

NANOMETRICS INC
Form 10-Q
August 09, 2007
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2007

OR

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____

Commission file number 0-13470

NANOMETRICS INCORPORATED

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

94-2276314
(I. R. S. Employer
Identification No.)

1550 Buckeye Drive, Milpitas, CA
(Address of principal executive offices)

95035
(Zip Code)

Registrant's telephone number, including area code: (408) 545-6000

Edgar Filing: NANOMETRICS INC - Form 10-Q

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of August 2, 2007, there were 18,695,944 shares of common stock, \$0.001 par value, issued and outstanding.

Table of Contents

NANOMETRICS INCORPORATED

INDEX TO QUARTERLY REPORT ON FORM 10-Q

FOR QUARTER ENDED JUNE 30, 2007

	Page
PART I.	
	<u>FINANCIAL INFORMATION</u>
Item 1.	3
	<u>Financial Statements (Unaudited)</u>
	3
	<u>Condensed Consolidated Balance Sheets at June 30, 2007 and December 30, 2006</u>
	3
	<u>Condensed Consolidated Statements of Operations for the Three- and Six-Month Periods Ended June 30, 2007 and July 1, 2006</u>
	4
	<u>Condensed Consolidated Statements of Cash Flows for the Six-Month Periods Ended June 30, 2007 and July 1, 2006</u>
	5
	<u>Notes to Condensed Consolidated Financial Statements</u>
	6
Item 2.	13
	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>
Item 3.	18
	<u>Quantitative and Qualitative Disclosures About Market Risk</u>
Item 4.	19
	<u>Controls and Procedures</u>
PART II.	19
	<u>OTHER INFORMATION</u>
Item 1.	19
	<u>Legal Proceedings</u>
Item 1A.	19
	<u>Risk Factors</u>
Item 2.	
	Unregistered Sales of Equity Securities and Use of Proceeds
Item 3.	
	Defaults Upon Senior Securities
Item 4.	
	Submission of Matters to a Vote of Security Holders
Item 5.	
	Other Information
Item 6.	26
	<u>Exhibits</u>
<u>Exhibit Index</u>	26
<u>Signatures</u>	28

Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS
NANOMETRICS INCORPORATED****CONDENSED CONSOLIDATED BALANCE SHEETS**

(Amounts in thousands except share amounts)

(Unaudited)

	June 30, 2007	December 30, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 15,387	\$ 7,957
Accounts receivable, net of allowances of \$573 and \$841, respectively	27,056	24,888
Inventories	33,118	43,601
Prepaid expenses and other	4,279	3,639
Assets held for sale	1,890	
Total current assets	81,730	80,085
Property, plant and equipment, net	46,479	43,294
Goodwill	54,922	55,217
Intangible assets, net	24,370	27,583
Other assets	1,643	1,985
Total assets	\$ 209,144	\$ 208,164
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 11,245	\$ 9,155
Accounts payable to related party		181
Accrued payroll and related expenses	5,489	5,227
Deferred revenue and product margin	4,958	6,239
Other current liabilities	9,070	8,381
Income taxes payable	390	695
Current portion of debt obligations	1,311	486
Total current liabilities	32,463	30,364
Deferred income taxes	1,553	1,848
Debt obligations and other long-term liabilities	712	1,321
Total liabilities	34,728	33,533
Contingencies		
Shareholders Equity:		
Preferred stock, \$0.001 par value; 3,000,000 shares authorized: issued or authorized		
Common stock, \$0.001 par value, 47,000,000 shares authorized: 18,646,733 and 18,141,589 respectively, outstanding	19	18
Additional paid-in capital	186,531	182,096

Edgar Filing: NANOMETRICS INC - Form 10-Q

Accumulated deficit	(14,650)	(9,909)
Accumulated other comprehensive income	2,516	2,426
Total stockholders' equity	174,416	174,631
Total liabilities and stockholders' equity	\$ 209,144	\$ 208,164

See Notes to Unaudited Condensed Consolidated Financial Statements

Table of Contents**NANOMETRICS INCORPORATED****CONSOLIDATED STATEMENTS OF OPERATIONS**

(Amounts in thousands except per share amounts)

(Unaudited)

	Three-Months Ended		Six-Months Ended	
	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
Net revenues:				
Products	\$ 32,732	\$ 20,121	\$ 65,258	\$ 36,093
Service	4,603	3,277	9,192	6,273
Total net revenues	37,335	23,398	74,450	42,366
Costs of net revenues:				
Cost of products	16,372	10,628	33,855	18,470
Cost of service	4,839	4,026	10,668	6,560
Total costs of net revenues	21,211	14,654	44,523	25,030
Gross profit	16,124	8,744	29,927	17,336
Operating expenses:				
Research and development	4,739	3,062	9,325	5,590
Selling	4,668	3,865	10,033	6,955
General and administrative	4,762	4,306	11,755	8,856
Amortization of intangible assets	1,663	159	3,212	238
Total operating expenses	15,832	11,392	34,325	21,639
Income (loss) from operations	292	(2,648)	(4,398)	(4,303)
Other income (expense)				
Interest income	29	299	52	631
Interest expense	(46)	(18)	(85)	(31)
Other, net	(541)	238	(422)	273
Total other income (expense), net	(558)	519	(455)	873
Loss before provision for income taxes	(266)	(2,129)	(4,853)	(3,430)
Provision (benefit) for income taxes	(136)	27	(112)	48
Net loss	\$ (130)	\$ (2,156)	\$ (4,741)	\$ (3,478)
Net loss per share:				
Basic	\$ (0.01)	\$ (0.16)	\$ (0.27)	\$ (0.27)
Diluted	\$ (0.01)	\$ (0.16)	\$ (0.27)	\$ (0.27)

Shares used in per share calculation:

Edgar Filing: NANOMETRICS INC - Form 10-Q

Basic	17,857	13,088	17,758	13,053
Diluted	17,857	13,088	17,758	13,053

See Notes to Unaudited Condensed Consolidated Financial Statements.

Table of Contents**NANOMETRICS INCORPORATED****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Amounts in thousands)

(Unaudited)

	Six-Months Ended	
	June 30, 2007	July 1, 2006
Cash flows from operating activities:		
Net loss	\$ (4,741)	\$ (3,478)
Reconciliation of net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	4,648	1,226
Stock-based compensation	1,876	2,006
Changes in assets and liabilities:		
Accounts receivable	(2,503)	(3,537)
Inventories, net	4,386	(3,086)
Prepaid expenses and other	(557)	(1,263)
Other assets	189	
Accounts payable, accrued and other liabilities	4,032	2,002
Deferred revenue and product margin	(1,189)	2,163
Income taxes payable	(185)	(57)
Net cash provided by (used in) operating activities	5,956	(4,024)
Cash flows from investing activities:		
Purchase of Soluris net assets, net of cash received		(6,841)
Sales/maturities of short-term investments		4,949
Purchase of property, plant and equipment	(736)	(69)
Deferred acquisition costs related to the Accent merger		(4,371)
Net cash used in investing activities	(736)	(6,332)
Cash flows from financing activities:		
Repayments of debt obligations	(261)	(1,386)
Proceeds from sale of shares under employee stock option plans and purchase plan	2,560	813
Net cash provided by (used in) financing activities	2,299	(573)
Effect of exchange rate changes on cash and cash equivalents	(89)	96
Net increase (decrease) in cash and cash equivalents	7,430	(10,833)
Cash and cash equivalents, beginning of period	7,957	40,445
Cash and cash equivalents, end of period	\$ 15,387	\$ 29,612
Supplemental disclosure of cash flow information:		
Cash for interest	\$ 64	\$ 28
Cash paid (refunded) for income taxes	\$ 71	\$ (112)
Capitalization of inventory as property, plant and equipment	\$ 5,775	\$

See Notes to Unaudited Condensed Consolidated Financial Statements.

Table of Contents

NANOMETRICS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Consolidated Financial Statements

In the opinion of management, the accompanying Unaudited Condensed Consolidated Financial Statements (financial statements) of Nanometrics Incorporated and its wholly-owned subsidiaries (collectively, Nanometrics or the Company) have been prepared on a consistent basis with the December 30, 2006 audited consolidated financial statements and include all adjustments, consisting of only normal recurring adjustments, necessary to fairly present the information set forth therein. The financial statements have been prepared in accordance with the regulations of the United States Securities and Exchange Commission (SEC), and, therefore, omit certain information and footnote disclosure necessary to present the statements in accordance with accounting principles generally accepted in the United States of America. The operating results for interim periods are not necessarily indicative of the operating results that may be expected for the entire year. These financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 30, 2006, which were included in the Company s Annual Report on Form 10-K, which was filed with the SEC on March 15, 2007.

Fiscal Period Nanometrics uses a 52/53 week fiscal year ending on the Saturday nearest to December 31. All references to the quarter refer to Nanometrics fiscal quarter. The fiscal quarters presented herein include 13 weeks.

Reclassification For the consolidated balance sheet as of December 30, 2006, Nanometrics reclassified \$4.2 million from inventories to deferred revenue and product margins to conform to the current period s presentation. In addition, the Company reclassified the amortization of intangible assets previously included in cost of product and selling expenses to a separate line on the Company s consolidated statement of operations. Amounts reclassified were \$0.2 million for the three- and six-month periods ended July 1, 2006.

Note 2. Recent Accounting Pronouncements

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities-Including an Amendment of FASB Statement No. 115* . SFAS No.159 permits all entities to choose to measure eligible assets and liabilities at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of SFAS No. 157. The Company is evaluating the impact of the adoption of the provisions of SFAS No. 159.

In September 2006, the FASB finalized SFAS No. 157, *Fair Value Measurements* which will become effective in 2008. This Statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements; however, it does not require any new fair value measurements. The provisions of SFAS No. 157 will be applied prospectively to fair value measurements and disclosures in the Company s financial statements beginning in the first quarter of 2008.

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109* (FIN 48), which provides clarification related to the process associated with accounting for uncertain tax positions recognized in the Company s Consolidated Financial Statements. The Company s adoption of the provisions of FIN 48 on December 31, 2006 did not have a material impact on its financial condition or results of operations. The application of this Interpretation requires a two-step process that separates recognition from measurement. The first step is determining whether a tax position has met the recognition threshold; the second step is measuring a tax position that meets the recognition threshold. The recognition threshold is met when the taxpayer (the reporting enterprise) concludes that it is more likely than not that the taxpayer will sustain the benefit taken or expected to be taken in the tax return in a dispute with taxing authorities if the taxpayer takes the dispute to the court of last resort. Upon implementing FIN 48 and performing the analysis, the Company did not recognize any increase or decrease to reserves for uncertain tax positions.

The Company has elected to record interest and penalties recognized in accordance with FIN 48 in the condensed consolidated financial statements as income taxes. Any subsequent change in classification of FIN 48 interest and penalties will be treated as a change in accounting principle subject to the requirements of SFAS No. 154, *Accounting Changes and Error Corrections*.

Table of Contents**Note 3. Accounts Receivable**

The Company maintains arrangements under which eligible accounts and notes receivable are sold without recourse to unrelated third-party financial institutions. These receivables were not included in the consolidated balance sheet as the criteria for sale treatment established by SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, had been met. Under SFAS No. 140, after a transfer of financial assets, an entity stops recognizing the financial assets when the control has been surrendered. The agreement met the criteria of a true sale of these assets since the acquiring party retained the title to these receivables and had assumed the risk that the receivables will be collectible. The Company pays administrative fees as well as interest at rates ranging from 1.375% to 1.875% based on the anticipated length of time between the date the sale is consummated and the expected collection date of the receivables sold. During the three- and six-month periods ended June 30, 2007, the Company sold \$5.6 million and \$9.5 million of receivables, respectively, under the terms of the agreement. For the three- and six-month periods ended July 1, 2006, \$3.5 million of receivables were sold under the terms of the agreement. There were no material gains or losses on the sale of such receivables. There were no amounts due from the financial institution at June 30, 2007 and December 30, 2006.

Note 4. Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market and consist of the following (in thousands):

	June 30, 2007	December 30, 2006
Raw materials and sub-assemblies	\$ 15,940	\$ 20,227
Work in process	8,958	9,693
Finished Goods	8,220	13,681
Total inventories	\$ 33,118	\$ 43,601

During second quarter 2007, the Company determined that certain demonstration/evaluation equipment will no longer be marketed to be sold. Accordingly, equipment totaling \$5.8 million were transferred from inventory to property, plant and equipment.

Note 5. Assets Held for Sale

As of June 30, 2007, the Company included \$1.9 million in *Assets held for sale* in the condensed consolidated balance sheet representing a parcel of land and building in Japan and a condominium in California. During the three-month period ended July 2, 2005 Nanometrics recorded an asset impairment charge of \$2.2 million related to certain assets in our Japanese operations including the land and building currently held for sale. In August 2007 Nanometrics entered into a contract to sell the Japanese land and building and expects to close the transaction in its third quarter of 2007 and realize a gain on the sale of approximately \$1 million. In addition the sale of the condominium in California was consummated in July 2007 and the Company expects to realize a gain of approximately \$0.2 million in the third quarter of 2007.

Note 6. Related Party Transactions

A former member of the Company's executive staff, who left the Company in April 2007, is a significant shareholder of a major supplier of assembly parts to the Company. Purchases of assembly parts from the related party were \$0.6 million for the three month period ended March 31, 2007 and \$1.6 and \$2.6 million in the three- and six month periods ended July 1, 2006, respectively. Consulting services received from the related party were \$0.2 million for the three-month period ended March 31, 2007 and \$0.2 and \$0.4 million for the three- and six-month periods ended July 1, 2006, respectively. The balance of amounts prepaid to the supplier was \$0.3 million at December 30, 2006, respectively. Amounts due to the related party as of December 30, 2006 was \$0.2 million. Accordingly, this vendor is no longer a related party from April 1, 2007.

Note 7. Acquisitions, Goodwill and Intangible Assets

Goodwill represents the excess of the purchase price paid over the fair value of tangible and identifiable intangible net assets acquired in a business combination. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill is reviewed annually or whenever events or circumstances occur which indicate that goodwill might be impaired. As a result of the Company's acquisition of Soluris and Accent in 2006, the Company recorded goodwill totaling \$54.5 million. During the second quarter of 2007, the Company recorded an adjustment to the

Edgar Filing: NANOMETRICS INC - Form 10-Q

recorded goodwill of \$0.3 million relating to the true-up of the acquiree's tax returns relating to periods prior to acquisition by the Company.

Intangible assets with an indefinite life are evaluated annually for impairment or whenever events or circumstances occur which indicate that those assets might be impaired. On March 15, 2006, as a result of the Company's acquisition of Soluris, the Company acquired a trademark with a value of \$0.4 million with an indefinite life.

Finite-lived intangible assets are recorded at cost, less accumulated amortization. Finite-lived intangible assets as of June 30, 2007 and December 30, 2006 consist of the following (in thousands):

Table of Contents

	Gross Carrying Amount	Accumulated Amortization	Net Intangible Assets
June 30, 2007			
Developed technology acquired in business combinations	\$ 9,800	\$ 1,380	\$ 8,420
Customer relationships	15,700	3,099	12,601
Brand names	3,600	507	3,093
Patented technology	1,790	1,534	256
Backlog	3,131	3,131	
Non-compete agreement	50	50	
Other	250	250	
Total	\$ 34,321	\$ 9,951	\$ 24,370
December 30, 2006			
Developed technology acquired in business combinations	\$ 9,800	\$ 607	\$ 9,193
Customer relationships	15,700	1,373	14,327
Brand names	3,600	216	3,384
Patented technology	1,790	1,406	384
Backlog	3,131	2,846	285
Non-compete agreement	50	40	10
Other	250	250	
Total	\$ 34,321	\$ 6,738	\$ 27,583

The amortization of finite-lived intangibles is computed using the straight-line method except for customer relationships which is computed using an accelerated method. Estimated lives of finite-lived intangibles range from five to ten years, except for the non-compete agreement and backlog which are amortized over one year. In the three-month period ended June 30, 2007, the Company wrote-off \$0.3 million of intangible assets in conjunction with the sale of a product line obtained in the Accent acquisition. Total amortization expense for the three-month periods ended June 30, 2007 and July 1, 2006 was \$1.7 million and \$0.2 million, respectively, and for the six-month periods ended June 30, 2007 and July 1, 2006 was \$3.2 million and \$0.2 million, respectively.

The estimated future amortization expense as of June 30, 2007 is as follows (in thousands):

Fiscal Years	
2007 (remaining six months)	\$ 2,569
2008	4,881
2009	4,257
2010	3,675
2011	3,201
2012 and thereafter	5,787
Total amortization	\$ 24,370

Soluris Inc.

On March 15, 2006, Nanometrics announced that it had acquired Soluris Inc., (Soluris) a Concord, Massachusetts-based privately held corporation focused on overlay and CD measurement technology. The acquisition of Soluris, which was renamed Nanometrics IVS Division, is expected to enhance Nanometrics line of overlay products and provide access to new customers. Under the terms of the merger agreement, which was an all-cash transaction, the total consideration to purchase all the outstanding stock of Soluris was \$7.0 million including \$0.4 million in transaction fees, including legal, valuation and accounting fees. The merger has been accounted for under the purchase method of accounting in accordance with SFAS No. 141, *Business Combinations*. Under the purchase method of accounting, the total estimated purchase price is allocated to the net tangible and identifiable intangible assets of Soluris acquired in connection with the merger, based on their respective estimated fair values. The results of operations of Soluris were included in the Company's condensed consolidated statements of operations from

Edgar Filing: NANOMETRICS INC - Form 10-Q

the date of the acquisition.

If the Company had acquired Soluris at the beginning of the periods presented, the Company's unaudited pro forma net revenues, net loss and net loss per share from continuing operations would have been as follows (in thousands, except per share amounts):

	Three Months Ended July 1,	Six Months Ended July 1,
	2006	2006
Net revenues	\$ 23,398	\$ 43,481
Net loss	\$ (2,154)	\$ (4,136)
Net loss per share:		
Basic	\$ (0.16)	\$ (0.32)
Diluted	\$ (0.16)	\$ (0.32)

Accent Optical Technologies, Inc.

On July 21, 2006, Nanometrics completed its acquisition of Accent Optical Technologies, Inc. (Accent), a Bend Oregon-based privately held corporation focused on overlay and thin film metrology and process control systems. The acquisition of Accent is expected to enhance Nanometrics' line of overlay and thin film products and to provide access to new customers, especially in Europe. Under the terms of the merger agreement relating to the acquisition, the total estimated purchase price of \$72.6 million includes the exchange of Nanometrics common stock valued at \$67.5 million, assumed stock options with a fair value of \$0.3 million, a loan made to Accent prior to completion of the acquisition of \$2.5 million and estimated direct transaction costs of \$2.2 million. The merger has been accounted for under the purchase method of accounting in accordance with SFAS No. 141, *Business Combinations*. The results of operations of Accent were included in the Company's condensed consolidated statements of operations from the date of the acquisition.

If the Company had acquired Accent at the beginning of the periods presented, the Company's unaudited pro forma net revenues, net loss and net loss per share from continuing operations would have been as follows (in thousands, except per share amounts):

	Three Months Ended July 1,	Six Months Ended July 1,
	2006	2006
Net revenues	\$ 37,330	\$ 66,363
Net loss	\$ (2,428)	\$ (5,143)
Net loss per share:		
Basic	\$ (0.19)	\$ (0.39)
Diluted	\$ (0.19)	\$ (0.39)

Note 8. Other Current Liabilities

Other current liabilities consist of the following (in thousands):

	June 30, 2007	December 30, 2006
Accrued warranty	\$ 4,952	\$ 4,349
Accrued professional services	679	1,912
Other	3,439	2,120
Total other current liabilities	\$ 9,070	\$ 8,381

Note 9. Stockholders' Equity

Net Income (Loss) Per Share Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income per share gives effect to all

Table of Contents

potentially dilutive common shares outstanding during the period, which include certain stock options, calculated using the treasury stock method. A reconciliation of the share denominator of the basic and diluted net income (loss) per share computations is as follows (in thousands):

	Three- Months Ended		Six- Months Ended	
	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
Weighted average common shares outstanding used in basic net loss per share computation	17,857	13,088	17,758	13,051
Potential dilutive common stock equivalents, using treasury stock method				
Shares used in diluted net loss per share computation	17,857	13,088	17,758	13,051

For the three- and six-month periods ended June 30, 2007 there were 0.5 million shares held in escrow in connection with the Accent acquisition which were excluded from weighted average common shares outstanding. For the three- and six-month periods ended June 30, 2007 and July 1, 2006, the Company had securities outstanding which could potentially dilute basic earnings per share in the future, which were excluded from the computation of diluted net loss per share in the periods presented as their impact would have been antidilutive. Weighted average common share equivalents, consisting of stock options excluded from the calculation of diluted net loss per share were 2.7 million and 2.0 million in the three-month periods ended June 30, 2007 and July 1, 2006, respectively, and were 2.7 and 1.2 million in the six-month periods ended June 30, 2007 and July 1, 2006, respectively.

Note 10 Stock-Based Compensation

The following table summarizes stock-based compensation expense for all share-based payment awards made to the Company's employees and directors pursuant to the Employee Stock Purchases under SFAS 123R for the three- and six-month periods ended June 30, 2007 and July 1, 2006 (in thousands):

	Three- Months Ended		Six- Months Ended	
	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
Cost of products	\$ 37	\$ 76	\$ 113	\$ 143
Cost of service	87	76	165	114
Research and development	310	304	531	564
Selling	158	247	437	394
General and administrative	50	450	630	791
Total stock-based compensation expense related to employee stock options and employee stock purchases	\$ 642	\$ 1,153	\$ 1,876	\$ 2,006

The fair value of each option award is estimated on the date of grant using the Black-Scholes valuation model and the assumptions noted in the following table. The expected term of options granted was calculated using the simplified method allowed by SAB 107. The risk-free rate is based on the U.S Treasury rates in effect during the corresponding period of grant. The expected volatility is based on the historical volatility of Nanometrics' stock price. The dividend yield reflects that the Company has not paid any cash dividends since inception and does not intend to pay any cash dividends in the foreseeable future.

Table of Contents

	Three- Months Ended		Six- Months Ended	
	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
Stock Options				
Expected life	4.4 years	4.5 years	4.4 years	4.4 years
Volatility	55.20%	72.70%	56.50%	73.30%
Risk free interest rate	5.14%	4.90%	5.10%	4.80%
Dividends				
Employee Stock Purchase Plan				
Expected life	0.5 years	0.5 years	0.5 years	0.5 years
Volatility	46.50%	42.7%	46.50%	40.1%
Risk free interest rate	2.25%	2.43%	2.25%	2.06%
Dividends				

The weighted average fair values per share of the stock options awarded in the three- and six-months ended June 30, 2007 was \$2.04 and \$2.10, respectively, based on the fair market value of the Company's common stock on the grant dates.

A summary of option activity under the Company's stock option plans during the quarter ended June 30, 2007 is as follows:

	Shares Available	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (in Thousands)
Options					
Outstanding at December 31, 2006	1,081,900	3,826,806	\$ 10.60		
Shares added through 2005 Option Plan	544,248				
Exercised		(449,576)	\$ 5.69		
Granted	(694,756)	694,756	\$ 7.83		
Cancelled	911,078	(911,078)	\$ 11.04		
Outstanding at June 30, 2007	1,842,470	3,160,908	\$ 10.52	4.34	\$ 816
Exercisable at June 30, 2007		1,691,343	\$ 10.98	2.74	\$ 536

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company's closing stock price of \$6.86 as of June 30, 2007, which would have been received by the option holders had all option holders exercised their options as of that date. The total intrinsic value of options exercised during both the three- and six-month periods ended June 30, 2007 was \$0.3 million and for the three- and six-month periods ended July 1, 2006 was \$0.3 million and \$0.6 million, respectively. The fair value of options vested for the three- and six-month periods ended June 30, 2007 was \$1.6 million and \$3.2 million, respectively and for the three- and six-month periods ended July 1, 2006 was \$0.6 million and \$0.9 million, respectively.

Note 11. Comprehensive Income (Loss)

The Company's comprehensive income (loss) was as follows (in thousands):

	Three- Months Ended		Six- Months Ended	
	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
Net loss	\$ (130)	\$ (2,156)	\$ (4,741)	\$ (3,478)
Foreign currency translation adjustments, net of tax	141	358	90	548
Total comprehensive income (loss)	\$ 11	\$ (1,798)	\$ (4,651)	\$ (2,930)

Edgar Filing: NANOMETRICS INC - Form 10-Q

Substantially all of the accumulated other comprehensive income reflected as a separate component of stockholders' equity consists of accumulated foreign currency translation adjustment for all periods presented.

Table of Contents**Note 12. Warranties**

Product Warranty The Company sells the majority of its products with a 12-month repair or replacement warranty from the date of acceptance which generally represents the date of shipment. The Company provides an accrual for estimated future warranty costs based upon the historical relationship of warranty costs to the cost of products sold. The estimated future warranty obligations related to product sales are recorded in the period in which the related revenue is recognized. The estimated future warranty obligations are affected by the warranty periods, sales volumes, product failure rates, material usage, and labor and replacement costs incurred in correcting a product failure. If actual product failure rates, material usage, labor or replacement costs differ from the Company's estimates, revisions to the estimated warranty obligations would be required. For new product introductions where limited or no historical information exists, the Company may use warranty information from other previous product introductions to guide it in estimating its warranty accrual. The warranty accrual represents the best estimate of the amount necessary to settle future and existing claims on products sold as of the balance sheet date. The Company periodically assesses the adequacy of its reported warranty reserve and adjusts the amounts in accordance with changes in these factors. Components of the warranty accrual, which was included in the accompanying condensed consolidated balance sheets with other current liabilities, were as follows (in thousands):

	Six- Months Ended	
	June 30,	July 1,
	2007	2006
Balance as of beginning of period	\$ 4,349	\$ 1,440
Actual warranty cost	(1,412)	(1,032)
Provision for warranty	2,015	1,429
Balance as of end of period	\$ 4,952	\$ 1,837

Intellectual Property Indemnification Obligations In addition to product warranties, the Company will, from time to time, in the normal course of business, agree to indemnify certain customers with whom it enters into contractual relationships. The Company has agreed to hold these customers harmless against third party claims that Nanometrics' products, when used for their intended purpose(s), infringe the intellectual property rights of such third parties or other claims made against the customer. It is not possible to determine the maximum potential amount of liability under these indemnification obligations due to the limited history of prior indemnification claims and the unique facts and circumstances that are likely to be involved in each particular claim. Historically, the Company has not made payments under these obligations and believes that the estimated fair value of these agreements is minimal. Accordingly, no liabilities have been recorded for these obligations on the accompanying condensed consolidated balance sheets as of June 30, 2007 and December 30, 2006.

Note 13. Income Taxes

The income taxes benefit of \$0.1 million for both the three- and six-month periods ended June 30, 2007 was the result of foreign taxes of \$0.2 million and \$0.4 million, respectively offset by \$0.3 million and \$0.5 million, respectively, of tax benefit in a certain foreign jurisdiction where sufficient deferred tax liabilities exist to allow for benefiting the operating loss. The Company's provision for income taxes expense for the three- and six-month periods ended July 1, 2006 was primarily a result of foreign income taxes. In the future, the Company will continue to review its expectations for future taxable income to determine the amount of valuation allowance necessary to reserve against deferred tax assets.

Note 14. Contingencies

On March 9, 2005, Nova Measuring Instruments Ltd. (Nova) filed suit against the Company in the United States District Court for the Northern District of California. The complaint alleged that certain of the Company's products infringe a Nova patent and sought a preliminary and permanent injunction against their sale and unspecified damages. In late March 2006, the Company filed suit against Nova in the United States District Court for the Northern District of California. The Company's complaint alleged that certain of Nova's products sold in the U.S. infringe intellectual property rights of Nanometrics. In a settlement conference on April 11, 2007, Nanometrics and Nova agreed to dismiss, without prejudice, all pending patent litigation between the two parties, and have entered into a covenant not to sue one another for any patent for a period of one year. The settlement terminated the three lawsuits pending in the U.S. District Court for the Northern District of California.

In August 2005, KLA-Tencor Corporation (KLA) filed a complaint against the Company in the United States District Court for the Northern District of California. The complaint alleges that certain of the Company's products infringe two of KLA's patents. On January 30, 2006, KLA added a third patent to their claim. The complaint seeks a preliminary and permanent injunction against the sale of these products as well as the

recovery of monetary damages and attorneys' fees. As

Table of Contents

part of its defense, the Company has filed a request for re-examination of two of the allegedly infringed KLA patents with the U.S. Patent & Trademark Office (PTO). These requests for re-examination were recently accepted for review by the PTO. In March 2006, the Company filed a motion for and was granted a stay in the patent litigation case until such re-examination is completed.

Note 15. Geographic and Significant Customer Information

The Company's operating divisions consist of geographically based entities in the United States, Europe, Japan, South Korea and Taiwan. All such operating divisions have similar economic characteristics, as defined in SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*, and accordingly, the Company operates in one reportable segment: the sale, design, manufacture, marketing and support of thin film, optical critical dimension and overlay dimension metrology systems. For the periods presented, the Company recorded revenue from customers primarily in the United States, Asia and Europe. The following table summarizes total net revenues and long-lived assets (excluding intangible assets) attributed to significant countries (in thousands):

	Three-Months Ended		Six-Months Ended	
	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
Total net revenues:				
United States	\$ 8,304	\$ 13,262	\$ 24,664	\$ 25,450
Japan	13,160	3,064	18,747	7,450
South Korea	6,366	3,265	10,131	4,636
Taiwan	4,538	1,988	6,702	2,394
Europe	2,176	352	9,478	565
All other	2,791	1,467	4,728	1,871
Total net revenues*	\$ 37,335	\$ 23,398	\$ 74,450	\$ 42,366

* Net revenues are attributed to countries based on the deployment and service locations of systems.

	June 30, 2007	December 30, 2006
Long lived assets		
United States	\$ 40,563	\$ 37,079
Japan	1,983	2,300
South Korea	4,968	5,095
Taiwan	92	97
Europe	516	708
Total long lived assets**	\$ 48,122	\$ 45,279

** Long-lived assets include tangible assets only.

As of June 30, 2007, two customers, Promos and Hynix, accounted for 17.5% and 12.7% of total accounts receivable, respectively. As of December 30, 2006, no customer accounted for 10% or more of total accounts receivable.

The following customers accounted for 10% or more of total revenue:

Three-Months Ended Six-Months Ended

Edgar Filing: NANOMETRICS INC - Form 10-Q

	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
Samsung	***	21.8%	18.4%	22.6%
Hynix	17.1%	12.7%	15.5%	***
Toshiba	15.6%	***	***	***
Promos	10.4%	***	***	***
Applied Materials	10.1%	23.7%	***	27.1%

*** The customer accounted for less than 10% of revenue during the period.

Table of Contents

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

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. The statements contained in this document that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, without limitation, statements regarding our expectations, beliefs, intentions or strategies regarding our business in future periods. We may identify these statements by the use of words such as anticipate, believe, continue, could, estimate, expect, intend, may, might, plan, potential, predict, project, should, will, would and other similar expressions. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements, except as may otherwise be required by law.

Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain risk factors, including those set forth in Part II Item 1A Risk Factors and elsewhere in this document. In evaluating our business, current and prospective investors should carefully consider these factors in addition to the other information set forth in this document. We believe that it is important to communicate our expectations to our investors. However, there may be events in the future that we are not able to predict accurately or over which we have no control. You should be aware that the occurrence of the events described in such risk factors and elsewhere in this report could materially and adversely affect our business, operating results and financial condition. While management believes that the discussion and analysis in this report is adequate for a fair presentation of the information presented, we recommend that you read this discussion and analysis in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 30, 2006, which were included in our Annual Report on Form 10-K filed with the Securities Exchange Commission on March 15, 2007.

Overview

We are an innovator in the field of metrology systems for the semiconductor industry. Our systems are designed to precisely monitor film thickness and critical dimensions that are necessary to control the manufacturing process and provide increased production yields and performance.

Capital expenditures by manufacturers of semiconductors and their suppliers are critical to our success. The demand by these manufacturers and suppliers is driven by the expected market demand for new products and new applications. The increasing complexity of the 300mm manufacturing processes for semiconductors is an important factor in the demand for our innovative metrology systems. The incorporation of smaller features sizes, copper interconnects technology and optical critical dimension technology is expected to result in increased demand. Our strategy is to continue to innovate organically as well to evaluate strategic acquisitions in order to address business challenges and opportunities.

Our revenues are derived from product sales and customer service, which include sales of accessories and service for the installed base of our products. In the year ended December 30, 2006, we derived 83.7% of our total net revenues from product sales and 16.3% of our total net revenues from services.

Important Themes and Significant Trends

The semiconductor equipment industry is characterized by cyclical growth. Changing trends in the semiconductor industry are increasing the need for metrology as a major component of manufacturing systems. These trends include:

Incorporation of Optical Critical Dimension Metrology in the Patterning Process. Our customers use photolithographic processes to create patterns on wafers. Critical dimensions must be carefully controlled during this process. Our proprietary optical critical dimension systems can provide the critical process control of these circuit dimensions that is necessary for successful manufacturing of these state of the art devices.

Copper Interconnect Technology. The need for ever increasing device circuit speed coupled with lower power consumption has pushed semiconductor device manufacturers to begin the replacement of the subtractive aluminum interconnect process with copper damascene technology. This new copper processing technology has driven the need for new metrology techniques such as non-destructive laser profiling and the use of optical critical dimension (OCD) technology for control of the copper process.

Edgar Filing: NANOMETRICS INC - Form 10-Q

Incorporation of 65nm and 45nm Feature Sizes. In an effort to reduce costs and increase device performance, semiconductor manufacturers are decreasing both the die size and feature size. Monitoring the increased tolerance requirements on smaller feature sizes requires increased use of metrology systems. Our thin film and critical dimension metrology systems are well suited and are being adopted for these next generation processes.

Reduced Number of Customers. Because of the escalating cost of 300mm manufacturing facilities, fewer

Table of Contents

semiconductor manufacturers can afford the significant investment in these next generation facilities. Therefore, fewer opportunities for semiconductor equipment companies exist. Given that the available number of potential customers is decreasing, previous customer relationships, product positioning and critical mass take on greater importance.

Adoption of New Types of Thin Film Materials. Manufacturers are adopting new processes and technologies that increase the importance and utilization of thin film metrology systems. To achieve greater semiconductor device speed, manufacturers are utilizing copper and new, low dielectric constant (low k) insulating materials. Our advanced metrology solutions are required in the manufacturing process to characterize these materials.

Need for Improved Process Control to Drive Process Efficiencies. Competitive forces influencing semiconductor device manufacturers, such as price-cutting and shorter product life cycles, place pressure on manufacturers to rapidly achieve production efficiency. Device manufacturers are using our integrated and standalone metrology systems throughout the fab to ensure that manufacturing processes scale rapidly, are accurate and can be repeated on a consistent basis.

Critical Accounting Policies

The preparation of our financial statements conforms with accounting principles generally accepted in the United States of America, which requires management to make estimates and judgments in applying our accounting policies that have an important impact on our reported amounts of assets, liabilities, revenue, expenses and related disclosures at the date of our financial statements. On an on-going basis, management evaluates its estimates including those related to bad debts, inventory valuations, warranty obligations and income taxes. Management bases its estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from management's estimates. We believe that the application of the following accounting policies requires significant judgments and estimates on the part of management. For a summary of all of our accounting policies, including those discussed below, see Note 1 to The Consolidated Financial Statements included in our Annual Report on Form 10-K filed with the SEC on March 15, 2007.

Revenue Recognition We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the sales price is fixed or determinable, and collectibility is reasonably assured. Product revenue includes hardware and also software that is incidental to the products. For product sales to existing customers, revenue recognition generally occurs at the time of shipment, as our terms are FOB shipping point, if we have met defined customer acceptance experience levels with both the customer and the specific type of equipment. All other product revenue is recognized upon customer acceptance including deemed acceptances. In Japan, where risk of loss and title transfers to the customer upon customer technical acceptance, our policy is that revenue is recognized upon customer technical acceptance.

All of our products are assembled prior to shipment to our customers. We often perform limited installation for our customers; however such installation is inconsequential and perfunctory as it may also be performed by third parties. Revenue related to spare parts sales is recognized generally upon shipment and is included as part of service revenue. Service revenue also includes service contracts and non-warranty, billable repairs of systems. Whereas service revenue related to service contracts is recognized ratably over the period under contract, service revenue related to billable repairs of systems is recognized as services are performed. On occasion, customers request a warranty period longer than our standard 12 month warranty. In those instances where extended warranty services are separately quoted to the customer, we follow the guidance of Financial Accounting Standards Board Technical Bulletin 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*, associated revenue is deferred and recognized to income ratably over the term of the contract. Unearned maintenance and service contract revenue is included in deferred revenue. Furthermore, generally we do not provide our customers with any return rights. Service contracts may be purchased by the customer when the warranty period expires.

In limited situations we have multiple deliverables in our customer arrangements. Those situations arise with the sale of repair services and parts together. Revenues on such sales are recognized when both the services and parts have been delivered. We also provide technical support to our customers as part of our warranty program. Upon recognition of product revenue, a liability is recorded for anticipated warranty costs.

Allowance for Doubtful Accounts We maintain allowances for estimated losses resulting from the inability of our customers to make required payments. Credit limits are established through a process of reviewing the financial history and stability of our customers. Where appropriate and available, we obtain credit rating reports and financial statements of customers when determining or modifying their credit limits. We regularly evaluate the collectibility of our trade receivable balances based on a combination of factors such as the length of time the receivables are past due, customary payment

Table of Contents

practices in the respective geographies and our historical collection experience with customers. We believe that our allowance for doubtful accounts reflects our risk associated with smaller rather than larger customers and that our reported allowances are adequate. If however, the financial conditions of customers were to deteriorate, resulting in their inability to make payments, we would assess the necessity to record additional allowances which would result in additional general and administrative expenses being recorded for the period in which such determination was made.

Inventories We are exposed to a number of economic and industry factors that could result in portions of our inventory becoming either obsolete or in excess of anticipated usage, or saleable only for amounts that are less than their carrying amounts. These factors include, but are not limited to, technological changes in our market, our ability to meet changing customer requirements, competitive pressures in products and prices, and the availability of key components from our suppliers. We have established inventory reserves when conditions exist that suggest that our inventory may be in excess of anticipated demand or is obsolete based upon our assumptions about future demand for our products and market conditions. We regularly evaluate our ability to realize the value of our inventory based on a combination of factors including the following: historical usage rates, forecasted sales of usage, product end-of-life dates, estimated current and future market values and new product introductions. For demonstration inventory, we also consider the age of the inventory and potential cost to refurbish the inventory prior to sale. When recorded, our reserves are intended to reduce the carrying value of our inventory to its net realizable value. If actual demand for our products deteriorates, or market conditions are less favorable than those that we project, additional reserves may be required. Inventories are stated at the lower of cost, using the first-in, first-out method, or market value.

Product Warranties We sell the majority of our products with a twelve-month repair or replacement warranty from the date of acceptance which generally represents the date of shipment. We provide an accrual for estimated future warranty costs based upon the historical relationship of warranty costs to the cost of products sold. The estimated future warranty obligations related to product sales are reported in the period in which the related revenue is recognized. The estimated future warranty obligations are affected by the warranty periods, sales volumes, product failure rates, material usage, labor and replacement costs incurred in correcting a product failure. If actual product failure rates, material usage, labor or replacement costs differ from our estimates, revisions to the estimated warranty obligations would be required. For new product introductions where limited or no historical information exists, we may use warranty information from other previous product introductions to guide us in estimating our warranty accrual. The warranty accrual represents the best estimate of the amount necessary to settle future and existing claims on products sold as of the balance sheet date. We periodically assess the adequacy of our recorded warranty reserve and adjust the amounts in accordance with changes in these factors.

Goodwill and Intangible Assets Goodwill is initially recorded when the purchase price paid for an acquisition exceeds the estimated fair value of the net identified tangible and intangible assets acquired. Under Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), intangible assets with finite lives are amortized over their useful lives while goodwill and indefinite lived assets are not amortized but tested annually for impairment. Our impairment review process, which is completed as of the last day of November of each year or whenever events or circumstances occur which indicate that an impairment has occurred, compares the fair value of our reportable segment (which we have determined to be our reporting unit) to its carrying value, including the goodwill related to the segment. To determine the fair value, our review process uses the income method and is based on a discounted future cash flow approach that uses estimates including the following for each segment: revenue, based on assumed market growth rates and our assumed market share; estimated costs; and appropriate discount rates based on the particular business's weighted average cost of capital. Our estimates of market segment growth, our market segment share and costs are based on historical data, various internal estimates and certain external sources, and are based on assumptions that are consistent with the plans and estimates we are using to manage the underlying businesses. Our business consists of both established and emerging technologies and our forecasts for emerging technologies are based upon internal estimates and external sources rather than historical information. If future forecasts are revised, they may indicate or require future impairment charges. We also considered our market capitalization on the dates of our impairment tests under SFAS 144, in determining the fair value of the respective businesses.

Our fair value estimates, are based on the extensive use of management's estimates and assumptions, and the result of these processes can have a significant impact on our future operating results.

Income Tax Assets and Liabilities We account for income taxes based on SFAS 109, *Accounting for Income Taxes*, whereby deferred tax assets and liabilities must be recognized using enacted tax rates for the effect of temporary differences between the book and tax accounting for assets and liabilities. Also, deferred tax assets must be reduced by a valuation allowance if it is more likely than not that a portion of the deferred tax asset will not be realized in the future. We evaluate the deferred tax assets on a quarterly basis to determine whether or not a valuation allowance is appropriate. Factors used in this determination include future expected income and the underlying asset or liability which generated the temporary tax difference. Our income tax provision is primarily impacted by federal statutory rates, state and foreign income taxes and changes in our valuation allowance.

Table of Contents

Stock-Based Compensation Upon adoption of SFAS 123(R) on January 1, 2006, we began estimating the value of employee stock options on the date of grant using the Black-Scholes model. Prior to the adoption of SFAS 123(R), the value of each employee stock option was estimated on the date of grant using the Black-Scholes model for the purpose of the pro forma financial disclosure in accordance with SFAS 123. The determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors. The expected term of options granted is calculated based on the simplified method allowed by SAB 107. The expected volatility is based on the historical volatility of our stock price.

Recent Accounting Pronouncements

See Note 2 of the Condensed Consolidated Financial Statements for a description of recent accounting pronouncements, including the respective dates of adoption and effects on results of operations and financial condition.

Results of Operations**Quarters ended June 30, 2007 and July 1, 2006**

Total net revenues. Our net revenues were comprised of the following categories:

	Three-Months Ended			Six-Months Ended		
	June 30, 2007	July 1, 2006	Percentage Change	June 30, 2007	July 1, 2006	Percentage Change
Automated systems	\$ 20,413	\$ 12,948	57.7%	\$ 49,413	\$ 21,260	132.4%
Integrated systems	12,319	7,173	71.7%	15,845	14,833	6.8%
Total product revenue	32,732	20,121	62.7%	65,258	36,093	80.8%
Service	4,603	3,277	40.5%	9,192	6,273	46.5%
Total net revenues	\$ 37,335	\$ 23,398	59.6%	\$ 74,450	\$ 42,366	75.7%

For the three- and six-month periods ended June 30, 2007 net revenues from automated systems increased over the comparable period of 2006 by 58% and 132%, respectively, primarily as a result of higher revenues of Accent and Soluris related products totaling \$7.4 million and \$12.7 million respectively. In addition the higher revenue reflects demand for our automated products as semiconductor manufacturers continue to increase their manufacturing capacity. Revenues from our integrated systems increased 72% and 7% for the three- and six-month periods ended June 30, 2007 over the comparable periods of 2006 as we recognized \$4.6 million of revenue which had been deferred in previous quarters as revenue recognition criteria was satisfied. Service revenue increased by \$1.3 million during the three-month period ended June 30, 2007 over the comparable period of 2006, as a result of our Accent and Soluris acquisitions which contributed to higher sales of parts and services, due in part to a larger installed base of systems.

Gross margins. Our gross margin breakdown was as follows (in percent):

	Three-Months Ended June 30,		Six-Months Ended June 30,	
	2007	July 1, 2006	2007	July 1, 2006
Products	50%	47%	48%	48%
Services	(5)%	(23)%	(16)%	(5)%

The product gross margin for the three-month period ended June 30, 2007 increased from the comparable period of 2006 as we continue to reduce costs associated with product reliability, complete the integration of our 2006 acquisitions of Accent and Soluris and to higher

Edgar Filing: NANOMETRICS INC - Form 10-Q

proportionate sales of our integrated systems. The negative gross margin for our services line of business decreased in the second quarter of 2007 as we have increased our focus on controlling expenses including personnel, personnel related expenses and material costs as compared to 2006. However, we have not been able to fully recover the costs associated with meeting our customers' increasing service demands. Management is currently evaluating the negative margins in our service line of business and if performance does not improve significantly, we may incur charges in the future to write-down the goodwill and intangible assets associated with the service line of business.

Operating expenses. Our operating expenses were comprised of the following categories (in thousands):

	Three-Months Ended				Six-Months Ended			
	June 30, 2007	July 1, 2006	Change		June 30, 2007	July 1, 2006	Change	
Research and development	\$ 4,739	\$ 3,062	\$ 1,677	55%	\$ 9,325	\$ 5,590	\$ 3,735	67%
Selling	4,668	3,865	803	21%	10,033	6,955	3,078	44%
General and administrative	4,762	4,306	456	11%	11,755	8,856	2,899	33%
Amortization of intangible assets	1,663	159	1,504	946%	3,212	238	2,974	1250%
Total operating expenses	\$ 15,832	\$ 11,392	\$ 4,440	39%	\$ 34,325	\$ 21,639	\$ 12,686	59%

Table of Contents

Research and development. Research and development expenses increased by \$1.7 million and \$3.7 million for the three- and six-month periods ended June 30, 2007, respectively, over the comparable periods in 2006 due to the headcount and related development expenses associated with our acquisitions of Accent and Soluris, respectively.

In the United States and United Kingdom, our research and development efforts are focused on semiconductor metrology. In South Korea, our research and development efforts are focused on the overlay metrology. We are committed to the development of new and enhanced products and believe that new product introductions are required for us to maintain a competitive position.

Selling. Selling expenses increased \$0.8 million and \$3.1 million for the three- and six-month periods ended June 30, 2007 over the comparable periods of 2006 due primarily to additional headcount related expenses of \$0.5 million and \$2.1 million, respectively, associated with the acquisitions of Accent and Soluris.

General and administrative. General and administrative expenses increased by \$0.5 million for the three-month period ended June 30, 2007 over the comparable period in 2006. The increase was primarily due to additional costs of \$0.3 million associated with an expanded management team due to the acquisitions of Soluris, termination charges of certain senior executives of \$0.3 million, recruiting and consulting fees of \$0.4 million. These increases were partially offset by lower stock-based compensation charges of \$0.4 million. For the six-month period ended June 30, 2007 general and administrative expenses increased \$2.9 million over the comparable period in 2006. The increase in general and administrative expenses was primarily due to additional costs of \$0.9 million associated with an expanded management team due to the acquisitions of Accent and Soluris, termination charges of certain senior executives of \$0.8 million, and consulting, travel and recruiting expenses of \$0.7 million. These increases were partially offset by lower regulatory and compliance costs of \$0.5 million.

Amortization of intangible assets: For the three- and six-month periods ended June 30, 2007 the increase in amortization of intangible assets of \$1.5 million and \$3.0 million over the comparable periods of 2006 reflects the amortization expense associated with the intangible assets acquired from our acquisition of Accent on July 21, 2006 and the write-off of \$0.3 million of intangible assets associated with the sale of our Diva product line in June 2007.

Other income (expense). Our net other income (expense) consisted of the following categories (in thousands):

	Three-Months Ended				Six-Months Ended			
	June 30, 2007	July 1, 2006	Change		June 30, 2007	July 1, 2006	Change	
Interest income	\$ 29	\$ 299	\$ (270)	(90)%	\$ 51	\$ 631	\$ (580)	(92)%
Interest expense	(46)	(18)	(28)	156%	(85)	(31)	(54)	174%
Other income (loss)	(541)	238	(779)	(327)%	(422)	273	(695)	(255)%
Total other income (expense)	\$ (558)	\$ 519	\$ (1,077)	(208)%	\$ (456)	\$ 873	\$ (1,329)	(152)%

The lower interest income is due to lower average cash and cash equivalent balances. Interest expenses is relate to our debt obligations in Japan and the United Kingdom and the factoring of receivables in Japan. We incurred foreign exchange losses due to exchange rate fluctuations associated with extensive inter-company balances between our various global entities.

Provision/credit for income taxes. The benefit for income taxes for both the three- and six-month periods ended June 30, 2007 of \$0.1 million was the result of foreign taxes of \$0.2 million and \$0.4 million, respectively offset by \$0.3 million and \$0.5 million, respectively, of tax benefit in a certain foreign jurisdiction where sufficient deferred tax liabilities exist to allow for benefiting the operating loss. Our provision for income taxes for the three- and six-month periods ended July 1, 2006 was primarily a result of foreign income taxes. In the future, we will continue to review our expectations for future taxable income to determine the amount of valuation allowance necessary to reserve against deferred tax assets.

Table of Contents

Liquidity and Capital Resources

At June 30, 2007, our cash and cash equivalents totaled \$15.4 million compared to \$8.0 million as of December 30, 2006. At June 30, 2007, we had working capital of \$48.8 million compared to \$49.7 million at December 30, 2006. The current ratio at June 30, 2007 was 2.5 to 1.

Operating activities provided cash of \$6.0 million for the six-month period ended June 30, 2007 resulting from decreases in net working capital of \$4.2 million and certain non-cash charges including \$4.6 million associated with amortization and depreciation and, \$1.9 million in stock-based compensation offset by our net loss of \$4.7 million. For the six-months ended June 30, 2007, cash provided from the reduction of working capital were primarily driven by reduction of inventory levels of \$4.4 million and increases in accounts payable and accrued liabilities of \$4.0 million offset by increases in accounts receivable of \$2.5 million due to higher revenue. For the six-month period ended July 1, 2006 net cash used in operating activities was \$4.0 million comprised of a net loss of \$3.5 million, increases in working capital of \$4.0 million offset by non-cash expenses of depreciation and amortization of \$1.2 and stock-based compensation of \$2.0 million. For the six-months ended July 1, 2006, uses of cash for working capital were primarily driven by higher accounts receivable of \$3.5 million from increased product shipments and increased inventory levels of \$3.7 million primarily as a function of management's objective to meet higher expected demand in the coming quarter.

Investing activities for the six-month period ended June 30, 2007 used \$0.7 million for capital equipment acquisitions. Cash used by investing activities was \$6.3 million in the first half of 2006, due to cash outlays of \$6.8 million related to our acquisition of Soluris and deferred acquisition costs of \$4.4 million associated with our merger with Accent partially offset, by maturities of short-term investments in the amount of \$5.0 million.

For the six-month period ended June 30, 2007, financing activities provided cash of \$2.3 million from the sale of stock from employee stock plans and purchase plan of \$2.6 million offset by the repayment of debt of \$0.3 million. For the six-month period ended July 1, 2006 cash used for financing activities were comprised of repayment of debt of \$1.4 million partially offset by the sale of stock from the sale of stock from employee stock plans and purchase plan of \$0.8 million.

We have evaluated and will continue to evaluate the acquisition of products, technologies or businesses that are complementary to our business. These activities may result in product and business investments, which may affect our cash position and working capital balances. Some of these activities might require significant cash outlays. For example, recently our Board of Directors authorized a stock repurchase program of up to \$4 million. However, we believe working capital including cash and cash equivalents and funds available to us under our line of credit; will be sufficient to meet our needs through at least the next twelve months. However, we may require additional cash to fund acquisitions or investment opportunities or other events may arise in the future. In these instances, we may seek to raise such additional funds through public or private equity or debt financings or from other sources. We may not be able to obtain adequate or favorable financing at that time. Any financing we obtain may dilute your ownership interests and any debt financing could contain covenants that impose limitations on the conduct of our business.

In February 2007, we entered into a two-year agreement for a revolving line of credit facility in a maximum principal amount of \$15 million. The instrument governing the facility includes certain financial covenants regarding net tangible worth. All borrowings under this credit line bear interest, at our election, at a per annum rate equal to the bank's prime rate or at the Libor rate plus 2.25%. The revolving line of credit agreement includes a provision for the issuance of commercial or standby letters of credit by the bank on our behalf. The value of all letters of credit outstanding reduces the total line of credit available. The revolving line of credit is collateralized by a blanket lien on all of our domestic assets excluding intellectual property. Although we have no current plans to request any advances under this credit facility, we may use the proceeds of any future borrowing for general corporate purposes or for future acquisitions or expansion of our business.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk does not differ materially from that discussed in our Annual Report on Form 10-K for the fiscal year ended December 30, 2006. However, we cannot give any assurance as to the effect that future changes in interest rates or foreign currency rates will have on our consolidated financial position, results of operations or cash flows.

Table of Contents

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. As of June 30, 2007 our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, concluded that our disclosure controls and procedures were effective to ensure that information that we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 were recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-(f) under the Exchange Act) that occurred during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On March 9, 2005, Nova Measuring Instruments Ltd. (Nova) filed suit against us in the United States District Court for the Northern District of California. The complaint alleged that certain of our products infringed a Nova patent and sought a preliminary and permanent injunction against their sale and unspecified damages. In late March 2006, we filed suit against Nova in the United States District Court for the Northern District of California. Our complaint alleged that certain of Nova s products sold in the U.S. infringe our intellectual property rights. In October, 2006, we filed suit against Nova in the United States District Court for the Northern District of California. The Complaint alleged that certain of Nova s products infringed one of our patents and seeks damages. In a settlement conference on April 11, 2007, we and Nova agreed to dismiss, without prejudice, all pending patent litigation between the two parties, and have entered into a covenant not to sue one another for any patent for a period of one year. The settlement terminated the three lawsuits pending in the U.S. District Court for the Northern District of California.

In August 2005, KLA-Tencor Corporation, or KLA, filed a complaint against us in the United States District Court for the Northern District of California. The complaint alleges that certain of our products infringe two of KLA s patents. On January 30, 2006, KLA added a third patent to their claim. The complaint seeks a preliminary and permanent injunction against the sale of these products as well as the recovery of monetary damages and attorneys fees. We do not believe that any of our products infringe the intellectual property of any third party and we intend to vigorously and aggressively defend ourselves in the litigation. As part of such defense, we have filed a request for re-examination of the three allegedly infringed KLA-Tencor patents with the U.S. Patent & Trademark Office, or PTO. These requests for re-examination were accepted for review by the PTO. In March 2006, we filed a motion for and were granted a stay in the patent litigation case until such re-examination is completed.

ITEM 1A. RISK FACTORS

A restated description of the risk factors associated with our business is set forth below. This description includes any material changes to and supersedes the description of the risk factors included in our Annual Report on Form 10-K for the fiscal year ended December 30, 2006. The risks and uncertainties described below are not the only ones that we face. If any of the following risks actually occurs, our business, financial condition or operating results could be harmed. In such case, the trading price of our common stock could decline, and you could lose all or part of your investment.

Risks Related to Our Business

Customer demand for our products is inelastic and has led to fluctuations in revenue from period to period and is expected to continue to do so.

Our operating results have varied significantly from period to period due to the inelastic nature of our products. The majority of our business depends upon the capital expenditures of semiconductor device and equipment manufacturers. These manufacturers capital expenditures, in turn,

Edgar Filing: NANOMETRICS INC - Form 10-Q

depend upon the current and anticipated market demand for semiconductors and products using semiconductors. The semiconductor industry has historically experienced periodic downturns. These downturns have often resulted in substantial decreases in the demand for semiconductor manufacturing equipment, including metrology systems. We have found that the resulting decrease in capital expenditures has typically been more pronounced than the downturn in semiconductor device industry revenues. We expect the inelastic nature of our products, and therefore, our business, to continue in the foreseeable future.

Table of Contents

We depend on OEM suppliers for sales of our integrated metrology systems, and the loss of our OEM suppliers as a customer could harm our business.

We believe that sales of integrated metrology systems will continue to be an important source of our revenues. Sales of our integrated metrology systems depend upon the ability of OEMs to sell semiconductor equipment products that include our metrology systems as components. If our OEMs are unable to sell such products, or if they choose to focus their attention on products that do not integrate our systems, our business could suffer. If we were to lose our OEMs as a customer for any reason, our ability to realize sales from integrated metrology systems would be significantly diminished, which would harm our business.

If any of our systems fail to meet or exceed our internal quality specifications, we do not ship them until such time as they have met such specifications. If we experience significant delays or are unable to ship our products to our customers as a result of our internal processes, or for any other reason, our business and reputation may suffer.

Our products are complex and require technical expertise to design and manufacture properly. Various problems occasionally arise during the manufacturing process that may cause delays and/or impair product quality. We must actively monitor our manufacturing processes to ensure that our products meet our internal quality specifications. Any significant delays stemming from the failure of our products to meet or exceed our internal quality specifications, or for any other reasons, would delay our shipments. Shipment delays could harm our business and reputation in the industry.

If we deliver systems with defects, our credibility will be harmed, revenue from, and market acceptance of, our systems will decrease and we could expend significant capital and resources as a result of such defects.

Notwithstanding our internal quality specifications, our systems have sometimes contained errors, defects and bugs when introduced. If we deliver systems with errors, defects or bugs, our credibility and the market acceptance and sales of our systems would be harmed. Further, if our systems contain errors, defects or bugs, we may be required to expend significant capital and resources to alleviate such problems. Defects could also lead to product liability as a result of product liability lawsuits against us or against our customers. We have agreed to indemnify our customers in some circumstances against liability arising from defects in our systems. In the event of a successful product liability claim, we could be obligated to pay damages significantly in excess of our product liability insurance limits.

Our largest customers account for a substantial portion of our revenue, and our revenue would materially decline if one or more of these customers were to purchase significantly fewer of our systems or if they delayed or cancelled a large order.

Historically, a significant portion of our revenues in each quarter and each year has been derived from sales to a relatively few number of customers, and we expect this trend to continue. There are only a limited number of large companies operating in the semiconductor industry. Accordingly, we expect that we will continue to depend on a small number of large customers for a significant portion of our revenues for the foreseeable future. If any of our key customers were to purchase significantly fewer systems, or if a large order were delayed or cancelled, our revenues could significantly decline. In 2006, sales to Applied Materials accounted for 20.1% and sales to Samsung accounted for 14.3% of our total net revenues, respectively. In 2005, sales to Applied Materials accounted for 20.6% and sales to Samsung accounted for 15.9% of our total net revenues, respectively. In 2004, sales to Applied Materials accounted for 21.4% and sales to Samsung accounted for 14.7% of our total net revenues, respectively.

The success of our product development efforts depends on our ability to anticipate market trends and the price, performance and functionality requirements of semiconductor device manufacturers. In order to anticipate these trends and ensure that critical development projects proceed in a coordinated manner, we must continue to collaborate closely with our customers. Our relationships with our customers provide us with access to valuable information regarding industry trends, which enables us to better plan our product development activities. If our current relationships with our large customers are impaired, or if we are unable to develop similar collaborative relationships with important customers in the future, our long-term ability to produce commercially successful systems could be adversely affected.

We have had significant management changes since the end of the last fiscal year and these changes may impact our ability to execute our business strategy in the near term. In general, our success depends to a significant extent on the performance of our senior management and on our ability to identify, hire and retain key management personnel.

In March 2007, our President and Chief Executive Officer resigned, and a President and Chief Executive Officer was named. In April 2007, our Chief Financial Officer left the Company, and an interim Chief Financial Officer was named. We have been in the process of conducting a search for these executives' successors and have recently announced the hiring of a new Chief Executive Officer. While we are confident in the interim officers' abilities to manage the Company, our business may be affected during the transition period. Furthermore, we must be able to

Edgar Filing: NANOMETRICS INC - Form 10-Q

identify, hire and retain key personnel. If we fail to attract, motivate and retain qualified senior management personnel, our business could be harmed and our ability to implement our strategy compromised.

Table of Contents

We could have new material weaknesses in our internal controls in the future.

We have in the past identified material weaknesses in our internal controls and procedures. A material weakness is a control deficiency, or combination of them, that results in more than a remote likelihood that a material misstatement in our financial statements will not be prevented or detected. We believe that we have remedied the past material weaknesses in our internal controls and procedures as of December 30, 2006, we could have new material weaknesses in the future, as we integrate the acquired entities during 2007 and streamline and or automate our current internal controls.

Our current and potential competitors have significantly greater resources than we do, and increased competition could impair sales of our products.

We operate in the highly competitive semiconductor industry and face competition from a number of companies, many of which have greater financial, engineering, manufacturing, marketing and customer support resources than we do. As a result, our competitors may be able to respond more quickly to new or emerging technologies or market developments by devoting greater resources to the development, promotion and sale of products, which could impair sales of our products. Moreover, there has been merger and acquisition activity among our competitors and potential competitors. These transactions by our competitors and potential competitors may provide them with a competitive advantage over us by enabling them to rapidly expand their product offerings and service capabilities to meet a broader range of customer needs. Many of our customers and potential customers in the semiconductor industry are large companies that require global support and service for their metrology systems. Some of our larger or more geographically diverse competitors might be better equipped to provide this global support.

Successful infringement claims by third parties could result in substantial damages, lost product sales and the loss of important intellectual property rights by us.

Our commercial success depends, in part, on our ability to avoid infringing or misappropriating patents or other proprietary rights owned by third parties. From time to time we may receive communications from third parties asserting that our metrology systems may contain design features which are claimed to infringe on their proprietary rights. For example, in August 2005, we were served with a complaint by KLA alleging that certain of our products infringe two of KLA's patents, Patent No. 6,483,580 and Patent No. 6,590,656. In January 2006, KLA added Patent No. 6,611,330 to its claim. In March 2006, we were granted a stay in the KLA patent infringement cases. In April 2007, we and Nova agreed to dismiss, without prejudice, all pending patent litigation and have entered into a covenant not to sue one another for any patent for a period of one year. There can be no assurance that Nanometrics' new or current products do not infringe any valid intellectual property rights. Even if our products do not infringe, we may be required to expend significant sums of money to defend against infringement claims, as in the KLA lawsuit described above, or to actively protect our intellectual property rights through litigation.

We obtain some of the components and subassemblies included in our systems from a single source or a limited group of suppliers, and the partial or complete loss of one of these suppliers could cause production delays and significant loss of revenue.

We rely on outside vendors to manufacture many components and subassemblies. Certain components, subassemblies and services necessary for the manufacture of our systems are obtained from a sole supplier or limited group of suppliers. We do not maintain any long-term supply agreements with any of our suppliers. We have entered into arrangements with J.A.

Woollam Company for the purchase of the spectroscopic ellipsometer component incorporated in our advanced measurement systems. Our reliance on a sole or a limited group of suppliers involves several risks, including the following:

we may be unable to obtain an adequate supply of required components;

we have reduced control over pricing and the timely delivery of components and subassemblies; and

our suppliers may be unable to develop technologically advanced products to support our growth and development of new systems. Some of our suppliers have relatively limited financial and other resources. Because the manufacturing of certain of these components and subassemblies involves extremely complex processes and requires long lead times, we may experience delays or shortages caused by our suppliers. If we were forced to seek alternative sources of supply or to manufacture such components or subassemblies internally, we could be

Edgar Filing: NANOMETRICS INC - Form 10-Q

forced to redesign our systems, which could cause production delays and prevent us from shipping our systems to customers on a timely basis. Any inability to obtain adequate deliveries from our suppliers, or any other circumstance that would restrict our ability to ship our products, could damage relationships with current and prospective customers, harm our business and result in significant loss of revenue.

Table of Contents

Variations in the amount of time it takes for us to sell our systems may cause fluctuations in our operating results, which could cause our stock price to decline.

Variations in the length of our sales cycles could cause our revenues to fluctuate widely from period to period. Our customers generally take long periods of time to evaluate our metrology systems. We expend significant resources educating and providing information to our prospective customers regarding the uses and benefits of our systems. The length of time that it takes for us to complete a sale depends upon many factors, including:

the efforts of our sales force and our independent sales representatives;

the complexity of the customer's metrology needs;

the internal technical capabilities and sophistication of the customer;

the customer's budgetary constraints; and

the quality and sophistication of the customer's current processing equipment.

Because of the number of factors influencing the sales process, the period between our initial contact with a customer and the time at which we recognize revenue from that customer, if at all, varies widely. Our sales cycles, including the time it takes for us to build a product to customer specifications after receiving an order, typically range from three to six months. Occasionally our sales cycles can be much longer, particularly with customers in Asia who may require longer evaluation periods. During the sales cycles, we commit substantial resources to our sales efforts in advance of receiving any revenue, and we may never receive any revenue from a customer despite our sales efforts.

If we do complete a sale, customers often purchase only one of our systems and then evaluate its performance for a lengthy period of time before purchasing additional systems. The purchases are generally made through purchase orders rather than through long-term contracts. The number of additional products that a customer purchases, if any, depends on many factors, including a customer's capacity requirements. The period between a customer's initial purchase and any subsequent purchases is unpredictable and can vary from three months to a year or longer. Variations in the length of this period could cause fluctuations in our operating results, which could adversely affect our stock price.

Relatively small fluctuations in our system sales volume may cause our operating results to vary significantly each quarter.

During any quarter, a significant portion of our revenue is derived from the sale of a relatively small number of systems. Our automated metrology systems range in price from approximately \$200,000 to over \$1,000,000 per system, our integrated metrology systems range in price from approximately \$80,000 to \$400,000 per system. Accordingly, a small change in the number or mix of systems that we sell could cause significant changes in our operating results.

We depend on orders that are received and shipped in the same quarter, and therefore our results of operations may be subject to significant variability from quarter to quarter.

Our net sales in any given quarter depend upon a combination of orders received in that quarter for shipment in that quarter and shipments from backlog. Our backlog at the beginning of each quarter does not include all systems sales needed to achieve expected revenues for that quarter. Consequently, we are dependent on obtaining orders for systems to be shipped in the same quarter that the order is received. Moreover, customers may reschedule shipments, and production difficulties could delay shipments. Accordingly, we have limited visibility into future product shipments, and our results of operations may be subject to significant variability from quarter to quarter.

Because of the high cost of switching equipment vendors in our markets, it may be difficult for us to attract customers from our competitors even if our metrology systems are superior to theirs.

Edgar Filing: NANOMETRICS INC - Form 10-Q

We believe that once a semiconductor customer has selected one vendor's metrology system, the customer generally relies upon that system and, to the extent possible, subsequent generations of the same vendor's system, for the life of the application. Once a vendor's metrology system has been installed, a customer must often make substantial technical modifications and may experience downtime in order to switch to another vendor's metrology system. Accordingly, unless our systems offer performance or cost advantages that outweigh a customer's expense of switching to our systems, it will be difficult for us to achieve significant sales from that customer once it has selected another vendor's system for an application.

Table of Contents

If we fail to develop new and enhanced metrology systems we will likely lose market share to our competitors.

We operate in an industry that is subject to technological changes, changes in customer demands and the introduction of new, higher performance systems with short product life cycles. To be competitive, we must continually design, develop and introduce in a timely manner new metrology systems that meet the performance and price demands of semiconductor manufacturers and suppliers. We must also continue to refine our current systems so that they remain competitive. We may experience difficulties or delays in our development efforts with respect to new systems, and we may not ultimately be successful in developing them. Any significant delay in releasing new systems could adversely affect our reputation, give a competitor a first-to-market advantage or cause a competitor to achieve greater market share.

Lack of market acceptance for our new products may affect our ability to generate revenue and may harm our business.

We have recently introduced several products to the market including the IVS 185, VerteX Rapid Photoluminescence Mapping System for Compound Semiconductors, Atlas-M and Orion. We have invested substantial time and resources into the development of these products. However, we cannot accurately predict the future level of acceptance of our new products by our customers. As a result, we may not be able to generate anticipated revenue from sales of these products. While we anticipate that our new products will become an increasingly larger component of our business, their failure to gain acceptance with our customers could materially harm our business. Additionally, if our new products do gain market acceptance, our ability to sell our existing products may be impeded. As a result, there can be no assurance that the introduction of these products will be commercially successful or that these products will result in significant additional revenues or improved operating margins in future periods.

Our intellectual property may be infringed upon by third parties despite our efforts to protect it, which could threaten our future success and competitive position and harm our operating results.

Our future success and competitive position depend in part upon our ability to obtain and maintain proprietary technology for our principal product families, and we rely, in part, on patent, trade secret and trademark law to protect that technology. If we fail to adequately protect our intellectual property, it will be easier for our competitors to sell competing products. We own or may license patents relating to our metrology systems, and have filed applications for additional patents. Any of our pending patent applications may be rejected, and we may not in the future be able to develop additional proprietary technology that is patentable. In addition, the patents we own, have been issued, or may license may not provide us with competitive advantages and may be challenged by third parties. Third parties may also design around these patents.

In addition to patent protection, we rely upon trade secret protection for our confidential and proprietary information and technology. We routinely enter into confidentiality agreements with our employees. However, in the event that these agreements may be breached, we may not have adequate remedies. Our confidential and proprietary information and technology might also be independently developed by or become otherwise known to third parties. We may be required to initiate litigation in order to enforce any patents issued to or licensed by us, or to determine the scope or validity of a third party's patent or other proprietary rights. Any such litigation, regardless of outcome, could be expensive and time consuming, and could subject us to significant liabilities or require us to re-engineer our product or obtain expensive licenses from third parties, any of which would adversely affect our business and operating results. In March 2006, we filed a complaint against Nova Measuring Instruments Ltd. for infringing our Patent No. Re 34,783. In October 2006, we filed a new complaint against Nova for infringement of Patent No. 5,867,276 and 7,115,858. In April 2007, we and Nova agreed to dismiss, without prejudice, all pending patent litigation and have entered into a covenant not to sue one another for any patent for a period of one year.

If we choose to acquire new and complementary businesses, products or technologies instead of developing them ourselves, we may be unable to complete these acquisitions or may not be able to successfully integrate an acquired business in a cost-effective and non-disruptive manner.

Our success depends on our ability to continually enhance and broaden our product offerings in response to changing technologies, customer demands and competitive pressures. To achieve this, from time to time we have acquired complementary businesses, products, or technologies instead of developing them ourselves and may choose to do so in the future. For example, in July 2006, we consummated our merger with Accent Optical, a leading supplier of process control and metrology systems to the global semiconductor manufacturing industry. At the outset, we do not know if we will be able to complete any acquisitions, or whether we will be able to successfully integrate any acquired business, operate them profitably or retain their key employees. Integrating any business, product or technology that we acquire could be expensive and time consuming, disrupt our ongoing business and distract our management. In addition, in order to finance any acquisitions, we may be required to raise additional funds through public or private equity or debt financings. In that event, we could be forced to obtain financing on terms that are not favorable to us and, in the case of an equity financing, that result in dilution to our stockholders. If we are unable to integrate any acquired entities, products or technologies effectively, our business will suffer.

Table of Contents

We manufacture all of our systems at a limited number of facilities, and any prolonged disruption in the operations of those facilities could reduce our revenues.

We produce all of our systems in our manufacturing facilities located in Milpitas, California, and beginning with our acquisition of Accent in July 2006, in York, England. To a lesser extent, we also manufacture through our subsidiary in South Korea and contract manufacturers in Japan and China. Our manufacturing processes are highly complex and require sophisticated, costly equipment and specially designed facilities. As a result, any prolonged disruption in the operations of our manufacturing facilities, such as those resulting from a severe fire or earthquake, could seriously harm our ability to satisfy our customer order deadlines.

Our efforts to protect our intellectual property may be less effective in some foreign countries where intellectual property rights are not as well protected as in the United States.

In 2006, 2005 and 2004, 53.9%, 66.7% and 71.8%, respectively, of our total net revenues were derived from sales to customers in foreign countries, including certain countries in Asia, such as Japan, South Korea and Taiwan. The laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the United States, and many U.S. companies have encountered substantial problems in protecting their proprietary rights against infringement in such countries. If we fail to adequately protect our intellectual property in these countries, it would be easier for our competitors to sell competing products.

Continuing economic and political instability could affect our business and results of operations.

The ongoing threat of terrorism targeted at the United States or other regions where we conduct business increases the uncertainty in our markets and the economy in general. This uncertainty is likely to result in economic stagnation, which would harm our business. In addition, increased international political instability may hinder our ability to do business by increasing our costs of operations. For example, our transportation costs, insurance costs and sales efforts may become more expensive as a result of geopolitical tension. These tensions may also negatively affect our suppliers and customers. If this international economic and political instability continues or increases, our business and results of operations could be harmed.

We incur increased costs as a result of changes in laws and regulations affecting public companies.

Compliance with changes in laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002, has resulted in and, we expect, will continue to result in substantial accounting, legal and administrative costs. In particular, Section 404 of the Sarbanes-Oxley Act of 2002 and the rules of the Securities and Exchange Commission and the Public Company Accounting Oversight Board impose requirements with respect to the evaluation of the effectiveness of our internal controls. The cost of complying with these requirements is substantial.

Our results of operations could vary as a result of the methods, estimates and judgments we use in applying our accounting policies.

The methods, estimates and judgments we use in applying our accounting policies have a significant impact on our results of operations, see Critical Accounting Policies in Part I, Item 2 of this Form 10-Q. Such methods, estimates and judgments are, by their nature, subject to substantial risks, uncertainties and assumptions, and factors may arise over time that lead us to change our methods, estimates and judgments. Changes in those methods, estimates and judgments could significantly affect our results of operations. In particular, the calculation of share-based compensation expense under SFAS No. 123(R) requires us to use valuation methodologies (which were not developed for use in valuing employee stock options) and a number of assumptions, estimates and conclusions regarding matters such as expected forfeitures, expected volatility of our share price, the expected dividend rate with respect to our common stock and the exercise behavior of our employees. Furthermore, there are no means, under applicable accounting principles, to compare and adjust our expense if and when we learn of additional information that may affect the estimates that we previously made, with the exception of changes in expected forfeitures of share-based awards. Factors may arise over time that lead us to change our estimates and assumptions with respect to future share-based compensation arrangements, resulting in variability in our share-based compensation expense over time. Changes in forecasted share-based compensation expense could impact our gross margin percentage; research and development expenses; marketing, general and administrative expenses; and our tax rate.

Our quarterly operating results have varied in the past and probably will continue to vary significantly in the future, which will cause volatility in our stock price.

Our quarterly operating results have varied significantly in the past and are likely to vary in the future, which volatility could cause our stock price to decline. Some of the factors that may influence our operating results and subject our stock to extreme price and volume fluctuations include:

changes in customer demand for our systems;

Table of Contents

economic conditions in the semiconductor industries;

the timing, cancellation or delay of customer orders and shipments;

market acceptance of our products and our customers' products;

our ability to recover the higher costs associated with meeting our customers' increasing service demands;

competitive pressures on product prices and changes in pricing by our customers or suppliers;

the timing of new product announcements and product releases by us or our competitors and our ability to design, introduce and manufacture new products on a timely and cost-effective basis;

the timing of acquisitions of businesses, products or technologies;

the levels of our fixed expenses, including research and development costs associated with product development, relative to our revenue levels; and

fluctuations in foreign currency exchange rates, particularly the Japanese yen and the Great British Pound.

If our operating results in any period fall below the expectations of securities analysts and investors, the market price of our common stock would likely decline.

We are highly dependent on international sales and operations, which exposes us to foreign political and economic risks.

Sales to customers in foreign countries accounted for approximately 53.9%, 66.7% and 71.8% of our total net revenues in 2006, 2005 and 2004, respectively. We maintain facilities in Japan, Taiwan, United Kingdom, South Korea and the European Union. We anticipate that international sales will continue to account for a significant portion of our revenues. International sales and operations carry inherent risks such as: regulatory limitations imposed by foreign governments, obstacles to the protection of our intellectual property, political, military and terrorism risks, disruptions or delays in shipments caused by customs brokers or other government agencies, unexpected changes in regulatory requirements, tariffs, customs, duties and other trade barriers, difficulties in staffing and managing foreign operations, and potentially adverse tax consequences resulting from changes in tax laws. If any of these risks materialize and we are unable to manage them, our international sales and operations would suffer.

We are exposed to fluctuations in the exchange rates of foreign currency.

As a global concern, we face exposure to adverse movements in foreign currency exchange rates. With our operations in Japan, South Korea, United Kingdom, Taiwan, the European Union and Singapore, a significant percentage of our cash flows are exposed to foreign currency risk. These exposures may change over time as business practices evolve and could have a material adverse impact on our financial results and cash flow.

We are subject to various environmental laws and regulations that could impose substantial costs upon us and may harm our business, operating results and financial condition.

Some of our operations use substances regulated under various federal, state, local, and international laws governing the environment, including those relating to the storage, use, discharge, disposal, labeling, and human exposure to hazardous and toxic materials. We could incur costs, fines and civil or criminal sanctions, third-party property damage or personal injury claims, or could be required to incur substantial investigation or

Edgar Filing: NANOMETRICS INC - Form 10-Q

remediation costs, if we were to violate or become liable under environmental laws. Liability under environmental laws can be joint and several and without regard to comparative fault. Compliance with current or future environmental laws and regulations could restrict our ability to expand our facilities or require us to acquire additional expensive equipment, modify our manufacturing processes, or incur other significant expenses. There can be no assurance that violations of environmental laws or regulations will not occur in the future as a result of the inability to obtain permits, human error, equipment failure or other causes.

Anti-takeover provisions in our charter documents and Delaware law could discourage, delay or prevent a change in control of our company and may affect the trading price of our common stock.

In September 2006, we changed our state of incorporation from California to Delaware. The anti-takeover provisions of the Delaware General Corporation Law may discourage, delay or prevent a change in control by prohibiting us from engaging in a business combination with an interested stockholder for a period of three years after the person becomes an interested stockholder, even if a change of control would be beneficial to our existing stockholders. In addition, our certificate of incorporation and bylaws may discourage, delay or prevent a change in our management or control over us that stockholders may consider favorable. Our certificate of incorporation and bylaws:

authorize the issuance of blank check preferred stock that could be issued by our board of directors to thwart a takeover attempt;

Table of Contents

establish a classified board of directors, as a result of which the successors to the directors whose terms have expired will be elected to serve from the time of election and qualification until the third annual meeting following their election;

limit who may call special meetings of stockholders; and

prohibit stockholder action by written consent, requiring all actions to be taken at a meeting of the stockholders.

Significant amounts of goodwill and intangible assets after the completion of the acquisitions of Accent and Soluris transactions could make our reported results more volatile.

Goodwill is tested for impairment annually or when an event occurs indicating the potential for impairment. The evaluation is prepared based on our current and projected performance for the identified reporting units. The fair value of our reporting units is determined using a combination of the cash flow and market comparable approaches. If we conclude at any time that the carrying value of our goodwill and other intangible assets for any of our reporting units exceeds its implied fair value, we will be required to recognize an impairment, which could materially reduce operating income and net income in the period in which such impairment is recognized.

In the application of these methodologies, we were required to make estimates of future operating trends and judgments on discount rates and other variables. Actual future results and other assumed variables could differ from these estimates, including changes in the economy, the business environment in which we operate, and/or our own relative performance. Any differences in actual results compared to our estimates could result in further future impairments. Accordingly, our future earnings may be subject to significant volatility, particularly on a period-to-period basis.

Any future acquisitions we make, or attempt to make, could disrupt our business and harm our financial condition if we are not able to timely and successfully close the acquisition or successfully integrate acquired businesses and technologies.

We have made and may continue to make acquisitions of business and technologies to enhance our business. Acquisitions involve numerous risks, including problems combining the purchased operations and key employees, technologies or products, unanticipated costs, diversion of management's attention from our core business, adverse effects on existing business relationships with suppliers and customers, risks associated with entering markets in which we have no or limited prior experience and potential loss of key employees. The integration of businesses that we have acquired or that we may acquire in the future into our business has been and will continue to be a complex, time consuming and expensive process. Failure to operate as a combined organization utilizing common information and communication systems, operating procedures, financial controls and human resources practices could adversely impact the success of any business combination.

ITEM 6. EXHIBITS

Exhibit Index

The following exhibits are filed or incorporated by reference with this Quarterly Report on Form 10-Q:

Exhibit No.	Description
3.(i)	Certificate of Incorporation
3.1(1)	Certificate of Incorporation of the Registrant
3.(ii)	Bylaws
3.2(1)	Bylaws of the Registrant

Table of Contents

10 Material Contracts

Management Contracts, Compensatory Plans, Contracts or Arrangements

10.1(2) Registrant's Incentive Cash Award Program

31 Rule 13a-14(a)/15d-14(a) Certifications

31.1 Certification of Bruce C. Rhine, principal executive officer of the Registrant, pursuant to rule 13a-14(a) or rule 15a-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Quentin B. Wright, interim principal financial officer of the Registrant, pursuant to rule 13a-14(a) or rule 15a-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32 Section 1350 Certifications

32.1 Certification of Bruce C. Rhine, principal executive officer of the Registrant, and Quentin B. Wright, interim principal financial officer of the Registrant, pursuant to rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

-
- (1) Incorporated by reference to exhibits filed with the Registrant's Current Report on Form 8-K filed October 5, 2006
(2) Incorporated by reference to the Registrant's Current Reports on Form 8-K filed May 31, 2007 and August 6, 2007.

Table of Contents

SIGNATURES

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

NANOMETRICS INCORPORATED
(Registrant)

By: /s/ Quentin B. Wright
Quentin B. Wright
Chief Financial Officer

Dated: August 9, 2007