

# INTEVAC INC

## FORM 10-K (Annual Report)

Filed 02/07/97 for the Period Ending 12/31/96

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-K (Annual Report)

Filed 2/7/1997 For Period Ending 12/31/1996

Address	3560 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, D.C. 20549**

**FORM 10-K**

(MARK ONE)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 1996

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]

FOR THE TRANSITION PERIOD FROM TO

COMMISSION FILE NUMBER 0-26946

**INTEVAC, INC.**

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

CALIFORNIA  
(STATE OR OTHER JURISDICTION OF  
INCORPORATION OR ORGANIZATION)

94-3125814  
(I.R.S. 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**  
**SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT: None**

TITLE OF EACH CLASS

NAME OF EXCHANGE ON WHICH REGISTERED

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none

none

**SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT: Common Stock (no par value)**

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 \_\_\_\_\_

Indicate by a check mark if disclosure of delinquent filers pursuant to

Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

The aggregate market value of voting stock held by non-affiliates of the Registrant, as of February 6, 1997 was approximately \$54,057,000 (based on the closing price for shares of the Registrant's Common Stock as reported by the Nasdaq National Market for the last trading day prior to that date). Shares of Common Stock held by each executive officer, director, and holder of 5% or more of the outstanding Common Stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

On February 6, 1997 approximately 12,530,084 shares of the Registrant's Common Stock, no par value, were outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE.**

PORTIONS OF THE REGISTRANT'S PROXY STATEMENT FOR THE 1997 ANNUAL MEETING OF SHAREHOLDERS ARE INCORPORATED BY REFERENCE INTO PART III. SUCH PROXY STATEMENT WILL BE FILED WITHIN 120 DAYS AFTER THE END OF THE FISCAL YEAR COVERED BY THIS ANNUAL REPORT ON FORM 10-K.

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This Annual Report on Form 10-K contains forward-looking statements which involve risks and uncertainties. The Company's actual results may differ materially from the results discussed in the forward-looking statements.

## PART I

### ITEM 1. BUSINESS

#### OVERVIEW

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-250B, which is the fourth generation of the Company's Magnetic Disk Processing ("MDP") system, enables disk manufacturers to achieve high coercivities, high signal-to-noise ratios, minimal disk defects, durability and uniformity, all of which are necessary in the production of high performance, high capacity disks. Additionally, the Company's static systems allow disk manufacturers to achieve low production costs through high yield, high uptime, and low acquisition, operating and facilities costs.

To leverage its expertise in thin-film disk production, the Company has acquired and intends to acquire or develop related businesses, products and technologies that enable it to expand its current product offerings. For example, in 1996 the Company completed three acquisitions including a company that manufactures disk lubrication equipment and a company that manufactures contact stop/start test equipment for hard disk drives and components, and the Company initiated development of a disk laser-texturing product. In addition, the Company believes that its expertise and technology may have applications other than for thin-film disk manufacturing and is in the process of expanding its product offerings to other areas, such as flat panel display manufacturing equipment and electro-optical products.

Market demand for disk drives is growing rapidly, stimulated by demand for new and more powerful computers, the growing use of sophisticated network servers and the development of more memory intensive software, such as Windows NT and multimedia applications. The strong growth in unit shipments of disk drives has in turn stimulated the growth of the thin-film disk market. With the increasing demand for reliable, rapid access storage and the intense competitiveness in the disk drive industry, thin-film disk manufacturers continually seek to produce higher capacity thin-film disks at a lower cost per megabyte of storage. Traditionally, thin-film disk manufacturers used in-line systems for disk sputtering. In 1982, Varian formed a business unit to design a disk sputtering system to address certain inherent limitations of the in-line sputtering architecture. That business, acquired by the Company in 1991, developed a single disk, multiple chamber static sputtering system, similar in concept to the single wafer processing machines used by the semiconductor industry. The Company's static systems differ from in-line systems in that static sputtering provides for deposition with no relative movement between the sputtering source and the disk being coated. This provides advantages in disk uniformity and precise control of process parameters. The benefits of the static approach have caused a number of leading disk manufacturers to purchase the Company's static systems. Additionally, changing requirements in thin-film disk technology, such as the trend towards higher disk coercivity, lower flying heights, reduced stiction and the use of MR heads, as well as the production of disks in new locations has created a need for the purchase of new sputtering systems.

The Company typically offers its static sputtering systems to both captive and merchant thin-film disk manufacturers at list prices ranging from \$2.0 million to \$3.5 million depending on configuration. Since 1991, Intevac systems have been installed for or ordered by the following customers: Akashic Memories, Fuji Electric, Hitachi, HMT Technology, IBM, Komag, MaxMedia, Mitsubishi, Seagate Technology, Sony, Stormedia, Tae Il Media Co., Trace Storage Technology and Western Digital. Based on data published by TrendFOCUS in March 1996, an independent market research firm, the Company believes it has the largest number of installed static sputtering systems worldwide. Based upon MDP shipments, the Company believes it had 99 systems installed as of December 31, 1996. The Company sells and markets its products directly in the United States, and through exclusive distributors in Japan and Korea. The Company has established a subsidiary in Singapore and a branch office in Taiwan to support customers in Southeast Asia. The Company's backlog was \$63.7 million at December 31, 1996.

## **DISK MEDIA TECHNOLOGY**

The disks in a hard disk drive are substrates that have been coated with several thin-film layers and are used as a storage medium for digital data. A thin magnetic film on the disk is capable of storing information in the form of magnetic patterns written and read by the disk drive recording head. The production of thin-film disks involves several complex process steps requiring specialized and expensive manufacturing equipment and facilities. The following briefly summarizes the steps in this manufacturing process:

- Plating, polishing and texturing. The disk substrate (typically aluminum), which must be flat, smooth and free of surface defects, is plated with a non-magnetic layer for strength and durability. The substrate is then polished and textured to produce a controlled roughness on the disk's surface. This improves the friction characteristics so that the disk drive head will not stick to the disk when the drive is turned off.
- Sputtering. Sputtering is a complex vacuum deposition process used to deposit multiple thin-films on the disk. The initial thin-film layers are various alloys that produce the magnetic qualities of a disk. The final thin-film layer is a protective carbon overcoat. The layers vary in thickness but are all very thin, typically less than 1/2,000th the thickness of a piece of paper.
- Lubrication. After thin-film sputtering, a microscopic layer of lubricant is applied to the disk's surface to improve durability and reduce surface friction.
- Test and certification. In the test and certification process, each disk is electronically scanned for both film integrity and asperity control and to ensure that the disk operates to the customer's specifications.

Improvements in the disk sputtering process have contributed significantly to increases in disk storage capacity through increasing areal density (the number of bits of data stored per unit of area). The most significant advances in disk media technology have been the achievement of better magnetic characteristics and improved mechanical properties permitting lower flying heights. Flying height, the distance between the head and the disk while the disk drive is operating, depends on the smoothness and flatness of the disk surface.

## **CHALLENGES FACING THIN-FILM DISK MANUFACTURERS**

Disk drive manufacturers continually seek to produce higher capacity disk drives at a lower cost per megabyte of storage. Because of the increasing demand for reliable, rapid access storage and the intense competitiveness in the disk drive industry, many thin-film disk manufacturers address this requirement by producing higher capacity disks capable of higher areal densities. As thin-film disk manufacturers do this, they face technical and operational challenges that fall into two principal categories: the production of high performance disks and the control of disk production costs.

### **Production of high performance disks.**

The ability of thin-film disk manufacturers to produce disks capable of high areal density is directly related to the manufacturer's ability to consistently control disk attributes that are largely determined in the sputtering process. The disk attributes include the following:

- Coercivity. Coercivity, a measure of the magnetic strength of the disk, is expressed in Oersted ("Oe"). The magnetic strength of the disk is determined by the types of disk substrate and thin-film materials used; substrate surface conditions before disk sputtering; and the conditions that exist during the sputtering process, including temperature, vacuum and possible sources of disk contamination. Coercivity is increasingly important as areal density increases because higher coercivity permits sharper transitions between magnetized regions, essentially allowing bits of data to be closer together and therefore more data to be stored in the same disk area. Advanced drive designs today require coercivities in the range of 2,000 to 2,200 Oes compared to a range of 950 to 1,200 Oes required five years ago. The Company believes coercivity requirements will continue to increase significantly over the next several years.

- Signal-to-noise ratio. The proper choice of magnetic alloy material and the uniform deposition of this material on the disk help to reduce "noise" (unwanted signals), thereby improving the signal-to-noise ratio of the data that is read from the disk. Higher signal-to-noise ratios permit higher recording density and better data rates.
- Defects. Suitability of the disks for use in disk drives with high areal density is dependent upon both the number and the size of surface imperfections on the disk. Surface imperfections result from a variety of factors, including preexisting substrate surface imperfections, minor damage, contaminants trapped in the sputtered film and non-uniform sputtering of the thin-film layers. As more data is stored in the same disk space, the number and size of disk defects that can be tolerated must be reduced.
- Smoothness and flatness. As areal density increases, a smaller magnetized region stores each bit of data. The lower the disk head flying height, the more accurately the head can read the magnetic signal. The smoother and flatter the disks, the lower the flying height that can be achieved without the head contacting the disk.
- Durability. Because the head and disk come into physical contact when the disk drive is turned off, a protective carbon overcoat is sputtered over the magnetic layer to minimize wear on the disk, to protect the information stored on the disk and to increase the useful life of the disk drive. The thickness of this overcoat must nevertheless be minimized in order to allow the head to fly as close as possible to the magnetic layer.
- Uniformity. The performance of a disk is affected by the uniformity of all of the above characteristics across the entire surface of the disk. Such uniformity is substantially affected by the quality of the disk sputtering process.

#### Control of disk production costs

It is important for thin-film disk manufacturers to control disk production costs in order to be competitive. Some of the most significant costs in the disk manufacturing process are influenced by the disk sputtering equipment. Disk manufacturers seek to lower their per disk manufacturing costs as part of the sputtering process by attention to:

- Yield. Overall yield significantly affects per disk manufacturing costs. The capability and performance of the sputtering equipment can significantly affect overall yield.
- Equipment acquisition and operating costs. Although acquisition costs are substantial, the cost of using the sputtering equipment, including operators, maintenance, spare parts and consumables over the life of the equipment is more significant.
- Increasing uptime and throughput. Operating cost per disk produced is directly related to the uptime and throughput realized from the equipment.
- Facilities costs. The loading and unloading portions of the sputtering machine must be in a clean room. Clean room space is very expensive to build, operate and maintain. Both the size and footprint of sputtering systems affect the amount of clean room space required to house them and the degree to which the manufacturing facility must be customized to accommodate the sputtering equipment.
- Time and cost of making process adjustments. At times during the production of disks it is necessary or desirable to add, remove or make adjustments to certain process steps. To the extent that process engineers are able to do so quickly and efficiently, the disk manufacturer is able to reduce equipment and line downtime and therefore reduce its per disk manufacturing cost.
- Flexible production scheduling. OEM customer specifications for disks and the mix of different disks produced by thin-film disk manufacturers vary. To the extent that the disk manufacturer has the flexibility to quickly and efficiently alter the product mix and volume of disks produced through its production lines, the disk manufacturer is able to rapidly respond to changing customer requirements.

## INTEVAC'S STATIC MANUFACTURING APPROACH

The Company's static systems differ from in-line systems in that static sputtering provides for deposition with no relative movement between the sputtering source and the disk being coated. Each disk is placed sequentially in fully isolated chambers in which various process steps are performed. The initial, first-generation static system, introduced by Varian in 1985, produced high performance disks but had low throughput compared with in-line systems. The Company's current, fourth-generation static system has a throughput of approximately 450 disks per hour, more than three times the throughput of the first-generation system. The Company believes this system is competitive with in-line systems on a cost per disk basis. The capability for making high performance disks has also been improved. For example, the current system has twelve process chambers compared to six chambers for the initial model. These improvements have led to a number of thin-film disk manufacturers adopting the static sputtering approach much as semiconductor manufacturers have moved away from batch processing systems to single wafer multiple chamber processing systems.

The Company's static sputtering system enables manufacturers to achieve high coercivities, high signal-to-noise ratios, minimal defects, high durability and high uniformity, all of which are necessary in the production of high performance, high areal density disks. Additionally, Intevac's static system allows the disk manufacturer to achieve low production costs through high yield, low equipment acquisition and operating costs, high uptime and low facilities costs.

The key features and benefits of the Intevac static sputtering approach are:

- Isolated process chambers. The Company's sputtering systems have isolated vacuum process chambers which can be separately controlled and optimized for each process step, enabling manufacturers to more efficiently achieve high levels of coercivity.
- Single disk processing. Each disk substrate is individually processed under the same process parameters in the Company's system. Disk to disk repeatability is high in the Company's sputtering systems because every disk is subjected to nearly identical static process conditions, and the thin-film coating is uniform due to the cylindrical shape and other design features of the sputter sources.
- Reduced contamination. In an Intevac system there is no pallet that is exposed to the atmosphere and then introduced into the process chambers; thus no absorbed gas on a pallet from outside the vacuum system can contaminate the sputtering process. The short time intervals between process steps further minimizes contamination of the disk surface and makes it possible for the Company's disk sputtering systems to produce thin-film disks with high coercivity.
- Precise temperature control. Intevac's sputtering systems afford precise temperature control and rapid changes in substrate temperature. This permits optimization of the conditions for deposition of the magnetic film in order to achieve high coercivity, while creating different process conditions for the top coat deposition in order to maximize durability.
- Rapid process development. The Company's systems permit rapid and precise change in process parameters. Stability of process conditions is achieved quickly, which significantly shortens process development time and new product qualification as well as disk production ramp up.
- Cost-effective, high throughput. The Company's systems have short transport time intervals and high sputtering rates, which enable high disk production throughput. Intevac has designed its sputter sources for high target utilization; this feature, together with the ability to use either platinum or non-platinum alloy targets to produce high coercivity disks, significantly reduces operating costs.
- Flexible manufacturing. The Company's multi-chamber, static systems fit well into relatively small scale production lines that can be installed, modified or expanded relatively quickly and comparatively inexpensively. This allows the disk manufacturer to incrementally change production levels and mix, to rapidly adapt manufacturing equipment to new product technology and to achieve fast production ramp up. The Company's static manufacturing systems thus allow the thin-film disk manufacturer to meet its customers' increasingly rapid time-to-market demands.



- Reduced facilities costs. The Company's system occupies approximately 370 square feet of factory floor space, including less than 30 square feet of clean room space. A critical cost factor for disk manufacturers is clean room facilities, which can cost several hundred dollars per square foot for initial construction and are very expensive to operate. The size of the Company's systems therefore reduces the cost of building and operating the manufacturing facilities.

The Company has continuously introduced static sputtering systems that give manufacturers more control of the disk manufacturing process thereby allowing manufacturers to produce high performance, high density disks. The advanced technology incorporated in the static system design has allowed Intevac to meet the rapidly changing needs of the disk drive industry. For instance, the design of the Intevac system allows the manufacture of disks that can be used with pseudo-contact recording and with magneto-resistive disk drive heads as well as the sputtering of thin-films onto alternative substrates.

## **PRODUCTS**

### **The MDP-250B Disk Sputtering System**

The Company's principal product, the MDP-250B, which is the fourth generation of the Company's "Magnetic Disk Processing" system, is fully automated, has 12 independent process stations and achieves throughput of approximately 450 disks per hour. The Company offers its static sputtering systems for list prices ranging from \$2.0 million to \$3.5 million, depending upon configuration, to both captive and merchant thin-film disk manufacturers.

The MDP-250B was designed by the Company to meet current requirements for the production of media and to provide the capability to meet future requirements. The MDP-250B is capable of producing disks with coercivity in excess of 2,500 Oe with or without a costly platinum based magnetic layer. In addition, the MDP-250B has the capability to sputter multi-layers (multiple magnetic layers with interspersed non-magnetic layers) onto alternative substrates (such as glass and ceramic), as well as conventional aluminum substrates, and also to make media with the appropriate characteristics for use with MR heads.

The mechanical design of the MDP-250B has characteristics which are similar to the cluster tools which are widely used in semiconductor manufacturing since each process station is separately vacuum pumped and is vacuum isolated during processing. The MDP-250B does not require a carrier or pallet to transport disks through the system. Cassettes containing 25 substrates are automatically moved one at a time to pedestals located on the rim of the disk transfer wheel. This wheel moves up and down and rotates, moving the disks sequentially into and out of the process chambers. When the wheel is in its up position, each process chamber is vacuum isolated from the transport chamber and from other process stations. The disks pass through up to 12 process stations, and are then placed in a cassette, which when full, moves into the exit load lock, from which it moves onto the exit conveyor.

Any number of process steps, up to 12, can be outfitted as the customer requires. The process station options include the direct current ("DC") or radio frequency ("RF") sputter process stations, an infrared substrate heating station, a gas conduction substrate cooling station and a sputter etch cleaning station. The Company designed its MDP-250B with twelve stations, more than current needs require, in order to support future, more complex manufacturing processes. The 12 independent process stations make it possible to produce disks with multi-layers, which reduce noise and thereby increase the signal to noise level of the data stream that is read from the disk. This permits higher recording density and data rates. Furthermore, process stations can be moved from any machine process position to any other to easily accommodate process changes.

The sputtering sources have been designed to provide for high utilization of the target material thus reducing the cost of depositing the various thin films. The Company has redesigned its CM-GUN, the sputtering source currently used in the MDP-250B, to provide for greater target utilization and longer target life. The Company is planning to offer the ES-GUN sputtering source acquired from Cathode Technology Company for use in the MDP-250B. The ES-GUN electrically sweeps plasma radially at the target which results in greater target utilization and longer target life and permits the deposition of two different materials

sequentially in the same chamber. In addition, the Company has introduced the RM-GUN sputtering source which uses a special rotating magnet assembly designed to achieve greater target utilization and longer target life for both magnetic and non-magnetic targets.

MDP-250B operation is controlled by a computer program which displays commands and process information on a color monitor. A user interface is provided which allows an operator to monitor process and to access the programmable controller. A color display unit and a keyboard located in the clean room enable an operator or engineer to access the computer program to control deposition or other processes through appropriate menu choices, to monitor deposition data, or to call up certain access-protected service mode subroutines. A data logging feature of the system enables users to transmit to a host computer the values of the parameters existing at each process station, providing valuable quality control information.

A "top coat" is sputtered onto the disk immediately over the magnetic recording layer to protect the recording layer from corrosion and mechanical damage due to head contact and to provide a surface condition that in conjunction with the lubrication layer minimizes "stiction," the tendency of the head to stick to the disk surface. The top coat is typically carbon or a carbon based substance. The Company believes that optimum deposition of carbon occurs at a lower temperature than is required for the magnetic layer. The MDP-250B incorporates a patented cooling station which permits the required reduction of disk temperature to be achieved within a few seconds. The Company believes that this feature plus the capability to sputter carbon in conjunction with hydrogen or nitrogen makes it possible for the MDP-250B to produce disks that are highly durable.

### **Related Disk Manufacturing and Test Equipment**

In 1996, the Company acquired two companies with product lines that complement the MDP-250B. In May, the Company acquired San Jose Technology Corp. ("SJT"), a leading supplier of systems used to lubricate thin-film disks. Lubrication is the production step that typically follows disk sputtering in the manufacture of thin-film disks. During lubrication, a microscopic layer of lubricant is applied to the disk's surface to improve durability and reduce surface friction. SJT's products allow thin-film disk manufacturers to uniformly lubricate disks in a temperature controlled, low vibration, contamination free environment with a minimal amount of solvent loss. In June, the Company acquired Lotus Technologies, Inc. ("Lotus"), a leading manufacturer of contact stop/start ("CSS") test equipment for hard disk drives and components. The Lotus family of PC-based CSS test equipment performs precise measurements of disk wear, friction, stiction and start-stop torques related to the interface of the read-write head with the thin-film disk. The Company intends to use the Lotus expertise in head-disk interface and CSS testing to further improve the Company's disk sputtering and disk lubrication equipment.

### **FPD MANUFACTURING EQUIPMENT DEVELOPMENT PROJECTS**

In recent years, flat panel displays ("FPDs") have emerged as a display technology for a variety of applications such as PCs, workstations and video displays. The manufacture of several types of flat panel displays such as STN, AMLCD and FED require the use of a sputtering process to deposit thin-film layers of different materials onto a glass substrate.

In 1992, after evaluating the dynamics of the flat panel display market and the technical requirements of meeting that market need, the Company initiated a program to develop a sputtering system for this market as the first step to enter this business area. The Company believes that the skills and technologies that it has developed for the thin-film disk manufacturing industry are directly applicable to the FPD manufacturing industry. These skills and technologies include its expertise and experience in sputtering, rapid heating, high vacuum, isolated process chambers and material handling. In addition, as with the thin-film disk manufacturing industry, the FPD industry involves providing complex, expensive capital equipment to a small number of customers worldwide.

Since inception, the Company has invested approximately \$11.5 million in the flat panel sputtering development effort, of which approximately half has been paid by Ebara Corporation ("Ebara"). The Company entered into its agreement with Ebara in September 1992. Under the agreement, as amended, Ebara has agreed to pay one-half of the development costs of the flat panel sputtering system, up to a maximum

amount of \$5.5 million, in exchange for joint ownership of the intellectual property rights and the exclusive right to manufacture and sell in Japan the flat panel sputtering systems developed under the agreement. The Company has retained the exclusive right to manufacture and sell such flat panel sputtering systems outside of Japan. Each party is required to pay royalties to the other party on its flat panel sputtering system sales. The agreement expires five years following completion of the joint development project. The Company has not yet completed development of its flat panel sputtering systems.

In 1994, the Company identified an additional opportunity in the FPD market. Certain advanced FPDs require amorphous silicon deposited on the substrate to be converted into poly-silicon. An effective way to accomplish this is to rapidly heat the amorphous silicon to a high temperature. In 1994, the Company acquired certain assets of Aktis Corporation and certain patents from Baccarat Electronics, Inc. and continued a project to develop a rapid thermal processing ("RTP") system for converting amorphous silicon into poly-silicon. The Company has sold two RTP systems. Also in 1994, the government's Advanced Research Project Agency ("ARPA") awarded the Company a contract to develop an "All Sputtered Thin Film Transistor".

The Company currently has contracts with ARPA providing for maximum funding over the lives of the contracts of approximately \$3.3 million. As of December 31, 1996, the cumulative billings were approximately \$2.1 million, unspent backlog under these contracts was approximately \$0.3 million and approximately \$0.9 million had not yet been funded under the contracts. In 1996, the Company spent \$12.8 million on research and development funded internally and through customer sponsored research and development, which included \$5.3 million that was spent on research and development related to the Company's FPD efforts. Of the amounts spent on FPD projects during 1996, approximately 59% of the funding was provided by customer sponsored research and development contracts and/or cost sharing agreements.

The Company has limited experience in the development, manufacture, sale and marketing of flat panel display manufacturing equipment, having sold only two RTP systems to date and having not yet completed development of its FPD sputtering system. There can be no assurance that the market for flat panel display manufacturing equipment targeted by the Company will develop as quickly or to the degree the Company currently anticipates, or that the Company's proposed FPD manufacturing equipment will achieve customer acceptance or that the Company will achieve any net revenues from the sale of its proposed FPD manufacturing equipment. 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.

## **INTEVAC TECHNOLOGY AND SKILLS**

The design and fabrication of sputtering systems for thin film disk production requires a broad range of technologies and skills, including:

- Sputtering processes
- Sputter source design
- Thin-film characterization
- Vacuum system design
- Thermal systems design
- Design of complex electromechanical systems
- Material transport systems and robotics
- Computer based control systems

The Company's scientists and engineers are knowledgeable about disk manufacturing processes and work with the Company's customers to design hardware and software systems to meet the customers' requirements. The Company has a MDP-250B in its laboratories to run various process tests for customers to determine the suitability of the machine for their production process, and also for the Company's design engineering department to test newly designed process capabilities. The Company believes that its process expertise, and the ability to communicate with its customer's process scientists, gives it an important competitive advantage.

The Company has the expertise to design apparatus for rapid, uniform substrate heating and cooling, substrate cleaning using glow discharge and sputter etch techniques, as well as both DC and RF sputtering. A

particular area of Company expertise is computer modeling, as well as practical design of the electromagnetic magnetron sputtering sources which are at the heart of the system. The Company believes that the ability to control magnetic field strength using electromagnetic magnetrons is an advantage in maintaining tight process control. The Company's computer programs also are used to calculate the uniformity of sputtered film thickness and magnetic characteristics and the overall utilization of target materials.

## **SALES CHANNEL, CUSTOMERS AND MARKETING**

The selling process for the Company's products is often a multi-level and long-term process involving individuals from marketing, engineering, operations, customer service and senior management. The process is lengthy and involves making sample thin-film disks for the prospective customer and responding to individual needs for moderate levels of machine customization. Intevac sells static sputtering systems to both captive and merchant thin-film disk manufacturers. Captive thin-film disk manufacturers produce disks to be used in disk drives they manufacture, and merchant thin-film disk manufacturers produce disks to be included in disk drives manufactured by third parties. The Company sells and markets its products directly in the United States, and through exclusive distributors in Japan (Matsubo) and Korea (Chung Song). The Company has established a wholly-owned subsidiary in Singapore and a branch office in Taiwan to support its customers in Southeast Asia.

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, Seagate and HMT Technology accounted for 32%, 32% and 13%, respectively, of the Company's total net revenues in 1996, and Seagate, HMT Technology, and Matsubo accounted for 40%, 20% and 17%, respectively, of the Company's total net revenues in 1995. Trace Storage Technology, Matsubo, Seagate, Varian Associates and Komag accounted for 25%, 15%, 13%, 12% and 10%, respectively, of the Company's total net revenues during 1994. Historically, a significant portion of the Company's revenues in any particular period have been attributable to sales to a limited number of customers. 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, 64% of the Company's backlog at December 31, 1996 was represented by three customers for disk sputtering systems, with each representing 10% or more of the Company's backlog at December 31, 1996. 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.

Foreign sales accounted for 41% of revenues in 1996, 20% in 1995 and 40% in 1994. The Company anticipates that foreign sales 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 and in Taiwan. 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. 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.

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.

## **CUSTOMER SUPPORT**

Since media production lines are often operated 24 hours per day, seven days per week, continuing service support is of vital importance and thus the Company provides process and applications support, customer training, installation and start-up assistance and emergency service support to its customers. Over the past two years, the Company has taken several steps to substantially improve customer support including expanding the training program, increasing the number of service engineers, adding product support engineering capability, reducing delivery times for spare parts and providing 24 hour per day response.

Process and applications support is provided by equipment process scientists who have access to a dedicated MDP-250B in the Company's applications laboratory, and who also visit customers at their plants to assist in process development projects.

The Company conducts training classes for process scientists, machine operators and machine service personnel. Additional training is also given during machine installation.

Installation and start up of the sputtering systems are provided within the United States by the Intevac customer service organization. This group also assists with the installation and start up of sputtering systems in overseas locations as required.

The Company provides a standard warranty for up to twelve months from customer acceptance or 2,000 hours of operation, whichever occurs first. During this warranty period any necessary non-consumable parts are supplied and installed. Currently, the Company has trained field service technicians located in the United States, Singapore and Taiwan. In addition, service in Japan and Korea is provided by the Company's distributors and representatives using personnel who have received training at Intevac. Intevac and its distributors stock consumables and spare parts to support the installed base of systems. These parts are available on a 24 hour per day basis.

Consistent with the Company's strategy to provide the industry's highest level of service to its customers, the Company has established operations in Singapore and in Taiwan to provide customer training, installation, start-up assistance, spare parts and service support to customers in Southeast Asia.

## **RESEARCH AND DEVELOPMENT**

The disk drive industry in general, and the thin film disk manufacturing industry in particular, are characterized by rapid technological change and evolving industry standards. The Company has invested substantial amounts in research and development for its disk sputtering systems and flat panel display manufacturing equipment. The Company's research and development expenses in 1996, 1995 and 1994 were \$8.4 million, \$2.6 million and \$3.5 million, respectively, and represented 9.5%, 6.1% and 17.2%, respectively, of net revenues. Research and development expenses do not include costs of \$1.3 million, \$1.1 million and

\$2.0 million that were incurred by the Company in 1996, 1995 and 1994 respectively, and were reimbursed under the terms of a cost sharing agreement.

The Company expects to continue an active development program to make sputter system improvements to increase machine throughput, add additional capabilities that will improve disk performance, 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 has expended significant amounts for research and development for its disk sputtering systems, FPD manufacturing equipment and other new products under development, such as disk laser-texturing equipment and electro-optical products.

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.

## **MANUFACTURING**

Substantially all of the Company's manufacturing is conducted at its headquarters facility in Santa Clara, California. The Company's manufacturing operations include electromechanical assembly, mechanical and vacuum assembly, fabrication of the sputter sources, and system assembly, alignment and testing. The Company makes extensive use of the infrastructure serving the semiconductor equipment business. The Company purchases vacuum pumps, valves, instrumentation and fittings, power supplies, printed wiring board assemblies, computers and control circuitry and specialized mechanical parts made by forging, machining and welding. The Company has a well-equipped fabrication center that is capable of producing most of the fabricated metal parts. This capability is used primarily for quick reaction requirements for design work or to cover shortages and most of the parts required for production are purchased from outside suppliers.

The Company's manufacturing strategy is to produce high quality, cost-effective systems and low cost replacement parts and to be able to respond effectively to changes in volume. To do this, the Company

currently designs its products to use standard parts where possible. The Company performs manufacturing activities that add value or that require unique technology or specialized knowledge and, taking advantage of its Silicon Valley location, utilizes subcontractors to perform other manufacturing activities.

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 implemented 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'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 has limited manufacturing capacity and 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.

## **BACKLOG**

The Company's backlog was \$63.7 million and \$42.8 million at December 31, 1996 and December 31, 1995, respectively. The Company includes in its backlog only those customer orders for systems, component parts and contract research and development for which it has accepted signed purchase orders with assigned delivery dates. In the case of a cancellation of a system order, the Company's system sales contracts generally provide for a non-refundable deposit, depending upon when the order is canceled. The equipment requirements for thin-film disk manufacturers cannot be determined with accuracy, and therefore the Company's backlog at any certain date may not be indicative of future demand for the Company's manufacturing systems.

Due to possible delays in obtaining materials, the average time between order and shipment of the Company's systems may increase substantially in the future. The Company's ability to quickly increase its manufacturing capacity in response to short-term increases in demand could be limited given the complexity of the manufacturing process, the lengthy lead times necessary to obtain critical components and the need for highly skilled personnel. The failure of the Company to satisfy any such short-term increases in demand and to keep pace with customer demand would lead to further extensions of delivery times, which could deter customers from placing additional orders. There can be no assurance that the Company will be successful in increasing its manufacturing capacity.

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 to the date of cancellation. 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 system is manufactured, the Company will not receive funds to cover the 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.

## **COMPETITION**

The Company believes that the principal competitive factors are system performance and features, reliability and uptime, overall cost of ownership and customer support. The Company believes that it competes favorably with respect to each of these factors. The Company believes it is the principal United States-based supplier of sputtering systems for thin-film disks.

The Company experiences intense competition worldwide from three principal competitors, Ulvac Japan, Ltd. ("Ulvac"), Balzars A.G. ("Balzars") 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. Each of Ulvac, Balzars and Anelva is a manufacturer of in-line and static sputtering systems, and each has substantially greater financial, technical, marketing, manufacturing and other resources than the Company. The Company also experiences competition from other manufacturers of in-line sputtering systems used in thin-film disk fabrication facilities as well as 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 will 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 three 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 competitiveness.

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 new customers, which could adversely affect the Company's business, financial condition 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.

## **PATENTS, INTELLECTUAL PROPERTY AND LICENSING**

The Company places a high value on intellectual property and has an active program to seek patent coverage for discoveries and designs that are believed to have significant value. The Company recognizes patentable inventions by employees through incentive payments to inventors. The Company currently has 23 patents issued in the United States, and has patent applications in the United States and foreign countries. Of the 23 patents, seven relate to sputtering, 10 relate to RTP, one relates to lubrication systems and five relate



to other areas not in Intevac's mainstream business. 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 have also been substantial amounts of 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 addition, a third party has sent correspondence to a consortium, of which the Company is a party, in a government sponsored research and development program claiming that the work to be done under this program may infringe patents owned by this third party. The Company and its subcontractors have reviewed the correspondence and patents and believe these claims are without merit; however, there can be no assurance that litigation will not result from such development program. There can be no assurance that 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 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. This could have a material adverse effect on the Company's business, operating results and financial condition, and, in addition, there could be no assurance that the Company would ultimately prevail in any such litigation.

## **EMPLOYEES**

At December 31, 1996, the Company had 292 employees, 39 of whom are contract employees. 282 of these employees are located in California, with 82 in research and development, 135 in manufacturing, and 65 in administration, customer support and marketing. The Company has 8 employees at its operation in Singapore and 2 employees at its operation in Taiwan.

The Company believes that it has good relations with its employees. None of the Company's employees is represented by a labor union, and the Company has never experienced a work stoppage. The Company believes that attracting and motivating skilled technical talent is vital to its success.

## **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.

## **OTHER FACTORS AFFECTING THE COMPANY'S BUSINESS**

### **Management of Expanding Operations**

The Company has recently experienced a period of rapid expansion in its operations that has placed, and could continue to place, a significant strain on the Company's management and other resources. The Company's ability to manage its expanding operations effectively will require it to continue to improve its operational, financial, and management information systems, and to train, motivate and manage its employees. If the Company's management is unable to manage its expanding operations effectively, the Company's results of operations could be adversely affected.

The Company's operating results will 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 the Company has difficulties attracting such personnel, 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.

### **Potential Acquisitions**

The Company's business strategy includes acquiring related businesses, products or technologies. The Company completed three acquisitions in 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, the incurrence of debt and contingent liabilities and amortization expense related to intangible assets acquired, any of which could materially adversely affect the Company's business, financial condition and results of operations. In particular, the Company will not be able to use the "pooling of interests" method of accounting due to a shareholder being greater than a 50% holder of the Company's Common Stock prior to the Company's initial public offering, in connection with any acquisition consummated prior to November 21, 1997 and the Company will therefore be required to amortize any intangible assets acquired in connection with any acquisition consummated during that period.

The Company incurred a charge to operations of \$5.8 million in the quarter ended June 29, 1996, to reflect the purchase of in-process research and development pursuant to the two acquisitions completed in the second quarter. In addition, the Company is amortizing intangible assets of approximately \$8.8 million of costs relating to the three acquisitions completed in 1996. The amortization period for such costs will be over the useful lives, which range from two years to seven years. Additional, unanticipated expenses may be incurred relating to the integration of technologies and 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.

## Possible Volatility of Stock Price

The Company believes that factors such as announcements of developments related to the Company's business, fluctuations in the Company's operating results, failure to meet securities analysts' expectations, general conditions in the disk drive and thin-film media manufacturing industries and the worldwide economy, announcements of technological innovations, new systems or product enhancements by the Company or its competitors, fluctuations in the level of cooperative development funding, acquisitions, changes in governmental regulations, developments in patents or other intellectual property rights and changes in the Company's relationships with customers and suppliers could cause the price of the Company's Common Stock to fluctuate substantially. In addition, in recent years the stock market in general, and the market for small capitalization and high technology stocks in particular, has experienced extreme price fluctuations which have often been unrelated to the operating performance of affected companies. Such fluctuations could adversely affect the market price of the Company's Common Stock.

## Concentration of Stock Ownership

Based on shares outstanding on December 31, 1996, the present directors and their affiliates and executive officers, in the aggregate, own beneficially approximately 76% of the Company's outstanding shares of Common Stock. As a result, these shareholders, acting together, are able to effectively control all matters requiring approval by the shareholders of the Company, including the election of a majority of the directors and approval of significant corporate transactions.

## ITEM 2. PROPERTIES

The Company leases all of its facilities, including approximately 101,900 square feet in Santa Clara, California. These buildings house the manufacturing, research and development, marketing and administration, and the Company's headquarters offices. The leases for these buildings expire in June 1999 (93,600 square feet) and October 1999 (8,300 square feet). The Company has an option to extend the lease with respect to 44,000 square feet for an additional five-year period, with a monthly base rent to be negotiated by the Company and the lessor. If the Company and the lessor are unable to reach agreement with respect to such monthly base rent, the monthly base rent for the extension will be determined by an appraisal process set forth in the lease.

The Company leases a 5,000 square-foot building in Rocklin, California. This building houses the RTP Business. This lease expires in April 1997. The Company has an option to extend the lease on a month by month basis. The Company is currently evaluating the extension of this lease while also reviewing alternate sites for its RTP Business.

The Company leases approximately 8,400 square feet in San Jose, California to house its San Jose Technology Division. The lease expires in November 1997.

The Company leases a facility of approximately 4,800 square feet in Los Gatos, California to house the Lotus Technology Division. The lease expires in December 1997.

The Company leases a facility of approximately 2,400 square feet in Singapore to house the Singapore customer support organization. This lease expires in December 1997. The Company has an option to extend the lease for an additional two years at market rates.

The Company leases approximately 1,400 square feet in Taiwan to house the Taiwan customer support organization. The lease expires in October 1999.

The Company believes that its current facilities are suitable and adequate for its current and foreseeable operations. The Company currently operates with one full manufacturing shift and one partial manufacturing shift and has sufficient manufacturing capacity to produce 4-5 static sputtering systems per month. The Company believes that it has sufficient productive capacity to meet its current needs. Further increases in demand for the Company's products may require the Company to further expand its facilities during 1997. There can be no assurance that the Company will be able to secure suitable expansion space if necessary.

### ITEM 3. LEGAL PROCEEDINGS

There are no material legal proceedings to which the Company is a party or to which any of its property is subject.

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

No matters were submitted to a vote of securityholders during the fourth quarter of the fiscal year covered by this Annual Report on Form 10-K.

### EXECUTIVE OFFICERS AND DIRECTORS

Certain information about the Company's directors and executive officers is listed below:

NAME	AGE	POSITION
-----		
Executive Officers and Directors:		
Norman H. Pond.....	58	Chairman of the Board, President and Chief Executive Officer
Charles B. Eddy III.....	46	Vice President, Finance and Administration, Chief Financial Officer, Treasurer and Secretary
Robert D. Hempstead.....	53	Chief Operating Officer and General Manager of the Vacuum Systems Division
John R. Dougery(1)(2).....	56	Director
Edward Durbin(1).....	69	Director
David N. Lambeth(1).....	49	Director
H. Joseph Smead(2).....	71	Director

(1) Member of Audit Committee

(2) Member of Compensation Committee

Mr. Pond is a founder of the Company and has served as Chairman of the Board, President and Chief Executive Officer since February 1991. Before joining the Company, from 1988 to 1990, Mr. Pond served as President and Chief Operating Officer of Varian, a publicly held manufacturer of semiconductor, communication, defense and medical products where he was responsible for overall management of Varian's operations. From 1984 to 1988, Mr. Pond was President of Varian's Electron Device and Systems Group and became a Director of Varian in 1986. Prior to joining Varian, Mr. Pond was employed by Teledyne, a diversified electronics company, from 1963 to 1984 where he served in various positions, including as Group Executive. Mr. Pond holds a B.S. in physics from the University of Missouri at Rolla and an M.S. in physics from the University of California at Los Angeles.

Mr. Eddy has served as Vice President, Finance and Administration, Chief Financial Officer, Treasurer and Secretary of the Company since April 1991. Mr. Eddy served as Chief Financial Officer of Videonics, Inc., a manufacturer of consumer video editing equipment, from 1987 to 1991 and served as Chief Financial Officer of Parallel Computers, Inc., a startup computer company, from 1983 to 1987. Mr. Eddy was with Intel Corporation from 1974 to 1983 where he served in a variety of positions, including controller and plant manager. Mr. Eddy holds a B.S. in engineering science from the University of Virginia and an M.B.A. from Dartmouth College.

Dr. Hempstead has served as Chief Operating Officer and General Manager of the Vacuum Systems Division of the Company since April 1996. Before joining the Company, Dr. Hempstead served as Executive Vice President of Censtor Corp., a manufacturer of computer disk drive heads and disks, from November 1994 to February 1996. He was a self-employed consultant from 1989 to November 1994. Dr. Hempstead holds a B.S. and M.S. in electrical engineering from Massachusetts Institute of Technology and a Ph.D. in physics from the University of Illinois.

Mr. Dougery has served as a Director of the Company since February 1991. Mr. Dougery has been a general partner of Dougery & Wilder, a venture capital firm, since 1981. Mr. Dougery currently serves as a director of Printronix and In Focus Systems, both publicly held companies, as well as several privately held technology companies. Mr. Dougery holds an A.B. in Mathematics from the University of California, Berkeley and an M.B.A. from Stanford University Graduate School of Business.

Mr. Durbin has served as a Director of the Company since February 1991. Mr. Durbin has been a Senior Vice President of Kaiser Aerospace and Electronics Corporation ("Kaiser"), a privately held manufacturer of electronic and electro-optical systems, responsible for marketing and business development since joining Kaiser in 1975. Mr. Durbin currently serves as a director for all of Kaiser's subsidiaries. Mr. Durbin holds a B.S. in electrical engineering from The Cooper Union and an M.S. in electrical engineering from the Polytechnic Institute of Brooklyn.

Dr. Lambeth has served as a Director of the Company since May 1996. Dr. Lambeth has been Professor of electrical and computer engineering and Associate Director of the Data Storage Systems at Carnegie Mellon University since 1989. Since 1988, Dr. Lambeth has been the owner of Lambeth Systems, an engineering consulting firm. From 1973 to 1988, Dr. Lambeth worked at Eastman Kodak Company's Research Laboratories, most recently as the head of the Magnetic Material Laboratory. Dr. Lambeth holds a B.S. in electrical engineering from the University of Missouri and a Ph.D. in physics from the Massachusetts Institute of Technology.

Dr. Smead has served as a Director of the Company since February 1991. Dr. Smead has been President of Kaiser since joining Kaiser in 1974. Since 1977, Dr. Smead has been President and Chairman of the Board of Directors of K Systems, Inc., Kaiser's parent company. Dr. Smead currently serves as Chairman of the Board of Directors of Kaiser and as a director for all of Kaiser's subsidiaries. Dr. Smead holds a B.S. in electrical engineering from the University of Colorado, an M.S. in electrical engineering from the University of Washington and a Ph.D. in electrical engineering from Purdue University.

## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED SHAREHOLDER MATTERS

The Company's Common Stock commenced trading on the Nasdaq National Market on November 21, 1995 and is traded under the symbol "IVAC." As of December 31, 1996, there were approximately 700 holders of record of the Common Stock. The following table sets forth for the periods indicated the high and low closing sale prices for the Common Stock as reported on the Nasdaq National Market.

	HIGH -----	LOW -----
Year Ended December 31, 1995		
Fourth Quarter (from November 21, 1995).....	\$ 7.000	\$ 6.250
Fiscal 1996		
First Quarter.....	\$ 8.250	\$ 6.125
Second Quarter.....	\$26.000	\$ 6.625
Third Quarter.....	\$17.500	\$11.250
Fourth Quarter.....	\$19.500	\$11.000
Fiscal 1997		
First Quarter (through February 5, 1997).....	\$22.500	\$16.000

### DIVIDEND POLICY

In August 1995, the Company paid a cash dividend of \$0.495 on each share of Common Stock outstanding as of the August 25, 1995 record date. The Company currently anticipates that it will retain its earnings, if any, for use in the operation of its business and does not expect to pay cash dividends on its capital stock in the foreseeable future. The Company's line of credit prohibits the payment of cash dividends on the Company's capital stock.

**ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA**

	YEAR ENDED DECEMBER 31,				
	1996	1995(3)	1994	1993	1992
	(IN THOUSANDS, EXCEPT PER SHARE DATA)				
CONSOLIDATED STATEMENTS OF INCOME DATA:					
Net Revenues:					
Disk, flat panel and other.....	\$88,232	\$42,187	\$18,266	\$16,026	\$17,744
MBE(1).....	--	695	2,185	6,370	9,606
Total net revenues.....	88,232	42,882	20,451	22,396	27,350
Cost of net revenues:					
Disk, flat panel and other.....	55,652	27,280	11,799	9,749	10,946
MBE(1).....	--	434	858	5,417	6,564
Total cost of net revenues.....	55,652	27,714	12,657	15,166	17,510
Gross profit.....	32,580	15,168	7,794	7,230	9,840
Operating expenses:					
Research and development.....	8,425	2,603	3,515	3,142	2,887
Selling, general and administrative.....	8,391	4,550	2,248	3,896	3,743
Acquired in-process research and development...	5,835	--	--	--	--
Total operating expenses.....	22,651	7,153	5,763	7,038	6,630
Operating income.....	9,929	8,015	2,031	192	3,210
Interest expense.....	(175)	(13)	(63)	(113)	(216)
Interest income and other income (expense), net.....	1,569	942	533	(88)	1,042
Income (loss) from continuing operations before income taxes.....	11,323	8,944	2,501	(9)	4,036
Provision for (benefit from) income taxes.....	6,350	3,179	826	(75)	1,655
Income from continuing operations.....	4,973	5,765	1,675	66	2,381
Income (loss) from discontinued operations.....	--	1,335	(267)	1,457	2,610
Net income.....	\$ 4,973	\$ 7,100	\$ 1,408	\$ 1,523	\$ 4,991
PER SHARE:					
Income from continuing operations.....	\$ 0.39	\$ 0.54	\$ 0.16	\$ 0.01	\$ 0.24
Net income.....	\$ 0.39	\$ 0.67	\$ 0.14	\$ 0.15	\$ 0.50
Shares used in per share calculations(2).....	12,901	10,606	10,285	10,305	10,056
CONSOLIDATED BALANCE SHEET DATA:					
Cash, cash equivalents and short-term investments.....	\$ 938	\$20,422	\$13,347	\$19,877	\$ 6,114
Working capital.....	15,847	21,327	23,229	21,792	16,021
Total assets.....	68,085	51,160	42,749	44,233	45,624
Long-term debt.....	730	--	--	--	1,375
Redeemable Series 1 Preferred Stock.....	--	--	6,100	6,100	6,100
Total shareholders' equity.....	33,736	27,320	22,987	21,588	20,051
Cash dividends declared per common share.....	--	0.495	--	--	--

(1) In the fourth quarter of 1993, the Company sold its MBE operations and acquired 20% of the outstanding capital stock of Chorus, a manufacturer of MBE products. The Company retained rights to sell certain other residual used systems of the MBE business that were not exchanged with Chorus. The sale of these used systems was completed during the first quarter of 1995.

(2) See Note 2 of Notes to Consolidated Financial Statements.

(3) During 1995, the Company (a) effected a recapitalization in which each outstanding share of Series A Preferred Stock was exchanged for two thirds of a share of Common Stock and \$0.76 (\$9.9 million in aggregate), (b) paid \$4.9 million of dividends to the common shareholders, (c) paid \$6.1 million to redeem the Series 1 Preferred Stock, and (d) received approximately \$12.0 million from the sale of common stock during the Initial Public Offering. See Notes 10 and 11 of Notes to Consolidated Financial Statements.

## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion and analysis contains forward-looking statements which involve risks and uncertainties. The Company's actual results may differ materially from the results discussed in the forward-looking statements and should be read in conjunction with the Consolidated Financial Statements and related Notes contained elsewhere in this Annual Report on Form 10-K.

### **OVERVIEW**

Intevac 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 has three primary sources of net revenues: sales of disk sputtering systems and related disk manufacturing equipment, sales of system components and contract research and development activities. The Company's disk sputtering systems, which represent the majority of the Company's revenue, are sold to vertically integrated disk drive manufacturers and to original equipment manufacturers that sell disk media to disk drive manufacturers. 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 primarily derived from contracts with ARPA for development projects for the flat panel display industry.

Through the first quarter of 1995, the Company also received revenues from sales of molecular beam epitaxy ("MBE") systems. MBE systems are used for the design and manufacture of materials having the characteristics of a semiconductor that are used to produce transistors, opto-electronic devices and integrated circuits. The Company acquired the MBE business from Varian in 1991 and sold the business to a third party in October 1993. MBE revenues in 1994 and through the first quarter of 1995 were derived from sales of used MBE equipment that had not been sold in the acquisition and from other activities in connection with the winding down of the MBE business. The Company does not expect any MBE revenues in future periods.

Income (loss) from discontinued operations represents results from the Company's sales of night vision products, primarily sales of night vision goggles and devices. The Company sold the night vision business to a third party in May 1995.

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 cyclicity of the thin-film disk manufacturing and disk drive industries, patterns of capital spending by customers, the timing of significant orders, order cancellations and shipment reschedulings, 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, changes in product development costs, expenses associated with acquisitions and exchange rate fluctuations. Over the last eight quarters the Company's operating income (loss) as a percentage of net revenues has fluctuated from approximately (9)% to 21% of net revenues. The Company anticipates that its operating margin 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 has derived a significant proportion of its net revenues from sales of its systems to manufacturers constructing new thin-film disk fabrication facilities. 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. According to a March 1996 report by TrendFOCUS, an independent market research firm, as of December 31, 1995 there were 187 installed disk sputtering lines worldwide and only 14 companies in the world with five or more installed disk sputtering lines. Therefore, winning or losing an order from any particular customer can significantly affect the Company's operating results. In addition, the Company's opportunities to sell its systems are further limited by the fact that a substantial majority 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. Many of these manufacturers have invested significant amounts of capital in their in-line systems, and as such there may be significant resistance to change to a static approach in the future.

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. 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. There can be no assurance that such growth will continue. The Company anticipates that a significant portion of new orders will depend upon demand from thin-film disk manufacturers building or expanding fabrication facilities, and there can be no assurance that such demand will exist. The Company's business, financial condition and results of operations could be materially adversely affected by downturns or slowdowns in the disk drive market.

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 public market analysts and investors. In such event it is likely the price of the Company's Common Stock would be materially adversely affected.

## **RESULTS OF OPERATIONS**

Net revenues. Net revenues totaled \$88.2 million, \$42.9 million, and \$20.5 million in 1996, 1995 and 1994, respectively. Net revenues increased from 1995 to 1996 primarily due to an increase in net revenues from disk sputtering systems and to a lesser extent as the result of the acquisition of SJT in May 1996 and Lotus in June 1996. Net revenues increased from 1994 to 1995 primarily due to a \$23.9 million increase in net revenues from disk sputtering systems and other components partially offset by a \$1.5 million decline in MBE sales. Matsubo, Seagate and HMT Technology accounted for 32%, 32% and 13% respectively, of the Company's total net revenues during 1996. Seagate, HMT Technology and Matsubo accounted for 40%, 20% and 17%, respectively, of the Company's total net revenues during 1995. Trace Storage Technology, Matsubo, Seagate, Varian Associates and Komag accounted for 25%, 15% 13%, 12% and 10%, respectively, of the Company's total net revenues during 1994.

MBE accounted for \$0.7 million and \$2.2 million of net revenues in 1995 and 1994, respectively. The Company sold substantially all of the assets related to its MBE operation in October 1993 in exchange for 20% of the outstanding stock of Chorus Corporation. This investment is accounted for under the equity method. The Company continued to dispose of residual assets of the MBE business through the first quarter of 1995. In the third quarter of 1995, the Company sold its investment interest in Chorus.

Foreign sales totaled \$36.4 million, \$8.7 million and \$8.2 million in 1996, 1995 and 1994, respectively. Foreign sales accounted for 41%, 20% and 40% of net revenues in 1996, 1995 and 1994, respectively. Substantially all of the Company's sales were denominated in US dollars.



Gross margin. Gross margin for disk, flat panel and other was 36.9%, 35.3%, and 35.4% in 1996, 1995 and 1994, respectively. Gross margin increased in 1996 as the result of higher margins on disk sputtering systems during the first two quarters of 1996. The Company believes the historical margins experienced in 1994, 1995 and last two quarters of 1996 are more indicative of future margins than the gross margins attained in the first two quarters of 1996. Gross margin for MBE was 37.6% and 60.7% in 1995 and 1994, respectively. MBE gross margin was above historical levels at 60.7% in 1994 and 37.6% in 1995 due to the resale at high margins of used MBE machines that the Company retained after the sale of the MBE business.

Research and development. Company funded research and development expense increased from \$2.6 million in 1995 to \$8.4 million in 1996. The \$5.8 million increase was caused primarily by an increase in expenses related to the development of disk sputtering equipment and to a lesser extent increases in net expenses related to development of flat panel manufacturing equipment, laser texturing equipment and contact stop/start test equipment. Company funded research and development expense decreased from \$3.5 million in 1994 to \$2.6 million in 1995. The \$0.9 million decrease was caused by a \$1.1 million decrease in expenses related to the development of a flat panel display machine and a \$0.2 million decrease in MBE research and development expenses, which were partially offset by a \$0.4 million increase in research and development spending on disk sputtering equipment and the advanced technology division.

Research and development expenses do not include costs of \$1.3 million, \$1.1 million, and \$2.0 million that were incurred by the Company in 1996, 1995 and 1994, respectively, and reimbursed under the terms of a research and development cost sharing agreement with the Company's Japanese development partner. At December 31, 1996, all of the \$5.5 million of funds available under this cost sharing agreement had been used. Future joint development under this agreement is contingent upon the Company's ability to negotiate further amendments to the development agreement. There can be no assurance that the Company will obtain further amendments to the development agreement.

Selling, general and administrative. Selling, general and administrative expense totaled \$8.4 million, \$4.6 million and \$2.2 million in 1996, 1995 and 1994, respectively, representing 9.5%, 10.6% and 11.0% of revenue. The \$3.8 million increase in selling, general and administrative expenses from 1995 to 1996 was primarily the result of an increase in marketing and administrative costs related to increased sales of disk sputtering systems and, to a lesser extent, increased marketing and administrative costs at the Company's Lotus Technology Division, Advanced Technology Division, and San Jose Technology Division, approximately \$282,000 of costs related to the cancellation of its proposed secondary stock offering in August 1996, and the increased costs of administering and insuring a public company as a result of the Company's November 21, 1995 initial public offering. The \$2.4 million increase in selling, general and administrative expenses from 1994 to 1995 was primarily the result of increased marketing and administrative expenses related to increased sales of disk sputtering systems and, to a lesser extent, the increased costs of administering and insuring a public company as a result of the Company's November 21, 1995 initial public offering. These costs were driven by an increase in administrative headcount to support the Company's increased level of business and administrative activities.

Other income (expense), net. Other income (expense), net totaled \$1.4 million, \$0.9 million, and \$0.5 million, in 1996, 1995 and 1994, respectively. Other income during 1996 consisted primarily of deferred income recognized on the sale of the Company's interest in Chorus Corporation and interest income, and to a lesser extent early payment discounts, which were partially offset by interest expense. Other income during 1995 consisted primarily of interest income and, to a lesser extent, deferred income recognized on the sale of the Company's interest in Chorus Corporation. Other income during 1994 resulted primarily from interest income.

Discontinued operations. In March 1995, the Company adopted a formal plan to discontinue the night vision business. The Company sold its night vision business to Litton Systems, Inc. in May 1995. Accordingly, the results of operations data for the years ended December 31, 1996, 1995 and 1994 reflects the night vision business as a discontinued operation. Net revenues included in discontinued operations for the years ended December 31, 1995 and 1994 were \$4.2 million and \$18.4 million, respectively.

Provision for (benefit from) income taxes. Income tax expense as a percentage of pretax income was 56%, 36% and 33% in 1996, 1995 and 1994, respectively. The Company's tax rate differs from the applicable statutory rates primarily due to non deductible expenses for acquired in-process research and development and goodwill amortization, state income taxes, the utilization of research and development tax credits, benefits from the Company's foreign sales corporation and tax exempt interest income.

A net deferred tax asset of \$4.0 million is reflected in the financial statements at December 31, 1996. Based on the Company's historical taxable income and projected future earnings, management believes that it is more likely than not that the Company will realize the benefit of this asset.

## **LIQUIDITY AND CAPITAL RESOURCES**

The Company's operating activities in 1996 used cash of \$5.7 million primarily due to aggregate increases in accounts receivable and inventories of \$23.7 million, which were partially offset by net income of \$5.0 million, \$5.8 million non-cash expense for the write-off of acquired in-process research and development, \$2.8 million of depreciation and amortization and a \$5.3 million increase in customer advances.

Investing activities in 1996 used cash of \$14.6 million due to the net investment of \$11.5 million of cash in the acquisitions of Cathode Technology Corporation, San Jose Technology Corporation, and Lotus Technologies, Inc. and the purchase of \$3.9 million of property and equipment which was partially offset by \$0.8 million of proceeds from the sale of the Company's Chorus Investment.

Financing activities in 1996 generated \$0.8 million of cash from the proceeds of the sale of the Company's common stock under its employee stock option and employee stock purchase plans.

At December 31, 1996, the Company had \$0.9 million of cash and cash equivalents. In addition, the Company has a \$20.0 million revolving line of credit which expires May 1, 1997. Borrowings under the agreement are based on eligible receivables and inventory. Borrowings based on receivables bear interest at prime rate or the LIBOR rate plus 250 basis points and borrowings based on inventory bear interest at Prime rate plus 1% or the LIBOR rate plus 350 basis points. Borrowings under the line of credit are secured by substantially all the Company's assets. The line of credit agreement requires the Company to maintain certain financial ratios and other financial conditions.

The Company intends to undertake approximately \$4 million in capital expenditures during the next 12 months. The Company believes the existing cash and cash equivalent balances and credit facilities will be sufficient to meet its cash requirements for at least the next twelve months. While operating activities may provide cash in certain periods, to the extent the Company may experience growth in the future, the Company anticipates that its operating and investing activities may use cash and, consequently, such growth may require the Company to obtain additional sources of financing. The Company may also from time to time consider the acquisition of related businesses, products or technologies, which may require additional financing.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**INTEVAC, INC.**

**CONSOLIDATED FINANCIAL STATEMENTS**

**CONTENTS**

	PAGE
Report of Ernst & Young LLP, Independent Auditors.....	24
Consolidated Balance Sheets.....	25
Consolidated Statements of Income.....	26
Consolidated Statements of Shareholders' Equity.....	27
Consolidated Statements of Cash Flows.....	28
Notes to Consolidated Financial Statements.....	29

## REPORT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

The Board of Directors and Shareholders  
Intevac, Inc.

We have audited the accompanying consolidated balance sheets of Intevac, Inc. as of December 31, 1996 and 1995, and the related consolidated statements of income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 1996. Our audits also included the financial statement schedule listed in the index at Item 14(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Intevac, Inc. at December 31, 1996 and 1995, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1996, in conformity with generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

Ernst & Young LLP San Jose, California  
January 20, 1997

**INTEVAC, INC.**

**CONSOLIDATED BALANCE SHEETS**  
(IN THOUSANDS)

	DECEMBER 31,	
	1996	1995
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents.....	\$ 938	\$20,422
Accounts receivable, net of allowances of \$1,024 and \$461 at December 31, 1996 and 1995, respectively, and includes related party receivables of \$199 at December 31, 1995.....	17,570	4,439
Inventories, including \$6,735 and \$2,579 at customers at December 31, 1996 and 1995, respectively.....	25,666	16,468
Short-term note receivable, arising from the sale of the investment in Chorus Corporation, net of allowance of \$1,180 and \$593 at December 31, 1996 and 1995, respectively.....	--	177
Prepaid expenses and other current assets.....	507	503
Deferred tax assets.....	4,397	3,158
<b>Total current assets.....</b>	<b>49,078</b>	<b>45,167</b>
Equipment and leasehold improvements, at cost:		
Leasehold improvements.....	2,872	1,416
Machinery and equipment.....	10,269	3,909
	13,141	5,325
Accumulated depreciation and amortization.....	3,868	1,846
	9,273	3,479
Long-term note receivable, arising from sale of the investment in Chorus Corporation, net of allowance of \$0 and \$1,180 at December 31, 1996 and 1995, respectively.....	--	--
Investment in 601 California Avenue LLC.....	2,431	2,431
Goodwill, net of amortization of \$951.....	5,603	--
Other intangibles, net of amortization of \$539.....	1,698	--
Deferred tax assets and other assets.....	2	83
<b>Total assets.....</b>	<b>\$68,085</b>	<b>\$51,160</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Notes payable.....	\$ 1,252	\$ --
Accounts payable.....	4,465	2,681
Accrued payroll and related liabilities.....	1,937	1,075
Accrued income taxes.....	799	2,616
Accrued product warranties.....	2,266	1,190
Other accrued liabilities.....	1,210	862
Customer advances.....	20,702	14,436
Net liabilities of discontinued operations.....	600	980
<b>Total current liabilities.....</b>	<b>33,231</b>	<b>23,840</b>
Long-term debt.....	730	--
Deferred tax liability.....	388	--
Commitments and contingencies.....		
Shareholders' equity:		
Undesignated Preferred Stock, no par value, 10,000 shares authorized, no shares issued and outstanding.....	--	--
Common stock, no par value:		
Authorized shares -- 50,000		
Issued and outstanding shares -- 12,449 and 12,248 at December 31, 1996 and 1995, respectively.....	16,747	15,304
Retained earnings.....	16,989	12,016
<b>Total shareholders' equity.....</b>	<b>33,736</b>	<b>27,320</b>
<b>Total liabilities and shareholders' equity.....</b>	<b>\$68,085</b>	<b>\$51,160</b>

See accompanying notes.

**INTEVAC, INC.**

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

	YEARS ENDED DECEMBER 31,		
	1996	1995	1994
Net revenues:			
Disk, flat panel, and other.....	\$88,232	\$42,187	\$18,266
MBE.....	--	695	2,185
Total net revenues (includes related party revenues of \$1,856 and \$2,897 for the years ended December 31, 1995 and 1994, respectively).....	88,232	42,882	20,451
Cost of net revenues:			
Disk, flat panel, and other.....	55,652	27,280	11,799
MBE.....	--	434	858
Total cost of net revenues.....	55,652	27,714	12,657
Gross profit.....	32,580	15,168	7,794
Operating expenses:			
Research and development.....	8,425	2,603	3,515
Selling, general, and administrative.....	8,391	4,550	2,248
Acquired in-process research and development.....	5,835	--	--
Total operating expenses.....	22,651	7,153	5,763
Operating income.....	9,929	8,015	2,031
Interest expense.....	(175)	(13)	(63)
Interest income and other, net.....	1,569	942	533
Income from continuing operations before income taxes.....	11,323	8,944	2,501
Provision for income taxes.....	6,350	3,179	826
Income from continuing operations.....	4,973	5,765	1,675
Discontinued operations:			
(Loss) from discontinued operations, net of applicable income taxes.....	--	(63)	(267)
Gain on disposal of discontinued operations including provision of \$2,622 for estimated closing, environmental remediation and warranty costs, net of applicable income taxes.....	--	1,398	--
Income (loss) from discontinued operations.....	--	1,335	(267)
Net income.....	\$ 4,973	\$ 7,100	\$ 1,408
Per share:			
Income from continuing operations.....	\$ 0.39	\$ 0.54	\$ 0.16
Net income.....	\$ 0.39	\$ 0.67	\$ 0.14
Shares used in per share amounts.....	12,901	10,606	10,285

See accompanying notes.

**INTEVAC, INC.**

**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
(IN THOUSANDS)**

	SERIES A CONVERTIBLE PREFERRED STOCK		COMMON STOCK		RETAINED EARNINGS	TOTAL SHAREHOLDER'S EQUITY
	SHARES	AMOUNT	SHARES	AMOUNT		
Balance at January 1, 1994.....	13,020	\$13,020	706	\$ 113	\$ 8,455	\$21,588
Sale of common stock under stock option plan.....	--	--	37	14	--	14
Repurchase of common stock under stock option plan.....	--	--	(29)	(23)	--	(23)
Net income.....	--	--	--	--	1,408	1,408
Balance at December 31, 1994.....	13,020	13,020	714	104	9,863	22,987
Exchange of Series A Preferred Stock for common stock.....	(13,020)	(13,020)	8,680	3,125	--	(9,895)
Common stock dividend.....	--	--	--	--	(4,922)	(4,922)
Redeemable Series 1 Preferred Stock dividend.....	--	--	--	--	(25)	(25)
Sale of common stock under stock option plan.....	--	--	557	174	--	174
Repurchase of common stock under stock option plan.....	--	--	(3)	(4)	--	(4)
Sale of common stock through initial public offering.....	--	--	2,300	11,905	--	11,905
Net income.....	--	--	--	--	7,100	7,100
Balance at December 31, 1995.....	--	--	12,248	15,304	12,016	27,320
Initial public offering costs.....	--	--	--	(7)	--	(7)
Sale of common stock under stock option plan.....	--	--	139	438	--	438
Sale of common stock under employee stock purchase plan.....	--	--	62	322	--	322
Income tax benefits realized from activity in employee stock plans...	--	--	--	690	--	690
Net income.....	--	--	--	--	4,973	4,973
Balance at December 31, 1996.....	--	\$ --	12,449	\$16,747	\$ 16,989	\$33,736
	=====	=====	=====	=====	=====	=====

See accompanying notes.

**INTEVAC, INC.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(IN THOUSANDS)

	YEARS ENDING DECEMBER 31,		
	1996	1995	1994
<b>OPERATING ACTIVITIES</b>			
Income from continuing operations.....	\$ 4,973	\$ 5,765	\$ 1,675
Income (loss) from discontinued operations.....	--	1,335	(267)
	-----	-----	-----
Net income.....	4,973	7,100	1,408
Adjustments to reconcile net income to net cash and cash equivalents provided by (used in) operating activities:			
Depreciation.....	1,354	883	1,663
Amortization of intangibles.....	1,490	--	--
Acquired in-process research and development.....	5,835	--	--
Gain on sale of Chorus Investment.....	(593)	--	--
Gain on disposition of discontinued operations.....	--	(1,398)	--
Loss on disposal of equipment.....	5	219	--
Changes in assets and liabilities:			
Accounts receivable.....	(12,344)	5,055	(3,829)
Inventories.....	(11,313)	(9,116)	(3,827)
Prepaid expenses and other assets.....	(1,132)	942	1,900
Accounts payable.....	1,464	1,276	(953)
Accrued payroll and other accrued liabilities.....	(284)	676	(3,586)
Customer advances.....	5,251	7,641	1,961
Discontinued operations -- noncash changes and working capital changes.....	(380)	(2,770)	--
	-----	-----	-----
Total adjustments.....	(10,647)	3,408	(6,671)
	-----	-----	-----
Net cash and cash equivalents provided by (used in) operating activities.....	(5,674)	10,508	(5,263)
<b>INVESTING ACTIVITIES</b>			
Purchase of short-term investments.....	(2,571)	(3,001)	(9,084)
Proceeds from maturities of short-term investments.....	2,571	7,080	6,006
Purchase of equipment.....	(3,854)	(3,042)	(953)
Investment in Cathode Technology Corporation.....	(1,074)	--	--
Investment in San Jose Technology Corporation.....	(2,270)	--	--
Investment in Lotus Technologies, Inc.....	(8,135)	--	--
Payment for non-compete covenant.....	--	--	(305)
Proceeds from sale of discontinued operations.....	--	7,546	--
Proceeds from sale of Chorus Investment.....	770	930	--
	-----	-----	-----
Net cash and cash equivalents provided by (used in) investing activities.....	(14,563)	9,513	(4,336)
<b>FINANCING ACTIVITIES</b>			
Proceeds from issuance of common stock.....	753	12,079	14
Repurchase of common stock.....	--	(4)	(23)
Dividends on common stock.....	--	(4,922)	--
Dividends on redeemable Series 1 Preferred Stock.....	--	(25)	--
Exchange of Series A Preferred Stock for common stock.....	--	(9,895)	--
Redemption of redeemable Series 1 Preferred Stock.....	--	(6,100)	--
	-----	-----	-----
Net cash and cash equivalents provided by (used in) financing activities.....	753	(8,867)	(9)
	-----	-----	-----
Net increase (decrease) in cash and cash equivalents.....	(19,484)	11,154	(9,608)
Cash and cash equivalents at beginning of period.....	20,422	9,268	18,876
	-----	-----	-----
Cash and cash equivalents at end of period.....	\$ 938	\$ 20,422	\$ 9,268
	=====	=====	=====
Cash paid (received) for:			
Interest.....	\$ 149	\$ --	\$ 12
Income taxes.....	9,321	3,487	52
Income tax refund.....	(250)	(727)	(1,120)
Other noncash changes:			
Investment in Cathode Technology Corporation through assumption of notes payable.....	\$ 1,980	\$ --	\$ --
Inventories capitalized for internal use.....	3,094	--	--
Income tax benefit realized from activity in employee stock plans.....	690	--	--

See accompanying notes.



# INTEVAC, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 1. BUSINESS AND NATURE OF OPERATIONS

Intevac, Inc. ("Intevac" or the "Company") was formed in October 1990 for the purpose of acquiring certain business assets and liabilities from Varian Associates, Inc. ("Varian"). In February 1991, certain agreements were entered into between Varian and the Company which provided for the transfer of the assets and business of Varian's disk sputtering equipment business, night vision device business and molecular beam epitaxy ("MBE") equipment business to Intevac.

In October 1993, certain assets of the MBE business were exchanged for a 20% ownership in the outstanding stock of Chorus Corporation ("Chorus"), a manufacturer of MBE products. The Company retained the rights to sell certain residual assets of the MBE business not exchanged with Chorus Corporation. Disposition of these assets was completed during the first quarter of 1995. In the third quarter of 1995, the Company sold its investment interest in Chorus.

In 1994, the Company purchased certain assets from Aktis Corporation and purchased certain patents from Baccarat Electronics, Inc. for \$182,000 which formed the genesis of its Rapid Thermal Processing Operation ("RTP"). RTP developed a rapid thermal system for use in the production of flat panel displays under Advanced Research Project Agency ("ARPA") contracts. RTP delivered and sold its first RTP system in the first quarter of 1995 and a second RTP system in the first quarter of 1996.

In the second quarter of 1995, the Company completed the sale of its night vision business to Litton Systems, Inc. for cash. The Company retained certain engineering personnel from the night vision business as well as some government contracts for research and development work in photocathodes, various applications of that technology, and development of processes for making thin-film transistors with sputtered materials. This activity was organized with the RTP business to form the Advanced Technology Division ("ATD"). ATD expects to continue this type of work and will seek continued customer support for research and development activities.

In the first quarter of 1996, the Company purchased all of the outstanding stock of Cathode Technology Corporation ("Cathode"). Cathode designs and manufactures magnetron sputter sources for use in the Company's disk sputtering systems. This acquisition was accounted for under the purchase method. See Note 16 of Notes to Consolidated Financial Statements.

In the second quarter of 1996, the Company purchased all of the outstanding stock of San Jose Technology Corp. ("SJT"). SJT is a manufacturer of systems used to lubricate thin-film disks. This acquisition was accounted for under the purchase method. See Note 16 of Notes to Consolidated Financial Statements.

In the second quarter of 1996, the Company purchased all of the outstanding stock of Lotus Technologies, Inc. ("Lotus"). Lotus is a manufacturer of contact stop/start test equipment for disk drives and drive components. This acquisition was accounted for under the purchase method. See Note 16 of Notes to Consolidated Financial Statements.

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. The Company's principal product, the MDP-250B system, enables disk manufacturers to achieve high coercivities, high signal-to-noise ratios, minimal disk defects, durability and uniformity, all of which are necessary in the production of high performance, high capacity disks. The Company sells its static sputtering systems 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 supports its customers in Southeast Asia through its wholly owned subsidiary in Singapore and a branch office in Taiwan.

# INTEVAC, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### **Basis of Presentation**

The consolidated financial statements include the accounts of Intevac and its subsidiaries. All intercompany transactions and balances have been eliminated.

#### **Revenue Recognition**

**Systems and Components** -- Revenue for disk sputtering system sales is recognized upon customer acceptance. Revenue for other systems and for system component sales is recognized upon shipment.

**Service and Maintenance** -- Service and maintenance contract revenue, which to date has been insignificant, is recognized ratably over applicable contract periods or as services are performed.

**Technology Development** -- The Company performs best efforts research and development work under various research contracts. Revenue on these contracts is recognized in accordance with contract terms, typically as costs are incurred.

These contracts cover such projects as developing a sputtering process for thin-film transistors, developing technology for rapid thermal processing of glass substrates and developing of technology in the areas of EBCCD's, TE photocathodes and Electron Beam Sources. Typically, for each contract, the Company commits to perform certain research and development efforts up to an agreed upon amount. In connection with these contracts, the Company receives funding on an incremental basis up to a ceiling. Upon completion of each contract, each party will typically receive certain rights to the technical and computer software data developed under the contract. Some of these contracts are cost-sharing in nature, where Intevac is reimbursed for a portion of the total costs expended. In addition, the Company has, from time to time, negotiated with a third party to fund a portion of the Company's costs in return for a joint interest to the Company's rights at the end of the contract.

Net revenues and related cost of net revenues associated with these contracts were \$3,265,000 and \$3,758,000 for 1996, respectively, \$1,210,000 and \$1,358,000 for 1995, respectively, and \$258,000 and \$373,000 for 1994, respectively.

#### **Warranty**

The Company's standard warranty provides for warranty for 2,000 hours of operation or up to twelve months from customer acceptance, whichever occurs first. During this warranty period any necessary non-consumable parts are supplied and installed. Non-system products are warranted for a period of up to twenty-four months from shipment. A provision for the estimated cost of warranty is recorded upon customer acceptance for systems and upon shipment for non-system products.

#### **International Distribution Costs**

The Company makes payments to agents and distributors under certain agreements related to international sales in return for obtaining orders and providing installation and warranty services. Payments to these agents and distributors are included in cost of net revenues. These amounts totaled approximately \$3,743,000, \$1,866,000 and \$1,289,000 for the years ended December 31, 1996, 1995 and 1994, respectively.

#### **Advertising Expenses**

The Company accounts for advertising costs as expense in the period in which they are incurred. Advertising expense for 1996, 1995 and 1994 were insignificant.

**INTEVAC, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)**

**Customer Advances**

Customer advances generally represent nonrefundable deposits invoiced by the Company in connection with receiving customer purchase orders and shipment of the systems. Customer advances related to systems that have not been shipped to customers included in accounts receivable represent \$804,000 and \$806,000 at December 31, 1996 and 1995, respectively.

**Cash and Cash Equivalents**

The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

**Short-Term Investments**

Short-term investments consist principally of debt instruments with maturities between three and twelve months and are carried at fair value. These investments are typically short-term in nature and therefore bear minimal risk.

Management determines the appropriate classification of debt securities at the time of purchase and reevaluates such designation as of each balance sheet date.

Cash and cash equivalents represent cash accounts and money market funds.

**Inventories**

Inventories for systems and components 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:

	DECEMBER 31,	
	1996	1995
	( IN THOUSANDS )	
Raw materials.....	\$ 6,953	\$ 2,900
Work-in-progress.....	11,728	10,818
Finished goods.....	6,985	2,750
	\$25,666	\$16,468
	=====	=====

**Equipment and Leasehold Improvements**

Equipment and leasehold improvements are carried at cost less allowances for accumulated depreciation. Profits and losses on dispositions are reflected in current operations.

Depreciation is computed using the straight-line method over the estimated useful lives of the assets, which are generally five to seven years for machinery and equipment. Amortization of leasehold improvements is computed using the shorter of the remaining terms of the leases or the estimated economic useful lives of the improvements.

**Intangible Assets**

The Company amortizes intangible assets on a straight-line basis over the estimated useful lives, which range from 2 to 7 years.

## INTEVAC, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

#### Income Taxes

The Company uses the liability method of accounting for income taxes as required by Statement of Financial Accounting Standards No. 109 ("SFAS 109").

#### Net Income Per Share

Net income per share is computed using the weighted average number of shares of common stock and common equivalent shares, when dilutive, from convertible preferred stock (using the as-if-converted method) and from stock options (using the treasury stock method). Pursuant to the Securities and Exchange Commission Staff Accounting Bulletins, common and common equivalent shares issued by the Company at prices below the initial public offering price during the twelve-month period prior to the offering have been included in the calculation as if they were outstanding for all periods presented. Dividends paid to Series 1 preferred stockholders through the redemption of the Series 1 Preferred Stock in the third quarter of 1995 were \$25,000. The impact on net income per share and net income applicable to common stock was not material.

#### Employee Stock Plans

The Company accounts for its stock option plans and its employee stock purchase plan in accordance with provisions of the Accounting Principles Board's Opinion No. 25 ("APB 25"), "Accounting For Stock Issued to Employees." In 1995, the Financial Accounting Standards Board released the Statement of Financial Accounting Standard No. 123 ("SFAS 123"), "Accounting for Stock Based Compensation." SFAS 123 provides an alternative to APB 25 and is effective for fiscal years beginning after December 15, 1995. The Company is continuing to account for its employee stock plans in accordance with the provisions of APB 25.

#### Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principals 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 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.

#### Financial Presentation

Certain prior year amounts on the Consolidated Financial Statements have been reclassified to conform to the 1996 presentation.

### 3. CONCENTRATIONS

#### Credit Risk and Significant Customers

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist of cash equivalents and accounts receivable. The Company generally invests its excess cash in money market funds and in variable rate municipal bonds, which have contracted maturities within one year. By policy, the Company's investments in commercial paper, certificates of deposit, Eurodollar time deposits, or bankers acceptances are rated A1/P1, or better. Investments in tax exempt or tax advantaged instruments, such as variable rate municipal bonds are rated A, or better. To date, the Company has not incurred losses related to these investments.

## INTEVAC, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

The Company operates primarily in one business segment (subsequent to the discontinuance of the night vision business), which is to design, manufacture, and sell capital equipment used in high technology manufacturing and research activities. Historically, a significant portion of the Company's revenues in any particular period have been attributable to sales to a limited number of customers. The Company performs credit evaluations of its customers' financial conditions and requires deposits on system orders but does not generally require collateral or other security to support customer receivables. Matsubo, Seagate and HMT Technology accounted for 32%, 32% and 13% respectively, of the Company's total net revenues during 1996. Seagate, HMT Technology and Matsubo accounted for 40%, 20% and 17%, respectively, of the Company's total net revenues during 1995. Trace Storage Technology, Matsubo, Seagate, Varian Associates and Komag accounted for 25%, 15%, 13%, 12% and 10%, respectively, of the Company's total net revenues during 1994. The Company's largest customers purchase disk-sputtering systems and change from period to period as thin-film disk fabrication facilities are built or expanded.

#### Products

Disk sputtering equipment contributed a significant portion of the Company's revenues and profits in 1996. The Company expects that its ability to maintain or expand its current levels of revenues and profits in the future will depend upon its success in enhancing its existing systems and developing and manufacturing competitive disk sputtering equipment.

#### Markets

The market for the Company's products is characterized by rapid technological developments, evolving industry standards, changes in customer requirements, new product introductions and enhancements. The market for disk sputtering systems is primarily dependent 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. In addition, the cyclicity 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.

#### Materials

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 implemented 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.

#### Inventories

Given the volatility of the market, the Company makes inventory provisions for potentially excess and obsolete inventory based on backlog and forecasted demand. However, such backlog demand is subject to revisions, cancellations, and rescheduling. Actual demand will inevitably differ from such anticipated demand, and such differences may have a material effect on the financial statements.

**INTEVAC, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)**

**Competition**

The Company experiences intense competition worldwide from three principal competitors, each of which has substantially greater financial, technical, marketing, manufacturing and other resources than the Company. There can be no assurance that the Company's competitors will not develop enhancements to, or future generations of, competitive products that will offer superior price or performance features or that new competitors will not enter the Company's markets and develop such enhanced products. Because of these competitive factors, there can be no assurance that the Company will be able to compete successfully in the future. Increased competitive pressure could cause the Company to lower prices for its products, thereby adversely affecting the Company's business, financial condition and results of operations.

**Export Net Revenues**

Export net revenues by geographic region were as follows (in thousands):

YEAR ENDED DECEMBER 31,	FAR EAST	REST OF WORLD	TOTAL
1996.....	\$36,315	\$ 57	\$36,372
1995.....	7,954	723	8,677
1994.....	8,231	13	8,244

Export sales do not include systems purchased by domestic corporations, but delivered to international locations. Those shipments accounted for approximately 28% of revenue in 1996. Export sales are likely to continue to account for a substantial portion of net revenues in the future. 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. 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 export 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.

**4. DISCONTINUED OPERATIONS**

In 1992, the Company was notified by the U.S. Army that the night vision business had not been awarded the next phase of a significant production contract that was critical to the business.

In the first quarter of 1995, the Company adopted a formal plan to discontinue the operations of its night vision business. Accordingly, the consolidated statements of operations and cash flows for all periods presented reflect the night vision operations as discontinued. In the second quarter of 1995, the Company sold its night vision business to Litton Systems, Inc. for cash of \$7,546,000. The terms of the sale of the night vision business required the Company to indemnify Litton Systems, Inc. for certain potential warranty and environmental claims. In connection with this sale, the Company recorded a net gain on disposal of \$2,254,000 (\$1,398,000 after tax, or \$0.13 per share) as follows:

Gain on sale, less applicable income taxes of \$1,007,000.....	\$1,645,000
Operating losses from April 1, 1995 to May 5, 1995, net of applicable benefit from income taxes of \$151,000.....	(247,000)
	\$1,398,000
	=====

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

In connection with this sale, the Company reduced the gain by a charge of \$2,622,000 (\$1,626,000 after tax, or \$0.15 per share) for costs associated with the sale. The significant components of this charge included \$795,000 for warranty costs, \$680,000 for estimated environmental remediation costs associated with the site of the night vision operations, and \$476,000 for write-offs of certain prepaid expenses and other assets. Remediation efforts were largely completed in 1996. Warranty on all products shipped by the business will expire in November 1997. The remaining accrual associated with closing the business is \$745,000 at December 31, 1996. Although management believes that the reserves remaining will cover any obligations the Company may have, with respect to the night vision operations and its occupancy of the Palo Alto site, there can be no assurance that such reserves will be adequate, or that there will not be a material impact in the near term on the financial statements presented.

Net revenues of the night vision business included in discontinued operations were \$4,221,000 and \$18,356,000 for the years ended December 31, 1995 and 1994, respectively. The income (loss) from discontinued operations were net of a provision (benefit) for income taxes of \$(163,000) and \$893,000 for the years ended December 31, 1995 and 1994, respectively.

## 5. INVESTMENT IN 601 CALIFORNIA AVENUE LLC

In the third quarter of 1995, the Company entered into a Limited Liability Company Operating Agreement ("the Operating Agreement") which expires December 31, 2015 with 601 California Avenue LLC (the "LLC"), a California limited liability company formed and owned by the Company and certain shareholders of the Company. The LLC was formed for the purpose of removing the buildings, remediation and the development of an office building at the site of the Company's discontinued night vision business (the "Site"). Under the Operating Agreement, the Company transferred its leasehold interest in the Site in exchange for a preferred share in the LLC, having an aggregate liquidation preference equal to \$3,900,000 (unaudited), and the remaining shareholders of the LLC contributed cash of approximately \$1,053,000 (unaudited). The Company's preferred share votes with the common shares and has one vote out of 1,001, except for votes on the sale, transfer or lease of the Site, the LLC or changes to the rights of the preferred share as to which approval of the holder of the preferred share is required. The leasehold interest in the Site is with the Board of Trustees of the Leland Stanford Junior University ("Stanford"). The leasehold interest is fully paid and expires in the year 2053. The fair market value of the leasehold interest in the Site was determined by an independent appraiser to be \$3,900,000 (unaudited). The Company is accounting for the investment under the cost recovery method and has recorded its investment in the LLC at approximately \$2,431,000, which represents the Company's historical carrying value of the leasehold interest in the Site which the Company believes is less than the net realizable value. The Company and the LLC have cross-indemnified each other for potential environmental claims relating to acts prior to and subsequent to the transfer of the Site, respectively. Per the Operating Agreement, the Company is not required to contribute additional capital to the LLC. The preferred share in the LLC accrues an annual 10% cumulative preferred return. The cumulative preferred return is not payable until the property is developed and generating positive operating cash flow, which among other factors, is dependent on the LLC obtaining additional financing, performing site environmental remediation for which Varian has made certain indemnifications, developing the Site, and negotiating a favorable lease(s).

During 1996, the buildings on the Site were remediated, closed and demolished, the LLC formed a joint venture with Stanford ("Stanford JV") to develop the property, the Stanford JV received approval from the City of Palo Alto for its redevelopment plans, and the Stanford JV signed an 11 year lease with a tenant for 75% of the proposed redevelopment (unaudited).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

6. INVESTMENT IN CHORUS CORPORATION

In 1993, the Company sold its MBE operations and acquired 20% of the outstanding capital stock of Chorus, a manufacturer of MBE products. The investment is accounted for under the equity method. The net effect of the Company's share of Chorus' net income (loss) is included in other income (expense), net and was \$165,000 and \$(2,000) for the years ended December 31, 1995 and 1994, respectively.

Certain MBE inventory, sufficient to fill MBE's backlog, was not sold to Chorus. However, Chorus used this inventory to complete the backlog sales and reimbursed the Company for the cost of this inventory upon completion of the sale. A receivable of \$249,000 was recorded in the Company's financial statements at December 31, 1994 for the cost of such inventory. In addition, the Company retained the rights to sell certain other residual used systems of the MBE business that were not exchanged with Chorus. The sale of these used systems was completed during the first quarter of 1995.

In the third quarter of 1995, the Company sold its 20% investment interest in Chorus, which represented 1,250,000 shares of Chorus stock to an individual for \$500,000 in cash and a note for \$2,380,000. This note bears interest at 12.5% per year with principal and interest payable in installments through August 1997. The note is secured by 1,033,000 shares of Chorus stock. The sales price of the Chorus stock exceeded the net carrying value of the Company's investment in Chorus by approximately \$1,800,000. Due to the inherent uncertainties regarding the performance of an individual making the remaining installment payments on the note, the Company deferred the gain on the sale and is recognizing it under the cost recovery method. Under the cost-recovery method, no profit is recognized until cash payments by the individual buyer, including principal and interest on debt due to the Company, exceed the Company's net carrying value of its investment. The December 31, 1996 note receivable reserve of approximately \$1,180,000 represents the deferred gain under the cost-recovery method.

7. LINE OF CREDIT

In September 1996, the Company entered into a Business Loan Agreement with two banks which provides for a total of \$20.0 million in available borrowings based on eligible receivables and inventory. This agreement replaces the Company's prior line of credit. The agreement is for a revolving line of credit, which is available until May 1, 1997, when the outstanding principal will be payable. The line of credit bears interest, at the option of the Company, at the prime rate, or the London Interbank Offering Rate (LIBOR) plus 250 basis points for receivable advances and at the prime rate plus one percent, or the LIBOR plus 350 basis points for inventory advances. Interest on outstanding Prime Rate Advances is due monthly and interest on LIBOR Advances is due at the end of the Interest Period as elected by the borrower. The Interest Period can be one, three or six months. In the event of default, interest on the outstanding loan increases to 5.00% above the interest rate applicable immediately prior to the default.

As of December 31, 1996, the Company had secured its \$2,000,000 note related to the purchase of Cathode with a stand-by letter of credit under its Business Loan Agreement. No additional amounts were outstanding under the agreement. The Company is required to maintain certain financial ratios and other financial conditions including restrictions on its ability to pay any dividends. Borrowings under the line of credit are secured by substantially all of the Company's assets.

8. COMMITMENTS AND CONTINGENCIES

**Commitments**

The Company leases certain facilities under non-cancelable operating leases that expire at various times up to 1999. The facility leases require the Company to pay for all normal maintenance costs.



# INTEVAC, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

Future minimum rental payments under these leases at December 31, 1996 are as follows (in thousands):

1997.....	\$1,195
1998.....	1,074
1999.....	519

Gross rental expense was approximately \$1,166,000, \$675,000 and \$1,212,000 for the years ended December 31, 1996, 1995, and 1994, respectively. Offsetting rental expense for the periods ending December 31, 1995 and 1994 was sublease income of \$14,000 and \$739,000, respectively.

### Contingencies

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 the Company that it may be liable in connection with contracts for certain products from the Company's discontinued night vision business. 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 financial position or results of operations. However, the Company believes that the ultimate resolution of this matter will not have a material adverse effect on its financial position, results of operations or cash flows.

### 9. EMPLOYEE BENEFIT PLAN

In 1991, the Company established a defined contribution retirement plan with 401(k) plan features. The plan covers all United States employees eighteen years and older. Employees may make contributions by a percentage reduction in their salaries, not to exceed the statutorily prescribed annual limit. The Company made contributions of \$109,000, \$112,000 and \$134,000 for the years ended December 31, 1996, 1995 and 1994, respectively. Administrative expenses relating to the plan are insignificant.

### 10. REDEEMABLE PREFERRED STOCK

On February 15, 1991, Intevac issued 610,000 shares of nonvoting redeemable Series 1 Preferred Stock to Varian. In 1995, the Company redeemed the shares of nonvoting redeemable Series 1 Preferred Stock held by Varian for \$6,100,000 and paid dividends of \$25,000 prior to the redemption.

### 11. SHAREHOLDERS' EQUITY

The Company's Articles of Incorporation authorizes 10,000,000 shares of Preferred Stock. The Board of Directors has the authority to issue the Preferred Stock in one or more series and to fix the price, rights, preferences, privileges and restrictions thereof, including dividend rights, dividend rates, conversion rights, voting rights, terms of redemption, redemption prices, liquidation preferences and the number of shares constituting any series or the designation of such series, without further vote or action by the shareholders.

### Convertible Preferred Stock

In the third quarter of 1995, the Series A convertible preferred shareholders of the Company exchanged all of the outstanding shares of Series A convertible preferred stock of the Company for common stock and cash. Each share of preferred stock was exchanged for two-thirds of a share of common stock and a cash payment of \$0.76 which was based on a valuation from an independent appraiser. As a result of the exchange, 13,020,000 shares of convertible preferred stock were exchanged for 8,680,000 shares of common stock, and the Company's total cash payment was approximately \$9,895,000 to the Series A convertible preferred shareholders. The Series A and B preferred stock were convertible into two-thirds of a share of common stock, at the option of the holder, subject to certain antidilution adjustments.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

**Common Stock Dividend**

In 1995, subsequent to the convertible preferred stock exchange described above, the Company paid a one time dividend of \$0.495 per outstanding share of common stock. The Company paid a cash dividend on 9,929,303 shares of approximately \$4,922,000 to the common shareholders. The Company has no plans to pay dividends in the future.

**Stock Option/Stock Issuance Plans**

The Board of Directors approved the 1991 Stock Option/Stock Issuance Plan (the "1991 Plan") in 1991. The maximum number of shares that may be issued over the term of the 1991 Plan is 2,666,667 shares.

The 1991 Plan is divided into two separate components: the Option Grant Program and the Stock Issuance Program. Under the Option Grant Program, the Company may grant either incentive stock options or nonqualified options or implement stock appreciation rights provisions at the discretion of the Board of Directors. Exercisability, option price, and other terms are determined by the Board of Directors, but the option price shall not be less than 85% and 100% of the fair market value for nonqualified options and incentive stock options, respectively, as determined by the Board of Directors.

In 1995, the Board of Directors approved adoption of (i) the 1995 Stock Option/Stock Issuance Plan under which employees, nonemployee directors, and consultants may be granted stock options to purchase stock or issued shares of stock at not less than 85% of fair market value on the grant/issuance date, and (ii) the 1995 Employee Stock Purchase Plan. The 1995 Stock Option/Stock Issuance Plan is intended to serve as the successor equity incentive program to the Company's 1991 Stock Option/Stock Issuance Plan. 1,882,013 shares of common stock have been authorized for issuance, comprised of the shares which remain available for issuance under the 1991 Stock Option/Stock Issuance Plan, including the shares subject to outstanding options and an additional increase of approximately 515,000 shares. Options granted under the 1995 Stock Option/Stock Issuance Plan are exercisable upon vesting and generally vest over a five-year period. Options currently expire no later than ten years from the date of grant.

Options granted under the 1991 Stock Option/Stock Issuance Plan are immediately exercisable, however, unexercised options and shares purchased upon the exercise of the options are subject to vesting over a five-year period. Shares that are not vested may be repurchased by the Company. Options to purchase 167,438, 129,135 and 578,457 shares were vested at December 31, 1996, 1995 and 1994, respectively. Shares totaling 21,750, 50,667 and 212,043 were subject to repurchase at December 31, 1996, 1995 and 1994, respectively.

The Company has elected to follow APB 25 and related Interpretations in accounting for its employee stock options because, as discussed below, the alternative fair value accounting provided for under SFAS 123, "Accounting for Stock-Based Compensation," requires use of option valuation models that were not developed for use in valuing employee stock options. Under APB 25, because the exercise price of the Company's stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized.

Pro forma information regarding net income and earnings per share is required by SFAS 123, which also requires that the information be determined as if the Company has accounted for its employee stock options granted subsequent to December 31, 1994 under the fair value method of this Statement. The fair value for these options was estimated at the date of grant using a Black-Scholes multiple option pricing model with the following weighted average assumptions: risk-free interest rates ranging from 5.32% to 6.25% and from 5.26% to 6.37% for 1995 and 1996, respectively; a dividend yield of 0.0%, a volatility factor of the expected market price of the Company's common stock of 0.67, and a weighted-average expected life of the option of 0.25 years beyond each respective vesting period. Options granted prior to the Company's Initial Public Offering in November 1995 have a volatility factor of 0.0.

INTEVAC, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

Under the 1995 Employee Stock Purchase Plan, the Company is authorized to issue up to 250,000 shares of common stock to participating employees. Under the terms of the Plan, employees can choose to have up to 10% of their annual base earnings withheld to purchase the Company's common stock. The purchase price of the stock is 85% of the lower of the subscription date fair market value and the purchase date fair market value. Approximately 80% of eligible employees have participated in the Plan in 1995 and 1996. Under the Plan, the Company sold 62,467 shares to employees in 1996. The Company does not recognize compensation cost related to employee purchase rights under the Plan. To comply with the pro forma reporting requirements of SFAS 123, compensation cost is estimated for the fair value of the employees' purchase rights using the Black-Scholes model with the following assumptions for those rights granted in 1995 and 1996: dividend yield of 0.0%; an expected life ranging up to 2.2 years (the offering period ends January 31, 1998 for all subscription periods); expected volatility factor of 0.67; and a risk free interest rate of 5.77%. The weighted average fair value of those purchase rights granted in November 1995, February 1996 and August 1996 were \$3.04, \$3.80 and \$5.57, respectively.

Had compensation cost for the Company's stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS 123, the Company's net income and earnings per share would have been reduced to the pro forma amounts indicated below:

	1996	1995
	-----	-----
	( IN THOUSANDS, EXCEPT PER SHARE DATA )	
Pro forma net income.....	\$3,878	\$6,985
Pro forma earnings per share.....	\$ 0.30	\$ 0.66

Because SFAS 123 is applicable only to options granted subsequent to December 31, 1994, its pro forma effect will not be fully reflected until 1999.

A summary of the Company's stock option activity and related information for the years ended December 31 follows:

	1996		1995		1994	
	-----	-----	-----	-----	-----	-----
	OPTIONS	WEIGHTED-AVERAGE EXERCISE PRICE	OPTIONS	WEIGHTED-AVERAGE EXERCISE PRICE	OPTIONS	WEIGHTED-AVERAGE EXERCISE PRICE
	-----	-----	-----	-----	-----	-----
Outstanding -- beginning						
of year.....	931,637	\$ 4.25	797,144	\$ 0.53	741,151	\$ 0.30
Granted.....	585,000	12.13	707,980	5.28	99,992	2.18
Exercised.....	(138,444)	3.16	(556,822)	0.31	(37,333)	0.36
Forfeited.....	(112,251)	5.43	(16,665)	1.28	(6,666)	0.75
Outstanding -- end of						
year.....	1,265,942	7.91	931,637	4.25	797,144	0.53
Exercisable at end of						
year.....	667,942	\$ 4.40	888,637	\$ 4.16	797,144	\$ 0.53
Weighted-average fair						
value of options						
granted during the						
year.....		\$ 5.87		\$ 1.01		

**INTEVAC, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)**

**OUTSTANDING AND EXERCISABLE BY PRICE RANGE AS OF DECEMBER 31, 1996**

RANGE OF EXERCISE PRICES	OPTIONS OUTSTANDING			OPTIONS EXERCISABLE	
	NUMBER OUTSTANDING AS OF DECEMBER 31, 1996	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER EXERCISABLE AS OF DECEMBER 31, 1996	WEIGHTED AVERAGE EXERCISE PRICE
\$ 0.150 -- \$ 2.175	239,120	7.09	\$ 1.47	239,120	\$ 1.47
\$ 6.000 -- \$ 6.000	441,322	8.62	\$ 6.00	418,822	\$ 6.00
\$ 7.500 -- \$ 7.625	260,000	9.25	\$ 7.62	10,000	\$ 7.50
\$11.000 -- \$16.000	155,500	9.70	\$12.04	--	--
\$17.750 -- \$21.250	170,000	9.42	\$18.58	--	--
\$ 0.150 -- \$21.250	1,265,942	8.70	\$ 7.91	667,942	\$ 4.40

**12. RELATED PARTY TRANSACTIONS**

Kaiser Aerospace & Electronics Corporation ("Kaiser") is a related party resulting from their stock interest in the Company. Kaiser owned approximately 45% and 46% of the outstanding common stock at December 31, 1996 and December 31, 1995, respectively. Varian was a related party until August 1995 when the nonvoting preferred stock was redeemed.

The Company had system and product sales to Varian of \$1,844,000 and \$2,491,000 for the years ended December 31, 1995 and 1994, respectively. The Company paid rent to Varian of approximately \$1,056,000 during the year ended December 31, 1994. No rent was paid to Varian in 1995. At December 31, 1995, \$199,000 was due from Varian. The Company has been a subcontractor to Kaiser on certain government contracts and recognized revenues of approximately \$12,000 and \$406,000 for the years ended December 31, 1995 and 1994, respectively. Gross margins on these contracts for the years ended December 31, 1995 and 1994 were insignificant. In 1995, final settlement was reached on a cost-type contract, which resulted in the Company receiving \$12,000 from Kaiser. The Company has not been a subcontractor to Kaiser during 1996.

Gross margins realized on related party transactions have not been materially different from the gross margins realized on similar types of transactions with unaffiliated customers. Management believes rent paid to Varian was made on terms no more favorable to the Company than could have been obtained from an unaffiliated third party.

**13. INCOME TAXES**

The provision for income taxes attributable to continuing operations consists of the following (in thousands):

	YEARS ENDED DECEMBER 31,		
	1996	1995	1994
Federal:			
Current.....	\$5,761	\$2,853	\$ 76
Deferred.....	(292)	(109)	633
	5,469	2,744	709
State:			
Current.....	1,362	99	--
Deferred.....	(481)	336	117
	881	435	117
Total.....	\$6,350	\$3,179	\$826

**INTEVAC, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)**

The tax benefits associated with exercises of nonqualified stock options and disqualifying dispositions of stock acquired through the incentive stock option and employee stock purchase plans reduce taxes currently payable for 1996 as shown above by \$690,000. Such benefits are credited to shareholders' equity when realized.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets computed in accordance with SFAS 109 are as follows (in thousands):

	DECEMBER 31,	
	1996	1995
Deferred tax assets:		
Discontinued operations reserve.....	\$ 316	\$ 809
Vacation accrual.....	333	264
Warranty reserve.....	1,011	454
Deferred investment gain.....	168	202
Bad debt reserve.....	447	235
Inventory valuation.....	2,110	1,051
Other.....	344	683
	-----	-----
	4,729	3,698
Valuation allowance for deferred tax assets.....	--	(462)
	-----	-----
Total deferred tax assets.....	\$4,729	\$3,236
	-----	-----
Deferred tax liabilities:		
Purchased technology.....	\$ 569	\$ --
Other.....	151	--
	-----	-----
Total deferred tax liabilities.....	\$ 720	\$ --
	-----	-----
Net deferred tax assets.....	\$4,009	\$3,236
	=====	=====

The valuation allowance of \$462,000 at December 31, 1995 relates to certain future state income tax deductions. The valuation allowance for the years ended December 31, 1996 and 1995 decreased by \$462,000 and \$400,000, respectively.

A reconciliation of the income tax provision at the federal statutory rate of 35% in 1996 and 1995 and 34% in 1994 to the income tax provision at the effective tax rate is as follows (in thousands):

	YEARS ENDED DECEMBER 31,		
	1996	1995	1994
Income taxes computed at the federal statutory rate.....	\$3,963	\$3,130	\$850
State taxes (net of federal benefit).....	573	283	90
Acquired in-process research and development.....	2,042	--	--
Foreign Sales Corporation benefit.....	(525)	(140)	--
Tax exempt income.....	(56)	(92)	(125)
Goodwill amortization.....	335	--	--
Research credit.....	--	--	(51)
Other.....	18	(2)	62
	-----	-----	-----
Total.....	\$6,350	\$3,179	\$826
	=====	=====	=====

**INTEVAC, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)**

The Company's effective tax rates for the years ended December 31, 1996, 1995 and 1994 were 56.1%, 35.5% and 33.0%, respectively.

**14. 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 was funded for one-half of the actual costs of the project up to a ceiling of \$5,450,000. At December 31, 1996, the Company had received \$5,450,000 under the contract. Qualifying costs of approximately \$3,283,000, \$1,958,000 and \$3,994,000 for the years ended December 31, 1996, 1995, and 1994, respectively, were incurred on this project, resulting in offsets against research and development costs of approximately \$1,347,000, \$1,130,000 and \$1,997,000 in 1996, 1995 and 1994, respectively.

As of December 31, 1996, all of the \$5,450,000 advance had been applied to qualifying costs. The Company and its Japanese partner are discussing further joint development work on the project. There can be no assurance that the Company and its development partner will reach agreement on further joint funding or cooperation.

Upon completion of the research and development work, if successful, each party will receive certain manufacturing and marketing rights for separate regions of the world. The agreement also calls for certain royalty payments by each party to the other party, based on production and sales. The royalty rate will be 5% for each party.

**15. QUARTERLY CONSOLIDATED RESULTS OF OPERATIONS (UNAUDITED)**

	THREE MONTHS ENDED			
	MARCH 30, 1996	JUNE 29, 1996	SEPTEMBER 28, 1996	DECEMBER 31, 1996
	(IN THOUSANDS, EXCEPT PER SHARE DATA)			
Net sales.....	\$15,126	\$ 20,235	\$24,603	\$ 28,268
Gross profit.....	5,923	8,007	8,560	10,090
Net income (loss).....	1,897	(3,225)	2,799	3,502
Net income (loss) per share.....	\$ 0.15	\$ (0.26)	\$ 0.22	\$ 0.27

	THREE MONTHS ENDED			
	APRIL 1, 1995	JULY 1, 1995	SEPTEMBER 30, 1995	DECEMBER 31, 1995
	(IN THOUSANDS, EXCEPT PER SHARE DATA)			
Net sales.....	\$ 5,369	\$ 11,105	\$12,071	\$ 14,337
Gross profit.....	1,691	3,989	4,369	5,119
Net income.....	1,802	1,637	1,730	1,931
Net income per share.....	\$ 0.18	\$ 0.16	\$ 0.16	\$ 0.17

**16. ACQUISITIONS**

In January, 1996, the Company acquired Cathode for \$1,060,000 cash and notes in the aggregate amount of \$2,000,000, secured by a \$2,000,000 standby letter of credit payable upon default of the note, and acquisitions costs of \$14,000. The notes bear interest at 5.58% compounded monthly and payable quarterly. Principal payments on the note are made quarterly based on unit sales of the Cathode sputter sources. Any remaining balance on the notes on January 24, 2001 is due in full regardless of sputter source sales. Cathode licenses its patented magnetron sputter source technology from Alum Rock Technology, Inc. ("Alum Rock") for a royalty of 2.5% of sales of Cathode sputter sources. As part of the transaction the Company received from

**INTEVAC, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)**

Alum Rock: (1) an exclusive license to use Alum Rock's technology in the disk sputtering business, (2) a non-exclusive license to use Alum Rock's technology in other business, and (3) an option to purchase Alum Rock's patents for \$1,000,000. The Company has also entered into five year non-compete agreements with the principals of Cathode and Alum Rock.

Goodwill of \$2,855,000 related to the Cathode acquisition is being amortized over seven years and \$200,000 assigned to a non-compete agreement will be amortized over 5 years. Accumulated amortization at December 31, 1996 is \$442,000 for these intangible assets.

On May 3, 1996, the Company completed the acquisition of the outstanding stock of SJT. The total purchase price was \$3,700,000 and acquisition costs were \$15,000. Current technology of \$786,000 related to the SJT acquisition is being amortized over 2 years and \$100,000 assigned to a non-compete agreement will be amortized over 5 years. Goodwill of \$375,000 created by the deferred tax liability on the SJT acquisition is being amortized over 2 years. Accumulated amortization at December 31, 1996 is \$400,000 for these intangible assets.

On June 6, 1996, the Company completed the acquisition of the outstanding stock of Lotus. The total purchase price was \$8,320,000 and acquisition costs were \$15,000. Goodwill of \$2,863,000 related to the Lotus acquisition is being amortized over 5 years while \$1,015,000 assigned to current technology and \$136,000 assigned to a non-compete agreement will be amortized over 3 years. Goodwill of \$461,000 created by the deferred tax liability on the Lotus acquisition is being amortized over 3 years. Accumulated amortization at December 31, 1996 is \$648,000 for these intangible assets.

Results for SJT and Lotus are included in the Consolidated Statements of Income beginning in May 1996 and June 1996, respectively. The following unaudited pro forma information assumes the acquisitions occurred at the beginning of each year presented:

	YEARS ENDED DECEMBER 31,	
	1996	1995
	(IN THOUSANDS, EXCEPT PER SHARE DATA)	
Net sales.....	\$91,938	\$48,290
Income from continuing operations.....	10,608	4,656
Net income.....	10,608	5,991
Per share:		
Income from continuing operations.....	\$ 0.82	\$ 0.44
Net income.....	\$ 0.82	\$ 0.56

The pro forma information excludes the \$5.8 million write-off of acquired in process research and development.

**INTEVAC, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)**

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

Not Applicable.

**PART III**

**ITEM 10. DIRECTORS AND OFFICERS OF THE REGISTRANT**

The information required by this item relating to the Company's directors and nominees and disclosure relating to compliance with Section 16 (a) of the Securities Exchange Act of 1934 is included under the captions "Election of Directors" and "Compliance with Section 16(a) of the Securities Exchange Act of 1934" in the Company's Proxy Statement for the 1997 Annual Meeting of Shareholders and is incorporated herein by reference. The information required by this item relating to the Company's executive officers and key employees is included under the caption "Executive Officers and Directors" under Item 4 in

Part I of this Annual Report on Form 10-K.

**ITEM 11. EXECUTIVE COMPENSATION**

The information required by this item is included under the caption "Executive Compensation and Related Information" in the Company's Proxy Statement for the 1997 Annual Meeting of Shareholders and is incorporated herein by reference.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT**

The information required by this item is included under the caption "Ownership of Securities" in the Company's Proxy Statement for the 1997 Annual Meeting of Shareholders and is incorporated herein by reference.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

The information required by this item is included under the caption "Certain Transactions" in the Company's Proxy Statement for the 1997 Annual Meeting of Shareholders and is incorporated herein by reference.

**PART IV**

**ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K**

(a) List of Documents filed as part of this Annual Report on Form 10-K.

1. The following consolidated financial statements of Intevac, Inc. are filed in Part II, Item 8 of this Report on Form 10-K:

**Report of Ernst & Young, LLP, Independent Auditors**

**Consolidated Balance Sheets -- December 31, 1996 and 1995**

Consolidated Statements of Income for the years ended December 31, 1996, 1995 and 1994

Consolidated Statements of Shareholders' Equity for the years ended December 31, 1996, 1995 and 1994

Consolidated Statements of Cash Flows for the years ended December 31, 1996, 1995 and 1994

Notes to Consolidated Financial Statements -- Years Ended December 31, 1996, 1995 and 1994



INTEVAC, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

2. Financial Statement Schedules.

The following financial statement schedule of Intevac, Inc. is filed pursuant to Part IV, Item 14(a) of this Annual Report on Form 10-K:

**Schedule II -- Valuation and Qualifying Accounts**

All other schedules have been omitted since the required information is not present in amounts sufficient to require submission of the schedule or because the information required is included in the consolidated financial statements or notes thereto.

3. Exhibits.

EXHIBIT NUMBER	DESCRIPTION
10.1	Stock Purchase Agreement by and among Lotus Technologies, Inc., Lewis Lipton, Dennis Stork, Steve Romine & Intevac, Inc., dated June 6, 1996
11.1	Computation of Net Income Per Share
21.1	Subsidiaries of the Registrant
23.1	Consent of Ernst & Young LLP, Independent Auditors
24.1	Power of Attorney (see page 46)
27.1	Financial Data Schedule

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(b) Reports on Form 8-K.

No reports on Form 8-K were filed during the last quarter of the fiscal year covered by this Annual Report on Form 10-K.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, on February 6, 1997.

### INTEVAC, INC.

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)

### POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Norman H. Pond and Charles B. Eddy III, and each of them, as his true and lawful attorneys-in-fact and agents, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments (including post-effective amendments) to this Report on Form 10-K, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents, or any of them, or their or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

SIGNATURE	TITLE	DATE
----- /s/ NORMAN H. POND ----- (Norman H. Pond)	Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer)	February 6, 1997
----- /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)	February 6, 1997
----- /s/ JOHN R. DOUGERY ----- (John R. Dougery)	Director	February 6, 1997
----- /s/ EDWARD DURBIN ----- (Edward Durbin)	Director	February 6, 1997
----- /s/ DAVID N. LAMBETH ----- (David N. Lambeth)	Director	February 6, 1997
----- /s/ H. JOSEPH SMEAD ----- (H. Joseph Smead)	Director	February 6, 1997

**SCHEDULE II -- VALUATION AND QUALIFYING ACCOUNTS**

**INTEVAC, INC.**

DESCRIPTION	BALANCE AT BEGINNING OF PERIOD	ADDITIONS		DEDUCTIONS-DESCRIBE	BALANCE AT END OF PERIOD
		CHARGED TO COSTS AND EXPENSES	CHARGED TO OTHER ACCOUNTS-DESCRIBE		
Year ended December 31, 1994:					
Deducted from asset accounts:					
Allowance for doubtful accounts.....	\$ 193,762	\$ 13,689	\$ 0	\$ 101,866	\$ 105,585
Year ended December 31, 1995:					
Deducted from asset accounts:					
Allowance for doubtful accounts.....	\$ 105,585	\$524,953	\$ 0	\$ 169,909(1)	\$ 460,629
Year ended December 31, 1996:					
Deducted from asset accounts:					
Allowance for doubtful accounts.....	\$ 460,629	\$589,712	\$ 0	\$ 25,900	\$1,024,441

(1) Includes \$95,000 transferred to net assets of discontinued operations.

**STOCK PURCHASE AGREEMENT**

**DATED JUNE 6, 1996**

**BY AND AMONG**

**LOTUS TECHNOLOGIES, INC.,**

**LEWIS T. LIPTON, TRUSTEE FOR THE LIPTON SEPARATE PROPERTY TRUST**

**DATED JANUARY 12, 1993,**

**DENNIS C. STARK, STEVEN ROMINE**

**AND**

**INTEVAC, INC.**

# TABLE OF CONTENTS

	Page
1. Purchase and Sale of Stock.....	1
1.1 Purchase and Sale.....	1
1.2 Closing.....	1
2. Representations and Warranties of the Company and the Selling Shareholders.....	1
2.1 Organization, Good Standing and Qualification.....	2
2.2 Capitalization.....	2
2.3 Subsidiaries.....	2
2.4 Authorization.....	2
2.5 Common Stock.....	2
2.6 Governmental Consents.....	3
2.7 Returns.....	3
2.8 Litigation.....	3
2.9 Intellectual Property.....	3
2.10 Proprietary Information and Inventions Agreements....	5
2.11 Compliance With Other Instruments.....	5
2.12 Agreements; Action.....	5
2.13 Disclosure.....	6
2.14 Title to Property and Assets.....	6
2.15 Financial Statements.....	6
2.16 Changes.....	6
2.17 Employee Benefit Plans.....	8
2.18 Taxes.....	8
2.19 Bank Accounts.....	8
2.20 Insurance.....	8
2.21 Minute Books.....	8
2.22 Labor Agreements and Actions.....	8
2.23 Brokers' or Finders' Fees.....	9
2.24 Accounts Receivable.....	9
2.25 Related Party Transactions.....	9
2.26 Manufacturing and Marketing.....	9
2.27 Inventory.....	9
2.28 Customers and Suppliers.....	10
2.29 Employee Matters.....	10
3. Representations and Warranties of the Selling Shareholders....	10
3.1 Authorization.....	10
3.2 Compliance With Other Instruments.....	10
3.3 Governmental Consents.....	11

3.4	Litigation.....	11
3.5	Title to Stock.....	11
3.6	Disclosure.....	11
3.7	Intellectual Property of the Selling Shareholders.....	11
4.	Representations and Warranties of the Purchaser.....	12
4.1	Organization, Good Standing and Qualification.....	12
4.2	Authorization.....	12
4.3	Purchase for Investment.....	12
4.4	Disclosure of Information; Due Diligence.....	12
4.5	Investment Experience; Accredited Investor Status.....	13
4.6	Governmental Consents.....	13
4.7	Insolvency.....	13
5.	Conditions of the Purchaser's Obligations at the Closing.....	13
5.1	Representations and Warranties.....	13
5.2	Performance.....	13
5.3	Compliance Certificate.....	14
5.4	Securities Laws Qualifications.....	14
5.5	Proceedings and Documents.....	14
5.6	Share Certificate.....	15
5.7	Government and Third-Party Consents.....	15
5.8	Company Options.....	15
5.9	Company Warrants.....	15
5.10	Selling Shareholder Non-Competition and Non-Disclosure Agreement.....	14
5.11	Opinion of Company Counsel.....	15
5.12	Opinion of Selling Shareholder Counsel.....	15
6.	Conditions of the Company's and Selling Shareholder's Obligations at Closing.....	15
6.1	Representations and Warranties.....	15
6.2	Performance.....	15
6.3	Compliance Certificate.....	15
6.4	Securities Laws Qualification.....	15
6.5	Proceedings and Documents.....	15
6.6	Government Consents.....	15
6.7	Payment of Purchase Price.....	15
6.8	Payment of Finder's Fee.....	16
6.9	Opinion of Purchaser Counsel.....	16
7.	Indemnification.....	16
7.1	Right to Indemnification.....	16
7.2	Limitation.....	16
7.3	Notification, Etc.....	17

Miscellaneous.....	17
8.1 Survival of Warranties.....	17
8.2 Successors and Assigns.....	17
8.3 Governing Law.....	18
8.4 Counterparts.....	18
8.5 Titles and Subtitles.....	18
8.6 Notices.....	18
8.7 Cost and Expense.....	18
8.8 Amendments and Waivers.....	18
8.9 Severability.....	18
8.10 Entire Agreement.....	18
8.11 California Corporate Securities Law.....	19
8.12 Publicity.....	19
8.13 Expenses; Attorneys' Fees.....	19

SCHEDULES AND EXHIBITS

Schedules:

Schedule A	Schedule of Selling Shareholders
Schedule B	Schedule of Exceptions
Schedule C	Schedule of Material Contracts

Exhibits:

Exhibit A	Selling Shareholder Non-Competition and Non-Disclosure Agreement
Exhibit B	Opinion of Company Counsel
Exhibit C	Opinion of Selling Shareholder Counsel
Exhibit D	Opinion of Purchaser Counsel

## STOCK PURCHASE AGREEMENT

THIS STOCK PURCHASE AGREEMENT (this "Agreement") is made as of June 6, 1996, by and among Lotus Technologies, Inc., a California corporation (the "Company"), Lewis T. Lipton, Trustee for the Lipton Separate Property Trust dated January 12, 1993 ("Mr. Lipton"), Dennis C. Stark, an individual ("Mr. Stark"), Steven Romine, an individual ("Mr. Romine") and Intevac, Inc., a California corporation (the "Purchaser").

### THE PARTIES HEREBY AGREE AS FOLLOWS:

#### 1. Purchase and Sale of Stock.

1.1 Purchase and Sale. Subject to the terms and conditions of this Agreement, at the Closing (as defined below) the Purchaser shall purchase from each of Mr. Lipton, Mr. Stark and Mr. Romine (collectively, the "Selling Shareholders" and each, individually, a "Selling Shareholder") that number of shares of Lotus Technologies, Inc. common stock, without par value (the "Common Stock"), set forth opposite each Selling Shareholder's name on Schedule A hereto for an aggregate price of \$8,025,000 (the "Purchase Price").

1.2 Closing. The purchase and sale of the Common Stock shall take place at the offices of Brobeck, Phleger & Harrison LLP, Two Embarcadero Place, 2200 Geng Road, Palo Alto, California 94303, at 11:00 a.m., on June 6, 1996 or at such other location and time as the Company, the Selling Shareholders and the Purchaser mutually agree upon (which time and place are designated as the "Closing"). At the Closing, each Selling Shareholder shall deliver to the Purchaser a certificate representing the Common Stock that the Purchaser is purchasing from such Selling Shareholder, properly endorsed in blank for transfer and accompanied by a duly executed stock power in proper form, against delivery to such Selling Shareholder by the Purchaser of a check or a bank wire transfer in the amount of the purchase price therefor.

2. Representations and Warranties of the Company and the Selling Shareholders. In this Agreement, any reference to a "Material Adverse Effect" with respect to any entity means any event, change or effect that is materially adverse to the condition (financial or otherwise), properties, assets, liabilities, business, operations, results of operations or prospects of such entity, taken as a whole. Each of the Company and the Selling Shareholders hereby represents and warrants to the Purchaser that, except as set forth on a Schedule of Exceptions attached hereto as Schedule B specifically identifying the relevant Section or subsection hereof:

1.



2.1 Organization, Good Standing and Qualification. The Company is a corporation duly organized, validly existing and in good standing under the laws of the State of California and has all requisite corporate power and authority to carry on its business as now conducted. The Company is duly qualified to transact business and is in good standing in each jurisdiction in which the failure to so qualify would have a Material Adverse Effect on the Company.

2.2 Capitalization.

(a) Common Stock. The authorized capital of the

Company consists of 10,000,000 shares of Common Stock, 3,780,000 shares of which are issued and outstanding.

(b) Rights. There are no outstanding options,

warrants, subscriptions, rights (including conversion or preemptive rights or first refusal rights) or agreements for the purchase or acquisition from the Company, or from any shareholder, of any shares of the Company's capital stock or securities convertible into its capital stock. Neither the Company nor any Selling Shareholder is a party or subject to any agreement or understanding, and there is no agreement or understanding between any persons and/or entities, that affects or relates to the voting or giving of written consents with respect to any security or by a director of the Company.

(c) Holders. All holders of securities of the Company

and all persons who have a right to hold securities of the Company are set forth by name and the type and amount of securities and/or other rights so held in Schedule A.

2.3 Subsidiaries. The Company does not presently own or control, and has never owned or controlled, directly or indirectly, any interest in any other corporation, association, partnership or other business or investment entity.

2.4 Authorization. All corporate action on the part of the Company, its officers, directors and shareholders necessary for the authorization, execution and delivery of this Agreement and the transactions contemplated herein, and the performance of all obligations of the Company hereunder, has been taken or will be taken prior to the Closing. This Agreement has been duly executed and delivered by the Company and constitutes a valid and legally binding obligation of the Company, enforceable in accordance with its terms, subject, as to the enforcement of remedies, to applicable bankruptcy, insolvency, moratorium, reorganization or similar laws affecting creditors' rights generally, to general equitable principles and to limitations on the enforceability of indemnification provisions as applied to certain types of claims arising hereafter, if any, under the federal securities law.

2.5 Common Stock. The outstanding shares of Common Stock are duly and validly authorized and issued, are fully paid and nonassessable, and were issued in compliance with all applicable federal and state securities laws.

2.6 Governmental Consents. No consent, approval, order or authorization of, or registration, qualification, designation, declaration or filing with, any federal, regional, state or local governmental authority on the part of the Company is required in connection with the consummation of the transactions contemplated by this Agreement. Based in part on the representations of the Purchaser in Sections 4.3 and 4.5 of this Agreement, the offer and sale of the Common Stock pursuant to the terms of this Agreement are exempt from the registration requirements of Section 5 of the Securities Act of 1933, as amended (the "Act").

2.7 Returns. The Company has not had any of its products returned by a purchaser or user thereof, other than for minor, nonrecurring warranty problems. The Company is not aware of any pending warranty claims other than those that arise in the ordinary course of business and which will not require a bulk recall or modification of products currently sold to customers.

2.8 Litigation. There are no actions, suits, proceedings and investigations pending or, to the Company's or the Selling Shareholders' knowledge, currently threatened against the Company. There is no action, suit, proceeding, or investigation pending or, to the Company's or the Selling Shareholders' knowledge, currently threatened against the Company which questions the validity of this Agreement or the right of the Company to enter into such Agreement, or to consummate the transactions contemplated hereby, or which might result, either individually or in the aggregate, in a Material Adverse Effect on the Company, or any change in the current equity ownership of the Company. The Company is not a party to or subject to the provisions of any order, writ, injunction, judgment or decree of any court or government agency or instrumentality. There is no legal action, lawsuit, legal proceeding or investigation related to any of the foregoing by the Company currently pending or which the Company intends to initiate.

2.9 Intellectual Property.

(a) The Company owns, or licenses or otherwise possesses legally enforceable rights to use all patents, trademarks, trade names, service marks, copyrights, and any applications therefor, schematics, technology, know-how, trade secrets, inventory, ideas, algorithms, processes, computer software programs or applications (in both source code and object code form), and tangible or intangible proprietary information or material ("Intellectual Property") that are used in the business of the Company as currently conducted, except to the extent that the failure to have such rights have not had and would not reasonably be expected to have a Material Adverse Effect on the Company.

(b) The Schedule of Exceptions lists (i) all patents and patent applications and all registered and unregistered trademarks, trade names, service marks, and copyrights, which the Company considers to be material its business and included in the Intellectual Property, including the jurisdictions in which each such Intellectual Property right has been issued or registered or in which any application for such issuance and registration has been filed, (ii) all material licenses, sublicenses and other agreements as to which the

Company is a party and pursuant to which any person is authorized to use any Intellectual Property, and (iii) all material licenses, sublicenses and other agreements as to which the Company is a party and pursuant to which the Company is authorized to use any third party patents, trademarks or registered copyrights, including software ("Third Party Intellectual Property Rights") which are incorporated in, are, or form a part of any Company product that is material to its business.

(c) To the best of the Company's knowledge, there is no material unauthorized use, disclosure, infringement or misappropriation of any Intellectual Property rights of the Company, any trade secret material to the Company, or any Intellectual Property right of any third party to the extent licensed by or through the Company, by any third party, including any employee or former employee of the Company. The Company has not entered into any agreement to indemnify any other person against any charge of infringement of any Intellectual Property, other than indemnification provisions contained in purchase orders arising in the ordinary course of business.

(d) The Company is not, nor will it as a result of the execution and delivery of this Agreement or the performance of its obligations under this Agreement, be in breach of any license, sublicense or other agreement relating to the Intellectual Property or Third Party Intellectual Property Rights, the breach of which would have a Material Adverse Effect on the Company.

(e) All patents and registered trademarks, service marks and copyrights held by the Company and listed on the Schedule of Exceptions are valid and existing. The Company (i) has not been sued in any suit, action or proceeding which involves a claim of infringement of any patents, trademarks, service marks, copyrights or violation of any trade secret or other proprietary right of any third party and (ii) has not brought any action, suit or proceeding for infringement of Intellectual Property or breach of any license or agreement involving Intellectual Property against any third party. To the best of the Company's knowledge, the manufacture, marketing, licensing or sale of the Company 's products does not infringe any patent, trademark, service mark, copyright, trade secret or other proprietary right of any third party, except where such infringement would not have a Material Adverse Effect on the Company.

(f) The Company has secured valid written assignments from all consultants and employees who contributed to the creation or development of Intellectual Property of the rights to such contributions that the Company does not already own by operation of law.

(g) The Company has taken reasonable and appropriate steps to protect and preserve the confidentiality of all Intellectual Property not otherwise protected by patents or copyright ("Confidential Information"). All use,

disclosure or appropriation of Confidential Information owned by the Company by or to a third party has been pursuant to the terms of a written agreement between the Company and such third party. All use, disclosure or appropriation of Confidential Information not owned by the Company has been pursuant to the terms of a written agreement between the Company and the owner of such Confidential Information, or is otherwise lawful.

2.10 Proprietary Information and Inventions Agreements. Each employee, officer, director and consultant of the Company has executed a non-disclosure agreement in the form provided to counsel to the Purchaser. The Company is not aware that any of such employees, officers, directors or consultants are in material violation thereof, and the Company will use its best efforts to prevent any such violation.

2.11 Compliance With Other Instruments. The Company is not in violation of any provision of its Articles of Incorporation or Bylaws or in violation or default of any provision of any instrument, judgment, order, writ, decree or contract to which it is a party or by which it is bound or any provision of any federal or state statute, rule or regulation applicable to the Company, which violation or default would have a Material Adverse Effect on the Company. The execution, delivery and performance of this Agreement and the consummation of the transactions contemplated hereby will not result in any such violation or default or require any consent under or be in conflict with or constitute, with or without the passage of time and giving of notice, either a violation or default under any such provision, instrument, judgment, order, writ, decree or contract, or an event which results in the creation of any lien, charge or encumbrance upon any assets of the Company where any such event would have a Material Adverse Effect on the Company.

2.12 Agreements; Action.

(a) Any agreements, understandings, instruments, contracts or proposed transactions to which the Company is a party or by which it is bound which involve obligations of or payments to the Company in excess of \$5,000 are listed on Schedule C hereto.

(b) No defaults exist with respect to the Company (or, to the Company's knowledge, any other party) under any contract or agreement to which the Company is a party that would have a Material Adverse Effect on the Company, either individually or in the aggregate.

(c) Since May 17, 1996, dividends and distributions made by the Company to its shareholders and bonuses paid by the Company to its employees have not exceeded, in the aggregate \$350,000.

(d) The Company has no obligation and is not a party to a contract, oral or written, which would result in the payment of a bonus to any employee or shareholder subsequent to the date hereof.

2.13 Disclosure. The Company has fully provided the Purchaser and the Purchaser's legal counsel with all the information in the Company's possession that the Purchaser has requested in determining whether to purchase the Common Stock offered by the Selling Shareholders. Neither Section 2 of this Agreement nor any schedule or exhibit attached to this Agreement nor any certificate delivered pursuant hereto that, in any such case, has been or will be provided by or on behalf of the Company contains any untrue statement of a material fact or omits to state a material fact necessary to make the statements made herein or therein not misleading in light of the circumstances under which they were made.

2.14 Title to Property and Assets. The Company owns its property and assets free and clear of all mortgages, liens, loans and encumbrances, except such encumbrances and liens which arise in the ordinary course of business and do not materially impair the Company's ownership or use of such property or assets. With respect to the property and assets it leases, the Company is in compliance with such leases in all material respects and holds a valid leasehold interest free of any material liens, claims or encumbrances. The property and assets of the Company that are used in the operation of its business are in good operating condition and repair.

2.15 Financial Statements. The Company has delivered to Purchaser its audited financial statements for the fiscal year ended January 31, 1996, and its unaudited financial statements (balance sheet, statement of operations and statement of cash flows) at, and for the two-month period ended March 31, 1996 (collectively, the "Financial Statements"). The Financial Statements have been prepared in accordance with generally accepted accounting principles (except that the unaudited financial statements do not have notes thereto) applied on a consistent basis throughout the periods indicated and with each other. The Financial Statements are complete and correct in all material respects and accurately set out and describe the financial condition and operating results of the Company as of the dates, and for the periods, indicated therein, subject to normal year-end audit adjustments. The Company's net book value (total assets minus total liabilities) as of the date hereof is not less than \$0.

2.16 Changes. Since March 31, 1996, except as permitted by Section 2.12(c), there has not been:

(a) any change in the financial condition or operating results of the Company from that reflected in the Financial Statements, except changes in the ordinary course of business which have not been, in the aggregate, materially adverse;

(b) any damage, destruction or loss, whether or not covered by insurance, which would have a Material Adverse Effect on the Company (as its business is currently conducted);

(c) any sale, exchange, or other disposition of the Company's assets or rights, other than in the ordinary course of business, or any waiver by the Company of a valuable right or of a material debt owed to it, or any material change or amendment to or default under a material contract or arrangement by which the Company or any of its assets or properties is bound or subject;

(d) any declaration, authorization or payment of any dividend or other distribution of the assets of the Company, or any agreement to declare, authorize or pay any such dividend or distribution;

(e) any satisfaction or discharge of any lien, claim or encumbrance or payment of any obligation by the Company, except in the ordinary course of business and which is not material to the assets, properties, financial condition, operating results or business of the Company;

(f) any commitments entered into by the Company involving capital expenditures in excess of \$5,000, or any debt obligation or liability (whether absolute or contingent), incurred by the Company in excess of \$5,000 or that would be required under generally accepted accounting principles to be reflected in the Company's financial statements (whether or not presently outstanding) except current liabilities incurred, and obligations under agreements entered into, in the ordinary course of business;

(g) any increase in the compensation or rate of compensation or commissions payable or to become payable by the Company to any of its directors or officers, or any payment of any bonus, profit-sharing amount or other extraordinary compensation to any such person or any change in any then existing bonus, profit-sharing, retirement or other similar plan, agreement or arrangement or any adoption of or entry into any new bonus, profit-sharing, group life or health insurance, or other similar plan, agreement or arrangement;

(h) any loans made by the Company to any of the Company's directors, officers or employees, or any of their affiliates, other than travel advances made in the ordinary course of business;

(i) to the Company's and the Selling Shareholders' knowledge, any other event or condition internal to the Company (e.g., other than external events or conditions, including without limitation, market conditions and trends, competitive product announcements, etc.) of any character which might have a Material Adverse Effect on the Company (as its business is currently conducted);

(j) any material increase in the returns or rates of returns by consumers or distributors of any products of the Company, any termination or failure to renew by a distributor of any material contract or arrangement for the sale or distribution of

the Company's products or any material and adverse change in the terms of any such contracts or arrangements; or

(k) any termination or failure to renew by a supplier of any material contract or arrangement for the sale or supply of parts necessary for the manufacture of the Company's products or any material and adverse change in the terms of any such contract.

2.17 Employee Benefit Plans. The Company does not have any Employee Benefit Plan as defined in the Employee Retirement Income Security Act of 1974, as amended.

2.18 Taxes. The Company has filed all income tax returns (federal, state, foreign and local) required to be filed by it, and all income taxes shown to be due and payable on such returns or on any assessments received by the Company and all other taxes (federal, state, foreign and local) due and payable by the Company on or before the date hereof have been paid. The income tax returns filed by the Company are true and correct in all material respects. There are no agreements, waivers or other arrangements providing for an extension of time with respect to the assessment of any tax or deficiency against the Company, nor are there any actions, suits, proceedings, investigations or claims now pending against the Company in respect of any tax or assessment, or, to the Company's knowledge, any matters under discussion with any federal, state, foreign or local authority relating to any taxes or assessments, or any claims for additional taxes or assessments asserted by any such authority. The provisions made for income taxes on the Financial Statements are expected to be sufficient for the payment of all unpaid federal, state, foreign and local income taxes of the Company for all periods prior to such date.

2.19 Bank Accounts. The Schedule of Exceptions sets forth the names and locations of all banks, trust companies, savings and loan associations and other financial institutions at which the Company maintains accounts of any nature and the names of all persons authorized to draw thereon or make withdrawals therefrom.

2.20 Insurance. The Company has in full force and effect fire and casualty insurance policies as listed in the Schedule of Exceptions. The Company has in full force and effect products liability and errors and omissions insurance in amounts set forth in the Schedule of Exceptions.

2.21 Minute Books. The minute books of the Company contain a record of all meetings of directors and shareholders since the time of incorporation and reflect all material transactions referred to in such minutes accurately in all material respects.

2.22 Labor Agreements and Actions. The Company is not bound by or subject to any written or oral, express or implied, contract, commitment or arrangement with any labor union, and no labor union has requested or has sought to represent any of the employees, representatives or agents of the Company.

2.23 Brokers' or Finders' Fees. The Company has not incurred and will not incur, directly or indirectly, any liability for brokers' or finders' fees, agents' commissions or other similar charges in connection with this Agreement or the transactions contemplated hereby other than the fee to be paid by the Purchaser to Broadview Associates, L.P. ("Broadview") in connection with the transactions contemplated by this Agreement.

2.24 Accounts Receivable. Subject to any reserves set forth in the Financial Statements, the accounts receivable shown on the Financial Statements represent and will represent bona fide claims against debtors for sales and other charges, and are not subject to discount except for normal cash and immaterial trade discounts. The amount carried for doubtful accounts and allowances disclosed in the Financial Statements is sufficient to provide for any losses which may be sustained on realization of the receivables.

2.25 Related Party Transactions. No employee, officer or director of the Company or member of his or her immediate family is indebted to the Company, nor is the Company indebted (or committed to make loans or extend or guarantee credit) to any of such persons. None of such persons has any direct or indirect ownership interest in any firm or corporation with which the Company is affiliated or with which the Company has a business relationship, or any firm or corporation that competes with the Company, except that the employees, officers or directors of the Company and members of their immediate families may own stock in publicly traded companies that may compete with the Company. No member of the immediate family of any officer or director of the Company is directly interested in any material contract with the Company.

2.26 Manufacturing and Marketing. The Company has not granted rights to manufacture, produce, assemble, license, market or to sell its products to any other person and is not bound by any agreement that affects the Company's exclusive right to develop, manufacture, assemble, distribute, market or sell its products.

2.27 Inventory. The inventories shown on the Financial Statements or thereafter acquired by the Company consisted of items of a quantity and quality usable or salable in the ordinary course of business. Since March 31, 1996, the Company has continued to replenish inventories in a normal and customary manner consistent with past practices. The Company has not received written or oral notice that it will experience in the foreseeable future any difficulty in obtaining, in the desired quantity and quality and at a reasonable price and upon reasonable terms and conditions, the raw materials, supplies or component products required for the manufacture, assembly or production of its products. The values at which inventories are carried reflect the inventory valuation policy of the Company, which is consistent with its past practice and in accordance with generally accepted accounting principles applied on a consistent basis. Since March 31, 1996, due provision was made on the books of the Company in the ordinary course of business consistent with past practices to provide for all slow-moving, obsolete, or unusable inventories to their estimated useful or scrap values and such inventory reserves are adequate to provide for such slow-moving, obsolete or unusable inventory and inventory shrinkage.



2.28 Customers and Suppliers. As of the date hereof, no customer which individually accounted for more than 5% of the Company's gross revenues during the 12 month period preceding the date hereof, and no supplier of the Company, has canceled or otherwise terminated, or made any written threat to the Company to cancel or otherwise terminate its relationship with the Company, or has at any time on or after March 31, 1996 decreased materially its services or supplies to the Company in the case of any such supplier, or its usage of the services or products of the Company in the case of such customer, and to the Company's knowledge, no such supplier or customer intends to cancel or otherwise terminate its relationship with the Company or to decrease materially its services or supplies to the Company or its usage of the services or products of the Company, as the case may be. The Company has not engaged in any fraudulent conduct with respect to any customer or supplier of the Company.

2.29 Employee Matters. There are no claims pending, or to the Company's or Selling Shareholder's knowledge, currently threatened, resulting from the Company's violation of any employment, labor or wage laws. All payments due from the Company on account of employee health and welfare insurance have been paid and all severance, sick or vacation payments by the Company which are or were due under the terms of any agreement or otherwise have been paid. All employees of the Company have been hired on an "at will" basis.

3. Representations and Warranties of the Selling Shareholders. Each of the Selling Shareholders hereby represents and warrants to the Purchaser for himself and not for the other Selling Shareholders, that:

3.1 Authorization. All acts and conditions required by law on the part of the Selling Shareholder to authorize the execution and delivery of this Agreement by such Selling Shareholder and the transactions contemplated herein and the performance of all obligations of such Selling Shareholder hereunder have been duly performed and obtained, and this Agreement constitutes a valid and legally binding obligation of the Selling Shareholder, enforceable in accordance with its terms, subject, as to the enforcement of remedies, to applicable bankruptcy, insolvency, moratorium, reorganization or similar laws affecting creditors' rights generally, to general equitable principles and to limitations on the enforceability of indemnification provisions as applied to certain types of claims arising hereafter, if any, under the federal securities laws.

3.2 Compliance With Other Instruments. The execution, delivery and performance of this Agreement and the consummation of the transactions contemplated hereby will not result in any violation or default of any provision of any instrument, judgment, order, writ, decree or contract to which such Selling Shareholder is a party or by which he or she is bound, or require any consent under or be in conflict with or constitute, with or without the passage of time and giving of notice, either a violation or default under any such provision.

3.3 Governmental Consents. No consent, approval, order or authorization of, or registration, qualification, designation, declaration or filing with, any federal, regional, state or local governmental authority of the United States on the part of such Selling Shareholder is required in connection with the consummation of the transactions contemplated by this Agreement, except for filings, if any, required pursuant to applicable federal and state securities laws, which filings will be made within the required statutory period.

3.4 Litigation. There is no action, suit, proceeding, or investigation pending or, to such Selling Shareholders' knowledge, currently threatened against such Selling Shareholder which questions the validity of this Agreement or the right of such Selling Shareholder to enter into this Agreement or to consummate the transactions contemplated hereby.

3.5 Title to Stock. Such Selling Shareholder has good title to the Common Stock to be transferred by such Selling Shareholder to the Purchaser under this Agreement, free and clear of any lien, pledge, security interest or other encumbrance (other than restrictions on transfer arising under applicable securities laws) and, upon delivery of the shares of Common Stock at the Closing as provided for in this Agreement, and assuming the Purchaser is acquiring the Common Stock in good faith and without notice of any adverse claim, the Purchaser will acquire good title thereto, free and clear of any lien, pledge, security interest or encumbrance (other than restrictions on transfer arising under applicable securities laws).

3.6 Disclosure. Such Selling Shareholder has fully provided the Purchaser and the Purchaser's legal counsel with all the information in such Selling Shareholders' possession that the Purchaser has requested in determining whether to purchase the Common Stock offered by such Selling Shareholder. Neither Section 3 of this Agreement nor any schedule or exhibit attached to this Agreement nor any certificate delivered pursuant hereto that, in any such case, has been or will be provided by or on behalf of such Selling Shareholder contains any untrue statement of a material fact or omits to state a material fact necessary to make the statements made herein or therein not misleading in light of the circumstances under which they were made.

3.7 Intellectual Property of the Selling Shareholders. Each of the Selling Shareholders individually represents and warrants to the Purchaser as follows:

(a) The conduct of the Company's business as now conducted and as now proposed to be conducted does not violate, conflict with or infringe any Intellectual Property of the Selling Shareholder or any affiliate of the Selling Shareholder.

(b) The Selling Shareholder does not now conduct any business that violates, conflicts with or infringes any Intellectual Property of the Company and does not now propose to conduct any such business, directly or through an affiliate.

(c) Neither the Selling Shareholder nor any affiliate of the Selling Shareholder (other than the Company) is a party to or otherwise bound by any option, license or agreement of any kind (whether formal or informal) to which the Company is a party or by which the Company is bound, which, in any such case (i) conflicts with the Company's representation in Section 2.9 hereof or (ii) would give the Selling Shareholder any continuing interest in, or would give the Company any continuing payment obligation to the Selling Shareholder with respect to, any Intellectual Property formerly owned by the Selling Shareholder and currently used by the Company.

(d) The non-disclosure agreement between the Selling Shareholder and the Company is in full force and effect, has not been amended or modified in any respect and no provision of such agreement has been waived.

4. Representations and Warranties of the Purchaser. The Purchaser hereby represents and warrants to the Company and the Selling Shareholders that:

4.1 Organization, Good Standing and Qualification. The Purchaser is a corporation duly organized, validly existing and in good standing under the laws of the State of California and has all requisite corporate power and authority to carry on its business as now conducted. The Purchaser is duly qualified to transact business and is in good standing in each jurisdiction in which the failure to so qualify would have a Material Adverse Effect on the Purchaser.

4.2 Authorization. All corporate action on the part of the Purchaser, its officers, directors and shareholders necessary for the authorization, execution and delivery of this Agreement and the transactions contemplated herein, and the performance of all obligations of the Purchaser hereunder, has been taken or will be taken prior to the Closing. This Agreement has been duly executed and delivered by the Purchaser and constitutes a valid and legally binding obligation of the Purchaser, enforceable in accordance with its terms, subject, as to the enforcement of remedies, to applicable bankruptcy, insolvency, moratorium, reorganization or similar laws affecting creditors' rights generally, to general equitable principles and to limitations on the enforceability of indemnification provisions as applied to certain types of claims arising hereafter, if any, under the federal securities law.

4.3 Purchase for Investment. This Agreement is made with the Purchaser in reliance upon the Purchaser's representation which, by the Purchaser's execution of this Agreement, the Purchaser hereby confirms, that the Common Stock to be received by the Purchaser will be acquired for investment and not with a view to the distribution of any part thereof, and that the Purchaser has no present intention of selling, granting any participation in, or otherwise distributing the same in a manner contrary to the Act or applicable state securities laws.

4.4 Disclosure of Information; Due Diligence. The Purchaser represents that it has made an independent investigation and has had an opportunity to ask questions of

and receive answers from the Company and the Selling Shareholders regarding the Company and the terms and conditions of the offering of the Common Stock offered hereby and to obtain additional information necessary to verify the accuracy of the information supplied or to which it had access. The foregoing, however, does not limit or modify the representations and warranties of the Company or the Selling Shareholders contained herein.

4.5 Investment Experience; Accredited Investor Status. The Purchaser is able to fend for itself in the transactions contemplated by this Agreement, can bear the economic risk of its investment (including possible complete loss of such investment) for an indefinite period of time and has such knowledge and experience in financial or business matters that it is capable of evaluating the merits and risks of the investment in the Common Stock. The Purchaser represents it has not been organized for the purpose of acquiring the Common Stock. The Purchaser understands that the Common Stock has not been registered under the Act, or under the securities laws of any jurisdiction by reason of reliance upon certain exemptions, and that the reliance of the Company and the Selling Shareholders on such exemptions is predicated upon the accuracy of the Purchaser's representations and warranties in this Section 4. The Purchaser is an "accredited investor" as defined in Rule 501(a) of Regulation D. The Purchaser acknowledges that the certificates representing the stock to be received by Purchaser will bear legends repeating the restrictions on resale contained in applicable securities laws.

4.6 Governmental Consents. No consent, approval, order or authorization of, or registration, qualification, designation, declaration or filing with, any federal, regional, state or local governmental authority on the part of the Purchaser is required in connection with the consummation of the transactions contemplated by this Agreement.

4.7 Insolvency. The consummation of the transactions contemplated by this Agreement will not render the Purchaser insolvent or bankrupt under any federal or state insolvency or bankruptcy law.

5. Conditions of the Purchaser's Obligations at the Closing. The obligations of the Purchaser under Section 1.1 of this Agreement are subject to the fulfillment at or before the Closing of each of the following conditions, unless waived by the Purchaser.

5.1 Representations and Warranties. The representations and warranties of (i) the Company and the Selling Shareholders contained in Section 2 hereof and (ii) each of the Selling Shareholders contained in Section 3 hereof, shall be true and correct on and as of the Closing with the same effect as though such representations and warranties had been made as of the date of the Closing.

5.2 Performance. The Company and the Selling Shareholders shall have performed and complied with all agreements, obligations and conditions contained in this

Agreement that are required to be performed or complied with by them on or before the Closing.

5.3 Compliance Certificate. The President of the Company shall have delivered to the Purchaser at the Closing a certificate certifying that the conditions specified in Sections 5.1 and 5.2, as those conditions relate to the Company, have been fulfilled and stating that there has been no material adverse change in the assets, condition, prospects or business of the Company, financial or otherwise, since March 31, 1996. Each of the Selling Shareholders shall have delivered to the Purchaser at the Closing a certificate certifying that the conditions specified in Sections 5.1 and 5.2, as those conditions relate to the Selling Shareholders, respectively, have been fulfilled.

5.4 Securities Laws Qualifications. The offer and sale of the Common Stock to the Purchaser pursuant to this Agreement shall be registered or qualified or exempt from registration or qualification under all applicable securities laws.

5.5 Proceedings and Documents. All corporate and other proceedings of the Company in connection with the transactions contemplated at the Closing and all documents incident thereto, shall be reasonably satisfactory in form and substance to the Purchaser's counsel, and the Purchaser and its counsel shall have received all such counterpart original and certified or other copies of such documents as they may reasonably request.

5.6 Share Certificates. The Selling Shareholders shall have delivered to the Purchaser share certificates representing the shares of Common Stock to be purchased hereunder by the Purchaser, properly endorsed in blank for transfer and accompanied by a duly executed stock power in proper form.

5.7 Government and Third-Party Consents. The Company shall deliver to the Purchaser at or prior to the Closing all government and third-party consents, releases, authorizations and approvals necessary for the consummation of the transactions contemplated by this Agreement.

5.8 Company Options. As of the date of the Closing, there will not be outstanding any options to purchase shares of the Company's stock.

5.9 Company Warrants. As of the date of the Closing, there will not be outstanding any warrants to purchase shares of the Company's stock.

5.10 Selling Shareholder Non-Competition and Non-Disclosure Agreement. Mr. Lipton, Mr. Stark and Mr. Romine shall have entered into a non-competition and non-disclosure agreement with Purchaser in the form attached hereto as of Exhibit A.

5.11 Opinion of Company Counsel. The Purchaser shall have received from Graham & James LLP, counsel for the Company, an opinion, dated as of the date of the Closing, substantially in the form attached hereto as Exhibit B.

5.12 Opinion of Selling Shareholder Counsel. The Purchaser shall have received from Graham & James LLP, counsel to the Selling Shareholders, an opinion, dated as of the date of the Closing, substantially in the form attached hereto as Exhibit C.

6. Conditions of the Company's and Selling Shareholder's Obligations at Closing. The obligations of the Company and the Selling Shareholders under this Agreement are subject to the fulfillment on or before the Closing of each of the following conditions:

6.1 Representations and Warranties. The representations and warranties of the Purchaser contained in Section 4 hereof, shall be true and correct on and as of the Closing with the same effect as though such representations and warranties had been made as of the date of the Closing.

6.2 Performance. The Purchaser shall have performed and complied with all agreements, obligations and conditions contained in this Agreement that are required to be performed or complied with by it on or before the Closing.

6.3 Compliance Certificate. The President or Chief Financial Officer of the Purchaser shall have delivered to the Company at the Closing a certificate stating that the conditions specified in Sections 6.1 and 6.2 have been fulfilled.

6.4 Securities Laws Qualification. The offer and sale to the Purchaser of the Common Stock shall be registered, qualified or exempt from registration or qualification under all applicable securities laws.

6.5 Proceedings and Documents. All corporate and other proceedings of the Purchaser in connection with the transactions contemplated at the Closing and all documents incident thereto, shall be reasonably satisfactory in form and substance to the Company's and Selling Shareholders' counsel, and the Company, the Selling Shareholders and their counsel shall have received all such counterpart original and certified or other copies of such documents as they may reasonably request.

6.6 Government Consents. The Purchaser shall deliver to the Company and the Selling Shareholders at or prior to the Closing all government consents, releases, authorizations and approvals necessary for the consummation of the transactions contemplated by this Agreement.

6.7 Payment of Purchase Price. The Purchaser shall have delivered to each Selling Shareholder the purchase price with respect to the Common Stock to be purchased

from such Selling Shareholder in the form of a check or bank wire transfer of immediately available funds.

6.8 Payment of Finder's Fee. As soon as practicable following the Closing, Purchaser shall pay to Broadview a finder's fee of \$295,000 in connection with the transactions contemplated pursuant to this Agreement.

6.9 Opinion of Purchaser Counsel. The Company and the Selling Shareholders shall have received from Brobeck, Phleger & Harrison LLP, counsel to the Purchaser, an opinion dated as of the Closing, substantially in the form attached hereto as Exhibit D.

## 7. Indemnification.

7.1 Right to Indemnification. Each of the Selling Shareholders, jointly and severally, agrees to indemnify and hold harmless the Purchaser (for purposes of Sections 7.1, 7.2 and 7.3 hereof, the "Indemnified Party") from the date of the Closing until the date three (3) months after the date of the Closing and each of the Selling Shareholders, severally, agrees to indemnify and hold harmless the Indemnified Party from the date three (3) months after the date of the Closing until the first anniversary of the date of the Closing from and against and shall reimburse the Indemnified Party against and in respect of any and all losses, claims, damages, costs, expenses, obligations, liabilities, remedies or penalties (collectively, "Losses") that the Indemnified Party shall suffer or incur relating to, arising out of or in connection with any breach or inaccuracy of the representations and warranties made by the Company and Selling Shareholders in Sections 2 and 3 of this Agreement; including any expenses reasonably incurred by the Indemnified Party in connection with defending any such action or claim (including, without limitation, reasonable fees and disbursements of counsel) in litigation to which the Indemnified Party is a party. With respect to the foregoing, the Selling Shareholders will not, however, be responsible for any Losses that are finally judicially determined to have resulted from the bad faith or gross negligence of the Indemnified Party.

7.2 Limitation. The liability of each Selling Shareholder under this Section 7 and for any other Losses relating to, arising out of or in connection with this Agreement or other transactions contemplated hereby shall be limited to the Purchase Price set forth opposite each Selling Shareholder's name on Schedule A hereto and no claim for indemnification hereunder shall be asserted until Losses exceed \$100,000 in the aggregate and such Losses exceed \$100,000, a claim by the Indemnified Party may be made for all additional Losses above \$100,000. A written notice specifying the specific basis for such claim must be delivered to the Selling Shareholders before the first anniversary of the date of the Closing. Section 7 is the exclusive remedy of the Purchaser with respect to any Losses incurred as a result of the matters specified in Section 7.1, provided, however, nothing in this Section 7 shall limit, in any manner, any remedy at law or in equity to which the

Purchaser shall be entitled against the Selling Shareholders as a result of wilful fraud or intentional misrepresentation by any Selling Shareholders.

In any case in which claims have been asserted as and when required hereunder, the Selling Shareholders and the Indemnified Party agree that the indemnity obligations of the Selling Shareholders with respect to such matters shall continue in full force and effect until such matters have been settled by agreement of the Selling Shareholders and the Indemnified Party.

7.3 Notification, Etc. In case any proceeding (including any governmental investigation) shall be instituted involving the Indemnified Party, the Indemnified Party shall promptly notify the Selling Shareholders in writing and the Selling Shareholders, upon request of the Indemnified Party, shall retain counsel reasonably satisfactory to the Indemnified Party to represent the Indemnified Party and any others the Selling Shareholders may designate in such proceeding and the fees and disbursements of such counsel related to such proceeding shall be paid by the Selling Shareholders which shall thereupon reduce the obligations of the Selling Shareholders in Section 7.2 hereof. In any such proceeding, the Indemnified Party shall have the right to retain its own counsel, but the fees and expenses of such counsel shall be at the expense of the Indemnified Party. It is understood that the Selling Shareholders shall not, in connection with any proceeding or related proceedings in the same jurisdiction, be liable for the reasonable fees and expenses of more than one separate firm (in addition to any local counsel) for the Indemnified Party. The Selling Shareholders shall not be liable for any settlement of any proceeding effected without the written consent of all of them, but if settled with such consent or if there be a final judgment for the plaintiff, the Selling Shareholders agree to indemnify the Indemnified Party from and against any loss or liability by reason of such settlement or judgment. The rights of the Indemnified Party to indemnification under this Section 7 are exclusive; provided, however, that any rights or remedies asserted against the Selling Shareholder shall be subject to the limitation set forth in Section 7.2 hereof.

## 8. Miscellaneous.

8.1 Survival of Warranties. The warranties, representations and covenants contained in or made pursuant to this Agreement shall survive the execution and delivery of this Agreement and the Closing until the first anniversary of the date of the Closing, notwithstanding any investigation by the Purchaser.

8.2 Successors and Assigns. The terms and conditions of this Agreement shall inure to the benefit of and be binding upon the respective successors and assigns of the parties. Nothing in this Agreement, express or implied, is intended to confer upon any party other than the parties hereto or their respective successors and assigns any rights, remedies, obligations or liabilities under or by reason of this Agreement, except as expressly provided in this Agreement.



8.3 Governing Law. This Agreement shall be governed by and construed under the laws of the State of California as applied to agreements among California residents entered into and to be performed entirely within the State of California.

8.4 Counterparts. This Agreement may be executed in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

8.5 Titles and Subtitles. The titles and subtitles used in this Agreement are used for convenience only and are not to be considered in construing or interpreting this Agreement.

8.6 Notices. Unless otherwise provided, any notice required or permitted under this Agreement shall be given in writing and shall be deemed effectively given upon (i) personal delivery to the party to be notified, or (ii) upon deposit with the United States Post Office, postage prepaid, registered or certified with return receipt requested and addressed to the party to be notified at the address indicated for such party on the signature page hereof, or (iii) upon confirmation of facsimile transmission at the facsimile number indicated for such party on the signature page hereof, or (iv) at such other address as such party may designate by 10 days' advance written notice to the other parties given in the foregoing manner.

8.7 Cost and Expense. Each of the Purchaser, Company and Selling Shareholders will be responsible for its own costs and expenses in connection with the negotiation and consummation of the transactions contemplated hereby. All legal expenses of the Company in excess of \$15,000 related to the transactions contemplated pursuant to this Agreement will be the responsibility of the Selling Shareholders.

8.8 Amendments and Waivers. After the Closing, any term of this Agreement may be amended and the observance of any term may be waived (either generally or in a particular instance and either retroactively or prospectively) only with the written consent of a majority in interest of the Selling Shareholders and the Purchaser, provided that no such amendment would affect any Shareholder in a manner different than the other Shareholders will be treated.

8.9 Severability. If one or more provisions of this Agreement are held to be unenforceable under applicable law, such provision shall be excluded from this Agreement, and the balance of this Agreement shall be interpreted as if such provision were so excluded and shall be enforceable in accordance with its terms.

8.10 Entire Agreement. This Agreement and the other documents delivered at the Closing constitute the full and entire understanding and agreement between the parties with respect to the subject matter hereof and supersede all prior agreements with respect to

the subject matter hereof, including without limitation the letter of intent dated May 16, 1996 among the Purchaser, the Company and the Selling Shareholders.

8.11 California Corporate Securities Law. THE SALE OF THE SECURITIES THAT IS THE SUBJECT OF THIS AGREEMENT HAS NOT BEEN QUALIFIED WITH THE COMMISSIONER OF CORPORATIONS OF THE STATE OF CALIFORNIA, AND IN THE ABSENCE OF AN EXEMPTION FROM SUCH QUALIFICATION REQUIREMENT, THE SALE OF SUCH SECURITIES OR THE PAYMENT OF ANY PART OF THE CONSIDERATION FOR SUCH SECURITIES PRIOR TO SUCH QUALIFICATION IS UNLAWFUL. THE RIGHTS OF ALL PARTIES TO THIS AGREEMENT ARE EXPRESSLY CONDITIONED UPON SUCH EXEMPTION BEING APPLICABLE.

8.12 Publicity. Purchaser and the Company will not make any press release or other public announcement concerning this Agreement or the transactions contemplated hereby except with the prior approval of the other, except for such disclosures as may be required by applicable law or securities exchange rules and regulations. A Selling Shareholder will not make any press release or other public announcement concerning this Agreement or the transactions contemplated hereby except with the prior approval of the Purchaser.

8.13 Expenses; Attorneys' Fees. If any action at law or in equity is necessary to enforce or interpret the terms of this Agreement, the prevailing party shall be entitled to reasonable attorneys' fees, costs and necessary disbursements in addition to any other relief to which such party may be entitled.

IN WITNESS WHEREOF, the parties have executed this Agreement as of the date first above written.

**COMPANY**

**LOTUS TECHNOLOGIES, INC.**

---

**Lewis T. Lipton, President**

Address: 130-C Knolls Drive  
Los Gatos, CA 95030

**SELLING SHAREHOLDERS**

---

Lewis T. Lipton, Trustee for the Lipton Separate Property Trust dated January 12, 1993

Address: 17660 Vista Avenue Monte Sereno, CA 95030

---

**Dennis C. Stark**

Address: #5 No Name Road  
Los Gatos, CA 95030

---

**Steven Romine**

Address: 671 Cresci Road  
Los Gatos, CA 95030

**PURCHASER**

**INTEVAC, INC.**

---

**Norman H. Pond, President**

Address: 3550 Bassett Street  
Santa Clara, CA 95054

SCHEDULE A

SCHEDULE OF SELLING SHAREHOLDERS

Selling Shareholder -----	Number of Shares of Common Stock -----	Purchase Price -----
Lewis T. Lipton, Trustee for the Lipton Separate Property		
Trust dated January 12, 1993	1,260,000	\$2,675,000.00
Dennis C. Stark	1,260,000	\$2,675,000.00
Steven Romine	1,260,000	\$2,675,000.00
Total	3,780,000 =====	\$8,025,000.00 =====

**SCHEDULE B**

**SCHEDULE OF EXCEPTIONS**

**SCHEDULE C**

**SCHEDULE OF MATERIAL CONTRACTS**

## EXHIBIT A

### SELLING SHAREHOLDER

#### NON-COMPETITION AND NON-DISCLOSURE AGREEMENT

This SELLING SHAREHOLDER NON-COMPETITION AND NON-DISCLOSURE AGREEMENT (this "Agreement"), is entered into as of this 6th day of June, 1996 ("Effective Date") by and among Intevac, Inc., a California corporation ("Intevac"), and 1~.

WHEREAS, Intevac, Mr. 2~ and certain other parties have entered into that certain Stock Purchase Agreement dated as of June 6, 1996 (the "Purchase Agreement"), pursuant to which Intevac is acquiring all of the outstanding stock of Lotus Technologies, Inc. (the "Stock Purchase");

WHEREAS, in order to induce Intevac to enter into the Purchase Agreement, the parties hereto have agreed that this Agreement shall govern their respective rights with respect to the matters set forth herein.

NOW, THEREFORE, in consideration of the mutual promises and covenants set forth herein and for other good and valuable consideration, the receipt of which is hereby acknowledged, the parties hereto hereby agree as follows:

#### 1. Non-Competition:

1.1 Covenant Not to Compete. The parties understand and agree that this Agreement is entered into in connection with the acquisition by Intevac of all of the issued and outstanding capital stock of Lotus Technologies, Inc. ("LTI") from the shareholders of LTI. The parties further understand and agree that Mr. 2~ was a key and significant shareholder of LTI. Commencing upon the Effective Date and continuing for a period up to and including the date that is three (3) years after the Effective Date, in consideration of the performance by Intevac of its respective obligations under the Purchase Agreement, Mr. 2~ agrees that he shall not engage in any of the following activities outside of his employment with Intevac:

(a) Enter into or engage in the business of designing, developing, manufacturing, marketing and selling of equipment for contact stop/start ("CSS") testing, including stiction, friction, torque and lifetime aspects related to those characteristics, and track average amplitude and pulse width 50 measurements as done on hard disks, heads used in hard disk drives and completed hard disk drives; or



(b) In any way interfere or compete with Intevac in its operation of the present business of LTI, including projects currently under development that relate to CSS testing, track average amplitude and pulse width 50 measurements done on hard disks, heads used in hard disk drives and completed hard disk drives; or

(c) Enter into or engage in any business or activity which would use LTI technology, trade secrets or know-how; or

(d) Assist any person or entity, in any manner, in the use of LTI patented technology, trade secrets or know-how.

However, Section 1.1 of this Agreement in no way shall restrict Mr. 2~ from working for any entity that does not commercially compete with Intevac.

1.2 Covenant Not to Solicit. Commencing upon the Effective Date and continuing for a period that is three (3) years after the Effective Date, Mr. 2~ agrees (i) not to solicit any employee, consultant or other service provider of Intevac or any of its respective affiliates to terminate his, her or its employment, consulting or other service arrangement with Intevac or such affiliate and (ii) not to solicit any business partner of Intevac or any of its respective affiliates to terminate its relationship with Intevac or such affiliate or otherwise interfere with such relationship.

1.3 Covenants Not Unduly Restrictive. Mr. 2~ acknowledges, represents and warrants to Intevac that the covenants of Mr. 2~ in Sections 1.1 and 1.2 hereof are reasonably necessary for the protection of Intevac's interests under this Agreement and are not unduly restrictive upon Mr. 2~. In any event, if any restriction set forth in Sections 1.1 and 1.2 hereof is held to be unreasonable, then Mr. 2~ agrees, and hereby submits, to the reduction and limitation of such prohibition to such area or period as shall be deemed reasonable.

## 2. Non-Disclosure.

2.1 Proprietary Information. Mr. 2~ has in his possession or may come into his possession in the future information relating to LTI's business (including, without limitation, trade secrets, computer programs, names and expertise of employees and consultants, designs, technology, know-how, ideas, compositions, data, techniques, improvements, inventions (whether patentable or not), schematics and other technical, business, financial, customer and product development plans, forecasts, strategies and information), which to the extent previously, presently or subsequently disclosed to Mr. 2~ is hereinafter referred to as "Proprietary Information."

2.2 Non-Disclosure of Proprietary Information. Mr. 2~ hereby agrees, except as Intevac may otherwise consent in writing, (i) to hold the Proprietary Information in strict confidence and to take all reasonable precautions to protect such Proprietary

Information, (ii) not to divulge any such Proprietary Information or any information derived therefrom to any third person, (iii) not to make any use whatsoever at any time of such Proprietary Information, except when providing services to Intevac, and (iv) not to copy any such Proprietary Information except in the performance of his duties to Intevac and its affiliates. Without granting any right or license, Intevac agrees that the foregoing clauses (i),

(ii), (iii) and (iv) shall not apply with respect to any Proprietary Information after three (3) years from the date hereof or any information that Mr. 2~ can document is, through no improper action or inaction by Mr. 2~ or any affiliate, agent, consultant or employee of Mr. 2~, generally available to the public. Mr. 2~ may make disclosures required by court order, provided Mr. 2~ uses reasonable efforts to limit such disclosure and to obtain confidential treatment or a protective order, and has allowed Intevac to participate in the proceeding.

### 3. REMEDIES.

3.1 Injunctive Relief. The parties hereto further agree that the covenants and obligations contained in this Agreement relate to special, unique and extraordinary matters and that a violation of any of such covenants or obligations may cause Intevac irreparable injury for which adequate remedy at law will not be available; and, therefore, that upon any such breach of any such covenant or obligation, or any threat thereof, Intevac shall be entitled to the immediate remedy of a temporary restraining order, preliminary injunction or such other form of injunctive or equitable relief in addition to whatever remedies they might have at law.

3.2 Remedies Cumulative. Intevac's rights and remedies under this Agreement are cumulative and are in addition to any other rights and remedies Intevac may have at law or in equity.

### 4. MISCELLANEOUS.

4.1 Notices. All notices and other communications required or permitted under this Agreement shall be delivered to the parties at the address set forth below their respective signature blocks, or at such other address that they designate by notice to the other party in accordance with this Section 4.1. All notices and communications must be sent by one of the methods specified below and shall be deemed to have been received unless otherwise set forth herein: (i) in the case of personal delivery, on the date of such delivery; (ii) in the case of telex or facsimile transmission, on the date on which the sender receives confirmation by telex or facsimile transmission that such notice was received by the addressee, provided that a copy of such transmission is additionally sent by mail as set forth in (iv) below; (iii) in the case of overnight air courier, on the second business day following the day sent, with receipt confirmed by the courier; and (iv) in the case of mailing by first class certified or registered mail, postage prepaid, return receipt requested, on the fifth business day following such mailing. All notices in (i), (ii) and (iii) must be followed by certified mail, return receipt requested within five (5) days.

4.2 Assignment. This Agreement shall be binding on, and shall inure to the benefit of, the parties hereto and their respective heirs, legal representatives, successors and assigns; provided, however, that Mr. 2~ may not assign, transfer or delegate his rights or obligations hereunder and any attempt to do so shall be null and void.

4.3 Entire Agreement. This Agreement contains the entire agreement of the parties with respect to the subject matter hereof, and all prior agreements, written or oral, are merged herein and are of no further force or effect.

4.4 Amendment. This Agreement may be modified or amended only by a written agreement signed by the President of Intevac and Mr. 2~.

4.5 Waivers. No waiver of any term or provision of this Agreement will be valid unless such waiver is in writing signed by the party against whom enforcement of the waiver is sought. The waiver of any term or provision of this Agreement shall not apply to any subsequent breach of this Agreement.

4.6 Counterparts. This Agreement may be executed in several counterparts, each of which shall be deemed an original, but which together shall constitute one and the same instrument.

4.7 Severability. The provisions of this Agreement shall be deemed severable, and if any part of any provision is held illegal, void or invalid under applicable law, such provision may be changed to the extent reasonably necessary to make the provision, as so changed, legal, valid and binding. If any provision of this Agreement is held illegal, void or invalid in its entirety, the remaining provisions of this Agreement shall not in any way be affected or impaired but shall remain binding in accordance with their terms.

4.8 Governing Law. The terms of this Agreement shall be governed by the laws of the State of California as applied to agreements among California residents entered into and to be performed entirely within the State of California.

4.9 Attorneys' Fees. In the event of any proceeding, claim or action being filed or instituted between the parties with respect to this Agreement, the prevailing party will be entitled to receive from the other party all costs, damages and expenses, including reasonable attorneys' fees, incurred by the prevailing party in connection with that action or proceeding whether or not the controversy is reduced to judgment or award. The prevailing party will be that party who may be fairly said by the trier of fact to have prevailed on the major disputed issues.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement as of the day and year first above written.

**INTEVAC, INC.**

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**Norman H. Pond, President**

Address: 3550 Bassett Street  
Santa Clara, CA 95054

1~

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**Address:**

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## EXHIBIT B

### MATTERS TO BE COVERED IN THE OPINION OF COUNSEL TO LOTUS TECHNOLOGIES, INC.

1. The Company is a corporation duly organized, validly existing and in good standing under the laws of the State of California, and the Company has the requisite corporate power and authority to own its properties and to conduct its business as presently conducted.
2. The Company is qualified to do business as a foreign corporation in each jurisdiction of the United States where its failure to do so would have a material adverse effect on its business or properties.
3. The Company has the requisite corporate power and authority to execute, deliver and perform the Stock Purchase Agreement. The foregoing has been duly and validly authorized by the Company, duly executed and delivered by an authorized officer of the Company and constitutes a legal, valid and binding obligation of the Company, enforceable against the Company according to its terms.
4. To our knowledge, the capitalization of the Company immediately prior to the Closing is as follows:
  - a. Common Stock. 10,000,000 shares of common stock ("Common Stock"), no par value, 3,780,000 shares of which have been duly authorized and validly issued, are nonassessable, and to our knowledge, fully paid.
  - b. There are no preemptive rights or options, warrants, conversion privileges or other rights (or agreements for any such rights) outstanding to purchase or otherwise obtain from the Company any of the Company's securities.
5. The execution, delivery, performance and compliance with the terms of the Stock Purchase Agreement do not violate any provision of any applicable federal or California corporate law or any provision of the Company's Articles of Incorporation or Bylaws and, to our knowledge, do not conflict with or constitute a default under the provisions of any judgment, writ, decree or order or the material provisions of any material agreement to which the Company is a party or by which it is bound.
6. All consents, approvals, permits, orders or authorizations of, and all qualifications, registrations, designations, declarations or filings with, any federal, or California state governmental authority on the part of the Company required in connection with the execution, delivery and performance of the Stock Purchase Agreement have been

obtained, and are effective, and we are not aware of any proceedings, or threat thereof, which question the validity thereof.

7. Based in part upon the representations of Purchaser in the Stock Purchase Agreement, the offer and sale of the Common Stock to Purchaser pursuant to the terms of the Stock Purchase Agreement are exempt from the registration requirements of Section 5 of the Securities Act of 1933, as amended.

8. We are not aware that there is any action, proceeding or governmental investigation pending against the Company, which questions the validity of the Stock Purchase Agreement or the right of the Company or its officers, directors and employees to enter into the Stock Purchase Agreement, or which is not referred to in the Schedule of Exceptions.

**EXHIBIT C**

**MATTERS TO BE COVERED IN THE OPINION OF  
COUNSEL FOR EACH OF THE SELLING SHAREHOLDERS**

- (i) The Stock Purchase Agreement has been duly executed and delivered on behalf of the Selling Shareholder.
- (ii) The Selling Shareholder has full power and authority, and any approval required by law (other than as required by State securities and blue sky laws as to which such counsel need express no opinion), to sell, assign, transfer and deliver the portion of the Stock to be sold by such Selling Shareholder.
- (iii) The stock power executed and delivered by the Selling Shareholder is a valid and binding instrument.
- (iv) Upon payment for and delivery of the Common Stock with all necessary endorsements in accordance with the terms of the Agreement, and assuming the Purchaser is acquiring the shares of Common Stock in good faith without notice of any adverse claim, the Purchaser will be the owner of the shares of Common Stock, free and clear of any adverse claim.

In rendering such opinion such counsel for the Selling Shareholders may rely, as to matters governed other than by the laws of the State of California or Federal law on local counsel in such jurisdictions and, as to the matters set forth in subparagraphs (ii), (iii) and (iv), on other counsel representing the respective Selling Shareholder provided that in each case counsel for the Selling Shareholder shall state that they believe that they and Intevac, Inc. are justified in relying on such other counsel.

## EXHIBIT D

### MATTERS TO BE COVERED IN THE OPINION OF COUNSEL TO INTEVAC, INC. (THE "PURCHASER")

1. The Purchaser is a corporation duly organized, validly existing and in good standing under the laws of the State of California, and the Purchaser has the requisite corporate power and authority to own its properties and to conduct its business as presently conducted.
2. The Purchaser has the requisite corporate power and authority to execute, deliver and perform the Stock Purchase Agreement. The Stock Purchase Agreement has been duly and validly authorized by the Purchaser, duly executed and delivered by an authorized officer of the Purchaser and constitutes a legal, valid and binding obligation of the Purchaser, enforceable against the Purchaser according to its terms.
3. The execution, delivery, performance and compliance with the terms of the Stock Purchase Agreement do not violate any provision of any applicable federal or California corporate law or any provision of the Articles of Incorporation or Bylaws and, to our knowledge, do not conflict with or constitute a default under the provisions of any judgment, writ, decree or order.
4. All consents, approvals, permits, orders or authorizations of, and all qualifications, registrations, designations, declarations or filings with any federal or California state governmental authority on the part of the Purchaser required in connection with the execution, delivery and performance of the Stock Purchase Agreement have been obtained, and are effective, and we are not aware of any proceedings, or threat thereof, which question the validity thereof.
5. We are not aware that there is any action, proceeding or governmental investigation pending against the Purchaser, which questions the validity of the Stock Purchase Agreement or the right of the Purchaser or its

officers, directors and employees to enter into the Stock Purchase Agreement.



**EXHIBIT 11.1**

**INTEVAC, INC.**

**COMPUTATION OF NET INCOME PER SHARE**

	YEAR ENDED DECEMBER 31,		
	1996	1995	1994
	(IN THOUSANDS, EXCEPT PER SHARE DATA)		
Shares used in Calculation of Net Income Per Share:			
Average Common Shares outstanding.....	12,311	3,653	700
Net effect of dilutive stock options.....	590	152	109
Shares related to SAB Nos. 55, 64 and 83:			
Stock options.....	--	198	217
Ordinary Shares issued.....	--	527	579
Series A convertible preferred shares as-if-converted.....	--	6,076	8,680
	-----	-----	-----
	12,901	10,606	10,285
	=====	=====	=====
Income from continuing operations.....	\$ 4,973	\$ 5,765	\$ 1,675
	=====	=====	=====
Net income.....	\$ 4,973	\$ 7,100	\$ 1,408
	=====	=====	=====
Income per share from continuing operations.....	\$ 0.39	\$ 0.54	\$ 0.16
	=====	=====	=====
Net income per share.....	\$ 0.39	\$ 0.67	\$ 0.14
	=====	=====	=====

**EXHIBIT 21.1**

**SUBSIDIARIES OF THE REGISTRANT**

1. Lotus Technologies, Inc. -- California
2. Intevac Foreign Sales Corporation -- Barbados
3. Intevac Asia Private Limited -- Singapore
4. Intevac GmbH -- Germany

**EXHIBIT 23.1**

**CONSENT OF ERNST AND YOUNG LLP, INDEPENDENT AUDITORS**

We consent to the incorporation by reference in the Registration Statement (Form S-8 No. 33-99648) pertaining to 1995 Stock Option/Stock Issuance Plan and Employee Stock Purchase Plan of Intevac, Inc. of our report dated January 20, 1997, with respect to the consolidated financial statements and schedule of Intevac, Inc. included in the Annual Report (Form 10-K) for the year ended December 31, 1996.

*San Jose, California  
February 5, 1997*

*/s/ ERNST & YOUNG LLP*

## ARTICLE 5

This schedule contains summary financial information extracted from (a) the Consolidated Balance Sheet at December 31, 1996 and the Consolidated Statement of Income for the year ended December 31, 1996 and is qualified in its entirety by reference to such (b) financial statements.

MULTIPLIER: 1000

PERIOD TYPE	YEAR
FISCAL YEAR END	DEC 31 1996
PERIOD START	JAN 01 1996
PERIOD END	DEC 31 1996
CASH	938
SECURITIES	0
RECEIVABLES	18,594
ALLOWANCES	1,024
INVENTORY	25,666
CURRENT ASSETS	49,078
PP&E	13,141
DEPRECIATION	3,868
TOTAL ASSETS	68,085
CURRENT LIABILITIES	33,231
BONDS	730
PREFERRED MANDATORY	0
PREFERRED	0
COMMON	16,747
OTHER SE	16,989
TOTAL LIABILITY AND EQUITY	68,085
SALES	88,232
TOTAL REVENUES	88,232
CGS	55,652
TOTAL COSTS	55,652
OTHER EXPENSES	22,061
LOSS PROVISION	590
INTEREST EXPENSE	175
INCOME PRETAX	11,323
INCOME TAX	6,350
INCOME CONTINUING	4,973
DISCONTINUED	0
EXTRAORDINARY	0
CHANGES	0
NET INCOME	4,973
EPS PRIMARY	0.39
EPS DILUTED	0.39

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