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PARTICIPANTS

Corporate Participants

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

Other Participants

Jim Ricchiuti – Analyst, Needham & Co. LLC
Tom Diffely – Analyst, D. A. Davidson & Co.
Mark S. Miller – Analyst, Noble Financial Capital Markets

MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the ESI Fiscal 2012 Second Quarter Earnings Conference Call. My name is Kiana and I will be your coordinator today. At this time, all participants are in a listen-only mode and we will accept your questions at the end of this conference. [Operator Instructions]

I would now like to turn the call over to Mr. Brian Smith. Please proceed.

Brian Smith, Director-Investor Relations

Thank you, Kiana, 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 2012 second quarter results.

Before we go into the details of the call, I would like to remind you that some of what we say in this call will include forward-looking statements concerning customer orders, shipments, revenues, 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, October 26, 2011 and which could change in the future. This call is the property of ESI.

Now, I would like to 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 second quarter conference call. Our second quarter was very successful as we delivered sequential improvement in sales, gross profit, operating margin, earnings per share and operating cash flow. We also continued to execute well on our growth initiatives as all of our new systems are involved in significant customer evaluations. From a market standpoint, the quarter had a different character as our semiconductor LED and passive component customers reacted to a slowing economic environment by halting orders for new capacity.

Revenues for the quarter were $82 million, up 16% from Q1. Non-GAAP earnings per share were $0.32. Paul will go into more detail around the financials in a moment. Orders of $41 million were down significantly following near-record orders last quarter. This is the result of the lumpiness in our micromachining business combined with cautious investing in new capacity by our semiconductor LED and passive components customers. We expect this caution will play itself out over the next few quarters as growth in end user demand for consumer electronic products strengthens and capacity utilization improves.

Let me now go through each business in turn. Our interconnect and micromachining group had a record quarter with revenue of $51 million. Business was solid for both flex interconnect and advanced micromachining. In addition, we shipped the majority of the large micromachining order received last quarter. Orders in interconnect and micromachining were down sequentially, reflecting the lumpy nature of this business. Micromachining orders will continue uneven in the future, but our opportunity funnel is full and our prospects to win new applications are good. Our flex interconnect business continues to see strong demand as growth in tablets and smartphones drives up the need for flexible PCBs.

Turning to our semiconductor business, revenues were $24 million, well above last quarter and last year on the strength of solid memory repair orders received in Q1. However, during the quarter, we showed a sharp decrease in capacity utilization among our customers driven by slowing PC growth. This caused our customers to pause new capacity additions. Looking forward, we expect demand over the next few quarters to be driven more by new technologies and smaller nodes than capacity additions. Our model 9900 thin wafer dicing system continues to be evaluated by major customers and process testing is yielding good results. We see excellent opportunities for these products in both thin wafer dicing and [ph] through silicon vias (4:28). Of course the weak economy could slow the adoption of technologies enabled by the system, but 3D packaging continues to represent an excellent growth opportunity for us.

Orders for our LED scribing products were weak during the quarter as the LED market also suffered from a significant oversupply condition. This is especially true for makers of LED backlights for displays, where capacity has continued to come online, especially in China. Looking forward, the growth in capacity for high-brightness LEDs will be driven primarily by general purpose lighting, which is relatively small today but growing steadily. Technology evaluation and investment in this segment is very active and our new model 2600 high-brightness scriber is ideally suited for the latest material and process technologies. Customers continue to evaluate the system on their most advanced sapphire substrates and the recent results are encouraging.

Our components group generated $6 million of revenues in the quarter reflecting the lower capacity investment in this space recently. For most customers capacity utilization is still below the threshold for new system purchases, but it's beginning to improve largely driven by the smallest metric 0402 size capacitors, which are seeing strong demand in tablets and smartphones. In the second quarter we shipped our first model 3800 packaged LED tester to a leading LED manufacturer where it is going final evaluation. The evaluation is going well and enforces our belief that the 3800 can become the leading packaged LED test system in the market.

Turning now to the outlook for ESI, we show a dramatic reduction in the semiconductor LED and passive components order activity during the last two months of the quarter as our customers concerned about economic slowing, pull back on their additions to new manufacturing capacity. Although the timing and magnitude of the capacity additions is unclear, we continue to expect investment in new technologies and processes and we have an active funnel of opportunities in our micromachining business. We feel confident that our new products and our micromachining opportunities will allow us to weather the slow economic environment and expect customer activity to push higher in Q3.

In the mean time, we will take actions to manage our cost structure within the current environment while continuing to invest in new products and applications. Overall, we expect revenues in the third quarter to be in the $50 million range. For the year, we still expect to see sales growth over last year but likely in the single digits percent. Non-GAAP EPS in Q3 is expected to be at break-even or slightly below.

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

Paul Oldham, CFO, Secretary & Vice President-Administration

Thank you, Nick, and good afternoon, everyone. The following information includes results from our second quarter of fiscal 2012, which ended October 1st. 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 and non-recurring items.

For the second quarter, we generated $41 million of orders compared to $99 million last quarter and $70 million a year ago. Both sequentially and year-over-year, the decrease was broad-based and reflected the slowing economy and the corresponding declining capital spending on new manufacturing capacity. In addition, last quarter included a large micromachining order which did not repeat. From a market perspective, the majority of our markets in an over capacity situation with the exception of smartphones and tablets and related technologies, which continued to drive good demand opportunities [ph] reflect in (8:34) micromachining applications.

Shipments were $59 million which included the shipment of the majority of a large micromachining order received last quarter. This resulted in ending backlog of $53 million and a book to bill ratio of 0.6 to 1. In addition, deferred revenue decreased $12.6 million as we received customer acceptances on several new systems. Revenue for the second quarter increased 6% sequentially to $82 million, our highest level in four years driven primarily by the strong shipments in IMG. However, revenue was below our expectations as several orders we expected to book and ship in our semiconductor segment pushed out.

Gross margin was 44% including $550,000 in cost of goods sold for purchase accounting and equity compensation. On a non-GAAP basis, gross margin was 45% about the same as last quarter. GAAP operating expenses were $25.6 million down $2.7 million from last quarter due mainly to lower stock compensation and one-time items incurred in Q1 that did not repeat. Excluding these items, non-GAAP operating expenses in Q2 were $23.4 million up slightly from last quarter. Looking forward we expect non-GAAP operating expenses in Q3 to be in the range of $21.5 million to $22 million. On a GAAP basis, operating income was $10.3 million compared to $5.5 million last quarter on higher sales and gross profit plus lower GAAP operating expenses. Non-GAAP operating profit was $13.1 million or 16% of sales, our highest level in over five years compared to $11.3 million or 15% of sales in the prior quarter.

Non-operating expense was $400,000 due mainly to market losses on assets held in our employee deferred compensation plan and unfavorable foreign exchange impact. Income tax expense for the quarter was $1.4 million and effective tax rate of approximately 14%. The tax rate was favorably impacted by the geographic mix of earnings and relatively fixed our tax benefits on lower projected annual income. The non-GAAP tax rate was 27%. On a GAAP basis, second quarter net income was $8.5 million or $0.29 per diluted share. On a non-GAAP basis, net income was $9.3 million or $0.32 per share up almost 20% from net income of $7.9 million or $0.27 per diluted share in the prior quarter.

Turning now to our balance sheet, cash and investments including restricted cash were $226 million, an increase of $27 million from last quarter. Cash flow generated from operations was $26 million. Cash flow benefited both from profitable operations and a substantial reduction in receivables. For the quarter, inventory increased by almost $4 million largely due to lower than expected shipments. Turns remained at 2.5 times. Accounts receivable decreased $31 million. DSO fell to a record 33 days primarily due to the timing of shipments early in the quarter and strong cash collections. We expect DSO to normalize next quarter. Capital expenditures were $1.5 million and depreciation and amortization excluding purchase accounting was $2.8 million.

Looking forward it is unclear how long the macro slowing which has caused many of our customers to pull back on their capacity expansion plans will last. During this time we expect business levels will be driven by technology investments, new products and timing of micromachining opportunities. As a result we expect revenues in Q3 to be in the range of $50 million. Non-GAAP earnings are expected to be at breakeven or a little lower.

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

Nicholas Konidaris, President, Chief Executive Officer & Director

To summarize, we have good financial results this quarter on the back of strong bookings activity in the prior quarter. However orders reflected the increasingly weaker market conditions during the quarter. We are still excited about the markets we are in and the new growth opportunities ahead of us. Cycles like this one are part of our business and the breadth of our portfolio has positioned us well to deal with it.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And our first question comes from the line of Jim Ricchiuti with Needham & Company. Please proceed.

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

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

<A – Paul Oldham – Electro Scientific Industries, Inc.>: Hi, Jim.

<Q – Jim Ricchiuti – Needham & Co. LLC>: I wonder if you could talk a little bit about the pipeline that you see in micromachining. I know the orders are lumpy, but just in general, how would you characterize the demand that you see over the next couple of quarters?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: Yes. The – this is a healthy business with good opportunities and the way we characterize the pipeline, and I cannot go in any greater detail, is that we're pursuing a number of opportunities that if successful may cause the – end up into having our system be plan of record system and that once that happens and the – the end-product of our customers go into the marketplace that ends into significant orders that again would be lumpy but would be big.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Okay. Now, Nick in just getting the business that you've been doing in this area, it would appear that you've already been considered to some extent the system of record. Are there some other milestones that you are anticipating or some other applications or customers perhaps?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: Good question. It is primarily new applications but also new customers.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Okay. And you mentioned on the passive business that the customers while they're experiencing low capacity utilization it sounds like that business you're seeing some improvement, but we're probably still a couple of quarters away from investment.

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: That's correct. What we see in the passive components, we see utilization that is in the 80% or maybe below, but we see a particular class of passive components that – those that have the format of metric 0402, which are the smallest, to be actively doing very well. And the main driver for that is the smartphone and tablets. Parenthetically, however, I would like to also emphasize that our Flex Via drilling business is strong exactly for the same reasons.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Got it. And last question from me. You guys have done a lot of work over the last year, year and a half, two years, in bringing new products to market and expanding the revenue base. You've looked at acquisitions and I assume you are still looking at acquisitions, but just given the cash position, given what you think is a temporary pause, is this a time where you might consider share buyback?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: This is a time that we are basically looking for opportunities to improve our market position. And the way we do that is by continuing to invest in the number of opportunities that we have identified which will continue financing a number of evaluations with very significant customers for our new products. Pursue aggressively the micromachining opportunities as we discussed earlier, and also looking at opportunity – at targeted strategic acquisitions. By the way, it's not that we are looking now and we are not looking before, but to continue to look. So, all of the above are what we do and our cash position is – gives us the strength to pursue that with a lot of purpose.

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

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

Operator: And our next question comes from the line of Tom Diffely with D.A. Davidson. Please proceed.

<Q – Tom Diffely – D. A. Davidson & Co.>: Yes. Good afternoon. Let me go back to the micromachining piece for a minute. So with your comments earlier, do you need new customers to return to growth there? Can you just get repeat business from the current customer for the growth over the next several quarters?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: It's primarily repeat business, but repeat is you got to keep in mind that no customer is a stationary target of opportunities.

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

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: Technology is moving out, technology is moving, so it is few big customers a rolling wave of opportunities that need to be sailing along with that wake. So we see a lot of opportunities. As I said in my prepared remarks the funnel is full, the opportunities are exciting and -- I mean that's the [indiscernible] (18:43).

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. And then you talked about in the press release how you invest more aggressively in R&D, but it looks like the guidance for OpEx doesn't really reflect that. I was wondering if you planned to ramp that further in the coming quarters or if just it's offset by cost controls and other areas?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: It's – the cost control is going to be targeted and you always have opportunities to do cost control. But aggressively – really mean aggressively, not necessarily in absolute, but in a relative sense as our numbers go down you're going to see percentages where we left money in R&D that are extremely aggressive.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. And then last summer you released I think three or four new LED products. Just wondered if there is any update on the customer acceptance of these products and what your view is of the LED market for you, anyway, over the next several quarters?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: Yes. The LED market is different from the DRAM and MLCC. I will call those DRAM and MLCC as mature cyclical markets. LED is immature, growing, but in a transition and the transition is the following. The underlying growth pattern for LED is basically the general illumination. This is a small part of the total market but it's going to be growing steadily over many years, more than 10 years, maybe 20 years. In the last couple of years, however, there was a big bubble of opportunity with backlighting LCD and that bubble basically burst. Because LCDs have slowed down and the technology evolved for the last couple of years and you need less LEDs to backlight the LCDs. And so we have a temporary lull but the fundamentals there are sound and basically this is an industry in transition.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. Has the view – your view of the opportunity changed much in the last quarter or two or has it always been more of an out year opportunity?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: No the opportunity has not changed. In fact, we have made significant progress. There was a time when we used to be talking this call that we did not have a solution for high-brightness LED, however we do have now solution for high-brightness LED.

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

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: This is in relation to the 2600 and very advanced supply wafers, and advanced meaning with all the layers that allow these wafers to basically reflect more light. There are some technical terms like DBR and Metal Mirrors and so forth that characterize those wafers. We do believe we have in the 2600 [indiscernible] (21:50) solutions and we are in evaluations with major players as we speak.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay, good. And then finally on the semiconductors side, I guess I was surprised that business was as good as it was during the quarter because we have been hearing about obviously DRAM price and how some capacity was actually taken offline over the quarter. I was just kind of curious, is it really just the move to the leading edge that's driving that business at this point as opposed to capacity adds?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: Lot of – first of all there is – our bookings were not as good as we expected.

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

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: And I think Paul alluded to that and we're expecting certain bookings that we would ship the products and if we're to – if that were to happen. And I remember a meeting, consumer meeting, during SEMICON where I was being told how critical those shipments are for the customer during the quarter and then in August we heard that there would be a delay in these bookings.

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

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: But clearly we have this tailored-pulse IR based solution that is the solution of record right now for all customers. But we have introduced the tailored-pulse [ph] grid (23:05) that we expect to be in great demand from a point of view of technology as we move forward in the short-term.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. And after seeing those [indiscernible] (23:22) memory guys through the quarter, have you seen them actually go up over the last three or four weeks like a lot of other companies have?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: It's – I would not entirely disagree with you, but it's a very difficult to – I mean things, as I said, look that we are going to be going upwards from here but it's a – we need to be careful in terms of how much encouragement we see.

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

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: In relation to last four weeks of data.

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

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

Operator: [Operator Instructions] And our next question comes from the line of Mark Miller with Noble Financial. Please proceed.

<Q – Mark Miller – Noble Financial Capital Markets>: Good afternoon.

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

<Q – Mark Miller – Noble Financial Capital Markets>: Just wanted to comment. I've listened to couple calls regarding the LED industry and there seems to be a contrasting outlook. Beetel the other day or yesterday said that they expected softness for a couple of quarters, two or three quarters, and yet if you look at some data [indiscernible] (24:33) is estimating installed capacity as 180 billion LEDs and other firms are projecting just demand this year of 75 billion which indicates to me that it's going to be far more in a couple of quarters. I am just wondering what's your sense is in terms of the LED market and capacity situation there?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: Yes. My sense is that this is an industry in transition but there is a bubble in the backlighting LEDs for LCDs and by bubble I mean clearly there is over capacity in that area and that over capacity is being accelerated by the fact that these LCDs need fewer LEDs than the past. However there is a smaller part of the LED markets that is growing which is in the – which is the general lighting and again that is going to be growing steadily. The last data that I have seen and it's very difficult to – I kind of think with a high degree of caution but it tells me that the number of devices in LEDs continues to grow.

Although the dollar value of the devices may have been flat or will be flat for a while. So that the fact is that if we do have over capacity, in our industry which is a tool industry, customers do not buy new systems. So whether the new system is an MOCVD or a scriber for a while customers are not going to buy because they are in over capacity they don't need them, they need to work out this over capacity. But the thing that I want to characterize about the LEDs, LEDs problem is more structural. The industry is not as mature and cyclical as memory or MLCC.

<Q – Mark Miller – Noble Financial Capital Markets>: Have you heard anything about some of the – there has been a lot of entrants in China that some of these entrants were already considering maybe you are leaving the business?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: Yes. We were hearing the same thing and we're hearing that there is a more restrained access to capital markets that was funding all of these startups in LEDs especially in China.

<Q – Mark Miller – Noble Financial Capital Markets>: And just the last question. I thought your inventories – I'm surprised they still seem high and can you give us a little color on that?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: Yes. We have made a lot of progress in inventory over the last year and a half and unfortunately because of the events of the last – the performance of the last quarter inventory went up by about $4 million to $5 million. This is however good inventory of systems that are in demand maybe not necessarily now, but soon and we think that that inventory is going to be [ph] a turn (27:53), and on top of that the progress we made in reducing the inventory over the last two years is going to resume.

<A – Paul Oldham – Electro Scientific Industries, Inc.>: Yes. Mark, I'll just comment also that we would expect inventory to come down again in Q3 and probably in Q4 as well. So, the little uptick that we saw here recently was in support of the large businesses that we had and some of the orders that moved out. Again just delayed at this point we think. And so looking forward we ought to see that number come down. I would expect to see turns, while not as high as we'd like to see them, but still keep turns higher than they've been historically.

<Q – Mark Miller – Noble Financial Capital Markets>: I assume this is more a components view systems rather than completed systems, is that correct?

<A – Paul Oldham – Electro Scientific Industries, Inc.>: For the most part, yes.

<Q – Mark Miller – Noble Financial Capital Markets>: Thank you.

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

Operator: And there are no further questions. I'll turn it back over to Mr. Nick Konidaris for closing remarks.

Nicholas Konidaris, President, Chief Executive Officer & Director

In summary we've finished a successful quarter. We will continue to execute our growth and diversification strategy within laser micromachining while adapting to the reality of the market and economic environment. 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: Ladies and gentlemen, you may now disconnect and have a great day.