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ESIO - Q3 2010 Electro Scientific Industries, Inc. Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen and welcome to be ESI fiscal 2010 third-quarter earnings conference call. My name is Christopher 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). I would now like to turn the conference over to your host for today, Mr. Brian Smith, Director of Investor Relations. Please proceed.

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

Thank you, Christopher; 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, Chief Financial Officer.

This conference call will cover our fiscal 2010 third-quarter results. Before we go into the details of the call, I would like to remind you that some of what we may 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 January 27, 2010 which could change in the future. This call is the property of ESI. Now I'll turn the call over to our CEO, Nick Konidaris.

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

Thank you, Brian. Good afternoon and welcome to our third-quarter conference call. During the quarter, we continued to see improvements in overall business activity with stronger revenues across most of our product lines and operating results approaching breakeven.



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Better demand for PCs, high-definition TVs and smart phones drove higher demand for our customers' products which raised their utilization rates and their need for our systems. Although we've not seen yet improvement in the memory repair market, our strategy to expand our addressable market and invest in new applications is creating new opportunities for growth.

Revenues grew 41% from last quarter to \$39 million with strong growth in all three of our businesses. Non-GAAP loss per share dropped to \$0.03 compared to \$0.14 last quarter. Bookings more than doubled from last quarter to \$61 million led by a large order for our new model ML 5900 micro-machining system.

We also saw strong growth in passive component test, [AVP] wafer scribing and LCD repair. Overall, our new wave research business had its strongest level of orders in its history. On the other hand, our memory repair business remained weak as the DRAM manufacturers still have excess capacity in laser [yield improvement] systems.

Revenues in our semiconductor segment were up 28% and bookings were about flat versus last quarter. The LED and LCD end markets were very strong and are both benefiting from the strong demand for LED backlit displays and TVs.

Looking forward in our semi business, we expect to see more of the same in the next few quarters. The LED industry continues to add capacity while the DRAM wafer repair market remained weak until the second half of 2010 when wafer starts should increase and the DRAM manufacturers begin to fully utilize their laser repair systems.

We may see some technology driven demand, but not in large quantities. However, we are encouraged by the projected level of [bit] growth and the front-end investment that is recurring and believe we will be well positioned in this market when additional capacity and new technology begins to come online.

Our Interconnect Micro-Machining Group continued its solid performance. The flex interconnect business was down seasonally but we added several new customers this quarter driven by the continued shift toward the need for sub 70 micron vias.

Looking forward into fiscal 2011, we expect solid growth in this business driven by demand for smart phones and other complex handheld devices. Our state-of-the-art micro-machining business had a very strong third quarter, winning a large order for our new model ML 5900.

As we announced in November, this revolutionary new system is a major step forward in terms of flexibility, accuracy and throughput. It works on three-dimensional devices in different materials and combines precision micro-machining and inspection into a single system.

With this product, we penetrated new applications and secured a large order which we expect to ship in the March quarter. We're excited about these new applications and we believe this versatile platform provides opportunities for follow-on business.

Our success in leveraging our core technologies into state-of-the-art micro-machining applications in markets has played a meaningful role in mitigating the impact of this economic downturn. During the quarter, we also purchased the intellectual property and assets of Applied Photonics.

This acquisition combined with our internal capability will enable us to expand our presence in the fast-growing market for both large and small format glass micro-machining. We expect to launch beta systems into this market during the next two quarters and have systems in production within the next 12 months.

Our passive components group also had a very good quarter with sales up 70% and bookings more than doubling versus Q2. Book to bill was well over 1.5 to 1. We think some of this [shortness will place] as a catch-up since many MLC manufacturers waited until they were at or near 100% utilization before adding capacity.

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In addition, during the quarter we introduced and shipped customer orders for the Model 3500, the latest in our family of market leading MLCC high-capacitance test solutions. The 3500 increases throughput by 50% and handles a wider range of component sizes and capacitance (inaudible)

Looking forward, orders in this business may be a little choppy as capacity is absorbed in the market but we believe that overall growth will continue to be delivered by the trend toward more and higher capacitance MLCCs in new electronic devices.

Turning now to the Outlook for ESI. Although visibility is still somewhat limited, we are more optimistic about the economy in our end markets and the growth forecast for 2010. Also encouraging is the success of our new products like the ML 5900, demonstrating our ability to continue to penetrate new applications and grow our addressable market.

Given the strength we have seen this quarter, we expect revenues in our fourth quarter of 50 to \$55 million and positive earnings per share on both a GAAP and non-GAAP basis. Now I will turn the call to Paul for a detailed discussion of our results for the third quarter.

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

Thank you, Nick; and good afternoon, everyone. The following information includes results from our third quarter of fiscal 2010 which ended January 2. 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 nonrecurring items.

Orders for the third quarter were \$61.2 million, up from \$29.3 million in the prior quarter and \$21.2 million from the prior year. As Nick mentioned, the biggest contributor to the growth was a large order for a new application on our recently introduced ML 5900 micro-machining system.

Excluding the impact of this order, overall demand increased approximately 25% sequentially with strong growth in passive components, LED scribing and LCD repair. In addition, we saw good volume in our laser ablation business driven by year-end government and university spending. However, memory repair orders continued to be weak and are not expected to show meaningful improvement before the second half of this calendar year.

Shipments in Q3 were \$33.8 million, up sequentially from \$28.4 million driven by the stronger order activity. Ending backlog increased by \$27 million from last quarter to \$52 million. Deferred revenue decreased by \$5.2 million as we had several new systems pass acceptance testing with customers.

Revenue for the third quarter was \$39 million, up 41% staunchly. All three businesses again showed a sequential improvement as they have each quarter since the trough in Q4 of last year.

Gross margin for the quarter was 38% including \$540,000 in cost of goods sold for a purchase accounting and equity compensation. On a non-GAAP basis, gross margins were 39%, up from 36% less quarter, primarily reflecting the higher sales volume and improved mix.

GAAP operating expenses were \$20.79, up from \$18.8 million in the previous quarter. Included in the third quarter's operating expenses were purchase accounting amortization of approximately \$230,000 and stock compensation of \$1.4 million.

Excluding the impact of these items, non-GAAP operating expenses were \$19 million, up \$2.3 million from the prior quarter, reflecting the effect of having an extra week in the quarter, the elimination of some of our temporary cost reduction measures and increased project expenses for our new products.

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On a GAAP basis, the third-quarter net loss was \$2.4 million or \$0.09 per share. Non-GAAP net loss was \$900,000 or \$0.03 per share compared with a net loss of \$3.9 million or \$0.14 per share in the prior quarter.

Income tax benefit for the quarter reflected a tax rate of 56%. On a non-GAAP basis, the tax rate was approximately 74%. The improved rate was primarily a result of better estimated annual results and credits related to the recent completion of our domestic tax audits.

Based on accounting rules for income taxes, some of the benefit of these items will be recognized next quarter, resulting in a tax rate near zero in Q4 on a GAAP basis and between 15 and 20% on a non-GAAP basis. Longer term, we expect our non-GAAP tax rate be in the low 30s.

Turning now to our balance sheet, cash and investments including restricted cash, were \$163 million, up over \$8 million from the prior quarter. Restricted cash increased by \$8.4 million resulting from the substitution of a letter of credit for the remaining bond related to our legal action in Taiwan to protect our intellectual property.

In addition, during the quarter, we sold \$1.9 million of auction rate securities at 71% of par. We continued to hold auction rate securities currently valued at approximately \$7 million.

Cash flow from operations was positive at almost \$1 million for the third quarter as losses from operations were more than offset by cash generated through working capital improvements. Inventories increased by \$1.4 million, reflecting inventory purchased at the end of the quarter to support higher Q4 shipments, partially offset by ongoing inventory reduction efforts.

Inventory turns were 1.2 times, an improvement over last quarter. Accounts receivable increased slightly on higher shipments, resulting in a reduction of DSO by 21 days to 52 days. This improvement was driven by strong cash collections and the timing and level of shipments during the quarter.

Capital expenditures were approximately \$800,000 and depreciation and amortization excluding purchase accounting was \$2.5 million. Looking forward, we are encouraged by current business activity and market forecasts, however, visibility continues to be limited, particularly beyond the current quarter.

Based on our current booking and backlog levels, we expect revenues in the fourth quarter of between 50 and \$55 million. Non-GAAP operating expenses are expected to increase \$1.5 million to \$2 million due to incremental investments in new products, restoration of employee pay levels and variable pay associated with the return to profitability.

As a result, we expect non-GAAP earnings excluding stock compensation, purchase accounting and other nonrecurring items of between \$0.05 and \$0.10 per share. Now I will turn the call back to Nick for a brief summary.

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

To summarize, in our third quarter, we showed excellent sales and bookings growth on the back of improving end markets and the successful execution of our strategy to grow the addressable market. We're excited about the opportunities for growth across our businesses.

The DRAM wafer repair market remains weak but it will eventually improve, driven by new capacity and technology needs. As this market recovers, we believe we will see faster growth in revenues and earnings.

This concludes our prepared remarks. We are ready for your questions. Christopher?



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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) David Duley, (inaudible) Securities.

David Duley - Steelhead Securities - Analyst

Good afternoon and congratulations on the projected return to profitability. It's been some time. I was wondering -- just a couple of housekeeping questions. Did you have any 10% customers during the quarter?

Paul Oldham - Electro Scientific Industries, Inc. - CFO

We did. We had two 10% customers in the quarter.

David Duley - Steelhead Securities - Analyst

And will you be putting those in your quarterly reports or we would have to wait until the annual thing to come out to know who they are?

Paul Oldham - Electro Scientific Industries, Inc. - CFO

We typically disclose the names of the 10% customers at the end of the year, not during the quarter. Because it can vary from quarter to quarter.

David Duley - Steelhead Securities - Analyst

Would one of these 10% customers be the same 10% customer you had last year?

Paul Oldham - Electro Scientific Industries, Inc. - CFO

We really don't comment on it during the quarters, David.

David Duley - Steelhead Securities - Analyst

Okay, can you -- I think you mentioned that it was a 14-week quarter versus a 13-week quarter but I saw the R&D number jump sequentially and I was kind of wondering how I might be setting that going forward.

Paul Oldham - Electro Scientific Industries, Inc. - CFO

We are making selective increases in our R&D expenses and so that was certainly impacted by the extra week and return of part of the pay, but also some increased investments. As we look into next quarter, we would expect that number just like the other expenses to also be up as we restore the balance of the pay.

We will have some variable pay associated with R&D as well as the other functions. But also some -- again, some selected investments there including some increases related to the investment in our glass micro-machining effort and the acquisition of Applied Photonics.

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David Duley - *Steelhead Securities - Analyst*

Okay, just a couple more from me. You mentioned the -- I think the new MLCC tester 3500. Is that an upgrade to the tester you released a couple of years ago that you were really successful with that kind of revolutionized the throughput or is it somehow a different tester that addresses different parts?

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

It's a different version (inaudible) same family. The family includes three testers, the 3500 which is the most recent; the 3555 and the 3550. And the 3555 is focused on large format devices. The 3550 is focused on high capacitance. This one is focused on all devices and a wider range of capacitance. Because of higher productivity, it is a higher price tester; and over time, we expect that to really obsolete one of the other two testers.

David Duley - *Steelhead Securities - Analyst*

I guess I'm kind of trying to figure out is you were quite successful with that previous tester's launch into that marketplace. Will we see the same kind of success with this product as it's adopted by several major players or is it more a niche product?

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

We think we're going to see the same success like we've seen with the previous products of 5500. That success basically will be underscored by the fact that we're going to open even more [captive] suppliers and the other thing I would say is that this product, the 3500, already enjoys backlog.

David Duley - *Steelhead Securities - Analyst*

And finally from me is you mentioned you got a large order for a micro-machining application. Can you help us understand what that application is? Is that a new application or is it an extension of a current application? Help us understand really what that is if you can.

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

I would not be helpful because we like not to comment on applications, but directionally I will tell you that this is a new application.

Operator

Jim Ricchiuti.

Jim Ricchiuti - *Needham & Company - Analyst*

Paul, I just want make sure I understood you correctly. Did you say that excluding the large order that you received in the quarter, your bookings were up about 25% sequentially?

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

That's correct.

Jim Ricchiuti - *Needham & Company - Analyst*

Okay, so we're talking about this order roughly in the magnitude of around \$25 million, this large order?

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

It's over \$20 million.

Jim Ricchiuti - *Needham & Company - Analyst*

Okay, so if we put that aside and we look at the bookings in that say \$35 million range for the rest of the business, if we assume kind of the current market environment, that is no improvement in DRAM until later in the year, is it fair to say that based on what you are seeing right now, potentially you could see bookings in the area going forward in the \$30 million to \$35 million or do you feel the market is stronger than that and maybe can support a higher order level?

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

I think looking beyond this quarter is always tough because the visibility is limited. But certainly we are encouraged by forecasts we're seeing relative to consumer electronics, relative to handsets, relative to a number of things that drive our business.

So we think we could see orders that support the level of business figures that you are suggesting or a little higher. In addition, if we see additional applications that we can penetrate with this new 5900 product which is very versatile product or if there's follow-on opportunities, then those could also help support a higher number.

Jim Ricchiuti - *Needham & Company - Analyst*

And you mentioned that you had two 10% customers. I can understand you don't want to comment directly on that but can help us maybe -- give us some indication as to which of the businesses the customer came from? Is one in the semiconductor side, one in interconnect or maybe you could just help us a little amount along those lines.

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

Well you can look at where the orders were and I think you could probably divine which group they were out of. But you know, clearly our passive component business was the next strongest business after after our interconnect and micro-machining business.

Jim Ricchiuti - *Needham & Company - Analyst*

And, Nick, you talked a little bit about some choppiness in passives. Based on just the some of the end markets PCs, smart phones, those applications including TVs can really chew up a lot of passives. Do you feel that that business is on a stronger growth trajectory even if there's going to be some lumpiness here in bookings?



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

Yes, the choppiness refers to the fact that the business is going to be lumpy but overall, we see this thing as a market in continuing recovery. Our utilization rates are at 90%. We see now orders from Japan, Korea, Taiwan. So we see a number of new consumer products that all of them have increased content of capacitance in and corresponding MLCCs and we feel good about that.

Jim Ricchiuti - *Needham & Company - Analyst*

Okay and just to clarify one of the earlier questions from David, I wasn't sure, did you say that this large order was from a new customer or is this from an existing customer?

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

I didn't say new customer or existing. I said that there -- actually it is a new application.

Jim Ricchiuti - *Needham & Company - Analyst*

New Application, okay. If you could just talk a little bit about this acquisition of the IP and assets of Applied Photonics. Is this company focused -- has it been focused primarily in the LCD market? Is that where you see the opportunity here?

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

Yes, we see that in LCD markets. We're very excited about this opportunity. It will allow us to really, with the IP they have, combined with our capability to focus on both large and small format glass, do micro-machining.

The beauty of this technology it's a single step, non-contact, non-mechanical process, zero debris, no (inaudible). There's no glass loss as you cut the glass; has better edge strength and is capable of very clean (inaudible) linear or [curvy] linear cuts. The company before we bought it had sold already systems to LCD customers and we think this is a market that from a total point of view is in the 75 to \$100 million.

Jim Ricchiuti - *Needham & Company - Analyst*

Nick, maybe broad terms, how many systems have they put into the field? And it sounds like you feel pretty confident that the new mixed version I guess or next-generation equipment is going to be out fairly shortly. It sounds like two quarters away?

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

It's two quarters away. The systems in the field are -- don't know exactly but in the two to three, this was a very [small] company at the time we acquired it. But these are revolutionary systems and we're very excited by the technology and the reception we have received from the customers who have the systems.

Jim Ricchiuti - *Needham & Company - Analyst*

That's it for me. Congratulations on the quarter.



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Operator

(Operator Instructions) David Duley, Steelhead Securities.

David Duley - *Steelhead Securities - Analyst*

Couple more questions from me. I guess my recollection is kind of at this point in the cycle historically, we might've seen some technology buys in the DRAM market and for some reason, they seem to be absent this time.

I was wondering if you might talk about why that is or if my perception is wrong. Also, there's a lot of people that worry about alternative technologies, i.e. using testers to blow these fuses rather than a memory repair system. Has there been any other customers that have adopted that methodology that might impact the technology buys?

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

Let me address the second part. There is no other customer. We're not concerned about adopting -- any customer adopting alternative technologies, not for this cycle; maybe two cycles and we don't know what will happen after that. So this is not the issue.

The issue here is that as you know, CapEx in memory in 2007 was close to 21, \$22 billion; and in 2010 is expected to be about 7 to \$8 billion. And the industry continues to suffer from excess supply and pricing pressures.

Although customers are implementing DDR3 and smaller nodes, they are trying to stretch the efficiency of their investment and doing that by extending existing fuse designs into new technology like DDR3 and new nodes like 5x nanometers. So, as a result, they can utilize some excess capacity that they have in terms of memory repair. We expect that excess capacity to be consumed as the bids increase by the end of the year and as they start turning up the volume and the wafer starts -- we start seeing both capacity and technology buys.

David Duley - *Steelhead Securities - Analyst*

Now is there something in the marketplace we might monitor as a leading indicator, for instance when they start to buy DRAM testers from Advantest and Teradyne and Verity? Would that be the time that they might start to buy some ESIO memory repair equipment to kind of address the (multiple speakers) product?

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

A good analysis would be DRAM testers from any of these companies and increases in buying high-end [probe] cards.

David Duley - *Steelhead Securities - Analyst*

So I guess essentially the DRAM guys are doing a major shrink right now. That's what they're spending this 7 and \$8 billion on. And you need to have that shrink put in place to have the incremental unit volumes come out the fabs before (multiple speakers)

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

We need to have that in place and we need to have that in place without them in the process of that shrink in order to save a little bit of extra money. We want them to also start shrinking the fuse banks.

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If they don't shrink the fuse banks and they happen to have all their glass equipment that can blow those fuses, then that thing may be delayed. But at the end of the day, we have zero doubts that with an increase in the memory bit growth that's expected to be, I don't know, 70 to 80% with the corresponding increase later on on wafers (inaudible) so the technology going down, we have zero doubts that we're going to see the business coming back. We think it's going to start in the second half and there is not any threat from the competitive technology that we are aware of.

David Duley - *Steelhead Securities - Analyst*

Okay.

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

And there's not a market share loss and we keep investing in this business either way to be ready.

David Duley - *Steelhead Securities - Analyst*

Did you guys buy any stock back during the quarter?

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

We did not. We have an authorization from the board for \$20 million to buy to control dilution. At this point in time, we are very aware about our strategic objective to really grow the top line and we think that conserving cost to really be poised for opportunities, and we see a lot to grow the top line, is the prudent thing to do.

David Duley - *Steelhead Securities - Analyst*

I support whatever growth opportunities that you see that you think you need your cash for, but I would point out that the stock is still trading below hard book value and if you do really think your memory business is going to turn on, then your earnings levels are going to go up dramatically and so is the stock. So Buying it here under \$11 might be better than waiting for it -- to buy it at a much higher price. That's just my two cents. Congratulations on a nice quarter.

Operator

Jim Ricchiuti, Needham & Co.

Jim Ricchiuti - *Needham & Company - Analyst*

I just wonder if you could comment on the revenue upside that you saw in the quarter relative to your prior guidance. Can you talk a little bit about what drove what areas?

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

I would say it was mostly a faster pickup of recovery in our passive component business. As you recall, last quarter we were encouraged by activity we were seeing around our tooling area that supports that business as well as levels of capacity. But we certainly saw that business take an uptick more than we expected in this quarter. We expected to see some but we saw more than anticipated there.

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Jim Ricchiuti - *Needham & Company - Analyst*

And then just turning to the interconnect micro-machining area, it sounds like you still feel pretty comfortable with the level of demand and potential for continued booking strength coming out of the LED and flex markets. Is that fair to say?

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

This quarter, our third quarter that we just ended, is typically a seasonally lower quarter for interconnect and for flex and that was consistent with what we saw. But that market we continue to feel very good about. If you look at the overall year last year, it was relatively strong and as we look into the next few quarters we see a very good business there again driven by strong sales of handsets and consumer electronics.

Jim Ricchiuti - *Needham & Company - Analyst*

Great. I wonder if you could just provide an update on some of the new product development, including in the LED area. Where do you stand with that? And maybe if you could give us a bit of a timeline on some of the new products that you talked about in the past.

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

In each segment that we report, we have active programs to really introduce new products in fiscal year 2011 towards the second half. In the semiconductor segment, we are working to introduce a [dicing] product for thin, non-flash wafers. When I say thin, 50 micron or below.

At this point in time, we have identified the beta sites. We're working very hard to install product there for evaluation and that product will be available for deployment in the second half. In the micro-machining area, in addition to the ML 5900, we are working very hard and we have [demonstrated] products already deployed for another class of application, totally new. We call it laser direct ablation.

The end result of that product would be to allow bypassing the (inaudible) step in making HDIs or IC packages and by using the laser technology at the micron levels, allow for more dense interconnect packages or denser HDI. Instead of an HDI PCP (inaudible) layers, we can have the same functionality with six layers, as an example.

And we feel very good about the reception we're receiving from the customers who have deployed that product. As we speak, that will be available again for volume production in the second half of the year.

In the LED area, there's two developments. One is we continue to keep working towards finding a solution that will not affect the light output of LEDs as we scribe the wafer. This is -- we think a solution there would open more significantly our opportunity in this market.

At this point in time, I would say we might be close to a solution but we've not found a solution and therefore I like to be a little bit more careful in predicting the timing of this thing. But in the LED, we're developing a visual tester and spectroscopic tester. This is a product that we have identified beta sites and we expect to be able to deploy that in production in the second half of the year.

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Jim Ricchiuti - *Needham & Company - Analyst*

Nick, in one of the new products area that you mentioned, the laser direct ablation for HDI, can you talk a little bit about the competitive environment in that market right now?

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

We really don't know of any competitor in this market. The issue there is that this is a totally new technology. It depends on us from a laser micro-machining point of view and we're the only ones who have that capability.

But also depends on adoption of special BCB materials that are laser activated as we micro-machine these organic layers. These materials exist and basically between the desire to shrink the HDI's, between the materials, the laser system and the development of a process; this thing is going to become we hope a significant business in the years to come.

Jim Ricchiuti - *Needham & Company - Analyst*

Just a final question. Some of the recent acquisition opportunities that you have come across seem to be more along the lines of technology buys.

Can you talk a little bit about how active the effort is from an acquisition standpoint? And to what extent do you think you might be continuing to follow the strategy of smaller, I don't know if you want to call them tuck-in acquisitions, that provide good technology or do you see some opportunities out there possibly for larger acquisitions?

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

Well as you know, our mission is to really be the leader and pioneer in the laser-based micro-machining and visual inspection and testing. We have made smaller technology acquisitions as you appropriately state, but don't forget that just over a year ago, we made an attempt towards a bigger acquisition. It didn't work out our way.

So we really don't have preference size-wise. Of course size sometimes can be a limitation but we're very focused on being very adjacent to what we do or to develop -- or to go into probably new markets but where the core technology would be fundamentally something that we understand very, very well.

Jim Ricchiuti - *Needham & Company - Analyst*

So just -- that might be a partial explanation for the cash on the balance sheet and maybe taking more of a wait-and-see attitude on going forward with additional buyback?

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

(multiple speakers) the capacity in the balance sheet is not so difficult to explain if you take into account the fact that we want to grow the top line. If you think that we want to grow the top line and acquisition is a valued way of doing that, and we believe it is, you need to have cash.

If you don't have cash, it's very difficult to borrow it these days. And you can borrow it but at terms that are not very pleasant, either very dilutive or very, very expensive and all you have to do is remind ourselves of people that we know very well and what happened to them because they borrowed at a very expensive cost of capital kind of terms.

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We don't need the cash to really -- because we like to have the cash. We need the cash because we want to grow the top line. And if at some point in time we feel that -- and if we're successful in growing the top line, I think the cash access, if we have any and we have some, is going to be taken care of instantaneously.

Jim Ricchiuti - *Needham & Company - Analyst*

Okay, thanks very much.

Operator

David Duley, Steelhead Securities.

David Duley - *Steelhead Securities - Analyst*

One final follow-up from me. I think the drop rate to gross margins in the current quarter on the incremental revenue was about 47%. Can we -- as the topline grows, can we project that kind of drop rate out going forward?

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

Is our goal would be for it to be a little bit higher than that. We talked about drop rates on gross margins between 50 and 60%. This quarter was impacted by the fact that we did put pay back partially and next quarter we will have that same feature as well as some slightly higher costs in some discretionary areas in things like warranties. So I think going forward in the long run, we would expect a higher drop rate than we saw this quarter.

David Duley - *Steelhead Securities - Analyst*

The range in EPS in the quarter from \$0.05 to \$0.10, that's a pretty big range. What's the key variable when you throw that range out that I should be trying to incorporate into my model?

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

The top line.

Operator

With no further questions in queue, I would now like to turn the call back to CEO, Nick Konidaris, for closing remarks. Please proceed.

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

To reiterate, we see our markets improving and slowly making their way back to previous demand levels. With our strong product portfolio and the successful execution of our strategy to grow the addressable market, we are becoming more diversified as we march towards profitable growth.

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

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Operator

Again, ladies and gentlemen, thank you for your interest in ESI. You may now disconnect. Have a good day.

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