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ESIO - Q4 2014 Electro Scientific Industries, Inc. Earnings Conference Call

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PRESENTATION

Operator

Welcome to the ESI fiscal 2014 fourth quarter earnings conference call. My name is Brittany, and I'll be the operator for today.

(Operator Instructions)

As a reminder, this conference is being recorded for replay purposes. At this time, I would now like to turn the presentation over to your host for today, Brian Smith. Please proceed.

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

Thank you, Brittany. Good afternoon, everyone. My name is Brian Smith, Director of Investor Relations for ESI. With me today are Edward C. Grady, our CEO, and Paul Oldham, our Chief Financial Officer. This call will cover our fiscal fourth quarter 2014 results.

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

This call also contains time sensitive information that we believe to be accurate as of today May 13, 2014, and which could change in the future. This call is the property of ESI.

Now, I'd like to turn the call over to Ed.

Edward Grady - *Electro Scientific Industries, Inc. - CEO*

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

I'm sure many of you looked at my career and know that several times in my career, I've been asked to take difficult situations with a focus on turning a company around. I've done this successfully three times. Unfortunately, while there's a common learning and a common discovery, there's no one common solution, but there is common sense and logic that applies to achieving desired results.

First, I want to thank our investor base for hanging in there with us over this past many quarters. I want to acknowledge our past failure to execute, but with that said, I'm focused on the present and the future.

As I've become deeply involved in the day-to-day dynamics of the Company, my perceptions and knowledge have grown dramatically. First, I'm pleased to have this opportunity as part of the ESI management team to change the direction of the Company to get back on course of profitable growth. I took on this role as Chief Executive knowing there were challenges, and I'm prepared for these challenges.

Second, I validated some of my concerns about the direction and strategy of the Company. And I've confirmed that the team at ESI is a strong and capable group of managers, a very talented and clever set of engineering and technical talent, and a dedicated, well connected global sales team, a well oiled capable operations group, and functional organizations that are effective and efficient.

I'm not going to go into detail of the Q4 and FY14 results. I'll leave that to Paul. But I will give you my perspective and share some actions we've taken.

First, let's take a look at Q4 2014, and let's look forward to 2015 and beyond. I want to focus on three metrics, bookings, revenue, and cash.

The first, bookings, in Q4 we missed our bookings estimate substantially. We can attribute this miss primarily to one customer, where within days at the end of the quarter, we knew our tool had been selected and believed we would get a significant multisystem order. The reality is, in the end of the customer took an alternate course and decided to upgrade the installed base rather than place new system orders. We were aware that this might reduce the system purchases over time, and had adjusted our projections but we did not have the full story.

While we do not expect the customer to change, we understand the volatility and the customers' demands, and we must adjust and become more intimate in their process. We've taken action and brought in a new account manager who is deeply familiar with the account and has a track record of success with the customer. I believe this will make a difference.

We've taken actions to change our delivery model and sample capability to dramatically increase our speed and effectiveness at addressing opportunities with the customer. This is already opening up new doors for us and giving us greater insight into new opportunities.

Second, although we anticipate some overcapacity in the flex [and field] drilling market, we underestimated the depth and impact on the OEM supply chain and the effect of more aggressive local competition. Again, we have taken action to deepen our analysis of the supply chain and to aggressively defend our market position using our balance sheet, defending our intellectual property, and introducing our new versions of our model 5335 that addresses customer needs for specific applications and cost of ownership in the flex market.

Next revenue, our revenue miss was driven by two things. Obviously, the bookings miss impacted our expected turns business from both our key customer and in flex. However, on the positive side, we did recognize revenue from the first Gen 6 glass cutting tool, and business in semiconductor and service were strong. Bottom line, we can only revenue what we book.

Third is cash, and Q4 receivables are up because of late quarter system shipments driven by product and customer mix changes. While we believe this is not an efficient use of cash, it is timing related and should reverse over time. In addition, we selectively invested in receivables to defend our market from competitive pressures. We believe this tactic is a prudent use of cash and will benefit our business.

Underlying inventory levels are higher than we would like. Looking forward, we are reforming our advanced material purchase policy and process to better match our risk with customer needs, and improving our NPI process to better match the timing of service inventory purchases for new product releases.

Last, we spent cash on discretionary unbudgeted items that are now a focus of the team to contain. Paul can provide more specifics on this topic.

We've already taken tactical actions as a result of the past quarter and past year's results to affect improvement in bookings, revenue, and cash flow. Beyond these near-term actions, we have and are putting in place longer term policy, process, and structural changes that we believe will improve predictability of our results.

Let me next address where we're going. I spent the last several weeks meeting with investors, customers, but mostly with our employees, and working with our executive staff, listening to their ideas on to how we can turn ESI into sustainable growth Company. Laser microfabrication is a large and growing market with lucrative market segments with specific market dynamics that we are not participating in today. These segments present opportunities for growth, but we need to make some changes.

My initial move has been to change from a centralized command and control environment to an empowered, distributed distribution decision-making structure with incentives and accountability for results. Second, I've consolidated and restructured the organization around market demand characteristics. We now have four business units, each with a unique set of market dynamics but who share product platforms. Each business unit has gone back to a clean sheet of paper and developed a business plan that looks at all of the potential applications they can serve, matching their shared core competencies with identified market dynamics.

Third, I focused the organization around enabling these business units, supported by centralized functional organizations of sales, operations, central engineering, administration, and human resources. Of course, any change of this magnitude and depth is a difficult process, but I've been very impressed by the enthusiasm and open-minded willingness to embrace these changes across the Company.

While the Company is changing its approach, the market also continues to evolve, and we must adapt. The challenges we continue to face as a Company include revenue volatility and uncertainty, customer concentration, low-cost competitors, and slow growth markets in parts of our business. We have been in the past enamored by technology and have pursued both high market risk and high technology risk for new products, believing that technology could be a sustainable differentiator as it was in the semiconductor business.

We must acknowledge our failure to commercialize our technologies to a broader range of industries and applications. We must also acknowledge that our new markets, our differentiators, are beyond just technology. We must leverage our technology to achieve not just capability, but also cost of ownership advantage and speed to solutions. Additionally, we must be perceived as local by our customers.

I believe the first step is to admit you have a problem, and we've done that. We are aware of these challenges, and we plan to tackle them head-on. I've already taken action to reorganize and restructure the Company. I've challenged the team and enabled and empowered them to think outside the box, to act aggressively, and to take the offensive in the markets and confront competitors.

We've established a form to engage and challenge each other as teams, identify areas for cooperation and organizational improvement, focused on lean operations across the Company. We have aggressively brought in new talent in targeted areas, and we will continue to do so.

We've also developed initial bold action plans to address our challenges. This exercise is not complete, but I'd like to give you a sense of the themes emerging from our discussions around how to grow this Company.

First, we need to move away from a unique customer-driven, opportunistic, and reactionary approach to a market-based and applications approach while maintaining our customer intimacy. In the future, we will develop and market systems designed and based on modular platforms leveraging standard parts and subsystems. Our configurable products will appeal to broader markets and take our technologies into multiple industries. We live to serve our customers, but we must increase the marketing contribution to our product development to help us broaden these markets we serve.

Second, we must shift from focussing our efforts on emerging markets and technology, high risk applications, to existing adjacent ones where both market and technology risks are substantially lower. In the past, we have made large bets on emerging technologies and industry processes, only to discover that the applications did not emerge as we had expected, and our market opportunity was smaller than we had hoped.

Existing markets have incumbent competitors, but the market opportunity and customer needs are established and known. We have substantial capability and technology in place to address them today. While we continue to see through our investments in semiconductor and glass microfabrication, we will be actively reallocating resources to pursue this broader set of opportunities.

Third, we must rapidly follow initial technology solutions with redesign for lower cost in order to address a broader set of micromachining markets. We can successfully apply our IP and technology into lower-cost solutions which will give us a cost of ownership advantage in some large and established markets that we do not fully participate in today. This will require some investment in channel and localization, but we believe these represent large opportunities for ESI.

Fourth, we must better utilize our internal laser capability to create both differentiation and cost advantage in our systems. Our acquired laser businesses possess compelling technology advantages, but we have been too slow in adopting them into our systems. Our plan is to accelerate that adoption dramatically.

Fifth, I mentioned that we will develop a more market based approach to our business, and that might involve bringing in selected competencies and expertise from outside the Company. And enhancing our distribution channel on variable cost basis. But for the most part, these changes will involve new ideas and approaches and the reallocation of resources rather than starting from scratch or increasing our overall investment.

The technologies in this Company are compelling and commercializable. We just need to do a better job applying them and directing them towards larger, more established markets.

These five themes are some of the high-level thinking as we begin to renew and refresh ESI as a Company. As our plans are put into action, the key will be execution.

I'm excited about the team we have here and about the future of ESI. The changes we're making are exciting. It will take some time to be fully realized.

As we continue to put more detail in place, we will share our plans and milestones with you in the coming months. Now, I'll turn the call over to Paul for detailed discussion of our results for the fourth quarter and guidance for the first quarter of FY15.

Paul Oldham - *Electro Scientific Industries Inc - CFO*

Thank you, Ed. Good afternoon, everyone.

The following information includes results from our fourth quarter and fiscal year 2014 which ended March 29. To improve comparability we are also providing earnings per share and related income statement results on a non-GAAP basis, excluding the impact of purchase accounting, equity compensation, impairment charges, and other items.

Orders for the quarter were $31.7 million compared to $35.6 million last quarter and $44.1 million a year ago. For the quarter, orders increased modestly in both the semiconductor and the components groups, but decreased in interconnect and microfabrication. The decrease in IMG was due primarily to the softness in flex via drilling that Ed mentioned earlier.

The fourth quarter is typically a seasonally strong quarter for the flex business as Korean manufacturers add capacity. The weakness in the market this year was also the primary factor in the year-over-year decline. Looking forward, we expect modest improvement in this market as other OEMs began to place demand on the supply chain.

In addition, microfabrication orders continue to be very soft as anticipated demand for a large opportunity did not materialize. In fact, the decline in our business as a Company over the last few quarters and for the year, is largely related to lower orders from this customer, as there have been few new design, and capacity needs have been satisfied through upgrades to the installed base.

While the nature of this business isn't something that will change, we believe that future opportunities to continue to abound, and we are taking several steps to broaden our exposure to new applications, improve our flexibility and speed, and develop new customers in this segment.

Within the semiconductor group, business levels were up primarily due to strong activity from our acquired semi systems business which saw excellent demand for circuit trim and wafer trim application. ESI acquired this business just over one year ago, and we are very pleased with the integration, with the team, and with the financial results. Within the components group, orders and revenues were down sequentially as the MLCC market continues in overcapacity, given low overall electronics growth and cannibalization of devices by smartphones. The growth forecast for the overall MLCC market remains very sluggish, but pockets of demand for new capacity will be driven by technology buys, where special application capacitors with new form factors and higher capacitance.

Shipments were $42.3 million. Backlog decreased by $10 million to $27.4 million, largely on shipments of the higher flex orders booked in the third quarter, and the shipments of both the Gen 4.5 and Gen 6 glass systems.

Revenue for the quarter was $37.1 million, a decline of 3% from last quarter and down 6% from last year. Semiconductor group revenues grew sequentially on the strength of the wafer and the circuit trim business. The other product groups showed sales declines which more than offset the increase in semi.

GAAP gross margin was 10% and included an inventory write-off of about $12.8 million related to discontinued products and services as part of our shift in strategy and refocusing our efforts on newer applications. Cost of sales also included about $450,000 of purchase accounting and $160,000 in equity compensation, both well below last quarter and last year.

On a non-GAAP basis, gross margin was 46.2%, compared to 44.6% last quarter, and up meaningfully from 42.2% last year. We were pleased to be able to drive gross margins up on lower revenues. Margins improved on favorable mix, lower manufacturing expenses, and several favorable items in other cost of sales. Looking forward to next quarter, we expect non-GAAP gross margin to normalize to the low 40% range on lower volume, a larger mix of lower-margin products, and more normalized other cost of sales.

GAAP operating expenses were $25.5 million, which included $2.3 million of one-time charges. These charges included $1.1 million of restructuring expenses associated with the closure of our Beijing manufacturing facility, and contractual payments to our outgoing CEO, $1 million of asset write-offs, and $200,000 of acquisition and integration costs. GAAP expenses also included $810,000 of equity compensation and $150,000 of purchase accounting.

Non-GAAP operating expenses in Q4 were $22.3 million. The increase from Q3 was due largely to installation costs associated with shipping the glass cutting systems and the completion and shipment of the technology development tool we won earlier in the year from a leading semiconductor manufacturer.

In addition, we incurred higher legal and IP costs related to a change in patent law resulting in accelerated filings of several provisional patents. These increases are largely one-time in nature, and as a result we expect non-GAAP expenses to be down approximately $1 million next quarter.

On a GAAP basis, operating loss was $21.8 million compared to a loss of $4.6 million last quarter. Non-GAAP operating loss was $5.1 million compared to a loss of $3.5 million in the prior quarter, largely as a result of the higher expenses.

Non-operating expense was $6.1 million, the result of an impairment charge against the Company's equity investment in OmniGuide. This charge is a result of our reassessment of this investment, given the current environment in the medical device market which has impacted recent business results.

Income tax benefit on a GAAP basis was $300,000, and on a non-GAAP basis $174,000. The benefit was the result of a refund recognized this quarter from a recent IRS audit which more than offset our foreign tax expense. For FY15, we expect to pay roughly $1 million to $1.5 million of tax, based on foreign income. As a result, we would expect to recognize tax expense again next quarter.

On a GAAP basis, fourth quarter net loss was $27.6 million or $0.92 per share, compared to a net loss of $4.6 million or $0.15 per share last quarter. On a non-GAAP basis, net loss was $5 million or $0.16 per share, compared with a loss of $3.1 million or $0.10 per share last quarter.

Turning now to the balance sheet, cash and investments were $111 million at year end. We used $15.2 million of operating cash during the quarter largely related to working capital. For the year, we used $19.1 million which represents our first year of negative operating cash flow in many years. In addition, during the year we paid $9.7 million to acquire the semi systems business and distributed $9.6 million related to our quarterly dividends of $0.08 per share.

Finally, late in the fourth quarter, we began to exercise our share repurchase program and spent $191,000 to repurchase about 20,000 shares. The Company continues to have just under $20 million in open share repurchase authorization and expects to repurchase shares opportunistically in the market.

For the quarter, inventories increased by $1.4 million before the impairment charges, largely due to lower system shipments. Turns were approximately 1.2 times. After the impairment, inventory was $58.9 million. Improving inventory utilization is a key focus for us next year.

Accounts receivable increased by $10 million to $37.8 million, largely due to timing of shipments late in the quarter. DSO rose to 93 days. We would expect the situation to moderate somewhat in Q1. Capital expenditures were $2.2 million, and depreciation and amortization excluding purchase accounting was $2 million.

In summary, we delivered good gross margins on lower revenues in our fourth quarter, but we are still below our break-even level. Looking forward, we see many opportunities to grow the business, both opportunistically and more broadly as we transition our focus to a more market based approach, penetrate adjacent markets, and develop and implement the other strategies Ed described earlier. However, the impacts of these changes will take several quarters to materialize. In the near term, we expect business levels to continue in this range.

In addition, although the expense structure will remain roughly the same, we are taking several actions to reallocate resources, improve efficiency, and reduce discretionary spending in order to enable the Company to make the investments necessary to return to profitable growth. Given current order and backlog levels, we expect Q1 revenues to be between $30 million and $35 million. Non-GAAP loss per share is expected to be $0.25 to $0.30, largely due to the impact of lower revenues and gross margin and higher tax expense, as I discussed earlier.

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

Edward Grady - *Electro Scientific Industries, Inc. - CEO*

Okay. To summarize, we concluded a difficult quarter and we face challenges ahead, but I'm encouraged by customer reaction to the changes we have initiated so far. I'm excited about the future of the Company. We will provide you with more details about our plans to return to growth and profitability as we move forward.

This concludes our prepared remarks. At this time, we would be pleased to take your questions. Brittany, if you can open the line, we'd like to have questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Jim Ricchiuti, Needham & Company.

Jim Ricchiuti - *Needham & Company - Analyst*

Hi, good afternoon. Thank you. I wonder if you could comment on the microfabrication portion of the business. Just given the developments in the fiscal fourth quarter, how would you characterize the window of opportunity, if you will, over the next two to three quarters in this portion of the business?

Edward Grady - *Electro Scientific Industries, Inc. - CEO*

I think, Jim, a couple things that we're beginning to see change. With the change out of one of our very large customers in terms of their executive management and how they're restructuring how they look at product releases, we're beginning to see a bit of a shift in how they look at when they add capacity and where they add capacity, the concept of repurposing tools that are in their production facility now. I think in the next couple quarters, we clearly have some visibility on some very interesting projects. But it's not quite the same as the seasonal look that we've had in the past. Paul, do you want to add to that?

Paul Oldham - *Electro Scientific Industries Inc - CFO*

Yes, I think clearly one of the drivers is people adding capacity and capability for fall product launches. There is a window of time when we see some programs coming. As we work to implement some of the strategies Ed talked about, however, and begin to penetrate other applications and customers, we see opportunities perhaps to see additional business throughout the year, rather than just in the next couple of quarters.

Jim Ricchiuti - *Needham & Company - Analyst*

Right. Okay. Ed, if I may, one other question, I wonder if you're in a position at this point to share with us some of the new markets, adjacent markets, that you might be targeting. I realize it's early, and you may or may not be able to shed any more light on that strategy.

Edward Grady - *Electro Scientific Industries, Inc. - CEO*

Yes, it is a bit difficult right now to talk about them, since we're still validating size of markets. The key, Jim, is as we've looked through what are the market opportunities, we want to make sure that we're going after ones of sufficient size and potential to actually move the needle. Chasing after very small markets even though they're adjacent doesn't make a lot of sense.

Validating what the growth rates and the size of these markets are before we completely move the product set is where we are today. There's not a lot that I can give you specific, but certainly in the next several months we'll be much more specific as the data becomes more clear.

Jim Ricchiuti - *Needham & Company - Analyst*

Okay. Thanks a lot.

Operator

David Duley, Steelhead Securities.

David Duley - *Steelhead Partners - Analyst*

Thanks for taking my questions. Just one housekeeping question, did you have any 10% customers for the year, and what was the percentage?

Paul Oldham - *Electro Scientific Industries Inc - CFO*

We did. We had one 10% customer. That will come out in our 10-K. But last year our 10% customer was 31%. This year we expect it to be about 15%.

David Duley - *Steelhead Partners - Analyst*

Okay. When you talked about your big micromachining customer basically upgrading systems rather than buying new systems, forget which ever customer it is, how does that translate into ESIO? What is the cost of a new system? What roughly is the cost of an upgrade? Can you just give us some flavor for how this impacted you overall?

Paul Oldham - *Electro Scientific Industries Inc - CFO*

Yes, that's a good question, David. It depends on the nature of the upgrade. It can vary from something that's fairly substantial, if it's a laser or process upgrade, or it can be quite minor in the case of being more a handling or form factor upgrade. I would say in this case a lot of it was the latter.

Edward Grady - *Electro Scientific Industries, Inc. - CEO*

I think, David, the key perspective is orders of magnitude in terms of revenue.

David Duley - *Steelhead Partners - Analyst*

Okay. Jim already asked this question. I know you don't want to tell us which segments that you're going to go after, other adjacent micromachining sectors, but maybe you can just help us understand for those of us who may not understand, what are the three biggest sectors out there that use this type of tools that are potential for you to attack?

Edward Grady - *Electro Scientific Industries, Inc. - CEO*

Dave, I think the key, and Jim, this is for you as well, the largest growing markets that we serve today are clearly in consumer electronics. Those drive the biggest play. It's a smartphone. It's tablets, and obviously we participate in other areas. But if you want to talk about where the growth is, it's in those general OEMs. I think what we call adjacent is within the subsectors of what's in those smartphones and tablets. What other things can we go do and add value to within that sector is a key focus area for us.

There are other areas that are emerging, things like wearables that are clearly of high interest to us. Some other applications that I think I mentioned when I was on the road maybe a month or two ago, that there's clearly some interesting opportunities within the automotive sector. There are a few places that appear to be pretty high level of interest.

There are a couple of other areas of interest in security, but again, it is too early to give you which one of those or which ones are the highest probability of success right now. Does that give you a flavor of what we're looking for? Focus on consumer electronics and other applications and then broadening that to taking our technology into a few other sectors.

David Duley - *Steelhead Partners - Analyst*

All right. Okay. That's very helpful, actually. Then just a couple other questions on the inventory write-down, what exactly, what product lines are you discontinuing?

Maybe take it from a little bit higher level, I'm certainly interested in what product lines that you're discontinuing, but I'm also interested in the new products that the Company has been talking about over the last year or so. Which ones will be continued to be invested in?

Paul Oldham - *Electro Scientific Industries Inc - CFO*

Yes, I'd say, Jim, for the most part these are still largely legacy-type products in semi, a little bit in LED, and a few of the other older areas. We've continued to sell some of these products from time to time, but I think as we tried to refocus our efforts, we're trying to bring those products to an end of life and really concentrate our efforts on the newer areas.

I will say, as Ed mentioned earlier, we will certainly be carrying through our investments in the semiconductor market around 3D packaging. We'll be assessing how the glass microfabrication market evolves and develops. Then certainly, from a new product area there are many applications in consumer electronics and adjacent areas in some of the other markets that we address.

David Duley - *Steelhead Partners - Analyst*

I guess the LED stuff is coming off the table.

Paul Oldham - *Electro Scientific Industries Inc - CFO*

Yes.

David Duley - *Steelhead Partners - Analyst*

Okay. Thank you.

Paul Oldham - *Electro Scientific Industries Inc - CFO*

There is still maybe an application here and there that takes advantage of our cutting capability in different types of material, but the LED is not a focus for us as a Company.

Operator

Tom Diffely, DA Davidson.

Tom Diffely - *DA Davidson & Company - Analyst*

First, Paul, a question on the cost side, initially do you have expectations for some more restructuring costs in the June quarter, or more write-downs?

Paul Oldham - *Electro Scientific Industries Inc - CFO*

We don't have any expectations for that at this time.

Tom Diffely - *DA Davidson & Company - Analyst*

Okay. Then when you look at the OpEx being down a million or so, it looks like it's still ahead of where it was a couple of quarters ago. I assume that's the initial investment for some of these new programs. But, curious, is there an increase in the COGS side of the business, as well, or any of the gross margin line?

Paul Oldham - *Electro Scientific Industries Inc - CFO*

You're right, there is a little bit of investment as we look at some of these new programs, but again lower than we saw in the fourth quarter. On the COGS side, we have a number of programs to improve our gross margins, everything from looking at material costs, being more efficient in manufacturing, improving quality to reduce warranty, lower scrap. We've seen benefit from a lot of those this year.

In fact, our gross margins, in the mid-40s at these revenue levels is probably as good a performance for the Company at these revenue levels as I've seen. That's due in part due to those efforts. Those efforts will continue on.

We'll continue to look for ways to lower our manufacturing costs and drive improvements. We do see as we look into our next quarter, that we'll see some impact of mix and lower volume, and we're not going to count on all of the savings we've seen here. Certainly, we'll continue to try to drive those as we go forward.

Tom Diffely - *DA Davidson & Company - Analyst*

Okay. Is there any way to quantify what your break-even was, what it is today? Obviously, it's mix dependent, but on a general basis?

Paul Oldham - *Electro Scientific Industries Inc - CFO*

Yes, it's mix dependent. We've always talked about it being between $45 million and $50 million, and towards the lower end of that. I think we're probably towards the middle of that $45 million to $50 million, or maybe a little bit higher, depending on the mix. If we keep the mix we've had recently, then I would say it's well into that $45 million range or maybe even a little lower. Given our broader anticipated mix, between $45 million and $50 million, is the right way to think about it.

Tom Diffely - *DA Davidson & Company - Analyst*

When you look at your large customer and the upgrades versus the new tools, based on the programs you're working on with them, does it look like they'll be able to upgrade for future programs, as well? Or at some point, do you need new tools?

Edward Grady - *Electro Scientific Industries, Inc. - CEO*

The specific upgrade was an existing installed base that was doing a particular application. The answer I guess, Tom, is what we're seeing today are some substantially new applications that are quite interesting to us. It's back to the same question is, will these things that we are working on from a development perspective actually materialize into products that get released to manufacturing?

What we're doing now with our new account managers is really getting into a deep dive to understand better if these will get adopted, and where they're going to get adopted, and so on. I think the answer is there are some cases where you can repurpose tools, and they've done that. In the case of most of what we're seeing now, as new applications, it's new technology.

Tom Diffely - *DA Davidson & Company - Analyst*

Okay. Then how would you expect a rollout, if there's going to be one, in the glass cutting tools to work? Is it they have a couple of tools in their hands right now, and it takes a few of quarters to evaluate them, and then potentially volume orders later in the year? How do you look at that?

Paul Oldham - *Electro Scientific Industries Inc - CFO*

Tom, the adoption of this notebook touch glass at the higher CT has certainly been slower than we or the glass manufacturer has anticipated. I think at this point, the way we're thinking about it is that we've got a couple of tools that are now installed at touch panel manufacturers, and that will give us a chance to assess what will be the adoption and what will be the adoption rate.

Until you get these tools on someone's factory floor, it's hard sometimes to anticipate in these emerging areas how quick or what the adoption will be. At this point, I'd say we are in a little bit of a wait-and-see mode, but we would expect if there is a pick-up, it will be one or two at a time, and then go from there.

Tom Diffely - *DA Davidson & Company - Analyst*

Finally, there's been a lot more chatter lately on the sapphire usage in the industry. Maybe just tell us where you are, as far as cutting sapphire, and if you have products or programs in that area?

Edward Grady - *Electro Scientific Industries, Inc. - CEO*

That's a great question because through the LED application, we had some very significant investments in sapphire cutting as part of the LED program. We're putting a significant amount of effort into understanding what the implications are of applying sapphire to multiple applications in consumer products, whether that's wearables, or smartphones, or whatever. We actually, similar to what GT has said, they see great opportunities. We're taking that as a cue to make sure we have all of the technology and tools in place to meet the needs of both cutting, marking, scribing, whatever needs to be done, for those applications. We actually feel quite good about being positioned in both the strength in glass, as well as the sapphire markets.

Tom Diffely - *DA Davidson & Company - Analyst*

Those are tools you have on hand today? It doesn't need to be developed?

Edward Grady - *Electro Scientific Industries, Inc. - CEO*

We actually have the capability today.

Tom Diffely - *DA Davidson & Company - Analyst*

All right. Thank you.

Operator

Mark Miller, Noble Finance Capital Markets.

Mark Miller - *Noble Financial Group - Analyst*

You mentioned you were seeing more aggressive competition. Was that in the flex [via] drilling area?

Edward Grady - *Electro Scientific Industries, Inc. - CEO*

Yes.

Mark Miller - *Noble Financial Group - Analyst*

Have you lost any legacy accounts there, or in other areas?

Edward Grady - *Electro Scientific Industries, Inc. - CEO*

We haven't lost any legacy accounts. We probably have lost an order in the past, not in Q4, but I think we may have lost an order in Q3. Basically, we've recognized where the shortfall is.

I think what's interesting is, as the 5335 comes to market, and we start demonstrating the cost of ownership of that tool versus our competition, it's actually being very well received. We have great plans on how to take that forward. Yes, we had an issue in Q3. We've addressed it in Q4, and we're ready to fly as we go forward.

Mark Miller - *Noble Financial Group - Analyst*

You took a hit for the shipment of this developmental system and the first DiamondBlaze. I assume there are going to be future DiamondBlaze systems. Is this a one-time hit? Are we going to see other costs due to shipment of other DiamondBlaze tools?

Paul Oldham - *Electro Scientific Industries Inc - CFO*

For the most part, Mark, these are the first shipment of these tools. They're both very substantial tools. The DiamondBlaze was a Gen 6. It's our first tool of that size that we've deployed to the field. The technology development tool for semiconductors is a very sophisticated, very high-accuracy tool.

I think given the unique requirements of each of those and coming together both last quarter, that drove a lot of the extra expenses to get over the top, to get the tools installed, and running, and accepted at the customer sites. I think that we've learned a lot from that. We're over the hump on the learning curve, and we won't see that nature of expense recur.

Mark Miller - *Noble Financial Group - Analyst*

Just finally, you mentioned last quarter that the rollout or the acceptance of [grow] glass was some what slower. That had an impact. Has there been any improvement or any speed up of that process?

Paul Oldham - *Electro Scientific Industries Inc - CFO*

Like we said, there's been some customer announcements about adopting this glass, but it has been relatively slow. It generally has been for thicker glass rather than the thinner glass that this tool is really developed for. At this point, we've been able to get the tools into touch panel manufacturers that gives them the capability where in their factory they can be developing and manufacturing this glass. We'll see if that is then be able to be the thing that starts to facilitate the quicker adoption of the glass by the OEMs. At this point, like I said, we're happy to have the tools installed, and we'll be assessing the market as it goes forward.

Edward Grady - *Electro Scientific Industries, Inc. - CEO*

Mark, just a quick addition to Paul's comment. I think we've said this in the past, that we see the adoption of this on the lower end, smaller, I'll call it PC-type applications, and some of the lower-end tablets. I think what really is the leading indicator of the demand for this product is going to be is how the PC market behaves, and how the tablet market adopts this.

I think the key thing to remember is if you watch those sectors, I think you'll see what might happen, but this is not an application that's going to smartphones or to some of the higher-end tablets. We're going to certainly learn, and we're going to improve the tool, and we're going to help our customers be able to give samples, so that we can help them show the advantage of this. But again at the end of the day, it's really going to be reliant on what the end user, the OEMs, do with their products to take it to market.

Mark Miller - *Noble Financial Group - Analyst*

If I could just go back to that first question about the aggressive competition, is this primarily through pricing or technology? How is it being aggressive? It's more pricing, I assume?

Edward Grady - *Electro Scientific Industries, Inc. - CEO*

It initially was a bit of a technology challenge. They came out with a new product that had some interesting cost of ownership advantages, and we were able to counter that with the 5335. But most aggressively, I guess it's been pricing terms, the normal things that people do to try to buy into a market.

Mark Miller - *Noble Financial Group - Analyst*

Thank you.

Operator

Jairam Nathan, Sidoti.

Jairam Nathan - *Sidoti & Company - Analyst*

Thanks for taking my question. Just kind of sticking to that competition and margin topic, as you expand into newer markets, some of which might not be as particular to the finer resolutions and stuff, do you see any push-back as far as pricing goes for these tools, and how do you expect to counter that?

Edward Grady - *Electro Scientific Industries, Inc. - CEO*

A couple things, first is the applications we're going after are clearly things that we see an advantage in what we can do, the smaller hole drilling, the better cutting, the more precise cutting, the less damage to surrounding surfaces. All of those things that we can do very well, we think those are advantages and in fact, will differentiate us at our customers.

But at the same time, to answer the second part of your question, we have to figure out how to take our technology that we put into these more advanced solutions and almost immediately look at how do we redesign for lower costs. The bottom line simply is rather than just rely on technology, we have to rely on our technology to drive the capability, but also to drive cost of ownership. At the end, if you can't get the cost of ownership right, the technology and the capability won't be adopted. Does that help you understand where we're going?

Jairam Nathan - *Sidoti & Company - Analyst*

Yes, sure. Just as a follow-up, you talked about in-sourcing of lasers. How soon do you think that's possible, and can you give us some idea of what kind of savings that could achieve?

Edward Grady - *Electro Scientific Industries, Inc. - CEO*

What's interesting to me is that we have had a very, very strong pull internally since I started working with the team here, and at least two of the platforms that we have on the horizon have adopted our internal lasers. We have more on the way of actually retrofitting back into existing systems that are installed in our existing products, that we can replace the merchant laser with a better-performing laser from our internal operation.

Jairam Nathan - *Sidoti & Company - Analyst*

Okay. Then, any idea of what other savings that could be expected from that move?

Paul Oldham - *Electro Scientific Industries Inc - CFO*

It will start off relatively small at first, because we haven't had large penetration of this, but I think over time, this could generate 100 to 200 basis points of margin improvement for us over the course of a few years.

Jairam Nathan - *Sidoti & Company - Analyst*

Okay. That's good. My last question, if I look at your portfolio of businesses, what is your thoughts on the old component segment and the MLCC? You talked about it continued to be a sluggish growth segment. What are your thoughts as far as regainng that business?

Edward Grady - *Electro Scientific Industries, Inc. - CEO*

Yes, I think on some of our traditional businesses, for example in MLCC, that business has been very slow-growing and largely in overcapacity for the last couple of years. In fact, the only business we've seen there on a system business has been more for technology buys for smaller chips, these metric 0402 chips. I think as products adopt those smaller chips, we'll continue to see technology buys from time to time there.

We're also seeing interest in other types of capacitors that would also require slightly different formats, which would then require new tool buys, as well. In general, this is going to be a slow-growth market. We have a solid tooling and supplies business in this area. But from a system perspective, I think we would characterize it as slow growth with technology buys as some of these new chips or smaller chips are adopted into devices.

Jairam Nathan - *Sidoti & Company - Analyst*

Okay. Thank you. That's all I had.

Operator

(Operator Instructions)

At this time, there are no further questions. I'll turn the call over to Ed Grady for closing remarks. Please proceed, sir.

Edward Grady - *Electro Scientific Industries, Inc. - CEO*

Okay. Thank you, all, for attending our call. We're pleased that you were able to get some questions out. You're welcome to call Paul, Brian, or me, if you have any further questions. Thanks for attending the call today.

Operator

Ladies and gentlemen, that concludes the presentation for today's conference. You may now all disconnect, and have a wonderful day.
