

**— PARTICIPANTS****Corporate Participants**

**Brian Smith** – Director-Investor Relations, Electro Scientific Industries, Inc.

**Nicholas Konidaris** – President, Chief Executive Officer & Director, Electro Scientific Industries, Inc.

**Paul Oldham** – Chief Financial Officer, Corporate Secretary & Vice President-Administration, Electro Scientific Industries, Inc.

**Other Participants**

**Tom R. Diffely** – Analyst, D.A. Davidson & Co.

**James Ricchiuti** – Analyst, Needham & Co. LLC

**David Duley** – Analyst, Steelhead Securities

**— MANAGEMENT DISCUSSION SECTION**

Operator: Good day, ladies and gentlemen, and welcome to the ESI Fiscal Second Quarter Earnings Conference Call. My name is Kim, and I'll 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. Please proceed.

**Brian Smith, Director-Investor Relations**

Thank you, Kim, 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, the Chief Financial Officer. This call will cover our fiscal second quarter of 2014 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 margin, expenses and earnings.

These statements are subject to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements include a number of risks and uncertainties that are discussed in more detail in today's press release and our filings with the SEC. Actual results may differ materially from those forward-looking statements.

This call also contains time-sensitive information that we believe to be accurate as of today, October 31, 2013 and which could change in the future. This call is the property of ESI.

Now with that, I will turn the call over to Nick.

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

Thank you, Brian. Good afternoon and welcome to our second quarter conference call. It was a great quarter for ESI on many fronts. We delivered sequential revenue growth in all three of our business groups and earnings per share above our expectations. Our acquired Semi Systems divisions had a particularly strong quarter and remains on track to achieve all our financial projections.

We generated nearly \$6 million of operating cash. More importantly, we executed well on our growth initiatives that will drive incremental revenue in glass cutting, 3D semiconductor packaging and advanced microfabrication. Revenues for the quarter were \$59.6 million. Non-GAAP earnings per share was \$0.09. Paul will go into more detail around the financials in a moment.

Now I'll discuss each of our business groups. The Interconnect & Microfabrication Group had revenue of \$38.3 million, which is up 11% from last quarter. Orders were down sequentially due to the timing of advanced microfabrication orders and lower flex demand.

Looking forward in advanced microfabrication, we are fully engaged with our key customers and see significant opportunities for design wins over the next several quarters. The application set in advanced consumer electronics continues to expand and we are well positioned to capture them and drive revenue growth.

Orders for flex via drilling products were solid, but below the robust levels for the past two quarters as our customers absorb the new capacity. Flex circuitry continues to penetrate new applications within consumer electronics and it represents an ongoing growth opportunity for ESI. The recently introduced Model 5335 furthers our performance and cost leadership in this market.

Our new DiamondBlaze system for cutting next generation strengthened glass continues to be actively evaluated. This quarter we expect to ship the first Gen 6 tool to a major touch panel manufacturer. We believe this will be the first large form of strengthened glass production tool in the industry. Adoption of this new glass by the OEMs has been slower than anticipated. We're confident that as these next generation glasses adopted in the industry over the next several quarters, it will drive significant new revenue opportunity for ESI during the next fiscal year.

Turning to our Semiconductor business. Revenues were \$10.9 million, which is nearly double that of last quarter, driven by excellent sales in our Semiconductor Systems business. During the quarter, we saw strong demand for circuit and wafer trimming products and received acceptance for the first fully automated 450 millimeter wafer marking system from a major wafer manufacturer.

As I mentioned earlier, this business has met all our expectations and is on track to achieve sales and profitability goals we set for it in its first year. The team in Massachusetts is excited and engaged and the collaboration between them and our engineers in Portland has already resulted in exciting new innovations.

Last quarter, we announced that we had secured several significant design wins in the semi space related to 3D packaging. These are long-term opportunities that have the potential to dramatically grow our addressable market. We're heavily engaged to industry leading customers, the programs are on track and we believe that they have the potential to drive significant revenue opportunities as early as next fiscal year.

Turning now to the Components Group. Revenues were \$10.4 million, the highest quarter level in over two years. Revenue was driven by strong orders last quarter for our recently introduced 3510 ceramic capacitor tester. Orders in Q2 were lower due to over capacity in the industry. Demand in

this market will continue to be driven by adoption of capacitors with smaller form factors and higher capacitance, which require our advanced technology solutions.

Turning now to the outlook for the company. As we transform the company into the premier provider of laser microfabrication solutions, we're heavily engaged with industry leading customers deploying innovative technologies and are executing with confidence from strategy of investing in advanced laser microfabrication, next generation singulation and semiconductor 3D packaging applications. We're excited about the opportunities we're pursuing and believe our long-term outlook for growth and profitability are bright. This transformation will not be linear and in the near term we will continue to see large demand based on the timing of advanced microfabrication orders and adoption for new technologies.

For the third quarter of fiscal 2014, we expect revenues to be in the low to mid \$40 million range and non-GAAP EPS is expected to be a loss of \$0.05 to \$0.09. In addition, we now expect fiscal year revenues to be down about 10%.

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

#### **Paul Oldham, Chief Financial Officer, Corporate Secretary & Vice President-Administration**

Thank you, Nick, and good afternoon, everyone. The following information includes results from our second quarter of fiscal 2014 which ended September 28. 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, impairment charges and other items.

Now turning to the operating results for the second quarter. Orders were \$46 million compared to \$58 million last quarter and \$35 million a year ago. Orders decreased from Q1 due to fewer design wins and lower follow on demand for advanced microfabrication equipment and absorption of capacity in both flex via drilling and component test systems. Shipments were \$57 million and backlog decreased to \$39 million as we shipped the majority of the microfabrication orders received in the June quarter to support our customer's ramp.

Our book-to-bill ratio was 0.81 to 1. Revenue for the quarter was \$59.6 million, up from \$46.2 million last quarter. All three business groups showed sequential sales growth. Interconnect & Microfabrication due to design wins in the June quarter, Semiconductor due to excellent sales in our acquired Semi Systems division and Components from strong system orders in Q1 from our new 3510 advanced ceramic capacitor tester.

GAAP gross margin was 41% and included \$965,000 of purchase accounting and \$189,000 in equity compensation. On a non-GAAP basis, gross margin was 43.2%, compared to 43.9% last quarter as the impact of the mix of higher volume, lower priced systems offset the benefit of higher volume. Looking forward to next quarter, we expect non-GAAP gross margin to decrease modestly on lower volumes, but a more favorable mix.

GAAP operating expenses were \$23.9 million, which included \$1 million of equity compensation and \$357,000 on purchase accounting. In addition, we incurred \$590,000 of acquisitions and integration costs.

Non-GAAP operating expenses in Q2 were \$22.1 million, an increase from Q1 due mainly to incremental development expenses associated with the strategic customer wins in our Semiconductor business and a full quarter of expenses from our acquired Semi Systems division.

Looking forward to next quarter, we expect non-GAAP expenses to decrease by about \$1 million on lower variable expenses and incremental development expenses. On a GAAP basis, operating income was \$697,000 compared to a loss of \$3.1 million last quarter. Non-GAAP operating income was \$3.7 million or roughly 6% of sales, compared to income of \$0.5 million in the prior quarter. The sequential improvement reflects the higher sales. Non-operating income was a loss of \$3.5 million due to a \$3.6 million impairment of our equity investment in OmniGuide.

OmniGuide is the provider of fiber technology for minimally invasive laser, micro-surgical applications in which the company has had an investment for the last several years. The impairment reflects the write-down of ESI's early investment and is the result of favorable terms of a new round of equity financing in which ESI made an additional investment of \$5 million.

Income tax expense on a GAAP basis for the quarter was a benefit of \$33,000. The small benefit reflects the impact of the discreet credit on foreign taxes. On a non-GAAP basis the tax rate was 30%. For fiscal year 2014, we expect the tax rate to be in the very low 30% range, reflecting a relatively fixed amount of foreign tax expense on lower projected annual income. However, as income grows, we would expect the corresponding decrease in the rate and continue to project approximately a 10% rate on higher level of profitability in future years.

On a GAAP basis, second quarter net loss was \$2.8 million or \$0.09 per share, compared to a loss of \$0.11 per share last quarter. On a non-GAAP basis, net income was \$2.6 million or \$0.09 per diluted share, up from net income of \$355,000 or \$0.01 per share last quarter.

Turning now to our balance sheet. Cash and investments were \$132 million at quarter end. During the quarter, we generated \$5.6 million of operating cash. Also during the quarter we paid \$1.7 million of cash as a net working capital adjustment for the Semiconductor Systems acquisition and \$2.4 million related to our normal quarterly dividend of \$0.08 per share. Lastly, we paid \$5 million to increase our equity investment in OmniGuide, as I discussed earlier.

For the quarter, inventories decreased by \$4 million. Inventory turns were approximately 1.9 turns. Accounts receivable decreased by \$3.5 million to \$35 million. DSO improved significantly to 53 days primarily on the timing of shipments early in the quarter. Capital expenditures were \$1.1 million and depreciation and amortization excluding purchase accounting was \$1.8 million.

Finally, I wanted to give a short update on a Semiconductor Systems business. As I mentioned, this quarter we finalized the net working capital adjustment and paid \$1.7 million for additional assets as part of the purchase agreement. The business performs consistent with our expectations in the second quarter with strong orders and sales and overall profitability. The integration activity is on track and is expected to be completed this quarter. We continue to expect this business to meet or exceed all of our financial goals.

In summary, revenues improved from last quarter and we generated non-GAAP earnings above the high end of our guidance range. Looking forward, we continue to be excited about the growth opportunities in advanced to laser microfabrication, glass singulation and semiconductor 3D packaging. However, in the near-term, the demand environment will remain challenging with business levels driven by capacity utilization, timing of advanced microfabrication orders and technology adoption. For Q3, we expect revenues to be in the low \$40 million range. Non-GAAP loss per share is expected to be \$0.05 to \$0.09.

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

**Electro Scientific Industries,  
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Q2 2014 Earnings Call  
*Event Type ▲*

Oct. 31, 2013  
*Date ▲*

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

To summarize, the quarter was good for ESI financially as we met or exceeded our projections on the top and bottom line. The near-term outlook remains lumpy as we pursue new design wins and develop new technologies with our customers. Looking forward, our pursuit of new revenue opportunities within consumer electronics, semiconductor and LED should expand our market and drive profitable growth.

These concludes our prepared remarks. We're ready for your questions. Kim?

**QUESTION AND ANSWER SECTION**

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

**<Q – Tom Diffely – D.A. Davidson & Co.>**: Yeah, good afternoon. First a couple of questions on some of the end markets here. It sounds like, last time we talked that you were expecting a little more linearity in the micromachining business versus in the years past and maybe there's couple of big [ph] lumps (15:55) that came through and went away. Has that changed then? Or it's just the timing of a couple orders?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>**: Fundamentally that has not changed. We are expecting more linearity because we are expecting that we would get the benefit of revenues from the new design wins in glass micromachining. That has moved to next year and basically that did not help in smooth increase, no linearity. So the advanced micromachining that we are facing this year is really subject to the timing of new orders. And there is a pattern that basically says that if you look at our last three years that fiscal Q4 and fiscal Q1 are stronger than the remaining two quarters.

**<Q – Tom Diffely – D.A. Davidson & Co.>**: Okay. So I guess the previous \$10 million to \$20 million of potential revenue from glass cutting, you don't believe it comes in this fiscal year, it's next fiscal year?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>**: That's correct. We expect that to be coming next year.

**<Q – Tom Diffely – D.A. Davidson & Co.>**: Okay. And then how do you compare the outlook for the third and fourth fiscal quarters versus where we were a year ago, if you take out the Semi Systems business, is that the part of the business that's giving you the \$5 million, \$6 million above where we were a year ago?

**<A – Paul Oldham – Electro Scientific Industries, Inc.>**: Yeah. That's certainly contributing to it. I would say that the second half of the year is on par or slightly better than what we saw a year ago, excluding the Semi Systems businesses.

**<Q – Tom Diffely – D.A. Davidson & Co.>**: Okay. And then finally when you look at the 3D packaging business, what are the specific tool that you think have the best possibilities there going forward? And what do you think revenues could be when you look out into the next fiscal year?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>**: Yeah. These particular tools that we're talking here is the – would be based on the 9900 platform. And these – the application that is the more embedded application is really scribing thin films on semiconductor wafers for the latest semiconductor nodes. This thing is on track. And if – as we deliver our technology development tools, we are able to intercept some of the deployment of these nodes in the industry. We would see revenues as early as next year which is – which will be an acceleration based on earlier statements that would be in fiscal year 2015.

As far as the size of the market, we said that this is a market that on that particular application has [indiscernible] (19:08) \$30 million per year. And we expect that to be a growing market moving forward on that particular application. There is of course other applications in 3D semiconductor like dicing very thin wafers that one is later the next year singulating interposers and that is a longer term application. But these scribing thin film wafers and semiconductors appears to be accelerating and that the industry is having a lead in a very short notice.

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Inc.**  
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ESIO  
Ticker▲

Q2 2014 Earnings Call  
Event Type▲

Oct. 31, 2013  
Date▲

**<Q – Tom Diffely – D.A. Davidson & Co.>**: Do you see the first application being NAND, DRAM or logic chips for that?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>**: Primary logic.

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

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

Operator: Your next question comes from the line of Jim Ricchiuti from Needham & Co. Please proceed.

**<Q – Jim Ricchiuti – Needham & Co. LLC>**: Hi, good afternoon. Just wanted to understand a little bit more about the Semiconductor Systems business that you acquired and that portion of the business is on track you say so. If we look at what the annualized revenues for that business were, maybe you said \$20 million number, does that suggest, Paul, that we're somewhere in the \$16 million to \$17 million area for this year?

**<A – Paul Oldham – Electro Scientific Industries, Inc.>**: No. I would say it would be higher than that because we acquired it during our first quarter. So we have part of the first quarter in there as well as the balance of the year. So it would be probably higher than that.

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

**<A – Paul Oldham – Electro Scientific Industries, Inc.>**: And we said at the time it would be \$20 million to \$30 million of revenue and...

**<Q – Jim Ricchiuti – Needham & Co. LLC>**: Right. Just didn't know just given the change here in guidance if we should think more in terms of the low end of that?

**<A – Paul Oldham – Electro Scientific Industries, Inc.>**: But, again, it's a partial year but that business I'd say is on track.

**<Q – Jim Ricchiuti – Needham & Co. LLC>**: Okay. On the Microfabrication business, can you help us understand what some of the dynamics are? We know the business is very variable, volatile quarter-to-quarter, but are there issues that have surfaced in which either programs you were considering or thinking you're going to be on or you are not going to be on some design wins that just have not materialized or not going into production. Help us, if you can, Nick, just how we should think about that business and what gives us the confidence you're going to see any, see the orders come in, in the next couple of quarters?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>**: Okay, good question. And I would characterize that as the market where the application set continues to expand that our funnel is full and extremely promising and we're very well positioned to win the opportunities that we're working in our funnel. We're not suffering from losses in this business. We're not suffering – the industry is growing. As we said before, it's growing but lumpy industry. And the lumpiness of the industry is that the strong quarters in that industry are in our fiscal Q4 and Q1 as opposed to the remaining fiscal Q2 and Q3. We're now in fiscal Q3 and we see that weakness that has been typical for the last three years and I think what we see is this role that has more or less a typical pattern that it is a repeat of whatever we saw in the last three years.

**<Q – Jim Ricchiuti – Needham & Co. LLC>**: Okay. Paul, can you talk at all, I think, you gave us some, so you characterized the orders in some of these areas. I think you said IMG orders down sequentially. Can you give us a sense how much and just in general on some of the other business

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

ESIO  
Ticker▲

Q2 2014 Earnings Call  
Event Type▲

Oct. 31, 2013  
Date▲

units how much the bookings have changed? I think in the Components Group wasn't quite sure where the orders are sequentially in that business? I presume they're down a bit given the strength you had last quarter?

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

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Yeah. What I would say here I don't have the numbers in front of me but qualitatively and directionally what I would say is that in the components area there is overcapacity in the industry that really the only demand that can create new orders comes from the MLCCs that are of the smallest form factor and the higher capacitance and this is an industry that is composed of few players but it's a very small subset of these few players that is really investing in these very, very small footprint and higher capacity. So you have very few players out of a small already set of players who invest in this latest devices. There is overcapacity in the industry and that's why you see a decrease in orders.

<A – Paul Oldham – Electro Scientific Industries, Inc.>: And we had a nice win in Q1.

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: And we had a nice win in Q1 and there is some need for absorption, again from the minority of that industry that investment is higher in the MLCCs. If you look at the flex we had good orders earlier, there is an absorption but other than that we see that flex circuitry continues to penetrate new applications but for this quarter we're going to see, flex is a bit seasonal around consumer electronics and we'll see some of that affecting the flex business but this is a growth business for us. It's a base business for us, we do very well, and [indiscernible] (25:20) a seasonal lot.

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

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

Operator: Your next question comes from the line David Duley from Steelhead. Please proceed.

<Q – Dave Duley – Steelhead Securities>: Yeah, thanks for taking my question. And I'm sorry I think I missed part of this explanation earlier on Tom's question, but could you talk in greater detail about the Gorilla Glass opportunity? You initially were thinking you're going to do I think \$10 million or \$20 million in this fiscal year and now that's been pushed to next fiscal year. Can you talk about the dynamics there and why we're off to a little bit of a false start? Thank you.

<A – Nick Konidaris – Electro Scientific Industries, Inc.>: Okay. This is the Gorilla Glass opportunity that is being applied into what is called OGS, One-Glass-Solution, on LCD displays and which requires that the panel of the glass that has been deposited with IPO is being cut as a panel as strengthened glass while it is strengthened as opposed to being cut when it is not strengthened and strengthen it by putting in the iron box and then applying IPO.

And there has been a delay of adoption not of our system, our system is being constantly evaluated we're shipping, we shipped orders, we're shipping what we believe, as I said, the first Gen 6 solutions but there has been a delay in adoption of that glass by the OEMs. The people who make the consumer devices and that – is a result primarily relative of the fact that the initial effort has been focused around laptops and laptops are being squeezed by tablets and that's the delay that that has happened. Other than that our solution is strong and great and we need to wait a little bit more until we see the results of our technology.

<Q – Dave Duley – Steelhead Securities>: So it's not just the overall Gorilla Glass that Corning is selling it's the special strengthened type that you need to have to take off because I believe that Corning has been talking about Gorilla Glass growing rapidly over the next couple of years?

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

ESIO  
Ticker▲

Q2 2014 Earnings Call  
Event Type▲

Oct. 31, 2013  
Date▲

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>**: And that is – no, no this is not the overall Gorilla Glass. It's Gorilla Glass that goes into this display packaging technology called OGS, One-Glass-Solution, which stands for One-Glass-Solution.

**<Q – Dave Duley – Steelhead Securities>**: And on the micromachining business, can you talk about have you expanded your customer footprint there or are we still just going up and down based on what your one big customer does in that marketplace?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>**: Well we continue to depend on one big customer but at the same time we're making efforts with other customers who are smaller customers. But the reality of the dynamic of that industry is that this industry is dominated by extremely few very big customers.

**<Q – Dave Duley – Steelhead Securities>**: And did you have any 10% customers during the quarter?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>**: We have two.

**<Q – Dave Duley – Steelhead Securities>**: Can you just give us the percentages? I know you probably don't want to talk about the names?

**<A – Nick Konidaris – Electro Scientific Industries, Inc.>**: We'll not talk about the names but Paul do you know the percentages?

**<A – Paul Oldham – Electro Scientific Industries, Inc.>**: Yeah. We don't tend to talk about the percentages in intra-quarters.

**<Q – Dave Duley – Steelhead Securities>**: All righty, thank you.

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

Operator: [Operator Instructions]. And there are no questions at this time. I will now turn the conference back to Nick Konidaris.

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

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: This concludes today's conference. Thank you for your participation. You may now disconnect. Have a great day.

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

ESIO  
Ticker▲

Q2 2014 Earnings Call  
Event Type▲

Oct. 31, 2013  
Date▲

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