INTEVAC INC

FORM 10-Q
(Quarterly Report)

Filed 11/10/98 for the Period Ending 09/26/98

Address	3560 BASSETT STREET
	SANTA CLARA, CA, 95054
Telephone	4089869888
CIK	0001001902
Symbol	IVAC
SIC Code	3559 - Special Industry Machinery, Not Elsewhere Classified
Industry	Industrial Machinery & Equipment
Sector	Industrials
Fiscal Year	12/31

INTEVAC INC

FORM 10-Q
(Quarterly Report)

Filed 11/10/1998 For Period Ending 9/26/1998

Address	356O BASSETT ST
	SANTA CLARA, California 95054
Telephone	408-986-9888
CIK	0001001902
Industry	Computer Storage Devices
Sector	Technology
Fiscal Year	12/31

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q
(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 26, 1998

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 0-26946

INTEVAC, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

CALIFORNIA	94-3125814
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(IRS EMPLOYER IDENTIFICATION NO.)

3550 BASSETT STREET
SANTA CLARA, CALIFORNIA 95054
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICE, INCLUDING ZIP CODE)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (408) 986-9888

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 [X] No [ ]

APPLICABLE ONLY TO CORPORATE ISSUERS:

On September 26, 1998 approximately 11,992,237 shares of the Registrant's Common Stock, no par value, were outstanding.

INTEVAC, INC.

INDEX

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

INTEVAC, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS)

	SEPTEMBER 26, 1998 (UNAUDITED)	DECEMBER 31, 1997
ASSETS		
Current assets:		
Cash and cash equivalents	$ 745	$ 3,338
Short-term investments	61,175	67,804
Accounts receivable, net of allowances of $1,775 and $1,505 at September 26, 1998 and December 31, 1997, respectively	9,728	9,634
Inventories	23,570	35,915
Short-term note receivable, net of allowance of $395 at December 31, 1997	--	--
Prepaid expenses and other current assets	675	641
Deferred tax asset	6,572	6,572
Total current assets	102,465	123,904
Property, plant, and equipment, net	14,615	13,760
Investment in 601 California Avenue LLC	2,431	2,431
Goodwill and other intangibles	3,945	5,344
Debt issuance costs	1,782	2,029
Deferred tax assets and other assets	192	326
Total assets	$125,430	$147,794
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 2,523	$ 4,585
Accrued payroll and related liabilities	1,780	1,949
Other accrued liabilities	7,119	10,304
Customer advances	9,913	28,247
Net liabilities of discontinued operations	--	794
Total current liabilities	21,335	45,879
Convertible notes	57,500	57,500
Long-term notes payable & other long-term liabilities	1,960	1,980
Shareholders' equity:		
Common stock, no par value	15,454	17,336
Retained earnings	29,181	25,099
Total shareholders' equity	44,635	42,435
Total liabilities and shareholders' equity	$125,430	$147,794

See accompanying notes.

INTEVAC, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

(UNAUDITED)

	THREE MONTHS ENDED		NINE MONTHS ENDED	
	SEPTEMBER 26, 1998	SEPTEMBER 27, 1997	SEPTEMBER 26, 1998	SEPTEMBER 27, 1997
Net revenues	$14,657	$30,350	$84,693	$95,254
Cost of net revenues	10,693	21,186	61,025	65,805
Gross profit	3,964	9,164	23,668	29,449
Operating expenses:				
Research and development	2,157	3,225	9,117	7,687
Selling, general and administrative	2,458	2,907	8,509	8,328
Restructuring	71	--	1,235	--
Total operating expenses	4,686	6,132	18,861	16,015
Operating income (loss)	(722)	3,032	4,807	13,434
Interest expense	(1,027)	(1,046)	(3,100)	(2,494)
Interest income and other, net	1,059	816	2,789	2,789
Income (loss) from continuing operations before income taxes	(690)	2,802	4,496	13,729
Provision for income taxes	(227)	871	1,485	4,805
Income (loss) from continuing operations	(463)	1,931	3,011	8,924
Gain from discontinued operations, net of applicable income taxes	--	--	1,005	--
Net income (loss)	$ (463)	$ 1,931	$ 4,016	$ 8,924
Basic earnings per share:				
Income (loss) from continuing operations	$ (0.04)	$ 0.15	$ 0.25	$ 0.71
Net income (loss)	$ (0.04)	$ 0.15	$ 0.33	$ 0.71
Shares used in per share amounts	11,994	12,585	12,098	12,541
Diluted earnings per share:				
Income (loss) from continuing operations	$ (0.04)	$ 0.15	$ 0.24	$ 0.67
Net income (loss)	$ (0.04)	$ 0.15	$ 0.32	$ 0.67
Shares used in per share amounts	11,994	13,104	12,414	15,294

See accompanying notes.

INTEVAC, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)

(UNAUDITED)

	NINE MONTHS ENDED	
	SEPTEMBER 26, 1998	SEPTEMBER 27, 1997
OPERATING ACTIVITIES		
Net income	$ 4,016	$ 8,924
Adjustments to reconcile net income to net cash and cash equivalents provided by (used in) operating activities:		
Depreciation and amortization	5,865	3,632
Gain on sale of Chorus Investment	(395)	(785)
Gain on sale of discontinued operations	(794)	--
Foreign currency loss	71	--
Loss on IMAT investment	132	39
Restructuring charge -- non-cash portion	194	--
Loss on disposal of equipment	95	38
Changes in assets and liabilities	(14,437)	1,290
Total adjustments	(9,269)	4,214
Net cash and cash equivalents provided by (used in) operating activities	(5,253)	13,138
INVESTING ACTIVITIES		
Purchase of investments	(107,993)	(95,442)
Proceeds from sale of investments	114,622	31,773
Proceeds from sale of Chorus Investment	395	785
Investment in IMAT	--	(436)
Purchase of leasehold improvements and equipment	(2,482)	(5,014)
Net cash and cash equivalents provided by (used in) investing activities	4,542	(68,334)
FINANCING ACTIVITIES		
Net borrowings under line of credit agreement	--	(2)
Notes payable repayments	--	(25)
Proceeds from issuance of common stock	1,118	901
Repurchase of common stock	(3,000)	--
Proceeds from convertible bond offering	--	55,197
Net cash and cash equivalents provided by (used in) financing activities	(1,882)	56,071
Net increase (decrease) in cash and cash equivalents	(2,593)	875
Cash and cash equivalents at beginning of period	3,338	938
Cash and cash equivalents at end of period	$ 745	$ 1,813
SUPPLEMENTAL SCHEDULE OF CASH FLOW INFORMATION		
Cash paid for:		
Interest	$ 3,838	$ 2,016
Income taxes	4,065	5,440
Other non-cash changes:		
Inventories capitalized for internal use	--	$ 567

See accompanying notes.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. BUSINESS ACTIVITIES AND BASIS OF PRESENTATION

Intevac, Inc. ("Intevac" or the "Company") is a leading supplier of static sputtering systems and related manufacturing equipment used to manufacture thin-film disks for computer hard disk drives. Sputtering is a complex vacuum deposition process used to deposit multiple thin-film layers on a disk. The Company's primary objective is to be the industry leader in supplying disk sputtering equipment by providing disk sputtering systems which have both the highest overall performance and the lowest cost of ownership in the industry. The Company's principal product, the MDP-250 disk sputtering system, enables disk manufacturers to produce high performance, high capacity disks. The Company sells its static sputtering systems and related manufacturing equipment to both captive and merchant thin-film disk manufacturers. The Company sells and markets its products directly in the United States, and through exclusive distributors in Japan and Korea. The Company has established subsidiaries in Singapore and Malaysia and a branch office in Taiwan to support its customers in Southeast Asia.

The Company also realizes revenues from the sales of system components, contract research and development activities, flat panel display ("FPD") manufacturing equipment and electron beam processing equipment. Intevac's system component business consists primarily of sales of spare parts and after-sale service to purchasers of the Company's disk sputtering systems, as well as sales of components to other manufacturers of vacuum equipment. Contract research and development revenues have been derived primarily from prime contracts awarded by and subcontracts awarded under various Department of Defense ("DOD") and NASA development projects for various photonics products and the FPD industry. FPD manufacturing equipment consists of sputtering and rapid thermal processing equipment for the manufacture of FPD's. Electron beam processing equipment is used for curing inks, coatings and adhesives, in the manufacture of shrink wrap films and for in-line sterilization.

The financial information at September 26, 1998 and for the three- and nine-month periods ended September 26, 1998 and September 27, 1997 is unaudited, but includes all adjustments (consisting only of normal recurring accruals) that the Company considers necessary for a fair presentation of the financial information set forth herein, in accordance with generally accepted accounting principles for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, it does not include all of the information and footnotes required by generally accepted accounting principles for annual financial statements. For further information, refer to the Consolidated Financial Statements and footnotes thereto included or incorporated by reference in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1997.

The preparation of financial statements in conformity with generally accepted accounting principles 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 reported amounts of revenue and expenses during the reporting period. Actual results inevitably will differ from those estimates, and such differences may be material to the financial statements.

The results for the three- and nine-month periods ended September 26, 1998 are not considered indicative of the results to be expected for any future period or for the entire year.

2. COMPREHENSIVE INCOME

As of January 1, 1998, the Company adopted Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income" ("SFAS 130"). SFAS 130 establishes new rules for the reporting and display of comprehensive income and its components; however, the adoption of this statement has no impact on the Company's net income or shareholders' equity. The Company's total comprehensive income was the same as its net income for all periods presented.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

3. INVENTORIES

The components of inventory consist of the following:

	SEPTEMBER 26, 1998	DECEMBER 31, 1997
	(IN THOUSANDS)	
Raw materials	$ 7,556	$ 8,784
Work-in-progress	12,993	18,756
Finished goods	3,021	8,375
	$23,570	$35,915

A significant portion of the finished goods inventory is represented by completed units at customer sites undergoing installation and acceptance testing.

4. NET INCOME PER SHARE

The following table sets forth the computation of basic and diluted earnings per share:

	THREE MONTHS ENDED		NINE MONTHS ENDED	
	SEPTEMBER 26, 1998	SEPTEMBER 27, 1997	SEPTEMBER 26, 1998	SEPTEMBER 27 1997
	(IN THOUSANDS)			
Numerator:				
Income (loss) from continuing operations	$ (463)	$ 1,931	$ 3,011	$ 8,924
Net income (loss)	$ (463)	$ 1,931	$ 4,016	$ 8,924
Numerator for basic earnings per share -- income (loss) available to common stockholders	(463)	1,931	4,016	8,924
Effect of dilutive securities:				
6 1/2% convertible notes(1)	--	--	--	1,324
Numerator for diluted earnings per share -- income (loss) available to common stockholders after assumed conversions	$ (463)	$ 1,931	$ 4,016	$10,248
Denominator:				
Denominator for basic earnings per share -- weighted-average shares	11,994	12,585	12,098	12,541
Effect of dilutive securities:				
Employee stock options(2)	--	519	316	556
6 1/2% convertible notes(1)	--	--	--	2,197
Dilutive potential common shares	--	519	316	2,753
Denominator for diluted earnings per share -- adjusted weighted-average shares and assumed conversions	$11,994	$13,104	$12,414	$15,294

(1) Diluted EPS for the three- and nine-month periods ended September 26, 1998 and for the three-month period ended September 27, 1997 excludes "as converted" treatment of the Convertible Notes as their inclusion would be anti-dilutive.

(2) Diluted EPS for the three-month period ended September 26, 1998 excludes employee stock options as their inclusion would be anti-dilutive.

5. RESEARCH AND DEVELOPMENT COST SHARING AGREEMENT

The Company entered into an agreement with a Japanese company to perform best efforts joint research and development work. The nature of the project is to develop a glass coating machine to be used in the production of flat panel displays. The Company is reimbursed by the other party for one-half of the actual costs of the project up to a ceiling of $9,450,000. As of September 26, 1998, the Company had received $7,900,000 under the agreement, all of which had been applied to qualifying costs.

6. RELATED PARTY

In 1997, Intevac and Matsubo formed a joint venture, IMAT Inc. ("IMAT"), to market the Company's flat panel manufacturing equipment in the Far East. The Company's share of IMAT is 49% and the investment is being accounted for under the equity method. At September 26, 1988, the cumulative adjustment related to IMAT activity resulted in a decrease of approximately $276,000 in the Company's investment in IMAT, which is included in other assets on the balance sheet. At September 26, 1998, the Company had an outstanding receivable balance with IMAT of $1,300,000 for a contract advance on an order for a flat panel machine. Total contract advances with IMAT were $1,900,000 at September 26, 1998.

7. FOREIGN EXCHANGE CONTRACTS

In September 1998, the Company entered into a foreign exchange forward contract to sell Japanese Yen in June 1999. The nominal amount of the forward contract is $1.6M. The forward contract has been entered into to hedge a specific order, which is expected to be received in the fourth quarter of 1998. As the order has not yet been received, the forward contract has been accounted for as a speculative hedge and has been accounted for under mark-to-market accounting. Related gains and losses will be reported as a component of income in the period incurred. As of September 26, 1998, related gains and losses were immaterial.

8. STOCK OPTION REPRICING

In the third quarter of 1998, the Company approved an exchange program that offered to each employee that held stock options granted between August 19, 1996 and July 31, 1998, the opportunity to exchange their options for newly granted stock options. The new option would be for the same number of shares as originally granted, but the vesting period would start on the day the new option was granted. This offer was open for a two week period of time. The exercise price of the new option was set at the fair market value of Intevac, Inc. common stock on the date each employee notified the Company of their acceptance of the exchange offer during the period.

New stock options were granted for a total of 500,700 shares of common stock. The new option prices ranged from $6.250 to $8.375.

9. RESTRUCTURING

On March 2, 1998, as a result of weak demand for its disk sputtering systems, the Company's management adopted a plan to reduce expenses. The expense reduction plan included a reduction in force of approximately 90 employees out of the Company's staff of contract and regular personnel. The reductions took place at the Company's facilities in Santa Clara, CA; Los Gatos, CA; Rocklin, CA; and Taiwan. Additionally, the Company relocated its Rapid Thermal Processing ("RTP") Operation from Rocklin to the Company's Santa Clara headquarters and closed the Rocklin facility.

In the first quarter of 1998, the Company incurred a restructuring charge of $1,164,000 related to the expense reduction plan. The significant components of this charge include $290,000 for closure of the Rocklin facility, $462,000 for the balance of the rent due on the lease for such facility and $392,000 for employee severance costs. Closure of the facility was complete at June 27, 1998.

On August 17, 1998, as a result of continued weak demand for its disk sputtering systems, the Company's management implemented a reduction in force of approximately 27 employees out of the Company's staff of contract and regular personnel. The reductions took place at the Company's facilities in Santa Clara, CA; Hayward, CA; Singapore; and Taiwan. In the third quarter of 1998, the Company incurred a restructuring charge of $71,000 related to severance costs for the affected employees.

As of September 26, 1998, of the foregoing amounts, approximately $398,000 in termination benefits had been paid out to affected employees and $299,000 had been spent related to the relocation of the RTP Operation, the closure of the Rocklin facility and rent on the lease on such facility.

10. SUBSEQUENT EVENTS

In October 1998, the Company entered into a foreign exchange forward contract to sell Japanese Yen in July 1999. The nominal amount of the forward contract is $10.0M. The forward contract will be utilized to mitigate yen fluctuation exposure related to future yen denominated orders.

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 which involve risks and uncertainties. The Company's actual results may differ materially from those discussed in the forward-looking statements. Factors that might cause such a difference, include but are not limited to, the risk factors set forth elsewhere in this Quarterly Report on Form 10-Q under "Certain Factors Which May Affect Future Operating Results" and in other documents the Company files from time to time with the Securities and Exchange Commission, including the Company's Annual Report on Form 10-K filed in March 1998, Form 10-Q's and Form 8-K's.

OVERVIEW

The Company's revenues are generated by the sale of disk sputtering systems and related disk manufacturing equipment; system components; contract research and development activities; flat panel display manufacturing equipment; and electron beam processing equipment. Disk sputtering systems and related disk manufacturing equipment generally represent the majority of the Company's revenue, and Intevac is a leading supplier of this equipment. Sputtering is a complex vacuum deposition process used to deposit multiple thin-film layers on a disk. Intevac's system component business consists primarily of sales of spare parts and after-sale service to purchasers of the Company's disk sputtering systems, as well as sales of components to other manufacturers of vacuum equipment. Contract research and development revenues have been derived primarily from prime contracts awarded by and subcontracts awarded under various DOD and NASA development projects for various photonics products and the FPD industry. Flat panel display manufacturing equipment consists of sputtering and rapid thermal processing equipment for the manufacture of FPD's. Electron beam processing equipment is used for curing inks, coatings and adhesives, in the manufacture of shrink-wrap films and for sterilization.

In the first quarter of 1997, the Company completed the sale of $57.5 million of its 6 1/2% Convertible Subordinated Notes Due 2004 (the "Convertible Notes"). In the second quarter of 1997, the Company paid $0.4 million for a 49% interest in IMAT Inc. ("IMAT"), a joint venture formed with its Japanese distributor, Matsubo, to market the Company's flat panel manufacturing equipment in the Far East. In the fourth quarter of 1997, the Company purchased all of the assets of RPC Industries ("RPC"). RPC is a manufacturer of electron beam processing systems. This acquisition was accounted for under the purchase method. The total purchase price was approximately $1.0 million plus contingent payments equal to 25% of the future earnings of RPC. The total of these contingent payments is limited to approximately $7.7 million.

In March 1998, as a result of weak orders for its disk sputtering systems and an expectation that revenues would decline significantly in the third quarter of 1998, the Company implemented an expense reduction plan that involved the termination of approximately 20% of the Company's work force. As part of the expense reduction plan, the Company also decided to close its Rocklin, California facility and transfer its Rapid Thermal Processing Operation from Rocklin to the Company's headquarters in Santa Clara. During the first quarter of 1998, the Company incurred a restructuring charge of approximately $1.2 million related to the expense reduction plan.

In August 1998, as a result of continued weak demand for its disk sputtering systems, the Company's management implemented a reduction in force of approximately 27 employees out of the Company's staff of contract and regular personnel. The reductions took place at the Company's facilities in Santa Clara, CA; Hayward, CA; Singapore; and Taiwan. In the third quarter of 1998, the Company incurred a restructuring charge of $71,000 related to severance costs for the affected employees.

As of September 26, 1998, of the foregoing amounts, approximately $398,000 in termination benefits had been paid out to affected employees and $299,000 had been spent related to the relocation of the RTP Operation, the closure of the Rocklin facility and rent due on the lease for such facility.

The Company's backlog was $26.1 million and $71.1 million at September 26, 1998 and September 27, 1997, respectively. The Company includes in backlog the value of purchase orders for its products with scheduled delivery dates. Delivery dates may be rescheduled from time to time. The Company's backlog at the beginning of a quarter may not include all system orders needed to achieve the Company's revenue objectives for that quarter.

RESULTS OF OPERATIONS

THREE MONTHS ENDED SEPTEMBER 26, 1998 AND SEPTEMBER 27, 1997

Net revenues. Net revenues consist primarily of sales of the Company's disk sputtering systems and related equipment used to manufacture thin-film disks for computer hard disk drives, and, to a lesser extent, flat panel display manufacturing equipment, system components, contract research and development and electron beam processing equipment. Net revenues from the sales of sputtering systems and electron beam processing equipment are recognized upon customer acceptance. Sales of related equipment and system components are recognized upon product shipment, and contract research and development is recognized in accordance with contract terms, typically as costs are incurred. Net revenues decreased by 52% to $14.7 million for the three months ended September 26, 1998 from $30.4 million for the three months ended September 27, 1997. The decrease in net revenues was due to a decrease in the net revenues from disk manufacturing equipment and to a lesser extent a decrease in the net revenues from flat panel display manufacturing equipment, which was partially offset by an increase in net revenues from electron beam processing equipment and contract research and development. Based upon its current backlog of orders and the scheduled shipment dates, the Company expects that net revenues during each of the three-month periods ended December 31, 1998 and March 27, 1999 will be less than or equal to the net revenues recorded during the three months ended September 26, 1998.

International sales decreased by 90% to $2.1 million for the three months ended September 26, 1998 from $22.0 million for the three months ended September 27, 1997. The decrease in international sales was primarily due to a decrease in the sales of disk manufacturing equipment to international customers. International sales constituted 14% of net revenues for the three months ended September 26, 1998 and 72% of net revenues for the three months ended September 27, 1997.

Gross margin. Cost of net revenues consists primarily of purchased materials, fabrication, assembly, test, installation, warranty costs, scrap and costs attributable to contract research and development. Gross margin was 27.0% for the three months ended September 26, 1998 as compared to 30.2% for the three months ended September 27, 1997. Gross margins declined primarily as the result of lower shipment levels which resulted in higher overhead costs as a percent of revenue. The Company believes that gross margins will decline further in the three-month period ended December 31, 1998 as the result of continuing industry over-capacity, which has caused an intense competitive environment and significantly reduced overall demand for the disk manufacturing equipment sold by the Company and its competitors.

Research and development. Research and development expense consists primarily of prototype materials, salaries and related costs of employees engaged in ongoing research, design and development activities for disk manufacturing equipment, flat panel manufacturing equipment and electron beam processing equipment and research by the Photonics Division. Company-funded research and development expense decreased by 33% to $2.2 million for the three months ended September 26, 1998 from $3.2 million for the three months ended September 27, 1997, representing 14.7% and 10.6%, respectively, of net revenue. This decrease was primarily the result of approximately $1.2 million of cost sharing funds received from the Company's D-STAR development partner and credited to research and development expense during the three months ended September 26, 1998. There were approximately $0.3 million of comparable credits recorded during the three months ended September 27, 1997. The Company also received approximately $0.1 million of cost sharing credits from the National Institute of Science and Technology ("NIST") during the three-month period ended September 26, 1998 related to the development of advanced lubrication techniques. There were no comparable credits from NIST recorded during the three months ended September 27, 1997. In addition, research and development expenses for the three-month periods ended September 26, 1998 and September 27, 1997 do not include $1.3 million and $0.9 million, respectively, of other expenditures that are charged to cost of sales in connection with contract research and development activities.

Selling, general and administrative. Selling, general and administrative expense consists primarily of selling, marketing, customer support, financial, travel, management, legal and professional services. Domestic sales are made by the Company's direct sales force, whereas international sales are made by distributors that typically provide sales, installation, warranty and ongoing customer support. The Company also has subsidiaries in Singapore and Malaysia and a branch office in Taiwan to support customers in Southeast Asia and markets its flat panel manufacturing equipment to the Far East through its Japanese joint venture, IMAT. Selling, general and administrative expense decreased by 15% to $2.5 million for the three months ended September 26, 1998 from $2.9 million for the three months ended September 27, 1997, representing 16.8% and 9.6%, respectively, of net revenue. The decrease in expense was primarily the result of reduced headcount and the reversal of employee profit sharing accruals which was partially offset by additional selling, general and administrative expenses associated with the electron beam equipment business which was acquired during the fourth quarter of 1997. Company-wide headcount declined to 289 employees at September 26, 1998 from 378 employees at September 27, 1997.

Restructuring expense. In August 1998, the Company reduced its staff by approximately 9%. This reduction was in addition to the approximate 20% reduction in staff completed during March 1998. During the three months ended September 26, 1998, the Company recorded approximately $71,000 of restructuring expense related to severance pay for the employees terminated as part of the August reduction in force.

Interest expense. Interest expense consists primarily of interest on the Convertible Notes, and, to a lesser extent, interest on approximately $2.0 million of long-term debt related to the purchase of Cathode Technology in 1996. Interest expense for the three months ended September 26, 1998 was essentially unchanged when compared to the three months ended September 27, 1997.

Interest and other income, net. Interest and other income, net consists primarily of interest income on the Company's investments, income related to the sale of the Company's 20% interest in the capital stock of Chorus Corporation and early payment discounts on the purchase of inventories, goods and services, partially offset by the Company's 49% share of the loss incurred by IMAT. Interest and other income, net increased by 30% to $1.1 million for the three months ended September 26, 1998 from $0.8 million for the three months ended September 27, 1997 as the result of increased income related to the sale of the Company's 20% interest in the capital stock of Chorus.

Provision for income taxes. Income tax expense as a percentage of pretax income for the three months ended September 26, 1998 and September 27, 1997 was 33% and 31%, respectively. The Company's tax rate differs from the applicable statutory rates primarily due to benefits from the Company's foreign sales corporation and tax-exempt interest income partially offset by nondeductible goodwill amortization. The tax rate for the three months ended September 27, 1997 was lower due to a year-to-date adjustment in the Company's tax provision rate from 36% to 35%.

NINE MONTHS ENDED SEPTEMBER 26, 1998 AND SEPTEMBER 27, 1997

Net revenues. Net revenues decreased by 11% to $84.7 million for the nine months ended September 26, 1998 from $95.3 million for the nine months ended September 27, 1997. The decrease in net revenues was due to a reduction in net revenues from disk manufacturing equipment, which was partially offset by an increase in net revenues from flat panel display manufacturing equipment, electron beam processing equipment (which was acquired during the fourth quarter of 1997) and contract research and development.

International sales decreased by 13% to $46.3 million for the nine months ended September 26, 1998 from $53.2 million for the nine months ended September 27, 1997. The decrease in revenues from international sales was primarily due to a decrease in sales of disk manufacturing equipment, which was partially offset by an increase in sales from electron beam processing equipment. International sales constituted 55% of net revenues for the nine months ended September 26, 1998 and 56% of net revenues for the nine months ended September 27, 1997.

Gross margin. Gross margin was 27.9% for the nine months ended September 26, 1998 as compared to 30.9% for the nine months ended September 27, 1997. The reduction in gross margins was primarily due to the negative gross margin incurred on the RIGEL flat panel sputtering system acceptance.

Research and development. Research and development expense increased to $9.1 million for the nine months ended September 26, 1998 from $7.7 million for the nine months ended September 27, 1997, representing 10.8% and 8.1%, respectively, of net revenues. The increase was primarily the result of increased development expenses in disk manufacturing products and to a lesser extent electron beam processing equipment, which were partially offset by lower development expense on flat panel manufacturing products.

Research and development expense in the nine months ended September 26, 1998 does not include costs of $1.2 million reimbursed to the Company under the terms of a research and development cost sharing agreement with the Company's D-STAR development partner, nor do they include costs of $0.2 million reimbursed to the Company under the terms of a research and development contract with NIST. Research and development expenses in the nine months ended September 27, 1997 do not include costs of $1.3 million reimbursed to the Company under the terms of a research and development cost sharing agreement with the Company's D-STAR development partner, nor do they include costs of $1.5 million reimbursed to the Company under a DARPA development contract funding development of the D-STAR and delivery of a beta-site unit. There were no comparable credits from NIST recorded during the nine months ended September 27, 1997. In addition, research and development expenses for the nine month periods ended September 26, 1998 and September 27, 1997 do not include $3.2 million and $2.4 million, respectively, of other expenditures that are charged to cost of sales in connection with contract research and development activities.

Selling, general and administrative. Selling, general and administrative expense increased to $8.5 million for the nine months ended September 26, 1998 from $8.3 million for the nine months ended September 27, 1997, representing 10.0% and 8.7%, respectively, of net revenues. The increase in selling, general and administrative expense was the result of additional selling, general and administration expenses associated with the electron beam equipment business which was acquired during the fourth quarter of 1997, partially offset by decreased expenses in other business units.

Restructuring expense. In March 1998, the Company's management adopted a restructuring plan to relocate its Rapid Thermal Processing Operation from Rocklin, California to the Company's Santa Clara, California headquarters and to close the Rocklin facility. The restructuring plan also included an approximate 20% reduction in the worldwide staff of the Company's contract and regular employees. In August 1998, the Company terminated an additional 9% of its workforce. As a result of the restructuring plan and the August reduction in force, the Company expensed approximately $1.2 million of restructuring expense in the nine months ended September 26, 1998. The restructuring expense included approximately $0.8 million related to closure of the Rocklin facility and approximately $0.4 million of severance pay for terminated employees.

Interest expense. Interest expense increased by $0.6M for the nine months ended September 26, 1998 due to interest incurred on the Company's 6 1/2% Convertible Notes issued in the first quarter of 1997.

Interest and other income, net. Interest and other income, net was $2.8 million for the nine months ended September 26, 1998 and $2.8 million for the nine months ended September 27, 1997 as the result of increased interest income on funds raised from the sale of the Company's 6 1/2% Convertible Subordinated Notes due 2004, which was offset by decreased income related to the sale of the Company's 20% interest in the capital stock of Chorus and an increase in the Company's 49% share of the loss incurred by IMAT.

Discontinued operations. During the nine months ended September 26, 1998, the Company recorded a gain from discontinued operations of $1.0M resulting from the reimbursement and reversal of excess warranty reserves related to the sale of the Company's night vision business in 1995.

Provision for income taxes. Income tax expense as a percentage of pretax income for the nine months ended September 26, 1998 and September 27, 1997 was 33% and 35%, respectively. The tax rate declined in 1998 because a larger percentage of 1998 income is expected to be derived from tax-exempt interest income.

LIQUIDITY AND CAPITAL RESOURCES

The Company's operating activities used cash of $5.3 million for the nine months ended September 26, 1998. The cash used was due primarily to reductions in customer advances, other accrued liabilities, accounts payable and net liabilities of discontinued operations, which were partially offset by lower inventories, depreciation and amortization expense, and net income.

The Company's investing activities provided cash of $4.5 million for the nine months ended September 26, 1998 due to the net redemption of investments and proceeds related to the sale of the Company's interest in the Chorus Corporation, which were partially offset by the purchase of fixed assets.

The Company's financing activities used cash of $1.9 million for the nine months ended September 26, 1998, primarily due to the repurchase of 341,000 shares of the Company's stock for $3.0 million, which was partially offset by the sale of the Company's stock to its employees through the Company's employee benefit plans.

YEAR 2000

The Company is currently evaluating the software and computer systems it uses in order to ensure compliance with Year 2000 issues. This evaluation, and any corrective actions required, is estimated to be largely completed no later than March 31, 1999. The Company does not expect to encounter significant problems or that material expenditures will be required to comply with Year 2000 issues. These expectations are based primarily on the fact that the Company purchases all business software from third party vendors.

Specific actions to be taken include: reviewing all software used internally by the Company and assessing the vendor's plans to comply with Year 2000; testing of all hardware to ensure its ability to recognize dates after 1999; contacting significant suppliers to determine their ability to comply with Year 2000; and reviewing all products the Company ships for Year 2000 problems.

The expectations of the findings of this project and the date on which the Company believes it will be completed are based on management's best estimates. However, there can be no guarantee that these expectations will be achieved, and actual results could differ materially.

CERTAIN FACTORS WHICH MAY AFFECT FUTURE OPERATING RESULTS

Fluctuations of Results of Operations

The Company's operating results have historically been subject to significant quarterly and annual fluctuations. The Company believes that its operating results will continue to fluctuate on a quarterly and annual basis due to a variety of factors. These factors include the cyclicality of the thin-film disk manufacturing and disk drive industries, patterns of capital spending by customers, the timing of significant orders, order cancellations or reschedulings, exchange rate fluctuations, market acceptance of the Company's products, unanticipated delays in design, engineering or production or in customer acceptance of product shipments, changes in pricing by the Company or its competitors, the timing of product announcements or introductions by the Company or its competitors, the mix of systems sold, the relative proportions of sputtering systems, system components and subassemblies, electron beam processing systems, and contract research and development net revenues, the availability and cost of components and subassemblies, changes in product development costs, and expenses associated with acquisitions.

The Company derives the majority of its net revenues from the sale of a relatively small number of sputtering systems. Over the last eleven quarters, the number of systems accepted by customers in any particular quarter has varied from three to thirteen and, as a result, the Company's net revenues and operating results for a particular period could be materially adversely affected if an anticipated order for even one system is not received in time to permit shipment and customer acceptance during that accounting period. Over the last eleven quarters the Company's gross margin and operating income (loss) as a percentage of net revenues has fluctuated from approximately 25% to 40% of net revenues and from (9)% to 18% of net revenues, respectively. The Company anticipates that its unit shipments, revenues, gross and operating margins will continue to fluctuate. As a result, the Company believes that period-to-period comparisons of its results of operations are not necessarily meaningful and should not be relied upon as indications of future performance.

The Company's backlog at the beginning of a quarter may not include all system orders needed to achieve the Company's revenue objectives for that quarter. In addition, orders in backlog are subject to cancellation, and although the Company generally requires a deposit on orders for its systems, such deposits may not be sufficient to cover the expenses incurred by the Company for the manufacture of the canceled systems or fixed operating expenses associated with such systems. The Company may from time to time manufacture a system in anticipation of an order that may not be placed during the period or at all. In any given quarter in which such a system is manufactured, the Company may not receive funds to cover its manufacturing costs. Orders may be subject to delay, deferral or rescheduling by a customer. From the date the Company receives an order, it often takes more than six months before the net revenues from such order are recognized and even longer before final payment is received. The relatively long manufacturing cycles of many of the Company's products has caused and could cause shipments of such products to be delayed from one quarter to the next, which could materially adversely affect the Company's business, financial condition and results of operations for a particular quarter. Announcements by the Company or its competitors of new products and technologies could cause customers to defer purchases of the Company's existing systems, which would have a material adverse effect on the Company's business, financial condition and results of operations.

Installing and integrating new sputtering systems into the thin-film disk manufacturing process requires a substantial investment by a customer. Sales of the Company's systems depend, in significant part, upon the decision of a prospective customer to replace obsolete equipment or to increase manufacturing capacity by upgrading or expanding existing manufacturing facilities or constructing new manufacturing facilities, all of which typically involve a significant capital commitment. Therefore, customers often require a significant number of product presentations and demonstrations, as well as substantial interaction with the Company's senior management, before making a purchasing decision. Accordingly, the Company's systems typically have a lengthy sales cycle, during which the Company may expend substantial funds and management time and effort with no assurance that a sale will result. Furthermore, the Company's expense levels are based, in part, on its expectations as to future net revenues. If revenue levels are below expectations, operating results are likely to be adversely affected. Net income, if any, may be disproportionately affected by a reduction in net revenues because a proportionately smaller amount of the Company's expenses varies with its net revenues. The impact of these and other factors on the Company's sales and operating results in any future period cannot be forecasted with certainty.

Due to all of the foregoing factors, the Company expects its quarterly operating results to fluctuate significantly and may in certain quarters be below the expectations of securities analysts and investors. In such event it is likely that the price of the Company's Common Stock would be materially adversely affected.

Cyclicality of the Media Industry

The cyclicality of the disk drive industry, among other factors, may cause prospective customers to postpone decisions regarding major capital expenditures, including purchases of the Company's systems. Customers with existing orders for the Company's systems may also request delays in their previously requested delivery schedules. The Company's business depends upon capital expenditures by manufacturers of thin-film disks, including manufacturers that are opening new fabrication facilities or entering the market, expanding or upgrading existing facilities, or replacing obsolete equipment, which in turn depend upon the current and anticipated market demand for hard disk drives. In recent years, the disk drive industry has experienced significant growth, which, in turn, has caused significant growth in the capital equipment industry supplying manufacturers of thin-film disks. However, the disk drive industry is cyclical and historically has experienced periods of oversupply, resulting in significantly reduced demand for thin-film disks and for the capital equipment used to manufacture such disks, including the systems manufactured and marketed by the Company.

A number of hard disk drives manufacturers and component suppliers have reported both substantial reductions in revenues and substantial financial losses. Many of these manufacturers attributed their problems to an excess supply of hard drives, or, in the case of component suppliers, an excess supply of components for hard drives (including thin-film disks) and rapid changes in technology which caused a number of products to become obsolete. This industry-wide over-capacity has led to a period of reduced demand for thin-film disk production and for the capital equipment used in such production. In March of 1998, as a result of weak orders for its disk sputtering systems, the Company implemented an expense reduction plan that involved the termination of approximately 20% of the Company's work force. In August of 1998 the Company terminated another 9% of its work force as the result of continuing weak demand for its products.

Cyclical downturns in the hard disk drive industry are likely to materially adversely affect the Company's business, financial condition and results of operations.

Intense Competition

The Company's disk sputtering business experiences intense competition worldwide from two principal competitors, Balzers A.G. ("Balzers") and Anelva Corporation ("Anelva"), each of which is a large manufacturer of complex vacuum equipment and thin-film disk manufacturing systems and has sold a substantial number of thin-film disk sputtering machines worldwide. Both Balzers and Anelva are manufacturers of static sputtering systems, and each has substantially greater financial, technical, marketing, manufacturing and other resources than the Company. The Company also experiences competition from two other manufacturers of static sputtering systems as well as from the manufacturers of thin-film disks that have developed the capability to manufacture their own sputtering systems. There can be no assurance that the Company's competitors will not develop enhancements to, or future generations of, competitive products that offer superior price or performance features or that new competitors will not enter the Company's markets and develop such enhanced products. Furthermore, the failure of manufacturers of thin-film disks currently using in-line machines and manufacturers using internally developed sputtering systems to switch to static sputtering systems in the future could adversely affect the Company's ability to increase its sputtering system market share.

In addition, the Company's two principal competitors are based in foreign countries and have cost structures and system prices based on foreign currencies. Accordingly, currency fluctuations could cause the Company's dollar-priced products to be less competitive than its competitors' products priced in other currencies. Currency fluctuations could also increase the Company's cost structure relative to those of its competitors, which could make it more difficult for the Company to maintain its gross margins. For example, at December 31, 1997 the exchange rate for Japanese Yen was approximately 130 Yen/$. In the period between December 31, 1997 and November 3, 1998 the Yen/$ exchange rate has fluctuated between approximately 115 Yen/$ and 147 Yen/$. The Company may from time to time enter into both economic and speculative foreign currency contracts in an effort to reduce the overall risk of currency fluctuations to the Company's business. However, there can be no assurance that these foreign currency hedging activities will not materially adversely affect the Company's financial condition and results of operations.

Given the lengthy sales cycle and the significant investment required to integrate a disk sputtering system into the manufacturing process, the Company believes that once a thin-film disk manufacturer has selected a particular supplier's disk sputtering equipment, the manufacturer generally relies upon that equipment for the specific production line application and frequently will continue to purchase its other disk sputtering equipment from the same supplier. The Company expects to experience difficulty in selling to a particular customer for a significant period of time if that customer selects a competitor's disk sputtering equipment. Accordingly, competition for customers in the disk sputtering equipment industry is particularly intense, and suppliers of disk sputtering equipment may offer pricing concessions and incentives to attract customers, which could adversely affect the Company's business, financial condition, gross margins and results of operations. Because of these competitive factors, there can be no assurance that the Company will be able to compete successfully in the future.

Customer Concentration

Historically, a significant portion of the Company's revenues in any particular period have been attributable to sales to a limited number of customers. For example, Matsubo, HMT Technology and Trace Storage Technology accounted for 37%, 17% and 15%, respectively of the Company's total net revenues in 1997, and Matsubo, Seagate and HMT Technology accounted for 32%, 32% and 13%, respectively, of the Company's total net revenues in 1996. Seagate, HMT Technology, and Matsubo accounted for 40%, 20% and 17%, respectively, of the Company's total net revenues in 1995. The Company's largest customers change from period to period as large thin-film disk fabrication facilities are completed and new projects are initiated. The Company expects that sales of its products to relatively few customers will continue to account for a high percentage of its net revenues in the foreseeable future. For example, 68% of the Company's backlog at December 31, 1997 was represented by two customers for disk sputtering systems, with each representing 10% or more of the Company's backlog at December 31, 1997. None of the Company's customers has entered into a long-term agreement requiring it to purchase the Company's products. As purchases related to a particular new or expanded fabrication facility are completed, sales to that customer may decrease sharply or cease altogether. If completed contracts are not replaced on a timely basis by new orders from the same or other customers, the Company's net revenues could be adversely affected. The loss of a significant customer, any reduction in orders from any significant customer or the cancellation of a significant order from a customer, including reductions or cancellations due to customer departures from recent buying patterns, financial difficulties of a customer or market, economic or competitive conditions in the disk drive industry, could materially adversely affect the Company's business, financial condition and results of operations.

Limited Number of Opportunities

The Company's business depends upon capital expenditures by manufacturers of thin-film disks, of which there are a limited number worldwide. According to a April 1997 report by TrendFocus, an independent market research firm, as of the end of 1996 there were 231 installed disk sputtering lines (sputtering systems and related equipment such as plating, polishing, texturing, lubrication and test equipment as well as related handling equipment) worldwide and only 15 companies in the world with five or more installed disk sputtering lines. Therefore, winning or losing an order from any particular customer could significantly affect the Company's operating results. In addition, the Company's opportunities to sell its systems are further limited by the fact that some of the manufacturers of thin-film disks have adopted an in-line approach as opposed to the Company's static approach to thin-film disk manufacturing. These manufacturers have invested significant amounts of capital in their in-line systems, and there may be significant resistance to change to a static approach in the future. The construction of new thin-film disk fabrication facilities involves extremely large capital expenditures, resulting in few thin-film disk fabrication facilities being constructed worldwide at any particular time. A substantial investment is also required by disk manufacturers to install and integrate additional thin-film disk manufacturing equipment in connection with upgrading or expanding their existing fabrication facilities. These costs are far in excess of the cost of purchasing the Company's system. The magnitude of such capital expenditures has caused certain thin-film disk manufacturers to forego purchasing significant additional thin-film disk manufacturing equipment. Consequently, only a limited number of opportunities for the Company to sell its systems may exist at any given time.

On October 11, 1998 one of the Company's customers, StorMedia, filed for Chapter 11 bankruptcy protection. The Company expects to charge approximately $97,000 of accounts receivable balances with StorMedia to its bad debt reserves during the three-month period ended December 31, 1998. Representatives of Stormedia have informed the Company that StorMedia intends to cease operations and liquidate its assets. This will result in two MDP-250A disk sputtering systems, four MDP-250B disk sputtering systems, twenty-three disk lubrication systems and one contact start stop tester, all manufactured by the Company, becoming available for resale by StorMedia. The availability of this equipment for resale, in competition with sales by the Company, could materially adversely affect the Company's business, financial condition and results of operations.

Rapid Technological Change; New Products

The disk drive industry in general, and the thin-film disk manufacturing industry in particular, is characterized by rapid technological change and evolving industry standards. The Company maintains an active development program to make sputter system improvements, to add additional capabilities that will improve disk performance, increase machine throughput, permit optimum utilization of alternative substrates, lower cost of ownership and respond to future market requirements. The Company's ability to remain competitive has required and will continue to require substantial investments in research and development to advance its technologies. The failure to develop, manufacture and market new systems, or to enhance existing systems, would have a material adverse effect on the Company's business, financial condition and results of operations. In the past, the Company has experienced delays from time to time in the introduction of, and certain technical difficulties with, certain of its systems and enhancements. In addition, the Company's competitors can be expected to continue to develop and introduce new and enhanced products, any of which could cause a decline in market demand for the Company's systems or a reduction in the Company's margins as a result of intensified price competition.

Changes in the manufacturing processes for thin-film disks could also have a material adverse effect on the Company's business, financial condition and results of operations. The Company anticipates continued changes in the requirements of the disk drive industry and thin-film disk manufacturing technologies. There can be no assurance that the Company will be able to develop, manufacture and sell systems that respond adequately to such changes. In addition, the data storage industry is subject to constantly evolving technological standards. There can be no assurance that future technological innovations will not reduce demand for thin-film disks. The Company's business, financial condition and results of operations could be materially adversely affected by any trend toward technology that would replace thin-film disks as a storage medium.

The Company's success in developing and selling enhanced disk sputtering systems and other new products depends upon a variety of factors, including accurate prediction of future customer requirements, technology advances, cost of ownership, introduction of new products on schedule, cost-effective manufacturing and product performance in the field. The Company's new product decisions and development commitments must anticipate the requirements for the continuously evolving disk drive industry approximately two or more years in advance of sales. Any failure to accurately predict customer requirements and to develop new generations of products to meet those requirements would have a sustained material adverse effect on the Company's business, financial condition and results of operations. New product transitions could adversely affect sales of existing systems, and product introductions could contribute to quarterly fluctuations in operating results as orders for new products commence and orders for existing products decline. There can be no assurance that the Company will be successful in selecting, developing, manufacturing and marketing new products or enhancements of existing products.

In September 1998 the Company announced that it was developing a new disk sputtering system, the MDP-250K. The MDP-250K disk sputtering system is derived from its predecessor, the MDP-250B. Maximum throughput is targeted to be over 1100 disks per hour compared to 550 disks per hour for the MDP-250B. Vacuum levels and transport time have been improved, which should lead to reduced contamination and improved magnetic performance. Leading edge deposition techniques, such as ion beam and RF magnetron deposition will be fully integrated. Windows NT based software, a graphical user interface and modern factory host communications are incorporated. The MDP-250K is expected to be available during the first half of 1999. Although the Company believes its current inventory reserves are adequate to cover the transition to the MDP-250K, any reductions in existing and/or forecasted orders for the MDP-250B could cause additional MDP-250B parts to become obsolete, which could materially adversely affect the Company's financial results.

Flat Panel Display Manufacturing Equipment Risks

In 1997, the Company spent approximately $4.9 million on various programs to fund the development of equipment for use in the FPD industry, of which approximately 54% was paid for by the Company's development partners. In exchange for certain development funding, the Company has granted to one of its development partners the exclusive rights to manufacture and market the Company's FPD sputtering systems in Japan. As of September 26, 1998 all of the approximately $7.9 million advanced by the Company's development partner had been applied to qualifying costs. The Company has limited experience in the development, manufacture, sale and marketing of FPD manufacturing equipment, having sold only three rapid thermal processing ("RTP") systems to date and two of its FPD sputtering systems. Although the Company delivered and the customer accepted a larger version of its FPD sputtering machine during 1998, there can be no assurance that the market for FPD manufacturing equipment targeted by the Company will develop as quickly or to the degree which the Company currently anticipates, or that the Company's proposed FPD manufacturing equipment will achieve market acceptance. There can be no assurance the Company will receive additional customer sponsored research and development funding in the future. The failure to receive additional customer-sponsored research and development funds could result in the Company internally funding the development of such FPD manufacturing equipment, and the costs of such research and development may have a material adverse effect on the Company's business, financial condition and results of operations. There can be no assurance that the Company will continue to fund research and development in the FPD area.

Risks Associated with International Sales and Operations

Foreign sales accounted for 64%, 41% and 20% of revenues in 1997, 1996 and 1995, respectively. Substantially all of the Company's Disk Equipment foreign sales are to companies in the Far East. The Company anticipates that sales to customers in the Far East will continue to be a significant portion of its revenues in the foreseeable future. In order to effectively service customers located in Southeast Asia, the Company has established sales and service operations in Singapore, Taiwan and Malaysia and a joint venture in Japan. Sales and operating activities outside of the United States are subject to certain inherent risks, including fluctuations in the value of the United States dollar relative to foreign currencies, tariffs, quotas, taxes and other market barriers, political and economic instability, restrictions on the export or import of technology, potentially limited intellectual property protection, difficulties in staffing and managing international operations and potentially adverse tax consequences. The Company's products have been sold to companies headquartered in the United States, Japan, Taiwan and Korea and have been installed in factories in the United States, Japan, Singapore, Malaysia, Korea and Taiwan. All of the Far Eastern countries with which the Company does business have banking systems and foreign currency exposures that have experienced serious troubles recently and therefore subject the Company's customers to substantial business risks. There can be no assurance that any of these factors will not have a material adverse effect on the Company's business, financial condition or results of operations. In particular, although the Company's international sales have been denominated in United States dollars, such sales and expenses may not be denominated in dollars in the future, and currency exchange fluctuations in countries where the Company does business could materially adversely affect the Company's business, financial condition and results of operations.

Dependence on Key Employees

The Company's operating results will depend significantly upon the continued contributions of its officers and key management, engineering, marketing, customer support and sales personnel, many of whom would be difficult to replace. The Company does not have an employment agreement with any of its employees or maintain key person life insurance with respect to any employee. The loss of any key employee could have a material adverse effect on the Company's business, financial condition and results of operations. Employees of the Company are currently required to enter into a confidentiality agreement as a condition of their employment. However, these agreements do not expressly prohibit the employees from competing with the Company after leaving its employ.

Ability to Attract Qualified Personnel

The Company's operating results depend in significant part upon its ability to retain and attract qualified management, engineering, marketing, customer support and sales personnel. Competition for such personnel is intense and there can be no assurance that the Company will be successful in attracting and retaining such personnel. The failure to attract and retain such personnel could make it difficult to undertake or could significantly delay the Company's research and development efforts and the expansion of its manufacturing capabilities or other activities, which could have a material adverse effect on the Company's business, financial condition and results of operations.

Leverage

In connection with the sale of the Convertible Notes, the Company incurred a substantial increase in the Company's ratio of long-term debt to total capitalization (shareholders' equity plus long-term debt). The ratios at September 26, 1998 and December 31, 1997 were approximately 57.1% and 58.4%, respectively. As a result of this indebtedness, the Company incurred substantial principal and interest obligations. The degree to which the Company is leveraged could have a material adverse effect on the Company's ability to obtain additional financing for working capital, acquisitions or other purposes and could make it more vulnerable to industry downturns and competitive pressures. The Company's ability to meet its debt service obligations will be dependent on the Company's future performance, which will be subject to financial, business and other factors affecting the operations of the Company, many of which are beyond its control.

Manufacturing Risks

The Company's systems have a large number of components and are highly complex. The Company may experience delays and technical and manufacturing difficulties in future introductions or volume production of new systems or enhancements. In addition, some of the systems built by the Company must be customized to meet individual customer site or operating requirements. The Company may be unable to complete the development or meet the technical specifications of its new systems or enhancements or to manufacture and ship these systems or enhancements in a timely manner. Such an occurrence would materially adversely affect the Company's business, financial condition and results of operations as well as its relationships with customers. In addition, the Company may incur substantial unanticipated costs early in a product's life cycle, such as increased cost of materials due to expediting charges, other purchasing inefficiencies and greater than expected installation and support costs which cannot be passed on to the customer. Any of such events could materially adversely affect the Company's business, financial condition and results of operations.

In certain instances, the Company is dependent upon a sole supplier or a limited number of suppliers, or has qualified only a single or limited number of suppliers, for certain complex components or sub-assemblies utilized in its products. The Company has a key supplier program in which it appoints certain key vendors as sole suppliers for certain parts with the goal of improving response time and reducing costs. In addition, the Company makes extensive use of suppliers serving the semiconductor equipment business and such suppliers may choose to give priority to their semiconductor equipment customers that are much larger than the Company. Any prolonged inability to obtain adequate deliveries could require the Company to pay more for inventory, parts and other supplies, seek alternative sources of supply, delay its ability to ship its products and damage relationships with current and prospective customers. Any such delay or damage could have a material adverse effect on the Company's business, financial condition and results of operations.

The Company conducts substantially all of its manufacturing activities at its leased facilities in Santa Clara, Hayward and Los Gatos, California. The Company's Santa Clara, Hayward and Los Gatos facilities are located in a seismically active area. A major catastrophe (such as an earthquake or other natural disaster) could result in a prolonged interruption of the Company's business.

Acquisitions

The Company's business strategy includes acquiring related businesses, products or technologies. The Company completed one acquisition during 1997 and three acquisitions during 1996 and expects that it may pursue additional acquisitions in the future. Any future acquisition may result in potentially dilutive issuance of equity securities, the write-off of in-process research and development and the assumption of debt and contingent liabilities, any of which could materially adversely affect the Company's business, financial condition and results of operations. Additionally, as a result of the Company's ongoing repurchase of its stock in the open market, the Company may not be able to use the "pooling of interests" method of accounting in some acquisitions, and the Company may therefore be required to amortize any intangible assets acquired in connection with any acquisition.

The Company incurred a charge to operations of $0.3 million in the fourth quarter of 1997 and $5.8 million in the second quarter of 1996 to reflect the purchase of in-process research and development related to the acquisitions completed in those quarters. In addition, the Company is amortizing intangible assets of approximately $9.0 million gross, and $3.9 million net at September 26, 1998, relating to the four acquisitions. The amortization period for such costs is over the useful lives of the assets, which range from two years to seven years. Additionally, unanticipated expenses may be incurred relating to the integration of technologies, research and development and administrative functions. Any acquisition will involve numerous risks, including difficulties in the assimilation of the acquired company's employees, operations and products, uncertainties associated with operating in new markets and working with new customers, and the potential loss of the acquired company's key employees.

Patents and Other Intellectual Property

The Company currently has 25 patents issued in the United States and 3 patents issued in foreign countries, and has pending patent applications in the United States and foreign countries. Of the 25 U.S. patents, 8 relate to sputtering, 10 relate to RTP, 1 relates to lubrication systems and 6 relate to photonics. Two foreign patent relates to sputtering and one relates to photonics. In addition, the Company has the right to utilize certain patents under licensing arrangements with Litton Industries, Varian Associates, Stanford University, Lawrence Livermore Laboratories and Alum Rock Technology.

There can be no assurance that any of the Company's patent applications will be allowed or that any of the allowed applications will be issued as patents. There can be no assurance that any patent owned by the Company will not be invalidated, deemed unenforceable, circumvented or challenged, that the rights granted thereunder will provide competitive advantages to the Company or that any of the Company's pending or future patent applications will be issued with claims of the scope sought by the Company, if at all. Furthermore, there can be no assurance that others will not develop similar products, duplicate the Company's products or design around the patents owned by the Company. In addition, there can be no assurance that foreign patent rights, intellectual property laws or the Company's agreements will protect the Company's intellectual property rights. Failure to protect the Company's intellectual property rights could have a material adverse effect upon the Company's business, financial condition and results of operations.

There has been substantial litigation in the technology industry regarding intellectual property rights. The Company has from time to time received claims that it is infringing third parties' intellectual property rights. In August 1993, Rockwell International Corporation ("Rockwell") sued the Federal government alleging infringement of certain patent rights with respect to the contracts the Federal government has had with a number of companies, including Intevac. The Federal government has notified Intevac that it may be liable in connection with contracts for certain products from the Company's discontinued night vision business. Although the Company believes it will have no material liability under these contracts, there can be no assurance that the resolution of the claims by Rockwell with the Federal government will not have a material adverse effect on the Company's business, operating results and financial condition. In the first quarter of 1997, Rockwell's patent in suit was held invalid. Rockwell appealed that decision, and in the second quarter of 1998, the appellate court reversed the decision of the lower court and referred the case again to the lower court to determine the validity of the patent.

There can be no assurance that other third parties will not in the future claim infringement by the Company with respect to current or future patents, trademarks, or other proprietary rights relating to the Company's disk sputtering systems, flat panel display manufacturing equipment or other products. Any present or future claims, with or without merit, could be time-consuming, result in costly litigation, cause product shipment delays or require the Company to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to the Company, or at all. Any of the foregoing could have a material adverse effect upon the Company's business, operating results and financial condition.

In addition, the Company believes that one of its competitors may be infringing the Company's patent rights in connection with products currently being offered by this competitor. Although the Company has not undertaken formal legal proceedings, the Company has informed this competitor that the Company believes its patent rights are being infringed and that the Company may undertake litigation to protect its patent rights if necessary. If undertaken, such litigation could be costly, time-consuming and result in legal claims being made against the Company, which could have a material adverse effect on the Company's business, operating results and financial condition. In addition, there can be no assurance that the Company would ultimately prevail in any such litigation.

Environmental Regulations

The Company is subject to a variety of governmental regulations relating to the use, storage, discharge, handling, emission, generation, manufacture, treatment and disposal of toxic or other hazardous substances, chemicals, materials or waste. Any failure to comply with current or future regulations could result in substantial civil penalties or criminal fines being imposed on the Company, or its officers, directors or employees, suspension of production, alteration of its manufacturing process or cessation of operations. Such regulations could require the Company to acquire expensive remediation or abatement equipment or to incur substantial expenses to comply with environmental regulations. Any failure by the Company to properly manage the use, disposal or storage of, or adequately restrict the release of, hazardous or toxic substances could subject the Company to significant liabilities.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 2. CHANGES IN SECURITIES

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY-HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) The following exhibits are filed herewith:

EXHIBIT NUMBER	DESCRIPTION
27.1	Financial Data Schedule

(b) Reports on Form 8-K:

None.

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.

INTEVAC, INC.

Date: November 10, 1998	By: /s/ NORMAN H. POND Norman H. Pond Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer)
Date: November 10, 1998	By: /s/ CHARLES B. EDDY III Charles B. Eddy III Vice President, Finance and Administration, Chief Financial Officer, Treasurer and Secretary (Principal Financial and Accounting Officer)

EXHIBIT INDEX

EXHIBIT NUMBER	DESCRIPTION
27.1	Financial Data Schedule

ARTICLE 5

THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM THE CONDENSED CONSOLIDATED BALANCE SHEET AT SEPTEMBER 26, 1998 (UNAUDITED) AND THE CONDENSED CONSOLIDATED STATEMENT OF INCOME (UNAUDITED) FOR THE NINE MONTHS ENDED SEPTEMBER 26, 1998 AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

MULTIPLIER: 1,000

PERIOD TYPE	9 MOS
FISCAL YEAR END	DEC 31 1998
PERIOD START	JAN 01 1998
PERIOD END	SEP 26 1998
CASH	745
SECURITIES	61,175
RECEIVABLES	11,503
ALLOWANCES	1,775
INVENTORY	23,570
CURRENT ASSETS	102,465
PP&E	25,085
DEPRECIATION	10,470
TOTAL ASSETS	125,430
CURRENT LIABILITIES	21,335
BONDS	59,460
PREFERRED MANDATORY	0
PREFERRED	0
COMMON	15,454
OTHER SE	29,181
TOTAL LIABILITY AND EQUITY	125,430
SALES	84,693
TOTAL REVENUES	84,693
CGS	61,025
TOTAL COSTS	61,025
OTHER EXPENSES	18,570
LOSS PROVISION	291
INTEREST EXPENSE	3,100
INCOME PRETAX	4,496
INCOME TAX	1,485
INCOME CONTINUING	3,011
DISCONTINUED	1,005
EXTRAORDINARY	0
CHANGES	0
NET INCOME	4,016
EPS PRIMARY	0.33
EPS DILUTED	0.32

End of Filing