

**Electro Scientific Industries,
Inc.**
Company▲

ESIO
Ticker▲

Q3 2012 Earnings Call
Event Type▲

Jan. 26, 2012
Date▲

— PARTICIPANTS

Corporate Participants

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

Other Participants

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

— MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the ESI Fiscal 2012 Third Quarter Earnings Call. My name is Chris and I will be your conference moderator for today. Presently, all participants are in listen-only mode, later we will facilitate a question-and-answer session. [Operator Instructions] At this time, I would now like to turn the conference over to your presenter for today Mr. Brian Smith, sir, you may proceed.

Brian Smith, Director-Investor Relations

Thank you, Chris, 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 third quarter results.

Before we go into the details of the call, I would like to remind you that some of what we say on this call will include forward-looking statements concerning customer orders, shipments, 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, January 26, 2012, and which could change in the future. This call is the property of ESI.

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

Nicholas Konidaris, President, Chief Executive Officer & Director

Thank you, Brian. Good afternoon, and welcome to our third quarter conference call. Our third quarter results reflected uncertainty in the broader economy and overcapacity in several of our markets. However, orders improved sequentially. Activity related to growth of smartphones and consumer electronics continues to be brisk and we delivered financial results consistent with our expectations. In addition, we've made progress with many of our new products, which are in evaluation with customers.

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Date▲

Revenues for the quarter were \$50 million. Non-GAAP earnings per share were \$0.02. Paul will go into more detail around the financials in a moment. We generated \$45 million of orders, up 11% from Q2. The higher orders included record bookings for our flex via drilling products, and improvement in our passive component business both driven by strong demand for smart mobile devices.

In addition, orders increased modestly for our semiconductor products. However our markets for memory repair, LED and passive components continued to be in overcapacity.

Let me now go through each business in turn. The Interconnect and Micromachining group had revenue of \$35 million, down from \$51 million last quarter, when we shipped most of the large micro-fabrication order received in the June quarter. We did pass two milestones this quarter, we shipped our 500th model 5330 system and we shipped our 300th model 5900 system. The 5900 family has only been around for two, so to ship 300 of them in that timeframe reflects the capability and flexibility of this product.

Orders for this group were down a little from Q2. The flex interconnect products continue to see strong demand and show no signs of slowing down with smartphones and tablets serving as organic growth drivers. In fact, our backlog in flex is higher than it has ever been. The advanced micro-fabrication business on the other hand was down, reflecting the lumpiness of design wins in this business. Although it is difficult to predict the timing of orders, it is important to note that our opportunity funnel beyond our current applications is more than full.

Turning to our semiconductor business; revenues were \$8 million, well below last quarter and last year due to weak capital spending on DRAM. Capacity utilization among our customers remains low and DRAM pricing remains below cash cost for many of them. Looking forward, forecasts are for DRAM pricing to improve, but capital spending in 2012 to be well below 2011 levels.

We continue to believe that demand over the next few quarters will be driven more by new technologies and smaller nodes and capacity additions. This quarter we introduced and shipped our new tailored-pulse green solution enabling laser processing of smaller [indiscernible] (5:02) dimensions in our IR solutions. The model 9900 thin wafer dicing system continues to be evaluated by multiple customers.

Our focus here is on process development and qualification for our tools for thin wafer dicing and through silicon via applications. In addition, we see opportunities for scribing silicon LED wafers and have generated good initial results on customer samples.

On our LED [ph] sub-five (0:05:35) wafer scribing products had a slow quarter as the LED market continued in its oversupply condition. Current activity in this market is focused on high brightness LEDs for general purpose lighting which is growing but is still a relatively small part of the market. Our model 2600 is ideally suited for the latest material and process technologies and is in evaluation with several customers.

Our Components group generated \$6 million of revenues in the quarter, about the same as last quarter. For most customers capacity utilization is still below the threshold for new system purchases, but it's beginning to improve largely driven by the smaller size capacitors which are seeing strong demand in tablets and smartphones.

This quarter, we introduced our new model, 3510 tester which is optimized for the smallest size chips and received initial orders from multiple customers.

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Q3 2012 Earnings Call
Event Type▲

Jan. 26, 2012
Date▲

On the LED package front, we're pleased to announce that our first model 3800 packaged LED tester has completed its qualification and has been accepted by a leading LED manufacturer. The throughput of this tool is more than double than of competing machines and the software handling results in fewer damaged chips. We're working to make the 3800, the leading packaged LED test system in the market.

Turning now to the outlook for ESI; with the exception of smart mobile devices, our customers are still cautious in their both capital purchasing due to lower capacity utilization and uncertainty about economic growth and the risks to the global economy. As a result, we expect business levels to be choppy. During this time, we are focused on qualifying new products, winning opportunities in consumer electronics, and managing our cost structure consistent with current business levels. We remain committed to our goal of expanding our addressable markets and driving shareholder value with innovations and breakthrough technologies that grow our top and bottom line.

Looking now to the fourth quarter, we expect revenues to be in the mid \$40 million range. Non-GAAP EPS in Q4 is expected to be a loss of between \$0.05 and \$0.10. For the next fiscal year, although we are not clear as to the timing, we expect growth to resume as markets recover, and we win new design win opportunities.

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

Paul Oldham, CFO, Secretary & Vice President-Administration

Thank you, Nick, and good afternoon everyone. The following information includes results from our third quarter of fiscal 2012, which ended December 31. To improve comparability, we are also providing earnings per share and related income statement results on a non-GAAP basis, excluding the impact of purchase accounting, equity compensation, restructuring charges and non-recurring items.

For the third quarter, we generated \$45 million of orders, compared to \$41 million last quarter and \$78 million a year ago. Sequentially, we saw growth in flex via drilling, which had another record quarter and increase in passive component tools or small format chips and a handful of orders for DRAM and trim applications.

Orders for advanced micro-fabrication were down following several quarters of large orders and reflecting the design win nature of this business. Shipments were \$49 million and the backlog fell by \$3 million to \$49 million. Our book-to-bill ratio was 0.9 to 1 and deferred revenue decreased \$1 million.

Revenue for the third quarter was \$50 million, down from \$82 million last quarter, but consistent with our expectations.

The decline was primarily related to the lower order rate for DRAM and LED as well as the shipment in Q2 of the majority of the large micro-fabrication order from Q1. Gross margin was 42.5% including \$600,000 million in cost of goods sold for purchase accounting and equity compensation.

On a non-GAAP basis, gross margin was 43.7% down less than a 100 basis points from last quarter on the lower sales volumes. Gross margins were above our target model for this level of revenue, the result of both good product mix and actions we took to lower our manufacturing costs on declining volumes.

**Electro Scientific Industries,
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Company▲

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Ticker▲

Q3 2012 Earnings Call
Event Type▲

Jan. 26, 2012
Date▲

Gross margins in the fourth quarter are expected to be around 40% on a more normalized mix and lower revenues. GAAP operating expenses were \$25.3 million, down \$300,000 million from last quarter. GAAP expenses included \$2 million of stock compensation and a \$100,000 for purchase accounting plus \$900,000 of restructuring charges resulting from actions we took during the quarter to align our cost structure. We expect to recognize an additional \$500,000 to \$1 million in Q4 as we complete these actions. Excluding these items, non-GAAP operating expenses in Q3 were \$22.2 million, down from \$23.4 million last quarter, largely related to lower variable expenses. Looking forward, we expect non-GAAP expenses in Q4 to decline by another \$500,000 to \$1 million, reflecting the impact of our actions to align our cost structure.

On a GAAP basis, operating loss was \$4.1 million compared to income of \$10.3 million last quarter on lower orders and gross profit. Non-GAAP operating loss was \$470,000 compared to income of \$13 million in the prior quarter. Income tax for the quarter was a benefit of \$2.2 million, an effective tax rate of approximately 54%. The tax rate was favorably impacted by relatively fixed dollar tax benefit on lower income and discrete items related to manufacturing and R&D credit. The non-GAAP tax benefit was \$1.3 million more than offsetting the small pre-tax loss.

On a GAAP basis third quarter net loss was \$1.9 million or \$0.07 per share. On a non-GAAP basis net income was \$500,000 or \$0.02 per diluted share. Turning now to our balance sheet, cash and investments including restricted cash were \$227 million, an increase of \$1 million from last quarter. Cash flow generated from operations was \$1.4 million with working capital improvement offsetting the impacts of the operating loss.

For the quarter inventories decreased by \$3 million as we shipped out the last of the large micromachining order from Q1. Turns fell to 1.5 times on the lower sales volume. Accounts receivable decreased by \$4 million. DSO increased as expected that at 47 days represents excellent performance. Capital expenditures were \$750,000 and the depreciation and amortization excluding purchase accounting was \$2.7 million.

Lastly, on December 13, we announced that our Board of Directors had initiated a quarterly dividend. The first pay-out of \$0.08 per share will be made on February 17 to shareholders of record on January 27. This decision represents our commitment to increase the return to shareholders and our confidence in our strong balance sheet and proven ability to generate cash through cyclical market.

Looking forward, we expect business levels to continue in the current range with overall activity driven by technology buys, timing of design wins from micro-fabrication orders, and improvement in the overall market.

For Q4, based on recent order levels, we expect revenues to be in the mid \$40 million range, non-GAAP loss is expected to be between \$0.05 and \$0.10 per share.

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

Nicholas Konidaris, President, Chief Executive Officer & Director

To summarize, with the exception of smart electronics, market conditions remain challenging for our semiconductor LED and components products. However, we continue to innovate and our new products are gaining momentum and acceptance by leading customers. There is potential for sequential improvement in our markets over the course of 2012. And we are executing to take advantage of the growth opportunities in these markets.

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

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Jan. 26, 2012
Date▲

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QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions]. And our first question comes from the line of Tom Diffely of D. A. Davidson. You may proceed.

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

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

<Q – Tom Diffely – D. A. Davidson & Co.>: Nick, in your prepared remarks, you talked about the advanced micro-fab. You said something along the lines of the business beyond the current applications are full, I didn't quite understand what you were saying?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: What we said is that for the advanced micro-fabrication business, we have an opportunity funnel that is full of opportunities.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. So in your mind it's more of just a timing issue of when this lumpy business kind of give...

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: The design wins, right.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. And then you also talked about resuming the growth in fiscal 2013. Are you looking at growth year-over-year or just on a sequential basis?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: We are looking for growth on a quarter-by-quarter basis.

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

<A – Paul Oldham – Electro Scientific Industries, Inc.>: Yeah, Tom. What we said is that the growth will be driven by a combination of technology wins, timing of design wins in micro-fabrication, and recovery of the overall markets. And those things could happen at different paces via different markets. So it's difficult to see exactly how that would play out over the course of the year, but generally, our business will be choppy with some upside, as Nick mentioned, over the year.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. So when you look at the three businesses as to the challenge in semi, LED and passive, is there somehow you can handicap which of those you think might be the first to thaw out or which ones do you think have the most overcapacity?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: Yeah, the – what I would say is that, as you know, as you mentioned DRAM, LED and MLCC remain in overcapacity. But, although it's unclear in my mind as for the timing of DRAM recovery, I do think that LED and MLCC gradually are going to be recovering, primarily driven by the brisk business in smart mobile devices. If we look into flex, that enjoys a brisk business right now, because of again smart consumer devices and if you look into the advanced micro-fabrication, while again we don't have a major order this quarter, our opportunity pipeline is full.

So, I mean that gives you a perspective, and therefore I would think that we're going to see in terms of orders that better results in the area of – in terms of the timing of how results would improve in IMD, possibly followed by CTI and then semiconductor.

**Electro Scientific Industries,
Inc.**
Company▲

ESIO
Ticker▲

Q3 2012 Earnings Call
Event Type▲

Jan. 26, 2012
Date▲

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. And do you guys have a – just a whole host of new products that are just emerging? Over the last quarter has your view of the ultimate market size for those products changed at all?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: No, no, it has not. We believe this is, I mean, whatever we discussed in the Investor Presentation and later on, at least in investor – in one of the investment houses conference remains unchanged. And the view is that these are markets that over the course of the next few years are going to double our addressable market.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. All right. Then also you talked about some operating expense reduction. Can you give us a feel for whether that's just a temporary reduction or are those permanent reductions? And is it more in the fixed cost structure or variable cost structure?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: Yeah, the – one thing to keep in mind, you need to do a proper thing because this thing is – the top line is fluctuating. But we do fully preserve our drive for profitable growth, drive to double the addressable markets and these reductions are primarily on the expense line, but also in the – but also justified in the cost of goods sold line.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. And I was just kind of curious if – coming out of perhaps R&D, where you're cutting on certain projects or if it's really just on the expense side from more of an SG&A point of view?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: Well, no. I think that the way to think about R&D is that we have largely completed the bunch of activities that are at least in the incubation period of the [indiscernible] (19:41) ready to go into the take-off period. These systems have been designed and most of the activity that is currently going on is in the area of process development.

<Q – Tom Diffely – D. A. Davidson & Co.>: Okay. All right. Thanks for your time today.

<A – Paul Oldham – Electro Scientific Industries, Inc.>: Tom, just to be clear, that shifts on cost between engineering and what would be considered marketing, because we think of application and process development more in the marketing line than in the engineering line. So you'll probably see some of that occur over the next couple of quarters.

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

<A – Paul Oldham – Electro Scientific Industries, Inc.>: Thank you.

Operator: Our next question comes from the line of Mark Miller of Noble Capital. You may proceed.

<Q – Mark Miller – Noble Financial Capital Markets>: I just wanted to clarify the – I believe you said non-cap expenses next quarter will be down \$0.5 million to \$1.0 million, is that correct or is that spread over a couple of quarters?

<A – Paul Oldham – Electro Scientific Industries, Inc.>: Next quarter.

<Q – Mark Miller – Noble Financial Capital Markets>: Next quarter. What has been your history of, typically we're seeing or hearing from other firms that the front-end of the semiconductor business of a pick-up in orders or a pick-up in quoting activity. Are you typically two quarters behind that historically?

**Electro Scientific Industries,
Inc.**

Company▲

ESIO
Ticker▲Q3 2012 Earnings Call
Event Type▲Jan. 26, 2012
Date▲

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: Yes. Typically, we are behind the front-end. And basically what happens is the front-end sees the, first the upturn, but also the front end, as a result of that, sees also the first of the downturn. And the front-end addresses capacity type of decisions and then we address utilization type of decisions for our customers, meaning that the customer has to commit to a building and long lead time items for the front end, and as the customer commits, eventually he has a capacity for, I don't know, 30,000 – let's say, 60,000 wafer starts per month. But his investment in the back-end is basically proportional to the actual need to test that capacity and that's the utilization decision.

<Q – Mark Miller – Noble Financial Capital Markets>: Outside of the demand in China, with consumer devices like tablets and iPads, has the credit tightening in China affected you at all in terms of direct orders for your equipment?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: The answer is, yes, and I think that although the details are not that crisp, but there is a tightening of – through credit or other means of capital available for expansion of LED. And as a result, there is consolidation that has taken place in China in terms of the number of LED manufacturers.

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

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

Operator: [Operator Instructions] Our next question comes from the line of Jim Ricchiuti of Needham & Company. Sir, you may proceed.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Hello. 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>: Could you remind us when you last received a sizable order in the advanced micromachining area? Was it two or three quarters ago?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: I think, people can correct me, it was May of...

<A – Paul Oldham – Electro Scientific Industries, Inc.>: Yeah, it was in the June quarter, was that...

<Q – Jim Ricchiuti – Needham & Co. LLC>: June quarter?

<A – Paul Oldham – Electro Scientific Industries, Inc.>: ...we talked about a sizeable order there. Although we've had orders in the quarters, but that was the sizeable one we talked about.

<Q – Jim Ricchiuti – Needham & Co. LLC>: And in that instance, that order, was that tied to a new product launch?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: Jim, you're a dear friend, but we cannot talk about – unfortunately, cannot answer that question.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Okay. And Nick, and I'm also curious is your experience in this area, have you gone through periods like this where you have two, three quarters where there – the activity is at a fairly low level and then there is a sudden increase in order

**Electro Scientific Industries,
Inc.**
Company▲

ESIO
Ticker▲

Q3 2012 Earnings Call
Event Type▲

Jan. 26, 2012
Date▲

activity? I mean, this instance, I guess, last time you did receive a sizable order. So I guess is this fairly common for what you've experienced with this customer in the past?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: It's common – the following is common and whether the common thing is eight months or nine months or six months, that's a different story, but let's not talk about customers, let's talk about how this micro-fabrication business works. This addresses the part of the markets that, as we discussed, has a very high clock speed based on the frequency by which they introduce products during the course of the year. And therefore that clock speed creates opportunities for design needs.

And these opportunities, by the way, this is – these are the formative years of the laser micro-fabrication entering into that area. From the point of view that we are taking basically share from other technologies that we discussed like mechanical technologies like CNC. So as the new product introduction is being contemplated, there is opportunities to really drive the new features that require some form of micro-fabrication. And sometimes that is being addressed by existing technology but sometimes and it with increasing frequency over time, people come to the conclusion that requires a new type for technology like laser based micro-fabrication.

And but – there is a designing cycle and the way I look at this thing is – are we busy with opportunities or we're not busy? And we're extremely busy. Our pipeline of opportunities is full. And I really don't look at the period before we got the big order because this is not consequential to the activities that we are doing and the opportunities that we can offer our customers and to ourselves.

<Q – Jim Ricchiuti – Needham & Co. LLC>: And how would you characterize your competitive position in this market at the moment? I would assume that there has been interest from other companies to get into this market. Do you feel you're as well situated competitively as you were six to nine months ago or do you feel, perhaps you're better positioned?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: I think we are as well situated as few months ago. We do have competition from other technologies, not laser micro-fabrication. And as you pointed out, you have competition from other laser companies or integrators that integrate other people's lasers into machines. But our position in the laser micro-fabrication is – remains unchanged and very strong.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Okay. I just had one additional question, and I did miss some of the discussion around the new products. And I'm wondering, if you could help us perhaps understand the near-term potential for some of the newer products. If you just take into account the current market conditions for some of the areas that these products are focused on, if we look out over the next six to nine months, which of these products do you feel have the potential to perhaps generate meaningful revenues?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: Yeah. We have three such products, let me talk in terms of orders and revenues because they're new, we have some time delay there. But clearly, the first product that comes to mind is the 3800 packaged LED tester. This is a product that already we recognized revenue this quarter, it was accepted last quarter, and at this point in time we are in full sales mode of that product. So that would be generating revenue in the next fiscal year.

And then we have two other products; one is the 2600, which is for high-brightness LED, we are in high-quality qualifications, we're doing very well. And the thing that is – remains to be seen is the extent by which the current overcapacity in LED may affect in the short term, the revenue opportunities for this product, but other than that, it's – we expect to see again revenues in the next fiscal year. And the last is the 9900. This is – I make it last because the issue, the opportunity around 3D packaging in terms of thin wafers, dicing thin wafers and through-silicon vias for 3D

**Electro Scientific Industries,
Inc.**
Company▲

ESIO
Ticker▲

Q3 2012 Earnings Call
Event Type▲

Jan. 26, 2012
Date▲

packaging. This is a little bit later, is going to start developing probably next year and the year after. So the market will – could be ahead of the market, but maybe seeing opportunities in LED scribing, not for Sapphire like the 2600, but for vertical LED that is going to be a fast-growing of – segment of the LED market on silicon wafers.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Okay. And it sounds like, just in the way you characterized the new products that in terms of market acceptance, given the current market condition, is it safe to say that on the LED tester you see a bigger near-term opportunity for revenues?

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: Yeah, I think if – depending on when you ask me the order may be changing, but right now in terms of readiness for revenues I would put 3800 first, 2600 second, 9900 third.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Okay, okay. Thank you.

<A – Nicholas Konidaris – Electro Scientific Industries, Inc.>: Our view as of today.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Okay. Thanks a lot.

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

Operator: [Operator Instructions]. And we have no further questions at this time. I would now like to turn the call back over to Mr. Nick Konidaris for any closing remarks.

Nicholas Konidaris, President, Chief Executive Officer & Director

In summary, we're executing and innovating in a volatile market environment. We've continued to pursue our strategy of applying our expertise to more and more applications within the consumer electronics supply chain. 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 a lot for your interest in ESI.

Operator: Ladies and gentlemen that concludes today's conference. Thank you so much for your participation. You may now disconnect. Have a great day

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