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ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

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FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the ESI fiscal 2017 Q3 earnings call. My name is Jamie and I will be your operator for today. At this time, all participants are in listen-only mode. (Operator instructions.)

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

Brian Smith - *Electro Scientific Industries, Inc. - Director, IR*

Thank you, Jamie, and good afternoon, everyone. My name is Brian Smith, Director of Investor Relations for ESI. With me today are Michael Burger, our CEO, and Paul Oldham, our Chief Financial Officer. This call will cover our fiscal third quarter of 2017 results.

Before we begin, I would like to remind you that some of what we say on this call will include forward-looking statements concerning customer orders, shipments, revenue, gross margins, expenses, and earnings. These statements are subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

These statements include a number of risks and uncertainties that are discussed in more detail in today's press release and our filings with the SEC. Actual results may differ materially from those forward-looking statements.

This call also contains time sensitive information that we believe to be accurate as of today, February 1st, 2017, and which could change in the future. This call is the property of ESI.

Now I would like to turn the call over to Michael.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Thank you, Brian. Good afternoon and welcome to our third quarter conference call. Before I begin, I'd like to take the opportunity to share with you how thrilled I am to have joined the ESI team.

I have spent the past four months visiting customers and employees in many parts of the world, working with the executive team, and understanding our customers' strengths and challenges. My initial thoughts on the company are as follows.



FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

ESI's core competencies are real and they are differentiating. These competencies involve expertise in laser-material interaction, high-speed precision laser beam positioning, proprietary laser technology, and micron level defect detection. These competencies are valued by our customers, and the market trends behind these customers are making these competencies more and more relevant.

Second, ESI in the past 18 months introduced several new platforms that take us into new market segments which have the potential to drive incremental revenue for the company.

And finally, our core markets are dynamic and growing, however, cyclical in nature. As you are aware, we have just experienced a two-quarter pause in capacity investments in the flex drilling market, which has had significant impact on our results.

Looking at the third quarter, we saw improving orders growing and based on the seasonal strengthening of the flex market, sequentially higher revenues, and progress on new products. We have essentially completed the integration of the Visicon acquisition, which we believe will provide new opportunities for growth and product differentiation.

That said, we still delivered a below break-even bottom line and negative cash flow, which is something my team and I are very focused on changing. The flex drilling capital equipment demand rebounded late in the third quarter after a two-quarter slump. Demand appears to be strong, broad based, and driven by new features and technologies.

These factors underscore our view that this is a good market that provides a solid, long term growth profile. Industry analysts continue to project high growth rates over the next several years for flexible circuits driven by new technologies, miniaturization, and increased flex content per device.

However, the annual demand profile for additional capacity also appears to become increasingly seasonal. With a large portion of our revenues in the past few years dependent on this market, this seasonality hit us hard in the past couple of quarters.

While it is too early to tell the effect that this seasonality will have on this coming year, we are working diligently to increase adoption of new products into new adjacent markets, which should eventually reduce the impact of this seasonality on our total business.

On the new product front, we've had several successes. We received customer acceptance and recognized revenue for our first CornerStone IC packaging tool. In addition, we shipped a tool against our second CornerStone order to another major customer, who should finish their installation in Q4.

We also received our first multiunit order of the new nViant HDI platform from a tier one customer. All of these orders and qualifications are very meaningful milestones in driving adoption of our products. The overall customer interest in ICP and HDI tools continues to be strong and encouraging. However, product adoption in these new markets just takes time.

As we go through this adoption process, we continue to learn and iterate our products and recipes to strengthen our position. Although this process is taking longer than we would like, we remain confident. Our objective is that, as we win initial slots, we will be able to establish a long term position in these large markets.

Turning to our micromachining business, we are focusing our efforts on applications involving either brittle materials such as glass or sapphire, or soft goods such as fabrics. These materials require more specialized processing that we believe plays to our strengths and broadens our opportunities beyond consumer electronics.

As I mentioned last quarter, our Visicon acquisition brings with it the competency of metrology and inspection, which is a natural value-add to laser micromachining.

In summary, there are a lot of opportunities at ESI, but there is more work to do. As a management team, we are working to aggregate these opportunities into a success model that will allow us to gauge our process on an ongoing basis. Our focus will be on maximizing our near term



FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

opportunities, improving our execution, accelerating the adoption of new products, and delivering more consistent earnings. I look forward to sharing more details on this model with you very soon.

With that, I'll turn the call over to Paul for an overview of our financial results.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Thanks, Michael, and good afternoon, everyone. The following information includes results from our third quarter of fiscal 2017, which ended December 31st, 2016. To improve comparability, we are also providing earnings per share and related income statement results on a non-GAAP or adjusted basis, excluding the impact of purchase accounting, equity compensation, acquisition costs, restructuring, and other items.

For the quarter, orders were \$44.1 million. The sequentially higher bookings are primarily the result of renewed demand in the flex via drilling market. Our overall interconnect product orders more than doubled sequentially and were higher than a solid quarter a year ago.

Our component test business also delivered solid orders growth, with higher demand in both our systems and our consumable tooling products. Our new Allegro high productivity MLCC tester is being embraced by customers. Orders for semiconductor products fell slightly on lower demand for circuit trim systems.

Demand in our micromachining segment was slow in Q3. With the repositioning of our focus in this market we have identified several opportunities, but they will require time to develop.

We also saw initial bookings for our inspection equipment in the medical market from our recent Visicon acquisition, and are encouraged with the opportunities we see in this market.

Shipments were \$35.8 million. Backlog increased by \$8 million to \$42.3 million, and our book-to-bill ratio was 1.2 to 1. Revenue for the quarter grew 14% to \$33.8 million, driven by higher order levels.

Systems revenue was \$25.4 million, up 19% from last quarter. Service revenue increased slightly to \$8.4 million. Looking forward, we see pressure on our service revenues primarily related to an aging installed base in micromachining. Conversely, we believe service revenues will recover as our new products are adopted in the market.

GAAP gross margin was 33.9% and included about \$370,000 of purchase accounting and equity compensation in cost of sales. On a non-GAAP basis, gross margin was 34.5%, compared to 38.2% last quarter, lower primarily on timing of several other cost of sale items, including some inventory expense, laser repair and warranty costs, and material cost variances.

Looking forward, we expect gross margins to be meaningfully higher in Q4 on higher volume and improved other cost of sales, as the unfavorable items from Q3 should not repeat.

GAAP operating expenses were \$21.5 million, about \$600,000 higher than last quarter, primarily on higher stock compensation. Operating expenses included a total of \$2 million of purchase accounting and stock compensation.

On a non-GAAP basis, operating expenses were \$19.3 million, slightly above last quarter, principally due to including three months of Visicon expenses versus two months last quarter. Looking forward, we expect non-GAAP expenses in Q4 to be up slightly from Q3 due to variable costs associated with higher revenues.

On a GAAP basis, operating loss was \$10.1 million. Non-GAAP operating loss was \$7.7 million.

Tax expense was a small benefit this quarter on credit from the expiration of a statute related to an uncertain tax position. Looking forward, we received a verbal notification that our pioneer incentive in Singapore will be renewed for an additional five years.

FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

As a result, we continue to expect to see annual tax expense in the \$1 million to \$2 million range regardless of our level of profitability. This increases income leverage as revenues improve.

GAAP net loss was \$9.7 million, or \$0.29 per share. This compares to a loss of \$0.30 last quarter and a loss of \$0.15 per share last year. On an adjusted basis, net loss was \$7.6 million, or \$0.23 per share, favorable to our guided range, compared to net loss, or \$7.7 million or \$0.24 per share last quarter, and income of \$0.4 million or \$0.01 per share last year.

Turning now to our balance sheet, cash and investments decreased to \$54.3 million. We used \$3.7 million of operating cash during the quarter, primarily on negative EBITDA, offset by improvements in working capital.

Accounts receivable decreased by \$2.1 million to \$27.7 million. DSO was 75 days. Inventories decreased by \$3.1 million to \$58.8 million. Inventory turns were approximately 1.5 times. Accounts payable increased by approximately \$700,000 on the timing of inventory receipts and payments.

And capital expenditures were about \$700,000, down from \$1.2 million last quarter. Depreciation and amortization, excluding purchase accounting, was \$1.8 million.

As we announced earlier this month, we closed a \$14 million 10 year term loan with First Tech Federal Credit Union. The loan is secured by a mortgage on ESI's Portland headquarters' facilities. This transaction partially monetizes a significant corporate asset with low cost, covenant light, long term debt. The fixed rate on the loan is 4.75% with no prepayment penalty.

We have also reached an agreement with Silicon Valley Bank to amend our primary \$30 million line of credit to provide more financial flexibility and extend the facility through March of 2019. These actions continue to strengthen our balance sheet and give us the financial flexibility to implement our transition and growth plans.

In summary, in the third quarter we began to see improved financial performance. And we expect things to further improve in Q4, primarily on seasonal strength in our flex business. As we've focused our efforts and investments on the initiatives and actions Michael mentioned earlier, we will look for innovative ways to grow our top line on a more consistent basis, lower our break-even revenue level, and improve our consistency of earnings over time.

Based on Q3 orders and backlog, we expect fourth quarter revenues to be between \$40 million and \$45 million, and non-GAAP loss per share to be between \$0.02 and \$0.07.

This concludes our prepared remarks. At this time, we would be pleased to take your questions. Jamie?

QUESTIONS AND ANSWERS

Operator

(Operator instructions.) Your first question comes from the line of Jim.

Jim Ricchiuti - Needham & Company, Inc. - Analyst

Thank you. Good afternoon. I guess, Michael, is -- the way to think about the flex drilling business going forward is, the seasonality in the business, June and September quarters would be potentially the high points for that business and then business slowing down a bit? And I'm talking about from a shipments standpoint.

FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

It seems that -- yes, I think that's pretty close. This is all about building capacity to ramp for typically consumer electronics deliveries in the third quarter -- calendar quarter, so yes. So, building capacity on the front half of the year, exercising that capacity through the summer months, and then getting ready for shipment at the end of the year, that's kind of what we have seen over the last couple years.

It is just -- I think it's taken us a little bit aback as it relates to just the severity of the seasonality. But, yes, that's kind of the way we think about it, Jim.

Jim Ricchiuti - *Needham & Company, Inc. - Analyst*

And then --.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

I might just clarify --.

Jim Ricchiuti - *Needham & Company, Inc. - Analyst*

Sure. Go ahead, Paul.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Hey, Jim, I might just clarify. I think it sort of begins in the March quarter from a shipments perspective. It's probably heavy in the June quarter and starts to tail off then a little bit in the September quarter, because people will want to have production capacity in place by midsummer.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

First half build, second half delivery.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

So, first half build, so the second half deliveries. And I think it can move around a little bit, plus-minus a month or two on either end of that.

The thing we saw this year is that the seasonality was much more abrupt. It was much more the bigger differences between the ups and the downs than we've seen historically. And what we don't know is, is that kind of the new pattern or was that just an unusual year, given the confluence of softening consumer electronics markets that we saw last year?

So, it's something we're paying attention to. But the general seasonal pattern will be stronger first calendar half and weaker second calendar half.

Jim Ricchiuti - *Needham & Company, Inc. - Analyst*

No, that makes sense. Thanks for clarifying that. As we think about the new product lines, it's still early. You seem like you're seeing some encouraging signs. But now do you have any line of sight with respect to CornerStone or nViant? And then in terms of additional traction beyond what you've discussed, what does the pipeline look like of interest, and how should we think about that in terms of maybe seeing that converted into bookings?



FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

We're tracking a large number of customers in both markets, all of which have expressed some interest. And so, the pipeline is actually pretty wide and actually encouraging in that context.

The thing that's hard for us to predict, Jim, is the length of time it takes each of these individual guys to go through their internal cycles. And that's what has I think been a bit disappointing, is it's taken us longer than we thought.

That being said, the funnel is, to answer your question directly, really healthy and very wide in both market segments.

Jim Ricchiuti - *Needham & Company, Inc. - Analyst*

Okay. And then last question, just with respect to the micromachining part of the product portfolio, it doesn't sound like you're seeing much in the way of a recovery in demand in the markets you've been addressing. You alluded to some new markets, which it sounds like you're going to have to potentially beef up sales and marketing to go after some of those markets. Is that a fair characterization?

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Well, actually we've been focused on these markets now for over a quarter. And so, the work has already begun. It's not starting from scratch.

And I think what we're saying is that even some of our traditional customers that we've done business with in the past on micromachining are still customers that we would be working with. What we're trying to do is really narrow our focus around specific areas where we think we add more value today.

And so, it's not a complete customer redo, although we are finding that there are a number of new customers that we haven't done micromachining work with in the past. And those do take longer.

But I think the way to think about the new focus around brittle materials and soft goods is it's really more of a filter to use where we actually can distinguish ourselves in terms of differentiation, different than kind of maybe the also ran guys that are all over the world.

So, this is really more around a winning strategy. It doesn't preclude us from doing business with the guys that we've done business in the past, but it has opened up new markets that we're excited about.

Jim Ricchiuti - *Needham & Company, Inc. - Analyst*

Okay, thanks. I'll jump back in the queue.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Thanks, Jim. Appreciate it.

Operator

Your next question comes from the line of Tom.



FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Yes, I hope I'm the right Tom (laughter). So, when you look at the flex business, you said that demand looked like it was fairly broad based. I'm just curious. What does that mean exactly? Is that a lot of different customers that all serve the same end markets? Is it different end markets? How would you describe that?

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Well, we think -- we don't know for sure, Tom, because frankly we don't -- we're not exposed directly to customer names by our customers. So, our customers are sworn to secrecy as it relates to who they're doing business with.

What we're feeling good about is it's a large number of customers, our customers. So, it's multiple customers. It's actually multiple regions, which is also very positive. And frankly it is kind of spread over several quarters in terms of backlog.

So, we believe that it's probably multiple end customers are pulling on the demand. We think it's probably primarily consumer electronics. Again, we don't know for sure. And again, kind of broad based in terms of the number of companies and the regions, both of which we feel pretty good about.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Okay. I guess the question is, it seems like you haven't been able to kind of track it down to one or two huge products in the end markets really driving the demand or causing a weaker than normal year. It's more of a general economic slowdown in electronics, or a consumer electronics slowdown that you've kind of matched with your performance.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

No, we're aware of some of the end applications. So, OLED is one of them, so we do believe that consumer electronics is a major driver. But we're not really privy firsthand. Everything is kind of third hand as it relates to the actual end customer name.

But it does fit the cycle of consumer electronics and it does fit the cycle of some of the bigger mobile communication guys who are trying to basically get ready for Q3, Q4 of the calendar year.

So, I think -- we believe that it's consumer electronics driven. We believe that it is mobile driven. But we do think that it's perhaps more than one company, which is always positive, but, again, with no real -- everything's kind of anecdotal at that stage -- from that stage.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Okay. And it's your belief that it was really a market slowdown. It wasn't any kind of share shifting or share loss along the way for last year.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

No, actually. We're actually more confident today that there was no share loss based on just the level of activity that we've gotten. In fact, of course when things turn down you get paranoid. And we did, but I feel actually really good about where we are from a share perspective based on just the level of recovery that we've seen, the amount of quote activity that we've seen from the general customer base.



FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

And the scary thing about the consumer electronics business at large is you're not really sure who's going to end up getting the business, so we end up basically doing a lot of quote activity that gives us kind of a real good understanding of who at least is involved in the potential of the business.

Now it looks like the business has been placed, and so we're able to really feel good about the fact that the recovery was a stall, not necessarily share loss, and that we're seeing the resurgence, again, very broad based. So, no, I think we can say pretty confidently that we did not lose share through that downturn.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Okay, great.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

And Tom, I'd say the factors that we discussed earlier that would cause this market to recover are exactly what we're seeing. So, we're seeing new features coming into the next generation of devices, and that's driving more content per device. And we're seeing projections for more devices in the coming year.

And so, those things are all playing to our strengths and to our market position. And that's what we're seeing, is a healthy rebound in the business.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

It's actually really encouraging.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Okay, good. I guess moving over to the MLCC world, the ramp you're seeing right now, is that sustainable for multiple quarters or was it a slug of business that just came through?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Well, I think we've seen it sort of build over the last couple of quarters. And historically MLCC strength was sort of a little bit of a predictor of the overall health of the electronics market. So, I think there will be some carry through to this, but we'll have to see how broad that is.

The last many years, that market was impacted by the fact that so many devices were being folded into essentially a smartphone. And so, that caused there to be quite a bit of capacity for quite a few years. It seems like we're getting through that now and that now the underlying -- just the number of MLCCs in the aggregate may be starting to grow again, and we're seeing the demand that results from that.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Okay. Yes, we've all seen the hundreds of MLCCs that goes into the advanced handset. What does kind of the simple IoT device look like from an MLCC point of view?



FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

It's all -- what's great about IoT devices is they're basically all -- they're all driven by radio. And the great thing about the MLCC is it really drives the filter set.

So, I think filtering is really one of the bigger drivers of capacitors. And so, we feel really good about that. The proliferation of wireless is absolute, and I think that's not only in IoT but I think even in automotive and a lot of other applications.

So, I think we're really in a good position in that context. I think wireless is the major driver.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Yes. Okay. And then Paul, you mentioned that you thought maybe service would come down a little bit from the micromachining. Is that a precursor to a refresh cycle for the micromachining tools?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Well, I think the dynamic here, Tom, is just that, if you go back in time, we've had some big slugs of tools we've put in the market. So, we've got a large installed base, but that installed base is kind of aging and starting to come offline. And so, we just think that the revenues associated with that installed base are going to start to decrease a little bit.

Partially offsetting that will be the new capacity we've put in the market for our flex tools, which is -- we've seen a big slug of that in the last year. We'll see more of that this year. And as the new products start to come in, we'll start to see some of that go under contract as well.

So, I think the point is is we've had a typically pretty strong service business. We're going to see a little bit of a soft spot in that for a few quarters. And we just wanted to kind of give some sense or color to that as one of the business dynamics we're seeing.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Okay. And then you mentioned the --.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Service will also long term be driven by new product adoption.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Right.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

So, there may be a pause. But as new product adoption accelerates, which as you hear we're working diligently on, that should long term -- actually you see a recovery in that service business.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Okay. And then Paul, you talked about the OpEx going up a little bit. Was that on a non-GAAP basis?



FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Yes, that's a non-GAAP basis. I think on a GAAP basis it'll probably flatten out or come down a little bit, because some of the stock compensation this quarter was a little heavier on the frontend than it will be on an ongoing basis.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Okay. And then finally, you quoted some cash investment numbers that don't seem to match up with the balance sheet. I'm wondering is there something that you're adding to what's on the balance sheet to get to that higher cash number.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Yes. If you add the long term investments to the short term cash and investments, you'll get the cash total number.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Okay. Well --.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

And then for clarity, the term loan was closed in January. So, that will not be in the December report quarterly numbers. That would be incremental to that.

Tom Diffely - *D.A. Davidson & Co. - Analyst*

Okay. All right. Thank you.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Thanks, Tom. Appreciate your interest.

Operator

Your next question comes from the line of David Nierenberg.

David Nierenberg - *Nierenberg Investment Management - Analyst*

Hey, team.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Hi, David.



FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

David Nierenberg - *Nierenberg Investment Management - Analyst*

Michael, you're off to a good start just as advertised by your prior shareholders. You can take (multiple speakers).

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Well, I must tell you I had nothing to do with -- I'd love to claim that, but I can't.

David Nierenberg - *Nierenberg Investment Management - Analyst*

(Laughter.) I have some little questions for you guys just from reading. There was a \$321,000 restructuring cost in the quarter. What was that?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Yes, that's primarily some costs from consolidation in the Visicon acquisition. So, as we bring that on and get that completed, there's a few people that are exiting associated with that, and that's what you see there.

David Nierenberg - *Nierenberg Investment Management - Analyst*

Okay. In the third paragraph of the press release, you used the word repositioning to describe the micromachining business. Is that what Michael was talking about in terms of changing the orientation towards brittle and soft away from some of the historical relationships and applications, or was there something else meant by the use of that word?

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

There is a little bit more as it relates to how we're going to market, David. We're -- with the addition of some of the Visicon people specifically, George Linscott, he has led a charge which I think we all feel really good about, which is this consultive sell approach, which I think has a lot of merit. We're seeing great feedback from it from our customers.

And what that really means is more of a go to market view. It means that we're not selling pieces of machine. We're selling solutions. And out of that, we should be able to sell not only the machine but also the expertise and the support and the services side with that.

And so, we're leading with expertise versus machines. And I think that is really what we mean by repositioning. And we're taking that repositioning and focusing it into specific markets where we believe we have a recipe set that is differentiated. And that's the brittle material and the soft goods.

David Nierenberg - *Nierenberg Investment Management - Analyst*

Got it. Thank you. Paul, I wanted to come back to your explanation of the change, the downward change, in the gross margin relative to the prior quarter. Because there's one thing I noticed that you didn't talk to, which is that there was a pretty substantial 520 basis point sequential drop in the gross margin of the services business as opposed to systems. So, could you take a little more time, please, to walk us through what happened to gross margin in this quarter and why you feel good about it recovering in the March quarter?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Yes, it's a good question, David. When we talked about the laser repair portion of that, that primarily affects the services business. So, that has to do with kind of the timing of our laser repair activity, which carries with it pretty good margins. So, if that's off in a quarter, that can have a large swing especially on the service business, but it can also impact the total.



FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

And that was one of several things, all of which are in other cost of sales, which impacted the total results. So, the other things were we had a little higher inventory expenses this quarter. Nothing out of the ordinary or special charges or anything, but just a little higher costs there. And then we also saw some timing related to material costs, which are more related to the timing of when those get reflected onto the income statement.

Now, all of that's compounded by the fact that we're only talking about \$33 million of revenue. So, a few hundred K is 100 basis points.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

It's material, yes.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

And so, that's -- it tends to make the percentage change quite large.

David Nierenberg - *Nierenberg Investment Management - Analyst*

Yes. Well, what makes it large is that, in a small business like service, you had a sequential increase of \$516,000 in the cost of sales at a time when the revenue only went up \$136,000, right? I'm still perplexed about --.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Yes, that's exactly right.

David Nierenberg - *Nierenberg Investment Management - Analyst*

What that was all about.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

And again, that's just the timing of the mix of that repair activity.

David Nierenberg - *Nierenberg Investment Management - Analyst*

Okay. Last question. I think, Michael, in your comments, you mentioned customer acceptance of --.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Yes, sir.

David Nierenberg - *Nierenberg Investment Management - Analyst*

The new product. The amount of shipped systems pending acceptance was very similar between the last quarter and this quarter. Does that reflect that the first unit was booked into revenue but the second unit is a system waiting for acceptance of virtually the same valuation?



FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Yes, that amount of kind of deferred revenue has several pieces moving in and out in a given quarter. But those are the two big ones, so that's exactly right, David. One moved into revenue. Another one moved into deferred upon shipment of the product.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Yes. What we said in our script is we expect to have that recognized in Q4, the second machine.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

I think the installation will be completed in Q4.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Yes, right.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

So, it'll see the timing on the final.

David Nierenberg - *Nierenberg Investment Management - Analyst*

Sorry for the nerdiness of the questions. I'll come back (inaudible -- technical difficulty).

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

(Laughter.) No, no.

David Nierenberg - *Nierenberg Investment Management - Analyst*

Congratulations.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

They're good questions. Thank you.

David Nierenberg - *Nierenberg Investment Management - Analyst*

Congratulations on a quarter in which you had a very, very substantial sequential increase in bookings and where you beat the Street and where your guidance beats the Street again. Nice start.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Thank you very much. Thank you, David.



FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

Operator

Your next question comes from the line of Jim Ricchiuti.

Jim Ricchiuti - *Needham & Company, Inc. - Analyst*

Hey, Paul, can you say what the revenue contribution was from Visicon in the quarter?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

We typically don't break that out at that level, Jim, but I'd say it's roughly consistent with our expectations. We expect that -- the first couple quarters to start to ramp up, and we're seeing that activity happen.

Overall, we said on an annualized basis we'd expect it to be in the \$10 million to \$20 million range. That's kind of what we'd expect kind of next fiscal year. So, we're ramping towards that.

Jim Ricchiuti - *Needham & Company, Inc. - Analyst*

Okay. I think in the last quarter it was slightly dilutive. Is it still -- is it kind of around break even-ish or dilutive?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

That's the -- I'd say it's still slightly dilutive on a full quarter of expenses. Last quarter we only had a partial quarter. But it's definitely moving in the right direction. It's narrowing rapidly.

Jim Ricchiuti - *Needham & Company, Inc. - Analyst*

Okay. And with respect to bookings --.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

And by the way, a higher book-to-bill in that business. So, like I say, directionally moving the right way.

Jim Ricchiuti - *Needham & Company, Inc. - Analyst*

Okay. And a question on bookings, maybe the tone of bookings that you're seeing thus far in the quarter. And this may not be a fair question because I know there's some seasonality. Things start off a little slow. But just what are you seeing, Michael, in the business in terms of the bookings activity thus far in the fourth quarter?

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Oh, in the fourth quarter?



FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

Jim Ricchiuti - *Needham & Company, Inc. - Analyst*

Yes. And again, it may not a fair question because of the seasonality of the year just starting -- calendar year starting.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Yes. I think what we said in our script, which we'll stay with, is that we expect continued improvement in the fourth quarter.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

That's right.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

And that's what it looks like, that the trend is going to strengthen here, at least in the near term.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

It looks very positive, Jim, overall.

Jim Ricchiuti - *Needham & Company, Inc. - Analyst*

Okay. Thanks a lot, guys.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Thank you very much, Jim. Appreciate it.

Operator

Your next question comes from the line of Jason Ursaner.

Jason Ursaner - *Bumbershoot Holdings - Analyst*

Thanks for taking my questions.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Hey, Jason. How are you?

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Hi, Jason.



FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

Jason Ursaner - *Bumbershoot Holdings - Analyst*

Good. How you guys doing? The reposition to the brittle material and fabrics, would that reflect the competitive advantage of the tunability pulse of the Pyro 25 platform and Eolite and kind of better position the internal laser strategy, or is that more through top [win], kind of the tiered model?

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Well, I think we believe that it better positions us to add value, either through the optics, the laser, or the actual application, the system application itself. We do believe that we have some advantages with our own laser in these applications.

But given the opportunity, it's really we're -- from a marketing perspective, we're somewhat agnostic in that we'll do whatever we believe is the right thing to do to help the customer. Certainly we would prefer to be able to supply it with our own laser, but that won't preclude us from taking the opportunity or engaging. But we did pick these two market segments because we have a lot of history and a lot of application understanding with and without our own laser set.

Jason Ursaner - *Bumbershoot Holdings - Analyst*

Got it. And just on the balance sheet, obviously a solid net cash position. You're adding a little bit to it with the mortgage, kind of back leveraging the property. Just maybe remind people what kind of are the goals for capital allocation, what are the big internal investment opportunities, since it kind of seems like the new product platforms are kind of in place already.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Yes, I'd say at a broad level our goals for cash are to grow our business organically. In the near term, we are making investments in the business. We've just had a couple quarters where we continue to invest despite lower revenues.

Obviously, we expect that to improve because we would expect revenues and margins and ultimately OpEx to come down to where we could be more closer to an EBITDA break-even or better level. But at the same time, we'll see working capital demands on the business, particularly as we see revenues up sharply from this quarter to next quarter and potentially after that.

So, just primarily, I'd say to fund the operations of the business. We don't -- we're not anticipating large investments beyond that. Our clear focus is around driving the organic growth opportunities in the company.

Jason Ursaner - *Bumbershoot Holdings - Analyst*

Okay, great. I really appreciate you guys taking the questions. Thanks.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Thank you, Jason.

Operator

Your next question comes from the line of J.D. [Delafield].



FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

J.D. Delafield - - Analyst

Hey, Michael. Hey, Paul.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Hey, J.D. How are you?

J.D. Delafield - - Analyst

Good. How are you guys?

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

We're doing well.

J.D. Delafield - - Analyst

Good. Hey, could you -- I don't know, I was thinking you might have had something to say today about restructuring and the sort of run rate expense base that you inherited and rationalization of certain activities. The operating expenses of the company have not come down meaningfully as the revenue of the company has declined. And I don't know if it's that you didn't say it because you -- it's too early to talk about it or you think you're going to grow back into it, or what is your thinking about restructuring?

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Yes, I think it's we are -- internally we are very much focused on driving profitability. And to your point around restructuring per se, we are working it diligently. And it is too early.

J.D. Delafield - - Analyst

Okay. So, it wasn't an oversight.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

No, sir.

J.D. Delafield - - Analyst

(Laughter.) Do you believe that you understand what a break-even revenue level is for the business now? And I'll go ahead and ask it. Have you got any early read on what you think a target operating model might be 18, 24 months out?

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

We do -- I think we understand very well what our break-even revenue is today. And we are in the throes -- as I think I've mentioned to the Street, that we want to explain what we think the operating model should be.



FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

And we have a Board meeting coming up here in the next week or so, in which we will basically vet that with our Board. And the output of that will be a communication with the Street.

J.D. Delafield - - *Analyst*

Okay. And the last question I have is on M&A. Do you think that that is something you'll continue to pursue as an organization, or are we done with acquisitions for a while?

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

We're done with acquisitions for a while. We have some internal cleanup that we are focused on.

And from there, we'll -- I think having dry powder is great. But as Paul said, we want to grow the business organically. I mean, if a great opportunity comes up, we have the opportunity to do it, but it's not our focus by any means right now.

J.D. Delafield - - *Analyst*

Okay. Well, it's good to be on board for the third time.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

All right. Thank you, J.D. Appreciate your time.

J.D. Delafield - - *Analyst*

Thank you.

Operator

Your next question comes from the line of David Nierenberg.

David Nierenberg - *Nierenberg Investment Management - Analyst*

Thank you for letting me back.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Hi, David.

David Nierenberg - *Nierenberg Investment Management - Analyst*

I want to pile on to Jason's question about capital allocation. Paul, your response was that the purpose of the capital is to grow organically, and you cited growth in working capital as revenues grow. However, this is company that, by your comments today, is turning inventory at only 1.5 times and DSO of 75 days.



FEBRUARY 01, 2017 / 10:00PM, ESIO - Q3 2017 Electro Scientific Industries Inc Earnings Call

So, as a former director and longstanding shareholder, I'd love to see DSO get shorter. And I'd love to see inventory turns get faster as part of this rationalization and rebasing that you guys are talking about, from a cost and an operational point of view.

Paul Oldham - *Electro Scientific Industries, Inc. - CFO*

Yes. Clearly we share those same goals, David, particularly around inventory. And I think we're encouraged that inventory declined this quarter. And I think there's a lot of opportunity to improve our inventory utilization.

DSO will be a little bit driven by the market. But certainly we've seen higher DSO than this before, and we've seen better. And so, we think there are some opportunities to improve that as well. And we will be managing the balance sheet closely, because that's what consumes the cash in this business. So, that's where we're focused.

David Nierenberg - *Nierenberg Investment Management - Analyst*

Great. Thanks.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Thanks, David.

Operator

At this time, there are no more questions. I'd like to turn the call back over to Michael Burger. Please go ahead.

Michael Burger - *Electro Scientific Industries, Inc. - President, CEO*

Want to thank everybody for participating. We are excited about our future, and look forward to having an update with you guys shortly. Thank you very much.

Operator

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

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