

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

ESIO  
*Ticker▲*

Q3 2013 Earnings Call  
*Event Type▲*

Jan. 31, 2013  
*Date▲*

## — PARTICIPANTS

### Corporate Participants

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

### Other Participants

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

## — MANAGEMENT DISCUSSION SECTION

Operator: Good day, Ladies and gentlemen. Welcome to the ESI Fiscal 2013 Q3 Earnings Call. My name is Cheverly and I'll be your operator for today. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. [Operator Instructions] As a remainder, this conference is being recorded for replay purposes.

I would now like to turn the conference over to your host for today, Mr. Brian Smith. Please proceed.

### Brian Smith, Director-Investor Relations

Thank you, Cheverly, 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 call will cover our fiscal 2013 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, 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 31, 2013, and which could change in the future. This call is the property of ESI.

Now, I would like to turn the call over to Nick.

### Nicholas Konidaris, President, Chief Executive Officer & Director

Thank you, Brian. Good afternoon, and welcome to our third quarter conference call.

I would like to start by briefly describing a fundamental transformation in ESI strategy that puts a useful perspective on our short-term results. ESI has turned the page on memory repair and is focused on the growing and exciting opportunities in laser micro machining for consumer

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*Event Type▲*

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*Date▲*

electronics including glass microfabrication, emerging technologies related to semiconductor 3D packaging, and leveraging proprietary laser capability.

In the short-term, this transformation has amplified the challenge of cyclical markets and uneven revenue levels. As a result, in addition to our growth initiatives, we're working to lower our breakeven point and implement an even more flexible cost structure.

Moving forward, we expect to be a leaner, a more focused company with increased ability to weather the intense cyclicalities in some parts of our business while addressing large and growing markets.

Turning now to the third quarter, solid execution and good expense control enabled us to deliver respectable results on significantly lower revenues. In addition, strong ongoing operating cash flow and successful settlement of our patent dispute enabled us to pay a \$2 per share, special dividend, while preserving our ability to grow the company and pursue our strategy.

But slow capital spending in our core markets, combined with the cyclicalities of design wins in laser microfabrication, resulted in orders of only \$26 million for the quarter. Looking forward, we continue to see a very active funnel related to consumer electronics, and we remain optimistic about our long-term opportunities.

Revenues for the quarter were \$58 million. Non-GAAP loss per share was \$0.05, or we'll go into more detail around the financials in a moment.

Now, we'll discuss each of our business. The Interconnect and Microfabrication Group had revenue of \$51 million, down about 56% from last quarter. However, year-to-date, revenues are up 9% over last year with both flex-circuit drilling and advanced Microfabrication showing gains.

Orders in this basin has also fell in Q3. Customer activity for our flex interconnect products remained slow, impacted by short-term overinvestment in the supply chain for smartphones and tablets relative to actual ramp in line.

However, we expect this situation to be resolved very soon as demand continues to grow and capacity utilization in flex circuit manufacturing is rising. Orders for Advanced Microfabrication decreased sequentially, but were up versus the same quarter last year. Year-to-date, orders in this business are up more than 50% over last year.

Despite the lower orders last quarter, activity in this market continues to be brisk, driven by new technology and we see an exciting funnel of potential opportunities. In addition, our investments in this business continued to broaden the application set we address and open up new opportunities of both existing and new customers.

A good example is that we recently announced the new DiamondBlaze 5000 system for rapidly cutting next generation, chemically strengthened glass used in consumer electronics devices. The DiamondBlaze product line uses a novel process to quickly and cleanly cut large sheets of next generation strengthened glass to size, including Corning's newest Concore touch panel cover glass.

We are very excited about this product, and its enabling technology capability, as it opens up a new growth market opportunity for ESI. Later this year, we would be adding to our portfolio of glass cutting solutions with a DiamondBlaze 7000 system, which will allow us to penetrate the very attractive market for larger panel sizes up to gen 6.

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ESIO  
*Ticker▲*

Q3 2013 Earnings Call  
*Event Type▲*

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*Date▲*

Turning to our Semiconductor business, at \$3.3 million, revenues were up slightly from last quarter, but continued the trough levels, as both the DRAM and LED markets remained in overcapacity. Due to both slower bit growth and apparent shifts in technology, activity in our DRAM repair business has been weak for over a year. We do not expect this business to contribute meaningfully to ESI revenues in the future.

Within LED, manufacturers continue to invest in technologies to boost light output, but not with the urgency we showed a year or two ago. Further, we have seen no signs that they are moving to increase production capacity. Our next generation wafer scribing solution has largely completed qualification, but with current overcapacity and focus on lower cost solutions, we do not expect meaningful opportunities for adoption until the market improves.

Within in our semi business we are focusing our investment on 3D packaging technologies and are working with large – several large customers from process development with our 9900 platform. We believe that over time these emerging technologies will provide significant opportunities for growth.

Our Components Group generated \$4 million of revenues, down from last quarter and reflecting the weakness in the MLCC market. With the exception of smartphones and tablets, the electronics products that drive demand for MLCCs showed little or no growth in 2012. As with previous quarters, almost all of the demand for new MLCC testers is being driven by the smallest size chips used in smartphones and tablets. We did see an upturn in orders during the quarter and won a large order for next generation devices with our new 3510 ceramic tester.

Over the past several years, we have invested in new capabilities in the testing of packet LEDs. As part of this effort, we developed our 3800 platform. However, given the extended overcapacity in the market and ongoing commoditization of packaged LED test, we no longer believe that it makes sense to continue the investment required to penetrate this market and have decided to redirect our investments into more attractive opportunities.

Turning now to the outlook for the company. The team at ESI has worked very hard to transform the company to address growth opportunities in multiple applications outside of memory. That has been successful to the point that our consumer electronics focused businesses are healthy and growing. This transformation is ongoing. We see significant opportunities for additional growth with new design wins and expansion into adjacent applications like glass and advanced PCB technologies.

In semiconductor and LED, we're investing and developing singulation solutions for next generation 3D packages and LED wafers and substrates. Although these technologies are still emerging and will take time to develop, we believe we have chosen high value applications with good growth potential. At the same time, our business has become more susceptible to rapid swings from one quarter to the next due to the design win nature of our advanced microfabrication business. As a result, we're working to further streamline our business and lower our breakeven point.

Looking forward, we expect to be a leaner, more focused company with increased ability to weather the cyclicity in our business and deliver profitable growth. In the near-term, business levels would be driven by technology wise, timing of design wins and modest improvements in capacity utilization. While we expect orders to improve in the fourth quarter, we expect revenue levels to be roughly flat with Q3. Non-GAAP EPS is expected to be a loss of \$0.05 to \$0.09.

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

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

ESIO  
Ticker▲

Q3 2013 Earnings Call  
Event Type▲

Jan. 31, 2013  
Date▲

**Paul Oldham, CFO, Corporate Secretary & Vice President-Administration**

Thank you, Nick, and good afternoon everyone. The following information includes results from our third quarter of fiscal 2013, which ended December 29. 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 nonrecurring items.

Before we're giving the operating results, I thought I would take a minute to discuss the one-time items in the quarter. First, as we announced in November, we came to a successful settlement in our patent litigation in Taiwan. This resulted in net settlement proceeds of approximately \$15.4 million on a pre-tax basis. In addition, it will enable us to free-up \$22.3 million of restricted cash related to the bond once the final documents are released from the court during this quarter. Also in the quarter, we sold one of our facilities for a net gain of \$1.3 million, which is recorded as a credit to operating expenses. This is part of our ongoing effort to consolidate facilities and location. Finally, we recognize the cost of discontinuing one of our investment – discontinuing our investment in the Model 3800 LED tester, resulting in an inventory write down of \$1.2 million recorded in cost of goods sold.

Given the patent settlement and ongoing positive cash flow, we paid a one-time special dividend of \$2 per share or \$58.7 million on December 27. In conjunction with this dividend, we expect to record approximately \$400,000 in additional stock compensation expense during the fourth quarter to partially neutralize the impact of the change in capital structure on existing optionholders.

Now turning the operating – turning to the operating results for the third quarter. Orders were \$26 million compared to \$35 million last quarter and \$45 million a year ago. Interconnect & Microfabrication orders declined sequentially on slower orders for both flex and microfabrication. Flex orders have been slow for the last several quarters as customers absorb capacity ordered in the fourth quarter last year. We are seeing increased customer activity and expect flex orders to improve in the near future.

Advanced microfabrication orders reflect lower follow-on orders for existing applications, but we continue to have a very active funnel of new opportunities. Both semiconductor and component orders increased modestly from Q2, but remain at trough levels reflecting the overcapacity and slow capital investment in those markets.

Shipments were \$35 million and backlog decreased to \$31 million. Revenue for the quarter was \$38 million, down from \$80 million last quarter. The sequential decrease was due entirely to decreased shipments in advanced microfabrication reflecting the large order nature of this business.

Gross margin was 35% including \$722,000 in cost of goods sold for purchase accounting and equity compensation. Also included is \$1.2 million of inventory write-off changes for the discontinued LED tester product.

On a non-GAAP basis, gross margin was 40%, down only three percentage points on less than half the sales volume of the prior quarter. Looking forward to next quarter, we expect non-GAAP gross margins to be roughly flat on similar revenue levels.

GAAP operating expenses were \$3.8 million reflecting the patent settlement and building sale discussed earlier. Non-GAAP operating expenses in Q3 were \$19 million, a decrease of \$4.7 million or over 20% from last quarter. We are pleased with our flexible cost structure and ability to reduce costs quickly on lower volumes.

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ESIO  
*Ticker▲*

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*Event Type▲*

Jan. 31, 2013  
*Date▲*

Looking forward, we expect non-GAAP expenses in Q4 to be down again slightly from Q3. On a GAAP basis, operating income was \$9.4 million compared to \$7.9 million last quarter. Non-GAAP operating loss was \$3.9 million compared to income of \$10.5 million in the prior quarter reflecting the lower sales and gross profit.

Income tax for the quarter was \$2.6 million for an effective tax rate of 28%. The non-GAAP tax rate was a benefit of 62% largely a result of timing of income between quarters. On a GAAP basis, third quarter net income was \$6.8 million or \$0.23 per diluted share, compared to \$0.17 per diluted share last quarter. On a non-GAAP basis, the net loss was \$3.9 million or \$0.05 per share compared to income of \$0.23 per share per diluted share last quarter.

Turning now to our balance sheet. Cash and investments including restricted cash were \$171 million, a decrease of \$34 million from last quarter. During the quarter, we generated \$27 million of operating cash including the proceeds of a legal settlement and building sale. We paid our normal quarterly \$0.08 per share dividend on December 5 and then on December 27, we paid a \$2 per share special dividend, for a total payout to shareholders of \$61 million.

For the quarter, inventories increased by \$1 million, primarily on lower shipments. Inventory turns were approximately 1.2 times on the lower volume. Accounts receivable decreased by \$40 million to \$19 million and DSO decreased to 45 days. Capital expenditures were \$2.6 million and depreciation and amortization excluding purchase accounting was \$2.3 million.

In summary, in a quarter where revenues dropped by more than half, we were able to hold non-GAAP gross margins to a modest decline and flex our expenses down significantly. And we generated excellent cash flow from operations, even excluding the settlement proceeds.

Turning to next quarter, while we expect the order rate to improve, we expect Q4 revenues to be roughly flat with Q3. Non-GAAP loss is expected to be \$0.05 to \$0.09, down from Q3 largely due to normalization of the tax rate.

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

**Nicholas Konidaris, President, Chief Executive Officer & Director**

To summarize, we're transforming ESI into a company focused on growing opportunities in laser microfabrication for consumer electronics, including glass singulation; emerging technologies related to semiconductor 3D packaging and leveraging proprietary laser capability. In addition, faced with a challenge of cyclical markets and uneven revenue levels, we're working to lower our breakeven point and implement an even more flexible cost structure. As a result, we expect to be a leaner, more focused company with increased ability to weather the cyclicity in our business and deliver profitable growth.

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

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ESIO  
Ticker▲

Q3 2013 Earnings Call  
Event Type▲

Jan. 31, 2013  
Date▲

## QUESTION AND ANSWER SECTION

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

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

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Hi, Jim.

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

<Q – Jim Ricchiuti – Needham & Co. LLC>: With respect to the improvements you're anticipating in orders in the current quarter, would you characterize that as modest improvement?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: I would characterize that we expect improvement in orders, but I would stay away from characterizing any further of the improvement.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Okay. And Nick, if we look at the various segments, is the pickup that you saw in orders in the passive business, was that do you think a one quarter phenomenon or are you beginning to see some churn there?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Well, we see that there is an improvement in utilization, but what we're seeing in this marketplace is that this is driven primarily by consumers and is driven primarily by the small form factor. So, I expect an improvement over the year, but nevertheless, that business suffers from the cyclical nature that all businesses suffer that are related to the consumer electronics.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Now, are you anticipating orders, any bookings for the DiamondBlaze in the current quarter? Can you talk a little bit about how many customers – potential customers are currently evaluating it?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: We – whether the bookings are going to be this quarter or next quarter, it's kind of early for us. But we are talking to a number of potential customers. These are touch panel manufacturers, and we expect that as this Concore Glass gets designed in new emerging touch panel implementation for consumer electronics that we're going to be participating in with orders. But definitely we expect orders in the first half of this year, and we expect meaningful revenue this coming fiscal year.

<Q – Jim Ricchiuti – Needham & Co. LLC>: And is there, last question from me is, could you perhaps help size the market for this tool in the next year, the market opportunity?

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: I would say is that this is a market that has over time a potential of becoming \$42 million to \$50 million a year size. And – but this is going to go through the typical profile of order starting from zero to some smaller level and then eventually maturing to the market size. So this year, it's going to be of course less than \$40 million to \$50 million, but that's the potential of the market.

<Q – Jim Ricchiuti – Needham & Co. LLC>: Okay. I'll jump back in the queue. Thank you.

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

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

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

ESIO  
Ticker▲

Q3 2013 Earnings Call  
Event Type▲

Jan. 31, 2013  
Date▲

**<Q – Tom Diffely – D. A. Davidson & Co.>:** Yeah. Good afternoon. First, just a couple of clarifications. The new glass cutting tool, you said the second generation would go up to gen 6. What is the capability of the first one from a size point of view?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>:** The capability of the first one is, the 5000, is 3.5 gen, and 3.5 is basically good for phones. Gen 6 make it available for tablets and laptops.

**<Q – Tom Diffely – D. A. Davidson & Co.>:** Okay. So I assume it works with all kinds of the latest technology like the AMOLED-type screens as well then?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>:** That is an opportunity that will follow that particular opportunity.

**<Q – Tom Diffely – D. A. Davidson & Co.>:** Okay. All right. And then another question on the memory repair side. I mean, you've talked about not a meaningful source going forward. Is that just because the capacity demands aren't there in the industry or have some of the customers moved to more of a software solution?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>:** I think it is both. Clearly, there is a reduction in the growth of bits and as a result of that, people are trying to economize. I'm talking about DRAMs here, economize in capital expenditures and utilize as best as they can and they are very innovative.

**<Q – Tom Diffely – D. A. Davidson & Co.>:** Okay. But just to be clear, you're not exiting the business?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>:** Memory repair tools.

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

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>:** But at the same time, they're also – we are seeing that they are pursuing an alternative that has been always in place and was a more painful alternative, but this is about moving what you call software solution, what I would call other kinds of fuse solutions, they're known as effuse and diffuse and so forth...

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

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>:** Do not require a laser system to excise those fuses; it can be done with a current during testing.

**<Q – Tom Diffely – D. A. Davidson & Co.>:** Okay. So, you're not exiting the business, you're just kind of cash-cowing it, if you will, and if business pops up then you'll be there for it?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>:** That's correct. We're not exiting the business.

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

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>:** We're here, available and any time there is an opportunity, we'll be taking it, and as far as I'm concerned, we're the only ones who are in this business.

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

ESIO  
Ticker▲

Q3 2013 Earnings Call  
Event Type▲

Jan. 31, 2013  
Date▲

**<Q – Tom Diffely – D. A. Davidson & Co.>**: Okay. And so, when you look at some of the movements for some of the staff engineers moving around. How fungible are engineers between these different groups? Are there certain expertises that take a while to learn or is a lot of it transferable pretty quickly?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>**: It's very transferable. The engineers we are using are not known as memory repair engineers, they're known as mechanical engineers, electronic engineers, software engineers, system engineers, applications engineers and so forth. And we need those people in every business unit that we participate. So, it's extremely transferable skill, number one.

Number two, if you look at the architecture of a laser microfabrication tool, although every system is different from the other, all of them need to have a laser source, need to have a stage, need to have some positioning capability, controls and so forth. So there's a lot of synergies and fungibility in transferring the skills throughout the company.

**<Q – Tom Diffely – D. A. Davidson & Co.>**: Okay. And on the MLCC side, it sounds like you still are getting the orders for the smaller units, kind of the technology buys. What's your sense of utilization rates for just more on the capacity side of that business?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>**: We think that the utilization is approaching the 80% mark. I think all this become a little bit brisker when we start hitting upper 80s and we are hitting – have a nine in the utilization. Because of the nature of the business that is basically, addresses consumer demand and consumer demand products and this is very cyclical, the MLCC manufacturers are careful in investing. That means they invest when they see some tangible opportunity as a result of a design in, into a new product. So, we expect this business to grow, but right now, we saw a kind of a weak in historical ways quarter.

**<Q – Tom Diffely – D. A. Davidson & Co.>**: Okay. And I may have missed it, Paul, but did you talk about a restructuring charge and a new operating cost structure?

**<A – Paul Oldham – Electro Scientific Industries, Inc.>**: We did allude to that. We'll be looking at a number of actions to continue to lower our breakeven point. We didn't refer specifically to size of that, but you'll be looking at a number of things. Not only will we be redeploying head count but looking to have some reductions, continue to consolidate locations and focus our business.

**<Q – Tom Diffely – D. A. Davidson & Co.>**: Okay. Does your guidance for the fiscal fourth quarter include a charge?

**<A – Paul Oldham – Electro Scientific Industries, Inc.>**: We gave guidance on a non-GAAP basis, so that would not include a charge.

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

Operator: Your next question comes from the line of Mark Miller with Noble Financial Capital Markets. Please proceed.

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

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

**<Q – Mark Miller – Noble Financial Capital Markets>**: You talked about the 3D area. I know you've been working that for a while. When do you see that becoming an appreciable opportunity? Is that going to be later this year or 2014?

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

ESIO  
Ticker▲

Q3 2013 Earnings Call  
Event Type▲

Jan. 31, 2013  
Date▲

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>**: No. I think this is – I think 2014 and beyond. What were involved there is dicing thin wafers, dicing wafers, dicing interposers that have devices of – logical memory devices packed one on top of the other, addressing scribing of low-k wafers for next generation wafers and singulating smaller wafers that relate to vertical LED substrates. The last one, as you know, LED is not as brisk as we would have liked, but all the other few opportunities are basically emerging, we think they're going to be significant, but they're going to be past – meaningful – big meaningful orders would be past fiscal year 2014.

**<Q – Mark Miller – Noble Financial Capital Markets>**: There's a lot of things going on right now in the smartphone market. I think one of the general trends seem like these phones are getting cheaper and people are going to more economical models. What was the net effect on you...?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>**: Well, the one way to think about the net effect is that as phones get cheaper, there is going to be a bigger acceptance and faster growth of these phones. So that will create more volume and that will be good news for us. Keep in mind that our focus on consumer electronics is in addressing with some form of laser microfabrication inspection, almost every component that is inside or outside the phone. So, higher volume is good for us.

**<Q – Mark Miller – Noble Financial Capital Markets>**: And finally, you mentioned one of the reasons for exiting the LED tester market was overcapacity and are you seeing any new competition, increased competition in your other areas?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>**: I won't say we see new competition, we see this overcapacity in commoditization. They were – but to see a lot of competitors, these are smaller competitors that basically are Asians that drive the gross margins down. They are the incumbents and they have a mentality that's cost driven. This is not a market that we can excel and we decided to exit it for that reason. But, this is just in testing, we don't see that in other areas.

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

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

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

**<Q – Jim Ricchiuti – Needham & Co. LLC>**: Nick, in the recent past, at least, it appears that you haven't gone more than two quarters without seeing a pickup in orders in the advanced microfabrication area. Is there any reason to – is there any reason why you wouldn't see a pickup in activity in the current quarter or is there just less visibility to make that kind of a forecast?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>**: Trying to be as simple as I can and as clear as I can, I would say there's no reason.

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

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

Operator: At this time, we have no additional questions in queue. I would now like to turn the call back over to Nick for closing remarks.

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

ESIO  
Ticker▲

Q3 2013 Earnings Call  
Event Type▲

Jan. 31, 2013  
Date▲

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**Nicholas Konidaris, President, Chief Executive Officer & Director**

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Thank you very much for joining us. You are welcome to call Paul, Brian, or me if you have further questions. We would like to announce that we would be holding an Analyst Day in New York on March 13. We hope to see you there. This concludes our call. Thanks for your interest in ESI.

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

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