

NANOMETRICS INC  
Form 10-Q  
October 31, 2014

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

FORM 10-Q

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 27, 2014

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)  
1550 Buckeye Drive, Milpitas, CA  
(Address of principal executive offices)  
Registrant's telephone number, including area code: (408) 545-6000

94-2276314  
(I. R. S. Employer  
Identification No.)  
95035  
(Zip Code)

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

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

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

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

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

As of October 24, 2014, there were 24,158,015 shares of common stock, \$0.001 par value, issued and outstanding.

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 FOR QUARTER ENDED SEPTEMBER 27, 2014

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## PART I — FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

NANOMETRICS INCORPORATED  
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share amounts)

(Unaudited)

	September 27, 2014	December 28, 2013
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$35,625	\$44,765
Marketable securities	48,748	48,097
Accounts receivable, net of allowances of \$253 and \$293, respectively	26,061	31,436
Inventories	35,762	34,520
Inventories-delivered systems	501	6,901
Prepaid expenses and other	9,356	10,519
Deferred income tax assets	2,922	14,516
Total current assets	158,975	190,754
Property, plant and equipment, net	50,736	47,439
Goodwill	11,039	11,743
Intangible assets, net	5,255	7,864
Deferred income tax assets	362	4,338
Other assets	593	696
Total assets	\$226,960	\$262,834
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$5,948	\$10,604
Accrued payroll and related expenses	8,395	7,853
Deferred revenue	5,944	21,749
Other current liabilities	7,834	7,993
Income taxes payable	639	758
Total current liabilities	28,760	48,957
Deferred revenue	3,253	3,718
Income taxes payable	635	1,171
Deferred tax liability	2,701	—
Other long-term liabilities	1,673	1,615
Total liabilities	37,022	55,461
Commitments and contingencies (Note 17)		
Stockholders' equity:		
Preferred stock, \$0.001 par value; 3,000,000 shares authorized; no shares issued or outstanding	—	—
Common stock, \$0.001 par value, 47,000,000 shares authorized; 24,156,554 shares and 23,537,275 shares, respectively, issued and outstanding	24	24
Additional paid-in capital	255,036	244,733
Accumulated deficit	(64,475)	(37,996)
Accumulated other comprehensive income (loss)	(647)	612
Total stockholders' equity	189,938	207,373

Total liabilities and stockholders' equity	\$226,960	\$262,834
See Notes to Condensed Consolidated Financial Statements		

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NANOMETRICS INCORPORATED  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 27, 2014	September 28, 2013	September 27, 2014	September 28, 2013
Net revenues:				
Products	\$ 19,487	\$ 30,164	\$ 101,991	\$ 69,776
Service	7,646	8,880	24,747	28,372
Total net revenues	27,133	39,044	126,738	98,148
Costs of net revenues:				
Cost of products	10,737	18,116	52,165	40,908
Cost of service	4,292	4,469	14,061	14,510
Amortization of intangible assets	688	658	2,039	1,963
Total costs of net revenues	15,717	23,243	68,265	57,381
Gross profit	11,416	15,801	58,473	40,767
Operating expenses:				
Research and development	8,037	8,926	25,724	24,695
Selling	6,389	6,758	20,443	20,303
General and administrative	5,781	5,424	18,120	16,442
Amortization of intangible assets	103	195	318	588
Restructuring charge	1,715	1,740	1,715	1,740
Total operating expenses	22,025	23,043	66,320	63,768
Loss from operations	(10,609	) (7,242	) (7,847	) (23,001
Other income (expense):				
Interest income	13	7	37	51
Interest expense	(90	) (118	) (286	) (549
Other income (expense), net	(57	) (334	) 111	(930
Total other expense, net	(134	) (445	) (138	) (1,428
Loss before income taxes	(10,743	) (7,687	) (7,985	) (24,429
Provision for (benefit from) income taxes	17,919	(3,133	) 18,494	(9,727
Net loss	\$(28,662	) \$(4,554	) \$(26,479	) \$(14,702
Net loss per share:				
Basic	\$(1.19	) \$(0.20	) \$(1.11	) \$(0.63
Diluted	\$(1.19	) \$(0.20	) \$(1.11	) \$(0.63
Weighted shares used in per share calculation:				
Basic	24,132	23,261	23,928	23,247
Diluted	24,132	23,261	23,928	23,247

See Notes to Condensed Consolidated Financial Statements

NANOMETRICS INCORPORATED  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(In thousands)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 27, 2014	September 28, 2013	September 27, 2014	September 28, 2013
Net loss	\$(28,662 )	\$(4,554 )	\$(26,479 )	\$(14,702 )
Other comprehensive income (loss):				
Change in foreign currency translation adjustment	(1,637 )	1,142	(1,252 )	(837 )
Net change on unrealized gains on available-for-sale investments	(15 )	20	(7 )	17
Other comprehensive income (loss)	(1,652 )	1,162	(1,259 )	(820 )
Comprehensive loss	\$(30,314 )	\$(3,392 )	\$(27,738 )	\$(15,522 )

See Notes to Condensed Consolidated Financial Statements

NANOMETRICS INCORPORATED  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended	
	September 27, 2014	September 28, 2013
Cash flows from operating activities:		
Net loss	\$(26,479	) \$(14,702
Reconciliation of net loss to net cash used in operating activities:		
Depreciation and amortization	8,660	6,536
Stock-based compensation	5,115	5,912
Excess tax benefit from equity awards	—	467
Loss on disposal of fixed assets	80	173
Provision for doubtful accounts receivable	11	—
Inventory write-down	1,109	6,307
Deferred income taxes	20,776	(9,659
Changes in fair value of contingent consideration	118	1,045
Changes in assets and liabilities:		
Accounts receivable	4,871	(1,818
Inventories	(7,998	) (7,173
Inventories-delivered systems	6,400	(300
Prepaid expenses and other	1,751	820
Accounts payable, accrued and other liabilities	(4,535	) 6,798
Deferred revenue	(16,270	) 2,044
Income taxes payable	(3,158	) (363
Net cash used in operating activities	(9,549	) (3,913
Cash flows from investing activities:		
Maturities of marketable securities	25,570	38,030
Purchases of marketable securities	(26,810	) (40,797
Purchases of property, plant and equipment	(2,800	) (3,516
Net cash used in investing activities	(4,040	) (6,283
Cash flows from financing activities:		
Payments to Zygo Corporation related to acquisition	(470	) (735
Repayments of debt obligations	—	(5,224
Proceeds from sale of shares under employee stock option and purchase plans	5,852	3,192
Excess tax benefit from equity awards	—	(467
Taxes paid on net issuance of stock awards	(664	) (86
Repurchases of common stock	—	(5,000
Net cash provided by (used in) financing activities	4,718	(8,320
Effect of exchange rate changes on cash and cash equivalents	(269	) (566
Net decrease in cash and cash equivalents	(9,140	) (19,082
Cash and cash equivalents, beginning of period	44,765	62,915
Cash and cash equivalents, end of period	\$35,625	\$43,833
Supplemental disclosure of non-cash investing activities:		
Transfer of inventory to property, plant and equipment, net	\$4,627	\$3,106
See Notes to Condensed Consolidated Financial Statements		





NANOMETRICS INCORPORATED  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Nature of Business and Basis of Presentation

Description of Business – Nanometrics Incorporated (“Nanometrics” or the “Company”) and its wholly-owned subsidiaries, design, manufacture, market, sell and support thin film, optical critical dimension and overlay dimension metrology and inspection systems used primarily in the manufacturing of semiconductors, solar photovoltaics (“solar PV”) and high-brightness LEDs (“HB-LED”), as well as by customers in the silicon wafer and data storage industries. Nanometrics' metrology systems precisely measure a wide range of film types deposited on substrates during manufacturing to control manufacturing processes and increase production yields in the fabrication of integrated circuits. The thin film metrology systems use a broad spectrum of wavelengths, high-sensitivity optics, proprietary software, and patented technology to measure the thickness and uniformity of films deposited on silicon and other substrates as well as their chemical composition. The Company’s optical critical dimension technology is a patented critical dimension measurement technology that is used to precisely determine the dimensions on the semiconductor wafer that directly control the resulting performance of the integrated circuit devices. The overlay metrology systems are used to measure the overlay accuracy of successive layers of semiconductor patterns on wafers in the photolithography process. Nanometrics' inspection systems are used to find defects on patterned and unpatterned wafers at nearly every stage of the semiconductor production flow. The corporate headquarters of Nanometrics is located in Milpitas, California.

Basis of Presentation – The accompanying condensed consolidated financial statements ("financial statements") have been prepared on a consistent basis with the audited consolidated financial statements as of December 28, 2013, and include all normal recurring adjustments necessary to fairly present the information set forth therein. All significant intercompany accounts and transactions have been eliminated in consolidation. The financial statements have been prepared in accordance with the regulations of the United States Securities and Exchange Commission (“SEC”) for interim periods in accordance with S-X Article 10, 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 ("U.S. GAAP"). 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 fiscal year ended December 28, 2013, which were included in the Company’s Annual Report on Form 10-K filed with the SEC on March 7, 2014.

Fiscal Period – The Company uses a 52/53 week fiscal year ending on the last Saturday of the calendar year. All references to the quarter refer to Nanometrics' fiscal quarter. The fiscal quarters presented herein include 13 weeks.

Reclassification – Certain prior year amounts have been reclassified to conform to the current year presentation.

Use of Estimates – The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ materially from those estimates. Estimates are used for, but not limited to, revenue recognition, the provision for doubtful accounts, the provision for excess, obsolete, or slow moving inventories, valuation of intangible and long-lived assets, warranty accruals, income taxes, valuation of stock-based compensation and contingencies.

Revenue Recognition – The Company derives revenue from the sale of process control metrology systems (“product revenue”) as well as spare part sales, billable service, service contracts and upgrades (together “service revenue”). Upgrades are a group of parts and/or software that change the existing configuration of a product and are included in

service revenue. They are distinguished from product revenue, which consists of complete, advanced process control metrology and inspection systems (the “system(s)”). Nanometrics' systems consist of hardware and software components that function together to deliver the essential functionality of the system. Arrangements for sales of systems often include defined customer-specified acceptance criteria.

In summary, the Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller's price is fixed or determinable, and collectability is reasonably assured.

NANOMETRICS INCORPORATED  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)  
(Unaudited)

For product sales to existing customers, revenue recognition occurs at the time title and risk of loss transfer to the customer, which usually occurs upon shipment from the Company's manufacturing location, if it can be reliably demonstrated that the product has successfully met the defined customer specified acceptance criteria and all other recognition criteria has been met. For initial sales where the product has not previously met the defined customer specified acceptance criteria, product revenues are recognized upon the earlier of receipt of written customer acceptance or expiration of the contractual acceptance period. In Japan, where contractual terms with the customer specify risk of loss and title transfers upon customer acceptance, revenue is recognized upon receipt of written customer acceptance, provided that all other recognition criteria have been met.

The Company warrants its products against defects in manufacturing. Upon recognition of product revenue, a liability is recorded for anticipated warranty costs. On occasion, customers request a warranty period longer than the Company's standard warranty. In those instances where extended warranty services are separately quoted to the customer, the associated revenue is deferred and recognized as service revenue ratably over the term of the contract. The portion of service contracts and extended warranty services agreements that are uncompleted at the end of any reporting period are included in deferred revenue.

As part of its customer services, the Company sells software that is considered to be an upgrade to a customer's existing systems. These standalone software upgrades are not essential to the tangible product's functionality and are accounted for under software revenue recognition rules which require vendor specific objective evidence ("VSOE") of fair value to allocate revenue in a multiple element arrangement. Revenue from upgrades is recognized when the upgrades are delivered to the customer, provided that all other recognition criteria have been met.

Revenue related to spare parts is recognized upon shipment. Revenue related to billable services is recognized as the services are performed. Service contracts may be purchased by the customer during or after the warranty period and revenue is recognized ratably over the service contract period.

Frequently, the Company delivers products and various services in a single transaction. The Company's deliverables consist of tools, installation, upgrades, billable services, spare parts, and service contracts. The Company's typical multi-element arrangements include a sale of one or multiple tools that include installation and standard warranty. Other arrangements consist of a sale of tools bundled with service elements or delivery of different types of services. The Company's tools, upgrades, and spare parts are generally delivered to customers within a period of up to six months from order date. Installation is usually performed soon after delivery of the tool. The portion of revenue associated with installation is deferred based on relative selling price and that revenue is recognized upon completion of the installation. Billable services are billed on a time and materials basis and performed as requested by customers. Under service contract arrangements, services are provided as needed over the fixed arrangement term. The Company does not grant its customers a general right of return or any refund terms and imposes a penalty on orders canceled prior to the scheduled shipment date.

The Company regularly evaluates its revenue arrangements to identify deliverables and to determine whether these deliverables are separable into multiple units of accounting. In accordance with revenue recognition guidance, the Company allocates the arrangement consideration among the deliverables based on relative selling prices. The Company has established VSOE for some of its products and services when a substantial majority of selling prices falls within a narrow range when sold separately. For deliverables with no established VSOE, the Company uses best estimate of selling price to determine standalone selling price for such deliverable. The Company does not use third party evidence to determine standalone selling price since this information is not widely available in the market as the

Company's products contain a significant element of proprietary technology and the solutions offered differ substantially from competitors. The Company has established a process for developing estimated selling prices, which incorporates historical selling prices, the effect of market conditions, gross margin objectives, pricing practices, as well as entity-specific factors. The Company monitors and evaluates estimated selling price on a regular basis to ensure that changes in circumstances are accounted for in a timely manner.

When certain elements in multiple-element arrangements are not delivered or accepted at the end of a reporting period, the relative selling prices of undelivered elements are deferred until these elements are delivered and/or accepted. If deliverables cannot be accounted for as separate units of accounting, the entire arrangement is accounted for as a single unit of accounting and revenue is deferred until all elements are delivered and all revenue recognition requirements are met.

NANOMETRICS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Note 2. Recent Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update No. 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (a consensus of the FASB Emerging Issues Task Force) ("ASU 2013-11"), which provides that a liability related to an unrecognized tax benefit would be offset against a deferred tax asset for a net operating loss carryforward, a similar tax loss or a tax credit carryforward if such settlement is required or expected in the event the uncertain tax position is disallowed. In situations in which a net operating loss carryforward, a similar tax loss or a tax credit carryforward is not available at the reporting date under the tax law of the jurisdiction or the tax law of the jurisdiction does not require, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit will be presented in the financial statements as a liability and will not be combined with deferred tax assets. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. ASU 2013-11 is effective for fiscal years and interim periods beginning after December 15, 2013. The Company adopted this standard during the three months ended March 29, 2014, resulting in a one-time tax benefit of \$0.3 million, a reduction in deferred tax assets of \$0.3 million, and a reduction in long-term income taxes payable of \$0.6 million.

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers ("ASU 2014-09"), which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The standard will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The new standard is effective for the Company on January 1, 2017. Early application is not permitted. The standard permits the use of either the retrospective or cumulative effect transition method. The Company is evaluating the effect that ASU 2014-09 will have on its consolidated financial statements and related disclosures. The Company has not yet selected a transition method nor has it determined the effect of the standard on its ongoing financial reporting.

Note 3. Fair Value Measurements and Disclosures

Fair value is defined as the price that would be received upon the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The standard assumes that the transaction to sell the asset or transfer the liability occurs in the principal or most advantageous market for the asset or liability, and establishes that the fair value of an asset or liability shall be determined based on the assumptions that market participants would use in pricing the asset or liability.

The Company determines the fair values of its financial instruments based on the fair value hierarchy established in ASC 820, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The classification of a financial asset or liability within the hierarchy is based upon the lowest level input that is significant to the fair value measurement. The fair value hierarchy prioritizes the inputs into the following three levels that may be used to measure fair value:

Level 1 — Quoted prices in active markets for identical assets or liabilities.

Level 2 — Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument.

Level 3 — Unobservable inputs that are supported by little or no market activity and are significant to the fair value of the assets or liabilities. Such unobservable inputs include an estimated discount rate used in the Company's discounted present value analysis of future cash flows, which reflects the Company's estimate of debt with similar terms in the current credit markets. As there is currently minimal activity in such markets, the actual rate could be materially different.



NANOMETRICS INCORPORATED  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)  
(Unaudited)

The following tables present the Company's assets and liabilities measured at estimated fair value on a recurring basis, excluding accrued interest components, categorized in accordance with the fair value hierarchy (in thousands), as of the following dates:

	September 27, 2014				December 28, 2013			
	Fair Value Measurements Using Input Types				Fair Value Measurements Using Input Types			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Assets:								
Cash equivalents:								
Money market funds	\$549	\$—	\$—	\$549	\$876	\$—	\$—	\$876
Commercial paper	—	650	—	650	—	750	—	750
Total cash equivalents	549	650	—	1,199	876	750	—	1,626
Marketable securities:								
U.S. Treasury, U.S. Government and U.S. Government agency debt securities	2,498	18,687	—	21,185	5,036	11,980	—	17,016
Commercial paper, municipal securities and corporate debt securities	—	27,563	—	27,563	—	31,081	—	31,081
Total marketable securities	2,498	46,250	—	48,748	5,036	43,061	—	48,097
Total <sup>(1)</sup>	\$3,047	\$46,900	\$—	\$49,947	\$5,912	\$43,811	\$—	\$49,723
Liabilities:								
Contingent consideration payable	\$—	\$—	\$2,431	\$2,431	\$—	\$—	\$2,783	\$2,783

<sup>(1)</sup> Excludes cash of \$34.4 million and \$43.1 million held in operating accounts as of September 27, 2014 and December 28, 2013, respectively.

The fair values of the marketable securities that are classified as Level 1 in the table above were derived from quoted market prices for identical assets or liabilities that the Company has the ability to access. The fair value of marketable securities that are classified as Level 2 in the table above were derived from: non-binding market consensus prices that were corroborated by observable market data, quoted market prices for similar instruments, or pricing models, such as discounted cash flow techniques, with all significant inputs derived from or corroborated by observable market data. There were no transfers of instruments between Level 1, Level 2 and Level 3 during the financial periods presented.

Changes in Level 3 liabilities (in thousands)

Fair value at December 28, 2013	\$2,783
Payments made to Zygo Corporation	(470)
Change in fair value included in earnings	118
Fair Value at September 27, 2014	\$2,431

As of September 27, 2014, the Company had liabilities of \$2.4 million resulting from the acquisition of certain assets from Zygo Corporation ("Zygo"), which are measured at fair value on a recurring basis, with changes in fair value recorded in other income (expense), net. Of the \$2.4 million of Zygo liabilities at September 27, 2014, \$0.9 million was a current liability and \$1.5 million was a long-term liability. As of December 28, 2013, the liabilities totaled \$2.8

million of which \$1.3 million was a current liability and \$1.5 million was a long-term liability. The fair values of these liabilities were determined using Level 3 inputs applying a discounted cash flow model incorporating assumptions that market participants would use in their estimates of fair value. Some of these assumptions included estimates for discount rate, and timing and the amount of cash flows.



NANOMETRICS INCORPORATED  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)  
(Unaudited)

Note 4. Cash and Investments

The following table presents cash, cash equivalents, and available-for-sale investments as of the following dates (in thousands):

	September 27, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Market Value
Cash	\$ 34,426	—	\$ —	\$ 34,426
Cash equivalents:				
Money market funds	549	—	—	549
Commercial paper	650	—	—	650
Marketable securities:				
Commercial paper	700	—	—	700
U.S. Treasury securities	2,497	1	—	2,498
U.S. Government agency securities	18,685	6	(4 )	18,687
Municipal securities	5,014	3	(2 )	5,015
Corporate debt securities	21,850	9	(11 )	21,848
Total cash, cash equivalents, and marketable securities	\$ 84,371	\$ 19	\$ (17 )	\$ 84,373
	December 28, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Market Value
Cash	\$ 43,139	\$ —	\$ —	\$ 43,139
Cash equivalents:				
Money market funds	876	—	—	876
Commercial paper	750	—	—	750
Marketable securities:				
U.S. Treasury Securities	5,036	—	—	5,036
U.S. Government agency securities	11,980	4	(4 )	11,980
Municipal securities	9,756	11	(4 )	9,763
Corporate debt securities	21,316	7	(5 )	21,318
Total cash, cash equivalents, and marketable securities	\$ 92,853	\$ 22	\$ (13 )	\$ 92,862

Available-for-sale marketable securities, readily convertible to cash, with maturity dates of 90 days or less are classified as cash equivalents, while those with maturity dates greater than 90 days are classified as marketable securities within short-term assets. All marketable securities as of September 27, 2014 and December 28, 2013, were available-for-sale and

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## NANOMETRICS INCORPORATED

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

reported at fair value based on the estimated or quoted market prices as of the balance sheet date. Unrealized gains or losses, net of tax effect, are recorded in accumulated other comprehensive income (loss) within stockholders' equity. Both the gross unrealized gains and gross unrealized losses for the three and nine months ended September 27, 2014 and September 28, 2013, were insignificant and no marketable securities had other than temporary impairment. All marketable securities as of September 27, 2014 and December 28, 2013, had maturity dates of less than two years and were not invested in foreign entities.

## Note 5. Accounts Receivable

The Company maintains arrangements under which eligible accounts receivables in Japan are sold without recourse to unrelated third party financial institutions. These receivables were not included in the consolidated balance sheets as the criteria for sale treatment had been met. The Company pays administrative fees as well as interest ranging in total from 1.19% to 1.68% based on the anticipated length of time between the date the sale is consummated and the expected collection date of the receivables sold. The Company sold \$1.3 million and \$0.6 million of receivables during the three months ended September 27, 2014 and September 28, 2013, respectively, and sold \$2.9 million and \$5.2 million of receivables during the nine months ended September 27, 2014 and September 28, 2013, respectively. There were no material gains or losses on the sale of such receivables. There were no amounts due from such third party financial institutions at September 27, 2014 and December 28, 2013, respectively.

## Note 6. Inventories

Inventories are stated at the lower of standard cost (which approximates actual cost on a first-in, first-out basis) or market. Inventories consist of the following as of the following dates (in thousands):

	September 27, 2014	December 28, 2013
Raw materials and sub-assemblies	\$18,836	\$19,655
Work in process	6,366	7,597
Finished goods	10,560	7,268
Inventories	35,762	34,520
Inventories-delivered systems	501	6,901
Total inventories	\$36,263	\$41,421

The Company reflects the cost of systems that were invoiced upon shipment but deferred for revenue recognition purposes separate from its inventory held for sale as "Inventories-delivered systems."

## Note 7. Property, Plant and Equipment

Property, plant and equipment, net, consist of the following as of the following dates (in thousands):

	September 27, 2014	December 28, 2013
Land	\$15,575	\$15,569
Building and improvements	19,826	19,403
Machinery and equipment	31,569	27,820
Furniture and fixtures	2,343	2,308
Software	7,844	1,851
Capital in progress	3,070	5,833

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Total property, plant and equipment, gross	80,227	72,784
Accumulated depreciation and amortization	(29,491)	(25,345)
Total property, plant and equipment, net	\$50,736	\$47,439

Total depreciation and amortization expense for the three months ended September 27, 2014 and September 28, 2013, was \$1.7 million and \$1.4 million, respectively. Total depreciation and amortization expense on property, plant and equipment for the nine months ended September 27, 2014 and September 28, 2013, was \$4.9 million and \$4.0 million, respectively.

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Note 8. Goodwill and Intangible Assets

The following table summarizes the activity in the Company's goodwill during the nine months ended September 27, 2014 (in thousands):

Balance as of December 28, 2013	\$ 11,743	
Foreign currency movements	(704	)
Balance as of September 27, 2014	\$ 11,039	

Finite-lived intangible assets are recorded at cost, less accumulated amortization. Finite-lived intangible assets consisted of the following as of the following dates (in thousands):

	September 27, 2014		
	Adjusted cost	Accumulated amortization	Net carrying amount
Developed technology	\$ 17,471	\$(12,647	) \$ 4,824
Customer relationships	9,510	(9,444	) 66
Brand names	1,927	(1,776	) 151
Patented technology	2,252	(2,038	) 214
Trademark	80	(80	) —
	\$ 31,240	\$(25,985	) \$ 5,255
	December 28, 2013		
	Adjusted cost	Accumulated amortization	Net carrying amount
Developed technology	\$ 18,095	\$(11,032	) \$ 7,063
Customer relationships	9,573	(9,263	) 310
Brand names	1,927	(1,700	) 227
Patented technology	2,252	(1,988	) 264
Trademark	80	(80	) —
	\$ 31,927	\$(24,063	) \$ 7,864

The amortization of finite-lived intangibles is computed using the straight-line method. Estimated lives of finite-lived intangibles range from 2 to 10 years. Total amortization expense for each of the three months ended September 27, 2014 and September 28, 2013 was \$0.8 million and \$0.9 million, respectively. Total amortization expense for each of the nine months ended September 27, 2014 and September 28, 2013, was \$2.3 million and \$2.6 million, respectively.

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At September 27, 2014, estimated future amortization expense of intangible assets were as follows (in thousands):

Fiscal years	Amount
2014 (remaining three months)	\$734
2015	2,293
2016	1,816
2017	206
2018	140
Thereafter	66
Total future amortization expense	\$5,255

Note 9. Other Current Liabilities

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

	September 27, 2014	December 28, 2013
Accrued warranty	\$2,990	\$3,426
Accrued professional services	726	545
Customer deposits	3	867
Fair value of contingent payments to Zygo Corporation related to acquisition - current portion	930	1,344
Other	3,185	1,811
Total other current liabilities	\$7,834	\$7,993

Note 10. Restructuring

The Company recorded a restructuring charge of approximately \$1.7 million during the three months ended September 27, 2014 as a result of its decision to consolidate a portion of its operations in the United Kingdom. This amount includes charges primarily related to employee severance, other expenses and early termination costs of a facility lease due to expire in 2017 in the amounts of \$0.6 million, \$0.3 million and \$0.8 million, respectively. The Company expects to complete this restructuring plan by March 2015. Other related costs will be recognized as incurred.

The Company had recorded a restructuring charge of \$1.7 million during the three months ended September 28, 2013 as a result of its decision to consolidate a portion of its European operations. As of December 28, 2013, the Company had completed and settled in full all cash payments related to the employee severance expenses and non-cash items related to the acceleration of vesting of RSUs.

As of September 27, 2014 and September 28, 2013, respectively, the components of the Company's restructuring reserves were included in other current liabilities and were as follows (in thousands):

	Employee severance and benefits	Facility termination costs	Other	Total
Balance as of June 28, 2014	\$—	\$—	\$—	\$—
Charges	560	846	309	1,715
Cash Payments	(152 )	—	(280 )	(432 )
Balance as of September 27, 2014	\$408	\$846	\$29	\$1,283



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	Employee severance and benefits	Facility termination costs	Other	Total
Balance as of June 29, 2013	\$—	\$—	\$—	—
Charges	1,740	—	—	1,740
Cash Payments	—	—	—	—
Non-cash items	(896 )	—	—	(896 )
Balance as of September 28, 2013	\$844	\$—	\$—	\$1,740

Note 11. Line of Credit and Debt Obligations

Line of Credit - On May 30, 2014, the Company amended its revolving line of credit facility (i) to extend the maturity date of such facility by two years to May 30, 2016, and (ii) to increase the minimum amount available to borrow to \$12.0 million. The instrument governing the line of credit facility includes certain financial covenants regarding tangible net worth. The revolving line of credit agreement includes a provision for the issuance of commercial or standby letters of credit by the bank on behalf of the Company. 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 the Company's domestic assets excluding intellectual property and real estate. The minimum borrowing interest rate is 3.00% per annum. Borrowing is limited to the lesser of (a) \$12.0 million plus the borrowing base, or (b) \$20.0 million. The total borrowing available as of September 27, 2014, was \$15.9 million. As of September 27, 2014, the Company was not in breach of any restrictive covenants in connection with this line of credit. There were no outstanding amounts drawn on this facility as of September 27, 2014. Although management has no current plans to request advances under this credit facility, the Company may use the proceeds of any future borrowing for general corporate purposes, future acquisitions or expansion of the Company's business.

Mortgage Loan - In July 2008, the Company entered into a mortgage loan agreement with General Electric Commercial Finance ("GE") pursuant to which it borrowed \$13.5 million, secured, in part, by a lien on and security interest in the building and land comprising the Company's principal offices in Milpitas, California. The loan initially bore interest at the rate of 7.18% per annum, which rate was scheduled to reset in August 2013 to 3.03% over the weekly average yield of five-year U.S Dollar Interest Rate Swaps as published by the Federal Reserve. Monthly principal and interest payments were based on a 20 year amortization for the first 60 months and 15 year amortization thereafter. The remaining principal balance of the loan and any accrued but unpaid interest will be due on August 1, 2018. According to the terms of the loan agreement, the Company could make annual pre-payments of up to 20% of the outstanding principal balance without incurring any penalty. GE subsequently sold the mortgage on March 31, 2011 to Sterling Saving Bank; however, no changes were made to the terms of the original loan agreement with GE as a result of the sale. In July 2012, the Company prepaid \$1.4 million of the loan, representing 20% of the outstanding balance at the time of prepayment. On July 18, 2013, the Company repaid \$4.8 million of the loan, representing the entire outstanding principal balance of the loan and all accrued interest. The Company did not incur any fees associated with the prepayment of the loan. As of September 27, 2014, there was no outstanding balance and no available amounts to borrow on the loan.

Note 12. Net Income (Loss) Per Share



The Company presents both basic and diluted net income (loss) per share on the face of its condensed consolidated statements of operations. Basic net income (loss) per share are computed by dividing net income (loss) by the weighted-average number of shares of common stock outstanding for the period. Diluted net income (loss) per share are computed using the weighted-average number of shares of common stock outstanding plus the effect of all dilutive securities representing potential shares of common stock outstanding during the period.

Since the Company had a net loss for the three and nine months ended September 27, 2014 and September 28, 2013, potentially dilutive securities of 0.4 million shares were not included in the computation of diluted shares for the nine months ended September 27, 2014 and the three and nine months ended September, 28, 2013, and 0.3 million shares for three months ended September 27, 2014, since inclusion of such shares would have been anti-dilutive.

Accordingly, basic and diluted net loss per share were the same for the three and nine months ended September 27, 2014 and September 28, 2013.

#### Note 13. Equity and Stock Based Compensation Plans

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## NANOMETRICS INCORPORATED

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## Options

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 life of options granted was calculated using the simplified method. 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 the Company's 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.

	Three Months Ended		Nine Months Ended	
	September 27, 2014	September 28, 2013	September 27, 2014	September 28, 2013
<b>Stock Options</b>				
Expected life	—	4.6 years	4.6 years	4.5 years
Expected volatility	—	64.38 %	54.86 %	71.04 %
Risk-free interest rate	—	1.52 %	1.54 %	1.00 %
Dividends	—	—	—	—
<b>Employee Stock Purchase Plan</b>				
Expected life	0.5 years	0.5 years	0.5 years	0.5 years
Expected volatility	29.64 %	25.94 %	32.60 %	26.75 %
Risk-free interest rate	0.06 %	0.10 %	0.54 %	0.11 %
Dividends	—	—	—	—

No stock options were awarded during the three months ended September 27, 2014. The weighted average fair value per share of the stock options awarded in the three months September 28, 2013 was \$7.75, and in the nine months ended September 27, 2014 and September 28, 2013, was \$8.13 and \$8.55, respectively, based on the fair market value of the Company's common stock on the grant dates.

A summary of activity under the Company's stock option plans during the nine months ended September 27, 2014 is as follows:

	Number of Shares Outstanding (Options)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (in Thousands)
<b>Options:</b>				
Outstanding at December 28, 2013	1,909,039	\$ 13.22	4.02	\$ 10,341
Exercised	(395,940)	) \$ 10.54		
Granted	74,300	\$ 17.56		
Cancelled	(104,781)	) \$ 15.64		
Outstanding at September 27, 2014	1,482,618	\$ 13.98	3.65	\$ 3,521
Exercisable at September 27, 2014	1,038,707	\$ 13.03	2.92	\$ 3,346

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company's closing stock price of \$15.70 as of September 26, 2014, the last trading day of the quarter, 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 the three months ended September 27, 2014 and September 28, 2013, was \$0.4 million and \$0.2 million, respectively, and during the nine months ended September 27, 2014 and September 28, 2013, was \$2.9 million and \$1.7 million, respectively.



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Restricted Stock Units ("RSUs")

A summary of activity for RSUs during the nine months ended September 27, 2014, is as follows:

	Number of RSUs	Weighted Average Fair Value
Outstanding RSUs at December 28, 2013	334,444	\$18.61
Granted	399,475	\$17.61
Released	(136,959)	) \$17.89
Cancelled	(63,711)	) \$16.75
Outstanding RSUs at September 27, 2014	533,249	\$18.27

Stock-based Compensation Expense

Stock-based compensation expense for all share-based payment awards made to the Company's employees and directors pursuant to the employee stock option and employee stock purchase plans by function was as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 27, 2014	September 28, 2013	September 27, 2014	September 28, 2013
Cost of products	\$70	\$55	\$199	\$153
Cost of service	53	74	227	204
Research and development	331	412	967	1,092
Selling	490	476	1,353	1,418
General and administrative	761	789	2,369	2,149
Restructuring	—	896	—	896
Total stock-based compensation expense	\$1,705	\$2,702	\$5,115	\$5,912

Note 14. Components of Accumulated Other Comprehensive Income (Loss)

The following table shows a summary of changes in components of accumulated other comprehensive income (loss) for the nine months ended September 27, 2014 (in thousands):

	Defined Benefit Pension Plans	Foreign Currency Translations	Unrealized Gain on Investment	Total
Balance at December 28, 2013	\$(28 )	\$631	\$9	\$612
Other comprehensive income (loss)	—	(1,252 )	(7 )	(1,259 )
Balance at September 27, 2014	\$(28 )	\$(621 )	\$2	\$(647 )

Note 15. Warranties

The Company sells the majority of its products with a 12 months repair or replacement warranty from the date of acceptance or shipment date. 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 were to 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

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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 such amounts in accordance with changes in these factors. Components of the warranty accrual, which were included in the accompanying condensed consolidated balance sheets within other current liabilities, were as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 27, 2014	September 28, 2013	September 27, 2014	September 28, 2013
Balance at beginning of the period	\$3,484	\$ 3,519	\$3,426	\$ 4,203
Accruals for warranties	1,242	1,161	4,459	2,886
Settlements during the period	(1,736 )	(1,278 )	(4,895 )	(3,687 )
Balance at end of the period	\$2,990	\$ 3,402	\$2,990	\$ 3,402

## Note 16. Income Taxes

The Company accounts for income taxes under the provisions of ASC 740, Accounting for Income Taxes. The Company adjusts its effective tax rate each quarter to be consistent with the estimated annual effective tax rate. The Company also records the tax effect of unusual or infrequently occurring discrete items, including changes in judgment about valuation allowances and effects of changes in tax laws or tax rates, in the interim period in which they occur. The Company's effective tax rate reflects the impact of a portion of its earnings being taxed in foreign jurisdictions as well as a valuation allowance maintained on certain deferred tax assets.

The Company recorded a tax provision of \$17.9 million and a tax benefit of \$3.1 million for the three months ended September 27, 2014 and September 28, 2013, respectively, and a tax provision of \$18.5 million and a tax benefit of \$9.7 million for the nine months ended September 27, 2014 and September 28, 2013, respectively. The change during the three and nine months ended September 27, 2014, compared to the corresponding period in 2013, was primarily related to a one-time charge of \$21.1 million related to the establishment of a valuation allowance against the Company's U.S. deferred tax assets during the three months ended September 27, 2014, partially offset by a one-time benefit of \$0.6 million recorded during the nine months ended September 28, 2013 related to the retroactive reinstatement of the 2012 Federal R&D tax credit.

The realization of deferred tax assets is primarily dependent on the Company generating sufficient U.S. and foreign taxable income in future fiscal years. The Company regularly assesses the need for a valuation allowance against its deferred tax assets. In making that assessment, the Company considers both positive and negative evidence related to the likelihood of realization of the deferred tax assets to determine, based on the weight of available evidence, whether it is more-likely-than-not that some or all of the deferred tax assets will not be realized. In evaluating the need for a valuation allowance, the Company considers its cumulative loss in the U.S. as a significant piece of negative evidence. During the three month period ended September 27, 2014, the Company recorded a \$21.1 million valuation allowance against its U.S. deferred tax assets as it determined, within the period, it would not meet the more likely than not threshold. The Company continued to maintain valuation allowances against certain foreign deferred tax assets as a result of uncertainties regarding the realization of the asset due to cumulative losses and uncertainty of future taxable income. The Company will continue to assess the realizability of the deferred tax assets in each of the applicable jurisdictions and maintain the valuation allowances until sufficient positive evidence exists to support a reversal. In the event that the Company determines that the deferred tax assets are realizable, an adjustment to the valuation allowances will be reflected in the tax provision for the period such determination is made.

The Company is subject to taxation in the U.S. and various states including California, and foreign jurisdictions including South Korea, Japan and United Kingdom. Due to tax attribute carry-forwards, the Company is subject to examination for tax years from 2003 forward for U.S. tax purposes. The Company is also subject to examination in various states for tax years from 2002 forward. The Company is subject to examination for tax years from 2006 forward for various foreign jurisdictions.

On September 13, 2013, the U.S. Treasury Department and the IRS issued final regulations that address costs incurred in acquiring, producing, or improving tangible property (the "tangible property regulations"). The tangible property regulations are generally effective for tax years beginning on or after January 1, 2014, and may be adopted in earlier years. The tangible property regulations required the Company to make additional tax accounting method changes as of January 1, 2014. The impact of these changes was not material to the Company's consolidated financial position or its results of operations.

The Company accrues interest and penalties related to unrecognized tax benefits in its provision for income taxes. The total amount of accrued penalties and interest was immaterial for the three and nine months ended September 27, 2014. During the next twelve months, the Company anticipates increases in its unrecognized tax benefits of approximately \$0.2 million.

#### Note 17. Commitments and Contingencies

**Intellectual Property Indemnification Obligations** – The Company will, from time to time, in the normal course of business, agree to indemnify certain customers, vendors or others against third party claims that the Company's products, when used for their intended purpose(s), or the Company's intellectual property, infringe the intellectual property rights of such third parties or other claims made against parties with which it enters into contractual relationships. 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 immaterial. Accordingly, no liabilities have been recorded for these obligations in the accompanying condensed consolidated balance sheets as of September 27, 2014 and December 28, 2013.

#### Note 18. Geographic and Significant Customer Information

The Company has one operating segment, which is the sale, design, manufacture, marketing and support of thin film and optical critical dimension systems. The following tables summarize total net revenues (based on the deployments and service location of the systems) and long-lived assets (excluding intangible assets) attributed to significant geographic regions (in thousands):

	Three Months Ended		Nine Months Ended	
	September 27, 2014	September 28, 2013	September 27, 2014	September 28, 2013
United States	\$5,511	\$15,665	\$25,554	\$41,426
Japan	4,099	2,387	10,005	9,617
Taiwan	640	3,737	11,337	6,959
China	2,848	901	27,694	6,952
South Korea	6,327	9,805	30,589	18,946
Other	7,708	6,549	21,559	14,248
Total net revenues	\$27,133	\$39,044	\$126,738	\$98,148

	At	
	September 27, 2014	December 28, 2013
United States	\$50,061	\$44,775
Japan	82	125
South Korea	337	445
All Other	256	2,094
Total long-lived tangible assets	\$50,736	\$47,439

The following customers accounted for 10% or more of total accounts receivable as of the following dates:



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	September 27, 2014		December 28, 2013	
SK Hynix	26	%	22	%
Taiwan Semiconductor Mfg. Co.	***		12	%
Global Foundries	14	%	***	
Samsung Electronics Co. Ltd.	***		27	%
Intel Corporation	***		14	%
Micron Technology, Inc.	12	%	***	

\*\*\* The customer accounted for less than 10% of total accounts receivable as of that period end.

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

	Three Months Ended		Nine Months Ended					
	September 27, 2014	September 28, 2013	September 27, 2014	September 28, 2013				
Intel Corporation	***	34	%	14	%	30	%	
SK Hynix	27	%	23	%	16	%	18	%
Samsung Electronics Co. Ltd.	***	***	28	%	***			
Micron Technology, Inc.	25	%	***		***		***	

\*\*\* The customer accounted for less than 10% of total net revenues for that period.

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 21E of the Securities Exchange Act of 1934, including, without limitation, statements regarding future periods, financial results, revenues, margins, growth, customers, tax rates, product performance, and the impact of accounting rules on our business and the future implications of our statements regarding goals, strategy, and similar terms. We may identify these statements by the use of words such as "anticipate," "believe," "continue," "could," "estimate," "expect," "intend," "likely," "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 risks, uncertainties and changes in circumstances, many of which may be difficult to predict or beyond our control, including those factors referenced in Part II, Item 1A, Risk Factors, and elsewhere in this document, and in Part I, Item 1A, Risk Factors, in our Annual Report on Form 10-K for the fiscal year ended December 28, 2013. In particular our results could vary significantly based on: changes in customer and industry spending; rate and extent of changes in product mix; adoption of new products; timing of orders, shipments, and acceptance of products; our ability to secure volume supply agreements; and general economic conditions. In evaluating our business, investors should carefully consider these factors in addition to any other risks and uncertainties set forth elsewhere. The occurrence of the events described in the risk factors and elsewhere in this report as well as other risks and uncertainties 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 (i) our audited consolidated financial statements and notes thereto for the fiscal year ended December 28, 2013, which were included in our 2013 Annual Report on Form 10-K filed with the Securities and Exchange Commission ("SEC") on March 7, 2014, and (ii) our other filings with the SEC.

We are an innovator in the field of metrology and inspection systems for semiconductor manufacturing and other industries. Our systems are designed to precisely monitor film thickness and critical dimensions that are necessary to control the manufacturing process and to identify defects that can affect production yields and performance.

Principal factors that impact our revenue growth include capital expenditures by manufacturers of semiconductors to increase capacity and to enable their development of new technologies, and our ability to gain market share. The increasing complexity of the manufacturing processes for semiconductors is an important factor in the demand for our innovative metrology systems, as are the adoption of optical critical dimension metrology across fabrication processes, the adoption of immersion lithography and double patterning, the adoption of new types of thin film materials, the adoption of advanced packaging strategies and wafer backside inspection, and the need for improved process control to drive process efficiencies. Our strategy is to continue to innovate organically as well as to evaluate strategic acquisitions to address business challenges and opportunities.

Our revenues are primarily derived from product sales but are also derived from customer service and system upgrades ("services") for the installed base of our products. For the nine months ended September 27, 2014, we derived 80% of our total net revenues from product sales and 20% of our total net revenues from services.

#### Overview

Together with our subsidiaries, we are a leading provider of advanced, high-performance process control metrology and inspection systems used primarily in the fabrication of integrated circuits, high-brightness LEDs ("HB-LED"), discrete components and data storage devices. Our automated and integrated systems address numerous process control applications, including critical dimension and film thickness measurement, device topography, defect

inspection, overlay registration, and analysis of various other film properties such as optical, electrical and material characteristics. Our process control solutions are deployed throughout the fabrication process, from front-end-of-line substrate manufacturing, to high-volume production of semiconductors and other devices, to advanced wafer-scale packaging applications. Our systems enable device manufacturers to improve yields, increase productivity and lower their manufacturing costs. Our defect inspection systems locate large area and microscopic defects on patterned and unpatterned wafers. This system can be used for inspection at nearly every stage of the semiconductor production flow.

## Nanometrics Products

We offer a diverse line of systems to address the broad range of process control requirements of the semiconductor manufacturing industry. In addition, we believe that our engineering expertise, strategic acquisitions, supplier alliances and short-cycle production strategies enable us to develop and offer advanced process control solutions in the future that should address industry advancement and trends. We categorize our systems as follows:

### Automated Standalone Systems

Our automated systems are made up of both semi-automated and fully automated metrology systems which are employed in both high-volume and low-volume production environments. The Atlas<sup>®</sup> II, Atlas II+, Atlas XP/Atlas XP+ and Atlas-M represent our line of high-performance metrology systems providing optical critical dimension (“OCD”), thin film metrology and wafer stress for transistor and interconnect metrology applications. The OCD technology is supported by our NanoCD<sup>®</sup> suite of solutions including our NanoDiffract<sup>®</sup> software and NanoGen<sup>™</sup> scalable computing engine that enables visualization, modeling, and analysis of complex structures. The UniFire<sup>™</sup> system enables users to measure multiple parameters at any given process step in the advanced packaging process flow for critical dimension, overlay, and topography applications. Our SPARK<sup>™</sup> defect inspection system, offers ultra-fast inspection of patterned and unpatterned semiconductor wafers.

We continue to offer automated products for 200mm factories running at 90nm nodes and above, as well as systems supporting micro-electrical mechanical systems (“MEMS”).

### System Platform

The Lynx<sup>®</sup> platform enables cluster metrology factory automation for improved cost of ownership to our customers by combining our Atlas<sup>®</sup> II and IMPULSE<sup>®</sup>, UniFire metrology and SPARK inspection systems in configurations to provide high throughput, reduced footprint systems for leading 300mm wafer metrology applications including OCD and thin film process control.

### Integrated Systems

Our integrated metrology (“IM”) systems are installed directly onto wafer processing equipment to provide near real-time measurements for improved process control and maximum throughput. Our IM systems are sold directly to end customers and through OEM channels. The IMPULSE<sup>®</sup> system is our latest metrology platform for OCD and thin film metrology, and has been successfully qualified on numerous OEM platforms. Our 90x0 system is qualified for OEM and direct sales supporting thin film and OCD applications. Our NanoCD solutions suite is sold in conjunction with our IMPULSE<sup>®</sup> and legacy 90x0 systems. Our Trajectory<sup>®</sup> system provides in-line measurement of layers in thin film thickness and composition in semiconductor applications.

### Materials Characterization

Our Materials Characterization products include systems that are used to monitor the physical, optical, electrical and material characteristics of discrete electronic industry, HB-LED, solar Photo-Voltaics (“PV”), compound semiconductor, strained silicon and silicon-on-insulator (“SOI”) devices, including composition, crystal structure, layer thickness, dopant concentration, contamination and electron mobility.

Our Vertex<sup>™</sup> is a photoluminescence (“PL”) mapping system designed for high-volume compound semiconductor metrology applications including power control and photonics applications. The RPMBLue<sup>™</sup> is our latest PL mapping system designed specifically for the HB-LED market. We sell Fourier-Transform Infrared (“FTIR”) automated and manual systems in the QS2200/3300 and QS1200 respectively. The FTIR systems are spectrometers designed for non-destructive wafer analysis for various applications. The NanoSpec<sup>®</sup> line, including the NanoSpec II products supporting thin film measurement across all applications in both low volume production and research applications.

We are continually working to strengthen our competitive position by developing new technologies and products in our market segment. In furtherance of our goals, we have:

• Introduced new products in every core product line and primary market served;

• Diversified our product line and addressed new markets through acquisitions, such as the 2011 acquisition of Nanda Technologies GmbH, a supplier of high sensitivity, high throughput defect inspection systems;

Continued development of new measurement and inspection technologies for advanced fabrication processes; and

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Researched and developed innovative applications of existing technology to new market opportunities within the solar PV, HB-LED, and data storage industries.

#### Important Themes and Significant Trends

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

**Proliferation of Optical Critical Dimension Metrology across Fabrication Processes.** Our customers use photolithographic processes to create patterns on wafers. Critical dimensions must be carefully controlled during this process. In advanced node device definition, additional monitoring of thickness and profile dimensions on these patterned structures at CMP, Etch, and Thin Film processing is driving broader OCD adoption. Our proprietary OCD systems can provide the critical process control of these circuit dimensions that is necessary for successful manufacturing of these state-of-the-art devices. Nanometrics OCD technology is broadly adopted across NAND, DRAM, HDD, and logic semiconductor manufacturing processes.

**Adoption of Advanced Packaging Processes.** Our customers use photolithographic, etching, metallization and wafer thinning to enable next generation advanced packaging solutions for semiconductor devices. The new packaging leads to increased functionality in smaller, less expensive form factors. Advanced packages can be broken down into high density flip chip or bump packages that increase pin density allowing for more complex I/O on advanced CPU parts. Similar or different devices can be stacked at the wafer level using a Through Silicon Via ("TSV") process. The TSV process enables high density small form factor parts, being primarily driven by mobile consumer products (e.g. cellular telephones with integrated CMOS camera sensors). Increasingly advanced packaging technologies are being adopted by our end customers.

**Adoption of New Types of Thin Film Materials.** The need for ever increasing device circuit speed coupled with lower power consumption has pushed semiconductor device manufacturers to begin the replacement of the traditional aluminum etch back interconnect flows as well as conventional gate dielectric materials, all which drive a broader adoption of thin film and OCD metrology systems. To achieve greater semiconductor device speed, manufacturers have adopted copper in Logic/IDM and it is now proliferating in next generation DRAM and Flash nodes.

Additionally, to achieve improved transistor performance in logic devices and higher cell densities in memory devices, new materials including high dielectric constant (or high-k) gate materials are increasingly being substituted for traditional silicon-oxide gate dielectric materials. High-k materials comprise complex thin films including layers of hafnium oxide and a bi-layer of thin film metals. Our advanced metrology and inspection solutions are required for control of process steps, which are critical to enable the device performance improvements that these new materials allow.

**Development of 3D Transistor Architectures.** Our end customers continue to improve device density and performance by scaling front-end-of-line transistor architectures. Many of these designs, including FinFET transistors and 3D-NAND have buried features and high aspect ratio stacked features that enable improved performance and density. The advanced designs require additional process control to manage the complex shapes and materials properties, driving additional applications for both OCD and our UniFire systems.

**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 automated systems throughout the fabrication process to ensure that manufacturing processes scale rapidly, are accurate and can be repeated on a consistent basis.

**Increased Customer Concentration.** Our market is characterized by continued consolidation in the customer base. Our largest customer accounted for 28.0% of our total revenue in the nine months ended September 27, 2014, and 29.8% of our total revenue in the nine months ended September 28, 2013.

#### Critical Accounting Policies

The preparation of our financial statements conforms to accounting principles generally accepted in the United States of America, which requires management, in applying our accounting policies, to make estimates and judgments 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 ongoing basis, management evaluates its estimates including those related to bad debts, inventory valuations, warranty obligations, impairment 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. There were no significant changes in our critical accounting policies during the nine months ended September 27, 2014. Please refer to Item 7, "Management's Discussion and Analysis of

Financial Condition and Results of Operations," in our Annual Report on Form 10-K for the fiscal year ended December 28, 2013 for a complete discussion of our critical accounting policies.

#### Recent Accounting Pronouncements

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

#### Results of Operations

##### Net Revenues

Our net revenues by category were as follows (in thousands, except percentages):

	Three Months Ended				Nine Months Ended				
	September 27, 2014	September 28, 2013	Changes In		September 27, 2014	September 28, 2013	Changes In		
			Amount	%			Amount	%	
Automated Systems	\$ 15,950	\$ 22,965	\$(7,015 )	(31 )%	\$ 83,286	\$ 51,593	\$ 31,693	61	%
Integrated Systems	1,570	4,453	(2,883 )	(65 )%	11,084	8,369	2,715	32	%
Materials Characterization	1,967	2,746	(779 )	(28 )%	7,621	9,814	(2,193 )	(22 )%	
Total product revenues	19,487	30,164	(10,677 )	(35 )%	101,991	69,776	32,215	46	%
Service revenues	7,646	8,880	(1,234 )	(14 )%	24,747	28,372	(3,625 )	(13 )%	
Total net revenues	\$ 27,133	\$ 39,044	\$(11,911)	(31 )%	\$ 126,738	\$ 98,148	\$ 28,590	29	%

For the three months ended September 27, 2014, total net revenues decreased by \$11.9 million relative to the comparable 2013 period. This decrease was primarily due to a significant pause in spending at our two largest customers. For the nine months ended September 27, 2014, total net revenues increased by \$28.6 million relative to the comparable 2013 period. This increase was primarily from an industry-wide improvement in memory-related semiconductor capital spending and from an increase in foundry penetration, supported by the adoption of multiple Atlas®, UniFire™ and IMPULSE® systems by several customers during the first half of the year partially offset by the decline in process control metrology spending that occurred in the third quarter of 2014.

For the three months ended September 27, 2014, product revenues decreased by \$10.7 million relative to the comparable 2013 period. The decrease was characterized by decreases in all product categories including \$7.0 million in Automated Systems and \$2.9 million in Integrated Systems. For the nine months ended September 27, 2014, product revenues increased by \$32.2 million relative to the comparable 2013 period led primarily by increases of \$31.7 million in Automated Systems sales (primarily from Atlas® II, followed by UniFire™) and \$2.7 million in Integrated Systems sales (primarily from IMPULSE® systems), for the reasons cited above.

Service revenues decreased by \$1.2 million and \$3.6 million, respectively, during the three and nine months ended September 27, 2014, relative to the comparable 2013 periods, primarily due to a decrease in upgrade revenue due to lower demand for upgrades of installed tools during the first and third quarter of 2014. Upgrades tend to fluctuate from quarter-to-quarter based on availability of new functionality from upgrades and customer production cycles, which determine when customers purchase available upgrades.

With a significant portion of the world's semiconductor manufacturing capacity located in Asia, a substantial portion of our revenues continue to be generated in that region. Although sales to customers within individual countries of that region will vary from time to time, we expect that a substantial portion of our revenues will continue to be generated in Asia.



## Gross Margin

Our gross margin for product and services were as follows:

	Three Months Ended		Nine Months Ended		
	September 27, 2014	September 28, 2013	September 27, 2014	September 28, 2013	
Product	41.4	% 37.8	% 46.9	% 38.6	%
Services	43.9	% 49.7	% 43.2	% 48.9	%

The calculation of product gross margin includes both cost of products and amortization of intangible assets. Product gross margin for the three and nine months ended September 27, 2014, was 41.4% and 46.9%, respectively, reflecting an increase of 3.6 percentage points and 8.3 percentage points, respectively, from the comparable periods in 2013. The increase in the three months ended September 27, 2014, compared to the same period in the prior fiscal year, was primarily driven by the more favorable mix of higher margin product and a write-off of inventory in the quarter ended September 28, 2013, offset in part by lower current quarter revenues against fixed costs. The increase in the nine months ended September 27, 2014, compared to the same period in the prior fiscal year, was primarily driven by a write-off of inventory in the quarter ended September 28, 2013, and by higher revenues for the nine months ended September 27, 2014 against lower fixed costs for the comparable period in 2013.

The gross margin for our services business was 43.9% and 43.2%, respectively, for the three and nine months ended September 27, 2014, reflecting decreases of 5.8 percentage points and 5.7 percentage points, respectively, from the comparable periods in 2013. The decreases in the three and nine months ended September 27, 2014, as compared to the same period in 2013, were due principally to a decrease in upgrade revenues, which typicall