

ELECTRO SCIENTIFIC INDUSTRIES INC

Form 10-Q

November 07, 2013

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 28, 2013

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: 0-12853

ELECTRO SCIENTIFIC INDUSTRIES, INC.

Oregon 93-0370304
(State or other jurisdiction of incorporation (I.R.S. Employer Identification No.)
or organization)

13900 N.W. Science Park Drive, Portland, Oregon 97229
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: 503-641-4141

Registrant's web address: www.esi.com

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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, 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

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

Yes No

The number of shares outstanding of the Registrant's Common Stock as of November 1, 2013 was 30,018,232 shares.

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 2014 FORM 10-Q QUARTERLY REPORT
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CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands)

ASSETS

Current assets:

	Sep 28, 2013	Mar 30, 2013
Cash and cash equivalents	\$71,975	\$88,913
Short-term investments	49,897	56,144
Trade receivables, net of allowances of \$465 and \$442	34,701	31,779
Inventories	70,208	63,067
Shipped systems pending acceptance	549	1,007
Deferred income taxes, net	1,737	1,682
Other current assets	4,890	3,898
Total current assets	233,957	246,490
Non-current assets:		
Non-current investments	10,388	12,329
Property, plant and equipment, net of accumulated depreciation of \$101,916 and \$98,734	28,209	27,894
Non-current deferred income taxes, net	3,421	3,766
Goodwill	7,889	7,889
Acquired intangible assets, net of accumulated amortization of \$16,938 and \$15,393	8,283	9,088
Other assets	16,770	14,752
Total assets	\$308,917	\$322,208

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities:

Accounts payable	\$15,534	\$16,958
Accrued liabilities	22,353	24,930
Deferred revenue	7,855	10,196
Total current liabilities	45,742	52,084
Non-current liabilities:		
Income taxes payable	6,214	5,982
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, without par value; 1,000 shares authorized; no shares issued	—	—
Common stock, without par value; 100,000 shares authorized; 30,018 and 29,583 issued and outstanding	180,069	176,631
Retained earnings	76,402	87,228
Accumulated other comprehensive income, other	490	283
Total shareholders' equity	256,961	264,142
Total liabilities and shareholders' equity	\$308,917	\$322,208

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements

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ELECTRO SCIENTIFIC INDUSTRIES, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
 (Unaudited)

(In thousands, except per share amounts)	Fiscal quarter ended		Two fiscal quarters ended		
	Sep 28, 2013	Sep 29, 2012	Sep 28, 2013	Sep 29, 2012	
Net sales	\$59,647	\$80,152	\$105,819	\$139,121	
Cost of sales	35,015	46,632	61,801	81,948	
Gross profit	24,632	33,520	44,018	57,173	
Operating expenses:					
Selling, service and administration	14,251	15,114	28,798	30,777	
Research, development and engineering	9,719	10,527	18,144	20,061	
Gain on acquisition of Semiconductor Systems business	(35	) —	(499) —	
Net operating expenses	23,935	25,641	46,443	50,838	
Operating income (loss)	697	7,879	(2,425	) 6,335
Non-operating (expense) income:					
Other-than-temporary impairment of cost based investments	(3,588	) —	(3,588) —	
Interest and other income (expense), net	80	91	20	(59)
Total non-operating (expense) income	(3,508) 91	(3,568) (59)
(Loss) income before income taxes	(2,811	) 7,970	(5,993	) 6,276
(Benefit from) provision for income taxes	(33	) 2,759	68	2,009
Net (loss) income	\$(2,778	) \$5,211	\$(6,061	) \$4,267
Net (loss) income per share—basic	\$(0.09	) \$0.18	\$(0.20	) \$0.15
Net (loss) income per share—diluted	\$(0.09	) \$0.17	\$(0.20	) \$0.14
Weighted average number of shares—basic	29,967	29,339	29,856	29,228	
Weighted average number of shares—diluted	29,967	29,961	29,856	29,912	
Cash dividends paid per outstanding common share	\$0.08	\$0.08	\$0.16	\$0.16	

ELECTRO SCIENTIFIC INDUSTRIES, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS COMPREHENSIVE (LOSS) INCOME
 (Unaudited)

(In thousands)	Fiscal quarter ended		Two fiscal quarters ended	
	Sep 28, 2013	Sep 29, 2012	Sep 28, 2013	Sep 29, 2012
Net (loss) income	\$(2,778	) \$5,211	\$(6,061	) \$4,267
Other comprehensive (loss) income:				
Foreign currency translation adjustment, net of taxes of \$108, \$41, \$108 and \$153	291	74	192	276
Accumulated other comprehensive income related to benefit plan obligation, net of taxes of \$2, \$1, \$3 and \$3	3	2	6	5
Net unrealized gain on available-for-sale securities, net of taxes of \$5, \$2, \$5 and \$4	27	4	8	6
Comprehensive (loss) income	\$(2,457	) \$5,291	\$(5,855	) \$4,554

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements

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ELECTRO SCIENTIFIC INDUSTRIES, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
 (Unaudited)

(In thousands)	Two fiscal quarters ended	
	Sep 28, 2013	Sep 29, 2012
CASH FLOWS FROM OPERATING ACTIVITIES		
Net (loss) income	\$(6,061	) \$4,267
Adjustments to reconcile net (loss) income to net cash provided by (used in) operating activities:		
Depreciation and amortization	3,521	4,598
Amortization of acquired intangible assets	1,546	1,155
Share-based compensation expense	3,868	4,650
Loss on sale of property and equipment, net	37	—
Gain on acquisition of Semiconductor Systems business	(499) —
Other-than-temporary impairment of cost based investments	3,588	—
(Increase) decrease in deferred income taxes	(126	) 2,665
Changes in operating accounts, net of acquisitions:		
Decrease (increase) in trade receivables, net	1,101	(25,254)
Increase in inventories	(170	) (11,859)
Decrease in shipped systems pending acceptance	458	1,098
(Increase) decrease in other current assets	(801	) 130
(Decrease) increase in accounts payable and accrued liabilities	(7,051	) 20,107
Decrease in deferred revenue	(2,520	) (1,407)
Net cash (used in) provided by operating activities	(3,109	) 150
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investments	(193,421	) (559,927)
Proceeds from sales and maturities of investments	201,615	577,733
Purchase of property, plant and equipment	(2,279	) (2,511)
Cash paid for business acquisitions	(9,731	) (9,466)
Minority equity investment	(5,000) —
Decrease in other assets	(67	) (63)
Net cash (used in) provided by investing activities	(8,883	) 5,766
CASH FLOWS FROM FINANCING ACTIVITIES		
Cash dividends paid to shareholders	(4,765	) (4,673)
Stock plan activity, net	(430	) (478)
Excess tax benefit of share-based compensation	—	54
Net cash used in financing activities	(5,195	) (5,097)
Effect of exchange rate changes on cash	249	357
NET CHANGE IN CASH AND CASH EQUIVALENTS	(16,938	) 1,176
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	88,913	69,780
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$71,975	\$70,956
SUPPLEMENTAL CASH FLOW INFORMATION		
Cash paid for interest	\$—	\$ (550)
Cash paid for income taxes	\$(2,540) \$—
Income tax refunds received	\$19	\$650

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements

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ELECTRO SCIENTIFIC INDUSTRIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

These unaudited interim condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted in these interim statements. Accordingly, these condensed consolidated financial statements are to be read in conjunction with the financial statements and notes included in the Company's Annual Report on Form 10-K for its fiscal year ended March 30, 2013. These interim statements include all adjustments (consisting of only normal recurring adjustments and accruals) necessary for a fair presentation of results for the interim periods presented. The results for interim periods are not necessarily indicative of the results of operations for the entire year.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of commitments and contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results may differ from those estimates.

Management believes that the estimates used are reasonable. Significant estimates made by management include: revenue recognition; inventory valuation; product warranty reserves; allowance for doubtful accounts; accrued restructuring costs; share-based compensation; income taxes including the valuation of deferred tax assets; fair value measurements; valuation of cost method equity investments; valuation of long-lived assets; valuation of goodwill; and valuation of acquired technology.

There have been no significant changes to the Company's significant accounting policies from those presented in Note 2 "Summary of Significant Accounting Policies" to the consolidated financial statements included in the Company's Annual Report on Form 10-K for its fiscal year ended March 30, 2013. All references to years or quarters relate to fiscal years or fiscal quarters unless otherwise noted.

2. Recent Accounting Pronouncements

There have been no recent accounting pronouncements or changes in accounting pronouncements during the quarter ended September 28, 2013 that are of significance to the Company.

3. Share-Based Compensation

The Company recognizes expense related to the fair value of its share-based compensation awards using the Black-Scholes model to estimate the fair value of awards on the date of grant, except for unvested restricted stock unit awards which are valued at the fair value of the Company's stock on the date of award. The Company recognizes compensation expense for all share-based compensation awards on a straight-line basis over the requisite service period of the award.

Stock-settled stock appreciation rights (SARs) grant the right to receive shares of the Company's stock equivalent to the increase in stock value of a specified number of shares over a specified period of time, divided by the stock price at the time of exercise. The Company uses the Black-Scholes model to estimate the fair value of SARs. Similar to options, SARs are recorded at the fair value of the award at grant date and the expense is recognized on a straight-line basis over the requisite service period of the award.

The Company granted a total of 616,000 restricted stock unit awards during the first two quarters of 2014, but did not grant any stock options or SARs. The Company granted 550,500 restricted stock unit awards and 5,000 stock options

during the first two quarters of 2013, but did not grant any SARs.

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Share-based compensation expense was included in the Company's Condensed Consolidated Statements of Operations as follows:

(In thousands)	Fiscal quarter ended		Two fiscal quarters ended	
	Sep 28, 2013	Sep 29, 2012	Sep 28, 2013	Sep 29, 2012
Cost of sales	\$189	\$217	\$374	\$433
Selling, service and administration	666	1,017	2,760	3,278
Research, development and engineering	379	666	734	1,166
Total share-based compensation expense	\$1,234	\$1,900	\$3,868	\$4,877

No share-based compensation costs were capitalized in the first two quarters of 2014. As of September 28, 2013, the Company had \$8.6 million of total unrecognized share-based compensation costs, net of estimated forfeitures, which are expected to be recognized over a weighted average period of 2.1 years.

4. Fair Value Measurements

Financial Assets Measured at Fair Value

ASC Topic 820 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include the following:

- Level 1, defined as observable inputs such as quoted prices in active markets for identical assets or liabilities;
- Level 2, defined as inputs that are observable either directly or indirectly such as quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active and other inputs that can be corroborated by observable market data; and
- Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

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The Company's fair value hierarchy for its financial assets measured at fair value on a recurring basis as of September 28, 2013 and March 30, 2013 was as follows (in thousands):

September 28, 2013	Level 1	Level 2	Level 3	Total
Money market securities	\$10,265	\$—	\$—	\$10,265
Corporate Bonds	—	17,723	—	17,723
Government agencies	—	17,592	—	17,592
Municipal bonds	—	16,917	—	16,917
Commercial paper	—	14,397	—	14,397
Forward purchase or (sale) contracts:				
Japanese Yen	—	23	—	23
New Taiwan Dollar	—	8	—	8
Korean Won	—	118	—	118
Euro	—	(235	) —	(235
British Pound	—	158	—	158
Chinese Renminbi	—	(2	) —	(2
Singapore Dollar	—	4	—	4
March 30, 2013	Level 1	Level 2	Level 3	Total
Money market securities	\$9,457	\$—	\$—	\$9,457
Commercial paper	—	51,443	—	51,443
Government agencies	—	29,646	—	29,646
Corporate bonds	—	18,396	—	18,396
Municipal bonds	—	3,389	—	3,389
Forward purchase or (sale) contracts:				
Japanese Yen	—	176	—	176
New Taiwan Dollar	—	(10	) —	(10
Korean Won	—	(46	) —	(46
Euro	—	100	—	100
British Pound	—	38	—	38
Chinese Renminbi	—	(1	) —	(1
Singapore Dollar	—	(12	) —	(12

For Level 1 assets, the Company utilized quoted prices in active markets for identical assets.

For Level 2 assets, exclusive of forward contracts, the Company utilized quoted prices in active markets for similar assets. For forward contracts, spot prices at September 28, 2013 and March 30, 2013 were utilized to calculate fair values.

During the first two quarters of 2014, there were no transfers between Level 1 and Level 2 assets.

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Investments

Certain information regarding the Company's investments at September 28, 2013 and March 30, 2013 was as follows (in thousands):

September 28, 2013	Cost	Unrealized Gain	Loss	Fair Value
Available-for-sale securities (current):				
Government agencies	\$ 15,588	\$ 5	\$—	\$ 15,593
Commercial paper	14,397	—	—	14,397
Corporate Bonds	13,394	9	—	13,403
Municipal Bonds	12,842	6	—	12,848
	\$ 56,221	\$ 20	\$—	\$ 56,241
Available-for-sale securities (non-current):				
Corporate Bonds	\$ 4,326	\$—	\$(6	) \$ 4,320
Municipal Bonds	4,064	5	—	4,069
Government agencies	1,996	3	—	1,999
	\$ 10,386	\$ 8	\$(6	) \$ 10,388
March 30, 2013	Cost	Unrealized Gain	Loss	Fair Value
Available-for-sale securities (current):				
Commercial paper	\$ 51,443	\$—	\$—	\$ 51,443
Government agencies	26,556	8	—	26,564
Corporate Bonds	10,473	7	—	10,480
Municipal Bonds	2,058	—	—	2,058
	\$ 90,530	\$ 15	\$—	\$ 90,545
Available-for-sale securities (non-current):				
Corporate Bonds	\$ 7,923	\$—	\$(7	) \$ 7,916
Government agencies	3,082	—	—	3,082
Municipal Bonds	1,330	1	—	1,331
	\$ 12,335	\$ 1	\$(7	) \$ 12,329

For purposes of determining gross realized gains and losses and reclassification out of accumulated other comprehensive (loss) income, the cost of securities sold is based on specific identification. Net unrealized holding gains and losses on current available-for-sale securities included in accumulated other comprehensive (loss) income were insignificant as of September 28, 2013 and March 30, 2013.

Underlying maturities of investments at September 28, 2013 were \$56.2 million within one year and \$10.4 million between one to five years.

5. Business Acquisitions

Fiscal 2014

On May 3, 2013, the Company completed the purchase of assets related to the Semiconductor Systems business of GSI Group Inc. for \$8.0 million, subject to certain closing working capital adjustments. As of June 29, 2013 the working capital adjustments had not been finalized and were estimated to range from \$1.1 million to \$1.9 million. As such, the Company accrued management's best estimate for the working capital adjustments of \$1.6 million. On September 20, 2013, the Company finalized the closing working capital adjustment and paid an additional \$1.7 million of cash for a total purchase price of \$9.7 million.

The acquisition provides the Company with direct access to industry-leading wafer marking, wafer trimming and circuit trimming laser systems. The purchase price was allocated to the underlying assets acquired and liabilities assumed based on their fair values and resulted in a net gain on bargain purchase of \$0.5 million. The fair value of the acquired net assets of \$10.5 million was in excess of the total purchase consideration of \$9.7 million, primarily due to the recognition of certain intangible assets. The resulting gain of \$0.8 million was partially offset by \$0.3 million of

deferred tax liabilities. Analyses supporting the purchase price allocation included a valuation of assets and liabilities as of the closing date, an analysis of

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intangible assets and a detailed review of the opening balance sheet to determine other significant adjustments required to recognize assets and liabilities at fair value. The acquisition was an asset purchase for tax purposes. As a result of the acquisition, the Company recorded approximately \$8.2 million of inventory, \$3.9 million of accounts receivable and other current assets, \$0.7 million of identifiable intangible assets, \$2.3 million of current liabilities, and a gain on bargain purchase of \$0.8 million. The \$0.7 million of identifiable intangible assets includes approximately \$0.5 million of backlog and \$0.2 million of developed technology. The acquired intangibles will be amortized over their estimated useful lives which range from one to three years.

In the first two quarters of 2014, the Company also incurred approximately \$1.0 million in acquisition related costs which are included in Selling, service and administration expenses in the Condensed Consolidated Statements of Operations.

The operating results of this purchase are included in the Company's results of operations since the date of acquisition. Pro forma financial information has not been provided for the purchase as it was not material to the Company's overall financial position.

Fiscal 2013

On June 14, 2012, the Company acquired Eolite Systems (Eolite), a designer and manufacturer of unique fiber lasers, for \$9.7 million in cash for all its outstanding shares. The purchase price of \$9.5 million, net of cash acquired, was allocated to the underlying assets acquired and liabilities assumed based on their fair values. Analyses supporting the purchase price allocation included a valuation of assets and liabilities as of the closing date, an analysis of intangible assets and a detailed review of the opening balance sheet to determine other significant adjustments required to recognize assets and liabilities at fair value.

The acquisition provides the Company with direct access to differentiated, higher power laser technology which can be used in a broad set of microfabrication applications. The Company has allocated \$3.9 million of the purchase price to goodwill. The premium paid over the fair value of the individual assets acquired and liabilities assumed reflects the Company's view that this acquisition will increase the Company's ability to customize lasers to specific customer applications with differentiated capability. None of the goodwill is deductible for tax purposes.

As a result of the acquisition, the Company recorded \$5.5 million of identifiable intangible assets including approximately \$5.0 million of developed technology, \$0.4 million in customer relationships, and \$0.1 million in trademarks and backlog. The acquired intangibles will be amortized over their estimated useful lives which range from one to nine years.

In the first two quarters of 2013, the Company also incurred approximately \$0.9 million in acquisition-related costs which are included in Selling, service and administration expenses in the Condensed Consolidated Statements of Operations.

The operating results of this acquisition are included in the Company's results of operations since the date of acquisition. Pro forma financial information has not been provided for the acquisition of Eolite as it was not material to the Company's overall financial position.

6. Inventories

Inventories are principally valued at standard costs, which approximate the lower of cost (first-in, first-out) or market. Components of inventories were as follows:

(In thousands)	Sep 28, 2013	Mar 30, 2013
Raw materials and purchased parts	\$37,634	\$44,332
Work-in-process	14,357	8,985
Finished goods	18,217	9,750
	\$70,208	\$63,067

7. Other Current Assets

Other current assets consisted of the following:

(In thousands)	Sep 28, 2013	Mar 30, 2013
Prepaid expenses	\$2,538	\$2,240
Value added tax receivable	1,086	763
Other	1,266	895

\$4,890

\$3,898

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8. Other Assets

Other assets consisted of the following:

(In thousands)	Sep 28, 2013	Mar 30, 2013
Minority equity investment	\$10,378	\$8,966
Consignment and demo equipment, net	4,742	4,263
Other	1,650	1,523
	\$16,770	\$14,752

Minority equity investment represents the Company's investment in OmniGuide, Inc. During the second quarter of 2014, the Company invested \$5.0 million in Series F Preferred Stock of OmniGuide, Inc. As of September 28, 2013, the Company had \$6.0 million invested in Series D Preferred Stock, \$3.0 million invested in Series E Preferred Stock, and \$5.0 million invested in Series F Preferred Stock of OmniGuide, Inc., representing a 15% interest. At each reporting period end, the Company determines whether events or circumstances have occurred that are likely to have a significant adverse effect on the fair value of these investments. If there are no events or circumstances identified that would adversely affect the fair value of the investments, the fair values of the investments are not calculated. In the second quarter of 2014, OmniGuide, Inc. engaged in a Series F Preferred Stock round of equity financing at pricing below previous rounds which was considered a triggering event. As a result, the Company performed a valuation of the investment which resulted in a \$3.6 million impairment charge of our Series D and Series E investments.

9. Accrued Liabilities

Accrued liabilities consisted of the following:

(In thousands)	Sep 28, 2013	Mar 30, 2013
Payroll-related liabilities	\$6,902	\$7,918
Product warranty accrual	5,563	5,411
Purchase order commitments and receipts	2,570	2,533
Pension benefit liabilities	1,656	1,501
Professional fees payable	1,410	1,322
Freight accrual	741	646
Income taxes payable	686	2,884
Customer deposits	430	225
Value added taxes payable	339	258
Restructuring costs payable	327	485
Other	1,729	1,747
	\$22,353	\$24,930

10. Product Warranty

The following is a reconciliation of the changes in the aggregate product warranty accrual:

(In thousands)	Fiscal quarter ended		Two fiscal quarters ended	
	Sep 28, 2013	Sep 29, 2012	Sep 28, 2013	Sep 29, 2012
Product warranty accrual, beginning	\$5,193	\$4,545	\$5,411	\$4,187
Warranty charges incurred, net	(1,722	) (1,866	) (3,543	) (3,910
Provision for warranty charges	2,092	3,417	3,695	5,819
Product warranty accrual, ending	\$5,563	\$6,096	\$5,563	\$6,096

Net warranty charges incurred include labor charges and costs of replacement parts for system repairs under warranty. These costs are recorded net of any estimated cost recoveries resulting from either successful repair of damaged parts or from warranties offered by the Company's suppliers for defective components. The provision for warranty charges reflects the estimate of future anticipated net warranty costs to be incurred for all products under warranty at quarter end and is recorded to cost of sales.

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11. Deferred Revenue

Generally, revenue is recognized upon fulfillment of acceptance criteria at the Company's factory and title transfer which frequently occurs at the time of delivery to a common carrier. Revenue is deferred whenever title transfer is pending and/or acceptance criteria have not yet been fulfilled. Deferred revenue occurrences include sales to Japanese customers, shipments of substantially new products and shipments with custom specifications and acceptance criteria. In sales involving multiple element arrangements, the relative selling price of any undelivered elements, including installation services, is deferred until the elements are delivered and acceptance criteria are met. Revenue related to maintenance and service contracts is deferred and recognized ratably over the duration of the contracts.

The following is a reconciliation of the changes in deferred revenue:

(In thousands)	Fiscal quarter ended		Two fiscal quarters ended	
	Sep 28, 2013	Sep 29, 2012	Sep 28, 2013	Sep 29, 2012
Deferred revenue, beginning	\$10,766	\$10,676	\$10,196	\$10,751
Revenue deferred	6,657	19,631	13,598	37,946
Revenue recognized	(9,568)	(20,851)	(15,939)	(39,241)
Deferred revenue, ending	\$7,855	\$9,456	\$7,855	\$9,456

12. Earnings (Loss) Per Share

The following is a reconciliation of weighted average shares outstanding used in the calculation of basic and diluted earnings per share:

(In thousands, except per share data)	Fiscal quarter ended		Two fiscal quarters ended	
	Sep 28, 2013	Sep 29, 2012	Sep 28, 2013	Sep 29, 2012
Net (loss) income	\$(2,778)	\$5,211	\$(6,061)	\$4,267
Weighted average shares used for basic earnings per share	29,967	29,339	29,856	29,228
Incremental diluted shares	—	622	—	684
Weighted average shares used for diluted earnings per share	29,967	29,961	29,856	29,912
Net (loss) income per share:				
Net (loss) income — basic	\$(0.09)	\$0.18	\$(0.20)	\$0.15
Net (loss) income — diluted	\$(0.09)	\$0.17	\$(0.20)	\$0.14

Awards of options, stock appreciation rights (SARs) and unvested restricted stock units (RSUs) representing an additional 4.1 million and 2.5 million shares of stock for the second quarter of 2014 and 2013, respectively, were not included in the calculation of diluted net earnings per share because their effect would have been antidilutive.

For the two quarters ended September 28, 2013 and September 29, 2012, awards of options, SARs, and unvested RSUs representing an additional 4.1 million and 2.4 million shares, respectively, were not included in the calculation of diluted net earnings per share because their effect would have been antidilutive.

13. Product and Geographic Information

Net sales by product type were as follows:

(In thousands)	Fiscal quarter ended		Two fiscal quarters ended	
	Sep 28, 2013	Sep 29, 2012	Sep 28, 2013	Sep 29, 2012
Interconnect & Microfabrication Group (IMG)	\$38,301	\$69,137	\$72,718	\$116,969
Semiconductor Group (SG)	10,935	3,184	16,548	6,616
Components Group (CG)	10,411	7,831	16,553	15,536
	\$59,647	\$80,152	\$105,819	\$139,121

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Net sales by geographic area, based on the location of the end user, were as follows:

(In thousands)	Fiscal quarter ended		Two fiscal quarters ended	
	Sep 28, 2013	Sep 29, 2012	Sep 28, 2013	Sep 29, 2012
Asia	\$49,439	\$73,580	\$88,274	\$126,034
Americas	7,110	4,532	10,676	8,706
Europe	3,098	2,040	6,869	4,381
	\$59,647	\$80,152	\$105,819	\$139,121

14. Restructuring and Cost Management Plans

In 2013, the Company initiated a restructuring plan to improve efficiency, transition from memory repair and other legacy products, and focus on laser microfabrication for consumer electronics, emerging technologies related to semiconductor 3D packaging, and proprietary laser technology. The planned completion date for remaining actions to be taken under this plan is April 30, 2014. See the Company's Form 10-K for the year ended March 30, 2013 for additional information related to restructuring and cost management plans.

In the first two quarters of 2014, restructuring credits of \$0.1 million were recognized due to changes in estimates. At September 28, 2013 and March 30, 2013, the amount of unpaid restructuring costs included in accrued liabilities was \$0.3 million and \$0.5 million, respectively.

The following table presents the amounts related to restructuring costs payable (in thousands):

Restructuring costs payable balance as of March 30, 2013	\$485	
Employee severance and related benefits:		
Cash payments	(153))
Other adjustments	(5))
Restructuring costs payable balance as of September 28, 2013	327	

15. Shareholders' Equity

Share Repurchase Program

On December 9, 2011, the Board of Directors authorized a share repurchase program totaling \$20.0 million to acquire shares of the Company's outstanding common stock. The repurchases are to be made at management's discretion in the open market or in privately negotiated transactions in compliance with applicable securities laws and other legal requirements and are subject to market conditions, share price and other factors. The Company did not repurchase any shares under this program in either the first two quarters of 2013 or 2014. There is no fixed completion date for the repurchase program.

Dividends

In December 2011, the Board of Directors adopted a dividend policy under which the Company intends to pay quarterly cash dividends. The following table summarizes the quarterly dividend declared and paid by the Company since the second quarter of 2013:

Date Declared	Record Date	Payable Date	Amount per Share
August 8, 2013	August 19, 2013	September 3, 2013	\$0.08
May 14, 2013	June 5, 2013	June 19, 2013	\$0.08
February 7, 2013	February 28, 2013	March 14, 2013	\$0.08
November 8, 2012	November 21, 2012	December 5, 2012	\$0.08
August 9, 2012	August 24, 2012	September 10, 2012	\$0.08

A special dividend of \$2.00 per share was declared by the Board of Directors on December 3, 2012 after the successful settlement of a patent dispute. The special dividend should not be considered a recurring event.

The Company paid aggregate dividends of \$4.8 million and \$4.7 million in the first two quarters of 2014 and 2013, respectively.

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The Company currently anticipates that it will continue to pay cash dividends on a quarterly basis in the future, although the declaration, timing and amount of any future cash dividends are at the discretion of the Board of Directors and will depend on the Company's financial condition, results of operations, capital requirements, business conditions and other factors, as well as a determination that cash dividends are in the best interest of the shareholders.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The statements contained in this report that are not statements of historical fact, including without limitation, statements containing the words "believes," "expects," "anticipates" and similar words, constitute forward-looking statements that are subject to a number of risks and uncertainties. From time to time we may make other forward-looking statements. Investors are cautioned that such forward-looking statements are subject to an inherent risk that actual results may materially differ as a result of many factors, including the risks described in Part II, Item 1A "Risk Factors."

Overview of Business

Electro Scientific Industries, Inc. and its subsidiaries (ESI) is a leading supplier of innovative laser-based manufacturing solutions for the microtechnology industry. Our advanced laser systems enable precise structuring of micron to submicron features in components and devices which are used in a wide variety of end products in the consumer electronics, computer, semiconductor, communications and other markets. These features enable our customers to achieve functionality, or improve yield and productivity in their manufacturing processes that can be critical to their profitability. Founded in 1944, ESI is headquartered in Portland, Oregon, with global operations and subsidiaries in Asia, Canada, Europe and the United States.

Our advanced laser microfabrication systems allow microelectronics, semiconductor, and other microtechnology manufacturers to physically alter select device features during high-volume production in order to increase performance and improve production yields. Laser microfabrication comprises a set of precise micron-level processes, including drilling, scribing, dicing, singulation, cutting, ablating, trimming, and precision marking on multiple types of materials. These processes require application-specific laser systems that are able to meet our customers' exacting performance and productivity requirements. Our laser-based systems improve production yields or enable improved performance for flexible and rigid high density interconnect printed circuit boards, semiconductor devices, light emitting diodes (LEDs), advanced semiconductor packaging, touch-panel glass, flat panel liquid crystal displays (LCDs) and other high value components.

Additionally, we produce high-capacity test and inspection equipment that is critical to the quality control process during the production of multilayer ceramic capacitors (MLCCs). Our equipment ensures that each component meets the electrical and physical tolerances required to perform properly. Lastly, we produce systems that use photonic technology to perform precision inspection for quality control and defect identification.

Summary of Sequential Quarterly Results

The financial results of the quarter ended September 28, 2013, which represented the second quarter of 2014, reflected sequential growth in sales and earnings despite continued challenges in some of our markets. Revenue increased to \$59.6 million from \$46.2 million in the first quarter of 2014 which ended June 29, 2013. However, total order volume for the second quarter of 2014 declined from \$58.3 million to \$46.2 million, primarily due to fewer design wins and lower follow on demand for advanced microfabrication equipment and absorption of capacity in both flex via drilling and component test systems.

Total shipments were \$56.9 million in the second quarter of 2014 compared to \$47.0 million in the first quarter of 2014. By product group, SG shipments decreased by approximately 4%, IMG shipments increased by approximately 18%, and CG shipments increased by approximately 71%, reflecting shipments of the strong systems orders received in the first quarter.

Net sales were \$59.6 million in the second quarter of 2014 compared to \$46.2 million in the first quarter of 2014. All three business groups showed sequential sales growth. IMG increased due to shipment of the strong orders received in the first quarter. CG increased due to shipment of the first quarter orders for our 3510 advanced ceramic capacitor tester. Finally, SG increased as the result of having a full quarter of the acquired Semiconductor Systems business and due to the recognition of revenue deferred from the first quarter.

Gross profit was \$24.6 million in the second quarter of 2014 compared to a gross profit of \$19.4 million in the first quarter of 2014. Gross margin was 41.3% on net sales of \$59.6 million in the second quarter of 2014 compared to a gross profit of 42.0% on net sales of \$46.2 million in the first quarter of 2014. The decrease was driven by a product mix of lower margin products, partially offset by the benefit of higher volume.

Net operating expense of \$23.9 million in the second quarter of 2014 increased \$1.4 million from \$22.5 million in the first quarter of 2014. This increase is due to a \$1.3 million increase in research, development, and engineering (RD&E) and a

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first quarter \$0.4 million gain on bargain purchase of the acquired Semiconductor Systems business of GSI, Inc. which did not repeat, partially offset by a \$0.3 million decrease in selling, service and administration (SS&A). RD&E increased primarily due to an increase in development expenses related to a new strategic customer win, variable expenses, and a full quarter of expenses related to our acquisition of the Semiconductor Systems business. SS&A expense decreased primarily due to \$1.4 million lower share-based compensation expense. Share-based compensation expense during the first quarter included the accelerated expensing associated with the annual grants to the Chief Executive Officer and the immediate vesting of the annual board of director share grants. This decrease was partially offset by a \$0.8 million increase in variable expenses due to higher business volumes and a full quarter of expenses related to our acquisition of the Semiconductor Systems business.

Operating income was \$0.7 million in the second quarter of 2014 compared to an operating loss of \$3.1 million in the first quarter of 2014, an increase of \$3.8 million. The increase in operating income was primarily due to higher sales volumes.

Non-operating expense was \$3.5 million in the second quarter of 2014 compared to expense of \$0.1 million in the first quarter of 2014. This increase is primarily due to a \$3.6 million impairment against our minority equity investment in OmniGuide, Inc.

Provision for income taxes was a benefit of \$33 thousand in the second quarter of 2014 compared to a provision for income taxes of \$101 thousand in the first quarter of 2014. Net loss was \$2.8 million in the second quarter of 2014 compared to a net loss of \$3.3 million in the first quarter of 2014. The improvement in net loss is due to the impact of the items discussed above.

Quarter Ended September 28, 2013 Compared to Quarter Ended September 29, 2012

Results of Operations

The following table presents results of operations data as a percentage of net sales:

	Fiscal quarter ended			
	Sep 28, 2013		Sep 29, 2012	
		%		%
Net sales	100.0		100.0	
Cost of sales	58.7		58.2	
Gross profit	41.3		41.8	
Selling, service and administration	23.9		18.9	
Research, development and engineering	16.3		13.1	
Gain on acquisition of Semiconductor Systems business	(0.1)	—	
Operating income (loss)	1.2		9.8	
Other-than-temporary impairment of cost based investments	(6.0)	—	
Interest and other income, net	0.1		0.1	
Total non-operating (expense) income	(5.9	)	0.1	
(Loss) income before income taxes	(4.7	)	9.9	
(Benefit from) provision for income taxes	—		3.4	
Net (loss) income	(4.7	)%	6.5	%

Net Sales

The following table presents net sales information by product group:

	Fiscal quarter ended			
	Sep 28, 2013		Sep 29, 2012	
(In thousands, except percentages)	Net Sales	% of Net Sales	Net Sales	% of Net Sales
Interconnect & Microfabrication Group (IMG)	\$38,301	64.2	% \$69,137	86.2
Components Group (CG)	10,411	17.5	7,831	9.8
Semiconductor Group (SG)	10,935	18.3	3,184	4.0
	\$59,647	100.0	% \$80,152	100.0

Net sales for the second quarter of 2014 decreased \$20.5 million or 26% from net sales for the second quarter of 2013. Sales in IMG decreased by 45%, while CG and SG increased by 33% and 243%, respectively.

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IMG sales for the second quarter of 2014 decreased \$30.8 million compared to the second quarter of 2013. The decrease in IMG sales was driven by the shipment of advanced microfabrication systems following large design wins in early 2013 which exceeded the order volume experienced in early 2014.

CG sales for the second quarter of 2014 increased \$2.6 million compared to the second quarter of 2013. The increase was primarily driven by strong sales of our recently introduced 3510 ceramic capacitor tester.

SG sales for the second quarter of 2014 increased \$7.8 million compared to the second quarter of 2013. The increase in SG sales was primarily driven by a full quarter of sales in our newly acquired Semiconductor Systems business.

The following table presents net sales information by geographic region:

(In thousands, except percentages)	Fiscal quarter ended		Fiscal quarter ended	
	Sep 28, 2013		Sep 29, 2012	
	Net Sales	% of Net Sales	Net Sales	% of Net Sales
Asia	\$49,439	82.9	% \$73,580	91.8
Americas	7,110	11.9	4,532	5.7
Europe	3,098	5.2	2,040	2.5
	\$59,647	100.0	% \$80,152	100.0

Gross Profit

(In thousands, except percentages)	Fiscal quarter ended		Fiscal quarter ended	
	Sep 28, 2013		Sep 29, 2012	
	Gross Profit	% of Net Sales	Gross Profit	% of Net Sales
Gross Profit	\$24,632	41.3	% \$33,520	41.8

Gross profit was \$24.6 million for the second quarter of 2014, a decrease of \$8.9 million compared to the second quarter of 2013. This decrease was primarily due to lower sales and production volumes partially offset by lower material and manufacturing costs. Gross profit as a percentage of net sales was 41.3% and 41.8% for the second quarter of 2014 and 2013, respectively.

Operating Expenses

(In thousands, except percentages)	Fiscal quarter ended		Fiscal quarter ended	
	Sep 28, 2013		Sep 29, 2012	
	Expense	% of Net Sales	Expense	% of Net Sales
Selling, service and administration	\$14,251	23.9	% \$15,114	18.9
Research, development and engineering	9,719	16.3	10,527	13.1
Gain on acquisition of Semiconductor Systems business	(35)	(0.1)	—	—
	\$23,935	40.1	% \$25,641	32.0

Selling, Service and Administration

Selling, service and administration (SS&A) expenses primarily consist of labor and other employee-related expenses including share-based compensation expense, travel expenses, professional fees, sales commissions and facilities costs.

SS&A expenses for the second quarter of 2014 decreased \$0.9 million compared to the second quarter of 2013. This decrease was primarily attributable to decreases in expenses associated with lower headcount and sales volume and, to a lesser degree, lower legal fees, share-based compensation and depreciation and amortization, partially offset by the addition of the Semiconductor Systems business.

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Research, Development and Engineering

Research, development and engineering (RD&E) expenses are primarily comprised of labor and other employee-related expenses, professional fees, project materials costs, equipment costs and facilities costs. RD&E expenses for the second quarter of 2014 decreased \$0.8 million compared to the second quarter of 2013. This decrease was primarily due to decreases in labor costs due to selective headcount reductions, lower share-based compensation expenses, and slightly lower depreciation, partially offset by the addition of the Semiconductor Systems business.

Gain on acquisition of Semiconductor Systems Business

Gain on acquisition of Semiconductor Systems business was \$35 thousand in the second quarter of 2014. This portion of the overall gain of \$0.5 million was a result of the finalization in the quarter of the net working capital adjustment to the purchase price of the Semiconductor Systems business and the final determination of the fair value of the assets purchased.

Non-operating Income and Expense

Interest and other expense, net, consists of interest income and expense, market gains and losses on assets held in employees' deferred compensation accounts, realized and unrealized foreign exchange gains and losses, bank charges, investment management fees, and other miscellaneous non-operating items. Net interest and other expense, net were as follows:

(In thousands, except percentages)	Fiscal quarter ended		Sep 29, 2012	
	Sep 28, 2013		Interest and	
	Other	% of Net Sales	Other	% of Net Sales
	(Expense)		(Expense)	
	Income, net		Income, net	
Other-than-temporary impairment of cost based investments	\$ (3,588)	) (6.0)%	\$ —	— %
Interest and other income, net	80	0.1	91	0.1
Interest and other expense, net	\$ (3,508)	) (5.9)%	\$ 91	0.1 %

Other-than-temporary impairment of cost based investments

Other-than-temporary impairment of cost based investments was \$3.6 million in the second quarter of 2014 and relates to our minority interest investment in OmniGuide, Inc. During the second quarter, OmniGuide, Inc. engaged in a Series F Preferred Stock round of equity financing at pricing below previous rounds which was considered a triggering event. We performed a valuation of the investment which resulted in a \$3.6 million impairment charge of our Series D and Series E investments.

Interest and other income, net

Net interest and other income was \$0.1 million in both the second quarter of 2014 and 2013.

Income Taxes

(In thousands, except percentages)	Fiscal quarter ended		Sep 29, 2012	
	Sep 28, 2013		Income Tax	Effective
	Benefit	Tax Rate	Provision	Tax Rate
(Benefit from) provision for income taxes	\$ (33)	) 1.2 %	\$ 2,759	34.6 %

The income tax benefit for the second quarter of 2014 was \$33 thousand on pretax loss of \$2.8 million, an effective tax rate of 1.2%. For the second quarter of 2013, the income tax provision was \$2.8 million on pretax income of \$8.0 million, an effective rate of 34.6%. The change in the effective tax rate is primarily due to the relative quarterly income level, the mix of income between foreign and domestic jurisdictions and their relative tax rates, the impact of the valuation allowance on domestic tax assets, and a discrete benefit resulting from the closure of various open foreign tax returns.

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Net (Loss) Income

(In thousands, except percentages)	Fiscal quarter ended				
	Sep 28, 2013		Sep 29, 2012		
	Net Loss	% of Net Sales	Net Income	% of Net Sales	
Net (loss) income	\$(2,778) (4.7)% \$5,211	6.5	%

As a result of the factors discussed above, net loss for the second quarter of 2014 was \$2.8 million, or \$0.09 per basic and diluted share, compared to net income of \$5.2 million, or \$0.18 per basic and \$0.17 per diluted share, for the second quarter of 2013.

Two Quarters Ended September 28, 2013 Compared to Two Quarters Ended September 29, 2012

Results of Operations

The following table presents results of operations data as a percentage of net sales:

	Two fiscal quarters ended			
	Sep 28, 2013		Sep 29, 2012	
		%		%
Net sales	100.0	%	100.0	%
Cost of sales	58.4		58.9	
Gross profit	41.6		41.1	
Selling, service and administration	27.3		22.1	
Research, development and engineering	17.1		14.4	
Gain on acquisition of Semiconductor Systems business	(0.5)	—	
Operating income (loss)	(2.3	)	4.6	
Other-than-temporary impairment of cost based investments	(3.4)	—	
Interest and other expense, net	—		(0.1)
Total non-operating (expense) income	(3.4	)	(0.1)
(Loss) income before income taxes	(5.7	)	4.5	
(Benefit from) provision for income taxes	—		1.4	
Net (loss) income	(5.7	)%	3.1	%

Net Sales

The following table presents net sales information by product group:

(In thousands, except percentages)	Two fiscal quarters ended				
	Sep 28, 2013		Sep 29, 2012		
	Net Sales	% of Net Sales	Net Sales	% of Net Sales	
Interconnect & Microfabrication Group (IMG)	\$72,718	68.8	% \$116,969	84.1	%
Components Group (CG)	16,553	15.6	15,536	11.1	
Semiconductor Group (SG)	16,548	15.6	6,616	4.8	
	\$105,819	100.0	% \$139,121	100.0	%

Net sales for the first two quarters of 2014 decreased \$33.3 million or 23.9% from net sales for the first two quarters of 2013. Sales in IMG decreased by 37.8%, while sales in CG and SG increased by 6.5% and 150.1%, respectively. IMG sales for the first two quarters of 2014 decreased \$44.3 million compared to the first two quarters of 2013. The decrease in IMG sales was primarily driven by lower sales of our advanced microfabrication systems following very large design wins in the first two quarters of 2013.

CG sales for the first two quarters of 2014 increased \$1.0 million compared to the first two quarters of 2013. The increase was primarily driven by sales of our new 3510 ceramic capacitor tester.

SG sales for the first two quarters of 2014 increased \$9.9 million compared to the first two quarters of 2013. The increase in SG sales was primarily driven by our acquisition of the Semiconductor Systems business of GSI, Inc.

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The following table presents net sales information by geographic region:

(In thousands, except percentages)	Two fiscal quarters ended			
	Sep 28, 2013		Sep 29, 2012	
	Net Sales	% of Net Sales	Net Sales	% of Net Sales
Asia	\$88,274	83.4	\$126,034	90.6
Americas	10,676	10.1	8,706	6.3
Europe	6,869	6.5	4,381	3.1
	\$105,819	100.0	\$139,121	100.0

Gross Profit

(In thousands, except percentages)	Two fiscal quarters ended			
	Sep 28, 2013		Sep 29, 2012	
	Gross Profit	% of Net Sales	Gross Profit	% of Net Sales
Gross Profit	\$44,018	41.6	\$57,173	41.1

Gross profit was \$44.0 million for the first two quarters of 2014 and decreased \$13.2 million compared to the first two quarters of 2013. This decrease was primarily due to lower sales and production volumes partially offset by product mix. Gross profit as a percentage of net sales remains relatively consistent at 41.6% and 41.1% for the first two quarters of 2014 and 2013, respectively.

Operating Expenses

(In thousands, except percentages)	Two fiscal quarters ended			
	Sep 28, 2013		Sep 29, 2012	
	Expense	% of Net Sales	Expense	% of Net Sales
Selling, service and administration	\$28,798	27.3	\$30,777	22.1
Research, development and engineering	18,144	17.1	20,061	14.4
Gain on acquisition of Semiconductor Systems business	(499)	(0.5)	—	—
	\$46,443	43.9	\$50,838	36.5

Selling, Service and Administration

Selling, service and administration (SS&A) expenses primarily consist of labor and other employee-related expenses including share-based compensation expense, travel expenses, professional fees, sales commissions and facilities costs.

SS&A expenses for the first two quarters of 2014 decreased \$2.0 million compared to the first two quarters of 2013. This decrease was primarily attributable to decreases in expense associated with lower headcount and sales volume, and, to a lesser degree, lower legal fees, share-based compensation and depreciation and amortization, partially offset by the addition of the Semiconductor Systems business.

Research, Development and Engineering

Research, development and engineering (RD&E) expenses are primarily comprised of labor and other employee-related expenses, professional fees, project materials costs, equipment costs and facilities costs. RD&E expenses for the first two quarters of 2014 decreased \$1.9 million compared to the first two quarters of 2013. This decrease was primarily due to decreases in labor costs due to selective headcount reductions, lower share-based compensation expense, and lower depreciation, partially offset by the addition of the Semiconductor Systems business.

Gain on acquisition of Semiconductor Systems Business

Gain on acquisition of Semiconductor Systems business was \$0.5 million in 2014. This purchase resulted in an overall gain as the estimated fair value of the assets purchased was in excess of the total purchase consideration, primarily due to the recognition of certain intangible assets, comprised of developed technology and order backlog.

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Non-operating Income and Expense

Interest and other expense, net, consists of interest income and expense, market gains and losses on assets held in employees' deferred compensation accounts, realized and unrealized foreign exchange gains and losses, bank charges, investment management fees, and other miscellaneous non-operating items. Net interest and other expense, net were as follows:

(In thousands, except percentages)	Two fiscal quarters ended					
	Sep 28, 2013		Sep 29, 2012			
	Interest and	% of Net Sales	Interest and	% of Net Sales		
	Other		Other			
	Expense, net		Expense, net			
Other-than-temporary impairment of cost based investments	\$ (3,588) (3.4)%	\$ —	—	%
Interest and other income (expense), net	\$ 20	—	%	\$ (59) (0.1)%
Total non-operating (expense) income	\$ (3,568) (3.4)%	\$ (59) (0.1)%

Other-than-temporary impairment of cost based investments

Other-than-temporary impairment of cost based investments was \$3.6 million in first two quarters of 2014 and relates to our minority interest investment in OmniGuide, Inc. During the second quarter, OmniGuide, Inc. engaged in a Series F Preferred Stock round of equity financing at pricing below previous rounds which was considered a triggering event. We performed a valuation of the investment which resulted in a \$3.6 million impairment charge of our Series D and Series E investments.

Interest and other (expense) income, net

Net interest and other income was \$20 thousand in the first two quarters of 2014 compared to net interest and other expense of \$59 thousand in the first two quarters of 2013.

Income Taxes

(In thousands, except percentages)	Two fiscal quarters ended					
	Sep 28, 2013		Sep 29, 2012			
	Income Tax	Effective	Income Tax	Effective		
	Provision	Tax Rate	Provision	Tax Rate		
(Benefit from) provision for income taxes	\$ 68	(1.1)%	\$ 2,009	32.0	%

The income tax provision for the first two quarters of 2014 was \$0.1 million on pretax loss of \$6.0 million, an effective tax rate of (1.1)%. For the first two quarters of 2013, the income tax provision was \$2.0 million on pretax income of \$6.3 million, an effective rate of 32.0%. The change in the effective tax rate is primarily due to the relative income level, the mix of income between foreign and domestic jurisdictions and their relative tax rates, the impact of the valuation allowance on domestic tax assets, and a discrete benefit resulting from the closure of various open foreign tax returns.

Net (Loss) Income

(In thousands, except percentages)	Two fiscal quarters ended					
	Sep 28, 2013		Sep 29, 2012			
	Net Loss	% of Net Sales	Net Income	% of Net Sales		
Net (loss) income	\$ (6,061) (5.7)%	\$ 4,267	3.1	%

As a result of the factors discussed above, net loss for the first two quarters of 2014 was \$6.1 million, or \$0.20 per basic and diluted share, compared to net income of \$4.3 million, or \$0.15 per basic and \$0.14 per diluted share, for the first two quarters of 2013.

Financial Condition and Liquidity

At September 28, 2013, our principal sources of liquidity were cash and cash equivalents of \$72.0 million, short-term investments of \$49.9 million and accounts receivable of \$34.7 million. At September 28, 2013, we had a current ratio of 5.11 and held no long-term debt. Working capital of \$188.2 million decreased \$6.2 million compared to the March 30, 2013 balance of \$194.4 million substantially impacted by the purchase of the Semiconductor Systems business for \$9.7 million, the \$5.0

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million investment in OmniGuide, Inc. and the payment of quarterly dividends. We also held approximately \$10.4 million of non-current investments at September 28, 2013.

In December 2011, the Board of Directors adopted a dividend policy under which we intend to pay quarterly cash dividends. The following table summarizes the quarterly dividend declared and paid by us since the second quarter of 2013:

Date Declared	Record Date	Payable Date	Amount per Share
August 8, 2013	August 19, 2013	September 3, 2013	\$0.08
May 14, 2013	June 5, 2013	June 19, 2013	\$0.08
February 7, 2013	February 28, 2013	March 14, 2013	\$0.08
November 8, 2012	November 21, 2012	December 5, 2012	\$0.08
August 9, 2012	August 24, 2012	September 10, 2012	\$0.08

A special dividend of \$2.00 per share was declared by the Board of Directors on December 3, 2012 after the successful settlement of a patent dispute. The special dividend should not be considered a recurring event.

We paid aggregate dividends of \$4.8 million and \$4.7 million in the second quarter of 2014 and 2013, respectively.

We currently anticipate that we will continue to pay cash dividends on a quarterly basis in the future, although the declaration, timing and amount of any future cash dividends are at the discretion of the Board of Directors and will depend on our financial condition, results of operations, capital requirements, business conditions and other factors, as well as a determination that cash dividends are in the best interest of our shareholders.

In December 2011, the Board of Directors authorized a share repurchase program totaling \$20.0 million to acquire shares of our outstanding common stock. The repurchases are to be made at management's discretion in the open market or in privately negotiated transactions in compliance with applicable securities laws and other legal requirements and are subject to market conditions, share price and other factors. We did not repurchase any shares under this program in 2014 or 2013. There is no fixed completion date for the repurchase program.

Sources and Uses of Cash

Net cash used in operating activities of \$3.1 million for the two quarters ended September 28, 2013, was the result of \$9.0 million of net decreases in working capital and \$6.1 million in net loss, partially offset by \$11.9 million in non-cash charges. For the two quarters ended September 28, 2013, the primary uses of cash from working capital consisted of \$7.1 million decrease in accounts payable and accrued liabilities, \$2.5 million decrease in deferred revenue, and \$0.8 million increase in other current assets, partially offset by \$1.1 million decrease in trade receivables and \$0.5 million decrease in shipped systems pending acceptance.

For the two quarters ended September 28, 2013, net cash used in investing activities of \$8.9 million primarily resulted from \$9.7 million paid for the acquisition of the Semiconductor Systems business of GSI, Inc., \$5.0 million in additional investment in OmniGuide, Inc. and \$2.3 million of net purchases and sales of property, plant and equipment, partially offset by \$8.2 million of proceeds from sales and maturities of securities, net of purchases.

For the two quarters ended September 28, 2013, net cash used in financing activities of \$5.2 million primarily resulted from \$4.8 million of cash dividends paid to shareholders and \$0.4 million from stock plan activity.

We believe that our existing cash, cash equivalents and short-term investments are adequate to fund our operations, any dividends which may be declared, our share repurchase program and contractual obligations for at least the next twelve months.

Critical Accounting Policies and Estimates

We reaffirm the "Critical Accounting Policies and Estimates" in Part II Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations reported in our Form 10-K for the year ended March 30, 2013.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes in the market risk disclosure contained in our Form 10-K for the year ended March 30, 2013.

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Item 4. Controls and Procedures

Attached to this quarterly report as exhibits 31.1 and 31.2 are the certifications of our President and Chief Executive Officer (CEO) and our Chief Financial Officer (CFO) required by Section 302 of the Sarbanes-Oxley Act of 2002 (the Section 302 Certifications). This portion of our quarterly report on Form 10-Q is our disclosure of the conclusions of our management regarding the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report based on management's evaluation of those disclosure controls and procedures. This disclosure should be read in conjunction with the Section 302 Certifications for a more complete understanding of the topics presented.

Disclosure Controls and Procedures

Our management has evaluated, under the supervision and with the participation of our CEO and CFO, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934, as amended (Exchange Act). Based on that evaluation, our CEO and CFO have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures are effective in ensuring that information required to be disclosed in our Exchange Act reports is (1) recorded, processed, summarized and reported in a timely manner, and (2) accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There has been no change in our internal control over financial reporting during the second quarter of 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

In the ordinary course of business, we are involved in various legal matters, either asserted or unasserted, and investigations. In the opinion of management, ultimate resolution of these matters will not have a material effect on our consolidated financial position, results of operations or cash flows.

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Item 1A. Risk Factors

The statements contained in this report that are not statements of historical fact, including without limitation statements containing the words “believes,” “expects” and similar words, constitute forward-looking statements that are subject to a number of risks and uncertainties. From time to time, we may make other forward-looking statements. Investors are cautioned that such forward-looking statements are subject to an inherent risk that actual results may differ materially. The following information highlights some of the factors that could cause actual results to differ materially from the results expressed or implied by our forward-looking statements. Forward-looking statements should be considered in light of these factors. Factors that may result in such variances include, but are not limited to, the following:

Risks Related to Our Competition and Customers

Volatility of Our Customers’ Industries

Our business is dependent upon the capital expenditures of manufacturers of microelectronics, semiconductors and light emitting diodes (LEDs) used in consumer electronics, computers, wireless communications and other electronic products. The capital equipment market for microelectronics, semiconductor and consumer electronics manufacturers has historically been characterized by sudden and severe cyclical variations in product supply and demand due to a number of factors including capacity utilization, timing of customers’ new product introductions and demand for their products, inventory levels relative to demand and access to affordable capital. The timing, severity and duration of these market cycles are difficult or impossible to predict. As a result, business levels can vary significantly from quarter to quarter or year to year. Significant downturns in the market for microelectronics, semiconductors, and LEDs used in electronic devices or in the market for consumer electronics reduce demand for our products and may materially and adversely affect our business, financial condition and results of operations. For example, starting in the second half of fiscal 2012, we experienced the negative impact of an uncertain economic environment, slower market growth and overcapacity in several of our markets, which resulted in overall lower order and revenue levels. As a result of this uncertain economic environment, our total order volume declined in 2012 compared to 2011 and continued to decline in 2013. In addition, due to changes in the memory repair industry, we do not expect to experience material sales of memory repair systems in future up cycles. The degree of the impact of any downturn on our business depends on a number of factors, including: the strength of the global and United States economies; the overall level of demand for consumer electronics products; the stability of global financial systems; and the overall health of the microelectronics, semiconductor, LEDs and consumer electronics industries.

Highly Competitive Markets

We face substantial competition from established competitors throughout the world, some of which have greater financial, engineering, manufacturing and marketing resources than we do. Those competitors with greater resources may, in addition to other things, be able to better withstand periodic downturns, compete more effectively on the basis of price and technology, or more quickly develop enhancements to, and new generations of, products that compete with the products we manufacture and market. New companies may enter the markets in which we compete, or industry consolidation may occur, further increasing competition in those markets. We believe that to be competitive we must continue to expend significant financial resources in order to, among other things, invest in new product development and enhancements. We may not be able to compete successfully in the future and increased competition may result in price reductions, reduced profit margins and loss of market share.

Increased Price Pressure

We have experienced and continue to experience pricing pressure in the sale of our products, from both competitors and customers. Pricing pressures typically have become more intense during cyclical downturns when competitors seek to maintain or increase market share, reduce inventory or introduce more technologically advanced products. In addition, we may agree to pricing concessions with our customers in connection with volume orders. Our business, financial condition, margins or results of operations may be materially and adversely affected by competitive pressure and intense price-based competition.

Revenues are Largely Dependent on Few Customers

We depend on a few significant customers for a large portion of our revenues. In 2013, our top ten customers accounted for approximately 61% of total net sales, with one customer accounting for approximately 31% of total net

sales. We anticipate that sales of our products to a relatively small number of customers will continue to account for a significant portion of our revenues. Consolidation between customers, changes in technologies or solutions used by customers, changes in products manufactured by customers or in end-user demand for those products, selection of suppliers other than us, customer bankruptcies or customer departures from their respective industries all may result in even fewer customers accounting for a

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high percentage of our revenue. Furthermore, none of our customers have any long-term obligation to continue to buy our products or services and may therefore delay, reduce or cease ordering our products or services at any time. The cancellation, reduction or deferral of purchases of our products by even a single customer could significantly reduce our revenues in any particular quarter. If we were to lose any of our significant customers or suffer a material reduction in their purchase orders, revenue could decline and our business, financial condition and results of operations could be materially and adversely affected.

Revenues are Largely Based on the Sale of a Small Number of Product Units

We derive a substantial portion of our revenue from the sale of a relatively small number of products. Accordingly, our revenues, margins and other operating results could fluctuate significantly from quarter to quarter depending upon a variety of factors in addition to those described above, including:

- changes in the timing of orders and terms or acceptance of product shipments by our customers;
- changes in the mix of products and services that we sell;
- timing and market acceptance of our new product introductions;
- customer adoption of new technologies or manufacturing processes requiring use of our equipment;
- timing of new application design wins; and
- delays or problems in the planned introduction of new products, or in the performance of any such products following delivery to customers.

As a result of these risks, we believe that quarter to quarter comparisons of our revenue and operating results may not be meaningful, and that these comparisons may not be an accurate indicator of our future performance.

Risks Related to Our Supply Chain and Production

Variability of Production Capacity

To meet rapidly changing demand in the industries we serve, we must effectively manage our resources and production capacity. During periods of decreasing demand for our products, we must be able to appropriately align our cost structure with prevailing market conditions and effectively manage our supply chain. Our ability to rapidly and effectively reduce our cost structure in response to such downturns is limited by the fixed nature of many of our expenses in the near term and by our need to continue our investment in next-generation product technology and to support and service our products. Conversely, when upturns occur in the markets we serve, we may have difficulty rapidly and effectively increasing our manufacturing capacity or procuring sufficient materials to meet sudden increases in customer demand that could result in the loss of business to our competitors and harm to our relationships with our customers. If we are not able to timely and appropriately adapt to changes in our business environment, our business, financial condition or results of operations may be materially and adversely affected.

Reliance on Critical Suppliers

We use a wide range of components from numerous suppliers in the manufacture of our products, including custom electronic, laser, optical and mechanical components. We generally do not have guaranteed supply arrangements with our suppliers. We seek to reduce the risk of production and service interruptions and shortages of key parts by selecting and qualifying alternative suppliers for key parts, monitoring the financial stability of key suppliers and maintaining appropriate inventories of key parts. Although we make reasonable efforts to ensure that parts are available from multiple suppliers, some key parts are available only from a single supplier or a limited group of suppliers in the short term. In addition, some of the lasers we use in our products are difficult to manufacture, and as a result we may not receive an adequate supply of lasers in a timely fashion to fill orders. Operations at our suppliers' facilities are subject to disruption or discontinuation for a variety of reasons, including changes in business relationships, competitive factors, financial difficulties, work stoppages, fire, natural disasters or other causes. Any such disruption or discontinuation to our suppliers' operations could interrupt or reduce our manufacturing activities and delay delivery of our products, any or all of which could materially and adversely affect our results of operations. In addition, when markets recover from economic downturns, there is a heightened risk that one or more of our suppliers may not be able to meet increased demand requirements, adversely impacting our ability to fulfill orders and win business with our customers.

Utilization of Contract Manufacturers

We have arrangements with contract manufacturers to complete the manufacturing of certain of our products or product subcomponents. Any significant interruption in our contract manufacturers' ability to provide manufacturing services to us as a result of contractual disputes with us or another party, labor disruptions, financial difficulties, natural disasters, delay or interruption in the receipt of inventory, customer prioritization or other causes could result in reduced manufacturing

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capabilities or delayed deliveries for certain of our products, any or all of which could materially and adversely affect our results of operations.

Charges for Excess or Obsolete Inventory

One factor on which we compete is the ability to ship products on schedules required by customers. In order to facilitate timely shipping, management forecasts demand, both in type and amount of products, and these forecasts are used to determine inventory to be purchased. We also order materials based on our technology roadmap, which represents management's assessment of technology that will be utilized in new products that we develop. Certain types of inventory, including lasers and optical equipment, are particularly expensive and may only be used in the production of a single type of product. If actual demand is lower than forecast with respect to the type or amount of products actually ordered, or both, our inventory levels may increase. As a result, there is a risk that we may have to incur material accounting charges for excess and obsolete inventory if inventory cannot be used, which would negatively affect our financial results. Also, if we alter our technology or product development strategy, we may have inventory that may not be usable under the new strategy, which may also result in material accounting charges. For example, during 2013, we recorded \$21.0 million of charges in cost of sales for an inventory write-off associated with discontinued products.

Uncertainties Resulting from Conflict Minerals Regulation

On August 22, 2012, the SEC adopted a new rule requiring disclosures of specified minerals, known as conflict minerals, that are necessary to the functionality or production of products manufactured or contracted to be manufactured by companies filing public reports. The new rule, which is effective for the 2013 calendar year and requires a disclosure report to be filed by May 31, 2014, will require companies to perform due diligence, disclose, and report whether such minerals originate from the Democratic Republic of Congo or an adjoining country. The new rule could affect sourcing at competitive prices and availability in sufficient quantities of certain minerals used in the manufacture of our products, including tantalum, tin, gold, and tungsten. The number of suppliers who provide conflict-free minerals may be limited. In addition, there may be material costs associated with complying with the disclosure requirements, such as costs related to determining the source of certain minerals used in our products, as well as costs of possible changes to products, processes, or sources of supply as a consequence of such verification activities. Since our supply chain is complex, we may not be able to sufficiently verify the origins of the relevant minerals used in our products through the due diligence procedures that we implement, which may harm our reputation. In addition, we may encounter challenges to satisfy those customers who require that all of the components of our products be certified as conflict-free, which could place us at a competitive disadvantage if we are unable to do so.

Risks Related to Our Organization

Operating a Global Business

International shipments accounted for 90% of net sales in 2013, with 85% of our net shipments to customers in Asia. We expect that international shipments will continue to represent a significant percentage of net sales in the future. We also have significant foreign operations, including manufacturing facilities in Singapore and China, research and development facilities in Canada, France and Taiwan, and sales and service offices in various countries. Under our globalization strategy, we intend to increase our foreign operations in the future. Our non-U.S. sales, purchases and operations are subject to risks inherent in conducting business abroad, many of which are outside our control, including the following:

- periodic local or geographic economic downturns and unstable political conditions;
- price and currency exchange controls;
- fluctuation in the relative values of currencies;
- difficulty in repatriating money, whether as a result of tax laws or otherwise;
- difficulties protecting intellectual property;
- compliance with labor laws and other laws governing employees;
- local labor disputes;
- shipping delays and disruptions;

- unexpected changes in trading policies, regulatory requirements, tariffs and other barriers; and
- difficulties in managing a global enterprise, including staffing, collecting accounts receivable, and managing suppliers, distributors and representatives.

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Our business and operating results could also be impacted, directly or indirectly, by natural disasters, outbreaks of infectious disease, military action, international conflicts, terrorist activities, civil unrest and associated political instability. Many of our facilities, including our Portland, Oregon headquarters, are in areas with known earthquake risk. Some of these events or circumstances may also result in heightened security concerns with respect to domestic and international travel and commerce, which may further affect our business and operating results. In particular, due to these uncertainties, we are subject to the following additional risks:

- future tightening of immigration controls may adversely affect the residence status of non-U.S. engineers and other key technical employees in our U.S. facilities or our ability to hire new non-U.S. employees in such facilities;
- more frequent instances of shipping delays;
- demand for our products may not increase or may decrease; and
- our customers or suppliers may experience financial difficulties or cease operations.

We currently benefit from a tax incentive program in Singapore pursuant to which we pay no Singapore income tax with respect to our manufacturing income. The incentive commenced on July 1, 2006 and will continue through June 30, 2016 assuming we are able to satisfy applicable requirements. There is no assurance we will be able to satisfy these requirements. Failure to meet such requirements may lead to reduction in future benefits.

Implementation and Modification of Globalization Strategy

We are implementing our globalization strategy in which we are moving certain operational resources and capabilities to different countries in Asia to be closer to many of our significant customers and to reduce costs. We believe this strategy will enhance customer relationships, improve our responsiveness, and reduce our manufacturing costs for certain products. We opened a manufacturing facility in Singapore in the fourth quarter of 2010, which manufactures certain IMG, LED, CG and laser ablation products and is now our primary system manufacturing facility.

Additionally, we have a manufacturing facility in Beijing China, which manufactures certain laser products.

Our globalization strategy is subject to a variety of complexities and risks, many of which we have little experience managing, and which may divert a substantial amount of management's time. These risks include:

- challenges in designing new facilities that can be scaled for future expansion, replicating current processes and bringing new facilities up to full operation;
- unpredictable costs, redundancy costs and cost overruns for developing new facilities and acquiring equipment;
- building local management teams, technical personnel and other staff for functions that we have not previously conducted outside of the United States;
- technical obstacles such as poor production or process yield and loss of quality control during the ramp of a new facility;
- re-qualifications and other procedures that may be required by our customers;
- our ability to bring up local suppliers to meet our quality and cycle-time needs;
- our ability to reduce costs in the United States as we add costs in Asia;
- rapidly changing business conditions that may require plans to be changed or abandoned before they are fully implemented; and
- challenges posed by distance and by differences in language and culture.

These and other factors could delay the development and implementation of our strategy, as well as impair our gross margins, delay shipments and deliveries, cause us to lose sales, require us to write off investments already made, damage our reputation and harm our business, financial condition and results of operations. If we decide to change our current globalization strategy, we may incur charges for certain costs incurred.

Acquisitions and Divestitures

We may make acquisitions of, or significant investments in, other businesses with complementary products, services or technologies, such as our June 2012 acquisition of Eolite Systems and our May 2013 acquisition of the assets of the Semiconductor Systems business from GSI, Group Inc. Acquisitions involve numerous risks, many of which are unpredictable and beyond our control, including:

difficulties and increased costs in connection with integration of the personnel, operations, technologies and products of the acquired businesses;

- implementation of our enterprise resource planning (ERP) system into the acquired company's operations;
- diversion of management's attention from other operational matters;

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the potential loss of key employees of the acquired company;
lack of synergy or inability to realize expected synergies resulting from the acquisition;
acquired assets becoming impaired as a result of technological advancements or worse-than-expected performance by the acquired company;
difficulties establishing satisfactory internal controls at the acquired company;
risks and uncertainties relating to the performance of the combined company following the transaction; and
acquiring unanticipated liabilities for which we will not be indemnified.

Furthermore, the accounting for an acquisition could result in significant charges resulting from amortization or write-off of intangible assets we acquire. Our inability to effectively manage these risks could result in our inability to realize the anticipated benefits of an acquisition on a timely basis, or at all, and materially and adversely affect our business, financial condition and results of operations. In addition, all acquisition transaction costs must be expensed as incurred rather than capitalized, which may have a material adverse effect on our results of operations.

The means by which we finance an acquisition may also significantly affect our business or the value of the shares of our common stock. If we issue common stock to pay for an acquisition, the ownership percentage of our existing shareholders will be diluted and the value of the shares held by our existing shareholders could be reduced. If we use cash on hand to pay for an acquisition, the payment could significantly reduce the cash that would be available to fund our operations or to use for other purposes. If we borrow funds in connection with an acquisition, we would be required to use cash to service the debt and to comply with financial and other covenants.

We may from time to time also make strategic investments in development stage companies. Investments in development stage companies are subject to a high degree of risk. We could lose all or a portion of our investment in any such company or could be required to recognize an impairment charge with respect to our investment, as we did in the second quarter of 2014 regarding our investment in OmniGuide, Inc.

Hiring and Retention of Personnel

Our continued success depends in part upon the services of our key managerial, financial and technical personnel. The loss of key personnel, or our inability to attract, assimilate and retain qualified personnel, could result in the loss of customers, inhibit our ability to operate and grow our business and otherwise have a material adverse effect on our business and results of operations. We have previously had to, and may in the future have to, impose salary reductions on employees during economic downturns in an effort to maintain our financial position. These actions may have an adverse effect on employee loyalty and may make it more difficult for us to attract and retain key personnel.

Competition for qualified personnel in the industries in which we compete is intense, and we may not be successful in attracting and retaining qualified personnel. We may incur significant costs in our efforts to recruit and retain key personnel, which could affect our financial position and results of operations.

Risks Related to Technology

Markets Characterized by Rapid Technological Change

The markets for our products are characterized by rapid technological change and innovation, frequent new product introductions, changes in customer requirements and evolving industry standards. Our future performance will depend on the successful development, introduction and market acceptance of new and enhanced products that address technological changes and the requirements of current and potential customers. The development of new, technologically advanced products is a complex and uncertain process, requiring high levels of innovation and highly skilled engineering and development personnel, as well as the accurate anticipation of technological and market trends. We cannot assure you that we will be able to identify, develop, manufacture, market or support new or enhanced products successfully, if at all, or on a timely basis. The introduction by us or by our competitors of new or enhanced products, or alternative technologies, may cause our customers to defer, change or cancel orders for our existing products or cease purchasing our products altogether. For example, our semiconductor memory customers are exploring alternative redundancy technologies such as electrical redundancy technology. We believe our historical semiconductor memory customers are converting these technologies into their manufacturing process for newer products, thereby materially reducing the size of the addressable market of our memory yield improvement systems. Further, we cannot assure that our new products will gain market acceptance or that we will be able to respond effectively to product announcements by competitors, technology changes or emerging industry standards. If we are

unable to develop new or enhanced products to address product or technology changes or new industry standards on a timely basis or at all, or if our new or enhanced products are not accepted by the market, or if our customers adopt alternative technologies, our business, financial condition and results of operations may be adversely affected.

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Need to Invest in Research and Development

Our industry is characterized by the need for continued investment in research and development. Because of intense competition in the industries in which we compete, if we were to fail to invest sufficiently in research and development, our products could become less attractive to our current and potential customers or obsolete, and our business and financial condition could be materially and adversely affected. As a result of our need to maintain our spending levels in this area, our operating results could be materially harmed if our net sales decline. In addition, as a result of our emphasis on research and development and technological innovation, our operating costs may increase in the future, and research and development expenses may increase as a percentage of total operating expenses and as a percentage of net sales.

Products are Highly Complex

Our products are highly complex, and our extensive product development, manufacturing and testing processes may not be adequate to detect all defects, errors, failures and quality issues that could impact customer satisfaction or result in claims against us. As a result, we may have to replace certain components or provide remediation in response to the discovery of defects in products after they are shipped. The occurrence of any defects, errors, failures or quality issues could result in cancellation of orders, product returns, diversion of our resources, legal actions by our customers and other losses to us or to our customers. These occurrences could also result in the loss of, or delay in, market acceptance of our products, loss of sales and increased expenses and warranty costs, which would harm our business and adversely affect our revenues and profitability.

Risks Related to Legal Matters

Protection of Proprietary Rights – Generally

Our success depends significantly upon the protection of our proprietary rights. We attempt to protect our proprietary rights through patents, copyrights, trademarks, maintenance of trade secrets and other measures, including entering into confidentiality agreements. We incur substantial costs to obtain and maintain patents and to defend our intellectual property rights. We rely upon the laws of the United States and foreign countries where we develop, manufacture or sell our products to protect our proprietary rights. We may not be successful in protecting these proprietary rights, these rights may not provide the competitive advantages that we expect, or other parties may challenge, invalidate or circumvent these rights.

Protection of Proprietary Rights – Foreign Jurisdictions

Our efforts to protect our intellectual property may be less effective in some foreign countries where intellectual property rights are not as well protected as in the United States. Many United States companies have encountered substantial problems in protecting their proprietary rights against infringement in foreign countries. If we fail to adequately protect our intellectual property in these countries, it could be easier for our competitors to sell competing products in foreign countries, which could result in reduced sales and gross margins.

Intellectual Property Infringement Claims

Several of our competitors hold patents covering a variety of technologies, applications and methods of use similar to some of those used in our products. While we attempt in our designs to avoid patent infringement, from time to time we and our customers have received correspondence from our competitors claiming that some of our products, as used by our customers, may be infringing one or more of these patents. Competitors or others have in the past and may in the future assert infringement claims against our customers or us with respect to current or future products or uses, and these assertions may result in costly litigation or require us to obtain a license to use intellectual property rights of others. If claims of infringement are asserted against our customers, those customers may seek indemnification from us for damages or expenses they incur.

If we become subject to infringement claims, we will evaluate our position and consider the available alternatives, which may include seeking licenses to use the technology in question or defending our position. These licenses, however, may not be available on satisfactory terms or at all. If we are not able to negotiate the necessary licenses on commercially reasonable terms or successfully defend our position, our financial condition and results of operations could be materially and adversely affected.

Tax Audits and Changes in Tax Law

We are periodically under audit by United States and foreign tax authorities and may have exposure to additional tax liabilities as a result. Significant judgment is required in determining our provision for income and other tax liabilities. Although we believe our tax estimates are reasonable, the final outcome of tax audits and the impact of changes in tax laws or the interpretation of tax laws could result in material differences from what is reflected in historical income tax accruals. If additional taxes are assessed as a result of an examination, a material effect on our financial results, tax positions or cash flows could occur in the period or periods in which the determination is made.

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Legal Proceedings

From time to time we are subject to various legal proceedings, including breach of contract claims and claims that involve possible infringement of patent or other intellectual property rights of third parties. It is inherently difficult to assess the outcome of litigation matters, and there can be no assurance that we will prevail in any litigation. Any litigation could result in substantial cost and diversion of management's attention, which by itself could have a material adverse effect on our financial condition and results of operations. Further, adverse determinations in such litigation could result in loss of our property rights, subject us to significant liabilities, require us to seek licenses from others or prevent us from manufacturing or selling our products, any of which could materially adversely affect our business, financial condition, results of operations or cash flows.

Provisions Restricting Our Acquisition

Our articles of incorporation and bylaws contain provisions that could make it harder for a third party to acquire us without the consent of our Board of Directors. Our Board of Directors has also adopted a shareholder rights plan, or "poison pill," which would significantly dilute the ownership of a hostile acquirer. In addition, the Oregon Control Share Act and the Oregon Business Combination Act limit the ability of parties who acquire a significant amount of voting stock to exercise control over us. These provisions may have the effect of lengthening the time required for a person to acquire control of us through a proxy contest or the election of a majority of our Board of Directors, may deter efforts to obtain control of us and may make it more difficult for a third party to acquire us without negotiation. These provisions may apply even if the offer may be considered beneficial by our shareholders.

Risks Related to Financial Matters

Unfavorable Currency Exchange Rate Fluctuations

Currency exchange rate fluctuations could have an adverse effect on our sales and results of operations and we could experience losses with respect to forward exchange contracts into which we may enter. Unfavorable currency fluctuations could require us to increase prices to foreign customers, which could result in lower net sales by us to those customers. Alternatively, if we do not adjust the prices for our products in response to unfavorable currency fluctuations, our results of operations could be materially and adversely affected. In addition, some of our foreign sales are denominated in the currency of the country in which these products are sold and the currency we receive in payment for such sales could be less valuable at the time of receipt as a result of exchange rate fluctuations. From time to time, we enter into forward exchange contracts to hedge the value of accounts receivable primarily denominated in Japanese yen and other currencies. However, we cannot be certain that our efforts will be adequate to protect us against significant currency fluctuations or that such efforts will not expose us to additional exchange rate risks, which could adversely affect our results of operations.

Fluctuations in Effective Tax Rate

As a global company, we are subject to taxation in the United States and numerous foreign jurisdictions. Our effective tax rate is subject to fluctuation from one period to the next because the income tax rates for each year are a function of many factors, including: (a) taxable income levels and the effects of a mix of profits (losses) earned by us and our subsidiaries in numerous tax jurisdictions with a broad range of income tax rates; (b) our ability to utilize deferred tax assets; (c) taxes, refunds, interest or penalties resulting from tax audits; (d) the magnitude of various credits and deductions as a percentage of total taxable income; and (e) changes in tax laws or the interpretation of such tax laws. Changes in the mix of these items may cause our effective tax rate to fluctuate between periods, which could have a material adverse effect on our financial position and results of operations.

Impairment of Intangible Assets

We held a total of \$8.3 million in acquired intangible assets and \$7.9 million in goodwill at September 28, 2013. We review our acquired intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. We test goodwill for impairment using a quantitative approach at least annually or between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value below the carrying value.

We performed a review of our acquired intangible assets in the fourth quarter of 2013. We identified intangible assets relating to acquired in-process research and development programs from which we no longer expect to derive value. As a result, we accelerated amortization of \$2.3 million on acquired intangible assets. There were no other events or

circumstances during the first two quarters of 2014 that would indicate the carrying value of our long-lived assets may not be recoverable.

We performed our annual goodwill impairment analysis during the fourth quarter of 2013 and determined that it was not “more likely than not” that the fair value of our single reporting unit was less than its carrying value. If at any time management determines that an impairment exists, we will be required to reflect the impaired value as part of operating

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income, which will result in a reduction in earnings and a corresponding reduction in our net asset value in the period such impairment is identified.

Stock Price Volatility

The market price of our common stock has fluctuated widely. During fiscal 2013, our stock price fluctuated between a high of \$15.20 per share and a low of \$9.46 per share. Consequently, the current market price of our common stock may not be indicative of future market prices, and we may be unable to sustain or increase the value of an investment in our common stock. Factors affecting our stock price, many of which are outside of our control, may include:

- variations in operating results from quarter to quarter;
- changes in either short term or long term earnings estimates by analysts or our failure to meet analysts' expectations;
- changes in the market price per share of our public company customers;
- market conditions in the semiconductor and other industries into which we sell products;
- general economic conditions;
- political changes, hostilities or natural disasters;
- low trading volume of our common stock;
- the number of analysts covering our common stock; and
- the number of firms making a market in our common stock.

In addition, the stock market has recently experienced significant price and volume fluctuations. These fluctuations have particularly affected the market prices of the securities of high-technology companies like ours. These market fluctuations could adversely affect the market price of our common stock.

Reduction or Cessation of Dividends

Our Board of Directors first adopted a dividend policy in December 2011. We intend 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 shareholders and are in compliance with all laws and agreements applicable to the declaration and payment of cash dividends. Future dividends may be affected by, among other factors: our views on potential future capital requirements for investments in acquisitions; funding of research and development; legal risks; stock repurchase programs; changes in federal and state income tax laws or corporate laws; and changes to our business model. 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. Further, the special dividend declared by the Board of Directors in December 2012 should not be considered a recurring event. A reduction or cessation in our dividend payments could have a negative effect on our stock price.

Impairment of Investments

Our investment portfolio is primarily comprised of commercial paper, debt securities issued by U.S. governmental agencies and municipal debt securities. These investments are intended to be highly liquid and low risk. If the markets for these securities were to deteriorate for any reason, including as a result of a downgrade in the credit rating of U.S. government securities, the liquidity and value of these investments could be negatively affected, which could result in impairment charges. In addition, the value of any investments we may make in private companies, such as OmniGuide, Inc., could be negatively affected by any number of reasons, including the financial condition or prospects of the company or the terms of any subsequent financing, which could also result in an impairment charge. Any such impairment charges may have a material impact on our financial condition and results of operations.

Item 4. Mine Safety Disclosures

Not Applicable.

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Item 6. Exhibits

This list is intended to constitute the exhibit index.

3.1	Third Restated Articles of Incorporation, as amended. Incorporated by reference to Exhibit 3.1 of the Company's Annual Report on Form 10-K for the fiscal year ended April 3, 2010.
3.2	2009 Amended and Restated Bylaws, as amended. Incorporated by reference to Exhibit 3.1 of the Company's Current Report on Form 8-K filed on November 9, 2012.
4.1	Rights Agreement, dated as of May 18, 2009, between Electro Scientific Industries, Inc. and Mellon Investor Services. Incorporated by reference to Exhibit 4.1 of the Company's Current Report on Form 8-K filed on May 19, 2009.
31.1	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
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 *

* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities and Exchange Act of 1934, and otherwise are not subject to liability under those sections.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: November 6, 2013

ELECTRO SCIENTIFIC INDUSTRIES, INC.

By: /s/ NICHOLAS KONIDARIS

Nicholas Konidaris

President and Chief Executive Officer

(Principal Executive Officer)

By: /s/ Paul Oldham

Paul Oldham

Vice President of Administration, Chief Financial Officer and

Corporate Secretary

(Principal Financial Officer)

By: /s/ Kerry Mustoe

Kerry Mustoe

Vice President, Corporate Controller and Chief Accounting

Officer

(Principal Accounting Officer)