0.15 to $0.20.

Now, I will turn the call over to Paul for a detailed discussion of our results for the first quarter.

Paul Oldham, CFO, Secretary & Vice President-Administration

Thank you, Nick, and good afternoon everyone. The following information includes results from our first quarter of fiscal 2013, which ended June 30. To improve comparability, we are also providing earnings per share and related income statement results on a non-GAAP basis, excluding the impact of purchase accounting, equity compensation, restructuring charges and non-recurring items.

For the first quarter, we generated $74 million of orders compared to $70 million last quarter and $99 million a year ago. Sequentially, we saw a growth in advanced microfabrication, driven by large orders including new design wins. And in component tests, primarily from technology buys for our new 3510 MLCC microchip tester. We also saw a modest increase in LED, but the overall LED, DRAM and MLCC markets continue in overcapacity. Although customer activity continues to be brisk, flex interconnect declined from the record March quarter.

Shipments were $59 million and backlog increased by over $15 million to $84 million, our highest level in over six years. We expect the majority of this backlog to ship in the next two quarters. Our book-to-bill ratio was 1.3 to 1 and deferred revenue remained flat at about $10.7 million.

Revenue for the first quarter was $59 million, up from $45 million last quarter and slightly above our expectations. The increase was primarily related to shipments of our flex interconnect products ordered last quarter.

Gross margin was 40% including $553,000 in cost of goods sold for purchase accounting and equity compensation. On a non-GAAP basis, gross margin was 41%, down sequentially due to product mix weighted towards higher volume business.

Looking forward, we expect non-GAAP gross margins to, again, be around 40% driven by continued mix of product toward higher-volume low-cost applications. Improvement in margins will be driven over time as our mix of traditional business recovers and by the introduction of new products. In addition, we expect gross margin improvement from our globalization strategy, material costs reductions and improved operational efficiency.

GAAP operating expenses were $25.2 million, down about $2.1 million from last quarter. The decrease was driven primarily by lower restructuring and non-recurring charges partially offset by higher equity compensation expenses. Increased stock-compensation this quarter is a result of the immediate expense recognition of annual grants to the Board and CEO. For the year, stock compensation will be down versus last year.

Purchase accounting amortization was $120,000. GAAP expenses also included $800,000 of transaction and integration costs related to the EOLITE acquisition.

Excluding these items, non-GAAP operating expenses in Q1 were $21.5 million, flat with last quarter. Looking forward, we expect non-GAAP expenses in Q2 to increase $1.5 million to $2 million on higher variable expenses and the addition of EOLITE costs.

On a GAAP basis, operating loss was $2.5 million compared to a $10.5 million loss last quarter, reflecting higher sales and lower restructuring and non-recurring charges. Non-GAAP operating income was $2.7 million compared to a loss of $2.1 million in the prior quarter on higher sales and gross profit.

Income tax for the quarter was a benefit of $750,000, an effective tax rate of approximately 44%. The non-GAAP tax rate was 26%. On a GAAP basis, first quarter net loss was $0.9 million or $0.03 per share. On a non-GAAP basis, net income was $1.9 million or $0.06 per diluted share.

Turning now to our balance sheet, cash and investments including restricted cash were $220 million, a decrease of only $2 million from last quarter. During the quarter, we issued a dividend of $0.08 per share or approximately $2.3 million and paid $9.2 million in net cash for EOLITE. This was largely funded by operating cash flows of $11.4 million or almost 20% of sales.

For the quarter, inventories increased by $2 million, and turns improves to approximately two times. Accounts receivable decreased by $5 million on higher sales, as DSO improved to 43 days based on timing of shipments and customer mix.

Capital expenditures were $1 million, and depreciation and amortization, excluding purchase accounting was $2.3 million. As I mentioned, at the end of the quarter, we acquired EOLITE Systems for $9.2 million in net cash. Transaction related costs were approximately $800,000. In addition, we expect to pay off approximately $1.8 million in the assumed debt during the second quarter.

For the fiscal year, we expect revenues from EOLITE of $3 million to $4 million and dilution of $0.01 to $0.02. Over time, we expect this acquisition to provide both differentiated capabilities that can be used across the broad set of applications and improved gross margins through vertical integration.

Looking forward, we continue to see multiple opportunities related to consumer electronics, although this business is lumpy, based on timing of design wins. At the same time, our traditional businesses in DRAM, LED and MLCC continue in overcapacity and increased uncertainty in the macro environment make timing and magnitude of recovery difficult to predict.

As a result, we expect business levels in the near-term to continue to be driven by design wins from micromachining applications, technology buys and timing of recovery in our markets. Based on recent order levels, we expect Q2 revenues to be between $75 million and $80 million. Non-GAAP EPS is expected to be between $0.15 and $0.20.

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

Nicholas Konidaris, President, Chief Executive Officer & Director

To summarize, in cyclical markets bounded by a slow growth macroeconomic environment, we're executing well and capturing the exciting revenue opportunities in interconnect and microfabrication. We're well positioned to capture a largest share of the opportunities in LED, component test and DRAM when customers in those industries resume their capital spending.

This concludes our prepared remarks. We're ready for your questions. Mariana?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And I can see that there is one question already. It is from the line of Tom Diffely [D. A. Davidson & Co.]. Please go ahead. Your line is open.

<Q – Tom Diffely – D. A. Davidson & Co.>: Yeah, good afternoon.

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Good afternoon, Tom.

<Q – Tom Diffely – D. A. Davidson & Co.>: Very impressive order number. So a quick question on the micromachining business. In the past, you've had, from time-to-time, really strong orders for, I think, quarter two and then we have two to three quarters off. Are you seeing the frequency of business, so the frequency of opportunities go up over time or just more products or more programs you can work on where you get, maybe, a little bit less lumpiness over time or more sequential stability in that space?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: What I would say is that this is a growing business, unlike the other business we're in that are cyclical, but continues to be characterized by lumpiness, which is a function of timing of design wins. We'll probably need more data to be more specific in terms of trends, whether we see...

<Q – Tom Diffely – D. A. Davidson & Co.>: Is it just a greater number of potential projects out there that may potentially enable to...

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: [ph] The business is slowing and (16:14), therefore, we have to see either a larger number of potential projects or bigger opportunity per project.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. And is there any way to characterize kind of the margin profile of the current – the most recent slug of orders for micromachining versus where they were a quarter ago?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Well, it's a – we have – correct this is different business than the rest of our business which characterized by very large orders and therefore we take that into account.

<A – Paul Oldham – Electro Scientific Industries, Inc.>: Well, larger orders in both dollar and units.

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: And units, right.

<A – Paul Oldham – Electro Scientific Industries, Inc.>: The high volumes.

<Q – Tom Diffely – D. A. Davidson & Co.>: Yeah, okay. And then I guess you mentioned too that you expect the expenses to go up $1.5 million to $2 million on a non-GAAP basis. What are your expectations on a GAAP basis?

<A – Paul Oldham – Electro Scientific Industries, Inc.>: They would probably be up a little less than that because stock comp in particular will be lower by about $1 million.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. And that's always the first quarter, kind of a lump?

<A – Paul Oldham – Electro Scientific Industries, Inc.>: That's right.

<Q – Tom Diffely – D. A. Davidson & Co.>: For the full year. Okay.

<A – Paul Oldham – Electro Scientific Industries, Inc.>: In addition, we won't have the transaction expenses we had this quarter. So if you took those out, I guess it might be flat or up a little bit.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. And then when you look at your three matured markets, Nick, obviously they're all fairly depressed at this point. But are you seeing signs there that the overcapacity is becoming less over time and you would expect to see something in the upcoming quarters or is it just too hard to read?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Well, we see signs of improvement in MLCC, but especially in the microchip segment of MLCC. This is the [indiscernible] (17:58). And we expect that to remain strong primarily because it really addresses the smaller and smarter consumer electronics. I think we started seeing signs, but to a lesser degree, in LED around high-brightness. I will not say that we see any signs in memory yet, although we do hear that the utilization has improved of our systems that are being deployed.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. And then may be just extended to the flex market, how long do you think this digestion period is going to last after many good quarters in a row?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: I would say it's in the neighborhood of about two quarters...

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay.

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Or take.

<Q – Tom Diffely – D. A. Davidson & Co.>: Great. All right thank you.

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Thank you.

Operator: Thank you for your question. The next question will be from the line of Jim Ricchiuti. [Needham & Co. LLC] Please go ahead. Your line is open.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Thank you. Good afternoon.

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Good afternoon.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Nick, last quarter, you talked a little bit about the orders you received for the 5950. And it sounded like the margin profile on that particular piece of business was lower than you would normally expect, because they were different applications. I guess what I'm struggling with now is looking at the margin profile for this quarter, was it a case of you seeing follow-on business for similar applications or are you seeing just pressure in this microfabrication business?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: So, first of all – and the kind of business this quarter was characterized from a point of view of orders from design – new design wins. Clearly, there is always special, but this is not the main point. The main point is that when we're faced with a big order in terms of both dollars and units, we take that under consideration around accounts that we think are extremely strategic for our future.

<Q – Jim Ricchiuti – Needham & Co. LLC>: So, can you just give us some sense as to where you might see your margins go, typically, these kind of revenue numbers that we're talking about? If we look back, your gross margins were a good deal higher. And so, going forward, how should we think about your gross margin? I know there's a mix issue, but is there a range that we should be thinking in terms of – is this toward the lower-end of that range with this revenue number?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Good point. Our thinking about margin has not changed that we believe in the model that we're having. And going forward, we think that – as a result of a better mix, because as we indicated in the current mix, we really don't have traditional business. But that traditional business recovers, as the new products take off, combined with our globalization strategy, combined with a number of initiatives we have for material cost reductions. And improved operational efficiency as a result of these large orders, we expect to be closer to our traditional model, which is a variable model, but which at around $90 million per quarter could offer and these – as a model offers 50% margin.

<Q – Jim Ricchiuti – Needham & Co. LLC>: So, it is a case where you really need to see that the improvement, the rebound, the recovery in this semiconductor portion of the business, as well as in the passive components area?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: We need to have better mix.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Yeah, okay.

<A – Paul Oldham – Electro Scientific Industries, Inc.>: I think what you're seeing right now, Jim, is that we really have one cylinder firing...

<Q – Jim Ricchiuti – Needham & Co. LLC>: Yeah.

<A – Paul Oldham – Electro Scientific Industries, Inc.>: ...very well. And that cylinder happens to be biased, right now, towards larger – higher-volume, larger orders which by its nature are going to come with somewhat lower margins than our corporate average. As other cylinders begin to fire and that mix normalizes, then we should see margins normalized as well.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Now, that's helpful. A final question from me, just with respect to acquisitions, some of the acquisitions, most recent acquisitions, they appeared to be more technology related acquisitions, albeit strategic. As you look at the acquisition opportunities that you see out there, is this what we can expect? Or are you also looking, perhaps, at potentially larger acquisitions that could be contributing more meaningful to revenues?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Clearly, you're going to – should expect to see strategic acquisitions where that can offer to us differentiated capability. But our fundamental strategic drive is to really grow the revenue. And if we have an acquisition that is of a larger size, but again strategic and consistent with our strategic objective of growing revenue that being profitable, we will do that.

<Q – Jim Ricchiuti – Needham & Co. LLC>: And how would you characterize the pipeline for some of these larger deals at the moment?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: The pipeline is always active. But we have our own criteria and we are extremely picky in what we think make sense for ESI.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Okay. Thanks very much.

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Thank you.

Operator: Thank you. [Operator Instructions] There are no further questions.

Nicholas Konidaris, President, Chief Executive Officer & Director

Okay. 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 ladies and gentlemen, that concludes your conference call. Thank you for joining. You may now disconnect. Have a good day.