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ESIO - Q1 2011 Electro Scientific Industries, Inc. Earnings Conference Call

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CORPORATE PARTICIPANTS

Brian Smith

Electro Scientific Industries, Inc. - Director, IR

Nick Konidaris

Electro Scientific Industries, Inc. - CEO

Paul Oldham

Electro Scientific Industries, Inc. - CFO

CONFERENCE CALL PARTICIPANTS

Jim Ricchiuti

Needham - Analyst

Tom Diffely

DA Davidson - Analyst

Mark Miller

Noble Financial - Analyst

Kelly Anderson

Sidoti - Analyst

Shawn Boyd

Westcliff Capital Management - Analyst

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the ESI fiscal 2011 first quarter earnings conference call. My name is Christine, and I will be your operator for today. At this time, all participants are in listen-only mode. Later we will conduct a question-and-answer session. (Operator instructions). As a reminder, this call is being recorded for replay purposes. I will now turn the call over to your host for today, Brian Smith, Director of Investor Relations. Please proceed.

Brian Smith - *Electro Scientific Industries, Inc. - Director, IR*

Thank you, Christine, 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 first 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, revenues, 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, July 28th, 2010, 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 - *Electro Scientific Industries, Inc. - CEO*

Thank you, Brian.



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Good afternoon, and welcome to our first quarter conference call.

This was a very good quarter for ESI. We saw strong demand across all of our product categories. The revenue more than doubled from last year, and we generated excellent operating cash flow. In addition, we began to see activity in our memory repair business, our products continued to gain share in key accounts, and we recently launched the first of several new products this year, the 9900, ultra thin wafer dicer. However, gross margins and overall profitability were impacted by unfavorable mix towards older products and sales of existing finished goods inventory, particularly in memory repair.

Revenues for the quarter were \$58.5 million, down slightly from last quarter. Non-GAAP earnings per share were \$0.03. Paul will go into more detail around the financials in a moment.

We generated \$64 million of orders, compared to \$54 million last quarter. The increase was driven by demand for memory repair systems as we saw orders for multiple customers. We're pleased that after a long drought, we're beginning to see the memory market investing again in repair. We also saw strong results in flex interconnect, passive component tests and, LED wafer scribe. And we received several follow-on orders for our advanced micromachining products.

Revenues in our semiconductor business were \$19 million, up dramatically from last quarter, and last year. The key driver of course was the return of our memory repair business, which accounted for over \$10 million in revenue. In addition, in our LED business we saw strong revenues as we had acceptance of several AccuScribe systems and won a large competitive order in China.

Looking forward in our semi business, we expect to see continuing improvement in the memory repair market, driven by strong growth in PCs, servers, and smartphones. In addition, all of our customers have recently announced increases in capital spending related to memory. Although order levels may be choppy over the next few quarters as customers begin to add capacity and implement new technology, we are confident that this will once again be a healthy long-term business for us. Separately, we expect the LED scribing and LCD repair businesses to remain solid.

We're also excited to enter the silicon wafer dicing market with the introduction of our new Model 9900 ultra-thin wafer dicing system, which we announced two weeks ago. This system solves a fundamental problem plaguing the industry as it moves towards 3-dimensional packaging and stacked die. Until today there has been no effective way to dice wafers that are thinner than 50 microns. Our Model 9900 is specifically targeted at this application, and moves ESI into an attractive adjacent market. Customers are currently evaluating the 9900 for new 3D applications and we expect to see meaningful orders later this fiscal year.

Our interconnect and micromachining group had another strong revenue quarter, at \$21 million, after record-setting revenues last quarter. Within IMG, revenues in our flex interconnect business were particularly strong, driven by continued robust seasonal demand. In addition, we saw customer acceptance of our new 5330 XI, which provides faster throughput and higher accuracy for sub-70 nanometer vias. Looking forward we expect this business to continue to perform well, driven by strong growth in consumer electronics.

We also had another good quarter in our advanced micromachining business. We received follow-on orders for the 5900 in multiple applications and we see many additional opportunities for this platform in the future. We're excited about our long-term growth potential as we expand our capabilities in glass, new generation of PCDs and 3D devices.

Revenues in our passive components group were \$19 million, the highest quarterly revenue in over two years, as we shipped and gained acceptance for our newest (inaudible). Orders were lower than the last two very strong quarters, but still reflect healthy markets and good customer demand. Looking forward, we believe that the end markets driving passive component demand are healthy, namely smartphones, PCs, and high-definition TVs. As such, demand should remain solid, but will be down in the short term as capacity is absorbed into the market.



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Before turning to the outlook for ESI, let me just comment about gross margin. Why we're not happy with gross margins this quarter, we believe that the factors that drove lower margins are transitional in nature. In addition, we were able to monetize existing inventory to meet customer demand. Looking forward, we're confident that strength in our top line and mix toward newer products, and efficiency gains from globalization will enable margins to rebound next quarter.

Turning now to the outlook for ESI. After many quarters in the desert, we are pleased the train has begun to haul again in the memory repair market. We mentioned before that this business is one of the key drivers to our growth in fiscal 2011, along with continued economic recovery and market expansion through new products such as the Model 9900. These drivers will take effect over the next several quarters. In the short-term, we expect revenues around the current level, as we continue to see some choppiness in our markets. For the second quarter we expect revenues to be between \$55 million and \$60 million, and non-GAAP earnings per share of \$0.05 to \$0.10.

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

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Thank you, Nick. And good afternoon.

The following information including results from our first quarter of fiscal 2011, which ended July 3rd. 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 expenses and non-recurring items.

Orders for the first quarter were \$64.1 million, up 18% from the prior quarter, and more than double from last year. As Nick mentioned, the sequential growth was driven mainly by the resumption of demand in the memory repair business and reflects our highest order level since Q3 of 2008. In addition, we had record LED scribe orders driven by a large competitive win for our AccuScribe system in China. These increases were partially offset by the timing of service contracts and lower passive component orders as customers installed and absorbed new capacity.

Shipments in Q1 were \$56 million compared to \$66 million from the previous quarter, which included the shipment of the large micromachining order ESI received in Q3. Excluding the shipment of the large order last quarter, shipments increased over 30%, with strong growth in passive components and memory repair. In addition, in both of these businesses, we were able to ship a significant amount of existing finished goods inventory.

Ending backlog increased by \$8 million to \$49 million, due to the strong bookings in the quarter. Deferred revenue decreased by \$2.6 million and is consistent with historical levels.

Revenue for the first quarter was \$58.5 million, compared to \$59.6 million in the prior quarter. Our book-to-bill ratio was 1.15 to 1.

Gross margin for the first quarter was 37%, including \$570,000 in costs of goods sold for purchase accounting and equity compensation. On a non-GAAP basis, gross margins were 38%, down from 44% last quarter. Decline in gross margin was driven primarily by a shift in mix towards our traditional flex via drilling systems, component tests and inspection tools, and lower margin older memory repair systems.

In addition, we had increased sales from existing finished goods inventory, particularly in our memory repair business. This allowed us to utilize existing inventory, but at a cost. Not only did these products not absorb new manufacturing expenses, but they also required effort to reconfigure and update. While we believe this was the right tradeoff that contributed to strong cash flow, it negatively impacted margins in the short-term.

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Looking forward, we expect gross margins will largely recover next quarter as the mix shifts back towards newer products and we ship more from current production. Over the longer term, we are committed to achieving our gross margin objectives, as we introduce new products and execute our ongoing actions to lower costs through globalization.

GAAP operating expenses were \$23.1 million, down slightly from the previous quarter. Included in the first quarter's operating expenses were purchase accounting and amortization of approximately \$225,000, and stock compensation of \$2.6 million. Increased stock compensation this quarter was due primarily to accelerated vesting of our annual Board grants as we had guided previously.

Also included in operating expenses was a onetime credit of \$900,000 related to the closing of the final escrow for our New Wave Research Acquisition. Excluding the impact of these items, non-GAAP operating expenses were \$21.1 million down \$0.5 million from the prior quarter. Increased R&D spending was more than offset by reductions in other operating expenses. Looking forward we expect non-GAAP operating expenses to be between \$22 million and \$23 million, due primarily to the impact of annual merit increases, and increased project expenses related to new products.

On a GAAP basis, operating loss was \$1.6 million or 3% of sales, compared to net income of \$2.4 million last quarter. Non-GAAP operating profit was \$925,000, compared to \$4.6 million in the prior quarter. The lower operating income is primarily the result of the lower gross margins I discussed earlier. Non-operating income declined from last quarter due to lower interest income, after a one time benefit last quarter that did not repeat, and the mark-to-market adjustment of our employee non-qualified deferred compensation plan.

Income taxes for the quarter reflected a benefit of \$1.7 million, offsetting the loss before taxes. The benefit was driven by the mix of US and foreign earnings and is a result of our tax strategy. Our non-GAAP tax rate was approximately 22%. Looking forward, the GAAP tax rate will continue to roughly mirror income or losses around break-even levels. In the long-term we expect our GAAP and non-GAAP tax rates to be in the low 30s as operating income increases.

On a GAAP basis, first quarter net income was \$200,000 or \$0.01 per diluted share. Non-GAAP net income was \$800,000 or \$0.03 per diluted share, compared to net income of \$4.4 million or \$0.16 per diluted share in the prior quarter.

Turning now to our balance sheet. Cash and investments including restricted cash were \$180 million, up nearly \$14 million from the prior quarter. Cash flow from operations was \$14.8 million for the first quarter, the result of excellent execution in all areas of working capital. Inventories decreased by \$2.2 million, however, finished goods and available for sale assets were down over \$5 million, resulting from our sale of older equipment. This marks our lowest level of inventory since early 2006, and the reduction of over 30% from its peak in 2008. Inventory turns, as a result, rose to 2.1 times.

Accounts receivable decreased to \$33.5 million on lower shipments, reflecting excellent DSO performance of 52 days. Capital expenditures were approximately \$1.3 million, and depreciation and amortization, excluding purchase accounting, was \$2.6 million.

Looking forward, we expect our markets to continue to be choppy in the short-term with revenues around the current level. As a result in the second quarter we expect revenues to be between \$55 million and \$60 million. We expect non-GAAP earnings, excluding stock compensation, purchase accounting, and other nonrecurring items, to be between \$0.05 and \$0.10 per share, driven primarily by improved gross margins.

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

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

To summarize, we completed a successful quarter.



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We're pleased about several things -- our healthy and recovering markets, our strong competitive position within those market, and our exciting new product pipeline. Although we are not happy with overall gross margin, we are able to monetize older inventory, and take advantage of market opportunities. Looking forward, we expect gross margins will largely recover next quarter as the mix shifts back towards new products. Over the longer term, our globalization effort to lower our costs and our growth strategy will allow us to realize full value for our products, and achieve our target margins.

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

Christine?

QUESTIONS AND ANSWERS

Operator

(Operator instructions). Your first question comes from the line of Jim Ricchiuti, representing Needham and Company. Please proceed.

Jim Ricchiuti - *Needham - Analyst*

Thank you, good afternoon.

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

Good afternoon.

Jim Ricchiuti - *Needham - Analyst*

The question I had relates to gross margins, and Paul, I just wanted to make sure I heard this right, there was a \$5 million reduction in finished goods inventory, and that -- was that mostly related to memory repair tools?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

It was mostly related to memory repair tools, but we were also able to move some older component-tested inspection tools and a couple of other areas where we were able to see some reductions. But it was primarily memory repair tools.

Jim Ricchiuti - *Needham - Analyst*

Okay. So the margins were down mostly in the semiconductor systems portion of the business, and that's due primarily to memory repair, but also down as well -- I'm talking about sequentially, in passive components?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

The passive components were actually about flat or maybe even up a little bit, as some of our newer products carry better gross margins. However, the mix of passive component was much higher this year as a proportion of the total than they were last quarter.

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Jim Ricchiuti - *Needham - Analyst*

Okay. How about the interconnect portion and micro machining? How were the margins in that area?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

As we mentioned we saw a heavy mix towards our traditional flex interconnect drilling machines, and those are more commodity-type products, and carry lower margins associated with them.

Jim Ricchiuti - *Needham - Analyst*

Got it. And when you say you see margins recovering in the current quarter, recovering -- do you assume -- should we assume they get close to the Q4 level?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Yes, we would certainly see them, you know, kind of recover back to what we have seen around these revenue levels. There is always going to be a little bit of variation related to mix. But the mix this quarter was quite unusual, if you look at each of the individual areas.

Also, the inventory reduction that we saw this quarter has largely been completed. I think there could be a little more that could flow through there, but that's largely completed, and so we don't expect to see margin levels at this level going forward.

Jim Ricchiuti - *Needham - Analyst*

Okay. And lastly for me, any 10% customers?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

We did have one 10% customer this quarter.

Jim Ricchiuti - *Needham - Analyst*

Can you say what product segment that was in?

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

Was the -- the passive components.

Jim Ricchiuti - *Needham - Analyst*

Okay. Thanks very much.

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Operator

Your next question comes from the line of Tom Diffely, representing D.A. Davidson. Please proceed.

Tom Diffely - *DA Davidson - Analyst*

Yes, good afternoon. Just one more question on the memory repair systems. The older margin stuff. Was the margin lower because of a reduced ASP, or simply just reconfigured and the cost associated with that?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Yes, it was really three things, Tom, the biggest one was we were able to utilize existing finished goods inventory. That was great, but we did have to take things that were basically built, tear them apart, make sure they were updated, ready to go and then ship those. Also the mix, because we saw acceleration of demand in the current quarter, the mix tended to be towards some of the lower-priced units, and therefore those tended to go out at lower prices. And the third thing is we did want to have some hooks into our newer technology, so we committed to some upgrades in the quarter, and that compressed margins because of deferred revenues and costs associated with that. So it's really a combination of things with the biggest one being the fact that we were able to utilize a lot of the existing inventory.

Tom Diffely - *DA Davidson - Analyst*

Okay.

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

Also by the way, the fact that it came from finished goods did not allow for absorption.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

That's right.

Tom Diffely - *DA Davidson - Analyst*

Okay.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

So we did a lot of work on them, but no value was added to either inventory or cost.

Tom Diffely - *DA Davidson - Analyst*

All right. Okay. Good. And have you seen any difference or any change in the competitive environment with the financial troubles of your biggest competitor?



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Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

What we have seen -- well, first of all -- I am not commenting about a competitor. I assume the competitor is going to compete, and we take other competition seriously. What I can comment is that we see our market share increasing.

Tom Diffely - *DA Davidson - Analyst*

Okay. All right. And then just quickly on the -- the new product -- the 9900. Where does that fit in from kind of a margin structure to your different categories?

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

This is going to be in the semiconductor division, and will be consistent with products in -- from a margin point of view that are semiconductor capital equipment and the experience that we have with these products in the last several years.

Tom Diffely - *DA Davidson - Analyst*

Okay. And can you give us any idea of what you expect, kind of a growth profile to be over the next year?

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

Yes. We think that the markets for dicing thin wafers is -- next year -- is in the neighborhood of about \$80 million to \$90 million, but that is not focusing on the entire market. This is focusing on the ultra thin, which is 50 micron and below.

Tom Diffely - *DA Davidson - Analyst*

Right.

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

And we believe this ultra-thin market is really -- cannot take off, and needs to take off -- needs to take off because of 3D packaging, but cannot take off because there is no effective solution in the market today. And we are the ones that will provide that. As we provide that, we expect to see orders towards the end of the year. We are in evaluations right now, and gradually as the market transitions into ultra-thin, we're going to see a gradual growth of that market faster than -- than the overall growth of dicing of thin wafers. Why? Because more people are going to be transitioning towards the ultra-thin.

Tom Diffely - *DA Davidson - Analyst*

Okay. And initially it is really the stacked demand that is the big driver?

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

That is one of the big drivers. This is the main point, and it's the overall umbrella is the 3D packaging.

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Tom Diffely - DA Davidson - Analyst

Yes. Okay. All right. And can you give us a quick update on the factory in Singapore?

Nick Konidaris - Electro Scientific Industries, Inc. - CEO

Yes, the factory was -- we opened the factory in March. It is producing right now products from two of our divisions, and as we have mentioned, we expect that in about two year's time we'll be producing products from all of the divisions, but right now it's about one-third of our production is out of the Singapore factory. We have hired people. We continue hiring people there, we're very pleased with the results. And this will be the factory -- the main factory as we move forward.

Tom Diffely - DA Davidson - Analyst

Okay. And Paul, could you just remind me what the restricted cash is for?

Paul Oldham - Electro Scientific Industries, Inc. - CFO

Yes, Tom, the restricted cash is related to the IP suit that we're prosecuting in Taiwan. We had originally had a cash deposit in Taiwan, and we were able to extract that cash in lieu of a letter of credit, so we were able to get the cash back, but because there is a letter of credit against that cash, then we report it as restricted cash.

Tom Diffely - DA Davidson - Analyst

Okay. And just to clarify on the bookings front, most of the bookings, kind of the strongest bookings in I guess two or three years was driven by the semi repair business?

Nick Konidaris - Electro Scientific Industries, Inc. - CEO

This is the strongest bookings since last calendar quarter of 2007.

Tom Diffely - DA Davidson - Analyst

Okay. Yes.

Nick Konidaris - Electro Scientific Industries, Inc. - CEO

So it's really a good record. Paul is checking --

Paul Oldham - Electro Scientific Industries, Inc. - CFO

Yes, Tom, if you look at the overall bookings, I would say it was pretty balanced across our business.

Certainly the sequential increase came from semi business, as I described, and long LED orders. We also had very good bookings in our interconnect and micromachining businesses. Passives was down a little bit, as we discussed, as people absorbed capacity, and also timing of our service contracts, which when we book a service contract, we recognize one year of that in orders was down, just because we tend to get a lot of service contracts renew around year end, which was last quarter.



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Tom Diffely - DA Davidson - Analyst

All right. Thank you very much.

Brian Smith - Electro Scientific Industries, Inc. - Director, IR

Thank you.

Operator

Your next question comes from the line of Mark Miller, representing Noble Financial. Please proceed.

Mark Miller - Noble Financial - Analyst

Nick or Paul, could you just kind of break out backlog a little bit more -- I assume it's more passive than interconnect, and are these newer systems, higher-margin systems or what?

Nick Konidaris - Electro Scientific Industries, Inc. - CEO

Yes, Mark, the backlog is in the neighborhood of about -- half of it would be interconnect, 30% would be the semiconductor, and 20% would be passives.

Mark Miller - Noble Financial - Analyst

Are these your more higher-margin tools or more legacy tools?

Paul Oldham - Electro Scientific Industries, Inc. - CFO

It's kind of a mix if you look at the total backlog. I would say our backlog is more of a normalized mix versus what we saw this quarter.

Mark Miller - Noble Financial - Analyst

Okay. Just wondering if you could comment on the latest update, what you are seeing in each of your three areas for the factory utilizations, your typical utilizations, in memory, interconnect, and passive?

Nick Konidaris - Electro Scientific Industries, Inc. - CEO

Yes, we do that update regularly every quarter, and I remember in the recent past we're hearing numbers of 80% or below, but in the last two quarters, in almost all businesses, that's in the neighborhood of 90% and above.

And one way of thinking about the tone of the business is that our markets have returned to health, and this year, the main driver for growth is here -- is going to be memory repair as that comes back to traditional levels. And then further out, we think it's going to be augmented by growth from demand in new products and platforms that are targeted to go to beta, and some production orders later in the year. And these new products would be the ultra-thin wafer scribe that we announced, the 9900, but later on we plan to introduce an LED tester.

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This is not a new business for us. We're working very hard on improving our presence with scribing LED in the high brightness segment, which we think is going to add growth in our LED presence. And then lastly, would be the laser direct ablation product for -- we have, in fact, an order for that product, we're shipping it later this calendar year. We think that gradually it's going to fall into the whole drive with 3D packaging, and would be allowing high-density interconnect and IC packages to become even denser, and therefore, smaller, and therefore, helping the ascent of 3D packages.

Mark Miller - *Noble Financial - Analyst*

I'm just wondering. We have heard recently from some people in the PC chain, on the disk drive companies, I think Altera also, said they were seeing signs of weakening of what was a strong result this quarter, especially from consumers while business remains strong. I'm just wondering what your visibility is there?

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

Yes, we -- I will not see that we see signs of weakening. We see, of course, headwinds at macro level. But what I would say is -- and that is not signs of weakening -- is that business in our traditional segments is going to be choppy for the next few quarters. This is because fundamentally our business is lumpy.

Mark Miller - *Noble Financial - Analyst*

Thank you.

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

Thank you.

Operator

Your next question comes from the line of Kelly Anderson, representing Sidoti & Company. Please proceed.

Kelly Anderson - *Sidoti - Analyst*

Good afternoon, guys. Thank you for taking my questions.

First off, just to be clear, the utilization rates that you quoted, were those specific to memory? And if so, could you talk a little bit about utilization of the passive components market? And given the rapid growth we have seen in passive components demand, if there is a kind of digestion period, how long do you think it will take for that problem to resolve?

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

The utilization was not specific to memory. It was a general statement across all of our lines.

The utilization in passive components, we hear that's in the 90%, and the problem with the -- it's based on the customers that we're hearing, but there's other customers that may have lesser utilization, because for instance, traditionally they have been focusing on automotive applications.

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As far as memory is concerned, there are customers that basically need the product yesterday, and there are other customers that still have excess product that -- from the previous upturn, and they are trying to utilize that fully by keeping their designs to the extent possible to a level that can be processed with previous generation products.

So utilization, overall, is healthy. There is pockets of under in every segment. There is pockets of almost 100% in almost every segment, and in particular on -- in passive components, you have another phenomenon other than utilization, which is sometimes because utilization approaches 100%, people order a lot of systems, and that takes some time to off-shelve them. So we have that problem of continuously balancing in the short-term demand and supply.

Kelly Anderson - *Sidoti - Analyst*

Okay. And in terms of the 5900 tool, just a clarification, I think you said you had some follow-on orders there. I assume that's from the same customer. And if so, can you talk about whether there are any additional customer engagements for that particular tool? And also with the follow-on orders that hit during the quarter, would your order rates still have been up without the follow-on there?

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

Yes, for the 5900, we have one customer right now, but we have several applications and -- with that customer, and the number of applications is expanding. We do have, however, other customers in advanced micromachining that would be candidates for 5900, and are candidates for other products that we're having. So the -- we have -- they are all multiple customers and multiple applications in advanced micromachining.

The follow-on orders were significant from an order point of view, but really did not make any difference in shipments or revenues for Q1.

Kelly Anderson - *Sidoti - Analyst*

Okay.

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

Those will be having an effect starting in Q2.

Kelly Anderson - *Sidoti - Analyst*

Okay. And then if I could just quickly touch on the balance sheet, sorry to kind of belabor this issue, but I think you had said that most of the inventory had sort of worked its way through. I'm a little bit concerned because inventory turns versus a lot of your peers in this space are still a little bit low. Do you have any further plans in flies get that more on track or more on par with the levels seen from some of the other equipment vendors?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Yes, Kelly, that's a good question.

If you look at our inventory, one component of course is our service inventory. That's probably fully a third of our inventory, maybe a little bit less, and it's -- that's going to roughly stay at that level. As our business grows, it doesn't need to grow a lot,

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but as our -- you know, it's not going to probably decline much. We do see opportunities to continue to reduce inventory. That's less and less a function of moving older equipment. We have moved a lot of that. There is a little bit more of that, as I said that we can move and come down. But it would be more a question of how will we be more efficient and not having to add inventory as business grows? So I think it can still come down some, but certainly as we see business grow, our goal would not have it increase.

Kelly Anderson - *Sidoti - Analyst*

That's very helpful. Thanks, guys.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Yes.

Operator

Your next question comes from the line of Shawn Boyd representing Westcliff Capital Management. Please proceed.

Shawn Boyd - *Westcliff Capital Management - Analyst*

Hi, for the first question, I was wondering in terms of the shipping of the older systems this quarter and the impact on the gross margins, were those in backlog going into the quarter? And I'm just wondering if this was sort of pop-up business? Why we didn't have a little more visibility that this was coming out of?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

That's a good question.

These were not in backlog at the beginning of the quarter. Particularly on the memory repair side, we saw an acceleration in customer activity in that business during this quarter. In fact Nick referred a little bit to that, that there were some customers that popped up, and all of a sudden needed stuff yesterday. So we were able to respond quickly. We were able to utilize some existing inventory. Took some work to get that out the door, but we were able to meet, really, to meet pretty quick turnaround for the short-term ramp requirements in that market.

Shawn Boyd - *Westcliff Capital Management - Analyst*

Got it. And in terms of the guidance that you are giving now for the September quarter, it looks like we're about two-thirds booked on that. How much of that needs to be turned?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Not much. You know, if you look at things that come in the door, our service business and our -- what we call our tooling business, which would be the belts and plates for our passive components, those tend to roll on pretty well. So we are largely booked for the second quarter.

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Shawn Boyd - *Westcliff Capital Management - Analyst*

Okay. And can you just speak -- we've come at this in a few different questions -- but in terms of the revenue breakdown as we go into September. Maybe you could just review directionally how you see these -- it looks like semi is probably up quarter-to-quarter, maybe passive is down. Can we break that down a little bit better in terms of quantifying the segments here?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

I would say as a general matter if we look at what is in backlog, and the timing of customer demand, we would probably expect to see semi down a little bit. We had quite a lot of shipments, as I said, kind of come up at the end of the were, things pulled in. We still see demand there, but the timing of shipments would probably skew a little more towards the third quarter. That business is the most choppy of all right now. We would expect to see our interconnect and micromachining business to stay healthy and probably up a little bit. And we still have backlog for delivery in our passive component business, so it's probably flat to up some as well.

Shawn Boyd - *Westcliff Capital Management - Analyst*

Okay. Very helpful. Thank you. Another, if I may.

The 9900 -- the wafer-dicing product, we were talking about earlier, we were trying to quantify that. I heard a number of -- I believe it was a \$70 million to \$80 million -- excuse me, \$80 million to \$90 million per year kind of market, but then we had clarification that it was really the ultra-thin. So are we referencing a subset of that? I guess what I want to do is just quantify the size of that market versus the 5900.

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

Yes, we're referencing the \$80 million to \$90 million, what we consider the wafer circulation. The ultra-thin is addressing a subset of that, which is going to be the fastest-growing part of that market, because that cannot grow because they don't have a system like the 9900.

Shawn Boyd - *Westcliff Capital Management - Analyst*

Got it. Okay. And in terms of the 5900, how do you guys size up that market?

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

This is a bit more difficult because this is pioneering on applications that are totally new, really advanced micromachining. But a good -- a good way of doing that is to take the business that we have had in the last six months of that market, and somehow extrapolate the growth of that -- that is commensurate to consumer electronics. That would be one way of approximating it.

Shawn Boyd - *Westcliff Capital Management - Analyst*

Okay. So, Nick, when you think of magnitude over, say, the next 12 months, do you think there is the potential for greater contribution out of the 9900 and the launch of that product versus the 5900 or less?

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Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

I would think that the 5900 is going to enjoy higher margins than 9900. 5900 is designed in many applications, and continues to get designed in additional applications, and 9900 is required to be designed in. And these application is required to really take off at the expense of other more traditional wafer thicknesses.

Shawn Boyd - *Westcliff Capital Management - Analyst*

Got it. And last question for me. Going back to an answer that I think you gave to Mark, perhaps, on the comment about orders being choppy. Would you say that this is just typical lumpiness that you normally see, or have you seen things shift a little bit over the past quarter or so, that looks a little bit more choppy at this point? And also --

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

Oh, it's -- choppy and lumpy, I use that interchangeably, and it's typically lumpiness. I think I refer to business as healthy. Came back out of the beast of 2008, and growth -- and, you know, all forecast is that CapEx is going to be growing through 2012. But growth and -- but it is not linear. It is lumpy because of the nature of this CapEx business.

Shawn Boyd - *Westcliff Capital Management - Analyst*

Got it. Very good. Okay. And you know what, I lied. One last one, if I can, on the operating expenses. If I heard correctly, we are guiding those up a little here, \$22 million to \$23 million for the September quarter. What is driving that increase again? And what can we think about as kind of a steady state that we can run this company off of going forward?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Yes, it was primarily related to our annual merit increases which take effect, basically going into this current quarter. It's a little bit last quarter, but it primarily affects Q2. Those are -- you know, for all intents and purposes, sort of permanent increases, because they are the merit that go across the company.

Also we are seeing some increases related to project spending for our new products. This will be kind of a peak year this year because of the number of projects that we have coming out this year, and I think we'll see that number bounce around a little bit quarter-to-quarter. As we think about it, you know, at least in the intermediate term, this \$22 million to \$23 million is probably a reasonable way to think about it, with possibly some opportunity to see that moderate down out two or three quarters once some of the new products are launched.

Shawn Boyd - *Westcliff Capital Management - Analyst*

Moderate down on an absolute basis?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

On an absolute basis. Certainly as we see revenue growth, we would look to leverage our operating expenses. And if you look at the spending, it's pretty clear, you know, really the additional investment is going into R&D. If you look over the last several quarters, and that's where we have made a big commitment. We think we have a lot of opportunity and irons in fire and want to see those through.

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Shawn Boyd - *Westcliff Capital Management - Analyst*

Very good. And as I recall, kind of longer-term product model at 50% gross margin, we should be knocking out a 20% operating margin.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

That's right. And we would see roughly 30% operating expenses at that level. And of course, that's a function of volume, but absolutely that's the target we're shooting for.

Shawn Boyd - *Westcliff Capital Management - Analyst*

Okay. Very good. Well congrats on the acceleration on the top line.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Thank you.

Brian Smith - *Electro Scientific Industries, Inc. - Director, IR*

Thanks, Shawn.

Operator

(Operator instructions). And your next question comes from the line of Jim Ricchiuti with Needham and Company. Please proceed.

Jim Ricchiuti - *Needham - Analyst*

Nick, I wonder if you could talk a little bit about the 5900 and the demand you are seeing for that. Is it coming mostly from new applications? Or is it coming from increased capacity? Capacity buys?

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

Yes, this is a very flexible system, so the demand comes from -- from both new applications and existing applications.

Jim Ricchiuti - *Needham - Analyst*

One more than the other in terms of the activity you are seeing?

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

One more than the other, but it's not two. It's multiple.

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Jim Ricchiuti - *Needham - Analyst*

And as you look at your outlook for orders in the next couple of quarters, do you think -- sounds like there is going to be some period of digestion in the passive component area. Will the orders -- as you see it now, be driven primarily in semi, or maybe perhaps you could just talk a little bit about the outlook for new order activity and interconnect?

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

Yes, the -- as I said, the tone of the business is that in the short-term we're going to see choppiness amongst our businesses. Clearly the main driver is going to be the resurgence of memory repair. That was a dormant business for us for more than a year and a half, and that is coming back alive. So that's going to play a big role in our growth for this year.

The passive components business is going to be from the point of MLCC, is going to be choppy for the next few quarters, choppy from the point of view that next quarter people need to absorb what they bought earlier, and then we may see another great quarter. But it's very difficult to forecast more than a quarter or two, but the business is healthy.

And there's an opportunity there as automotive comes back to life to see additional growth in the MLCC. But in that segment, we -- we're lumping the LED tester, and I think that is going to be an opportunity for growth. LED continues to be, and it's going to be a very strong business for whoever participates. And we're going to be introducing a tester that we think is going to be a unique solution when it comes to high-volume -- very high beam testing of packaged LEDs.

In the micromachining, I think we are going to continue seeing healthy, much less choppy growth in the -- but with some seasonality in the in the via formation for flex. The reason for that is that flex really addresses many consumer products, but all of them are very healthy right now. As far as the advanced micro machining, we are working very hard, and we are very encouraged by -- by the flexibility of the 5900, the flexibility of the 53 as it is being reincarnated in -- with our universal architecture, and becomes more modern system. And we're very encouraged by the richness of opportunities to do unique advanced micromachining applications with few customers right now, but these are big substantial customers that can absorb fully our capability.

But in the interconnect -- in the micromachining, we also like the opportunities that we see with what we call the laser direct ablation, that's the ability to process in another way PCDs, and make them denser. And also we are very excited with opportunities to process glass, and these are going to be opportunities that are going to be coming later.

But the overall idea is that existing markets will continue choppy for a while. We're going to be adding to that the memory repair and later on the new applications.

Jim Ricchiuti - *Needham - Analyst*

Would you remind us, in the last cycle for memory repair, roughly how big of business was that for you at the peak of the cycle?

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

The peak of the cycle -- assuming the peak of the cycle was -- I mean, there was -- for fiscal year '08, was in the neighborhood of \$100 million plus.

Jim Ricchiuti - *Needham - Analyst*

Okay. And from where you see it now, assuming we see continued investment, is there any reason to think at the peak of the cycle that, perhaps you won't get close to that level again?

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Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

My expectation is that we're going to be getting close to that again. At the peak of the cycle.

Jim Ricchiuti - *Needham - Analyst*

Okay. And last question -- (Overlapping Speakers)

I'm sorry?

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

On an annual basis.

Jim Ricchiuti - *Needham - Analyst*

On an annual basis?

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

Yes.

Jim Ricchiuti - *Needham - Analyst*

Okay. And last question for me, Nick. I may have missed it.

Did you give any kind of a time line as to where you are with the LED tester in terms of when you might see betas?

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

Yes, with the LED tester, we're working very hard with teaching customer, and other customers, and we expect to have beta out in -- last quarter -- calendar quarter of this year.

Jim Ricchiuti - *Needham - Analyst*

Okay. Thank you.

Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

Thank you.

Operator

At this time, there are no additional questions. I will now turn the call back over to Mr. Nick Konidaris. Please proceed.

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Nick Konidaris - *Electro Scientific Industries, Inc. - CEO*

To reiterate, with memory repair beginning to recover, all of our markets are now active and healthy. We're executing well in delivering innovative systems to our customers, and in developing our next generation of products that will expand our addressable market and fuel profitable growth.

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 the presentation. You may now disconnect. Have a wonderful day.

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