

KLA TENCOR CORP
Form 10-Q
January 27, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark one)

QUARTERLY
REPORT
PURSUANT
TO SECTION
x 13 or 15(d) OF
THE
SECURITIES
EXCHANGE
ACT OF 1934

For the quarterly period ended December 31, 2016

or

TRANSITION
REPORT
PURSUANT
TO SECTION
13 or 15(d)
OF THE
SECURITIES
EXCHANGE
ACT OF 1934

For the transition period from _____ to _____

Commission File Number 000-09992

KLA-Tencor Corporation

(Exact name of registrant as specified in its charter)

Delaware 04-2564110
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

One Technology Drive, Milpitas, California 95035
(Address of Principal Executive Offices) (Zip Code)
(408) 875-3000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of January 17, 2017, there were 156,729,320 shares of the registrant's Common Stock, \$0.001 par value, outstanding.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS
KLA-TENCOR CORPORATION
Condensed Consolidated Balance Sheets
(Unaudited)

| (In thousands) | December 31, 2016 | June 30, 2016 |
|---|----------------------|------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 937,033 | \$ 1,108,488 |
| Marketable securities | 1,655,944 | 1,382,806 |
| Accounts receivable, net | 663,852 | 613,233 |
| Inventories | 671,172 | 698,635 |
| Other current assets | 103,638 | 64,870 |
| Total current assets | 4,031,639 | 3,868,032 |
| Land, property and equipment, net | 279,966 | 278,014 |
| Goodwill | 335,170 | 335,177 |
| Deferred income taxes | 259,507 | 302,219 |
| Purchased intangibles, net | 2,551 | 4,331 |
| Other non-current assets | 185,623 | 174,659 |
| Total assets | \$ 5,094,456 | \$ 4,962,432 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 116,163 | \$ 106,517 |
| Deferred system profit | 193,942 | 174,551 |
| Unearned revenue | 56,750 | 59,147 |
| Current portion of long-term debt | 249,958 | — |
| Other current liabilities | 570,923 | 662,208 |
| Total current liabilities | 1,187,736 | 1,002,423 |
| Non-current liabilities: | | |
| Long-term debt | 2,729,239 | 3,057,936 |
| Unearned revenue | 62,619 | 56,336 |
| Other non-current liabilities | 149,766 | 156,623 |
| Total liabilities | 4,129,360 | 4,273,318 |
| Commitments and contingencies (Note 11 and Note 12) | | |
| Stockholders' equity: | | |
| Common stock and capital in excess of par value | 483,077 | 452,974 |
| Retained earnings | 534,175 | 284,825 |
| Accumulated other comprehensive income (loss) | (52,156) | (48,685) |
| Total stockholders' equity | 965,096 | 689,114 |
| Total liabilities and stockholders' equity | \$ 5,094,456 | \$ 4,962,432 |

See accompanying notes to condensed consolidated financial statements (unaudited).

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KLA-TENCOR CORPORATION
 Condensed Consolidated Statements of Operations
 (Unaudited)

| (In thousands, except per share amounts) | Three months ended | | Six months ended | |
|--|--------------------|-----------|------------------|-----------|
| | December 31, | | December 31, | |
| | 2016 | 2015 | 2016 | 2015 |
| Revenues: | | | | |
| Product | \$683,733 | \$527,780 | \$1,245,486 | \$988,519 |
| Service | 193,152 | 182,465 | 382,072 | 364,370 |
| Total revenues | 876,885 | 710,245 | 1,627,558 | 1,352,889 |
| Costs and expenses: | | | | |
| Costs of revenues | 318,507 | 280,980 | 596,343 | 551,224 |
| Research and development | 130,912 | 118,272 | 260,145 | 238,215 |
| Selling, general and administrative | 93,532 | 96,532 | 187,920 | 188,195 |
| Interest expense | 30,624 | 30,539 | 61,356 | 61,103 |
| Other expense (income), net | (3,535) | (1,553) | (7,271) | (5,622) |
| Income before income taxes | 306,845 | 185,475 | 529,065 | 319,774 |
| Provision for income taxes | 68,594 | 33,268 | 112,713 | 62,670 |
| Net income | \$238,251 | \$152,207 | \$416,352 | \$257,104 |
| Net income per share: | | | | |
| Basic | \$1.52 | \$0.98 | \$2.66 | \$1.65 |
| Diluted | \$1.52 | \$0.98 | \$2.65 | \$1.64 |
| Cash dividends declared per share | \$0.54 | \$0.52 | \$1.06 | \$1.04 |
| Weighted-average number of shares: | | | | |
| Basic | 156,335 | 155,252 | 156,232 | 156,036 |
| Diluted | 157,123 | 155,996 | 157,071 | 156,971 |

See accompanying notes to condensed consolidated financial statements (unaudited).

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KLA-TENCOR CORPORATION
Condensed Consolidated Statements of Comprehensive Income
(Unaudited)

| (In thousands) | Three months ended | | Six months ended | |
|---|--------------------|-----------|------------------|-----------|
| | December 31, | | December 31, | |
| | 2016 | 2015 | 2016 | 2015 |
| Net income | \$238,251 | \$152,207 | \$416,352 | \$257,104 |
| Other comprehensive income (loss): | | | | |
| Currency translation adjustments: | | | | |
| Change in currency translation adjustments | (11,305) | (2,144) | (7,381) | (8,268) |
| Change in income tax benefit or expense | 1,086 | 380 | 1,868 | 1,764 |
| Net change related to currency translation adjustments | (10,219) | (1,764) | (5,513) | (6,504) |
| Cash flow hedges: | | | | |
| Change in net unrealized gains or losses | 13,969 | 707 | 12,131 | (1,154) |
| Reclassification adjustments for net gains or losses included in net income | 1,305 | 165 | 2,684 | (237) |
| Change in income tax benefit or expense | (5,494) | (314) | (5,329) | 500 |
| Net change related to cash flow hedges | 9,780 | 558 | 9,486 | (891) |
| Net change related to unrecognized losses and transition obligations in connection with defined benefit plans | 819 | 576 | 1,064 | 806 |
| Available-for-sale securities: | | | | |
| Change in net unrealized gains or losses | (7,037) | (4,715) | (9,914) | (4,234) |
| Reclassification adjustments for net gains or losses included in net income | (30) | (26) | (234) | (43) |
| Change in income tax benefit or expense | 1,164 | 989 | 1,640 | 920 |
| Net change related to available-for-sale securities | (5,903) | (3,752) | (8,508) | (3,357) |
| Other comprehensive income (loss) | (5,523) | (4,382) | (3,471) | (9,946) |
| Total comprehensive income | \$232,728 | \$147,825 | \$412,881 | \$247,158 |

See accompanying notes to condensed consolidated financial statements (unaudited).

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KLA-TENCOR CORPORATION

Condensed Consolidated Statements of Cash Flows
(Unaudited)

| | Six months ended December 31, | |
|---|----------------------------------|------------|
| (In thousands) | 2016 | 2015 |
| Cash flows from operating activities: | | |
| Net income | \$416,352 | \$257,104 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 29,314 | 36,264 |
| Asset impairment charges | 358 | 358 |
| Non-cash stock-based compensation expense | 23,922 | 23,573 |
| Excess tax benefit from equity awards | — | (11,541) |
| Net gain on sales of marketable securities and other investments | (885) | (1,258) |
| Changes in assets and liabilities: | | |
| Decrease (increase) in accounts receivable, net | (62,627) | 157,023 |
| Decrease (increase) in inventories | 14,319 | (67,911) |
| Increase in other assets | (8,838) | (3,663) |
| Increase in accounts payable | 10,239 | 19,205 |
| Increase (decrease) in deferred system profit | 19,391 | (16,843) |
| Decrease in other liabilities | (49,355) | (98,205) |
| Net cash provided by operating activities | 392,190 | 294,106 |
| Cash flows from investing activities: | | |
| Acquisition of non-marketable securities | (2,370) | — |
| Capital expenditures, net | (18,512) | (15,279) |
| Proceeds from sale of assets | 2,582 | 1,215 |
| Purchases of available-for-sale securities | (830,462) | (624,861) |
| Proceeds from sale of available-for-sale securities | 189,242 | 485,087 |
| Proceeds from maturity of available-for-sale securities | 356,177 | 326,335 |
| Purchases of trading securities | (73,278) | (35,005) |
| Proceeds from sale of trading securities | 68,465 | 35,576 |
| Net cash provided by (used in) investing activities | (308,156) | 173,068 |
| Cash flows from financing activities: | | |
| Repayment of debt | (80,000) | (60,000) |
| Issuance of common stock | 23,694 | 21,908 |
| Tax withholding payments related to vested and released restricted stock units | (17,455) | (22,021) |
| Common stock repurchases | — | (181,711) |
| Payment of dividends to stockholders | (173,842) | (183,054) |
| Excess tax benefit from equity awards | — | 11,541 |
| Net cash used in financing activities | (247,603) | (413,337) |
| Effect of exchange rate changes on cash and cash equivalents | (7,886) | (5,271) |
| Net increase (decrease) in cash and cash equivalents | (171,455) | 48,566 |
| Cash and cash equivalents at beginning of period | 1,108,488 | 838,025 |
| Cash and cash equivalents at end of period | \$937,033 | \$886,591 |
| Supplemental cash flow disclosures: | | |
| Income taxes paid, net | \$110,575 | \$59,475 |
| Interest paid | \$60,016 | \$59,860 |
| Non-cash activities: | | |
| Purchase of land, property and equipment, net - investing activities | \$1,985 | \$2,253 |

| | | |
|--|----------|----------|
| Dividends payable - financing activities | \$12,763 | \$20,284 |
|--|----------|----------|

See accompanying notes to condensed consolidated financial statements (unaudited).

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KLA-TENCOR CORPORATION

Notes to Condensed Consolidated Financial Statements
(Unaudited)

NOTE 1 – DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

Description of Business. KLA-Tencor Corporation (“KLA-Tencor” or the “Company”) is a leading supplier of process control and yield management solutions for the semiconductor and related nanoelectronics industries. KLA-Tencor’s broad portfolio of inspection and metrology products, and related service, software and other offerings primarily supports integrated circuit, which is referred to as an “IC” or “chip,” manufacturers throughout the entire semiconductor fabrication process, from research and development to final volume production. KLA-Tencor provides leading-edge equipment, software and support that enable IC manufacturers to identify, resolve and manage significant advanced technology manufacturing process challenges and obtain higher finished product yields at lower overall cost. In addition to serving the semiconductor industry, KLA-Tencor also provides a range of technology solutions to a number of other high technology industries, including the LED and data storage industries, as well as general materials research. Headquartered in Milpitas, California, KLA-Tencor has subsidiaries both in the United States and in key markets throughout the world.

Terminated Merger Agreement. On October 20, 2015, the Company entered into an Agreement and Plan of Merger and Reorganization (the “Merger Agreement” or “Merger”) with Lam Research Corporation (“Lam Research”) which was subject to regulatory approvals. On October 5, 2016, the parties mutually agreed to terminate the Merger Agreement and no termination fees were payable by either party.

Basis of Presentation. The condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the unaudited interim financial statements reflect all adjustments (consisting only of normal, recurring adjustments) necessary for a fair statement of the financial position, results of operations, comprehensive income, and cash flows for the periods indicated. These financial statements and notes, however, should be read in conjunction with Item 8, “Financial Statements and Supplementary Data” included in the Company’s Annual Report on Form 10-K for the fiscal year ended June 30, 2016, filed with the SEC on August 5, 2016. The condensed consolidated financial statements include the accounts of KLA-Tencor and its majority-owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

The results of operations for the three and six months ended December 31, 2016 are not necessarily indicative of the results that may be expected for any other interim period or for the full fiscal year ending June 30, 2017.

Certain reclassifications have been made to the prior year’s Condensed Consolidated Balance Sheet and notes to conform to the current year presentation. The reclassifications had no effect on the prior year’s Condensed Consolidated Statements of Operations, Comprehensive Income and Cash Flows.

Management Estimates. The preparation of the condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions in applying the Company’s accounting policies that affect the reported amounts of assets and liabilities (and related disclosure of contingent assets and liabilities) at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Revenue Recognition. The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the selling price is fixed or determinable, and collectibility is reasonably assured. The Company derives revenue from three sources—sales of systems, spare parts and services. In general, the Company recognizes revenue for systems when the system has been installed, is operating according to predetermined specifications and is accepted by the customer. When the Company has demonstrated a history of successful installation and acceptance, the Company recognizes revenue upon delivery and customer acceptance. Under certain circumstances, however, the Company recognizes revenue prior to acceptance from the customer, as follows:

• When the customer fab has previously accepted the same tool, with the same specifications, and when the Company can objectively demonstrate that the tool meets all of the required acceptance criteria.

• When system sales to independent distributors have no installation requirement, contain no acceptance agreement, and 100% of the payment is due based upon shipment.

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When the installation of the system is deemed perfunctory.

When the customer withholds acceptance due to issues unrelated to product performance, in which case revenue is recognized when the system is performing as intended and meets predetermined specifications.

In circumstances in which the Company recognizes revenue prior to installation, the portion of revenue associated with installation is deferred based on estimated fair value, and that revenue is recognized upon completion of the installation.

In many instances, products are sold in stand-alone arrangements. Services are sold separately through renewals of annual maintenance contracts. The Company has multiple element revenue arrangements in cases where certain elements of a sales arrangement are not delivered and accepted in one reporting period. To determine the relative fair value of each element in a revenue arrangement, the Company allocates arrangement consideration based on the selling price hierarchy. For substantially all of the arrangements with multiple deliverables pertaining to products and services, the Company uses vendor-specific objective evidence (“VSOE”) or third-party evidence (“TPE”) to allocate the selling price to each deliverable. The Company determines TPE based on historical prices charged for products and services when sold on a stand-alone basis. When the Company is unable to establish relative selling price using VSOE or TPE, the Company uses estimated selling price (“ESP”) in its allocation of arrangement consideration. The objective of ESP is to determine the price at which the Company would transact a sale if the product or service were sold on a stand-alone basis. ESP could potentially be used for new or customized products. The Company regularly reviews relative selling prices and maintains internal controls over the establishment and updates of these estimates.

In a multiple element revenue arrangement, the Company defers revenue recognition associated with the relative fair value of each undelivered element until that element is delivered to the customer. To be considered a separate element, the product or service in question must represent a separate unit of accounting, which means that such product or service must fulfill the following criteria: (a) the delivered item(s) has value to the customer on a stand-alone basis; and (b) if the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the Company. If the arrangement does not meet all the above criteria, the entire amount of the sales contract is deferred until all elements are accepted by the customer.

Trade-in rights are occasionally granted to customers to trade in tools in connection with subsequent purchases. The Company estimates the value of the trade-in right and reduces the revenue recognized on the initial sale. This amount is recognized at the earlier of the exercise of the trade-in right or the expiration of the trade-in right.

Spare parts revenue is recognized when the product has been shipped, risk of loss has passed to the customer and collection of the resulting receivable is probable.

Service and maintenance contract revenue is recognized ratably over the term of the maintenance contract. Revenue from services performed in the absence of a maintenance contract, including consulting and training revenue, is recognized when the related services are performed and collectibility is reasonably assured.

The Company sells stand-alone software that is subject to software revenue recognition guidance. The Company periodically reviews selling prices to determine whether VSOE exists, and in situations where the Company is unable to establish VSOE for undelivered elements such as post-contract service, revenue is recognized ratably over the term of the service contract.

The Company also defers the fair value of non-standard warranty bundled with equipment sales as unearned revenue. Non-standard warranty includes services incremental to the standard 40-hour per week coverage for 12 months.

Non-standard warranty is recognized ratably as revenue when the applicable warranty term period commences.

The deferred system profit balance equals the value of products that have been shipped and billed to customers which have not met the Company’s revenue recognition criteria, less applicable product and warranty costs. Deferred system profit does not include the profit associated with product shipments to certain customers in Japan, to whom title does not transfer until customer acceptance. Shipments to such customers in Japan are classified as inventory at cost until the time of acceptance.

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Recent Accounting Pronouncements.

Recently Adopted

In April 2015, the Financial Accounting Standards Board (“FASB”) issued an accounting standard update for customer’s cloud based fees. The guidance changes what a customer must consider in determining whether a cloud computing arrangement contains a software license. If the arrangement contains a software license, the customer would account for the fees related to the software license element in accordance with guidance related to internal use software; if the arrangement does not contain a software license, the customer would account for the arrangement as a service contract. The Company adopted this update beginning in the first quarter of its fiscal year ending June 30, 2017 on a prospective basis and there was no impact of adoption on its condensed consolidated financial statements.

In March 2016, the FASB issued an accounting standard update to simplify certain aspects of share-based payment awards to employees, including the accounting for income taxes, an option to recognize gross stock-based compensation expense with actual forfeitures recognized as they occur and statutory tax withholding requirements, as well as certain classifications in the statement of cash flows. The update is effective for the Company beginning in the first quarter of its fiscal year ending June 30, 2018, with early adoption permitted and all of the guidance must be adopted in the same period. However, the Company elected to early-adopt this standard update beginning in the first quarter of its fiscal year ending June 30, 2017.

Impact to Condensed Consolidated Statements of Operations

The primary impact of adopting the standard update is a change in the recording of the excess tax benefits or deficiencies from share-based payments. Before adoption, the Company recognized the excess tax benefits or deficiencies related to stock-based compensation as a credit or charge to additional paid-in capital (“APIC”) in the Company’s Condensed Consolidated Balance Sheets. Under the standard update, these excess tax benefits or deficiencies are recognized as a discrete tax benefit or discrete tax expense in the income tax provision in the Company’s Condensed Consolidated Statement of Operations. For the three and six months ended December 31, 2016, the Company recognized a discrete tax benefit of \$0.1 million and \$5.8 million, respectively, related to net excess tax benefits mainly from stock-based compensation and dividend equivalents. The standard update requires companies to adopt the amendment related to accounting for excess tax benefits or deficiencies on a prospective basis only and as a result, prior periods were not retrospectively adjusted.

Impact to Condensed Consolidated Statements of Cash Flows

In addition to the income tax consequence as described above, the standard update for share-based payment requires that cash flows from excess tax benefits related to share-based payments be reported as operating activities in the Condensed Consolidated Statements of Cash Flows. Previously, cash flows from excess tax benefit related to share-based payments were reported as financing activities. The standard update allows for two methods of adoption which are prospective or retrospective application. The Company elected to adopt this amendment on a prospective basis and as a result, prior periods were not retrospectively adjusted.

Updates Not Yet Effective

In May 2014, the FASB issued an accounting standard update regarding revenue from customer contracts to transfer goods and services or non-financial assets unless the contracts are covered by other standards (for example, insurance or lease contracts). Under the new guidance, an entity should recognize revenue in connection with the transfer of promised goods or services to customers in an amount that reflects the consideration that the entity expects to be entitled to receive in exchange for those goods or services. In addition, the new standard requires that reporting companies disclose the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. In August 2015, the FASB issued an amendment to defer the effective date of the update by one year, with early adoption on the original effective date permitted. With this amendment, the updates are effective for the Company beginning in the first quarter of the fiscal year ending June 30, 2019, with early adoption permitted beginning in the first quarter of the fiscal year ending June 30, 2018. Subsequent to this amendment, the FASB has issued additional clarifying implementation guidance. The new revenue standard may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of adoption. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

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In July 2015, the FASB issued an accounting standard update for the subsequent measurement of inventory. The amended guidance requires entities to measure inventory at the lower of cost or net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. The requirement would replace the current lower of cost or market evaluation and the accounting guidance is unchanged for inventory measured using last-in, first-out (“LIFO”) or the retail inventory method. The update is effective for the Company beginning in the first quarter of the Company’s fiscal year ending June 30, 2018 and should be applied prospectively with early adoption permitted as of the beginning of an interim or annual reporting period. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

In January 2016, the FASB issued an accounting standard update that changes the accounting for financial instruments primarily related to equity investments (other than those accounted for under the equity method of accounting or those that result in consolidation of the investee), financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. The accounting standard update is effective for the Company beginning in the first quarter of its fiscal year ending 2019, and early adoption is permitted. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

In February 2016, the FASB issued an accounting standard update which amends the existing accounting standards for leases. Consistent with current guidance, the recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification. Under the new guidance, a lessee will be required to recognize assets and liabilities for all leases with lease terms of more than 12 months. The update is effective for the Company beginning in the first quarter of its fiscal year ending June 30, 2020 using a modified retrospective transition method. Early adoption is permitted. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

In June 2016, the FASB issued an accounting standard update that changes the accounting for recognizing impairments of financial assets. Under the update, credit losses for certain types of financial instruments will be estimated based on expected losses. The update also modifies the impairment models for available-for-sale debt securities and for purchased financial assets with credit deterioration since their origination. The update is effective for the Company beginning in the first quarter of its fiscal year ending June 30, 2021, with early adoption permitted starting in the first quarter of fiscal year ending 2020. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

In October 2016, the FASB issued an accounting standard update to recognize the income tax consequences of intra-entity transfers of assets other than inventory when they occur. This eliminates the exception to postpone recognition until the asset has been sold to an outside party. This standard is effective for the Company beginning in the first quarter of its fiscal year ending 2019, and early adoption is permitted. It is required to be applied on a modified retrospective basis through a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

NOTE 2 – FAIR VALUE MEASUREMENTS

The Company’s financial assets and liabilities are measured and recorded at fair value, except for certain equity investments in privately-held companies. These equity investments are generally accounted for under the cost method of accounting and are periodically assessed for other-than-temporary impairment when an event or circumstance indicates that an other-than-temporary decline in value may have occurred. The Company’s non-financial assets, such as goodwill, intangible assets, and land, property and equipment, are recorded at cost and are assessed for impairment when an event or circumstance indicates that an other-than-temporary decline in value may have occurred.

Fair Value of Financial Instruments. KLA-Tencor has evaluated the estimated fair value of financial instruments using available market information and valuations as provided by third-party sources. The use of different market assumptions and/or estimation methodologies could have a significant effect on the estimated fair value amounts. The fair value of the Company’s cash equivalents, accounts receivable, accounts payable and other current assets and liabilities approximate their carrying amounts due to the relatively short maturity of these items.

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Fair Value Hierarchy. The authoritative guidance for fair value measurements establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are described below:

Level 1 Valuations based on quoted prices in active markets for identical assets or liabilities that the entity has the ability to access.

Level 2 Valuations based on quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable data for substantially the full term of the assets or liabilities.

Level 3 Valuations based on inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

The Company's financial instruments were classified within Level 1 or Level 2 of the fair value hierarchy as of December 31, 2016, because they were valued using quoted market prices, broker/dealer quotes or alternative pricing sources with reasonable levels of price transparency. As of December 31, 2016, the types of instruments valued based on quoted market prices in active markets included money market funds, U.S. Treasury securities, certain U.S. Government agency securities and certain sovereign securities. Such instruments are generally classified within Level 1 of the fair value hierarchy.

As of December 31, 2016, the types of instruments valued based on other observable inputs included corporate debt securities, municipal securities, and certain sovereign securities. The market inputs used to value these instruments generally consist of market yields, reported trades and broker/dealer quotes. Such instruments are generally classified within Level 2 of the fair value hierarchy.

The principal market in which the Company executes its foreign currency contracts is the institutional market in an over-the-counter environment with a relatively high level of price transparency. The market participants generally are large financial institutions. The Company's foreign currency contracts' valuation inputs are based on quoted prices and quoted pricing intervals from public data sources and do not involve management judgment. These contracts are typically classified within Level 2 of the fair value hierarchy.

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Financial assets (excluding cash held in operating accounts and time deposits) and liabilities measured at fair value on a recurring basis, as of the date indicated below, were presented on the Company's Condensed Consolidated Balance Sheet as follows:

| As of December 31, 2016 (In thousands) | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) |
|---|-------------|---|---|
| Assets | | | |
| Cash equivalents: | | | |
| Money market and other | \$552,189 | \$ 552,189 | \$ — |
| U.S. Treasury securities | 33,646 | 33,646 | — |
| Marketable securities: | | | |
| Corporate debt securities | 933,247 | — | 933,247 |
| Municipal securities | 1,004 | — | 1,004 |
| Sovereign securities | 58,024 | 1,991 | 56,033 |
| U.S. Treasury securities | 277,660 | 277,660 | — |
| U.S. Government agency securities | 378,632 | 378,632 | — |
| Total cash equivalents and marketable securities ⁽¹⁾ | 2,234,402 | 1,244,118 | 990,284 |
| Other current assets: | | | |
| Derivative assets | 13,978 | — | 13,978 |
| Other non-current assets: | | | |
| Executive Deferred Savings Plan | 173,490 | 130,692 | 42,798 |
| Total financial assets ⁽¹⁾ | \$2,421,870 | \$ 1,374,810 | \$ 1,047,060 |
| Liabilities | | | |
| Other current liabilities: | | | |
| Derivative liabilities | \$ (4,103) | \$ — | \$ (4,103) |
| Total financial liabilities | \$ (4,103) | \$ — | \$ (4,103) |

(1) Excludes cash of \$327.8 million held in operating accounts and time deposits of \$30.8 million as of December 31, 2016.

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Financial assets (excluding cash held in operating accounts and time deposits) and liabilities measured at fair value on a recurring basis, as of the date indicated below, were presented on the Company's Condensed Consolidated Balance Sheet as follows:

| As of June 30, 2016 (In thousands) | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) |
|---|-------------|---|---|
| Assets | | | |
| Cash equivalents: | | | |
| Corporate debt securities | \$20,569 | \$ — | \$ 20,569 |
| Money market and other | 626,156 | 626,156 | — |
| U.S. Treasury securities | 68,748 | 68,748 | — |
| Marketable securities: | | | |
| Corporate debt securities | 657,905 | — | 657,905 |
| Municipal securities | 5,016 | — | 5,016 |
| Sovereign securities | 41,257 | 6,426 | 34,831 |
| U.S. Treasury securities | 258,754 | 258,754 | — |
| U.S. Government agency securities | 405,705 | 385,731 | 19,974 |
| Total cash equivalents and marketable securities ⁽¹⁾ | 2,084,110 | 1,345,815 | 738,295 |
| Other current assets: | | | |
| Derivative assets | 1,095 | — | 1,095 |
| Other non-current assets: | | | |
| Executive Deferred Savings Plan | 162,160 | 106,149 | 56,011 |
| Total financial assets ⁽¹⁾ | \$2,247,365 | \$ 1,451,964 | \$ 795,401 |
| Liabilities | | | |
| Other current liabilities: | | | |
| Derivative liabilities | \$(11,647) | \$ — | \$ (11,647) |
| Total financial liabilities | \$(11,647) | \$ — | \$ (11,647) |

(1) Excludes cash of \$330.1 million held in operating accounts and time deposits of \$77.1 million as of June 30, 2016. There were no transfers between Level 1 and Level 2 fair value measurements during the six months ended December 31, 2016. The Company did not have any assets or liabilities measured at fair value on a recurring basis within Level 3 fair value measurements as of December 31, 2016 or June 30, 2016.

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NOTE 3 – FINANCIAL STATEMENT COMPONENTS

Balance Sheet Components

| (In thousands) | As of December 31, 2016 | As of June 30, 2016 |
|---|-------------------------------|---------------------------|
| Accounts receivable, net: | | |
| Accounts receivable, gross | \$685,454 | \$634,905 |
| Allowance for doubtful accounts | (21,602) | (21,672) |
| | \$663,852 | \$613,233 |
| Inventories: | | |
| Customer service parts | \$238,446 | \$234,712 |
| Raw materials | 197,641 | 208,689 |
| Work-in-process | 182,342 | 187,733 |
| Finished goods | 52,743 | 67,501 |
| | \$671,172 | \$698,635 |
| Other current assets: | | |
| Prepaid expenses | \$33,456 | \$37,127 |
| Income tax related receivables | 47,658 | 18,190 |
| Other current assets | 22,524 | 9,553 |
| | \$103,638 | \$64,870 |
| Land, property and equipment, net: | | |
| Land | \$40,601 | \$40,603 |
| Buildings and leasehold improvements | 315,558 | 313,239 |
| Machinery and equipment | 528,351 | 507,378 |
| Office furniture and fixtures | 21,091 | 21,737 |
| Construction-in-process | 6,255 | 5,286 |
| | 911,856 | 888,243 |
| Less: accumulated depreciation and amortization | (631,890) | (610,229) |
| | \$279,966 | \$278,014 |
| Other non-current assets: | | |
| Executive Deferred Savings Plan ⁽¹⁾ | \$173,490 | \$162,160 |
| Other non-current assets | 12,133 | 12,499 |
| | \$185,623 | \$174,659 |
| Other current liabilities: | | |
| Compensation and benefits | \$137,614 | \$224,496 |
| Executive Deferred Savings Plan ⁽¹⁾ | 174,071 | 162,289 |
| Customer credits and advances | 79,519 | 81,994 |
| Interest payable | 19,427 | 19,395 |
| Warranty | 40,673 | 34,773 |
| Income taxes payable | 23,223 | 27,964 |
| Other accrued expenses | 96,396 | 111,297 |
| | \$570,923 | \$662,208 |
| Other non-current liabilities: | | |
| Pension liabilities | \$66,255 | \$69,418 |
| Income taxes payable | 57,315 | 50,365 |
| Other non-current liabilities | 26,196 | 36,840 |
| | \$149,766 | \$156,623 |

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KLA-Tencor has a non-qualified deferred compensation plan (known as “Executive Deferred Savings Plan”) under which certain executives and non-employee directors may defer a portion of their compensation. Participants are credited with returns based on their allocation of their account balances among measurement funds. The Company controls the investment of these funds, and the participants remain general creditors of the Company. The Company invests these funds in certain mutual funds and such investments are classified as trading securities in the condensed consolidated balance sheets. Distributions from the Executive Deferred Savings Plan commence following a participant’s retirement or termination of employment or on a specified date allowed per the Executive Deferred Savings Plan provisions, except in cases where such distributions are required to be delayed in order to avoid a prohibited distribution under Internal Revenue Code Section 409A. Participants can generally elect the distributions to be paid in lump sum or quarterly cash payments over a scheduled period for up to 15 years and are (1) allowed to make subsequent changes to their existing elections as permissible under the Executive Deferred Savings Plan provisions. Changes in the Executive Deferred Savings Plan liability are recorded in selling, general and administrative expense in the condensed consolidated statements of operations. The expense (benefit) associated with changes in the liability included in selling, general and administrative expense was \$1.2 million and \$6.8 million during the three months ended December 31, 2016 and 2015, respectively, and was \$7.0 million and \$(3.3) million during the six months ended December 31, 2016 and 2015, respectively. Changes in the Executive Deferred Savings Plan assets are recorded as gains (losses), net in selling, general and administrative expense in the condensed consolidated statements of operations. The amount of gains (losses), net included in selling, general and administrative expense was \$0.8 million and \$6.9 million during the three months ended December 31, 2016 and 2015, respectively, and was \$6.7 million and \$(3.1) million during the six months ended December 31, 2016 and 2015, respectively.

Accumulated Other Comprehensive Income (Loss)

The components of accumulated other comprehensive income (loss) (“OCI”) as of the dates indicated below were as follows:

| (In thousands) | Currency Translation Adjustments | Unrealized Gains (Losses) on Available-for-Sale Securities | Unrealized Gains (Losses) on Cash Flow Hedges | Unrealized Gains (Losses) on Defined Benefit Plans | Total |
|---------------------------------|----------------------------------|--|---|--|------------|
| Balance as of December 31, 2016 | \$ (37,937) | \$ (5,057) | \$ 10,261 | \$ (19,423) | \$(52,156) |
| Balance as of June 30, 2016 | \$ (32,424) | \$ 3,451 | \$ 775 | \$ (20,487) | \$(48,685) |

The effects on net income of amounts reclassified from accumulated OCI to the Condensed Consolidated Statement of Operations for the indicated period were as follows (in thousands):

| Accumulated OCI Components | Location in the Condensed Consolidated Statements of Operations | Three months ended | | Six months ended | |
|---|---|--------------------|---------|-------------------|----------|
| | | December 31, 2016 | 2015 | December 31, 2016 | 2015 |
| Unrealized gains (losses) on cash flow hedges from foreign exchange and interest rate contracts | Revenues | \$(1,425) | \$324 | \$(2,906) | \$1,009 |
| | Costs of revenues | (69) | (678) | (156) | (1,150) |
| | Interest expense | 189 | 189 | 378 | 378 |
| | Net gains (losses) reclassified from accumulated OCI | \$(1,305) | \$(165) | \$(2,684) | \$237 |
| Unrealized gains (losses) on available-for-sale securities | Other expense (income), net | \$30 | \$26 | \$234 | \$43 |

The amounts reclassified out of accumulated OCI related to the Company's defined benefit pension plans, which were recognized as a component of net periodic cost for the three and six months ended December 31, 2016 were \$0.9 million and \$1.3 million, respectively. The amounts reclassified out of accumulated OCI related to the Company's defined benefit pension plans, which were recognized as a component of net periodic cost for the three and six months ended December 31, 2015 were \$0.7 million and \$1.0 million, respectively. For additional details, refer to Note 10, "Employee Benefit Plans" in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2016.

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NOTE 4 – MARKETABLE SECURITIES

The amortized cost and fair value of marketable securities as of the dates indicated below were as follows:

| As of December 31, 2016 (In thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| Corporate debt securities | \$936,011 | \$ 205 | \$ (2,969) | \$933,247 |
| Money market and other | 552,189 | — | — | 552,189 |
| Municipal securities | 1,004 | — | — | 1,004 |
| Sovereign securities | 58,129 | 1 | (106) | 58,024 |
| U.S. Treasury securities | 312,438 | 71 | (1,203) | 311,306 |
| U.S. Government agency securities | 380,532 | 57 | (1,957) | 378,632 |
| Subtotal | 2,240,303 | 334 | (6,235) | 2,234,402 |
| Add: Time deposits ⁽¹⁾ | 30,814 | — | — | 30,814 |
| Less: Cash equivalents | 609,272 | — | — | 609,272 |
| Marketable securities | \$1,661,845 | \$ 334 | \$ (6,235) | \$1,655,944 |

| As of June 30, 2016 (In thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| Corporate debt securities | \$676,259 | \$ 2,372 | \$ (157) | \$678,474 |
| Money market and other | 626,156 | — | — | 626,156 |
| Municipal securities | 5,014 | 2 | — | 5,016 |
| Sovereign securities | 41,224 | 38 | (5) | 41,257 |
| U.S. Treasury securities | 326,321 | 1,181 | — | 327,502 |
| U.S. Government agency securities | 404,889 | 830 | (14) | 405,705 |
| Subtotal | 2,079,863 | 4,423 | (176) | 2,084,110 |
| Add: Time deposits ⁽¹⁾ | 77,131 | — | — | 77,131 |
| Less: Cash equivalents | 778,451 | 1 | (17) | 778,435 |
| Marketable securities | \$1,378,543 | \$ 4,422 | \$ (159) | \$1,382,806 |

(1) Time deposits excluded from fair value measurements.

KLA-Tencor's investment portfolio consists of both corporate and government securities that have a maximum maturity of three years. The longer the duration of these securities, the more susceptible they are to changes in market interest rates and bond yields. As yields increase, those securities with a lower yield-at-cost show a mark-to-market unrealized loss. All unrealized losses are due to changes in market interest rates, bond yields and/or credit ratings. The Company believes that it has the ability to realize the full value of all of these investments upon maturity. The following table summarizes the fair value and gross unrealized losses of the Company's investments that were in an unrealized loss position as of the date indicated below:

| As of December 31, 2016 (In thousands) | Fair Value | Gross Unrealized Losses ⁽¹⁾ |
|--|-------------|--|
| Corporate debt securities | \$702,366 | \$ (2,969) |
| U.S. Government agency securities | 310,258 | (1,957) |
| U.S. Treasury securities | 173,202 | (1,203) |
| Sovereign securities | 43,433 | (106) |
| Municipal securities | 1,004 | — |
| Total | \$1,230,263 | \$ (6,235) |

(1) As of December 31, 2016, the amount of total gross unrealized losses related to investments that had been in a continuous loss position for 12 months or more was immaterial.

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The contractual maturities of securities classified as available-for-sale, regardless of their classification on the Company's Condensed Consolidated Balance Sheet, as of the date indicated below were as follows:

| As of December 31, 2016 (In thousands) | Amortized Cost | Fair Value |
|--|-------------------|-------------|
| Due within one year | \$673,708 | \$673,484 |
| Due after one year through three years | 988,137 | 982,460 |
| | \$1,661,845 | \$1,655,944 |

Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Realized gains and losses on available-for-sale securities for the three and six months ended December 31, 2016 and 2015 were immaterial.

NOTE 5 – GOODWILL AND PURCHASED INTANGIBLE ASSETS**Goodwill**

Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in prior business combinations. The Company has four reporting units: Wafer Inspection, Patterning, Global Service and Support, and Others. The following table presents goodwill balances and movements by reporting unit during the six months ended December 31, 2016:

| (In thousands) | Wafer Inspection | Patterning | Others | Total |
|---------------------------------|---------------------|------------|--------|-----------|
| Balance as of June 30, 2016 | \$281,026 | \$ 53,255 | \$ 896 | \$335,177 |
| Goodwill adjustment | (7) | — | — | (7) |
| Balance as of December 31, 2016 | \$281,019 | \$ 53,255 | \$ 896 | \$335,170 |

Goodwill is net of accumulated impairment losses of \$277.6 million, which were recorded prior to the fiscal year ended June 30, 2014. The changes in the goodwill balance during the six months ended December 31, 2016 resulted from foreign currency translation adjustments.

The Company performed a qualitative assessment of the goodwill by reporting unit as of November 30, 2016 during the three months ended December 31, 2016 and concluded that it was more likely than not that the fair value of each of the reporting units exceeded its carrying amount. As a result of the Company's determination following its qualitative assessment, it was not necessary to perform the two-step quantitative goodwill impairment test at this time. In assessing the qualitative factors, the Company considered the impact of key factors, including changes in the industry and competitive environment, market capitalization, stock price, earnings multiples, budgeted-to-actual revenue performance from prior year, gross margin and cash flows from operating activities.

Based on the Company's assessment, goodwill in the reporting units was not impaired as of December 31, 2016 or June 30, 2016.

Purchased Intangible Assets

The components of purchased intangible assets as of the dates indicated below were as follows:

| Category | Range of Useful Lives | As of December 31, 2016 | | | As of June 30, 2016 | | |
|------------------------|--------------------------|-----------------------------|--|---------------|-----------------------------|--|---------------|
| | | Gross Carrying Amount | Accumulated Amortization and Impairment | Net Amount | Gross Carrying Amount | Accumulated Amortization and Impairment | Net Amount |
| Existing technology | 4-7 years | \$141,659 | \$ 139,161 | \$ 2,498 | \$141,659 | \$ 138,160 | \$ 3,499 |
| Trade name/Trademark | 4-10 years | 19,893 | 19,893 | — | 19,893 | 19,743 | 150 |
| Customer relationships | 6-7 years | 54,980 | 54,927 | 53 | 54,980 | 54,298 | 682 |
| Total | | \$216,532 | \$ 213,981 | \$ 2,551 | \$216,532 | \$ 212,201 | \$ 4,331 |

Intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable.

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For the three months ended December 31, 2016 and 2015, amortization expense for purchased intangible assets was \$0.5 million and \$1.3 million, respectively. For the six months ended December 31, 2016 and 2015, amortization expense for purchased intangible assets was \$1.8 million and \$5.0 million, respectively. Based on the intangible assets recorded as of December 31, 2016, and assuming no subsequent additions to, or impairment of, the underlying assets, the remaining estimated amortization expense is expected to be as follows:

| | |
|-----------------------------|--------------------------------|
| Fiscal year ending June 30: | Amortization (In thousands) |
| 2017 (remaining 6 months) | \$ 1,026 |
| 2018 | 1,525 |
| Total | \$ 2,551 |

NOTE 6 – DEBT

The following table summarizes the debt of the Company as of December 31, 2016 and June 30, 2016:

| | As of December 31, 2016 | | As of June 30, 2016 | |
|---|-----------------------------|-------------------------------|-----------------------------|-------------------------------|
| | Amount (In thousands) | Effective Interest Rate | Amount (In thousands) | Effective Interest Rate |
| Fixed-rate 2.375% Senior notes due on November 1, 2017 | \$250,000 | 2.396 % | \$250,000 | 2.396 % |
| Fixed-rate 3.375% Senior notes due on November 1, 2019 | 250,000 | 3.377 % | 250,000 | 3.377 % |
| Fixed-rate 4.125% Senior notes due on November 1, 2021 | 500,000 | 4.128 % | 500,000 | 4.128 % |
| Fixed-rate 4.650% Senior notes due on November 1, 2024 ⁽¹⁾ | 1,250,000 | 4.682 % | 1,250,000 | 4.682 % |
| Fixed-rate 5.650% Senior notes due on November 1, 2034 | 250,000 | 5.670 % | 250,000 | 5.670 % |
| Term loans | 496,250 | 2.000 % | 576,250 | 1.714 % |
| Total debt | 2,996,250 | | 3,076,250 | |
| Unamortized discount | (3,107) | | (3,312) | |
| Unamortized debt issuance costs | (13,946) | | (15,002) | |
| Total long-term debt | \$2,979,197 | | \$3,057,936 | |
| Reported as: | | | | |
| Current portion of long-term debt | \$249,958 | | \$— | |
| Long-term debt | 2,729,239 | | 3,057,936 | |
| Total debt | \$2,979,197 | | \$3,057,936 | |

The effective interest rate disclosed above for this series of Senior Notes excludes the impact of the treasury rate (1)lock hedge discussed below. The effective interest rate including the impact of the treasury rate lock hedge was 4.626%.

As of December 31, 2016, future principal payments for the long-term debt are summarized as follows. There are no scheduled payment for the term loans for fiscal years ending 2017 and 2018, since the Company made \$178.8 million of principal prepayments as of December 31, 2016.

| | |
|-----------------------------|-----------------------------|
| Fiscal year ending June 30: | Amount (In thousands) |
| 2017 (remaining 6 months) | \$— |
| 2018 | 250,000 |
| 2019 | 30,000 |
| 2020 | 716,250 |
| 2021 | — |
| Thereafter | 2,000,000 |
| Total payments | \$2,996,250 |

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Senior Notes:

In November 2014, the Company issued \$2.50 billion aggregate principal amount of senior, unsecured long-term notes (collectively referred to as “Senior Notes”). The Company issued the Senior Notes as part of the leveraged recapitalization plan under which the proceeds from the Senior Notes in conjunction with the proceeds from the term loans (described below) and cash on hand were used (x) to fund a special cash dividend of \$16.50 per share, aggregating to approximately \$2.76 billion, (y) to redeem \$750.0 million of 2018 Senior Notes, including associated redemption premiums, accrued interest and other fees and expenses and (z) for other general corporate purposes, including repurchases of shares pursuant to the Company’s stock repurchase program. The interest rate specified for each series of the Senior Notes will be subject to adjustments from time to time if Moody’s Investor Service, Inc. (“Moody’s”) or Standard & Poor’s Ratings Services (“S&P”) or, under certain circumstances, a substitute rating agency selected by us as a replacement for Moody’s or S&P, as the case may be (a “Substitute Rating Agency”), downgrades (or subsequently upgrades) its rating assigned to the respective series of Senior Notes such that the adjusted rating is below investment grade. If the adjusted rating of any series of Senior Notes from Moody’s (or, if applicable, any Substitute Rating Agency) is decreased to Ba1, Ba2, Ba3 or B1 or below, the stated interest rate on such series of Senior Notes as noted above will increase by 25 bps, 50 bps, 75 bps or 100 bps, respectively (“bps” refers to Basis Points and 1% is equal to 100 bps). If the rating of any series of Senior Notes from S&P (or, if applicable, any Substitute Rating Agency) with respect to such series of Senior Notes is decreased to BB+, BB, BB- or B+ or below, the stated interest rate on such series of Senior Notes as noted above will increase by 25 bps, 50 bps, 75 bps or 100 bps, respectively. The interest rates on any series of Senior Notes will permanently cease to be subject to any adjustment (notwithstanding any subsequent decrease in the ratings by any of Moody’s, S&P and, if applicable, any Substitute Rating Agency) if such series of Senior Notes becomes rated “Baa1” (or its equivalent) or higher by Moody’s (or, if applicable, any Substitute Rating Agency) and “BBB+” (or its equivalent) or higher by S&P (or, if applicable, any Substitute Rating Agency), or one of those ratings if rated by only one of Moody’s, S&P and, if applicable, any Substitute Rating Agency, in each case with a stable or positive outlook. In October 2014, the Company entered into a series of forward contracts to lock the 10-year treasury rate (“benchmark rate”) on a portion of the Senior Notes with a notional amount of \$1.00 billion in aggregate. For additional details, refer to Note 14, “Derivative Instruments and Hedging Activities.”

The original discount on the Senior Notes amounted to \$4.0 million and is being amortized over the life of the debt. Interest is payable semi-annually on May 1 and November 1 of each year. The debt indenture (the “Indenture”) includes covenants that limit the Company’s ability to grant liens on its facilities and enter into sale and leaseback transactions, subject to certain allowances under which certain sale and leaseback transactions are not restricted. As of December 31, 2016, the Company was in compliance with all of its covenants under the Indenture associated with the Senior Notes.

In certain circumstances involving a change of control followed by a downgrade of the rating of a series of Senior Notes by at least two of Moody’s, S&P and Fitch Inc., unless the Company has exercised its right to redeem the Senior Notes of such series, the Company will be required to make an offer to repurchase all or, at the holder’s option, any part, of each holder’s Senior Notes of that series pursuant to the offer described below (the “Change of Control Offer”). In the Change of Control Offer, the Company will be required to offer payment in cash equal to 101% of the aggregate principal amount of Senior Notes repurchased plus accrued and unpaid interest, if any, on the Senior Notes repurchased, up to, but not including, the date of repurchase.

Based on the trading prices of the Senior Notes on the applicable dates, the fair value of the Senior Notes as of December 31, 2016 and June 30, 2016 was approximately \$2.62 billion and \$2.68 billion, respectively. While the Senior Notes are recorded at cost, the fair value of the long-term debt was determined based on quoted prices in markets that are not active; accordingly, the long-term debt is categorized as Level 2 for purposes of the fair value measurement hierarchy.

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Credit Facility (Term Loans and Unfunded Revolving Credit Facility):

In November 2014, the Company entered into \$750.0 million of five-year senior unsecured prepayable term loans and a \$500.0 million unfunded revolving credit facility (collectively, the “Credit Facility”) under the Credit Agreement (the “Credit Agreement”). The interest under the Credit Facility will be payable on the borrowed amounts at the London Interbank Offered Rate (“LIBOR”) plus a spread, which is currently 125 bps, and this spread is subject to adjustment in conjunction with the Company’s credit rating downgrades or upgrades. The spread ranges from 100 bps to 175 bps based on the Company’s then effective credit rating. The Company is also obligated to pay an annual commitment fee of 15 bps on the daily undrawn balance of the revolving credit facility, which is also subject to an adjustment in conjunction with the Company’s credit rating downgrades or upgrades by Moody’s and S&P. The annual commitment fee ranges from 10 bps to 25 bps on the daily undrawn balance of the revolving credit facility, depending upon the then effective credit rating. Principal payments with respect to the term loans will be made on the last day of each calendar quarter, and any unpaid principal balance of the term loans, including accrued interest, shall be payable on November 14, 2019 (the “Maturity Date”). The Company may prepay the term loans and unfunded revolving credit facility at any time without a prepayment penalty. During the second quarter of the fiscal year ending June 30, 2017, the Company made term loan principal payments of \$40.0 million.

Future principal payments for the Company’s term loans (without giving effect to \$178.8 million of principal prepayments as of December 31, 2016 that shall be applied to the future scheduled quarterly payments) as of December 31, 2016, are as follows:

| Fiscal Quarters Ending | Quarterly Payment (In thousands) |
|---|---|
| March 31, 2017 through December 31, 2017 | \$ 14,063 |
| March 31, 2018 through September 30, 2019 | \$ 18,750 |
| December 31, 2019 | \$ 487,500 |

The Credit Facility requires the Company to maintain an interest expense coverage ratio as described in the Credit Agreement, on a quarterly basis, covering the trailing four consecutive fiscal quarters of no less than 3.50 to 1.00. In addition, the Company is required to maintain the maximum leverage ratio as described in the Credit Agreement, on a quarterly basis, covering the trailing four consecutive fiscal quarters for the fiscal quarters as described below.

| Fiscal Quarters Ending | Maximum Leverage Ratio |
|--------------------------------------|------------------------|
| December 31, 2016 and March 31, 2017 | 3.50:1.00 |
| Thereafter | 3.00:1.00 |

The Company was in compliance with the financial covenants under the Credit Agreement as of December 31, 2016 and had no outstanding borrowings under the unfunded revolving credit facility.

NOTE 7 – EQUITY AND LONG-TERM INCENTIVE COMPENSATION PLANS

Equity Incentive Program

As of December 31, 2016, the Company had two plans under which the Company was able to issue equity incentive awards, such as restricted stock units and stock options, to its employees, consultants and members of its Board of Directors: the 2004 Equity Incentive Plan (the “2004 Plan”) and the 1998 Director Plan (the “Outside Director Plan”).

2004 Plan:

The 2004 Plan provides for the grant of options to purchase shares of the Company’s common stock, stock appreciation rights, restricted stock units, performance shares, performance units and deferred stock units to the Company’s employees, consultants and members of its Board of Directors. As of December 31, 2016, 3.6 million shares were available for issuance under the 2004 Plan.

Any 2004 Plan awards of restricted stock units, performance shares, performance units or deferred stock units with a per share or unit purchase price lower than 100% of fair market value on the grant date are counted against the total number of shares issuable under the 2004 Plan as follows, based on the grant date of the applicable award: (a) for any such awards granted before November 6, 2013, the awards counted against the 2004 Plan share reserve as 1.8 shares for every one share subject thereto; and (b) for any such awards granted on or after November 6, 2013, the awards

count against the 2004 Plan share reserve as 2.0 shares for every one share subject thereto.

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In addition, the plan administrator has the ability to grant “dividend equivalent” rights in connection with awards of restricted stock units, performance shares, performance units and deferred stock units before they are fully vested. The plan administrator, at its discretion, may grant a right to receive dividends on the aforementioned awards which may be settled in cash or Company stock at the discretion of the plan administrator subject to meeting the vesting requirement of the underlying awards.

Outside Director Plan

The Outside Director Plan only permits the issuance of stock options to the non-employee members of the Board of Directors. As of December 31, 2016, 1.7 million shares were available for grant under the Outside Director Plan.

Equity Incentive Plans - General Information

The following table summarizes the combined activity under the Company’s equity incentive plans for the indicated periods:

| (In thousands) | Available For Grant ⁽¹⁾ |
|---|---------------------------------------|
| Balance as of June 30, 2016 | 6,778 |
| Restricted stock units granted ⁽²⁾ | (1,545) |
| Restricted stock units canceled | 67 |
| Balance as of December 31, 2016 | 5,300 |

(1) The number of restricted stock units reflects the application of the award multiplier as described above (1.8x or 2.0x depending on the grant date of the applicable award).

(2) Includes restricted stock units granted to senior management during the six months ended December 31, 2016 with performance-based vesting criteria (in addition to service-based vesting criteria for any of such restricted stock units that are deemed to have been earned). As of December 31, 2016, it had not yet been determined the extent to which (if at all) the performance-based vesting criteria had been satisfied. Therefore, this line item includes all such performance-based restricted stock units granted during the six months ended December 31, 2016, reported at the maximum possible number of shares that may ultimately be issuable if all applicable performance-based criteria are achieved at their maximum levels and all applicable service-based criteria are fully satisfied (84 thousand shares for the six months ended December 31, 2016 after application of the multiplier described above).

The fair value of stock-based awards is measured at the grant date and is recognized as an expense over the employee’s requisite service period. For restricted stock units granted without “dividend equivalent” rights, fair value is calculated using the closing price of the Company’s common stock on the grant date, adjusted to exclude the present value of dividends which are not accrued on those restricted stock units. The fair value for restricted stock units granted with “dividend equivalent” rights is determined using the closing price of the Company’s common stock on the grant date. As of December 31, 2016, the Company accrued \$12.7 million of dividends payable, which included both a special cash dividend and quarterly cash dividends for the unvested restricted stock units outstanding as of the dividend record date. The fair value for purchase rights under the Company’s Employee Stock Purchase Plan is determined using a Black-Scholes valuation model.

The following table shows pre-tax stock-based compensation expense for the indicated periods:

| (In thousands) | Three months ended December 31, | | Six months ended December 31, | |
|--|---------------------------------------|----------|----------------------------------|----------|
| | 2016 | 2015 | 2016 | 2015 |
| Stock-based compensation expense by: | | | | |
| Costs of revenues | \$1,305 | \$1,266 | \$2,567 | \$2,730 |
| Research and development | 2,052 | 2,269 | 4,073 | 4,761 |
| Selling, general and administrative | 9,087 | 7,790 | 17,282 | 16,082 |
| Total stock-based compensation expense | \$12,444 | \$11,325 | \$23,922 | \$23,573 |

As a result of the early adoption of the accounting standard update on accounting for share-based payment awards in the first quarter of its fiscal year ending June 30, 2017, the Company recorded excess tax benefits in the provision for

income taxes for the three and six months ended December 31, 2016 of \$0.1 million and \$5.8 million, respectively. See Note 1, "Description of Business and Basis of Presentation" for additional details.

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The following table shows stock-based compensation capitalized as inventory as of the dates indicated below:

| | As of December 31, 2016 | As of June 30, 2016 |
|-----------|-------------------------------|------------------------------|
| Inventory | \$ 2,659 | \$2,685 |

Restricted Stock Units

The following table shows the applicable number of restricted stock units and weighted-average grant date fair value for restricted stock units granted, vested and released, withheld for taxes, and forfeited during the six months ended December 31, 2016 and restricted stock units outstanding as of December 31, 2016 and June 30, 2016:

| Restricted Stock Units | Shares ⁽¹⁾ (In thousands) | Weighted-Average Grant Date Fair Value |
|---|---|--|
| Outstanding restricted stock units as of June 30, 2016 ⁽²⁾ | 1,849 | \$ 56.41 |
| Granted ⁽²⁾ | 772 | \$ 70.95 |
| Vested and released | (350) | \$ 52.78 |
| Withheld for taxes | (238) | \$ 52.78 |
| Forfeited | (34) | \$ 59.96 |
| Outstanding restricted stock units as of December 31, 2016 ⁽²⁾ | 1,999 | \$ 63.04 |

Share numbers reflect actual shares subject to awarded restricted stock units. As described above, under the terms of the 2004 Plan, the number of shares subject to each award reflected in this number is multiplied by either 1.8x or 2.0x (depending on the grant date of the award) to calculate the impact of the award on the share reserve under the 2004 Plan.

Includes restricted stock units granted to senior management with performance-based vesting criteria (in addition to service-based vesting criteria for any of such restricted stock units that are deemed to have been earned). As of December 31, 2016, it had not yet been determined the extent to which (if at all) the performance-based vesting criteria had been satisfied. Therefore, this line item includes all such performance-based restricted stock units, reported at the maximum possible number of shares (0.3 million shares for the fiscal year ended June 30, 2015, 0.3 million shares for the fiscal year ended June 30, 2016 and 42 thousand shares for the six months ended December 31, 2016) that may ultimately be issuable if all applicable performance-based criteria are achieved at their maximum and all applicable service-based criteria are fully satisfied.

The restricted stock units granted by the Company since the beginning of the fiscal year ended June 30, 2013 generally vest (a) with respect to awards with only service-based vesting criteria, in four equal installments on the first, second, third and fourth anniversaries of the grant date and (b) with respect to awards with both performance-based and service-based vesting criteria, in two equal installments on the third and fourth anniversaries of the grant date, in each case subject to the recipient remaining employed by the Company as of the applicable vesting date. The restricted stock units granted by the Company from the beginning of the fiscal year ended June 30, 2007 through the fiscal year ended June 30, 2012 generally vested in two equal installments on the second and fourth anniversaries of the grant date, subject to the recipient remaining employed by the Company as of the applicable vesting date. The restricted stock units granted to the independent members of the board of directors vest on the first anniversary of the date of grant.

The following table shows the weighted-average grant date fair value per unit for the restricted stock units granted and the restricted stock units vested and tax benefits realized by the Company in connection with vested and released restricted stock units for the indicated periods:

| Three months ended December 31, | Six months ended December 31, |
|---------------------------------------|----------------------------------|
|---------------------------------------|----------------------------------|

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| (In thousands, except for weighted-average grant date fair value) | 2016 | 2015 | 2016 | 2015 |
|--|---------|---------|----------|----------|
| Weighted-average grant date fair value per unit | \$75.38 | \$66.83 | \$70.95 | \$51.12 |
| Grant date fair value of vested restricted stock units | \$1,843 | 2,299 | \$31,051 | \$48,021 |
| Tax benefits realized by the Company in connection with vested and released restricted stock units | \$765 | \$2,165 | \$14,694 | \$25,682 |

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As of December 31, 2016, the unrecognized stock-based compensation expense balance related to restricted stock units was \$90.5 million, excluding the impact of estimated forfeitures, and will be recognized over a weighted-average remaining contractual term and an estimated weighted-average amortization period of 1.7 years. The intrinsic value of outstanding restricted stock units as of December 31, 2016 was \$157.3 million.

Cash-Based Long-Term Incentive Compensation

The Company has adopted a cash-based long-term incentive (“Cash LTI”) program for many of its employees as part of the Company’s employee compensation program. During the six months ended December 31, 2016 and 2015, the Company approved Cash LTI awards of \$50.3 million and \$47.1 million, respectively under the Company’s Cash Long-Term Incentive Plan (“Cash LTI Plan”). Cash LTI awards issued to employees under the Cash LTI Plan will vest in four equal installments, with 25% of the aggregate amount of the Cash LTI award vesting on each anniversary of the grant date over a four-year period. In order to receive payments under a Cash LTI award, participants must remain employed by the Company as of the applicable award vesting date. Executives and non-employee Board members are not participating in this program. During the three months ended December 31, 2016 and 2015, the Company recognized \$11.2 million and \$11.5 million, respectively, in compensation expense under the Cash LTI Plan. During the six months ended December 31, 2016 and 2015, the Company recognized \$23.4 million and \$21.4 million, respectively, in compensation expense under the Cash LTI Plan. As of December 31, 2016, the unrecognized compensation balance (excluding the impact of estimated forfeitures) related to the Cash LTI Plan was \$108.4 million.

Employee Stock Purchase Plan

KLA-Tencor’s Employee Stock Purchase Plan (“ESPP”) provides that eligible employees may contribute up to 10% of their eligible earnings toward the semi-annual purchase of KLA-Tencor’s common stock. The ESPP is qualified under Section 423 of the Internal Revenue Code. The employee’s purchase price is derived from a formula based on the closing price of the common stock on the first day of the offering period versus the closing price on the date of purchase (or, if not a trading day, on the immediately preceding trading day).

The offering period (or length of the look-back period) under the ESPP has a duration of six months, and the purchase price with respect to each offering period beginning on or after such date is, until otherwise amended, equal to 85% of the lesser of (i) the fair market value of the Company’s common stock at the commencement of the applicable six-month offering period or (ii) the fair market value of the Company’s common stock on the purchase date. The Company estimates the fair value of purchase rights under the ESPP using a Black-Scholes valuation model.

The fair value of each purchase right under the ESPP was estimated on the date of grant using the Black-Scholes option valuation model and the straight-line attribution approach with the following weighted-average assumptions:

| | Three months ended December 31, 2016 | | Six months ended December 31, 2015 | |
|---------------------------------|--|--------|--|--------|
| Stock purchase plan: | | | | |
| Expected stock price volatility | 20.6 % | 23.9 % | 20.6 % | 23.9 % |
| Risk-free interest rate | 0.4 % | 0.1 % | 0.4 % | 0.1 % |
| Dividend yield | 3.0 % | 3.7 % | 3.0 % | 3.7 % |
| Expected life (in years) | 0.5 | 0.5 | 0.5 | 0.5 |

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The following table shows total cash received from employees for the issuance of shares under the ESPP, the number of shares purchased by employees through the ESPP, the tax benefits realized by the Company in connection with the disqualifying dispositions of shares purchased under the ESPP and the weighted-average fair value per share for the indicated periods:

| (In thousands, except for weighted-average fair value per share) | Three months ended | | Six months ended | |
|---|--------------------|----------|------------------|----------|
| | December 31, | | December 31, | |
| | 2016 | 2015 | 2016 | 2015 |
| Total cash received from employees for the issuance of shares under the ESPP | \$23,694 | \$21,908 | \$23,694 | \$21,908 |
| Number of shares purchased by employees through the ESPP | 384 | 454 | 384 | 454 |
| Tax benefits realized by the Company in connection with the disqualifying dispositions of shares purchased under the ESPP | \$218 | \$339 | \$922 | \$719 |
| Weighted-average fair value per share based on Black-Scholes model | \$14.05 | \$11.34 | \$14.05 | \$11.34 |

The ESPP shares are replenished annually on the first day of each fiscal year by virtue of an evergreen provision. The provision allows for share replenishment equal to the lesser of 2.0 million shares or the number of shares which KLA-Tencor estimates will be required to be issued under the ESPP during the forthcoming fiscal year. As of December 31, 2016, a total of 1.0 million shares were reserved and available for issuance under the ESPP.

Quarterly cash dividends

On November 2, 2016, the Company's Board of Directors declared a regular quarterly cash dividend of \$0.54 per share on the outstanding shares of the Company's common stock, which was paid on December 1, 2016 to the stockholders of record as of the close of business on November 15, 2016. The total amount of regular quarterly cash dividends paid by the Company during the three months ended December 31, 2016 and 2015 was \$84.5 million and \$80.8 million, respectively. The total amount of regular quarterly cash dividends paid by the Company during the six months ended December 31, 2016 and 2015 was \$166.1 million and \$162.5 million, respectively. The amount of accrued dividends payable for regular quarterly cash dividends on unvested restricted stock units with dividend equivalent rights as of December 31, 2016 and June 30, 2016 was \$3.3 million and \$2.7 million, respectively. These amounts will be paid upon vesting of the underlying unvested restricted stock units.

Special cash dividend

On November 19, 2014, the Company's Board of Directors declared a special cash dividend of \$16.50 per share on our outstanding common stock, which was paid on December 9, 2014 to the stockholders of record as of the close of business on December 1, 2014. The declaration and payment of the special cash dividend was part of the Company's leveraged recapitalization transaction under which the special cash dividend was financed through a combination of existing cash and proceeds from the debt financing disclosed in Note 6, "Debt" that was completed during the three months ended December 31, 2014. As of the declaration date, the total amount of the special cash dividend accrued by the Company was approximately \$2.76 billion, substantially all of which was paid out during the three months ended December 31, 2014, except for the aggregate special cash dividend of \$43.0 million that was accrued for the unvested restricted stock units. As of December 31, 2016 and June 30, 2016, the Company had a total of \$9.4 million and \$16.9 million, respectively, of accrued dividends payable for the special cash dividend with respect to outstanding unvested restricted stock units, which will be paid when such underlying unvested restricted stock units vest. The Company paid a special cash dividend with respect to vested restricted stock units during the three months ended December 31, 2015 of \$0.6 million. The amount paid during the three months ended December 31, 2016 was immaterial. The Company paid a special cash dividend with respect to vested restricted stock units during the six months ended December 31, 2016 and 2015 of \$7.7 million and \$20.5 million, respectively. Other than the special cash dividend declared during the three months ended December 31, 2014, the Company historically has not declared any special cash dividend.

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The Company's Board of Directors has authorized a program for the Company to repurchase shares of the Company's common stock. The intent of this program is to offset the dilution from KLA-Tencor's equity incentive plans and employee stock purchase plan, as well as to return excess cash to the Company's stockholders. Subject to market conditions, applicable legal requirements and other factors, the repurchases were made in the open market in compliance with applicable securities laws, including the Securities Exchange Act of 1934 and the rules promulgated thereunder, such as Rule 10b-18. As of December 31, 2016, an aggregate of approximately 5.9 million shares were available for repurchase under the Company's repurchase program.

Share repurchases for the indicated periods (based on the trade date of the applicable repurchase) were as follows:

| | Three months ended December 31, 2015 | Six months ended December 31, 2015 |
|--|---|--|
| (In thousands) | | |
| Number of shares of common stock repurchased | —568 | —3,445 |
| Total cost of repurchases | \$—29,509 | \$—175,743 |

NOTE 9 – NET INCOME PER SHARE

Basic net income per share is calculated by dividing net income available to common stockholders by the weighted-average number of common shares outstanding during the period. Diluted net income per share is calculated by using the weighted-average number of common shares outstanding during the period, increased to include the number of additional shares of common stock that would have been outstanding if the shares of common stock underlying the Company's outstanding dilutive restricted stock units and stock options had been issued. The dilutive effect of outstanding restricted stock units and options is reflected in diluted net income per share by application of the treasury stock method.

The following table sets forth the computation of basic and diluted net income per share:

| (In thousands, except per share amounts) | Three months ended December 31, | | Six months ended December 31, | |
|--|------------------------------------|-----------|----------------------------------|-----------|
| | 2016 | 2015 | 2016 | 2015 |
| Numerator: | | | | |
| Net income | \$238,251 | \$152,207 | \$416,352 | \$257,104 |
| Denominator: | | | | |
| Weighted-average shares-basic, excluding unvested restricted stock units | 156,335 | 155,252 | 156,232 | 156,036 |
| Effect of dilutive restricted stock units and options ⁽¹⁾ | 788 | 744 | 839 | 935 |
| Weighted-average shares-diluted | 157,123 | 155,996 | 157,071 | 156,971 |
| Basic net income per share | \$1.52 | \$0.98 | \$2.66 | \$1.65 |
| Diluted net income per share | \$1.52 | \$0.98 | \$2.65 | \$1.64 |
| Anti-dilutive securities excluded from the computation of diluted net income per share | 2 | 139 | 56 | 182 |

(1) The Company has not had any outstanding stock options since August 2016.

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NOTE 10 – INCOME TAXES

The following table provides details of income taxes:

| (Dollar amounts in thousands) | Three months ended | | Six months ended | | |
|-------------------------------|--------------------|-----------|------------------|-----------|---|
| | December 31, | | December 31, | | |
| | 2016 | 2015 | 2016 | 2015 | |
| Income before income taxes | \$306,845 | \$185,475 | \$529,065 | \$319,774 | |
| Provision for income taxes | \$68,594 | \$33,268 | \$112,713 | \$62,670 | |
| Effective tax rate | 22.4 | % 17.9 | % 21.3 | % 19.6 | % |

Tax expense was higher as a percentage of income before taxes during the three months ended December 31, 2016 compared to the three months ended December 31, 2015 primarily due to the impact of the following items:

Tax expense increased by \$6.3 million during the three months ended December 31, 2016 due to absence of the impact of reinstatement of the U.S. federal research credit during the three months ended December 31, 2015 when the Protecting Americans from Tax Hikes (PATH) Act of 2015 permanently reinstated the research credit on December 18, 2015 retroactively to January 1, 2015;

Tax expense increased by \$1.9 million during the three months ended December 31, 2016 due to the impact of a lower non-taxable increase in the value of the assets held within the Company's Executive Deferred Savings Plan during the three months ended December 31, 2016; and

Tax expense increased by \$1.9 million during the three months ended December 31, 2016 due to the impact of a decrease in the proportion of the Company's earnings generated in jurisdictions with tax rates lower than the U.S. statutory rate during the three months ended December 31, 2016.

Tax expense was higher as a percentage of income before taxes during the six months ended December 31, 2016 compared to the six months ended December 31, 2015 primarily due to the impact of the following items:

Tax expense increased by \$4.2 million during the six months ended December 31, 2016 due to absence of the impact of reinstatement of the U.S. federal research credit during the six months ended December 31, 2015 when the Protecting Americans from Tax Hikes (PATH) Act of 2015 permanently reinstated the research credit on December 18, 2015 retroactively to January 1, 2015;

Tax expense increased by \$3.2 million during the six months ended December 31, 2016 due to the impact of a decrease in the proportion of the Company's earnings generated in jurisdictions with tax rates lower than the U.S. statutory rate during the six months ended December 31, 2016.

In the normal course of business, the Company is subject to examination by tax authorities throughout the world. The Company is subject to United States federal income tax examination for all years beginning from the fiscal year ended June 30, 2014. The Company is subject to state income tax examinations for all years beginning from the fiscal year ended June 30, 2012. The Company is also subject to examinations in other major foreign jurisdictions, including Singapore, for all years beginning from the fiscal year ended June 30, 2012. It is possible that certain examinations may be concluded in the next twelve months. The Company believes that it may recognize up to \$3.9 million of its existing unrecognized tax benefits within the next twelve months as a result of the lapse of statutes of limitations and the resolution of examinations with various tax authorities.

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NOTE 11 – LITIGATION AND OTHER LEGAL MATTERS

Litigation Related to Terminated Merger with Lam Research.

The California Class Actions. In connection with the previously announced Merger transaction, four purported KLA-Tencor stockholders filed putative class actions on behalf of all KLA-Tencor stockholders. Three actions were filed in the California Superior Court for Santa Clara County captioned, Hedgecock v. KLA-Tencor Corp., et al., Case No. 115CV287329, Karr v. KLA-Tencor Corporation, et al., Case No. 115CV287331, (both filed on October 28, 2015) and Spoleto Corp. v. Wallace, et al., Case No. 115CV289552 (filed on December 29, 2015) (collectively, the “California Class Actions”). The California Class Actions all named KLA-Tencor, the members of the KLA-Tencor Board, Lam Research, Merger Sub 1, and Merger Sub 2 (together with Merger Sub 1 and Lam Research, the “Lam Group”) as defendants. The California Class Actions alleged that the members of the KLA-Tencor Board breached their fiduciary duties by, among other things, causing KLA-Tencor to agree to a merger transaction with the Lam Group at an unfair price and pursuant to an unfair process, and by making disclosures concerning the transaction that are materially misleading. Plaintiffs alleged that the Lam Group aided and abetted such breaches. Plaintiffs sought to enjoin or rescind KLA-Tencor’s transaction with the Lam Group, as applicable, as well as an award of damages and attorneys’ fees, in addition to other relief.

The Delaware Chancery Court Class Action. One putative class action was filed on November 10, 2015, in the Court of Chancery in the State of Delaware captioned, Rooney v. Wallace, et al., Case No. 11700. The Rooney action was filed against the members of the KLA-Tencor Board and similar to the California Class Actions alleged that the members of the KLA-Tencor Board breached their fiduciary duties by, among other things, causing KLA-Tencor to agree to a merger transaction with Lam Research at an unfair price and pursuant to an unfair process, and by making disclosures concerning the transaction that are materially misleading. Plaintiff Rooney sought to enjoin or rescind KLA-Tencor’s transaction with Lam Research, as applicable, as well as an award of attorneys’ fees, in addition to other relief.

Agreement in Principle to Resolve Merger-Related Litigation. On or about December 29, 2015, plaintiffs in all four actions agreed to coordinate and proceed in the California Superior Court. On February 5, 2016, an agreement in principle was reached with the plaintiffs in the Rooney Action, Hedgecock Action, and Spoleto Action to settle those actions. Pursuant to the agreement in principle, as set forth in a signed memorandum of understanding, the parties agreed to resolve disputed legal claims and KLA-Tencor and Lam agreed to make certain supplemental disclosures regarding the proposed Merger, as set forth in the Form 8-K filed by KLA-Tencor on February 5, 2016. None of the defendants in these actions admitted wrongdoing of any kind, including that there were any inadequacies in any disclosure, any breach of any fiduciary duty, or aiding or abetting any of the foregoing. On February 17, 2016, the California Superior Court dismissed the Karr action pursuant to a stipulation by the parties.

In light of the termination of the Merger Agreement, the parties to the Rooney, Hedgecock, and Spoleto actions agreed that the actions should be dismissed. In response to plaintiffs’ intention to submit fee applications to the California Superior Court and the Delaware Court of Chancery, KLA-Tencor agreed to pay plaintiffs’ attorneys’ fees and expenses in the amount of \$140,000 in connection with certain claims that the plaintiffs believe were mooted by KLA-Tencor’s filing of the supplemental disclosures on the Form 8-K on February 5, 2016. On January 13, 2017, the parties to the Rooney action filed a Stipulation and Proposed Order Regarding Payment of Attorneys’ Fees and Expenses, Notice to Stockholders, and the Dismissal of the Actions in the Delaware Court of Chancery and the parties to the Hedgecock and Spoleto actions filed a Joint Request for Dismissal with the California Superior Court. On January 18, 2017, the California Superior Court granted the request and dismissed the Hedgecock and Spoleto actions with prejudice. On January 23, 2017, the Delaware Chancery Court dismissed the Rooney action with prejudice as to plaintiff Rooney.

Other Legal Matters.

The Company is named from time to time as a party to lawsuits and other types of legal proceedings and claims in the normal course of its business. Actions filed against the Company include commercial, intellectual property, customer, and labor and employment related claims, including complaints of alleged wrongful termination and potential class action lawsuits regarding alleged violations of federal and state wage and hour and other laws. In general, legal proceedings and claims, regardless of their merit, and associated internal investigations (especially those relating to intellectual property or confidential information disputes) are often expensive to prosecute, defend or conduct and

may divert management's attention and other company resources. Moreover, the results of legal proceedings are difficult to predict, and the costs incurred in litigation can be substantial, regardless of outcome. The Company believes the amounts provided in its condensed consolidated financial statements are adequate in light of the probable and estimated liabilities. However, because such matters are subject to many uncertainties, the ultimate outcomes are not predictable, and there can be no assurances that the actual amounts required to satisfy alleged liabilities from the matters described above will not exceed the amounts reflected in the Company's condensed consolidated financial statements or will not have a material adverse effect on its results of operations, financial condition or cash flows.

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NOTE 12 – COMMITMENTS AND CONTINGENCIES

Employee Retention Commitments. In connection with the retention program adopted at the time the Company entered into the Merger Agreement with Lam Research, the Company has an estimated \$23.1 million of employee-related retention commitments as of December 31, 2016 which are expected to be paid during the quarter ending December 31, 2017.

Factoring. KLA-Tencor has agreements (referred to as “factoring agreements”) with financial institutions to sell certain of its trade receivables and promissory notes from customers without recourse. The Company does not believe it is at risk for any material losses as a result of these agreements. In addition, the Company periodically sells certain letters of credit (“LCs”), without recourse, received from customers in payment for goods.

The following table shows total receivables sold under factoring agreements and proceeds from sales of LCs for the indicated periods:

| | Three months ended | | Six months ended | |
|---|--------------------|----------|------------------|----------|
| | December 31, | | December 31, | |
| (In thousands) | 2016 | 2015 | 2016 | 2015 |
| Receivables sold under factoring agreements | \$28,242 | \$41,756 | \$84,975 | \$75,600 |
| Proceeds from sales of LCs | \$9,740 | \$4,062 | \$13,148 | \$4,062 |

Factoring and LC fees for the sale of certain trade receivables were recorded in other expense (income), net and were not material for the periods presented.

Facilities. KLA-Tencor leases certain of its facilities under arrangements that are accounted for as operating leases. Rent expense was \$2.4 million and \$2.2 million for the three months ended December 31, 2016 and 2015, respectively and was \$4.8 million and \$4.3 million for the six months ended December 31, 2016 and 2015, respectively.

The following is a schedule of expected operating lease payments:

| Fiscal year ending June 30, | Amount (In thousands) |
|------------------------------|--------------------------|
| 2017 (remaining 6 months) | \$ 3,978 |
| 2018 | 5,994 |
| 2019 | 3,405 |
| 2020 | 2,657 |
| 2021 | 1,779 |
| 2022 and thereafter | 3,376 |
| Total minimum lease payments | \$ 21,189 |

Purchase Commitments. KLA-Tencor maintains commitments to purchase inventory from its suppliers as well as goods and services in the ordinary course of business. The Company’s liability under these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecasted time-horizon can vary among different suppliers. The Company’s estimate of its significant purchase commitments is approximately \$337.9 million as of December 31, 2016 which are primarily due within the next 12 months. Actual expenditures will vary based upon the volume of the transactions and length of contractual service provided. In addition, the amounts paid under these arrangements may be less in the event that the arrangements are renegotiated or canceled. Certain agreements provide for potential cancellation penalties.

Cash Long-Term Incentive Plan. As of December 31, 2016, the Company had committed \$121.0 million for future payment obligations under its Cash LTI Plan. The calculation of compensation expense related to the Cash LTI Plan includes estimated forfeiture rate assumptions. Cash LTI awards issued to employees under the Cash LTI Plan vest in four equal installments, with 25% of the aggregate amount of the Cash LTI award vesting on each yearly anniversary of the grant date over a four-year period. In order to receive payments under a Cash LTI award, participants must remain employed by the Company as of the applicable award vesting date.

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Warranties, Guarantees and Contingencies. KLA-Tencor provides standard warranty coverage on its systems for 40 hours per week for 12 months, providing labor and parts necessary to repair the systems during the warranty period. The Company accounts for the estimated warranty cost as a charge to costs of revenues when revenue is recognized. The estimated warranty cost is based on historical product performance and field expenses. Utilizing actual service records, the Company calculates the average service hours and parts expense per system and applies the actual labor and overhead rates to determine the estimated warranty charge. The Company updates these estimated charges on a regular basis. The actual product performance and/or field expense profiles may differ, and in those cases the Company adjusts its warranty accruals accordingly.

The following table provides the changes in the product warranty accrual for the indicated periods:

| | Three months ended | | Six months ended | |
|---|--------------------|----------|------------------|-----------|
| | December 31, | | December 31, | |
| (In thousands) | 2016 | 2015 | 2016 | 2015 |
| Beginning balance | \$36,967 | \$35,892 | \$34,773 | \$36,413 |
| Accruals for warranties issued during the period | 13,191 | 10,733 | 24,093 | 19,772 |
| Changes in liability related to pre-existing warranties | (1,131) | (3,411) | (1,576) | (3,594) |
| Settlements made during the period | (8,354) | (7,066) | (16,617) | (16,443) |
| Ending balance | \$40,673 | \$36,148 | \$40,673 | \$36,148 |

The Company maintains guarantee arrangements available through various financial institutions for up to \$22.4 million, of which \$18.7 million had been issued as of December 31, 2016, primarily to fund guarantees to customs authorities for value-added tax (“VAT”) and other operating requirements of the Company’s subsidiaries in Europe and Asia.

KLA-Tencor is a party to a variety of agreements pursuant to which it may be obligated to indemnify the other party with respect to certain matters. Typically, these obligations arise in connection with contracts and license agreements or the sale of assets, under which the Company customarily agrees to hold the other party harmless against losses arising from, or provides customers with other remedies to protect against, bodily injury or damage to personal property caused by the Company’s products, non-compliance with the Company’s product performance specifications, infringement by the Company’s products of third-party intellectual property rights and a breach of warranties, representations and covenants related to matters such as title to assets sold, validity of certain intellectual property rights, non-infringement of third-party rights, and certain income tax-related matters. In each of these circumstances, payment by the Company is typically subject to the other party making a claim to and cooperating with the Company pursuant to the procedures specified in the particular contract.

This usually allows the Company to challenge the other party’s claims or, in case of breach of intellectual property representations or covenants, to control the defense or settlement of any third-party claims brought against the other party. Further, the Company’s obligations under these agreements may be limited in terms of amounts, activity (typically at the Company’s option to replace or correct the products or terminate the agreement with a refund to the other party), and duration. In some instances, the Company may have recourse against third parties and/or insurance covering certain payments made by the Company.

Subject to certain limitations, the Company is obligated to indemnify its current and former directors, officers and employees with respect to certain litigation matters and investigations that arise in connection with their service to the Company. These obligations arise under the terms of the Company’s certificate of incorporation, its bylaws, applicable contracts, and Delaware and California law. The obligation to indemnify generally means that the Company is required to pay or reimburse the individuals’ reasonable legal expenses and possibly damages and other liabilities incurred in connection with these matters.

In addition, the Company may in limited circumstances enter into agreements that contain customer-specific commitments on pricing, tool reliability, spare parts stocking levels, response time and other commitments.

Furthermore, the Company may give these customers limited audit or inspection rights to enable them to confirm that the Company is complying with these commitments. If a customer elects to exercise its audit or inspection rights, the Company may be required to expend significant resources to support the audit or inspection, as well as to defend or

settle any dispute with a customer that could potentially arise out of such audit or inspection. To date, the Company has made no significant accruals in its condensed consolidated financial statements for this contingency. While the Company has not in the past incurred significant expenses for resolving disputes regarding these types of commitments, the Company cannot make any assurance that it will not incur any such liabilities in the future.

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It is not possible to predict the maximum potential amount of future payments under these or similar agreements due to the conditional nature of the Company's obligations and the unique facts and circumstances involved in each particular agreement. Historically, payments made by the Company under these agreements have not had a material effect on its business, financial condition, results of operations or cash flows.

NOTE 13 — RESTRUCTURING CHARGES

The Company has in recent years undertaken a number of cost reduction activities, including workforce reductions, in an effort to lower its ongoing expense run rate. The program in the United States is accounted for in accordance with the authoritative guidance related to compensation for non-retirement post-employment benefits, whereas the programs in the Company's international locations are accounted for in accordance with the authoritative guidance for contingencies.

During the fourth quarter of fiscal year ended 2015, the Company implemented a plan to reduce its global employee workforce to streamline the organization and business processes in response to changing customer requirements in the industry. The goals of this reduction were to enable continued innovation, direct the Company's resources toward its best opportunities and lower its ongoing expense run rate. The Company substantially completed its global workforce reduction during the fiscal year ended June 30, 2016. Restructuring charges for the three months ended December 31, 2015 were \$1.4 million, of which \$0.5 million was recorded to costs of revenues, \$0.5 million to research and development expense and \$0.4 million to selling, general and administrative expense lines in the condensed consolidated statements of operations. Restructuring charges for the six months ended December 31, 2015 were \$8.5 million, of which \$3.3 million was recorded to costs of revenues, \$1.5 million to research and development expense and \$3.7 million to selling, general and administrative expense lines in the condensed consolidated statements of operations.

The following table shows the activity which is primarily related to accrued severance and benefits for the three and six months ended December 31, 2016 and 2015:

| | Three months ended December 31, | | Six months ended December 31, | |
|---------------------|---------------------------------------|-----------|-------------------------------------|-----------|
| (In thousands) | 2016 | 2015 | 2016 | 2015 |
| Beginning balance | \$287 | \$13,061 | \$587 | \$24,887 |
| Restructuring costs | — | 1,392 | — | 8,458 |
| Adjustments | (121) | (563) | (147) | (190) |
| Cash payments | (166) | (10,881) | (440) | (30,146) |
| Ending balance | \$— | \$3,009 | \$— | \$3,009 |

NOTE 14 – DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

The authoritative guidance requires companies to recognize all derivative instruments and hedging activities, including foreign currency exchange contracts, as either assets or liabilities at fair value on the balance sheet. Changes in the fair value of derivatives that do not qualify for hedge treatment, as well as the ineffective portion of any hedges, are recognized in other expense (income), net in the condensed consolidated statements of operations. In accordance with the guidance, the Company designates foreign currency forward exchange and option contracts as cash flow hedges of certain forecasted foreign currency denominated sales and purchase transactions.

KLA-Tencor's foreign subsidiaries operate and sell KLA-Tencor's products in various global markets. As a result, KLA-Tencor is exposed to risks relating to changes in foreign currency exchange rates. KLA-Tencor utilizes foreign currency forward exchange contracts and option contracts to hedge against future movements in foreign exchange rates that affect certain existing and forecasted foreign currency denominated sales and purchase transactions, such as the Japanese yen, the euro, the New Taiwan dollar and the Israeli new shekel. The Company routinely hedges its exposures to certain foreign currencies with various financial institutions in an effort to minimize the impact of certain currency exchange rate fluctuations. These currency forward exchange contracts and options, designated as cash flow hedges, generally have maturities of less than 18 months. Cash flow hedges are evaluated for effectiveness monthly, based on changes in total fair value of the derivatives. If a financial counterparty to any of the Company's hedging arrangements experiences financial difficulties or is otherwise unable to honor the terms of the foreign currency

hedge, the Company may experience material losses.

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For derivative instruments that are designated and qualify as cash flow hedges, the effective portion of the gains or losses on the derivative is reported as a component of accumulated other comprehensive income (loss) (“OCI”) and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Changes in the fair value of currency forward exchange and option contracts due to changes in time value are excluded from the assessment of effectiveness. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings.

For derivative instruments that are not designated as accounting hedges, gains and losses are recognized in other expense (income), net. The Company uses foreign currency forward contracts to hedge certain foreign currency denominated assets or liabilities. The gains and losses on these derivatives are largely offset by the changes in the fair value of the assets or liabilities being hedged.

In October 2014, in anticipation of the issuance of the Senior Notes, the Company entered into a series of forward contracts (“Rate Lock Agreements”) to lock the benchmark rate on a portion of the Senior Notes. The objective of the Rate Lock Agreements was to hedge the risk associated with the variability in interest rates due to the changes in the benchmark rate leading up to the closing of the intended financing, on the notional amount being hedged. The Rate Lock Agreements had a notional amount of \$1.00 billion in aggregate which matured in the second quarter of the fiscal year ended June 30, 2015. The Company designated each of the Rate Lock Agreements as a qualifying hedging instrument and accounted for as a cash flow hedge, under which the effective portion of the gain or loss on the close out of the Rate Lock Agreements was initially recognized in accumulated other comprehensive income (loss) as a reduction of total stockholders’ equity and subsequently amortized into earnings as a component of interest expense over the term of the underlying debt. The ineffective portion, if any, was recognized in earnings immediately. The Rate Lock Agreements were terminated on the date of pricing of the \$1.25 billion of 4.650% Senior Notes due in 2024 and the Company recorded the fair value of \$7.5 million as a gain within accumulated other comprehensive income (loss) as of December 31, 2014. The Company recognized \$0.2 million for each of the three months ended December 31, 2016 and 2015 and \$0.4 million for each of the six months ended December 31, 2016 and 2015 for the amortization of the gain recognized in accumulated other comprehensive income (loss), which amount reduced the interest expense. As of December 31, 2016, the unamortized portion of the fair value of the forward contracts for the rate lock agreements was \$5.9 million.

Derivatives in Cash Flow Hedging Relationships: Foreign Exchange and Interest Rate Contracts

The locations and amounts of designated and non-designated derivative instruments’ gains and losses reported in the condensed consolidated financial statements for the indicated periods were as follows:

| (In thousands) | Location in Financial Statements | Three months ended | | Six months ended | |
|---|--|--------------------|---------|-------------------|-----------|
| | | December 31, 2016 | 2015 | December 31, 2016 | 2015 |
| Derivatives Designated as Hedging Instruments | | | | | |
| Gains (losses) in accumulated OCI on derivatives (effective portion) | Accumulated OCI | \$ 13,969 | \$ 707 | \$ 12,131 | \$(1,154) |
| Gains (losses) reclassified from accumulated OCI into income (effective portion): | Revenues | \$(1,425) | \$ 324 | \$(2,906) | \$ 1,009 |
| | Costs of revenues | (69) | (678) | (156) | (1,150) |
| | Interest expense | 189 | 189 | 378 | 378 |
| | Net gains (losses) reclassified from accumulated OCI into income (effective portion) | \$(1,305) | \$(165) | \$(2,684) | \$ 237 |
| Losses recognized in income on derivatives (ineffective portion and amount excluded from effectiveness testing) | Other expense (income), net | \$(1,442) | \$(273) | \$(1,453) | \$(399) |

Derivatives Not Designated as Hedging
Instruments

| | | | | | |
|-------------------------------------|-----------------------------|---------|-------|---------|-----------|
| Gains (losses) recognized in income | Other expense (income), net | \$5,295 | \$747 | \$5,131 | \$(5,635) |
|-------------------------------------|-----------------------------|---------|-------|---------|-----------|

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The U.S. dollar equivalent of all outstanding notional amounts of hedge contracts, with maximum remaining maturities of approximately seven months as of December 31, 2016 and June 30, 2016 was as follows:

| (In thousands) | As of December 31, 2016 | As of June 30, 2016 |
|--|-------------------------------|---------------------------|
| Cash flow hedge contracts | | |
| Purchase | \$ 11,377 | \$ 7,591 |
| Sell | \$ 111,374 | \$ 91,793 |
| Other foreign currency hedge contracts | | |
| Purchase | \$ 111,119 | \$ 122,275 |
| Sell | \$ 91,406 | \$ 115,087 |

The locations and fair value amounts of the Company's derivative instruments reported in its Condensed Consolidated Balance Sheets as of the dates indicated below were as follows:

| (In thousands) | Asset Derivatives | | Liability Derivatives | | | |
|---|------------------------|--|------------------------------|---------------------------|--|---------------------------|
| | Balance Sheet Location | As of December 31, 2016 Fair Value | As of June 30, 2016 | Balance Sheet Location | As of December 31, 2016 Fair Value | As of June 30, 2016 |
| Derivatives designated as hedging instruments | | | | | | |
| Foreign exchange contracts | Other current assets | \$ 10,540 | \$ 342 | Other current liabilities | \$ 497 | \$ 4,736 |
| Total derivatives designated as hedging instruments | | \$ 10,540 | \$ 342 | | \$ 497 | \$ 4,736 |
| Derivatives not designated as hedging instruments | | | | | | |
| Foreign exchange contracts | Other current assets | \$ 3,438 | \$ 753 | Other current liabilities | \$ 3,606 | \$ 6,911 |
| Total derivatives not designated as hedging instruments | | \$ 3,438 | \$ 753 | | \$ 3,606 | \$ 6,911 |
| Total derivatives | | \$ 13,978 | \$ 1,095 | | \$ 4,103 | \$ 11,647 |

The following table provides the balances and changes in accumulated OCI, before taxes, related to derivative instruments for the indicated periods:

| (In thousands) | Three months ended December 31, 2016 | | Six months ended December 31, 2016 | |
|--|---|----------|---|----------|
| | 2016 | 2015 | 2016 | 2015 |
| Beginning balance | \$ 751 | \$ 4,847 | \$ 1,210 | \$ 7,110 |
| Amount reclassified to income | 1,305 | 165 | 2,684 | (237) |
| Net change in unrealized gains or losses | 13,969 | 707 | 12,131 | (1,154) |
| Ending balance | \$ 16,025 | \$ 5,719 | \$ 16,025 | \$ 5,719 |

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Offsetting of Derivative Assets and Liabilities

KLA-Tencor presents derivatives at gross fair values in the Condensed Consolidated Balance Sheets. The Company has entered into arrangements with each of its counterparties, which reduce credit risk by permitting net settlement of transactions with the same counterparty under certain conditions. As of December 31, 2016 and June 30, 2016, information related to the offsetting arrangements was as follows (in thousands):

| Description | Gross Amounts of Derivatives | Gross Amounts of Derivatives Offset in the Condensed Consolidated Balance Sheets | Net Amount of Derivatives Presented in the Condensed Consolidated Balance Sheets | Gross Amounts of Derivatives Not Offset in the Condensed Consolidated Balance Sheets | | |
|---------------------------|------------------------------|--|--|--|--------------------------|------------|
| | | | | Financial Instruments | Cash Collateral Received | Net Amount |
| As of December 31, 2016 | | | | | | |
| Derivatives - Assets | \$ 13,978 | \$ — | \$ 13,978 | \$ (3,114) | \$ — | \$ —10,864 |
| Derivatives - Liabilities | \$ (4,103) | \$ — | \$ (4,103) | \$ 3,114 | \$ — | \$ —(989) |

As of June 30, 2016

| Description | Gross Amounts of Derivatives | Gross Amounts of Derivatives Offset in the Condensed Consolidated Balance Sheets | Net Amount of Derivatives Presented in the Condensed Consolidated Balance Sheets | Gross Amounts of Derivatives Not Offset in the Condensed Consolidated Balance Sheets | | |
|---------------------------|------------------------------|--|--|--|--------------------------|--------------|
| | | | | Financial Instruments | Cash Collateral Received | Net Amount |
| As of June 30, 2016 | | | | | | |
| Derivatives - Assets | \$ 1,095 | \$ — | \$ 1,095 | \$ (843) | \$ — | \$ —252 |
| Derivatives - Liabilities | \$ (11,647) | \$ — | \$ (11,647) | \$ 843 | \$ — | \$ —(10,804) |

NOTE 15 – RELATED PARTY TRANSACTIONS

During the three and six months ended December 31, 2016 and 2015, the Company purchased from, or sold to, several entities, where one or more executive officers of the Company or members of the Company's Board of Directors, or their immediate family members, also serves as an executive officer or a board member, including Citrix Systems, Inc., Keysight Technologies, Inc., MetLife Insurance K.K. and NetApp, Inc. The following table provides the transactions with these parties for the indicated periods (for the portion of such period that they were considered related):

| Three months ended | Six months ended December |
|--------------------|---------------------------|
|--------------------|---------------------------|

December 31,
31,

(In thousands) 2016 2015 2016 2015

Total revenues \$8 \$2 \$8 \$2

Total purchases \$226 \$182 \$583 \$586

The receivable and payable balances from these parties were immaterial at December 31, 2016 and June 30, 2016. Management believes that such transactions are at arm's length and on similar terms as would have been obtained from unaffiliated third parties.

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NOTE 16 – SEGMENT REPORTING AND GEOGRAPHIC INFORMATION

KLA-Tencor reports one reportable segment in accordance with the provisions of the authoritative guidance for segment reporting. Operating segments are defined as components of an enterprise about which separate financial information is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. KLA-Tencor's chief operating decision maker is its Chief Executive Officer. The Company is engaged primarily in designing, manufacturing, and marketing process control and yield management solutions for the semiconductor and related nanoelectronics industries.

All operating segments have been aggregated due to their inter-dependencies, commonality of long-term economic characteristics, products and services, the production processes, class of customer and distribution processes. The Company's service products are an extension of the system product portfolio and provide customers with spare parts and fab management services (including system preventive maintenance and optimization services) to improve yield, increase production uptime and throughput, and lower the cost of ownership. Since the Company operates in one reportable segment, all financial segment information required by the authoritative guidance can be found in the condensed consolidated financial statements.

On December 1, 2016, the Company announced certain organizational changes affecting the duties and responsibilities of its executive officers who will lead the newly created Semiconductor Business Organization (comprised of the Company's Global Customer Solutions Group, the Global Customer Organization and the Global Products Group). As of December 31, 2016, there is no change in the Company's reportable segment for segment reporting purposes.

The Company's significant operations outside the United States include manufacturing facilities in China, Germany, Israel and Singapore and sales, marketing and service offices in Japan, the rest of the Asia Pacific region and Western Europe. For geographical revenue reporting, revenues are attributed to the geographic location in which the customer is located. Long-lived assets consist of land, property and equipment, net and are attributed to the geographic region in which they are located.

The following is a summary of revenues by geographic region, based on ship-to location, for the indicated periods (as a percentage of total revenues):

| (Dollar amounts in thousands) | Three months ended December 31, | | | | Six months ended December 31, | | | |
|-------------------------------|---------------------------------|-------|-----------|-------|-------------------------------|-------|-------------|-------|
| | 2016 | | 2015 | | 2016 | | 2015 | |
| Revenues: | | | | | | | | |
| Taiwan | \$336,058 | 38 % | \$251,364 | 35 % | \$609,750 | 37 % | \$505,411 | 38 % |
| North America | 153,162 | 17 % | 116,729 | 17 % | 240,428 | 15 % | 225,937 | 17 % |
| Korea | 96,846 | 11 % | 79,877 | 11 % | 231,935 | 14 % | 153,310 | 11 % |
| Europe & Israel | 93,440 | 11 % | 41,335 | 6 % | 128,288 | 8 % | 81,181 | 6 % |
| China | 73,152 | 9 % | 91,412 | 13 % | 158,841 | 10 % | 166,764 | 12 % |
| Japan | 67,855 | 8 % | 109,125 | 15 % | 172,639 | 11 % | 180,743 | 13 % |
| Rest of Asia | 56,372 | 6 % | 20,403 | 3 % | 85,677 | 5 % | 39,543 | 3 % |
| Total | \$876,885 | 100 % | \$710,245 | 100 % | \$1,627,558 | 100 % | \$1,352,889 | 100 % |

The following is a summary of revenues by major products for the indicated periods (as a percentage of total revenues):

| (Dollar amounts in thousands) | Three months ended December 31, | | | | Six months ended December 31, | | | |
|---|---------------------------------|-------|-----------|-------|-------------------------------|-------|-------------|-------|
| | 2016 | | 2015 | | 2016 | | 2015 | |
| Revenues: | | | | | | | | |
| Wafer Inspection | \$428,875 | 49 % | \$275,825 | 39 % | \$784,736 | 48 % | \$503,608 | 37 % |
| Patterning | 223,796 | 26 % | 206,549 | 29 % | 396,409 | 24 % | 404,634 | 30 % |
| Global Service and Support ⁽¹⁾ | 214,534 | 24 % | 211,048 | 30 % | 417,664 | 26 % | 410,919 | 30 % |
| Other | 9,680 | 1 % | 16,823 | 2 % | 28,749 | 2 % | 33,728 | 3 % |
| Total | \$876,885 | 100 % | \$710,245 | 100 % | \$1,627,558 | 100 % | \$1,352,889 | 100 % |

(1) The Global Service and Support revenues includes service revenues as presented in the condensed consolidated statements of operations as well as certain product revenues, primarily revenues from the Company's K-T Certified business.

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In the three months ended December 31, 2016, two customers accounted for approximately 31% and 13% of total revenues. In the three months ended December 31, 2015, four customers accounted for approximately 16%, 12%, 11% and 10% of total revenues. In the six months ended December 31, 2016, two customers accounted for approximately 30% and 11% of total revenues. In the six months ended December 31, 2015, three customers accounted for approximately 19%, 11% and 10% of total revenues. Two customers on an individual basis accounted for greater than 10% of net accounts receivables as of December 31, 2016 and June 30, 2016.

Long-lived assets by geographic region as of the dates indicated below were as follows:

| (In thousands) | As of December 31, 2016 | As of June 30, 2016 |
|--------------------|-------------------------------|---------------------------|
| Long-lived assets: | | |
| United States | \$ 185,132 | \$ 182,597 |
| Singapore | 40,346 | 41,658 |
| Israel | 31,980 | 30,844 |
| Europe | 13,152 | 13,347 |
| Rest of Asia | 9,356 | 9,568 |
| Total | \$ 279,966 | \$ 278,014 |

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements other than statements of historical fact may be forward-looking statements. You can identify these and other forward-looking statements by the use of words such as "may," "will," "could," "would," "should," "expects," "plans," "anticipates," "relies," "believes," "estimates," "predicts," "potential," "continue," "thinks," "seeks," or the negative of such terms, or other comparable terminology. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements. Such forward-looking statements include, among others, forecasts of the future results of our operations, including profitability; orders for our products and capital equipment generally; sales of semiconductors; the investments by our customers in advanced technologies and new materials; the allocation of capital spending by our customers (and, in particular, the percentage of spending that our customers allocate to process control); growth of revenue in the semiconductor industry, the semiconductor capital equipment industry and our business; technological trends in the semiconductor industry; future developments or trends in the global capital and financial markets; our future product offerings and product features; the success and market acceptance of new products; timing of shipment of backlog; our future product shipments and product and service revenues; our future gross margins; our future research and development expenses and selling, general and administrative expenses; our ability to successfully maintain cost discipline; international sales and operations; our ability to maintain or improve our existing competitive position; success of our product offerings; creation and funding of programs for research and development; attraction and retention of employees; results of our investment in leading edge technologies; the effects of hedging transactions; the effect of the sale of trade receivables and promissory notes from customers; our future effective income tax rate; our recognition of tax benefits; future payments of dividends to our stockholders; the completion of any acquisitions of third parties, or the technology or assets thereof; benefits received from any acquisitions and development of acquired technologies; sufficiency of our existing cash balance, investments, cash generated from operations and unfunded revolving line of credit under a Credit Agreement (the "Credit Agreement") to meet our operating and working capital requirements, including debt service and payment thereof; future dividends, and stock repurchases; our compliance with the financial covenants under the Credit Agreement; the expected timing of the completion of our global employee workforce reduction; the additional charges that we may incur in connection with our global employee workforce reduction; the expected cost savings that we expect to recognize as a result of such workforce reduction; the adoption of new accounting pronouncements; and our repayment of our outstanding indebtedness.

Our actual results may differ significantly from those projected in the forward-looking statements in this report. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in Part II, Item 1A, "Risk Factors" in this report as well as in Item 1, "Business" and Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the year ended June 30, 2016, filed with the Securities and Exchange Commission on August 5, 2016. You should carefully review these risks and also review the risks described in other documents we file from time to time with the Securities and Exchange Commission. You are cautioned not to place undue reliance on these forward-looking statements, and we expressly assume no obligation and do not intend to update the forward-looking statements in this report after the date hereof.

EXECUTIVE SUMMARY

KLA-Tencor Corporation is a leading supplier of process control and yield management solutions for the semiconductor and related nanoelectronics industries. Our broad portfolio of inspection and metrology products, and related service, software and other offerings primarily supports integrated circuit ("IC" or "chip") manufacturers throughout the entire semiconductor fabrication process, from research and development to final volume production. We provide leading-edge equipment, software and support that enable IC manufacturers to identify, resolve and manage significant advanced technology manufacturing process challenges and obtain higher finished product yields at lower overall cost. In addition to serving the semiconductor industry, we also provide a range of technology solutions to a number of other high technology industries, including the LED and data storage industries, as well as general materials research.

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Our products and services are used by the vast majority of bare wafer, IC, lithography reticle (“reticle” or “mask”) and disk manufacturers around the world. Our products, services and expertise are used by our customers to measure, detect, analyze and resolve critical product defects that arise in that environment in order to control nanometric level manufacturing processes. Our revenues are driven largely by our customers’ spending on capital equipment and related maintenance services necessary to support key transitions in their underlying product technologies, or to increase their production volumes in response to market demand. Our semiconductor customers generally operate in one or more of the three major semiconductor markets - memory, foundry and logic. All three of these markets are characterized by rapid technological changes and sudden shifts in end-user demand, which influence the level and pattern of our customers’ spending on our products and services. Although capital spending in all three semiconductor markets has historically been very cyclical, the demand for more advanced and lower cost chips used in a growing number of consumer electronics, communications, data processing, and industrial and automotive products has resulted over the long term in a favorable demand environment for our process control and yield management solutions, particularly in the foundry and logic markets, which have higher levels of process control adoption than the memory market.

As we are a supplier to the global semiconductor and semiconductor-related industries, our customer base continues to become more highly concentrated over time, thereby increasing the potential impact of a sudden change in capital spending by a major customer on our revenues and profitability. As our customer base becomes increasingly more concentrated, large orders from a relatively limited number of customers account for a substantial portion of our sales, which potentially exposes us to more volatility for revenues and earnings. We are also subject to the cyclical capital spending that has historically characterized the semiconductor and semiconductor-related industries. The timing, length, intensity and volatility of the capacity-oriented capital spending cycles of our customers are unpredictable. The semiconductor industry has also been characterized by constant technological innovation. The growing use of increasingly sophisticated semiconductor devices in mobile consumer products has caused many of our customers to invest in additional semiconductor manufacturing capabilities and capacity. On the other hand, higher design costs for the most advanced ICs could economically constrain leading-edge manufacturing technology customers to focus their resources on only the large technologically advanced products and applications. We believe that, over the long term, our customers will continue to invest in advanced technologies and new materials to enable smaller design rules and higher density applications that fuel demand for process control equipment, although the growth for such equipment may be adversely impacted by higher design costs for advanced ICs, reuse of installed products, and delays in production ramps by our customers in response to higher costs and technical challenges at more advanced technology nodes.

The demand for our products and our revenue levels are driven by our customers’ needs to solve the process challenges that they face as they adopt new technologies required to fabricate advanced ICs that are incorporated into sophisticated mobile devices. The timing for our customers in ordering and taking delivery of process control and yield management equipment is also determined by our customers’ requirements to meet the next generation production ramp schedules, and the timing for capacity expansion to meet end customer demand. During the three months ended December 31, 2016, total revenues for our process control equipment and services increased from prior quarter levels, as a result of strong demand from our foundry and logic market customers. Our earnings will depend not only on our revenue levels, but also on the amount of research and development spending required to meet our customers’ technology roadmaps. We have maintained production volumes and capacity to meet anticipated customer requirements and remain at risk of incurring significant inventory-related and other restructuring charges if business conditions deteriorate. Over the past year, our customers have taken delivery of higher volumes of process control equipment than they did in the previous year. However, any delay or push out by our customers in taking delivery of process control and yield management equipment may cause earnings volatility, due to increases in the risk of inventory related charges as well as timing of revenue recognition.

Terminated Merger with Lam Research

On October 20, 2015, we entered into an Agreement and Plan of Merger and Reorganization (the “Merger Agreement” or “Merger”) with Lam Research Corporation (“Lam Research”) which was subject to regulatory approvals. On October 5, 2016, we mutually agreed to terminate the Merger Agreement and no termination fees were payable by either party in connection with the termination.

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The following table sets forth some of our key quarterly unaudited financial information:

| (In thousands, except net income per share) | Three months ended | | | | | |
|---|--------------------|--------------------|---------------|----------------|-------------------|--------------------|
| | December 31, 2016 | September 30, 2016 | June 30, 2016 | March 31, 2016 | December 31, 2015 | September 30, 2015 |
| Total revenues | \$876,885 | \$750,673 | \$919,171 | \$712,433 | \$710,245 | \$642,644 |
| Gross margin | \$558,378 | \$472,837 | \$581,603 | \$437,834 | \$429,265 | \$372,400 |
| Net income | \$238,251 | \$178,101 | \$271,541 | \$175,777 | \$152,207 | \$104,897 |
| Net income per share: | | | | | | |
| Basic ⁽¹⁾ | \$1.52 | \$1.14 | \$1.74 | \$1.13 | \$0.98 | \$0.67 |
| Diluted ⁽¹⁾ | \$1.52 | \$1.13 | \$1.73 | \$1.12 | \$0.98 | \$0.66 |

(1) Basic and diluted net income per share are computed independently for each of the quarters presented based on the weighted-average basic and fully diluted shares outstanding for each quarter. Therefore, the sum of quarterly basic and diluted net income per share information may not equal annual (or other multiple-quarter calculations of) basic and diluted net income per share.

CRITICAL ACCOUNTING ESTIMATES AND POLICIES

The preparation of our condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions in applying our accounting policies that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. Note 1 to the consolidated financial statements in our Annual Report on Form 10-K for the fiscal year ended June 30, 2016 describes the significant accounting policies and methods used in preparation of the condensed consolidated financial statements. We base these estimates and assumptions on historical experience, and evaluate them on an ongoing basis to ensure that they remain reasonable under current conditions. Actual results could differ from those estimates. We discuss the development and selection of the critical accounting estimates with the Audit Committee of our Board of Directors on a quarterly basis, and the Audit Committee has reviewed our related disclosure in this Quarterly Report on Form 10-Q. The accounting policies that reflect our more significant estimates, judgments and assumptions and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results include the following:

Revenue Recognition**Inventories****Warranty****Allowance for Doubtful Accounts****Equity and Cash-Based Long-Term Incentive Compensation Plans****Contingencies and Litigation****Goodwill and Intangible Assets****Income Taxes****Valuation of Marketable Securities**

Other than the impact of the early adoption of the accounting standard update on accounting for share-based payment awards to employees (see Note 1, "Description of Business and Basis of Presentation" of the Notes to Condensed Consolidated Financial Statements), there were no significant changes in our critical accounting estimates and policies during the six months ended December 31, 2016. Please refer to Management's Discussion and Analysis of Financial Condition and Results of Operations contained in Part II, Item 7 of our Annual Report on Form 10-K for our fiscal year ended June 30, 2016 for a more complete discussion of our critical accounting policies and estimates.

Revenue Recognition

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the selling price is fixed or determinable, and collectibility is reasonably assured. We derive revenue from three sources—sales of systems, spare parts and services. In general, we recognize revenue for systems when the system has been installed, is operating according to predetermined specifications and is accepted by the customer.

When we have demonstrated a history of successful installation and acceptance, we recognize revenue upon delivery and customer acceptance.

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Under certain circumstances, however, we recognize revenue prior to acceptance from the customer, as follows:

• When the customer has previously accepted the same tool, with the same specifications, and when we can objectively demonstrate that the tool meets all of the required acceptance criteria.

• When system sales to independent distributors have no installation requirement, contain no acceptance agreement, and 100% of the payment is due based upon shipment.

• When the installation of the system is deemed perfunctory.

• When the customer withholds acceptance due to issues unrelated to product performance, in which case revenue is recognized when the system is performing as intended and meets predetermined specifications.

In circumstances in which we recognize revenue prior to installation, the portion of revenue associated with installation is deferred based on estimated fair value, and that revenue is recognized upon completion of the installation.

In many instances, products are sold in stand-alone arrangements. Services are sold separately through renewals of annual maintenance contracts. We have multiple element revenue arrangements in cases where certain elements of a sales arrangement are not delivered and accepted in one reporting period. To determine the relative fair value of each element in a revenue arrangement, we allocate arrangement consideration based on the selling price hierarchy. For substantially all of the arrangements with multiple deliverables pertaining to products and services, we use vendor-specific objective evidence (“VSOE”) or third-party evidence (“TPE”) to allocate the selling price to each deliverable. We determine TPE based on historical prices charged for products and services when sold on a stand-alone basis. When we are unable to establish relative selling price using VSOE or TPE, we use estimated selling price (“ESP”) in our allocation of arrangement consideration. The objective of ESP is to determine the price at which we would transact a sale if the product or service were sold on a stand-alone basis. ESP could potentially be used for new or customized products. We regularly review relative selling prices and maintain internal controls over the establishment and updates of these estimates. In a multiple element revenue arrangement, we defer revenue recognition associated with the relative fair value of each undelivered element until that element is delivered to the customer. To be considered a separate element, the product or service in question must represent a separate unit of accounting, which means that such product or service must fulfill the following criteria: (a) the delivered item(s) has value to the customer on a stand-alone basis; and (b) if the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in our control. If the arrangement does not meet all the above criteria, the entire amount of the sales contract is deferred until all elements are accepted by the customer.

Trade-in rights are occasionally granted to customers to trade in tools in connection with subsequent purchases. We estimate the value of the trade-in right and reduce the revenue recognized on the initial sale. This amount is recognized at the earlier of the exercise of the trade-in right or the expiration of the trade-in right.

Spare parts revenue is recognized when the product has been shipped, risk of loss has passed to the customer and collection of the resulting receivable is probable.

Service and maintenance contract revenue is recognized ratably over the term of the maintenance contract. Revenue from services performed in the absence of a maintenance contract, including consulting and training revenue, is recognized when the related services are performed and collectibility is reasonably assured.

We sell stand-alone software that is subject to software revenue recognition guidance. We periodically review selling prices to determine whether VSOE exists, and in situations where we are unable to establish VSOE for undelivered elements such as post-contract service, revenue is recognized ratably over the term of the service contract.

We also defer the fair value of non-standard warranty bundled with equipment sales as unearned revenue.

Non-standard warranty includes services incremental to the standard 40-hour per week coverage for 12 months.

Non-standard warranty is recognized ratably as revenue when the applicable warranty term period commences.

The deferred system profit balance equals the value of products that have been shipped and billed to customers which have not met our revenue recognition criteria, less applicable product and warranty costs. Deferred system profit does not include the profit associated with product shipments to certain customers in Japan, to whom title does not transfer until customer acceptance. Shipments to such customers in Japan are classified as inventory at cost until the time of acceptance.

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We enter into sales arrangements that may consist of multiple deliverables of our products and services where certain elements of the sales arrangement are not delivered and accepted in one reporting period. Judgment is required to properly identify the accounting units of the multiple deliverable transactions and to determine the manner in which revenue should be allocated among the accounting units. Additionally, judgment is required to interpret various commercial terms and determine when all criteria of revenue recognition have been met in order for revenue recognition to occur in the appropriate accounting period. While changes in the allocation of the estimated selling price between the accounting units will not affect the amount of total revenue recognized for a particular arrangement, any material changes in these allocations could impact the timing of revenue recognition, which could have a material effect on our financial position and results of operations.

Valuation of Goodwill and Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in each business combination. We have four reporting units: Wafer Inspection, Patterning, Global Services and Support, and Others. See Note 5, “Goodwill and Purchased Intangible Assets” to the Condensed Consolidated Financial Statements for additional details.

We performed a qualitative assessment of the goodwill by reporting unit as of November 30, 2016 during the three months ended December 31, 2016 and concluded that there was no impairment. We assess goodwill for impairment annually as well as whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Long-lived intangible assets are tested for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable.

If we were to encounter challenging economic conditions, such as a decline in our operating results, an unfavorable industry or macroeconomic environment, a substantial decline in our stock price, or any other adverse change in market conditions, we may be required to perform the two-step quantitative goodwill impairment analysis. In addition, if such conditions have the effect of changing one of the critical assumptions or estimates we use to calculate the value of our goodwill or intangible assets, we may be required to record goodwill and/or intangible asset impairment charges in future periods, whether in connection with our next annual impairment assessment or prior to that, if any triggering event occurs outside of the quarter during which the annual goodwill impairment assessment is performed. It is not possible at this time to determine if any such future impairment charge would occur or, if it does, whether such charge would be material to our results of operations.

Accounting for Stock-Based Compensation

We account for stock-based awards granted to employees for services based on the fair value of those awards. The fair value of stock-based awards is measured at the grant date and is recognized as expense over the employee’s requisite service period. The fair value for restricted stock units granted without “dividend equivalent” rights is determined using the closing price of our common stock on the grant date for restricted stock units, adjusted to exclude the present value of dividends which are not accrued on the restricted stock units. The fair value for restricted stock units granted with “dividend equivalent” rights is determined using the closing price of our common stock on the grant date. The award holder is not entitled to receive payments under dividend equivalent rights unless the associated restricted stock unit award vests (i.e., the award holder is entitled to receive credits, payable in cash or shares of our common stock, equal to the cash dividends that would have been received on the shares of our common stock underlying the restricted stock units had the shares been issued and outstanding on the dividend record date, but such dividend equivalents are only paid subject to the recipient satisfying the vesting requirements of the underlying award). The fair value is determined using a Black-Scholes valuation model for purchase rights under our Employee Stock Purchase Plan. The Black-Scholes option-pricing model requires the input of assumptions, including the option’s expected term and the expected price volatility of the underlying stock. The expected stock price volatility assumption is based on the market-based historical implied volatility from traded options of our common stock.

Recent Accounting Pronouncements

For a description of recent accounting pronouncements, including those recently adopted and the expected dates of adoption as well as estimated effects, if any, on our condensed consolidated financial statements of those not yet adopted, see Note 1, “Description of Business and Basis of Presentation” of the Notes to Condensed Consolidated Financial Statements.

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RESULTS OF OPERATIONS

Revenues and Gross Margin

| (Dollar amounts in thousands) | Three months ended | | | | | | |
|-------------------------------|--------------------|--------------------|-------------------|---------------------|-----|---------------------|-----|
| | December 31, 2016 | September 30, 2016 | December 31, 2015 | Q2 FY17 vs. Q1 FY17 | | Q2 FY17 vs. Q2 FY16 | |
| Revenues: | | | | | | | |
| Product | \$683,733 | \$561,753 | \$527,780 | \$121,980 | 22% | \$155,953 | 30% |
| Service | 193,152 | 188,920 | 182,465 | 4,232 | 2% | 10,687 | 6% |
| Total revenues | \$876,885 | \$750,673 | \$710,245 | \$126,212 | 17% | \$166,640 | 23% |
| Costs of revenues | \$318,507 | \$277,836 | \$280,980 | \$40,671 | 15% | \$37,527 | 13% |
| Gross margin percentage | 64 | % 63 | % 60 | % | | | |

| (Dollar amounts in thousands) | Six months ended | | |
|-------------------------------|-------------------|-------------------|-----------------------------|
| | December 31, 2016 | December 31, 2015 | Q2 FY17 YTD vs. Q2 FY16 YTD |
| Revenues: | | | |
| Product | \$1,245,486 | \$988,519 | \$256,967 26% |
| Service | 382,072 | 364,370 | 17,702 5% |
| Total revenues | \$1,627,558 | \$1,352,889 | \$274,669 20% |
| Costs of revenues | \$596,343 | \$551,224 | \$45,119 8% |
| Gross margin percentage | 63 | % 59 | % |

Product revenues

Our business is affected by the concentration of our customer base and our customers' capital equipment procurement schedules as a result of their investment plans. Our product revenues in any particular quarter are significantly impacted by the amount of new orders that we receive during that quarter and, depending upon the duration of manufacturing and installation cycles, in the preceding quarters.

Product revenues increased during the three months ended December 31, 2016 compared to the three months ended September 30, 2016, primarily due to sales of next generation inspection products during the three months ended December 31, 2016 and increased investments by foundry and logic customers to support their new device architectures and process technologies for capacity-related expansion.

Product revenues increased during the three and six months ended December 31, 2016 compared to the three and six months ended December 31, 2015, respectively, primarily due to sales of next generation inspection products during the three months ended December 31, 2016 and increased investments by foundry, memory and logic customers to support their new device architectures and process technologies for capacity-related expansion.

Service revenues

Service revenues are generated from maintenance contracts, as well as billable time and material service calls made to our customers after the expiration of the warranty period. The amount of our service revenues is typically a function of the number of post-warranty systems installed at our customers' sites and the utilization of those systems, but it is also impacted by other factors, such as our rate of service contract renewals, the types of systems being serviced and fluctuations in foreign exchange rates. Service revenues during the three months ended December 31, 2016 compared to the three months ended September 30, 2016 remained relatively unchanged. Service revenues during the three and six months ended December 31, 2016 increased compared to the three and six months December 31, 2015, primarily due to an increase over time in the number of post-warranty systems installed at our customers' sites.

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Revenues by region

The following is a summary of revenues by geographic region, based on ship-to location, for the indicated periods (as a percentage of total revenues):

| (Dollar amounts in thousands) | Three months ended | | | | | |
|-------------------------------|--------------------|-------|--------------------|-------|-------------------|-------|
| | December 31, 2016 | | September 30, 2016 | | December 31, 2015 | |
| Taiwan | \$336,058 | 38 % | \$273,692 | 35 % | \$251,364 | 35 % |
| North America | 153,162 | 17 % | 87,266 | 12 % | 116,729 | 17 % |
| Korea | 96,846 | 11 % | 135,089 | 18 % | 79,877 | 11 % |
| Europe & Israel | 93,440 | 11 % | 34,848 | 5 % | 41,335 | 6 % |
| China | 73,152 | 9 % | 85,689 | 12 % | 91,412 | 13 % |
| Japan | 67,855 | 8 % | 104,784 | 14 % | 109,125 | 15 % |
| Rest of Asia | 56,372 | 6 % | 29,305 | 4 % | 20,403 | 3 % |
| Total | \$876,885 | 100 % | \$750,673 | 100 % | \$710,245 | 100 % |

A significant portion of our revenues continues to be generated in Asia, where a substantial portion of the world's semiconductor manufacturing capacity is located, and we expect that trend to continue.

Gross margin

Our gross margin fluctuates with revenue levels and product mix and is affected by variations in costs related to manufacturing and servicing our products, including our ability to scale our operations efficiently and effectively in response to prevailing business conditions.

The following table summarizes the major factors that contributed to the changes in gross margin percentage:

| | Gross Margin Percentage | | | Gross Margin Percentage | |
|--|-------------------------|--|---------|-------------------------|------------------|
| | Three months ended | Three months ended | | Three months ended | Six months ended |
| September 30, 2016 | 63.0 % | December 31, 2015 | 60.4 % | 59.3 % | |
| Revenue volume of products and services | 1.8 % | Revenue volume of products and services | 2.0 % | 2.0 % | |
| Mix of products and services sold | (1.7) % | Mix of products and services sold | 1.6 % | 2.0 % | |
| Manufacturing labor, overhead and efficiencies | 0.7 % | Manufacturing labor, overhead and efficiencies | (0.2) % | (0.1) % | |
| Other service and manufacturing costs | (0.1) % | Other service and manufacturing costs | (0.1) % | 0.2 % | |
| December 31, 2016 | 63.7 % | December 31, 2016 | 63.7 % | 63.4 % | |

Changes in gross margin percentage driven by revenue volume of products and services reflect our ability to leverage existing infrastructure to generate higher revenues. It also includes the effect of fluctuations in foreign exchange rates, average customer pricing and customer revenue deferrals associated with volume purchase agreements. Changes in gross margin percentage from mix of products and services sold reflect the impact of changes in the composition within product and service offerings. Changes in gross margin percentage from manufacturing labor, overhead and efficiencies reflect our ability to manage costs and drive productivity as we scale our manufacturing activity to respond to customer requirements; this includes the impact of capacity utilization, use of overtime and variability of cost structure. Changes in gross margin percentage from other service and manufacturing costs include the impact of customer support costs, including the efficiencies with which we deliver services to our customers, and the effectiveness with which we manage our production plans and inventory risk.

Our gross margin increased to 63.7% during the three months ended December 31, 2016 from 63.0% during the three months ended September 30, 2016, primarily due to higher revenue volume of products and services and an increase in manufacturing efficiencies, partially offset by less favorable mix of products and services sold and higher warranty charges.

Our gross margin increased during the three and six months ended December 31, 2016, primarily due to higher revenue volume of products and services and a favorable mix of products and services sold, partially offset by higher warranty charges and a reduction in manufacturing efficiencies driven by lower manufacturing output.

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Research and Development (“R&D”)

| (Dollar amounts in thousands) | Three months ended | | | | | | |
|--|--------------------|--------------------|-------------------|---------------------|---------------------|----------|-----|
| | December 31, 2016 | September 30, 2016 | December 31, 2015 | Q2 FY17 vs. Q1 FY17 | Q2 FY17 vs. Q2 FY16 | | |
| R&D expenses | \$130,912 | \$129,233 | \$118,272 | \$1,679 | 1% | \$12,640 | 11% |
| R&D expenses as a percentage of total revenues | 15 | % 17 | % 17 | % | | | |

| (Dollar amounts in thousands) | Six months ended | | | Q2 FY17 YTD vs. Q2 FY16 YTD |
|--|-------------------|-------------------|----------|-----------------------------|
| | December 31, 2016 | December 31, 2015 | | |
| R&D expenses | \$260,145 | \$238,215 | \$21,930 | 9% |
| R&D expenses as a percentage of total revenues | 16 | % 18 | % | |

R&D expenses may fluctuate with product development phases and project timing as well as our focused R&D efforts that are aligned with our overall business strategy. As technological innovation is essential to our success, we may incur significant costs associated with R&D projects, including compensation for engineering talent, engineering material costs, and other expenses.

R&D expenses during the three months ended December 31, 2016 increased compared to the three months ended September 30, 2016, primarily due to an increase in engineering materials and supplies expenses of \$4.0 million, partially offset by a decrease in employee-related expenses of \$1.8 million.

R&D expenses during the three months ended December 31, 2016 increased compared to the three months ended December 31, 2015, primarily due to an increase in employee-related expenses of \$4.5 million on account of additional engineering headcount and higher variable compensation, an increase in engineering materials and supplies expenses of \$4.9 million, an increase in consulting expenses of \$4.3 million and an increase in merger-related expenses of \$1.1 million, partially offset by a decrease in depreciation expense of \$2.0 million.

R&D expenses during the six months ended December 31, 2016 increased compared to the six months ended December 31, 2015, primarily due to an increase in employee-related expenses of \$10.5 million as a result of higher variable compensation and additional engineering headcount, an increase in consulting expenses of \$9.2 million, an increase in engineering materials and supplies expenses of \$6.7 million and an increase in merger-related expenses of \$2.0 million, partially offset by a decrease in depreciation expense of \$4.2 million, an increase in the benefit to R&D expense from external funding of \$2.0 million and lower severance-related charges of \$1.5 million.

Our future operating results will depend significantly on our ability to produce products and provide services that have a competitive advantage in our marketplace. To do this, we believe that we must continue to make substantial and focused investments in our research and development. We remain committed to product development in new and emerging technologies as we address the yield challenges our customers face at future technology nodes.

Selling, General and Administrative (“SG&A”)

| (Dollar amounts in thousands) | Three months ended | | | | | | |
|---|--------------------|--------------------|-------------------|---------------------|---------------------|-----------|------|
| | December 31, 2016 | September 30, 2016 | December 31, 2015 | Q2 FY17 vs. Q1 FY17 | Q2 FY17 vs. Q2 FY16 | | |
| SG&A expenses | \$93,532 | \$94,388 | \$96,532 | \$(856) | (1)% | \$(3,000) | (3)% |
| SG&A expenses as a percentage of total revenues | 11 | % 13 | % 14 | % | | | |

| (Dollar amounts in thousands) | Six months ended | | | Q2 FY17 YTD vs. Q2 FY16 YTD |
|-------------------------------|-------------------|-------------------|---------|-----------------------------|
| | December 31, 2016 | December 31, 2015 | | |
| SG&A expenses | \$187,920 | 188,195 | \$(275) | -% |

SG&A expenses as a percentage of total revenues 12 % 14 %

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SG&A expenses during the three months ended December 31, 2016 remained relatively unchanged compared to the three months ended September 30, 2016.

SG&A expenses during the three months ended December 31, 2016 decreased compared to the three months ended December 31, 2015, primarily due to a decrease in our merger-related expenses of \$6.5 million, partially offset by an increase in employee-related expenses of \$1.6 million as a result of higher variable compensation, an increase in consulting expenses of \$1.3 million and an increase in cost of support for sales evaluations of \$1.0 million.

SG&A expenses during the six months ended December 31, 2016 decreased slightly compared to the six months ended December 31, 2015, primarily due to a decrease in our merger-related expenses of \$7.4 million and lower severance-related charges of \$3.7 million, partially offset by an increase in employee-related expenses of \$6.1 million as a result of higher variable compensation, an increase in cost of support for sales evaluations of \$1.7 million, an increase in consulting expenses of \$1.6 million and an increase in facilities related expenses of \$1.1 million.

Restructuring Charges

During the fourth quarter of the fiscal year ended 2015, we announced a plan to reduce our global employee workforce to streamline our organization and business processes in response to changing customer requirements in our industry. The goals of this reduction were to enable continued innovation, direct our resources toward our best opportunities and lower our ongoing expense run rate. We substantially completed our global workforce reduction during the fiscal year ended June 30, 2016.

The following table shows the activity which is primarily related to accrued severance and benefits for the three and six months ended December 31, 2016 and 2015:

| | Three months ended | | Six months ended | |
|---------------------|--------------------|-----------|------------------|-----------|
| | December 31, | | December 31, | |
| (In thousands) | 2016 | 2015 | 2016 | 2015 |
| Beginning balance | \$287 | \$13,061 | \$587 | \$24,887 |
| Restructuring costs | — | 1,392 | — | 8,458 |
| Adjustments | (121) | (563) | (147) | (190) |
| Cash payments | (166) | (10,881) | (440) | (30,146) |
| Ending balance | \$— | \$3,009 | \$— | \$3,009 |

Interest Expense and Other Expense (Income), Net

| (Dollar amounts in thousands) | Three months ended | | |
|---|--------------------|--------------------|-------------------|
| | December 31, 2016 | September 30, 2016 | December 31, 2015 |
| Interest expense | \$30,624 | \$ 30,732 | \$ 30,539 |
| Other expense (income), net | \$(3,535) | \$(3,736) | \$(1,553) |
| Interest expense as a percentage of total revenues | 3 % | 4 % | 4 % |
| Other expense (income), net as a percentage of total revenues | — % | — % | — % |

| (Dollar amounts in thousands) | Six months ended | |
|---|-------------------|-------------------|
| | December 31, 2016 | December 31, 2015 |
| Interest expense | \$61,356 | \$61,103 |
| Other expense (income), net | \$(7,271) | \$(5,622) |
| Interest expense as a percentage of total revenues | 4 % | 5 % |
| Other expense (income), net as a percentage of total revenues | — % | — % |

Interest expense is primarily attributable to our \$2.5 billion Senior Notes, the \$496.3 million outstanding unsecured prepayable term loans and \$500 million unfunded revolving credit facility.

Interest expense during the three and six months ended December 31, 2016 remained relatively unchanged compared to the three months ended September 30, 2016 and December 31, 2015 and six months ended December 31, 2015, respectively.

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Other expense (income), net is comprised primarily of realized gains or losses on sales of marketable securities, gains or losses from revaluations of certain foreign currency denominated assets and liabilities as well as foreign currency contracts, impairments associated with equity investments in privately-held companies and any subsequent recoveries of impaired investments, interest-related accruals (such as interest and penalty accruals related to our tax obligations) and interest income earned on our investment and cash portfolio.

Other expense (income), net was relatively unchanged during the three months ended December 31, 2016 compared to the three months ended September 30, 2016.

The increase in other expense (income), net during the three months ended December 31, 2016 compared to the three months ended December 31, 2015 was primarily due to an increase in interest income and realized gains from our investment portfolio of \$1.8 million.

The increase in other expense (income), net during the six months ended December 31, 2016 compared to the six months ended December 31, 2015 was primarily due to an increase in interest income and realized gains from our investment portfolio of \$3.4 million, partially offset by a decrease in interest and penalty accruals related to uncertain tax positions of \$1.2 million.

Provision for Income Taxes

The following table provides details of income taxes:

| | Three months ended | | Six months ended | | |
|-------------------------------|--------------------|-----------|------------------|-----------|---|
| | December 31, | | December 31, | | |
| (Dollar amounts in thousands) | 2016 | 2015 | 2016 | 2015 | |
| Income before income taxes | \$306,845 | \$185,475 | \$529,065 | \$319,774 | |
| Provision for income taxes | \$68,594 | \$33,268 | \$112,713 | \$62,670 | |
| Effective tax rate | 22.4 | % 17.9 | % 21.3 | % 19.6 | % |

We have forecasted an effective tax rate of 22% for the fiscal year ending June 30, 2017.

Tax expense was higher as a percentage of income before taxes during the three months ended December 31, 2016 compared to the three months ended December 31, 2015 primarily due to the impact of the following items:

Tax expense increased by \$6.3 million during the three months ended December 31, 2016 due to absence of the impact of reinstatement of the U.S. federal research credit during the three months ended December 31, 2015 when the Protecting Americans from Tax Hikes (PATH) Act of 2015 permanently reinstated the research credit on December 18, 2015 retroactively to January 1, 2015;

- Tax expense increased by \$1.9 million during the three months ended December 31, 2016 due to the impact of a lower non-taxable increase in the value of the assets held within our Executive Deferred Savings Plan during the three months ended December 31, 2016; and

Tax expense increased by \$1.9 million during the three months ended December 31, 2016 due to the impact of a decrease in the proportion of our earnings generated in jurisdictions with tax rates lower than the U.S. statutory rate during the three months ended December 31, 2016.

Tax expense was higher as a percentage of income before taxes during the six months ended December 31, 2016 compared to the six months ended December 31, 2015 primarily due to the impact of the following items:

Tax expense increased by \$4.2 million during the six months ended December 31, 2016 due to absence of the impact of reinstatement of the U.S. federal research credit during the six months ended December 31, 2015 when the Protecting Americans from Tax Hikes (PATH) Act of 2015 permanently reinstated the research credit on December 18, 2015 retroactively to January 1, 2015.

Tax expense increased by \$3.2 million during the six months ended December 31, 2016 due to the impact of a decrease in the proportion of our earnings generated in jurisdictions with tax rates lower than the U.S. statutory rate during the six months ended December 31, 2016.

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In the normal course of business, we are subject to examination by tax authorities throughout the world. We are subject to United States federal income tax examination for all years beginning from the fiscal year ended June 30, 2014. We are subject to state income tax examinations for all years beginning from the fiscal year ended June 30, 2012. We are also subject to examinations in other major foreign jurisdictions, including Singapore, for all years beginning from the fiscal year ended June 30, 2012. It is possible that certain examinations may be concluded in the next twelve months. We believe that we may recognize up to \$3.9 million of our existing unrecognized tax benefits within the next twelve months as a result of the lapse of statutes of limitations and the resolution of examinations with various tax authorities.

LIQUIDITY AND CAPITAL RESOURCES

| (Dollar amounts in thousands) | As of December 31, 2016 | As of June 30, 2016 |
|--|-------------------------------|------------------------|
| Cash and cash equivalents | \$937,033 | \$1,108,488 |
| Marketable securities | 1,655,944 | 1,382,806 |
| Total cash, cash equivalents and marketable securities | \$2,592,977 | \$2,491,294 |
| Percentage of total assets | 51 | % 50 % |

| (In thousands) | Six months ended December 31, | |
|--|----------------------------------|------------|
| | 2016 | 2015 |
| Cash flows: | | |
| Net cash provided by operating activities | \$392,190 | \$294,106 |
| Net cash provided by (used in) investing activities | (308,156) | 173,068 |
| Net cash used in financing activities | (247,603) | (413,337) |
| Effect of exchange rate changes on cash and cash equivalents | (7,886) | (5,271) |
| Net increase (decrease) in cash and cash equivalents | \$(171,455) | \$48,566 |

Cash and Cash Equivalents and Marketable Securities:

As of December 31, 2016, our cash, cash equivalents and marketable securities totaled \$2.59 billion, which is an increase of \$101.7 million from June 30, 2016. The increase is primarily attributable to our cash generated from operations, partially offset by payment of regular quarterly cash dividends and payment of a special cash dividend with respect to fully vested restricted stock units with dividend equivalent rights aggregating to \$173.8 million, prepayment of term loans of \$80.0 million, capital expenditures of \$18.5 million and other investing activities. As of December 31, 2016, \$1.84 billion of our \$2.59 billion of cash, cash equivalents and marketable securities were held by our foreign subsidiaries and branch offices. We currently intend to indefinitely reinvest \$1.70 billion of the cash, cash equivalents and marketable securities held by our foreign subsidiaries. If, however, a portion of these funds were to be repatriated to the United States, we would be required to accrue and pay U.S. and foreign taxes of approximately 30%-50% of the funds repatriated. The amount of taxes due will depend on the amount and manner of the repatriation, as well as the location from which the funds are repatriated. We have accrued (but have not paid) U.S. taxes on the remaining cash of \$132.6 million of the \$1.84 billion held by our foreign subsidiaries and branch offices. As such, these funds can be returned to the U.S. without accruing any additional U.S. tax expense.

Quarterly Cash Dividends and Special Cash Dividend:

During the three months ended December 31, 2016, our Board of Directors declared a regular quarterly cash dividend of \$0.54 per share on our outstanding common stock, which was paid on December 1, 2016 to our stockholders of record as of the close of business on November 15, 2016. During the same period in fiscal year 2016, our Board of Directors declared and paid a regular quarterly cash dividend of \$0.52 per share on our outstanding common stock. The total amount of regular quarterly cash dividends paid during the three months ended December 31, 2016 and 2015 was \$84.5 million and \$80.8 million, respectively. The total amount of regular quarterly cash dividends paid during the six months ended December 31, 2016 and 2015 was \$166.1 million and \$162.5 million, respectively. The amount of accrued dividends payable for regular quarterly cash dividends on unvested restricted stock units with dividend

equivalent rights as of December 31, 2016 and June 30, 2016 was \$3.3 million and \$2.7 million, respectively. These amounts will be paid upon vesting of the underlying unvested restricted stock units as described in Note 7, "Equity and Long-term Incentive Compensation Plans."

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On November 19, 2014, we declared a special cash dividend of \$16.50 per share on our outstanding common stock which was paid on December 9, 2014 to our stockholders of record as of the close of business on December 1, 2014. The declaration and payment of the special cash dividend was part of our leveraged recapitalization transaction under which the special cash dividend was financed through a combination of existing cash and proceeds from the debt financing disclosed in Note 6, "Debt" that was completed during the three months ended December 31, 2014. As of the declaration date, the total amount of the special cash dividend accrued by us was approximately \$2.76 billion, substantially all of which was paid out during the three months ended December 31, 2014, except for the aggregate special cash dividend of \$43.0 million that was accrued for the unvested restricted stock units. As of December 31, 2016 and June 30, 2016, we had \$9.4 million and \$16.9 million, respectively, of accrued dividends payable for the special cash dividend with respect to outstanding unvested restricted stock units, which will be paid when such underlying unvested restricted stock units vest. We paid a special cash dividend with respect to vested restricted stock units during the three months ended December 31, 2015 of \$0.6 million. The amount paid during the three months ended December 31, 2016 was immaterial. We paid a special cash dividend with respect to vested restricted stock units during the six months ended December 31, 2016 and 2015 of \$7.7 million and \$20.5 million, respectively. Other than the special cash dividend declared during the three months ended December 31, 2014, we historically have not declared any special cash dividend.

Stock Repurchases:

The shares repurchased under our stock repurchase program have reduced our basic and diluted weighted-average shares outstanding. The stock repurchase program is intended, in part, to offset shares issued in connection with the purchases under our ESPP program and the vesting of employee restricted stock units. There were no stock repurchase activities during the three months ended December 31, 2016.

Cash Flows from Operating Activities:

We have historically financed our liquidity requirements through cash generated from operations. Net cash provided by operating activities during the six months ended December 31, 2016 increased by \$98.1 million compared to the six months ended December 31, 2015 primarily as a result of the following factors:

- An increase in collections of approximately \$125.0 million during the six months ended December 31, 2016 compared to the six months ended December 31, 2015, driven by higher shipments;

- The positive impact of our early adoption of the new accounting standard update for share-based payment awards to employees on a prospective basis during the six months ended December 31, 2016, which no longer requires the excess tax benefit from share-based compensation to be shown as a reduction within cash flows from operating activities of approximately \$12.0 million compared to the six months ended December 31, 2015;

- An increase in interest income of approximately \$4.0 million during the six months ended December 31, 2016 compared to the six months ended December 31, 2015, as U.S. interest rates increased; partially offset by

- An increase in income tax payments of approximately \$51.0 million during the six months ended December 31, 2016 compared to the six months ended December 31, 2015.

Cash Flows from Investing Activities:

Net cash used by investing activities during the six months ended December 31, 2016 was \$308.2 million compared to cash provided by investing activities of \$173.1 million during the six months ended December 31, 2015. This change was mainly due to the net liquidation of investments in marketable securities of approximately \$187.0 million during the six months ended December 31, 2015, compared to net purchases of marketable securities of approximately \$285.0 million during the six months ended December 31, 2016, as we increased our investment portfolio to align with our current investment plans and strategy.

Cash Flows from Financing Activities:

Net cash used in financing activities during the six months ended December 31, 2016 decreased by approximately \$166.0 million compared to the six months ended December 31, 2015. Net cash used in financing activities were mainly impacted by:

- A decrease in common stock repurchases of \$181.7 million during the six months ended December 31, 2016 compared to the six months ended December 31, 2015;

A decrease in payment of dividends to stockholders of \$9.2 million, mainly due to lower payments of dividend equivalents related to the special cash dividend during the six months ended December 31, 2016 compared to the six months ended December 31, 2015;

A decrease in payment of restricted stock unit withholding taxes of \$4.5 million during the six months ended December 31, 2016 compared to the six months ended December 31, 2015; partially offset by

An increase in the repayment of debt of \$20.0 million during the six months ended December 31, 2016 compared to the six months ended December 31, 2015; and

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The impact of our early adoption of the new accounting standard update for share-based payment awards to employees on a prospective basis during the six months ended December 31, 2016, which no longer requires the excess tax benefit from share-based compensation to be shown as a cash inflow from financing activities of approximately \$12.0 million compared to the six months ended December 31, 2015.

Senior Notes:

In November 2014, we issued \$2.50 billion aggregate principal amount of senior, unsecured long-term notes (collectively referred to as “Senior Notes”). We issued the Senior Notes as part of the leveraged recapitalization plan under which the proceeds from the Senior Notes in conjunction with the proceeds from the term loans (described below) and cash on hand were used (x) to fund a special cash dividend of \$16.50 per share, aggregating to approximately \$2.76 billion, (y) to redeem \$750.0 million of 2018 Senior Notes, including associated redemption premiums, accrued interest and other fees and expenses and (z) for other general corporate purposes, including repurchases of shares pursuant to our stock repurchase program. The interest rate specified for each series of the Senior Notes will be subject to adjustments from time to time if Moody’s Investor Service, Inc. (“Moody’s”) or Standard & Poor’s Ratings Services (“S&P”) or, under certain circumstances, a substitute rating agency selected by us as a replacement for Moody’s or S&P, as the case may be (a “Substitute Rating Agency”), downgrades (or subsequently upgrades) its rating assigned to the respective series of Senior Notes such that the adjusted rating is below investment grade. If the adjusted rating of any series of Senior Notes from Moody’s (or, if applicable, any Substitute Rating Agency) is decreased to Ba1, Ba2, Ba3 or B1 or below, the stated interest rate on such series of Senior Notes as noted above will increase by 25 bps, 50 bps, 75 bps or 100 bps, respectively (“bps” refers to Basis Points and 1% is equal to 100 bps). If the rating of any series of Senior Notes from S&P (or, if applicable, any Substitute Rating Agency) with respect to such series of Senior Notes is decreased to BB+, BB, BB- or B+ or below, the stated interest rate on such series of Senior Notes as noted above will increase by 25 bps, 50 bps, 75 bps or 100 bps, respectively. The interest rates on any series of Senior Notes will permanently cease to be subject to any adjustment (notwithstanding any subsequent decrease in the ratings by any of Moody’s, S&P and, if applicable, any Substitute Rating Agency) if such series of Senior Notes becomes rated “Baa1” (or its equivalent) or higher by Moody’s (or, if applicable, any Substitute Rating Agency) and “BBB+” (or its equivalent) or higher by S&P (or, if applicable, any Substitute Rating Agency), or one of those ratings if rated by only one of Moody’s, S&P and, if applicable, any Substitute Rating Agency, in each case with a stable or positive outlook. In October 2014, we entered into a series of forward contracts to lock the 10-year treasury rate (“benchmark rate”) on a portion of the Senior Notes with a notional amount of \$1.00 billion in aggregate. For additional details, refer to Note 14, “Derivative Instruments and Hedging Activities.”

The original discount on the Senior Notes amounted to \$4.0 million and is being amortized over the life of the debt. Interest is payable semi-annually on May 1 and November 1 of each year. The debt indenture (the “Indenture”) includes covenants that limit our ability to grant liens on its facilities and enter into sale and leaseback transactions, subject to certain allowances under which certain sale and leaseback transactions are not restricted. As of December 31, 2016, we were in compliance with all of the covenants under the Indenture associated with the Senior Notes.

Credit Facility (Term Loans and Unfunded Revolving Credit Facility):

In November 2014, we entered into \$750.0 million of five-year senior unsecured prepayable term loans and a \$500.0 million unfunded revolving credit facility (collectively, the “Credit Facility”) under the Credit Agreement (the “Credit Agreement”). The interest under the Credit Facility will be payable on the borrowed amounts at the London Interbank Offered Rate (“LIBOR”) plus a spread, which is currently 125 bps, and this spread is subject to adjustment in conjunction with our credit rating downgrades or upgrades. The spread ranges from 100 bps to 175 bps based on the then effective credit rating. We are also obligated to pay an annual commitment fee of 15 bps on the daily undrawn balance of the revolving credit facility, which is also subject to an adjustment in conjunction with our credit rating downgrades or upgrades by Moody’s and S&P. The annual commitment fee ranges from 10 bps to 25 bps on the daily undrawn balance of the revolving credit facility, depending upon the then effective credit rating. Principal payments with respect to the term loans will be made on the last day of each calendar quarter and any unpaid principal balance of the term loans, including accrued interest, shall be payable on November 14, 2019 (the “Maturity Date”). We may prepay the term loans and unfunded revolving credit facility at any time without a prepayment penalty. During the second quarter of our fiscal year ending June 30, 2017, we made term loan principal payments of \$40.0 million.

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Future principal payments for the term loans (without giving effect to \$178.8 million of principal prepayments as of December 31, 2016 that shall be applied to the future scheduled quarterly payments) as of December 31, 2016, are as follows:

| Fiscal Quarters Ending | Quarterly Payment (In thousands) |
|---|---|
| March 31, 2017 through December 31, 2017 | \$ 14,063 |
| March 31, 2018 through September 30, 2019 | \$ 18,750 |
| December 31, 2019 | \$ 487,500 |

The Credit Facility requires us to maintain an interest expense coverage ratio as described in the Credit Agreement, on a quarterly basis, covering the trailing four consecutive fiscal quarters of no less than 3.50 to 1.00. In addition, we are required to maintain the maximum leverage ratio as described in the Credit Agreement, on a quarterly basis, covering the trailing four consecutive fiscal quarters for the fiscal quarters as described below.

| Fiscal Quarters Ending | Maximum Leverage Ratio |
|--------------------------------------|------------------------|
| December 31, 2016 and March 31, 2017 | 3.50:1.00 |
| Thereafter | 3.00:1.00 |

We were in compliance with the financial covenants under the Credit Agreement as of December 31, 2016 (the interest expense coverage ratio was 10.67 to 1.00 and the leverage ratio was 2.28 to 1.00) and had no outstanding borrowings under the unfunded revolving credit facility. Considering our current liquidity position, short-term financial forecasts and ability to prepay the term loans, if necessary, we expect to continue to be in compliance with our financial covenants at the end of our fiscal year ending June 30, 2017.

Contractual Obligations:

The following is a schedule summarizing our significant obligations to make future payments under contractual obligations as of December 31, 2016:

| (In thousands) | Fiscal year ending June 30, | | | | | | | |
|--|-----------------------------|---------------------|-----------|-----------|-----------|-----------|---------------------|-----------|
| | Total | 2017 ⁽²⁾ | 2018 | 2019 | 2020 | 2021 | 2022 and thereafter | Other |
| Debt obligations ⁽¹⁾ | \$2,996,250 | \$— | \$250,000 | \$30,000 | \$716,250 | \$— | \$2,000,000 | \$— |
| Interest payment associated with all debt obligations ⁽³⁾ | 888,321 | 59,649 | 116,362 | 113,394 | 101,604 | 92,875 | 404,437 | — |
| Purchase commitments ⁽⁴⁾ | 337,936 | 317,477 | 20,180 | 88 | 30 | 161 | — | — |
| Income taxes payable ⁽⁵⁾ | 62,367 | — | — | — | — | — | — | 62,367 |
| Operating leases | 21,189 | 3,978 | 5,994 | 3,405 | 2,657 | 1,779 | 3,376 | — |
| Cash long-term incentive program ⁽⁶⁾ | 121,014 | 1,906 | 47,547 | 36,015 | 23,290 | 12,256 | — | — |
| Pension obligations ⁽⁷⁾ | 21,436 | 651 | 1,487 | 1,536 | 1,452 | 1,664 | 14,646 | — |
| Executive Deferred Savings Plan ⁽⁸⁾ | 174,071 | — | — | — | — | — | — | 174,071 |
| Other ⁽⁹⁾ | 35,817 | 855 | 30,196 | 4,079 | 667 | 20 | — | — |
| Total contractual cash obligations | \$4,658,401 | \$384,516 | \$471,766 | \$188,517 | \$845,950 | \$108,755 | \$2,422,459 | \$236,438 |

In November 2014, we issued \$750.0 million aggregate principal amount of term loans due in 2020 (outstanding balance of \$496.3 million as of December 31, 2016) and \$2.50 billion aggregate principal amount of Senior Notes due from fiscal year 2018 to fiscal year 2035. During the second quarter of our fiscal year ending June 30, 2017, we made term loan principal payments of \$40.0 million.

(2) For remaining six months of fiscal year 2017.

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The interest payments associated with the Senior Notes obligations included in the table above are based on the principal amount multiplied by the applicable coupon rate for each series of Senior Notes. Our future interest payments are subject to change if our then effective credit rating is below investment grade as discussed above. The interest payments under the term loans are payable on the borrowed amounts at the LIBOR plus 125 bps. As of (3) December 31, 2016, we utilized the existing interest rates to project our estimated term loans interest payments through fiscal year 2020. The interest payment under the revolving credit facility for the undrawn balance is payable at 15 bps as a commitment fee based on the daily undrawn balance and we utilized the existing rate for the projected interest payments included in the table above. Our future interest payments for the term loans and the revolving credit facility are subject to change due to future fluctuations in the LIBOR rates as well as any upgrades or downgrades to our then effective credit rating.

Represents an estimate of significant commitments to purchase inventory from our suppliers as well as an estimate of significant purchase commitments associated with other goods and services in the ordinary course of business. Our liability under these purchase commitments is generally restricted to a forecasted time-horizon as mutually (4) agreed upon between the parties. This forecasted time-horizon can vary among different suppliers. Actual expenditures will vary based upon the volume of the transactions and length of contractual service provided. In addition, the amounts paid under these arrangements may be less in the event the arrangements are renegotiated or canceled. Certain agreements provide for potential cancellation penalties.

Represents the estimated income tax payable obligation related to uncertain tax positions as well as related accrued (5) interest. We are unable to make a reasonably reliable estimate of the timing of payments in individual years due to uncertainties in the timing of tax audit outcomes.

Represents the amount committed under our cash long-term incentive program. The expected payment after (6) estimated forfeitures is approximately \$97.7 million.

Represents an estimate of expected benefit payments up to fiscal year 2026 that was actuarially determined and (7) excludes the minimum cash required to contribute to the plan. As of December 31, 2016, our defined benefit pension plans do not have material required minimum cash contribution obligations.

Represents the amount committed under our non-qualified executive deferred compensation plan. We are unable to (8) make a reasonably reliable estimate of the timing of payments in individual years due to the uncertainties in the timing around participant's separation and any potential changes that participants may decide to make to the previous distribution elections.

Includes \$23.1 million of employee-related retention commitments in connection with the retention program adopted at the time we entered into the Merger Agreement with Lam Research as well as the amount committed for (9) accrued dividends payable of \$12.7 million, substantially all of which are for the special cash dividend for the unvested restricted stock units as of the dividend record date as well as restricted stock units granted with dividend equivalent rights. For additional details, refer to Note 7, "Equity and Long-term Incentive Compensation Plans."

We have adopted a cash-based long-term incentive ("Cash LTI") program for many of our employees as part of our employee compensation program. Cash LTI awards issued to employees under the Cash Long-Term Incentive Plan ("Cash LTI Plan") generally vest in four equal installments, with 25% of the aggregate amount of the Cash LTI award vesting on each yearly anniversary of the grant date over a four-year period. In order to receive payments under the Cash LTI Plan, participants must remain employed by us as of the applicable award vesting date.

We have agreements with financial institutions to sell certain of our trade receivables and promissory notes from customers without recourse. In addition, we periodically sell certain letters of credit ("LCs"), without recourse, received from customers in payment for goods.

The following table shows total receivables sold under factoring agreements and proceeds from sales of LCs for the indicated periods:

| | Three months ended | | Six months ended | |
|---|--------------------|----------|------------------|----------|
| | December 31, | | December 31, | |
| (In thousands) | 2016 | 2015 | 2016 | 2015 |
| Receivables sold under factoring agreements | \$28,242 | \$41,756 | \$84,975 | \$75,600 |

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| | | | | |
|----------------------------|---------|---------|----------|---------|
| Proceeds from sales of LCs | \$9,740 | \$4,062 | \$13,148 | \$4,062 |
|----------------------------|---------|---------|----------|---------|

Factoring and LC fees for the sale of certain trade receivables were recorded in other expense (income), net and were not material for the periods presented.

We maintain guarantee arrangements available through various financial institutions for up to \$22.4 million, of which \$18.7 million had been issued as of December 31, 2016, primarily to fund guarantees to customs authorities for value-added tax ("VAT") and other operating requirements of our subsidiaries in Europe and Asia.

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We maintain certain open inventory purchase commitments with our suppliers to ensure a smooth and continuous supply for key components. Our liability under these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecasted time-horizon can vary among different suppliers. Our open inventory purchase commitments were approximately \$337.9 million as of December 31, 2016 and are primarily due within the next 12 months. Actual expenditures will vary based upon the volume of the transactions and length of contractual service provided. In addition, the amounts paid under these arrangements may be less in the event that the arrangements are renegotiated or canceled. Certain agreements provide for potential cancellation penalties.

We provide standard warranty coverage on our systems for 40 hours per week for 12 months, providing labor and parts necessary to repair the systems during the warranty period. We account for the estimated warranty cost as a charge to costs of revenues when revenue is recognized. The estimated warranty cost is based on historical product performance and field expenses. The actual product performance and/or field expense profiles may differ, and in those cases we adjust our warranty accruals accordingly. The difference between the estimated and actual warranty costs tends to be larger for new product introductions as there is limited historical product performance to estimate warranty expense; our warranty charge estimates for more mature products with longer product performance histories tend to be more stable. Non-standard warranty coverage generally includes services incremental to the standard 40 hours per week coverage for 12 months. See Note 12, "Commitments and Contingencies," to the condensed consolidated financial statements for additional details.

Working Capital:

Working capital was \$2.84 billion as of December 31, 2016, which is a decrease of \$21.7 million compared to our working capital of \$2.87 billion as of June 30, 2016. As of December 31, 2016, our principal sources of liquidity consisted of \$2.59 billion of cash, cash equivalents and marketable securities. Our liquidity is affected by many factors, some of which are based on the normal ongoing operations of the business, and others of which relate to the uncertainties of global and regional economies and the semiconductor and the semiconductor equipment industries. Although cash requirements will fluctuate based on the timing and extent of these factors, we believe that cash generated from operations, together with the liquidity provided by existing cash and cash equivalents balances and our \$500.0 million unfunded revolving credit facility, will be sufficient to satisfy our liquidity requirements associated with working capital needs, capital expenditures, cash dividends, stock repurchases and other contractual obligations, including repayment of outstanding debt, for at least the next 12 months.

Our credit ratings as of December 31, 2016 are summarized below:

| Rating Agency | Rating |
|-------------------|--------|
| Fitch | BBB- |
| Moody's | Baa2 |
| Standard & Poor's | BBB |

Factors that can affect our credit ratings include changes in our operating performance, the economic environment, conditions in the semiconductor and semiconductor equipment industries, our financial position, and changes in our business strategy.

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Off-Balance Sheet Arrangements

Under our foreign currency risk management strategy, we utilize derivative instruments to protect our earnings and cash flows from unanticipated fluctuations in earnings and cash flows caused by volatility in currency exchange rates. This financial exposure is monitored and managed as an integral part of our overall risk management program which focuses on the unpredictability of financial markets and seeks to reduce the potentially adverse effects that the volatility of these markets may have on our operating results. We continue our policy of hedging our current and forecasted foreign currency exposures with hedging instruments having tenors of up to 18 months (see Note 14, “Derivative Instruments and Hedging Activities,” to the condensed consolidated financial statements for additional details). Our outstanding hedge contracts, with maximum remaining maturities of approximately seven months as of December 31, 2016 and June 30, 2016, respectively, were as follows:

| (In thousands) | As of December 31, 2016 | As of June 30, 2016 |
|--|-------------------------------|---------------------------|
| Cash flow hedge contracts | | |
| Purchase | \$ 11,377 | \$ 7,591 |
| Sell | \$ 111,374 | \$ 91,793 |
| Other foreign currency hedge contracts | | |
| Purchase | \$ 111,119 | \$ 122,275 |
| Sell | \$ 91,406 | \$ 115,087 |

In October 2014, in anticipation of the issuance of the Senior Notes, we entered into a series of forward contracts (“Rate Lock Agreements”) to lock the benchmark rate on a portion of the Senior Notes. The objective of the Rate Lock Agreements was to hedge the risk associated with the variability in interest rates due to the changes in the benchmark rate leading up to the closing of the intended financing, on the notional amount being hedged. The Rate Lock Agreements had a notional amount of \$1.00 billion in aggregate which matured in the second quarter of the fiscal year ended June 30, 2015. We designated each of the Rate Lock Agreements as a qualifying hedging instrument and accounted for as a cash flow hedge, under which the effective portion of the gain or loss on the close out of the Rate Lock Agreements was initially recognized in accumulated other comprehensive income (loss) as a reduction of total stockholders’ equity and subsequently amortized into earnings as a component of interest expense over the term of the underlying debt. The ineffective portion, if any, was recognized in earnings immediately. The Rate Lock Agreements were terminated on the date of pricing of the \$1.25 billion of 4.650% Senior Notes due in 2024 and we recorded the fair value of \$7.5 million as a gain within accumulated other comprehensive income (loss) as of December 31, 2014. We recognized \$0.2 million for each of the three months ended December 31, 2016 and 2015 and \$0.4 million for each of the six months ended December 31, 2016 and 2015 for the amortization of the gain recognized in accumulated other comprehensive income (loss), which amount reduced the interest expense. As of December 31, 2016, the unamortized portion of the fair value of the forward contracts for the rate lock agreements was \$5.9 million.

Indemnification Obligations. Subject to certain limitations, we are obligated to indemnify our current and former directors, officers and employees with respect to certain litigation matters and investigations that arise in connection with their service to us. These obligations arise under the terms of our certificate of incorporation, our bylaws, applicable contracts, and Delaware and California law. The obligation to indemnify generally means that we are required to pay or reimburse the individuals’ reasonable legal expenses and possibly damages and other liabilities incurred in connection with these matters. For example, we have paid or reimbursed legal expenses incurred in connection with the investigation of our historical stock option practices and the related litigation and government inquiries by a number of our current and former directors, officers and employees. Although the maximum potential amount of future payments we could be required to make under the indemnification obligations generally described in this paragraph is theoretically unlimited, we believe the fair value of this liability, to the extent estimable, is appropriately considered within the reserve we have established for currently pending legal proceedings.

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We are a party to a variety of agreements pursuant to which we may be obligated to indemnify the other party with respect to certain matters. Typically, these obligations arise in connection with contracts and license agreements or the sale of assets, under which we customarily agree to hold the other party harmless against losses arising from, or provide customers with other remedies to protect against, bodily injury or damage to personal property caused by our products, non-compliance with our product performance specifications, infringement by our products of third-party intellectual property rights and a breach of warranties, representations and covenants related to matters such as title to assets sold, validity of certain intellectual property rights, non-infringement of third-party rights, and certain income tax-related matters. In each of these circumstances, payment by us is typically subject to the other party making a claim to and cooperating with us pursuant to the procedures specified in the particular contract. This usually allows us to challenge the other party's claims or, in case of breach of intellectual property representations or covenants, to control the defense or settlement of any third-party claims brought against the other party. Further, our obligations under these agreements may be limited in terms of amounts, activity (typically at our option to replace or correct the products or terminate the agreement with a refund to the other party), and duration. In some instances, we may have recourse against third parties and/or insurance covering certain payments made by us.

In addition, we may in limited circumstances enter into agreements that contain customer-specific commitments on pricing, tool reliability, spare parts stocking levels, service response time and other commitments. Furthermore, we may give these customers limited audit or inspection rights to enable them to confirm that we are complying with these commitments. If a customer elects to exercise its audit or inspection rights, we may be required to expend significant resources to support the audit or inspection, as well as to defend or settle any dispute with a customer that could potentially arise out of such audit or inspection. To date, we have made no accruals in our condensed consolidated financial statements for this contingency. While we have not in the past incurred significant expenses for resolving disputes regarding these types of commitments, we cannot make any assurance that we will not incur any such liabilities in the future.

It is not possible to predict the maximum potential amount of future payments under these or similar agreements due to the conditional nature of our obligations and the unique facts and circumstances involved in each particular agreement. Historically, payments made by us under these agreements have not had a material effect on our business, financial condition, results of operations or cash flows.

Table of Contents**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to financial market risks, including changes in interest rates, foreign currency exchange rates and marketable equity security prices. To mitigate these risks, we utilize derivative financial instruments, such as foreign currency hedges. All of the potential changes noted below are based on sensitivity analyses performed on our financial position as of December 31, 2016. Actual results may differ materially.

As of December 31, 2016, we had an investment portfolio of fixed income securities of \$1.7 billion. These securities, as with all fixed income instruments, are subject to interest rate risk and will decline in value if market interest rates increase. If market interest rates were to increase immediately and uniformly by 100 bps from levels as of December 31, 2016, the fair value of the portfolio would have declined by \$20.7 million.

In November 2014, we issued \$2.50 billion aggregate principal amount of fixed rate senior, unsecured long-term notes (collectively referred to as "Senior Notes") due in various fiscal years ranging from 2018 to 2035. The fair market value of long-term fixed interest rate notes is subject to interest rate risk. Generally, the fair market value of fixed interest rate notes will increase as interest rates fall and decrease as interest rates rise. As of December 31, 2016, the fair value and the book value of our Senior Notes were \$2.62 billion and \$2.50 billion, respectively. Additionally, the interest expense for the Senior Notes is subject to interest rate adjustments following a downgrade of our credit ratings below investment grade by the credit rating agencies. Following a rating change below investment grade, the stated interest rate for each series of Senior Notes may increase between 25 bps to 100 bps based on the adjusted credit rating. Refer to Note 6, "Debt" to the condensed consolidated financial statements in Part I, Item 1 and Management's Discussion and Analysis of Financial Condition and Results of Operations, "Liquidity and Capital Resources," in Part I, Item 2 for additional details. Factors that can affect our credit ratings include changes in our operating performance, the economic environment, conditions in the semiconductor and semiconductor equipment industries, our financial position, and changes in our business strategy. As of December 31, 2016, if our credit rating was downgraded below investment grade by Moody's and S&P, the maximum potential increase to our annual interest expense on the Senior Notes, considering a 200 bps increase to the stated interest rate for each series of our Senior Notes, is estimated to be approximately \$50.0 million.

In November 2014, we entered into \$750 million aggregate principal amount of floating rate senior, unsecured prepayable term loans due in 2019 and a \$500 million unfunded revolving credit facility. The interest rates for the term loans are based on LIBOR plus a fixed spread and this spread is subject to adjustment in conjunction with our credit rating downgrades or upgrades. The spread ranges from 100 bps to 175 bps based on the adjusted credit rating. The fair value of the term loans is subject to interest rate risk only to the extent of the fixed spread portion of the interest rates which does not fluctuate with change in interest rates. As of December 31, 2016, the difference between book value and fair value of our term loans was immaterial. We are also obligated to pay an annual commitment fee of 15 bps on the daily undrawn balance of the unfunded revolving credit facility which is also subject to an adjustment in conjunction with our credit rating downgrades or upgrades. The annual commitment fee ranges from 10 bps to 25 bps on the daily undrawn balance of the revolving credit facility, depending upon the then effective credit rating. As of December 31, 2016, if LIBOR-based interest rates increased by 100 bps, the change would increase our annual interest expense annually by approximately \$4.6 million as it relates to our borrowings under the term loans. Additionally, as of December 31, 2016, if our credit rating was downgraded to be below investment grade, the maximum potential increase to our annual interest expense for the term loans and the revolving credit facility, using the highest range of the ranges discussed above, is estimated to be approximately \$3.0 million.

See Note 4, "Marketable Securities," to the condensed consolidated financial statements in Part I, Item 1; Management's Discussion and Analysis of Financial Condition and Results of Operations, "Liquidity and Capital Resources," in Part I, Item 2; and Risk Factors in Part II, Item 1A of this Quarterly Report on Form 10-Q for a description of recent market events that may affect the value of the investments in our portfolio that we held as of December 31, 2016.

As of December 31, 2016, we had net forward and option contracts to sell \$80.3 million in foreign currency in order to hedge certain currency exposures (see Note 14, "Derivative Instruments and Hedging Activities," to the condensed consolidated financial statements for additional details). If we had entered into these contracts on December 31, 2016, the U.S. dollar equivalent would have been \$70.4 million. A 10% adverse move in all currency exchange rates

affecting the contracts would decrease the fair value of the contracts by \$22.1 million. However, if this occurred, the fair value of the underlying exposures hedged by the contracts would increase by a similar amount. Accordingly, we believe that, as a result of the hedging of certain of our foreign currency exposure, changes in most relevant foreign currency exchange rates should have no material impact on our income or cash flows.

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ITEM 4 CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures and Related CEO and CFO Certifications

Evaluation of Disclosure Controls and Procedures

The Company conducted an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) (“Disclosure Controls”) as of the end of the period covered by this Quarterly Report on Form 10-Q (this “Report”) required by Exchange Act Rules 13a-15(b) or 15d-15(b). The controls evaluation was conducted under the supervision and with the participation of the Company’s management, including the Company’s Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”). Based on this evaluation, the CEO and CFO have concluded that as of the end of the period covered by this Report the Company’s Disclosure Controls were effective at a reasonable assurance level.

Attached as exhibits to this Report are certifications of the CEO and CFO, which are required in accordance with Rule 13a-14 of the Exchange Act. This Controls and Procedures section includes the information concerning the controls evaluation referred to in the certifications, and it should be read in conjunction with the certifications for a more complete understanding of the topics presented.

Definition of Disclosure Controls

Disclosure Controls are controls and procedures designed to reasonably assure that information required to be disclosed in the Company’s reports filed under the Exchange Act, such as this Report, is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms. Disclosure Controls are also designed to reasonably assure that such information is accumulated and communicated to the Company’s management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. The Company’s Disclosure Controls include components of its internal control over financial reporting, which consists of control processes designed to provide reasonable assurance regarding the reliability of its financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles in the United States. To the extent that components of the Company’s internal control over financial reporting are included within its Disclosure Controls, they are included in the scope of the Company’s annual controls evaluation.

Limitations on the Effectiveness of Controls

The Company’s management, including the CEO and CFO, does not expect that the Company’s Disclosure Controls or internal control over financial reporting will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system’s objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Changes in Internal Control over Financial Reporting

There were no changes in the Company’s internal control over financial reporting during the three months ended December 31, 2016 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The information set forth above under Note 11, "Litigation and Other Legal Matters," to the condensed consolidated financial statements in Item 1 of Part 1 is incorporated herein by reference.

ITEM 1A. RISK FACTORS

A description of factors that could materially affect our business, financial condition or operating results is provided below.

Risks Associated with Our Industry

Ongoing changes in the technology industry, as well as the semiconductor industry in particular, could expose our business to significant risks.

The semiconductor equipment industry and other industries that we serve are constantly developing and changing over time. Many of the risks associated with operating in these industries are comparable to the risks faced by all technology companies, such as the uncertainty of future growth rates in the industries that we serve, pricing trends in the end-markets for consumer electronics and other products (which place a growing emphasis on our customers' cost of ownership), changes in our customers' capital spending patterns and, in general, an environment of constant change and development, including decreasing product and component dimensions; use of new materials; and increasingly complex device structures, applications and process steps. If we fail to appropriately adjust our cost structure and operations to adapt to any of these trends, or, with respect to technological advances, if we do not timely develop new technologies and products that successfully anticipate and address these changes, we could experience a material adverse effect on our business, financial condition and operating results.

In addition, we face a number of risks specific to ongoing changes in the semiconductor industry, as the significant majority of our sales are made to semiconductor manufacturers. Some of the trends that our management monitors in operating our business include the following:

- the trend of increasing cost per transistor for leading edge technology transitions below the 28 nanometer node, a reversal of the historical trend of declining cost per transistor with each new generation of technological advancement within the semiconductor industry, and the adverse impact that such reversal may have upon our business;
- the increasing cost of building and operating fabrication facilities and the impact of such increases on our customers' investment decisions;
- differing market growth rates and capital requirements for different applications, such as memory, logic and foundry;
- lower level of process control adoption by our memory customers compared to our foundry and logic customers;
- our customers' reuse of existing and installed products, which may decrease their need to purchase new products or solutions at more advanced technology nodes;
- the emergence of disruptive technologies that change the prevailing semiconductor manufacturing processes (or the economics associated with semiconductor manufacturing) and, as a result, also impact the inspection and metrology requirements associated with such processes;
- the higher design costs for the most advanced integrated circuits, which could economically constrain leading-edge manufacturing technology customers to focus their resources on only the large, technologically advanced products and applications;
- the possible introduction of integrated products by our larger competitors that offer inspection and metrology functionality in addition to managing other semiconductor manufacturing processes;
- changes in semiconductor manufacturing processes that are extremely costly for our customers to implement and, accordingly, our customers could reduce their available budgets for process control equipment by reducing inspection and metrology sampling rates for certain technologies;
- the bifurcation of the semiconductor manufacturing industry into (a) leading edge manufacturers driving continued research and development into next-generation products and technologies and (b) other manufacturers that are content with existing (including previous generation) products and technologies;
- the ever escalating cost of next-generation product development, which may result in joint development programs between us and our customers or government entities to help fund such programs that could restrict our control of, ownership of and profitability from the products and technologies developed through those programs;

the potential industry transition from 300mm to 450mm wafers; and the entry by some semiconductor manufacturers into collaboration or sharing arrangements for capacity, cost or risk with other manufacturers, as well as increased outsourcing of their manufacturing activities, and greater focus only on specific markets or applications, whether in response to adverse market conditions or other market pressures.

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Any of the changes described above may negatively affect our customers' rate of investment in the capital equipment that we produce, which could result in downward pressure on our prices, customer orders, revenues and gross margins. If we do not successfully manage the risks resulting from any of these or other potential changes in our industries, our business, financial condition and operating results could be adversely impacted.

We are exposed to risks associated with a highly concentrated customer base.

Our customer base, particularly in the semiconductor industry, historically has been, and is becoming increasingly, highly concentrated due to corporate consolidation, acquisitions and business closures. In this environment, orders from a relatively limited number of manufacturers have accounted for, and are expected to continue to account for, a substantial portion of our sales. This increasing concentration exposes our business, financial condition and operating results to a number of risks, including the following:

The mix and type of customers, and sales to any single customer, may vary significantly from quarter to quarter and from year to year, which exposes our business and operating results to increased volatility tied to individual customers.

New orders from our foundry customers in the past several years have constituted a significant portion of our total orders. This concentration increases the impact that future business or technology changes within the foundry industry may have on our business, financial condition and operating results.

In a highly concentrated business environment, if a particular customer does not place an order, or if they delay or cancel orders, we may not be able to replace the business. Furthermore, because our products are configured to each customer's specifications, any changes, delays or cancellations of orders may result in significant, non-recoverable costs.

As a result of this consolidation, the customers that survive the consolidation represent a greater portion of our sales and, consequently, have greater commercial negotiating leverage. Many of our large customers have more aggressive policies regarding engaging alternative, second-source suppliers for the products we offer and, in addition, may seek and, on occasion, receive pricing, payment, intellectual property-related or other commercial terms that may have an adverse impact on our business. Any of these changes could negatively impact our prices, customer orders, revenues and gross margins.

Certain customers have undergone significant ownership changes, created alliances with other companies, experienced management changes or have outsourced manufacturing activities, any of which may result in additional complexities in managing customer relationships and transactions. Any future change in ownership or management of our existing customers may result in similar challenges, including the possibility of the successor entity or new management deciding to select a competitor's products.

The highly concentrated business environment also increases our exposure to risks related to the financial condition of each of our customers. For example, as a result of the challenging economic environment during fiscal year 2009, we were (and in some cases continue to be) exposed to additional risks related to the continued financial viability of certain of our customers. To the extent our customers experience liquidity issues in the future, we may be required to incur additional bad debt expense with respect to receivables owed to us by those customers. In addition, customers with liquidity issues may be forced to reduce purchases of our equipment, delay deliveries of our products, discontinue operations or may be acquired by one of our customers, and in either case such event would have the effect of further consolidating our customer base.

Semiconductor manufacturers generally must commit significant resources to qualify, install and integrate process control and yield management equipment into a semiconductor production line. We believe that once a semiconductor manufacturer selects a particular supplier's process control and yield management equipment, the manufacturer generally relies upon that equipment for that specific production line application for an extended period of time. Accordingly, we expect it to be more difficult to sell our products to a given customer for that specific production line application and other similar production line applications if that customer initially selects a competitor's equipment. Similarly, we expect it to be challenging for a competitor to sell its products to a given customer for a specific production line application if that customer initially selects our equipment.

Prices differ among the products we offer for different applications due to differences in features offered or manufacturing costs. If there is a shift in demand by our customers from our higher-priced to lower-priced products,

our gross margin and revenue would decrease. In addition, when products are initially introduced, they tend to have higher costs because of initial development costs and lower production volumes relative to the previous product generation, which can impact gross margin.

Any of these factors could have a material adverse effect on our business, financial condition and operating results.

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The semiconductor equipment industry is highly cyclical. The purchasing decisions of our customers are highly dependent on the economies of both the local markets in which they are located and the semiconductor industry worldwide. If we fail to respond to industry cycles, our business could be seriously harmed.

The timing, length and severity of the up-and-down cycles in the semiconductor equipment industry are difficult to predict. The cyclical nature of the primary industry in which we operate is largely a function of our customers' capital spending patterns and need for expanded manufacturing capacity, which in turn are affected by factors such as capacity utilization, consumer demand for products, inventory levels and our customers' access to capital. This cyclicity affects our ability to accurately predict future revenue and, in some cases, future expense levels. During down cycles in our industry, the financial results of our customers may be negatively impacted, which could result not only in a decrease in, or cancellation or delay of, orders (which are generally subject to cancellation or delay by the customer with limited or no penalty) but also a weakening of their financial condition that could impair their ability to pay for our products or our ability to recognize revenue from certain customers. Our ability to recognize revenue from a particular customer may also be negatively impacted by the customer's funding status, which could be weakened not only by adverse business conditions or inaccessibility to capital markets for any number of macroeconomic or company-specific reasons, but also by funding limitations imposed by the customer's unique corporate structure. Any of these factors could negatively impact our business, operating results and financial condition.

When cyclical fluctuations result in lower than expected revenue levels, operating results may be adversely affected and cost reduction measures may be necessary in order for us to remain competitive and financially sound. During periods of declining revenues, we must be in a position to adjust our cost and expense structure to prevailing market conditions and to continue to motivate and retain our key employees. If we fail to respond, or if our attempts to respond fail to accomplish our intended results, then our business could be seriously harmed. Furthermore, any workforce reductions and cost reduction actions that we adopt in response to down cycles may result in additional restructuring charges, disruptions in our operations and loss of key personnel. In addition, during periods of rapid growth, we must be able to increase manufacturing capacity and personnel to meet customer demand. We can provide no assurance that these objectives can be met in a timely manner in response to industry cycles. Each of these factors could adversely impact our operating results and financial condition.

In addition, our management typically provides quarterly forecasts for certain financial metrics, which, when made, are based on business and operational forecasts that are believed to be reasonable at the time. However, largely due to the cyclicity of our business and the industries in which we operate, and the fact that business conditions in our industries can change very rapidly as part of these cycles, our actual results may vary (and have varied in the past) from forecasted results. These variations can occur for any number of reasons, including, but not limited to, unexpected changes in the volume or timing of customer orders, product shipments or product acceptances; an inability to adjust our operations rapidly enough to adapt to changing business conditions; or a different than anticipated effective tax rate. The impact on our business of delays or cancellations of customer orders may be exacerbated by the short lead times that our customers expect between order placement and product shipment. This is because order delays and cancellations may lead not only to lower revenues, but also, due to the advance work we must do in anticipation of receiving a product order in order to meet the expected lead times, to significant inventory write-offs and manufacturing inefficiencies that decrease our gross margin. Any of these factors could materially and adversely affect our financial results for a particular quarter and could cause those results to differ materially from financial forecasts we have previously provided. We provide these forecasts with the intent of giving investors and analysts a better understanding of management's expectations for the future, but parties reviewing such forecasts must recognize that such forecasts are comprised of, and are themselves, forward-looking statements subject to the risks and uncertainties described in this Item 1A and elsewhere in this report and in our other public filings and public statements. If our operating or financial results for a particular period differ from our forecasts or the expectations of investment analysts, or if we revise our forecasts, the market price of our common stock could decline.

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Risks Related to Our Business Model and Capital Structure

If we do not develop and introduce new products and technologies in a timely manner in response to changing market conditions or customer requirements, our business could be seriously harmed.

Success in the semiconductor equipment industry depends, in part, on continual improvement of existing technologies and rapid innovation of new solutions. The primary driver of technology advancement in the semiconductor industry has been to shrink the lithography that prints the circuit design on semiconductor chips. That driver appears to be slowing, which may cause semiconductor manufacturers to delay investments in equipment, investigate more complex device architectures, use new materials and develop innovative fabrication processes. These and other evolving customer plans and needs require us to respond with continued development programs and cut back or discontinue older programs, which may no longer have industry-wide support. Technical innovations are inherently complex and require long development cycles and appropriate staffing of highly qualified employees. Our competitive advantage and future business success depend on our ability to accurately predict evolving industry standards, develop and introduce new products and solutions that successfully address changing customer needs, win market acceptance of these new products and solutions, and manufacture these new products in a timely and cost-effective manner. Our failure to accurately predict evolving industry standards and develop as well as offer competitive technology solutions in a timely manner with cost-effective products could result in loss of market share, unanticipated costs, and inventory obsolescence, which would adversely impact our business, operating results and financial condition.

In this environment, we must continue to make significant investments in research and development in order to enhance the performance, features and functionality of our products, to keep pace with competitive products and to satisfy customer demands. Substantial research and development costs typically are incurred before we confirm the technical feasibility and commercial viability of a new product, and not all development activities result in commercially viable products. There can be no assurance that revenues from future products or product enhancements will be sufficient to recover the development costs associated with such products or enhancements. In addition, we cannot be sure that these products or enhancements will receive market acceptance or that we will be able to sell these products at prices that are favorable to us. Our business will be seriously harmed if we are unable to sell our products at favorable prices or if the market in which we operate does not accept our products.

In addition, the complexity of our products exposes us to other risks. We regularly recognize revenue from a sale upon shipment of the applicable product to the customer (even before receiving the customer's formal acceptance of that product) in certain situations, including sales of products for which installation is considered perfunctory, transactions in which the product is sold to an independent distributor and we have no installation obligations, and sales of products where we have previously delivered the same product to the same customer location and that prior delivery has been accepted. However, our products are very technologically complex and rely on the interconnection of numerous subcomponents (all of which must perform to their respective specifications), so it is conceivable that a product for which we recognize revenue upon shipment may ultimately fail to meet the overall product's required specifications. In such a situation, the customer may be entitled to certain remedies, which could materially and adversely affect our operating results for various periods and, as a result, our stock price.

We derive a substantial percentage of our revenues from sales of inspection products. As a result, any delay or reduction of sales of these products could have a material adverse effect on our business, financial condition and operating results. The continued customer demand for these products and the development, introduction and market acceptance of new products and technologies are critical to our future success.

Our success is dependent in part on our technology and other proprietary rights. If we are unable to maintain our lead or protect our proprietary technology, we may lose valuable assets.

Our success is dependent in part on our technology and other proprietary rights. We own various United States and international patents and have additional pending patent applications relating to some of our products and technologies. The process of seeking patent protection is lengthy and expensive, and we cannot be certain that pending or future applications will actually result in issued patents or that issued patents will be of sufficient scope or strength to provide meaningful protection or commercial advantage to us. Other companies and individuals, including our larger competitors, may develop technologies and obtain patents relating to our business that are similar or superior to

our technology or may design around the patents we own, adversely affecting our business. In addition, we at times engage in collaborative technology development efforts with our customers and suppliers, and these collaborations may constitute a key component of certain of our ongoing technology and product research and development projects. The termination of any such collaboration, or delays caused by disputes or other unanticipated challenges that may arise in connection with any such collaboration, could significantly impair our research and development efforts, which could have a material adverse impact on our business and operations.

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We also maintain trademarks on certain of our products and services and claim copyright protection for certain proprietary software and documentation. However, we can give no assurance that our trademarks and copyrights will be upheld or successfully deter infringement by third parties.

While patent, copyright and trademark protection for our intellectual property is important, we believe our future success in highly dynamic markets is most dependent upon the technical competence and creative skills of our personnel. We attempt to protect our trade secrets and other proprietary information through confidentiality and other agreements with our customers, suppliers, employees and consultants and through other security measures. We also maintain exclusive and non-exclusive licenses with third parties for strategic technology used in certain products. However, these employees, consultants and third parties may breach these agreements, and we may not have adequate remedies for wrongdoing. In addition, the laws of certain territories in which we develop, manufacture or sell our products may not protect our intellectual property rights to the same extent as do the laws of the United States. In any event, the extent to which we can protect our trade secrets through the use of confidentiality agreements is limited, and our success will depend to a significant extent on our ability to innovate ahead of our competitors.

Our future performance depends, in part, upon our ability to continue to compete successfully worldwide.

Our industry includes large manufacturers with substantial resources to support customers worldwide. Some of our competitors are diversified companies with greater financial resources and more extensive research, engineering, manufacturing, marketing, and customer service and support capabilities than we possess. We face competition from companies whose strategy is to provide a broad array of products and services, some of which compete with the products and services that we offer. These competitors may bundle their products in a manner that may discourage customers from purchasing our products, including pricing such competitive tools significantly below our product offerings. In addition, we face competition from smaller emerging semiconductor equipment companies whose strategy is to provide a portion of the products and services that we offer, using innovative technology to sell products into specialized markets. The strength of our competitive positions in many of our existing markets is largely due to our leading technology, which is the result of continuing significant investments in product research and development. However, we may enter new markets, whether through acquisitions or new internal product development, in which competition is based primarily on product pricing, not technological superiority. Further, some new growth markets that emerge may not require leading technologies. Loss of competitive position in any of the markets we serve, or an inability to sell our products on favorable commercial terms in new markets we may enter, could negatively affect our prices, customer orders, revenues, gross margins and market share, any of which would negatively affect our operating results and financial condition.

Our business would be harmed if we do not receive parts sufficient in number and performance to meet our production requirements and product specifications in a timely and cost-effective manner.

We use a wide range of materials in the production of our products, including custom electronic and mechanical components, and we use numerous suppliers to supply these materials. We generally do not have guaranteed supply arrangements with our suppliers. Because of the variability and uniqueness of customers' orders, we do not maintain an extensive inventory of materials for manufacturing. Through our business interruption planning, we seek to minimize the risk of production and service interruptions and/or shortages of key parts by, among other things, monitoring the financial stability of key suppliers, identifying (but not necessarily qualifying) possible alternative suppliers and maintaining appropriate inventories of key parts. Although we make reasonable efforts to ensure that parts are available from multiple suppliers, certain key parts are available only from a single supplier or a limited group of suppliers. Also, key parts we obtain from some of our suppliers incorporate the suppliers' proprietary intellectual property; in those cases we are increasingly reliant on third parties for high-performance, high-technology components, which reduces the amount of control we have over the availability and protection of the technology and intellectual property that is used in our products. In addition, if certain of our key suppliers experience liquidity issues and are forced to discontinue operations, which is a heightened risk during economic downturns, it could affect their ability to deliver parts and could result in delays for our products. Similarly, especially with respect to suppliers of high-technology components, our suppliers themselves have increasingly complex supply chains, and delays or disruptions at any stage of their supply chains may prevent us from obtaining parts in a timely manner and result in delays for our products. Our operating results and business may be adversely impacted if we are unable to obtain parts

to meet our production requirements and product specifications, or if we are only able to do so on unfavorable terms. Furthermore, a supplier may discontinue production of a particular part for any number of reasons, including the supplier's financial condition or business operational decisions, which would require us to purchase, in a single transaction, a large number of such discontinued parts in order to ensure that a continuous supply of such parts remains available to our customers. Such "end-of-life" parts purchases could result in significant expenditures by us in a particular period, and ultimately any unused parts may result in a significant inventory write-off, either of which could have a material and adverse impact on our financial condition and results of operations for the applicable periods.

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If we fail to operate our business in accordance with our business plan, our operating results, business and stock price may be significantly and adversely impacted.

We attempt to operate our business in accordance with a business plan that is established annually, revised frequently (generally quarterly), and reviewed by management even more frequently (at least monthly). Our business plan is developed based on a number of factors, many of which require estimates and assumptions, such as our expectations of the economic environment, future business levels, our customers' willingness and ability to place orders, lead-times, and future revenue and cash flow. Our budgeted operating expenses, for example, are based in part on our future revenue expectations. However, our ability to achieve our anticipated revenue levels is a function of numerous factors, including the volatile and cyclical nature of our primary industry, customer order cancellations, macroeconomic changes, operational matters regarding particular agreements, our ability to manage customer deliveries, the availability of resources for the installation of our products, delays or accelerations by customers in taking deliveries and the acceptance of our products (for products where customer acceptance is required before we can recognize revenue from such sales), our ability to operate our business and sales processes effectively, and a number of the other risk factors set forth in this Item 1A.

Because our expenses are in most cases relatively fixed in the short term, any revenue shortfall below expectations could have an immediate and significant adverse effect on our operating results. Similarly, if we fail to manage our expenses effectively or otherwise fail to maintain rigorous cost controls, we could experience greater than anticipated expenses during an operating period, which would also negatively affect our results of operations. If we fail to operate our business consistent with our business plan, our operating results in any period may be significantly and adversely impacted. Such an outcome could cause customers, suppliers or investors to view us as less stable, or could cause us to fail to meet financial analysts' revenue or earnings estimates, any of which could have a material adverse impact on our business, financial condition or stock price.

In addition, our management is constantly striving to balance the requirements and demands of our customers with the availability of resources, the need to manage our operating model and other factors. In furtherance of those efforts, we often must exercise discretion and judgment as to the timing and prioritization of manufacturing, deliveries, installations and payment scheduling. Any such decisions may impact our ability to recognize revenue, including the fiscal period during which such revenue may be recognized, with respect to such products, which could have a material adverse effect on our business, financial condition or stock price.

Our outstanding indebtedness was substantially increased in the second quarter of our fiscal year ended June 30, 2015 and, as a result, our capital structure is more highly leveraged.

As of December 31, 2016, we had \$3.00 billion aggregate principal amount of outstanding indebtedness, consisting of \$2.50 billion aggregate principal amount of senior, unsecured long-term notes and \$496.3 million of term loans under a Credit Agreement (the "Credit Agreement"). Additionally, we have commitments for an unfunded revolving credit facility of \$500.0 million under the Credit Agreement. We may incur additional indebtedness in the future by accessing the unfunded revolving credit facility under the Credit Agreement and/or entering into new financing arrangements. Our ability to pay interest and repay the principal of our current indebtedness is dependent upon our ability to manage our business operations, our credit rating, the ongoing interest rate environment and the other risk factors discussed in this section. There can be no assurance that we will be able to manage any of these risks successfully.

In addition, the interest rates of the senior, unsecured long-term notes may be subject to adjustments from time to time if Moody's Investors Service, Inc. ("Moody's"), Standard & Poor's Ratings Services ("S&P") or, under certain circumstances, a substitute rating agency selected by us as a replacement for Moody's or S&P, as the case may be (a "Substitute Rating Agency"), downgrades (or subsequently upgrades) its rating assigned to the respective series of notes such that the adjusted rating is below investment grade. Accordingly, changes by Moody's, S&P, or a Substitute Rating Agency to the rating of any series of notes, our outlook or credit rating could require us to pay additional interest, which may negatively affect the value and liquidity of our debt and the market price of our common stock could decline. Factors that can affect our credit rating include changes in our operating performance, the economic environment, conditions in the semiconductor and semiconductor equipment industries, our financial position, including the incurrence of additional indebtedness, and our business strategy.

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In certain circumstances involving a change of control followed by a downgrade of the rating of a series of notes by at least two of Moody's, S&P and Fitch Inc., unless we have exercised its right to redeem the notes of such series, we will be required to make an offer to repurchase all or, at the holder's option, any part, of each holder's notes of that series pursuant to the offer described below (the "Change of Control Offer"). In the Change of Control Offer, we will be required to offer payment in cash equal to 101% of the aggregate principal amount of notes repurchased plus accrued and unpaid interest, if any, on the notes repurchased, up to, but not including, the date of repurchase. We cannot make any assurance that we will have sufficient financial resources at such time or will be able to arrange financing to pay the repurchase price of that series of notes. Our ability to repurchase that series of notes in such event may be limited by law, by the indenture associated with that series of notes, or by the terms of other agreements to which we may be party at such time. If we fail to repurchase that series of notes as required by the terms of such notes, it would constitute an event of default under the indenture governing that series of notes which, in turn, may also constitute an event of default under other of our obligations.

The term loans under the Credit Agreement bear interest at a floating rate, which is based on the London Interbank Offered Rate plus a fixed spread, and, therefore, any increase in interest rates would require us to pay additional interest, which may have an adverse effect on the value and liquidity of our debt and the market price of our common stock could decline. The interest rate under the Credit Facility is also subject to an adjustment in conjunction with our credit rating downgrades or upgrades. Additionally, under the Credit Agreement, we are required to comply with affirmative and negative covenants, which include the maintenance of certain financial ratios, the details of which can be found in Note 6, "Debt." If we fail to comply with these covenants, we will be in default and our borrowings will become immediately due and payable. There can be no assurance that we will have sufficient financial resources or we will be able to arrange financing to repay our borrowings at such time. In addition, certain of our domestic subsidiaries under the Credit Agreement are required to guarantee our borrowings under the Credit Agreement. In the event that we default on our borrowings, these domestic subsidiaries shall be liable for our borrowings, which could disrupt our operations and result in a material adverse impact on our business, financial condition or stock price. Our leveraged capital structure may adversely affect our financial condition, results of operations and net income per share.

We completed our leveraged recapitalization transaction during the fiscal quarter ended December 31, 2014, which included raising \$3.25 billion in new borrowings, consisting of \$2.50 billion aggregate principal amount of senior, unsecured long-term notes and \$750.0 million of term loans under the Credit Agreement, payment of a special cash dividend of approximately \$2.76 billion and prepayment of our \$750 million of existing senior notes due in 2018. Our issuance and maintenance of higher levels of indebtedness could have adverse consequences including, but not limited to:

- a negative impact on our ability to satisfy our future obligations;
 - an increase in the portion of our cash flows that may have to be dedicated to increased interest and principal payments that may not be available for operations, working capital, capital expenditures, acquisitions, investments, dividends, stock repurchases, general corporate or other purposes;
 - an impairment of our ability to obtain additional financing in the future; and
 - obligations to comply with restrictive and financial covenants as noted in the above risk factor and Note 6, "Debt."
- Our ability to satisfy our future expenses as well as our new debt obligations will depend on our future performance, which will be affected by financial, business, economic, regulatory and other factors. Furthermore, our future operations may not generate sufficient cash flows to enable us to meet our future expenses and service our new debt obligations, which may impact our ability to manage our capital structure to preserve and maintain our investment grade rating. If our future operations do not generate sufficient cash flows, we may need to access the unfunded revolving credit facility of \$500 million under the Credit Agreement or enter into new financing arrangements to obtain necessary funds. If we determine it is necessary to seek additional funding for any reason, we may not be able to obtain such funding or, if funding is available, we may not be able to obtain it on acceptable terms. Any additional borrowing under the Credit Agreement will place further pressure on us to comply with the financial covenants. If we fail to make a payment associated with our new debt obligations, we could be in default on such debt, and such a default could cause us to be in default on our other outstanding indebtedness.

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There can be no assurance that we will continue to declare cash dividends at all or in any particular amounts. Our Board of Directors first instituted a quarterly dividend during the fiscal year ended June 30, 2005. Since that time, we have announced a number of increases in the amount of our quarterly dividend level as well as payment of a special cash dividend that was declared and substantially paid in the second quarter of our fiscal year ended June 30, 2015. We intend to continue to pay quarterly dividends subject to capital availability and periodic determinations by our Board of Directors that cash dividends are in the best interest of our stockholders and are in compliance with all laws and agreements applicable to the declaration and payment of cash dividends by us. Future dividends may be affected by, among other factors: our views on potential future capital requirements for investments in acquisitions and the funding of our research and development; legal risks; stock repurchase programs; changes in federal and state income tax laws or corporate laws; changes to our business model; and our increased interest and principal payments required by our \$3.00 billion aggregate principal amount of outstanding indebtedness and any additional indebtedness that we may incur in the future. Our dividend payments may change from time to time, and we cannot provide assurance that we will continue to declare dividends at all or in any particular amounts. A reduction in our dividend payments could have a negative effect on our stock price.

We are exposed to risks related to our commercial terms and conditions, including our indemnification of third parties, as well as the performance of our products.

Although our standard commercial documentation sets forth the terms and conditions that we intend to apply to commercial transactions with our business partners, counterparties to such transactions may not explicitly agree to our terms and conditions. In situations where we engage in business with a third party without an explicit master agreement regarding the applicable terms and conditions, or where the commercial documentation applicable to the transaction is subject to varying interpretations, we may have disputes with those third parties regarding the applicable terms and conditions of our business relationship with them. Such disputes could lead to a deterioration of our commercial relationship with those parties, costly and time-consuming litigation, or additional concessions or obligations being offered by us to resolve such disputes, or could impact our revenue or cost recognition. Any of these outcomes could materially and adversely affect our business, financial condition and results of operations.

In addition, in our commercial agreements, from time to time in the normal course of business we indemnify third parties with whom we enter into contractual relationships, including customers, suppliers and lessors, with respect to certain matters. We have agreed, under certain conditions, to hold these third parties harmless against specified losses, such as those arising from a breach of representations or covenants, other third party claims that our products when used for their intended purposes infringe the intellectual property rights of such other third parties, or other claims made against certain parties. We may be compelled to enter into or accrue for probable settlements of alleged indemnification obligations, or we may be subject to potential liability arising from our customers' involvements in legal disputes. In addition, notwithstanding the provisions related to limitations on our liability that we seek to include in our business agreements, the counterparties to such agreements may dispute our interpretation or application of such provisions, and a court of law may not interpret or apply such provisions in our favor, any of which could result in an obligation for us to pay material damages to third parties and engage in costly legal proceedings. It is difficult to determine the maximum potential amount of liability under any indemnification obligations, whether or not asserted, due to our limited history of prior indemnification claims and the unique facts and circumstances that are likely to be involved in any particular claim. Our business, financial condition and results of operations in a reported fiscal period could be materially and adversely affected if we expend significant amounts in defending or settling any purported claims, regardless of their merit or outcomes.

We are also exposed to potential costs associated with unexpected product performance issues. Our products and production processes are extremely complex and thus could contain unexpected product defects, especially when products are first introduced. Unexpected product performance issues could result in significant costs being incurred by us, including increased service or warranty costs, providing product replacements for (or modifications to) defective products, litigation related to defective products, reimbursement for damages caused by our products, product recalls, or product write-offs or disposal costs. These costs could be substantial and could have an adverse impact upon our business, financial condition and operating results. In addition, our reputation with our customers could be damaged as a result of such product defects, which could reduce demand for our products and negatively

impact our business.

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Furthermore, we occasionally enter into volume purchase agreements with our larger customers, and these agreements may provide for certain volume purchase incentives, such as credits toward future purchases. We believe that these arrangements are beneficial to our long-term business, as they are designed to encourage our customers to purchase higher volumes of our products. However, these arrangements could require us to recognize a reduced level of revenue for the products that are initially purchased, to account for the potential future credits or other volume purchase incentives. As a result, these volume purchase arrangements, while expected to be beneficial to our business over time, could materially and adversely affect our results of operations in near-term periods, including the revenue we can recognize on product sales and therefore our gross margins.

In addition, we may in limited circumstances enter into agreements that contain customer-specific commitments on pricing, tool reliability, spare parts stocking levels, response time and other commitments. Furthermore, we may give these customers limited audit or inspection rights to enable them to confirm that we are complying with these commitments. If a customer elects to exercise its audit or inspection rights, we may be required to expend significant resources to support the audit or inspection, as well as to defend or settle any dispute with a customer that could potentially arise out of such audit or inspection. To date, we have made no significant accruals in our condensed consolidated financial statements for this contingency. While we have not in the past incurred significant expenses for resolving disputes regarding these types of commitments, we cannot make any assurance that we will not incur any such liabilities in the future. Our business, financial condition and results of operations in a reported fiscal period could be materially and adversely affected if we expend significant amounts in supporting an audit or inspection, or defending or settling any purported claims, regardless of their merit or outcomes.

There are risks associated with our receipt of government funding for research and development.

We are exposed to additional risks related to our receipt of external funding for certain strategic development programs from various governments and government agencies, both domestically and internationally. Governments and government agencies typically have the right to terminate funding programs at any time in their sole discretion, or a project may be terminated by mutual agreement if the parties determine that the project's goals or milestones are not being achieved, so there is no assurance that these sources of external funding will continue to be available to us in the future. In addition, under the terms of these government grants, the applicable granting agency typically has the right to audit the costs that we incur, directly and indirectly, in connection with such programs. Any such audit could result in modifications to, or even termination of, the applicable government funding program. For example, if an audit were to identify any costs as being improperly allocated to the applicable program, those costs would not be reimbursed, and any such costs that had already been reimbursed would have to be refunded. We do not know the outcome of any future audits. Any adverse finding resulting from any such audit could lead to penalties (financial or otherwise), termination of funding programs, suspension of payments, fines and suspension or prohibition from receiving future government funding from the applicable government or government agency, any of which could adversely impact our operating results, financial condition and ability to operate our business.

We have recorded significant restructuring, inventory write-off and asset impairment charges in the past and may do so again in the future, which could have a material negative impact on our business.

Historically, we recorded material restructuring charges related to our prior global workforce reductions, large excess inventory write-offs, and material impairment charges related to our goodwill and purchased intangible assets. During the fourth quarter of fiscal year ended 2015, we implemented a plan to reduce our global employee workforce to streamline our organization and business processes in response to changing customer requirements in our industry.

We substantially completed the global employee workforce reduction during the fiscal year ended June 30, 2016.

Such workforce changes can also temporarily reduce workforce productivity, which could be disruptive to our business and adversely affect our results of operations. In addition, we may not achieve or sustain the expected cost savings or other benefits of our restructuring plans, or do so within the expected time frame. If we again restructure our organization and business processes, implement additional cost reduction actions or discontinue certain business operations, we may take additional, potentially material, restructuring charges related to, among other things, employee terminations or exit costs. We may also be required to write-off additional inventory if our product build plans or usage of service inventory decline. Also, as our lead times from suppliers increase (due to the increasing complexity of the parts and components they provide) and the lead times demanded by our customers decrease (due to

the time pressures they face when introducing new products or technology or bringing new facilities into production), we may be compelled to increase our commitments, and therefore our risk exposure, to inventory purchases to meet our customers' demands in a timely manner, and that inventory may need to be written-off if demand for the underlying product declines for any reason. Such additional write-offs could constitute material charges.

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As noted above, in the past, we recorded a material charge related to the impairment of our goodwill and purchased intangible assets. Goodwill represents the excess of costs over the net fair value of net assets acquired in a business combination. Goodwill is not amortized, but is instead tested for impairment at least annually in accordance with authoritative guidance for goodwill. Purchased intangible assets with estimable useful lives are amortized over their respective estimated useful lives based on economic benefit if known or using the straight-line method, and are reviewed for impairment in accordance with authoritative guidance for long-lived assets. The valuation of goodwill and intangible assets requires assumptions and estimates of many critical factors, including revenue and market growth, operating cash flows, market multiples, and discount rates. A substantial decline in our stock price, or any other adverse change in market conditions, particularly if such change has the effect of changing one of the critical assumptions or estimates we previously used to calculate the value of our goodwill or intangible assets (and, as applicable, the amount of any previous impairment charge), could result in a change to the estimation of fair value that could result in an additional impairment charge.

Any such additional material charges, whether related to restructuring or goodwill or purchased intangible asset impairment, may have a material negative impact on our operating results and related financial statements. We are exposed to risks related to our financial arrangements with respect to receivables factoring and banking arrangements.

We enter into factoring arrangements with financial institutions to sell certain of our trade receivables and promissory notes from customers without recourse. In addition, we maintain bank accounts with several domestic and foreign financial institutions, any of which may prove not to be financially viable. If we were to stop entering into these factoring arrangements, our operating results, financial condition and cash flows could be adversely impacted by delays or failures in collecting trade receivables. However, by entering into these arrangements, and by engaging these financial institutions for banking services, we are exposed to additional risks. If any of these financial institutions experiences financial difficulties or is otherwise unable to honor the terms of our factoring or deposit arrangements, we may experience material financial losses due to the failure of such arrangements or a lack of access to our funds, any of which could have an adverse impact upon our operating results, financial condition and cash flows.

We are subject to the risks of additional government actions in the event we were to breach the terms of any settlement arrangement into which we have entered.

In connection with the settlement of certain government actions and other legal proceedings related to our historical stock option practices, we have explicitly agreed as a condition to such settlements that we will comply with certain laws, such as the books and records provisions of the federal securities laws. If we were to violate any such law, we might not only be subject to the significant penalties applicable to such violation, but our past settlements may also be impacted by such violation, which could give rise to additional government actions or other legal proceedings. Any such additional actions or proceedings may require us to expend significant management time and incur significant accounting, legal and other expenses, and may divert attention and resources from the operation of our business. These expenditures and diversions, as well as an adverse resolution of any such action or proceeding, could have a material adverse effect on our business, financial condition and results of operations.

General Commercial, Operational, Financial and Regulatory Risks

We are exposed to risks associated with a weakening in the condition of the financial markets and the global economy.

The markets for semiconductors, and therefore our business, are ultimately driven by the global demand for electronic devices by consumers and businesses. Economic uncertainty frequently leads to reduced consumer and business spending, which caused our customers to decrease, cancel or delay their equipment and service orders from us in the economic slowdown during fiscal year 2009. In addition, the tightening of credit markets and concerns regarding the availability of credit that accompanied that slowdown made it more difficult for our customers to raise capital, whether debt or equity, to finance their purchases of capital equipment, including the products we sell. Reduced demand, combined with delays in our customers' ability to obtain financing (or the unavailability of such financing), has at times in the past adversely affected our product and service sales and revenues and therefore has harmed our business and operating results, and our operating results and financial condition may again be adversely impacted if economic conditions decline from their current levels.

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In addition, a decline in the condition of the global financial markets could adversely impact the market values or liquidity of our investments. Our investment portfolio includes corporate and government securities, money market funds and other types of debt and equity investments. Although we believe our portfolio continues to be comprised of sound investments due to the quality and (where applicable) credit ratings, a decline in the capital and financial markets would adversely impact the market value of our investments and their liquidity. If the market value of such investments were to decline, or if we were to have to sell some of our investments under illiquid market conditions, we may be required to recognize an impairment charge on such investments or a loss on such sales, either of which could have an adverse effect on our financial condition and operating results.

If we are unable to timely and appropriately adapt to changes resulting from difficult macroeconomic conditions, our business, financial condition or results of operations may be materially and adversely affected.

A majority of our annual revenues are derived from outside the United States, and we maintain significant operations outside the United States. We are exposed to numerous risks as a result of the international nature of our business and operations.

A majority of our annual revenues are derived from outside the United States, and we maintain significant operations outside the United States. We expect that these conditions will continue in the foreseeable future. Managing global operations and sites located throughout the world presents a number of challenges, including but not limited to:

- managing cultural diversity and organizational alignment;
 - exposure to the unique characteristics of each region in the global semiconductor market, which can cause capital equipment investment patterns to vary significantly from period to period;
 - periodic local or international economic downturns;
 - potential adverse tax consequences, including withholding tax rules that may limit the repatriation of our earnings, and higher effective income tax rates in foreign countries where we do business;
 - government controls, either by the United States or other countries, that restrict our business overseas or the import or export of semiconductor products or increase the cost of our operations;
 - compliance with customs regulations in the countries in which we do business;
 - tariffs or other trade barriers (including those applied to our products or to parts and supplies that we purchase);
 - political instability, natural disasters, legal or regulatory changes, acts of war or terrorism in regions where we have operations or where we do business;
 - fluctuations in interest and currency exchange rates may adversely impact our ability to compete on price with local providers or the value of revenues we generate from our international business. Although we attempt to manage some of our near-term currency risks through the use of hedging instruments, there can be no assurance that such efforts will be adequate;
 - longer payment cycles and difficulties in collecting accounts receivable outside of the United States;
 - difficulties in managing foreign distributors (including monitoring and ensuring our distributors' compliance with all applicable United States and local laws); and
 - inadequate protection or enforcement of our intellectual property and other legal rights in foreign jurisdictions.
- Any of the factors above could have a significant negative impact on our business and results of operations.

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We might be involved in claims or disputes related to intellectual property or other confidential information that may be costly to resolve, prevent us from selling or using the challenged technology and seriously harm our operating results and financial condition.

As is typical in the semiconductor equipment industry, from time to time we have received communications from other parties asserting the existence of patent rights, copyrights, trademark rights or other intellectual property rights which they believe cover certain of our products, processes, technologies or information. In addition, we occasionally receive notification from customers who believe that we owe them indemnification or other obligations related to intellectual property claims made against such customers by third parties. With respect to intellectual property infringement disputes, our customary practice is to evaluate such infringement assertions and to consider whether to seek licenses where appropriate. However, we cannot ensure that licenses can be obtained or, if obtained, will be on acceptable terms or that costly litigation or other administrative proceedings will not occur. The inability to obtain necessary licenses or other rights on reasonable terms could seriously harm our results of operations and financial condition. Furthermore, we may potentially be subject to claims by customers, suppliers or other business partners, or by governmental law enforcement agencies, related to our receipt, distribution and/or use of third-party intellectual property or confidential information. Legal proceedings and claims, regardless of their merit, and associated internal investigations with respect to intellectual property or confidential information disputes are often expensive to prosecute, defend or conduct; may divert management's attention and other company resources; and/or may result in restrictions on our ability to sell our products, settlements on significantly adverse terms or adverse judgments for damages, injunctive relief, penalties and fines, any of which could have a significant negative effect on our business, results of operations and financial condition. There can be no assurance regarding the outcome of future legal proceedings, claims or investigations. The instigation of legal proceedings or claims, our inability to favorably resolve or settle such proceedings or claims, or the determination of any adverse findings against us or any of our employees in connection with such proceedings or claims could materially and adversely affect our business, financial condition and results of operations, as well as our business reputation.

We are exposed to various risks related to the legal (including environmental), regulatory and tax environments in which we perform our operations and conduct our business.

We are subject to various risks related to compliance with new, existing, different, inconsistent or even conflicting laws, rules and regulations enacted by legislative bodies and/or regulatory agencies in the countries in which we operate and with which we must comply, including environmental, safety, antitrust, anti-corruption/anti-bribery, unclaimed property and export control regulations. Our failure or inability to comply with existing or future laws, rules or regulations, or changes to existing laws, rules or regulations (including changes that result in inconsistent or conflicting laws, rules or regulations), in the countries in which we operate could result in violations of contractual or regulatory obligations that may adversely affect our operating results, financial condition and ability to conduct our business. From time to time, we may receive inquiries or audit notices from governmental or regulatory bodies, or we may participate in voluntary disclosure programs, related to legal, regulatory or tax compliance matters, and these inquiries, notices or programs may result in significant financial cost (including investigation expenses, defense costs, assessments and penalties), reputational harm and other consequences that could materially and adversely affect our operating results and financial condition.

Our properties and many aspects of our business operations are subject to various domestic and international environmental laws and regulations, including those that control and restrict the use, transportation, emission, discharge, storage and disposal of certain chemicals, gases and other substances. Any failure to comply with applicable environmental laws, regulations or requirements may subject us to a range of consequences, including fines, suspension of certain of our business activities, limitations on our ability to sell our products, obligations to remediate environmental contamination, and criminal and civil liabilities or other sanctions. In addition, changes in environmental regulations (including regulations relating to climate change and greenhouse gas emissions) could require us to invest in potentially costly pollution control equipment, alter our manufacturing processes or use substitute (potentially more expensive and/or rarer) materials. Further, we use hazardous and other regulated materials that subject us to risks of strict liability for damages caused by any release, regardless of fault. We also face increasing complexity in our manufacturing, product design and procurement operations as we adjust to new and prospective

requirements relating to the materials composition of our products, including restrictions on lead and other substances and requirements to track the sources of certain metals and other materials. The cost of complying, or of failing to comply, with these and other regulatory restrictions or contractual obligations could adversely affect our operating results, financial condition and ability to conduct our business.

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In addition, we may from time to time be involved in legal proceedings or claims regarding employment, immigration, contracts, product performance, product liability, antitrust, environmental regulations, securities, unfair competition and other matters (in addition to proceedings and claims related to intellectual property matters, which are separately discussed elsewhere in this Item 1A). These legal proceedings and claims, regardless of their merit, may be time-consuming and expensive to prosecute or defend, divert management's attention and resources, and/or inhibit our ability to sell our products. There can be no assurance regarding the outcome of current or future legal proceedings or claims, which could adversely affect our operating results, financial condition and ability to operate our business. Regulations related to "conflict minerals" may force us to incur additional expenses, may result in damage to our business reputation and may adversely impact our ability to conduct our business.

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the SEC adopted requirements for companies that use certain minerals and derivative metals (referred to as "conflict minerals," regardless of their actual country of origin) in their products. Some of these metals are commonly used in electronic equipment and devices, including our products. These requirements require companies to annually investigate, disclose and report whether or not such metals originated from the Democratic Republic of Congo or adjoining countries. We have an extremely complex supply chain, with numerous suppliers (many of whom are not obligated to investigate their own supply chains) for the components and parts used in each of our products. As a result, we may incur significant costs to comply with the diligence and disclosure requirements, including costs related to determining the source of any of the relevant metals used in our products. In addition, because our supply chain is so complex, we may not be able to sufficiently verify the origin of all the relevant metals used in our products through the due diligence procedures that we implement, which may harm our business reputation. Though we do not anticipate that our customers will need to know our conflict mineral status to satisfy their own SEC reporting obligations (if any), we may also face difficulties in satisfying customers if they nonetheless require that we prove or certify that our products are "conflict free." Key components and parts that can be shown to be "conflict free" may not be available to us in sufficient quantity, or at all, or may only be available at significantly higher cost to us. If we are not able to meet customer requirements, customers may choose to disqualify us as a supplier. Any of these outcomes could adversely impact our business, financial condition or operating results.

We depend on key personnel to manage our business effectively, and if we are unable to attract, retain and motivate our key employees, our sales and product development could be harmed.

Our employees are vital to our success, and our key management, engineering and other employees are difficult to replace. We generally do not have employment contracts with our key employees. Further, we do not maintain key person life insurance on any of our employees. The expansion of high technology companies worldwide has increased demand and competition for qualified personnel. In addition, we experienced employee attrition above our normal levels during the pendency of the Merger with Lam Research, especially within the general and administrative functions. We will need to devote additional effort and resources in the near term to filling the positions for which we experienced employee departures over the last year. If we are unable to attract and retain key personnel, or if we are not able to attract, assimilate and retain additional highly qualified employees to meet our current and future needs, our business and operations could be harmed.

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We outsource a number of services to third-party service providers, which decreases our control over the performance of these functions. Disruptions or delays at our third-party service providers could adversely impact our operations. We outsource a number of services, including our transportation, information systems management and logistics management of spare parts and certain accounting and procurement functions, to domestic and overseas third-party service providers. While outsourcing arrangements may lower our cost of operations, they also reduce our direct control over the services rendered. It is uncertain what effect such diminished control will have on the quality or quantity of products delivered or services rendered, on our ability to quickly respond to changing market conditions, or on our ability to ensure compliance with all applicable domestic and foreign laws and regulations. In addition, many of these outsourced service providers, including certain hosted software applications that we use for confidential data storage, employ “cloud computing” technology for such storage (which refers to an information technology hosting and delivery system in which data is not stored within the user’s physical infrastructure but instead is delivered to and consumed by the user as an Internet-based service). These providers’ cloud computing systems may be susceptible to “cyber incidents,” such as intentional cyber attacks aimed at theft of sensitive data or inadvertent cyber-security compromises, which are outside of our control. If we do not effectively develop and manage our outsourcing strategies, if required export and other governmental approvals are not timely obtained, if our third-party service providers do not perform as anticipated, or do not adequately protect our data from cyber-related security breaches, or if there are delays or difficulties in enhancing business processes, we may experience operational difficulties (such as limitations on our ability to ship products), increased costs, manufacturing or service interruptions or delays, loss of intellectual property rights or other sensitive data, quality and compliance issues, and challenges in managing our product inventory or recording and reporting financial and management information, any of which could materially and adversely affect our business, financial condition and results of operations.

We are exposed to risks related to cybersecurity threats and cyber incidents.

In the conduct of our business, we collect, use, transmit and store data on information systems. This data includes confidential information, transactional information and intellectual property belonging to us, our customers and our business partners, as well as personally-identifiable information of individuals. We allocate significant resources to network security, data encryption and other measures to protect our information systems and data from unauthorized access or misuse. Despite our ongoing efforts to enhance our network security measures, our information systems are susceptible to computer viruses, cyber-related security breaches and similar disruptions from unauthorized intrusions, tampering, misuse, criminal acts, including phishing, or other events or developments that we may be unable to anticipate or fail to mitigate and are subject to the inherent vulnerabilities of network security measures. We have experienced cyber-related attacks in the past, and may experience cyber-related attacks in the future. Our security measures may also be breached due to employee errors, malfeasance, or otherwise. Third parties may also attempt to influence employees, users, suppliers or customers to disclose sensitive information in order to gain access to our, our customers’ or business partners’ data. Because the techniques used to obtain unauthorized access to the information systems change frequently, and may not be recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures.

Any of such occurrences could result in disruptions to our operations; misappropriation, corruption or theft of confidential information, including intellectual property and other critical data, of KLA-Tencor, our customers and other business partners; misappropriation of funds and company assets; reduced value of our investments in research, development and engineering; litigation with, or payment of damages to, third parties; reputational damage; costs to comply with regulatory inquiries or actions; data privacy issues; costs to rebuild our internal information systems; and increased cybersecurity protection and remediation costs.

We carry insurance that provides some protection against the potential losses arising from a cybersecurity incident but it will not likely cover all such losses, and the losses that it does not cover may be significant.

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We rely upon certain critical information systems for our daily business operations. Our inability to use or access our information systems at critical points in time could unfavorably impact our business operations.

Our global operations are dependent upon certain information systems, including telecommunications, the internet, our corporate intranet, network communications, email and various computer hardware and software applications. System failures or malfunctioning, such as difficulties with our customer relationship management (“CRM”) system, could disrupt our operations and our ability to timely and accurately process and report key components of our financial results. Our enterprise resource planning (“ERP”) system is integral to our ability to accurately and efficiently maintain our books and records, record transactions, provide critical information to our management, and prepare our financial statements. Any disruptions or difficulties that may occur in connection with our ERP system or other systems (whether in connection with the regular operation, periodic enhancements, modifications or upgrades of such systems or the integration of our acquired businesses into such systems) could adversely affect our ability to complete important business processes, such as the evaluation of our internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act of 2002. Any of these events could have an adverse effect on our business, operating results and financial condition.

Acquisitions are an important element of our strategy but, because of the uncertainties involved, we may not find suitable acquisition candidates and we may not be able to successfully integrate and manage acquired businesses. We are also exposed to risks in connection with strategic alliances into which we may enter.

In addition to our efforts to develop new technologies from internal sources, part of our growth strategy is to pursue acquisitions and acquire new technologies from external sources. As part of this effort, we may make acquisitions of, or significant investments in, businesses with complementary products, services and/or technologies. There can be no assurance that we will find suitable acquisition candidates or that acquisitions we complete will be successful. In addition, we may use equity to finance future acquisitions, which would increase our number of shares outstanding and be dilutive to current stockholders.

If we are unable to successfully integrate and manage acquired businesses or if acquired businesses perform poorly, then our business and financial results may suffer. It is possible that the businesses we have acquired, as well as businesses that we may acquire in the future, may perform worse than expected or prove to be more difficult to integrate and manage than anticipated. In addition, we may lose key employees of the acquired companies. As a result, risks associated with acquisition transactions may give rise to a material adverse effect on our business and financial results for a number of reasons, including:

- we may have to devote unanticipated financial and management resources to acquired businesses;
 - the combination of businesses may cause the loss of key personnel or an interruption of, or loss of momentum in, the activities of our company and/or the acquired business;
- we may not be able to realize expected operating efficiencies or product integration benefits from our acquisitions;
- we may experience challenges in entering into new market segments for which we have not previously manufactured and sold products;
- we may face difficulties in coordinating geographically separated organizations, systems and facilities;
 - the customers, distributors, suppliers, employees and others with whom the companies we acquire have business dealings may have a potentially adverse reaction to the acquisition;
- we may have to write-off goodwill or other intangible assets; and
- we may incur unforeseen obligations or liabilities in connection with acquisitions.

At times, we may also enter into strategic alliances with customers, suppliers or other business partners with respect to development of technology and intellectual property. These alliances typically require significant investments of capital and exchange of proprietary, highly sensitive information. The success of these alliances depends on various factors over which we may have limited or no control and requires ongoing and effective cooperation with our strategic partners. Mergers and acquisitions and strategic alliances are inherently subject to significant risks, and the inability to effectively manage these risks could materially and adversely affect our business, financial condition and operating results.

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Disruption of our manufacturing facilities or other operations, or in the operations of our customers, due to earthquake, flood, other natural catastrophic events, health epidemics or terrorism could result in cancellation of orders, delays in deliveries or other business activities, or loss of customers and could seriously harm our business. We have significant manufacturing operations in the United States, Singapore, Israel, Germany and China. In addition, our business is international in nature, with our sales, service and administrative personnel and our customers located in numerous countries throughout the world. Operations at our manufacturing facilities and our assembly subcontractors, as well as our other operations and those of our customers, are subject to disruption for a variety of reasons, including work stoppages, acts of war, terrorism, health epidemics, fire, earthquake, volcanic eruptions, energy shortages, flooding or other natural disasters. Such disruption could cause delays in, among other things, shipments of products to our customers, our ability to perform services requested by our customers, or the installation and acceptance of our products at customer sites. We cannot ensure that alternate means of conducting our operations (whether through alternate production capacity or service providers or otherwise) would be available if a major disruption were to occur or that, if such alternate means were available, they could be obtained on favorable terms. In addition, as part of our cost-cutting actions, we have consolidated several operating facilities. Our California operations are now primarily centralized in our Milpitas facility. The consolidation of our California operations into a single campus could further concentrate the risks related to any of the disruptive events described above, such as acts of war or terrorism, earthquakes, fires or other natural disasters, if any such event were to impact our Milpitas facility. We are predominantly uninsured for losses and interruptions caused by terrorist acts and acts of war. If international political instability continues or increases, our business and results of operations could be harmed. The threat of terrorism targeted at, or acts of war in, the regions of the world in which we do business increases the uncertainty in our markets. Any act of terrorism or war that affects the economy or the semiconductor industry could adversely affect our business. Increased international political instability in various parts of the world, disruption in air transportation and further enhanced security measures as a result of terrorist attacks may hinder our ability to do business and may increase our costs of operations. We maintain significant manufacturing and research and development operations in Israel, an area that has historically experienced a high degree of political instability, and we are therefore exposed to risks associated with future instability in that region. Such instability could directly impact our ability to operate our business (or our customers' ability to operate their businesses) in the affected region, cause us to incur increased costs in transportation, make such transportation unreliable, increase our insurance costs, and cause international currency markets to fluctuate. Such instability could also have the same effects on our suppliers and their ability to timely deliver their products. If international political instability continues or increases in any region in which we do business, our business and results of operations could be harmed. We are predominantly uninsured for losses and interruptions caused by terrorist acts and acts of war. We self-insure certain risks including earthquake risk. If one or more of the uninsured events occurs, we could suffer major financial loss. We purchase insurance to help mitigate the economic impact of certain insurable risks; however, certain risks are uninsurable, are insurable only at significant cost or cannot be mitigated with insurance. Accordingly, we may experience a loss that is not covered by insurance, either because we do not carry applicable insurance or because the loss exceeds the applicable policy amount or is less than the deductible amount of the applicable policy. For example, we do not currently hold earthquake insurance. An earthquake could significantly disrupt our manufacturing operations, a significant portion of which are conducted in California, an area highly susceptible to earthquakes. It could also significantly delay our research and engineering efforts on new products, much of which is also conducted in California. We take steps to minimize the damage that would be caused by an earthquake, but there is no certainty that our efforts will prove successful in the event of an earthquake. We self-insure earthquake risks because we believe this is a prudent financial decision based on our large cash reserves and the high cost and limited coverage available in the earthquake insurance market. Certain other risks are also self-insured either based on a similar cost-benefit analysis, or based on the unavailability of insurance. If one or more of the uninsured events occurs, we could suffer major financial loss.

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We are exposed to foreign currency exchange rate fluctuations. Although we hedge certain currency risks, we may still be adversely affected by changes in foreign currency exchange rates or declining economic conditions in these countries.

We have some exposure to fluctuations in foreign currency exchange rates, primarily the Japanese Yen and the euro. We have international subsidiaries that operate and sell our products globally. In addition, an increasing proportion of our manufacturing activities are conducted outside of the United States, and many of the costs associated with such activities are denominated in foreign currencies. We routinely hedge our exposures to certain foreign currencies with certain financial institutions in an effort to minimize the impact of certain currency exchange rate fluctuations, but these hedges may be inadequate to protect us from currency exchange rate fluctuations. To the extent that these hedges are inadequate, or if there are significant currency exchange rate fluctuations in currencies for which we do not have hedges in place, our reported financial results or the way we conduct our business could be adversely affected. Furthermore, if a financial counterparty to our hedges experiences financial difficulties or is otherwise unable to honor the terms of the foreign currency hedge, we may experience material financial losses. We are exposed to fluctuations in interest rates and the market values of our portfolio investments; impairment of our investments could harm our earnings. In addition, we and our stockholders are exposed to risks related to the volatility of the market for our common stock.

Our investment portfolio primarily consists of both corporate and government debt securities that are susceptible to changes in market interest rates and bond yields. As market interest rates and bond yields increase, those securities with a lower yield-at-cost show a mark-to-market unrealized loss. We believe we have the ability to realize the full value of all these investments upon maturity. However, an impairment of the fair market value of our investments, even if unrealized, must be reflected in our financial statements for the applicable period and may therefore have a material adverse effect on our results of operations for that period.

In addition, the market price for our common stock is volatile and has fluctuated significantly during recent years. The trading price of our common stock could continue to be highly volatile and fluctuate widely in response to various factors, including without limitation conditions in the semiconductor industry and other industries in which we operate, fluctuations in the global economy or capital markets, our operating results or other performance metrics, or adverse consequences experienced by us as a result of any of the risks described elsewhere in this Item 1A. Volatility in the market price of our common stock could cause an investor in our common stock to experience a loss on the value of their investment in us and could also adversely impact our ability to raise capital through the sale of our common stock or to use our common stock as consideration to acquire other companies.

We are exposed to risks in connection with tax and regulatory compliance audits in various jurisdictions.

We are subject to tax and regulatory compliance audits (such as related to customs or product safety requirements) in various jurisdictions, and such jurisdictions may assess additional income or other taxes, penalties, fines or other prohibitions against us. Although we believe our tax estimates are reasonable and that our products and practices comply with applicable regulations, the final determination of any such audit and any related litigation could be materially different from our historical income tax provisions and accruals related to income taxes and other contingencies. The results of an audit or litigation could have a material adverse effect on our operating results or cash flows in the period or periods for which that determination is made.

A change in our effective tax rate can have a significant adverse impact on our business.

We earn profits in, and are therefore potentially subject to taxes in, the U.S. and numerous foreign jurisdictions, including Singapore, Israel and the Cayman Islands, the countries in which we earn the majority of our non-U.S. profits. Due to economic, political or other conditions, tax rates in those jurisdictions may be subject to significant change. A number of factors may adversely impact our future effective tax rates, such as the jurisdictions in which our profits are determined to be earned and taxed; changes in the tax rates imposed by those jurisdictions; the resolution of issues arising from tax audits with various tax authorities; changes in the valuation of our deferred tax assets and liabilities; adjustments to estimated taxes upon finalization of various tax returns; increases in expenses not deductible for tax purposes, including write-offs of acquired in-process research and development and impairment of goodwill in connection with acquisitions; changes in available tax credits; changes in stock-based compensation expense; changes in tax laws or the interpretation of such tax laws (for example, proposals for fundamental United States international

tax reform); changes in generally accepted accounting principles; and the repatriation of earnings from outside the United States for which we have not previously provided for United States taxes. A change in our effective tax rate can materially and adversely impact our results from operations.

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Compliance with federal securities laws, rules and regulations, as well as NASDAQ requirements, has become increasingly complex, and the significant attention and expense we must devote to those areas may have an adverse impact on our business.

Federal securities laws, rules and regulations, as well as NASDAQ rules and regulations, require companies to maintain extensive corporate governance measures, impose comprehensive reporting and disclosure requirements, set strict independence and financial expertise standards for audit and other committee members and impose civil and criminal penalties for companies and their chief executive officers, chief financial officers and directors for securities law violations. These laws, rules and regulations have increased, and in the future are expected to continue to increase, the scope, complexity and cost of our corporate governance, reporting and disclosure practices, which could harm our results of operations and divert management's attention from business operations.

A change in accounting standards or practices or a change in existing taxation rules or practices (or changes in interpretations of such standards, practices or rules) can have a significant effect on our reported results and may even affect reporting of transactions completed before the change is effective.

New accounting pronouncements and taxation rules and varying interpretations of accounting pronouncements and taxation rules have occurred and will continue to occur in the future. Changes to (or revised interpretations or applications of) existing tax or accounting rules or the questioning of current or past practices may adversely affect our reported financial results or the way we conduct our business.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Equity Repurchase Plans

Our Board of Directors has authorized a program for us to repurchase shares of our common stock under which an aggregate of approximately 5.9 million shares were available for repurchase as of December 31, 2016. We did not repurchase any shares during the three months ended December 31, 2016.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

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ITEM 6. EXHIBITS

| Exhibit Number | Exhibit Description | Incorporated by Reference | | |
|----------------|--|---------------------------|---------------|----------------------------|
| | | Form | File Number | Exhibit Filing Number Date |
| 2.1 | Termination Agreement with Lam Research Corporation | 8-K | 000-099922.1 | 10/6/2016 |
| 10.1 | Amended and Restated Executive Severance Plan* | 8-K | 000-0999210.1 | 10/20/2016 |
| 31.1 | Certification of Chief Executive Officer Under Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934 | | | |
| 31.2 | Certification of Chief Financial Officer Under Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934 | | | |
| 32 | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 | | | |
| 101.INS | XBRL Instance Document | | | |
| 101.SCH | XBRL Taxonomy Extension Schema Document | | | |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document | | | |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document | | | |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document | | | |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document | | | |

* Denotes a management contract, plan or arrangement.

+ Confidential treatment has been requested as to a portion of this exhibit.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

KLA-Tencor Corporation
(Registrant)

January 26, 2017 /s/ RICHARD P. WALLACE
(Date) Richard P. Wallace
President and Chief Executive Officer
(Principal Executive Officer)

January 26, 2017 /s/ BREN D. HIGGINS
(Date) Bren D. Higgins
Executive Vice President and Chief Financial Officer
(Principal Financial Officer)

January 26, 2017 /s/ VIRENDRA A. KIRLOSKAR
(Date) Virendra A. Kirloskar
Senior Vice President and Chief Accounting Officer
(Principal Accounting Officer)

Table of ContentsKLA-TENCOR CORPORATION
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