

INTEVAC INC  
Form 10-Q  
May 10, 2007

**Table of Contents**

**SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549**

**Form 10-Q**

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the quarterly period ended March 31, 2007**
- OR**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the transition period from        to**

**Commission file number 0-26946**

**INTEVAC, INC.**

*(Exact name of registrant as specified in its charter)*

**California**

*(State or other jurisdiction of  
incorporation or organization)*

**94-3125814**

*(IRS Employer  
Identification No.)*

**3560 Bassett Street**

**Santa Clara, California 95054**

*(Address of principal executive office, including Zip Code)*

**Registrant's telephone number, including area code:**

**(408) 986-9888**

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):  
Large accelerated filer  Accelerated filer  Non-accelerated filer

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

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

On May 7, 2007, 21,394,023 shares of the Registrant's Common Stock, no par value, were outstanding.



**INTEVAC, INC.**

**INDEX**

<b>No.</b>		<b>Page</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>		
<b><u>Item 1.</u></b>	<u>Financial Statements (unaudited)</u>	
	<u>Condensed Consolidated Balance Sheets</u>	2
	<u>Condensed Consolidated Statements of Income and Comprehensive Income</u>	3
	<u>Condensed Consolidated Statements of Cash Flows</u>	4
	<u>Notes to Condensed Consolidated Financial Statements</u>	5
<b><u>Item 2.</u></b>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	16
<b><u>Item 3.</u></b>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	22
<b><u>Item 4.</u></b>	<u>Controls and Procedures</u>	23
<b><u>PART II. OTHER INFORMATION</u></b>		
<b><u>Item 1.</u></b>	<u>Legal Proceedings</u>	24
<b><u>Item 1A.</u></b>	<u>Risk Factors</u>	24
<b><u>Item 2.</u></b>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	34
<b><u>Item 3.</u></b>	<u>Defaults Upon Senior Securities</u>	34
<b><u>Item 4.</u></b>	<u>Submission of Matters to a Vote of Security Holders</u>	34
<b><u>Item 5.</u></b>	<u>Other Information</u>	34
<b><u>Item 6.</u></b>	<u>Exhibits</u>	35
<b><u>SIGNATURES</u></b>		36
	<u>EXHIBIT 31.1</u>	
	<u>EXHIBIT 31.2</u>	
	<u>EXHIBIT 32.1</u>	

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****INTEVAC, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

	<b>March 31, 2007</b>	<b>December 31, 2006</b>
	<b>(Unaudited)</b>	
	<b>(In thousands)</b>	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 30,796	\$ 39,440
Short-term investments	71,700	55,595
Trade and other accounts receivable, net of allowances of \$149 and \$143 at March 31, 2007 and December 31, 2006	33,298	39,927
Inventories	33,926	37,942
Prepaid expenses and other current assets	2,134	2,506
Deferred tax assets	4,100	3,269
Total current assets	175,954	178,679
Property, plant and equipment, net	14,511	13,546
Long-term investments	12,000	8,000
Investment in 601 California Avenue LLC	2,431	2,431
Goodwill	5,434	
Other intangible assets, net	299	
Deferred income taxes and other long term assets	3,666	3,347
Total assets	\$ 214,295	\$ 206,003
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Notes payable	\$ 1,921	\$
Accounts payable	16,287	15,994
Accrued payroll and related liabilities	5,189	11,769
Other accrued liabilities	9,796	6,612
Customer advances	20,404	26,243
Total current liabilities	53,597	60,618
Other long-term liabilities	1,062	1,075
Long-term notes payable	1,830	
Shareholders equity:		

Edgar Filing: INTEVAC INC - Form 10-Q

Common stock, no par value	101,096	99,468
Additional paid-in capital	9,321	7,319
Accumulated other comprehensive income	375	354
Retained earnings	47,014	37,169
Total shareholders' equity	157,806	144,310
Total liabilities and shareholders' equity	\$ 214,295	\$ 206,003

Note: Amounts as of December 31, 2006 are derived from the December 31, 2006 audited consolidated financial statements.

See accompanying notes.

Table of Contents

## INTEVAC, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

	<b>Three Months Ended</b>	
	<b>March 31, 2007</b>	<b>April 1, 2006</b>
	<b>(Unaudited)</b>	
	<b>(In thousands, except per share amounts)</b>	
Net revenues:		
Systems and components	\$ 73,593	\$ 48,074
Technology development	2,781	1,546
Total net revenues	76,374	49,620
Cost of net revenues:		
Systems and components	42,129	31,340
Technology development	1,507	952
Inventory provisions (reversal of reserve)	(44)	22
Total cost of net revenues	43,592	32,314
Gross profit	32,782	17,306
Operating expenses:		
Research and development	12,192	5,561
Selling, general and administrative	7,513	5,114
Total operating expenses	19,705	10,675
Operating income	13,077	6,631
Interest expense	(46)	(4)
Interest income and other, net	1,366	602
Income before income taxes	14,397	7,229
Provision for income taxes	4,552	218
Net income	\$ 9,845	\$ 7,011
Other comprehensive income:		
Foreign currency translation adjustments	21	29
Total comprehensive income	\$ 9,866	\$ 7,040
Basic income per share:		
Net income	\$ 0.46	\$ 0.34
Shares used in per share amounts	21,293	20,832
Diluted income per share:		

Edgar Filing: INTEVAC INC - Form 10-Q

Net income	\$	0.44	\$	0.32
Shares used in per share amounts		22,188		21,920

See accompanying notes.

3

---



**Table of Contents****INTEVAC, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>Three Months Ended</b>	
	<b>March 31,</b>	<b>April 1,</b>
	<b>2007</b>	<b>2006</b>
	<b>(Unaudited)</b>	
	<b>(In thousands)</b>	
<b>Operating activities</b>		
Net income	\$ 9,845	\$ 7,011
Adjustments to reconcile net income to net cash and cash equivalents provided by (used in) operating activities:		
Depreciation and amortization	1,163	601
Inventory provisions (reversal of reserve)	(44)	22
Equity-based compensation	1,357	460
Loss on disposal of equipment		1
Changes in operating assets and liabilities	5,258	(12,863)
Total adjustments	3,351	(11,779)
Net cash and cash equivalents provided by (used in) operating activities	13,196	(4,768)
<b>Investing activities</b>		
Purchases of investments	(43,700)	(33,631)
Proceeds from sales and maturities of investments	23,500	38,500
Acquisition of DeltaNu LLC, net of cash acquired	(5,803)	
Purchases of leasehold improvements and equipment	(1,856)	(1,152)
Net cash and cash equivalents provided by (used in) investing activities	(27,859)	3,717
<b>Financing activities</b>		
Net proceeds from issuance of common stock	1,645	1,708
Issuance of notes payable	3,738	
Tax benefit from equity-based compensation	645	
Net cash and cash equivalents provided by financing activities	6,028	1,708
Effect of exchange rate changes on cash	(9)	19
Net increase (decrease) in cash and cash equivalents	(8,644)	676
Cash and cash equivalents at beginning of period	39,440	15,255
Cash and cash equivalents at end of period	\$ 30,796	\$ 15,931
<b>Supplemental Schedule of Cash Flow Information</b>		
Cash paid for:		
Income taxes	\$ 1,500	\$

See accompanying notes.

**Table of Contents**

**INTEVAC, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Business Activities and Basis of Presentation**

We are the world's leading provider of disk sputtering equipment to manufacturers of magnetic media used in hard disk drives and a developer and provider of leading technology for extreme low light imaging sensors, cameras and systems. We operate two businesses: Equipment and Imaging.

Our Equipment business designs, manufactures, markets and services complex capital equipment used in the sputtering, or deposition, of highly engineered thin-films of material onto magnetic disks which are used in hard disk drives. Hard disk drives are the primary storage medium for digital data and function by storing data on magnetic disks. These disks are created in a sophisticated manufacturing process involving a variety of many steps, including plating, annealing, polishing, texturing, sputtering and lubrication. We are also utilizing our expertise in complex manufacturing equipment to develop new manufacturing products that address the semiconductor market.

Our Imaging business develops and manufactures electro-optical sensors, cameras, and systems that permit highly sensitive detection of photons in the visible and near infrared portions of the spectrum, allowing vision in extreme low light situations.

The vast majority of our revenue is currently derived from our Equipment business and we expect that the majority of our revenues for at least the next several years will continue to be derived from our Equipment business.

The financial information at March 31, 2007 and for the three-month periods ended March 31, 2007 and April 1, 2006 is unaudited, but includes all adjustments (consisting only of normal recurring accruals) that we consider necessary for a fair presentation of the financial information set forth herein, in accordance with accounting principles generally accepted in the United States of America ( U.S. GAAP ) for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, it does not include all of the information and footnotes required by U.S. GAAP for annual financial statements. For further information, refer to the Consolidated Financial Statements and footnotes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenue and expenses during the reporting period. Actual results inevitably will differ from those estimates, and such differences may be material to the financial statements.

The results for the three-month period ended March 31, 2007 are not considered indicative of the results to be expected for any future period or for the entire year.

Inteva®, LIVAR and 200 Lean are trademarks of Intevac, Inc.

**2. Concentrations**

Historically, a significant portion of our revenues in any particular period has been attributable to sales to a limited number of customers. Our largest customers tend to change from period to period.

We evaluate the collectibility of trade receivables on an ongoing basis and provide reserves against potential losses when appropriate.

### **3. New Accounting Pronouncements**

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 ( SFAS 159 ). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The fair value option established by SFAS 159 permits all entities to choose to measure eligible items at fair value at specified election dates and report unrealized gains and losses on items for which the fair value option

**Table of Contents****INTEVAC, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

has been elected in earnings at each subsequent reporting date. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of adopting this standard.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within that fiscal year. We are currently evaluating the impact of adopting SFAS 157.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections – a Replacement of APB Opinion No. 20 and FASB Statement No. 3 (SFAS 154), which requires retrospective application to prior periods financial statements of voluntary changes in accounting principle unless it is impracticable to do so. SFAS 154 is effective for accounting changes and corrections of errors beginning in fiscal 2007. The implementation of this standard did not have a material effect on our financial position or results of operations.

**4. Inventories**

Inventories are priced using average actual costs, which approximate cost under the first-in, first-out method, and are stated at the lower of cost or market. Inventories consist of the following:

	<b>March 31, 2007</b>	<b>December 31, 2006</b>
	<b>(In thousands)</b>	
Raw materials	\$ 20,501	\$ 19,906
Work-in-progress	13,054	12,271
Finished goods	371	5,765
	<b>\$ 33,926</b>	<b>\$ 37,942</b>

Finished goods inventory consists primarily of completed systems at customer sites that are undergoing installation and acceptance testing.

Inventory reserves included in the above numbers were \$8.5 million and \$9.1 million at March 31, 2007 and December 31, 2006, respectively. Each quarter, we analyze our inventory (raw materials, WIP and finished goods) against the forecast demand for the next 12 months. Raw materials with no forecast requirements in that period are considered excess and inventory provisions are established to write those items down to zero net book value. Work-in-progress and finished goods inventories with no forecast requirements in that period are typically written down to the lower of cost or market. During this process, some inventory is identified as having no future use or value to us and is disposed of against the reserves.

The following table displays the activity in the inventory reserve account for the three-month periods ending March 31, 2007 and April 1, 2006:

	<b>Three Months Ended</b>	
	<b>March 31,</b>	<b>April 1,</b>
	<b>2007</b>	<b>2006</b>
	<b>(In thousands)</b>	
Beginning balance	\$ 9,128	\$ 10,988
New provisions (reversal of reserve) in cost of sales	(44)	22
New provisions for refurbishment of consigned products	6	5
Disposals of inventory	(547)	(70)
Ending balance	\$ 8,543	\$ 10,945

Table of Contents**INTEVAC, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****5. Stock-Based Compensation**

At March 31, 2007, we had stock-based awards outstanding under the 2004 Equity Incentive Plan (the 2004 Plan ) and the 2003 Employee Stock Purchase Plan (the ESPP ). Our shareholders approved both of these plans.

The 2004 Plan permits the grant of incentive or non-statutory stock options, restricted stock, stock appreciation rights, performance units and performance shares. During the three months ended March 31, 2007, we granted 73,500 stock options with an estimated total grant-date fair value of \$1.2 million. Of this amount, we estimated that the stock-based compensation for the awards not expected to vest was \$374,000.

The ESPP provides that eligible employees may purchase our common stock through payroll deductions at a price equal to 85% of the lower of the fair market value at the beginning of the applicable offering period or at the end of each applicable purchase period. Offering periods are generally two years in length, and consist of a series of six-month purchase intervals. Eligible employees may join the ESPP at the beginning of any six-month purchase interval. During the three months ended March 31, 2007, we granted purchase rights with an estimated total grant-date value of \$158,000.

***Compensation Expense***

The effect of recording stock-based compensation for the three-month periods ended March 31, 2007 and April 1, 2006 was as follows:

	<b>Three Months Ended March 31, 2007</b>	<b>Three Months Ended April 1, 2006</b>
Stock-based compensation by type of award:		
Stock options	\$ 1,145	\$ 344
Employee stock purchase plan	213	116
Amounts capitalized as inventory	(4)	(32)
Total stock-based compensation	1,354	428
Tax effect on stock-based compensation	(428)	(13)
Net effect on net income	\$ 926	\$ 415
Effect on earnings per share:		
Basic	\$ 0.04	\$ 0.02
Diluted	\$ 0.04	\$ 0.02

Approximately \$73,000 and \$32,000 of stock-based compensation was capitalized as inventory at March 31, 2007 and April 1, 2006, respectively.

***Valuation Assumptions***

The fair value of share-based payment awards is estimated at the grant date using the Black-Scholes option valuation model. The determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, our expected stock price volatility over the term of the awards, and actual employee stock option exercise behavior.

The weighted-average estimated value of employee stock options granted during the three months ended March 31, 2007 and April 1, 2006 was \$15.91 per share and \$11.89 per share, respectively. The weighted-average estimated fair value of employee stock purchase rights granted pursuant to the ESPP during the three months ended March 31, 2007 and April 1, 2006 was \$10.54 and \$5.16 per share, respectively. The fair value of each option and



**Table of Contents****INTEVAC, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

employee stock purchase right grant is estimated on the date of grant using the Black-Scholes option valuation model with the following weighted-average assumptions:

	<b>Three Months Ended</b>	
	<b>March 31, 2007</b>	<b>April 1, 2006</b>
Stock Options:		
Expected volatility	67.42%	77.04%
Risk free interest rate	4.49%	4.83%
Expected term of options (in years)	4.5	4.8
Dividend yield	None	None
Stock Purchase Rights:		
Expected volatility	63.48%	61.47%
Risk free interest rate	4.84%	4.64%
Expected term of purchase rights (in years)	1.5	0.5
Dividend yield	None	None

The computation of the expected volatility assumptions used in the Black-Scholes calculations for new grants and purchase rights is based on the historical volatility of our stock price, measured over a period equal to the expected term of the grant or purchase right. The risk-free interest rate is based on the yield available on U.S. Treasury Strips with an equivalent remaining term. The expected life of employee stock options represents the weighted-average period that the stock options are expected to remain outstanding and was determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards and vesting schedules. The expected life of purchase is the period of time remaining in the current offering period. The dividend yield assumption is based on our history of not paying dividends and the assumption of not paying dividends in the future.

As the stock-based compensation expense recognized in the Condensed Consolidated Statement of Operations is based on awards ultimately expected to vest, such amount has been reduced for estimated forfeitures. Statement of Financial Accounting Standards No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on our historical experience.

**Table of Contents****INTEVAC, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Stock Plan Activity******2004 Equity Incentive Plan***

A summary of activity under the above captioned plan is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Options outstanding at December 31, 2006	2,354,215	\$ 11.47	7.93	\$ 34,107,462
Options granted	73,500	\$ 28.14		
Options forfeited	(9,016)	\$ 11.72		
Options exercised	(158,517)	\$ 6.14		
Options outstanding at March 31, 2007	2,260,182	\$ 12.39	7.90	\$ 31,776,661
Vested and expected to vest at March 31, 2007	1,931,137	\$ 11.87	7.42	\$ 28,120,443
Options exercisable at March 31, 2007	844,310	\$ 8.47	6.48	\$ 15,113,902
Available to grant at March 31, 2007	221,886			

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on our closing stock price of \$26.37 as of March 30, 2007, which would have been received by the option holders had all options holders exercised their options as of that date.

As of March 31, 2007, the unrecorded deferred stock-based compensation balance related to stock options was \$9.0 million and will be recognized over an estimated weighted average recognition period of 1.8 years. The recognition period is based on the expected term of the option, which is defined as the period from grant date to exercise date.

***2003 Employee Stock Purchase Plan***

During the three months ended March 31, 2007, 39,069 shares were purchased at an average per share price of \$17.17. At March 31, 2007, there were 348,868 shares available to be issued under the ESPP.

As of March 31, 2007, the unrecorded deferred stock-based compensation balance related to purchase rights was \$1.1 million and will be recognized over an estimated weighted average recognition period of 1.3 years. The recognition period is based on the expected term of the option, which is defined as the period from grant date to expiration of the offering period.

## 6. Business Combinations

On January 31, 2007, we completed the acquisition of the assets and certain liabilities of DeltaNu, LLC ( DeltaNu ) for a total purchase price of \$6 million. The purchase price was comprised of \$2 million cash due at the close of the acquisition and \$2 million due on each of January 31, 2008 and January 31, 2009, which is in the form of a note. DeltaNu is a Laramie, Wyoming company specializing in small footprint and handheld Raman spectrometry instruments. We believe that the combination of DeltaNu s miniature Raman spectrometer designs with our capabilities in near-infrared sensors will enable a new class of portable instruments with greatly enhanced chemical detection capabilities.

We accounted for the acquisition as a taxable purchase transaction and, accordingly, the purchase price has been allocated to tangible assets, liabilities assumed, and identifiable intangible assets acquired based on their estimated fair values on the acquisition date. The excess of the purchase price over the aggregate fair values was

**Table of Contents****INTEVAC, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

recorded as goodwill. The fair value assigned to identifiable intangible assets acquired is determined using the income approach, which discounts expected future cash flows to present value using estimates and assumptions determined by management. Purchased intangible assets are amortized on a straight-line basis over the respective useful lives. Our allocation of the purchase price is summarized below (in thousands):

Net liabilities assumed, net of cash of \$4	\$ (31)
Goodwill	5,434
Backlog	120
Trademarks/names	120
Customer relationships	60
Non-compete agreements	100
 Total	 \$ 5,803

The \$5.8 million allocated purchase price consists of \$2.0 million paid in cash, \$3.7 million in notes payable (present value at January 31, 2007) and \$87,000 in acquisition-related expenses. The estimated useful economic lives of the identified intangible assets acquired are two years for the customer relationships and non-compete agreements and approximately four months for the backlog. The trademark/names asset has an indefinite life. Future amortization of the identified intangible assets will be \$193,000 in 2007, \$80,000 in 2008 and \$7,000 in 2009.

The results of operations for the acquired business have been included in our condensed consolidated statements of operations for the period subsequent to our acquisition of DeltaNu. DeltaNu's results of operations for periods prior to this acquisition were not material to our condensed consolidated statement of operations and, accordingly, pro forma financial information has not been presented.

**7. Warranty**

We provide for the estimated cost of warranty when revenue is recognized. Our warranty is per contract terms and for our systems the warranty typically ranges between 12 and 24 months from customer acceptance. During this warranty period any defective non-consumable parts are replaced and installed at no charge to the customer. The warranty period on consumable parts is limited to their reasonable usable life. We use estimated repair or replacement costs along with our actual warranty experience to determine our warranty obligation. We exercise judgment in determining the underlying estimates.

On the condensed consolidated balance sheet, the short-term portion of the warranty is included in other accrued liabilities, while the long-term portion is included in other long-term liabilities.

The following table displays the activity in the warranty provision account for the three-month periods ending March 31, 2007 and April 1, 2006:

**Three Months Ended**

	<b>March 31, 2007</b>	<b>April 1, 2006</b>
	<b>(In thousands)</b>	
Beginning balance	\$ 5,283	\$ 3,399
Expenditures incurred under warranties	(1,235)	(1,123)
Accruals for product warranties issued during the reporting period	1,074	965
Adjustments to previously existing warranty accruals	107	332
Ending balance	\$ 5,229	\$ 3,573

**Table of Contents****INTEVAC, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table displays the balance sheet classification of the warranty provision account at March 31, 2007 and at December 31, 2006:

	<b>March 31, 2007</b>	<b>December 31, 2006</b>
	<b>(In thousands)</b>	
Other accrued liabilities	\$ 4,167	\$ 4,208
Other long-term liabilities	1,062	1,075
Total warranty provision	\$ 5,229	\$ 5,283

**8. Guarantees**

We have entered into agreements with customers and suppliers that include limited intellectual property indemnification obligations that are customary in the industry. These guarantees generally require us to compensate the other party for certain damages and costs incurred as a result of third party intellectual property claims arising from these transactions. The nature of the intellectual property indemnification obligations prevents us from making a reasonable estimate of the maximum potential amount we could be required to pay our customers and suppliers. Historically, we have not made any significant indemnification payments under such agreements, and no amount has been accrued in the accompanying consolidated financial statements with respect to these indemnification obligations.

**9. Cash, Cash Equivalents and Investments in Debt Securities**

Our investment portfolio consists of cash, cash equivalents and investments in debt securities and municipal bonds. We consider all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. Investments in debt securities and municipal bonds consist principally of highly rated debt instruments with maturities generally between one and 25 months.

We account for our investments in debt securities and auction rate securities in accordance with Statement of Accounting Standards No. 115 Accounting for Certain Investments in Debt and Equity Securities, which requires certain securities to be categorized as either trading, available-for-sale or held-to-maturity. Available-for-sale securities, consisting solely of Auction Rate Securities, are carried at fair value, with unrealized gains and losses recorded within other comprehensive income (loss) as a separate component of shareholders' equity. Auction Rate Securities have long-term underlying maturities (ranging from 20 to 40 years), however the market is highly liquid and the interest rates reset every 7 or 28 days. Our intent is not to hold these securities to maturity, but rather to use the interest rate reset feature to sell securities to provide liquidity as needed. Our practice is to invest in these securities for higher yields compared to cash equivalents. Held-to-maturity securities are carried at amortized cost. We have no trading securities. The cost of investment securities sold is determined by the specific identification method. Interest income is recorded using an effective interest rate, with the associated premium or discount amortized to interest income. Realized gains and losses and declines in value judged to be other than temporary, if any, on available-for-sale securities are included in earnings. The table below presents the amortized principal amount, major

security type and maturities for our investments in debt securities and auction rate securities.

**Table of Contents****INTEVAC, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	<b>March 31, 2007</b>	<b>December 31, 2006</b>
	<b>(In thousands)</b>	
Amortized Principal Amount:		
Debt securities issued by the US government and its agencies	\$ 12,000	\$ 8,000
Auction rate securities	71,700	53,595
Corporate debt securities		2,000
 Total investments in debt securities	 \$ 83,700	 \$ 63,595
 Short-term investments	 \$ 71,700	 \$ 55,595
Long-term investments	12,000	8,000
 Total investments in debt securities	 \$ 83,700	 \$ 63,595
 Approximate fair value of investments in debt securities	 \$ 83,699	 \$ 63,585

The decline in the fair value of our investments from the principal amount is attributable to changes in interest rates and not credit quality. In accordance with EITF 03-01, we have the ability and intent to hold these investments until fair value recovers, which may be maturity, and we do not consider these investments to be other-than-temporarily impaired at March 31, 2007.

Cash and cash equivalents represent cash accounts and money market funds. Cash balances held in foreign bank accounts totaled \$2.0 million and \$1.6 million at March 31, 2007 and December 31, 2006, respectively. Included in accounts payable is \$5.2 million and \$2.4 million of book overdraft at March 31, 2007 and December 31, 2006, respectively.

**10. Net Income Per Share**

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

	<b>Three Months Ended</b>	
	<b>March 31, 2007</b>	<b>April 1, 2006</b>
	<b>(In thousands)</b>	
Numerator:		
Numerator for diluted earnings per share	income available to common stockholders	\$ 9,845
		\$ 7,011
Denominator:		
Denominator for basic earnings per share	weighted-average shares	21,293
		20,832



Effect of dilutive securities:		
Employee stock options(1)	895	1,088
Dilutive potential common shares	895	1,088
Denominator for diluted earnings per share adjusted weighted-average shares and assumed conversions	22,188	21,920

(1) Potentially dilutive securities, consisting of shares issuable upon exercise of employee stock options, are excluded from the calculation of diluted EPS when their effect would be anti-dilutive. The weighted average number of employee stock options excluded for the three-month periods ended March 31, 2007 and April 1, 2006 was 249,850 and 65,753 respectively.

**Table of Contents****INTEVAC, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****11. Segment Reporting*****Segment Description***

We have two reportable operating segments: Equipment and Imaging. Our Equipment business designs, manufactures, markets and services complex capital equipment used in the sputtering, or deposition, of highly engineered thin-films of material onto magnetic disks which are used in hard disk drives and is developing a system for the semiconductor manufacturing market. Our Imaging business develops and manufactures electro-optical sensors, cameras and systems that permit highly sensitive detection of photons in the visible and near infrared portions of the spectrum, allowing vision in extreme low light situations.

Included in corporate activities are general corporate expenses, less an allocation of corporate expenses to operating units equal to 3% of net revenues. Assets of corporate activities include unallocated cash and investments, deferred tax assets and other assets.

***Segment Profit or Loss and Segment Assets***

We evaluate performance and allocate resources based on a number of factors, including profit or loss from operations and future revenue potential. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies.

***Business Segment Net Revenues***

	<b>Three Months Ended</b>	
	<b>March 31,</b>	<b>April 1,</b>
	<b>2007</b>	<b>2006</b>
	<b>(In thousands)</b>	
Equipment	\$ 72,446	\$ 47,573
Imaging	3,928	2,047
Total	\$ 76,374	\$ 49,620

***Business Segment Profit & Loss***

<b>Three Months Ended</b>	
<b>March 31,</b>	<b>April 1,</b>
<b>2007</b>	<b>2006</b>
<b>(In thousands)</b>	

Edgar Filing: INTEVAC INC - Form 10-Q

Equipment	\$ 14,989	\$ 8,480
Imaging	(1,600)	(1,869)
Corporate activities	(312)	20
Operating income	13,077	6,631
Interest expense	(46)	(4)
Interest income	1,238	492
Other income and expense, net	128	110
Income before income taxes	\$ 14,397	\$ 7,229

**Table of Contents****INTEVAC, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Business Segment Net Assets***

	<b>March 31, 2007</b>	<b>December 31, 2006</b>
	<b>(In thousands)</b>	
Equipment	\$ 72,071	\$ 84,366
Imaging	15,657	7,379
Corporate activities	126,567	114,258
Total	\$ 214,295	\$ 206,003

***Geographic Area Net Trade Revenues***

	<b>Three Months Ended</b>	
	<b>March 31, 2007</b>	<b>April 1, 2006</b>
	<b>(In thousands)</b>	
United States	\$ 7,000	\$ 8,556
Asia	69,004	41,064
Europe	370	
Total	\$ 76,374	\$ 49,620

**12. Income Taxes**

For the three months ended March 31, 2007, we accrued income tax using an effective tax rate of 31.6% of pretax income. This rate is based on an estimate of our annual tax rate calculated in accordance with Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*. Our effective tax rate is highly dependent on the availability of tax credits and the geographic composition of our worldwide earnings. Our deferred tax asset is partially offset by a valuation allowance, resulting in a net deferred tax asset of \$5.4 million at March 31, 2007.

For the three months ended April 1, 2006, we accrued income tax using an effective tax rate of 3.0% of pretax income. Our tax rate differs from the applicable statutory rates due to the utilization of net operating loss carry-forwards and deferred credits.

We adopted the provisions of Financial Accounting Standards Board ( FASB ) Interpretation Number 48, *Accounting for Uncertainty in Income Taxes*, ( FIN 48 ) on January 1, 2007. As required by FIN 48, which clarifies SFAS No. 109, *Accounting for Income Taxes*, we recognize the financial statement benefit of a tax position only after determining

that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more-likely-than-not threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement with the relevant tax authority. At January 1, 2007, we applied FIN 48 to all tax positions for which the statute of limitations remained open and determined there are no material unrecognized tax benefits as of that date. In addition, there have been no material changes in unrecognized benefits since January 1, 2007. As a result, the adoption of FIN 48 did not have an effect on our financial condition, or results of operation.

We are subject to income taxes in the U.S. federal jurisdiction, and various states and foreign jurisdictions. Tax regulations within each jurisdiction are subject to the interpretation of the related tax laws and regulations and require significant judgment to apply. With few exceptions, we are no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for the years before 2000.

The Company recognizes interest and penalties accrued related to unrecognized tax benefits in the provision for income taxes for all periods presented, which were not significant.

**Table of Contents**

**INTEVAC, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**13. Contingencies**

From time to time, we may have certain contingent liabilities that arise in the ordinary course of our business activities. We account for contingent liabilities when it is probably that future expenditures will be made and such expenditures can be reasonably estimated.

On July 7, 2006, we filed a patent infringement lawsuit against Unaxis USA, Inc. and its affiliates, Unaxis Balzers AG and Unaxis Balzers, Ltd., in the United States District Court for the Central District of California. Our lawsuit against Unaxis asserts infringement by Unaxis of United States Patent 6,919,001, which relates to our 200 Lean system. Our complaint seeks monetary damages and an injunction that bars Unaxis from making, using, offering to sell or selling in the United States, or importing into the United States, Unaxis allegedly infringing product. In the suit, we seek damages and a permanent injunction for infringement of the same patent. We believe we have meritorious claims, and we intend to pursue them vigorously.

On September 12, 2006, Unaxis filed a response to our lawsuit in which it asserted non-infringement, invalidity of our patent, inequitable conduct by Intevac, patent misuse by Intevac, and lack of jurisdiction by the court as defenses. Additionally, Unaxis requested a declaratory judgment of patent non-infringement, invalidity and unenforceability; asserted our violation of the California Business and Professional Code; requested that we be enjoined from engaging in any unfair competition; and requested that we be required to pay Unaxis attorney fees. We believe such claims lack merit, and we intend to defend ourselves vigorously.

We replied to Unaxis response on October 3, 2006, denying the assertions of non-infringement, invalidity and unenforceability of the Intevac patent, and denying any unfair competition. With the approval of the Court, we amended our complaint on February 6, 2007 to assert an additional ground for our infringement claim and to add a request for a declaratory judgment of infringement. Unaxis filed a response on February 21, 2007, in which it repeated the assertions of its September 12, 2006 response.

On March 29, 2007, the court denied a motion filed by Unaxis requesting a stay of the litigation pending action by the U.S. Patent Office on their February 27, 2007 request for a reexamination of United States Patent 6,919,001. Unaxis renewed the stay motion on May 1, 2007 after the U.S. Patent Office granted the reexamination request and issued an initial office action rejecting the claims of the 001 patent. Intevac had no input to the initial determination by the U.S. Patent Office, but will now participate in the reexamination.

**14. Capital Transactions**

During the three-month period ending March 31, 2007, we sold stock to our employees under Intevac's Stock Option and Employee Stock Purchase Plans. A total of 197,000 shares were issued under these plans, for which Intevac received \$1.6 million.

**15. Financial Presentation**

Certain prior year amounts in the Condensed Consolidated Financial Statements have been reclassified to conform to 2007 presentation. The reclassifications had no material effect on total assets, liabilities, equity, revenue, net income

(loss) or comprehensive income (loss) previously reported.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*This Quarterly Report on Form 10-Q contains forward-looking statements, which involve risks and uncertainties. Words such as believes, expects, anticipates and the like indicate forward-looking statements. These forward looking statements include comments related to our shipments, projected revenue recognition, product costs, gross margin, operating expenses, interest income, cash balances and financial results in 2007; our projected customer requirements for new capacity and for technology upgrades for their installed base of our thin-film disk sputtering equipment, and when, and if, our customers will place orders for these products; Imaging's ability to proliferate its technology into major military weapons programs and to develop and introduce commercial imaging products; and the timing of delivery and/or acceptance of the systems and products that comprise our backlog for revenue. Our actual results may differ materially from the results discussed in the forward-looking statements for a variety of reasons, including those set forth under Risk Factors and in other documents we file from time to time with the Securities and Exchange Commission, including Intevac's Annual Report on Form 10-K filed in March 2007, Form 10-Q's and Form 8-K's.*

**Critical Accounting Policies and Estimates**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America ( US GAAP ) requires management to make judgments, assumptions and estimates that affect the amounts reported. Our significant accounting policies are described in Note 2 to the consolidated financial statements included in Item 8 of our Annual Report on Form 10-K. Certain of these significant accounting policies are considered to be critical accounting policies, as defined below.

A critical accounting policy is defined as one that is both material to the presentation of our financial statements and requires management to make difficult, subjective or complex judgments that could have a material effect on our financial conditions and results of operations. Specifically, critical accounting estimates have the following attributes: 1) We are required to make assumptions about matters that are highly uncertain at the time of the estimate; and 2) different estimates we could reasonably have used, or changes in the estimate that are reasonably likely to occur, would have a material effect on our financial condition or results of operations.

Estimates and assumptions about future events and their effects cannot be determined with certainty. We base our estimates on historical experience and on various other assumptions believed to be applicable and reasonable under the circumstances. These estimates may change as new events occur, as additional information is obtained and as our operating environment changes. These changes have historically been minor and have been included in the consolidated financial statements as soon as they become known. In addition, management is periodically faced with uncertainties, the outcomes of which are not within its control and will not be known for prolonged periods of time. Many of these uncertainties are discussed in the section below entitled Risk Factors. Based on a critical assessment of our accounting policies and the underlying judgments and uncertainties affecting the application of those policies, management believes that our consolidated financial statements are fairly stated in accordance with US GAAP, and provide a meaningful presentation of our financial condition and results of operation.

We believe the following critical accounting policies affect the more significant judgments and estimates we make in preparing our consolidated financial statements. We also have other key accounting policies and accounting estimates related to the collectibility of trade receivables, valuation of deferred tax assets and prototype product costs. We believe that these other accounting policies and other accounting estimates either do not generally require us to make estimates and judgments that are as difficult or subjective, or are less likely to have a material impact on our reported results of operation for a given period.



***Revenue Recognition***

Certain of our system sales with customer acceptance provisions are accounted for as multiple-element arrangements. If we have previously met defined customer acceptance levels with the specific type of system, then we recognize revenue for the fair market value of the system upon shipment and transfer of title, and recognize revenue for the fair market value of installation and acceptance services when those services are completed. We estimate the fair market value of the installation and acceptance services based on our actual historical experience. For systems that have generally not been demonstrated to meet a particular customer's product specifications prior

## **Table of Contents**

to shipment, revenue recognition is typically deferred until customer acceptance. For example, while initial shipments of our 200 Lean system were recognized for revenue upon customer acceptance during 2004, revenue was recognized upon shipment for the majority of 200 Leans shipped in 2005, 2006 and 2007 to date. Most of the systems in backlog at March 31, 2007 are for customers where we have met defined customer acceptance levels, and we expect to recognize revenue upon shipment for those systems.

In some instances, hardware that is not essential to the functioning of the system may be delivered after acceptance of the system. In these cases, we estimate the fair market value of the non-essential hardware as if it had been sold on a stand-alone basis, and defer recognizing revenue on that value until the hardware is delivered.

In certain cases, we sell limited rights to our intellectual property. Revenue from the sale of any intellectual property license is generally recognized at the inception of the license term.

We perform best efforts research and development work under various government-sponsored research contracts. These contracts are a mixture of cost-plus-fixed-fee ( CPFF ) and firm fixed-price ( FFP ). Revenue on CPFF contracts is recognized in accordance with contract terms, typically as costs are incurred. Revenue on FFP contracts is generally recognized on the percentage-of-completion method based on costs incurred in relation to total estimated costs. Provisions for estimated losses on government-sponsored research contracts are recorded in the period in which such losses are determined.

## ***Inventories***

Inventories are priced using average actual costs, which approximate first-in, first-out, and are stated at the lower of cost or market. The carrying value of inventory is reduced for estimated excess and obsolescence by the difference between its cost and the estimated market value based on assumptions about future demand. We evaluate the inventory carrying value for potential excess and obsolete inventory exposures by analyzing historical and anticipated demand. In addition, inventories are evaluated for potential obsolescence due to the effect of known and anticipated engineering change orders and new products. If actual demand were to be substantially lower than estimated, additional inventory adjustments would be required, which could have a material adverse effect on our business, financial condition and results of operation. A cost-to-market reserve is established for work-in-progress and finished goods inventories when the value of the inventory plus the estimated cost to complete exceeds the net realizable value of the inventory.

## ***Warranty***

We provide for the estimated cost of warranty when revenue is recognized. Our warranty is per contract terms, and for our systems, the warranty typically ranges between 12 and 24 months from customer acceptance. We use estimated repair or replacement costs along with our actual warranty experience to determine our warranty obligation. We exercise judgment in determining the underlying estimates. Should actual warranty costs differ substantially from our estimates, revisions to the estimated warranty liability would be required, which could have a material adverse effect on our business, financial condition and results of operations.

## ***Income Taxes***

We account for income taxes in accordance with Statement of Financial Accounting Standard No. 109, Accounting for Income Taxes, ( SFAS 109 ), which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between book and tax bases of recorded assets and liabilities. SFAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that a portion of the deferred tax asset will not be realized. Based on our history of losses through 2004, our deferred tax asset was

fully offset by a valuation allowance as of December 31, 2005. During 2006, the deferred tax asset and the related valuation allowance were both reduced due to the usage of our remaining NOL and credit carry-forwards. As of December 31, 2006, \$4.6 million of the deferred tax asset was valued on the balance sheet, net of a valuation allowance of \$2.8 million. This represents the amount of the deferred tax asset from which we expect to realize a benefit. We cannot predict with certainty when, or if, we will realize the benefit of the portion of the deferred tax asset currently offset with a valuation allowance.

**Table of Contents**

On a quarterly basis, we provide for income taxes based upon an annual effective income tax rate. The effective tax rate is highly dependent upon the level of our projected earnings, the geographic composition of worldwide earnings, tax regulations governing each region, net operating loss carry-forwards, availability of tax credits and the effectiveness of our tax planning strategies. We carefully monitor the changes in many factors and adjust our effective income tax rate on a timely basis. If actual results differ from the estimates, this could have a material effect on our business, financial condition and results of operations. For example, as our projected level of earnings increased throughout 2006, we increased the annual effective tax rate from 3.0% at the end of the first quarter, to 8.8% at the end of the second quarter, to 10.0% at the end of the third quarter and to 12% at the end of the fourth quarter. The current estimate of the annual effective income tax rate for 2007 is 31.6%.

The calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with our expectations could have a material effect on our business, financial condition and results of operations.

**Results of Operations*****Three Months Ended March 31, 2007 and April 1, 2006.****Net revenues*

	<b>Three Months Ended</b>		<b>Change Over</b>	
	<b>March 31,</b>	<b>April 1,</b>	<b>Prior Period</b>	
	<b>2007</b>	<b>2006</b>	<b>Amount</b>	<b>%</b>
	<b>(In thousands, except percentages)</b>			
Equipment net revenues	\$ 72,446	\$ 47,573	\$ 24,873	52%
Imaging net revenues	3,928	2,047	1,881	92%
Total net revenues	\$ 76,374	\$ 49,620	\$ 26,754	54%

Net revenues consist primarily of sales of equipment used to manufacture thin-film disks, and, to a lesser extent, related equipment and system components, flat panel equipment technology license fees, contract research and development related to the development of electro-optical sensors, cameras and systems and low light imaging products.

Equipment revenue for the three months ending March 31, 2007 included revenue recognition for thirteen 200 Lean systems, and a significant quarter over quarter increase in revenue from disk equipment technology upgrades and spare parts. We also sold a D-Star® flat panel technology license for \$1.3 million. Revenue for the three months ended April 1, 2006 included revenue recognition of nine 200 Lean systems. We expect Equipment revenues in the first half of 2007 will be higher than in the first half of 2006, but revenues in the second half of 2007 will be lower than the comparable period of 2006.

Imaging revenue for the three months ending March 31, 2007 consisted of \$2.8 million of research and development contract revenue and \$1.1 million of product sales. Revenue for the three months ended April 1, 2006 consisted of \$1.5 million of contract research and development revenue and \$501,000 of product sales. The increase in contract research and development revenue was the result of a better mix of fully funded vs. partially funded programs.

Product revenue included contributions from our new DeltaNu subsidiary, which was acquired on January 31, 2007. Substantial growth in future Imaging revenues is dependent on proliferation of our technology into major military weapons programs, the ability to obtain export licenses for foreign customers, obtaining production subcontracts for these programs, and development and sale of commercial products.

Our backlog of orders at March 31, 2007 was \$92.8 million, as compared to \$125.0 million at December 31, 2006 and \$124.8 million at April 1, 2006. The decrease in backlog was primarily the result of the recognition for revenue of thirteen disk sputtering systems in the quarter. We include in backlog the value of purchase orders for our products that have scheduled delivery dates. We do not recognize revenue on this backlog until we have met the criteria contained in our revenue recognition policy, including customer acceptance of newly developed systems.

International sales increased by 69% to \$69.4 million for the three months ended March 31, 2007 from \$41.1 million for the three months ended April 1, 2006. International revenues include products shipped to overseas

**Table of Contents**

operations of U.S. companies. The increase in international sales was primarily due to an increase in net revenues from disk sputtering systems and disk equipment technology upgrades and spare parts. Substantially all of our international sales are to customers in Asia. International sales constituted 91% of net revenues for the three months ended March 31, 2007 and 83% of net revenues for the three months ended April 1, 2006. Our mix of domestic versus international sales will change from period to period depending on the location of our largest customer in each period.

*Gross margin*

	<b>Three Months Ended</b>		<b>% Change</b>
	<b>March 31, 2007</b>	<b>April 1, 2006</b>	
	<b>(In thousands, except percentages)</b>		
Equipment gross profit	\$ 31,345	\$ 16,769	87%
% of Equipment net revenues	43.3%	35.2%	
Imaging gross profit	\$ 1,437	\$ 537	168%
% of Imaging net revenues	36.6%	26.2%	
Total gross profit	\$ 32,782	\$ 17,306	89%
% of net revenues	42.9%	34.9%	

Cost of net revenues consists primarily of purchased materials and costs attributable to contract research and development, and also includes fabrication, assembly, test and installation labor and overhead, customer-specific engineering costs, warranty costs, royalties, provisions for inventory reserves and scrap. Cost of net revenues for the three months ended March 31, 2007 and April 1, 2006 included \$173,000 and \$46,000, respectively, of equity-based compensation expense.

Equipment gross margin improved to 43.3% in the three months ended March 31, 2007 from 35.3% in the three months ended April 1, 2006. The increase in gross margin was due to the flat panel license fee, cost reduction programs, increased volume and product mix. We expect the gross margin for the Equipment business in 2007 to be better than 2006, primarily as a result of continued cost reduction efforts undertaken on the 200 Lean system. Gross margins in the Equipment business will vary depending on a number of factors, including product mix, product cost, system configuration and pricing, factory utilization, and provisions for excess and obsolete inventory.

Imaging gross margin improved to 36.6% in the three months ended March 31, 2007 from 26.2% in the three months ended April 1, 2006. The increase in gross margin resulted primarily from higher margins on development contracts and favorable adjustments related to contract closeouts. We expect Imaging gross margin in 2007 to be improved over 2006, due primarily to an increase in both product revenue and revenue from fully funded research and development contracts.

*Research and development*

	<b>Three Months Ended</b>		<b>Change Over</b>	
	<b>March 31, 2007</b>	<b>April 1, 2006</b>	<b>Prior Period Amount</b>	<b>%</b>
	<b>(In thousands, except percentages)</b>			
Research and development expense	\$ 12,192	\$ 5,561	\$ 6,631	119%

% of net revenues	16.0%	11.2%
-------------------	-------	-------

Research and development expense consists primarily of prototype materials, salaries and related costs of employees engaged in ongoing research, design and development activities for disk sputtering equipment, semiconductor equipment and Imaging products. Research and development expense for the three months ended March 31, 2007 and April 1, 2006 included \$502,000 and \$204,000, respectively, of equity-based compensation expense.

Research and development spending increased in both Equipment and in Imaging during the three months ended March 31, 2007 as compared to the three months ended April 1, 2006. The increase in Equipment was due primarily to spending on the development of a new product line to serve the semiconductor market and, to a lesser

**Table of Contents**

extent, spending for continuing development of our disk sputtering products. The increase in Imaging was due primarily to increased spending on the development of our commercial Imaging products. Engineering headcount increased from 94 at April 1, 2006 to 137 at March 31, 2007. We expect that research and development spending will increase in 2007 due primarily to expenditures related to our new semiconductor equipment product line and the addition of key engineering personnel.

Research and development expenses do not include costs of \$1,439,000 and \$952,000 for the three-month periods ended March 31, 2007 and April 1, 2006, respectively, which are related to contract research and development and included in cost of net revenues.

*Selling, general and administrative*

	<b>Three Months Ended</b>		<b>Change Over</b>	
	<b>March 31,</b>	<b>April 1,</b>	<b>Prior Period</b>	
	<b>2007</b>	<b>2006</b>	<b>Amount</b>	<b>%</b>
	<b>(In thousands, except percentages)</b>			
Selling, general and administrative expense	\$ 7,513	\$ 5,114	\$ 2,399	47%
% of net revenues	9.8%	10.3%		

Selling, general and administrative expense consists primarily of selling, marketing, customer support, financial and management costs and also includes production of customer samples, travel, liability insurance, legal and professional services and bad debt expense. All domestic sales and international sales of disk sputtering products in Asia, with the exception of Japan, are typically made by Intevac's direct sales force, whereas sales in Japan of disk sputtering products and other products are typically made by our Japanese distributor, Matsubo, who provides services such as sales, installation, warranty and customer support. We also have subsidiaries in Singapore and in Hong Kong, along with field offices in Japan, Malaysia, Korea and Shenzhen, China to support our equipment customers in Asia. Selling, general and administrative expense for the three months ended March 31, 2007 and April 1, 2006 included \$679,000 and \$178,000, respectively, of equity-based compensation expense.

The increase in selling, general and administrative spending in the three months ended March 31, 2007 as compared to the three months ended April 1, 2006 was primarily the result of increases in costs related to business development, customer service and support in the Equipment business and legal expenses associated with the Unaxis litigation. Our selling, general and administrative headcount increased from 66 at April 1, 2006 to 87 at March 31, 2007. We expect that selling, general and administrative expenses will increase in 2007 over the amount spent in 2006 due primarily to a projected increase in costs related to customer service and support for the Equipment business, the addition of key business development and administrative personnel and increasing legal expenses.

*Interest income and other, net*

	<b>Three Months</b>		<b>Change Over</b>	
	<b>Ended</b>	<b>April 1,</b>	<b>Prior Period</b>	
	<b>March 31,</b>	<b>2006</b>	<b>Amount</b>	<b>%</b>
	<b>2007</b>			
	<b>(In thousands, except percentages)</b>			
Interest income and other, net	\$ 1,320	\$ 598	\$ 722	121%



Interest income and other, net consists primarily of interest and dividend income on investments and foreign currency gains and losses. The increase in the three months ended March 31, 2007 was driven by higher interest rates on our investments and a higher average invested balance. We expect interest income and other, net to increase in 2007 due to a higher average level of investments.

*Provision for income taxes*

	<b>Three Months Ended</b>		<b>Change Over Prior Period</b>	
	<b>March 31, 2007</b>	<b>April 1, 2006</b>	<b>Amount</b>	<b>%</b>
	<b>(In thousands, except percentages)</b>			
Provision for income taxes	\$ 4,552	\$ 218	\$ 4,334	1988%

## **Table of Contents**

For the three months ended March 31, 2007, we accrued income tax using an effective tax rate of 31.6% of pretax income. This rate is based on an estimate of our annual tax rate calculated in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes. Our effective tax rate is highly dependent on the availability of tax credits and the geographic composition of our worldwide earnings. Our deferred tax asset is partially offset by a valuation allowance, resulting in a net deferred tax asset of \$5.4 million at March 31, 2007.

For the three months ended April 1, 2006, we accrued income tax using an effective tax rate of 3.0% of pretax income. Our tax rate differs from the applicable statutory rates due to the utilization of net operating loss carry-forwards and deferred credits.

## **Stock-Based Compensation**

During the three months ended March 31, 2007 and April 1, 2006, we recorded stock-based compensation expense related to stock options of \$1.1 million and \$344,000, respectively. As of March 31, 2007, the unrecorded deferred stock-based compensation balance related to stock options was \$9.0 million and will be recognized over an estimated weighted average amortization period of 1.8 years.

The compensation cost associated with the employee stock purchase plan for the three months ended March 31, 2007 and April 1, 2006 was \$213,000 and \$116,000, respectively. There were 39,069 shares purchased under the employee stock purchase plan during the three months ended March 31, 2007.

Approximately \$73,000 and \$69,000 of stock-based compensation was capitalized as inventory at March 31, 2007 and December 31, 2006, respectively.

## **Liquidity and Capital Resources**

During the first fiscal quarter of 2007, cash, cash equivalents and short-term investments decreased by \$8.6 million, from \$39.4 million as of December 31, 2006 to \$30.8 million as of March 31, 2007.

Operating activities provided cash of \$13.2 million in the first quarter of 2007. The cash provided from operating activities was due primarily to net income, adjusted to exclude the effect of non-cash charges including depreciation and equity-based compensation, and to decreases in accounts receivable and inventories. This was partially offset by decreases in customer advances and accrued payroll. Accounts receivable totaled \$33.3 million at March 31, 2007, compared to \$39.9 million at December 31, 2006. The decrease of \$6.6 million in the receivable balance was due primarily to collections related to the record revenue generated in the fourth quarter of 2006. Net inventories decreased by \$4.0 million during the first quarter of 2007 due to a decrease in finished goods inventory. Accounts payable increased \$293,000 to \$16.3 million at March 31, 2007. Accrued payroll and related liabilities decreased by \$6.6 million during the three months ended March 31, 2007 due primarily to bonuses and profit sharing payments. Other accrued liabilities totaled \$9.8 million at March 31, 2007 compared to \$6.6 million at December 31, 2006. The increase of \$3.2 million is due primarily to income tax accruals. Customer advances decreased by \$5.8 million during the first quarter of 2007, due to both the number of systems shipped in the first quarter and to the systems accepted during the quarter.

Investing activities in the first three months of 2007 used cash of \$27.9 million. Purchases of investments, net of proceeds from sales and maturities, totaled \$20.2 million and our acquisition of DeltaNu, LLC used cash of \$5.8 million during the first quarter of 2007. Capital expenditures for the three months ended March 31, 2007 were \$1.9 million.

Financing activities provided cash of \$6.0 million during the three months ended March 31, 2007 due primarily to the issuance of \$3.7 million in notes payable related to the acquisition of DeltaNu, LLC. We also sold \$1.6 million of Intevac common stock to our employees through our employee benefit plans and recognized \$645,000 in tax benefits from equity-based compensation.

We have generated operating income for the last two years, after incurring annual operating losses from 1998 through 2004. We expect our Equipment business to be profitable again in 2007. We also expect to continue to invest in Imaging during 2007, but with lower losses than in 2006.

**Table of Contents**

We believe that our existing cash, cash equivalents and short-term investments, combined with the cash we anticipate generating from operating activities will be sufficient to meet our cash requirements for the foreseeable future. We intend to undertake approximately \$14 million in capital expenditures during the remainder of 2007.

**Contractual Obligations**

In the normal course of business, we enter into various contractual obligations that will be settled in cash. These obligations consist primarily of operating lease and purchase obligations. The expected future cash flows required to meet these obligations as of March 31, 2007 are shown in the table below.

	<b>Payments Due by Period</b>				
	<b>Total</b>	<b>&lt; 1 Year</b>	<b>1-3 Years</b>	<b>3-5 Years</b>	<b>&gt; 5 Years</b>
	<b>(In thousands)</b>				
Operating lease obligations	\$ 11,672	\$ 2,228	\$ 4,632	\$ 4,617	\$ 195
Purchase obligations	22,333	22,333			
<b>Total</b>	<b>\$ 34,005</b>	<b>\$ 24,561</b>	<b>\$ 4,632</b>	<b>\$ 4,617</b>	<b>\$ 195</b>

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

*Interest rate risk.* Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. We do not use derivative financial instruments in our investment portfolio. We place our investments with high quality credit issuers and, by policy, limit the amount of credit exposure to any one issuer. Short-term investments typically consist of investments in commercial paper, auction rate securities and debt instruments issued by the US government and its agencies.

The table below presents principal amounts and related weighted-average interest rates by year of maturity for our investment portfolio at March 31, 2007.

	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>Beyond</b>	<b>Total</b>	<b>Fair Value</b>
	<b>(In thousands, except percentages)</b>					
Cash equivalents						
Fixed rate amounts	\$ 5,176				\$ 5,176	\$ 5,176
Weighted-average rate	5.26%					
Variable rate amounts	\$ 10,961				\$ 10,961	\$ 10,961
Weighted-average rate	5.24%					
Short-term investments						
Fixed rate amounts	\$ 71,700				\$ 71,700	\$ 71,700
Weighted-average rate	5.24%					
Long-term investments						
Fixed rate amounts		\$ 8,000	\$ 4,000		\$ 12,000	\$ 11,999

Edgar Filing: INTEVAC INC - Form 10-Q

Weighted-average rate		5.28%	5.48%		
Total investment portfolio	\$ 87,837	\$ 8,000	\$ 4,000	\$ 99,837	\$ 99,836

Due to the short-term nature of our investments, we believe that we do not have any material exposure to changes in the fair value of our investment portfolio as a result of changes in interest rates.

*Foreign exchange risk.* From time to time, we enter into foreign currency forward exchange contracts to economically hedge certain of our anticipated foreign currency transaction, translation and re-measurement exposures. The objective of these contracts is to minimize the impact of foreign currency exchange rate movements on our operating results. At March 31, 2007, we had no foreign currency forward exchange contracts.

**Table of Contents**

**Item 4. *Controls and Procedures***

**Evaluation of disclosure controls and procedures.**

We maintain a set of disclosure controls and procedures that are designed to ensure that information relating to Intevac, Inc. required to be disclosed in periodic filings under Securities Exchange Act of 1934, or Exchange Act, is recorded, processed, summarized and reported in a timely manner under the Exchange Act. In connection with the filing of this Form 10-Q for the quarter ended March 31, 2007, as required under Rule 13a-15(b) of the Exchange Act, an evaluation was carried out under the supervision and with the participation of management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this quarterly report. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of March 31, 2007.

Attached as exhibits to this Quarterly Report are certifications of the CEO and the CFO, which are required in accordance with Rule 13a-14 of the Securities Exchange Act of 1934, as amended (Exchange Act). This Controls and Procedures section includes the information concerning the controls evaluation referred to in the certifications, and it should be read in conjunction with the certifications for a more complete understanding of the topics presented.

**Definition of Disclosure Controls**

Disclosure Controls are controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act, such as this Quarterly Report, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure Controls are also designed to ensure that such information is accumulated and communicated to our management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. Our Disclosure Controls include components of our internal control over financial reporting, which consists of control processes designed to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles in the U.S. To the extent that components of our internal control over financial reporting are included within our Disclosure Controls, they are included in the scope of our quarterly controls evaluation.

**Limitations on the Effectiveness of Controls**

Our management, including the CEO and CFO, does not expect that our Disclosure Controls or our internal control over financial reporting will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

**Changes in internal controls over financial reporting**

There were no changes in our internal controls over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents**

**PART II. OTHER INFORMATION**

**Item 1. *Legal Proceedings***

***Patent Infringement Complaint against Unaxis***

On July 7, 2006, we filed a patent infringement lawsuit against Unaxis USA, Inc. and its affiliates, Unaxis Balzers AG and Unaxis Balzers, Ltd., in the United States District Court for the Central District of California. Our lawsuit against Unaxis asserts infringement by Unaxis of United States Patent 6,919,001, which relates to our 200 Lean system. Our complaint seeks monetary damages and an injunction that bars Unaxis from making, using, offering to sell or selling in the United States, or importing into the United States, Unaxis allegedly infringing product. In the suit, we seek damages and a permanent injunction for infringement of the same patent. We believe we have meritorious claims, and we intend to pursue them vigorously.

On September 12, 2006, Unaxis filed a response to our lawsuit in which it asserted non-infringement, invalidity of our patent, inequitable conduct by Intevac, patent misuse by Intevac, and lack of jurisdiction by the court as defenses. Additionally, Unaxis requested a declaratory judgment of patent non-infringement, invalidity and unenforceability; asserted our violation of the California Business and Professional Code; requested that we be enjoined from engaging in any unfair competition; and requested that we be required to pay Unaxis attorney fees. We believe such claims lack merit, and we intend to defend ourselves vigorously.

We replied to Unaxis response on October 3, 2006, denying the assertions of non-infringement, invalidity and unenforceability of the Intevac patent, and denying any unfair competition. With the approval of the Court, we amended our complaint on February 6, 2007 to assert an additional ground for our infringement claim and to add a request for a declaratory judgment of infringement. Unaxis filed a response on February 21, 2007, in which it repeated the assertions of its September 12, 2006 response.

On March 29, 2007, the court denied a motion filed by Unaxis requesting a stay of the litigation pending action by the U.S. Patent Office on their February 27, 2007 request for a reexamination of United States Patent 6,919,001. Unaxis renewed the stay motion on May 1, 2007 after the U.S. Patent Office granted the reexamination request and issued an initial office action rejecting the claims of the 001 patent. Intevac had no input to the initial determination by the U.S. Patent Office, but will now participate in the reexamination.

***Other Legal Matters***

From time to time, we are involved in claims and legal proceedings that arise in the ordinary course of business. We expect that the number and significance of these matters will increase as our business expands. Any claims or proceedings against us, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time, result in the diversion of significant operational resources, or require us to enter into royalty or licensing agreements which, if required, may not be available on terms favorable to us or at all. We are not presently party to any lawsuit or proceeding that, in our opinion, is likely to seriously harm our business.

**Item 1A. *Risk Factors***

***Demand for capital equipment is cyclical, which subjects our business to long periods of depressed revenues interspersed with periods of unusually high revenues.***



Our Equipment business sells equipment to capital-intensive industries, which sell commodity products such as disk drives. When demand for these commodity products exceeds capacity, demand for new capital equipment such as ours tends to be amplified. Conversely, when supply of these commodity products exceeds demand, the demand for new capital equipment such as ours tends to be depressed. The hard disk drive industry has historically been subject to multi-year cycles because of the long lead times and high costs involved in adding capacity, and to seasonal cycles driven by consumer purchasing patterns, which tend to be heaviest in the third and fourth quarters of each year.

The cyclical nature of the capital equipment industry means that in some years we will have unusually high sales of new systems, and that in other years our sales of new systems will be severely depressed. The timing, length

**Table of Contents**

and volatility of these cycles are difficult to predict. These cycles have affected the timing and amounts of our customers' capital equipment purchases and investments in new technology. For example, sales of systems for magnetic disk production were severely depressed from mid-1998 until mid-2003 and grew rapidly from 2004 through 2006. We cannot predict with any certainty when these cycles will begin and end.

***If the projected growth in demand for hard disk drives does not materialize and our customers do not replace or upgrade their installed base of disk sputtering systems, then future sales of our disk sputtering systems will suffer.***

From mid-1998 until mid-2003, there was very little demand for new disk sputtering systems, as magnetic disk manufacturers were burdened with over-capacity and were not investing in new disk sputtering equipment. By 2003, however, over-capacity had diminished, and orders for our 200 Lean began to increase.

Sales of our equipment for capacity expansions are dependent on the capacity expansion plans of our customers and upon whether our customers select our equipment for their capacity expansions. We have no control over our customers' expansion plans, and we cannot assure you that they will select our equipment if they do expand their capacity. Our customers may not implement capacity expansion plans, or we may fail to win orders for equipment for those capacity expansions, which could have a material adverse effect on our business and our operating results. In addition, some manufacturers may choose to purchase used systems from other manufacturers or customers rather than purchasing new systems from us.

Sales of our 200 Lean disk sputtering systems are also dependent on obsolescence and replacement of the installed base of disk sputtering equipment. If technological advancements are developed that extend the useful life of the installed base of systems, then sales of our 200 Lean will be limited to the capacity expansion needs of our customers, which would significantly decrease our revenue.

Our customers have experienced competition from other companies that produce alternative storage technologies like flash memory, where increased capacity, improving cost, lower power consumption and performance ruggedness have resulted in competition with lower capacity, smaller form factor disk drives in handheld applications. While this competition has traditionally been in the markets for handheld consumer electronics applications like personal media players, these competitors have recently announced products for notebook and enterprise compute applications. If alternative technologies, such as flash memory, replace hard disk drives as a primary method of digital storage, demand for our products would decrease.

***Our operating results fluctuate significantly from quarter to quarter, which may cause the price of our stock to decline.***

Over the last 9 quarters, our revenues per quarter have fluctuated between \$10.6 million and \$95.9 million. Over the same period our operating income (loss) as a percentage of revenues has fluctuated between approximately 23% and (41%) of revenues. We anticipate that our revenues and operating margins will continue to fluctuate. We expect this fluctuation to continue for a variety of reasons, including:

changes in the demand, due to seasonality, cyclicity and other factors, for computer systems, storage subsystems and consumer electronics containing disks our customers produce with our systems; and

delays or problems in the introduction and acceptance of our new products, or delivery of existing products;

our business is inherently subject to fluctuations in revenue from quarter to quarter due to factors such as timing of orders, acceptance of new systems by our customers or cancellation of those orders;

new products, services or technological innovations by our competitors or us.

Additionally, because our systems are priced in the millions of dollars and we sell a relatively small number of systems, we believe that quarter-to-quarter comparisons of our revenues and operating results may not be an accurate indicator of our future performance. Our operating results in one or more future quarters may fail to meet the expectations of investment research analysts or investors, which could cause an immediate and significant decline in the trading price of our common shares.

**Table of Contents*****We are exposed to risks associated with a highly concentrated customer base.***

Historically, a significant portion of our revenue in any particular period has been attributable to sales of our disk sputtering systems to a limited number of customers. In 2006, one of our customers accounted for 52% of our revenues, and three customers in the aggregate accounted for 93% of our revenues. The same three customers, in the aggregate, accounted for 86% of our net accounts receivable at December 31, 2006. During 2006, Seagate acquired Maxtor, which further consolidated our customer base. Orders from a relatively limited number of magnetic disk manufacturers have accounted for, and likely will continue to account for, a substantial portion of our revenues. The loss of, or delays in purchasing by, any one of our large customers would significantly reduce potential future revenues. The concentration of our customer base may enable customers to demand pricing and other terms unfavorable to us. Furthermore, the concentration of customers can lead to extreme variability in revenue and financial results from period to period. For example, during 2006 revenues ranged between \$49.6 million in the first quarter and \$95.9 million in the fourth quarter. These factors could have a material adverse effect on our business, financial condition and results of operations.

***Our long-term revenue growth is dependent on new products. If these new products are not successful, then our results of operations will be adversely affected.***

We have invested heavily, and continue to invest, in the development of new products. Our success in developing and selling new products depends upon a variety of factors, including our ability to predict future customer requirements accurately, technological advances, total cost of ownership of our systems, our introduction of new products on schedule, our ability to manufacture our products cost-effectively and the performance of our products in the field. Our new product decisions and development commitments must anticipate continuously evolving industry requirements significantly in advance of sales.

The majority of our revenues in both fiscal 2006 and fiscal 2005 were from sales of our 200 Lean disk sputtering system, which was first delivered in December 2003. When first introduced, advanced vacuum manufacturing equipment, such as the 200 Lean, is subject to extensive customer acceptance tests after installation at the customer's factory. These acceptance tests are designed to validate reliable operation to specifications in areas such as throughput, vacuum level, robotics, process performance and software features and functionality. These tests are generally more comprehensive for new systems than for mature systems, and are designed to highlight problems encountered with early versions of the equipment. For example, initial builds of the 200 Lean experienced high production and warranty costs in comparison to our more established product lines. Failure to promptly address any of the problems uncovered in these tests could have adverse effects on our business, including rescheduling of backlog, failure to achieve customer acceptance and therefore revenue recognition as anticipated, unanticipated product rework and warranty costs, penalties for non-performance, cancellation of orders, or return of products for credit.

We are making a substantial investment to develop a new manufacturing system for semiconductor manufacturing. We spent a substantial portion of our research and development costs on this new product in 2006 and expect to increase our level of spending on this project in 2007. Intevac has not developed or sold products for this market previously. Failure to correctly assess the size of the market, to successfully develop a cost effective product to address the market, or to establish effective sales and support of the new product would have a material adverse effect on our future revenues and profits, including loss of the Company's entire investment in the project.

We are jointly developing a next generation head mounted night-vision system with another defense contractor. This system is planned for sale to the U.S. military and will compete with head-mounted systems developed by our competitors. The US military does not intend to initiate production of this system until 2010. We plan to make a significant investment in this product and cannot be assured when, or if, we will be awarded any production contracts

for these night vision systems.

We have developed a night-vision sensor and camera module for use in a NATO customer's digital head-mounted and rifle-sight system. In 2006, we entered into a purchasing agreement with our customer to deliver 32,000 camera modules over seven years. We cannot guarantee that we will achieve the yield improvements and cost reductions necessary for this program to be successful. Shipments under this program are subject to export approval from the U.S. government.

**Table of Contents**

Our LIVAR target identification and low light level camera technologies are designed to offer significantly improved capability to military customers. We are also developing commercial products in our Imaging business. None of our Imaging products are currently being manufactured in high volume, and we may encounter unforeseen difficulties when we commence volume production of these products. Our Imaging business will require substantial further investment in sales and marketing, in product development and in additional production facilities in order to expand our operations. We may not succeed in these activities or generate significant sales of these new products. In 2006, sales of our Imaging products totaled \$1.7 million.

Failure of any of these new products to perform as intended, to penetrate their markets and develop into profitable product lines or to achieve their production cost objectives would have a material adverse effect on our business.

***We may not be successful in maintaining and obtaining the necessary export licenses to conduct operations abroad, and the United States government may prevent proposed sales to foreign customers.***

Many of our Imaging products require export licenses from United States Government agencies under the Export Administration Act, the Trading with the Enemy Act of 1917, the Arms Export Act of 1976 and the International Traffic in Arms Regulations. This limits the potential market for our products. We can give no assurance that we will be successful in obtaining all the licenses necessary to export our products. Recently, heightened government scrutiny of export licenses for products in our market has resulted in lengthened review periods for our license applications. Export to countries, which are not considered by the United States Government to be allies, is likely to be prohibited, and even sales to U.S. allies may be limited. Failure to obtain, delays in obtaining, or revocation of previously issued licenses would prevent us from selling our products outside the United States, may subject us to fines or other penalties, and would have a material adverse effect on our business, financial condition and results of operations.

***Our products are complex, constantly evolving and often must be customized to individual customer requirements.***

The systems we manufacture and sell in our Equipment business have a large number of components and are complex, which require us to make substantial investments in research and development. If we were to fail to develop, manufacture and market new systems or to enhance existing systems, that failure would have an adverse effect on our business. We may experience delays and technical and manufacturing difficulties in future introduction, volume production and acceptance of new systems or enhancements. In addition, some of the systems that we manufacture must be customized to meet individual customer site or operating requirements. In some cases, we market and commit to deliver new systems, modules and components with advanced features and capabilities that we are still in the process of designing. We have limited manufacturing capacity and engineering resources and may be unable to complete the development, manufacture and shipment of these products, or to meet the required technical specifications for these products, in a timely manner. Failure to deliver these products on time, or failure to deliver products that perform to all contractually committed specifications, could have adverse effects on our business, including rescheduling of backlog, failure to achieve customer acceptance and therefore revenue recognition as anticipated, unanticipated rework and warranty costs, penalties for non-performance, cancellation of orders, or return of products for credit. In addition, we may incur substantial unanticipated costs early in a product's life cycle, such as increased engineering, manufacturing, installation and support costs, that we may be unable to pass on to the customer and that may affect our gross margins. Sometimes we work closely with our customers to develop new features and products. In connection with these transactions, we sometimes offer a period of exclusivity to these customers.

***Our sales cycle is long and unpredictable, which requires us to incur high sales and marketing expenses with no assurance that a sale will result.***

The sales cycle for our equipment systems can be a year or longer, involving individuals from many different areas of our company and numerous product presentations and demonstrations for our prospective customers. Our sales process for these systems also includes the production of samples and customization of products for our

**Table of Contents**

prospective customers. We do not enter into long-term contracts with our customers and therefore until an order is actually submitted by a customer there is no binding commitment to purchase our systems.

Our Imaging business is also subject to long sales cycles because many of our products, such as our LIVAR system, often must be designed into our customers' products, which are often complex state-of-the-art products. These development cycles are often multi-year, and our sales are contingent on our customers successfully integrating our product into their product, completing development of their product and then obtaining production orders for their product from the U.S. government or its allies.

As a result, we may not recognize revenue from our products for extended periods of time after we have completed development, and made initial shipments of our products, during which time we may expend substantial funds and management time and effort with no assurance that a sale will result.

***We operate in an intensely competitive marketplace, and our competitors have greater resources than we do.***

In the market for our disk sputtering systems, we have experienced competition from competitors such as Anelva Corporation, which is a subsidiary of Canon, and Oerlikon, each of which has sold substantial numbers of systems worldwide. In the market for semiconductor equipment, we expect to experience competition from competitors such as Applied Materials, LAM Research and Tokyo Electron, Ltd. In the market for our military Imaging products, we experience competition from companies such as ITT Industries, Inc. and Northrop Grumman Corporation, the primary U.S. manufacturers of Generation-III night vision devices and their derivative products. In the markets for our commercial Imaging products, we compete with companies such as Andor, E2V, Hamamatsu, Texas Instruments and Roper Scientific for sensor and camera products, and with companies such as Ahura, B&W Tek, Horiba Jobin Yvon, InPhotonics, Ocean Optics, and Smiths Detection for portable Raman spectrometer products. Our competitors have substantially greater financial, technical, marketing, manufacturing and other resources than we do. We cannot assure you that our competitors will not develop enhancements to, or future generations of, competitive products that offer superior price or performance features. Likewise, we cannot assure you that new competitors will not enter our markets and develop such enhanced products. Moreover, competition for our customers is intense, and our competitors have historically offered substantial pricing concessions and incentives to attract our customers or retain their existing customers.

***We experienced significant growth in our business and operations and if we do not appropriately manage this growth and any future growth, our operating results will be negatively affected.***

Our business has grown significantly in recent years in both operations and headcount, and continued growth may cause a significant strain on our infrastructure, internal systems and managerial resources. To manage our growth effectively, we must continue to improve and expand our infrastructure, including information technology and financial operating and administrative systems and controls, and continue managing headcount, capital and processes in an efficient manner. Our productivity and the quality of our products may be adversely affected if we do not integrate and train our new employees quickly and effectively and coordinate among our executive, engineering, finance, marketing, sales, operations and customer support organizations, all of which add to the complexity of our organization and increase our operating expenses. We also may be less able to predict and effectively control our operating expenses due to the growth and increasing complexity of our business. In addition, our information technology systems may not grow at a sufficient rate to keep up with the processing and information demands placed on them by a much larger company. The efforts to continue to expand our information technology systems or our inability to do so could harm our business. Further, revenues may not grow at a sufficient rate to absorb the costs associated with a larger overall headcount.



Our future growth may require significant additional resources, given that, as we increase our business operations in complexity and scale, we may have insufficient management capabilities and internal bandwidth to manage our growth and business effectively. We cannot assure you that resources will be available when we need them or that we will have sufficient capital to fund these potential resource needs. Also, growth in the number of orders received in our Equipment business may require additional physical space and headcount, and our ability to fulfill such orders may be constrained if we are unable to effectively grow our business. If we are unable to manage our growth effectively or if we experience a shortfall in resources, our results of operations will be harmed.

**Table of Contents**

***Our Imaging business depends heavily on government contracts, which are subject to immediate termination and are funded in increments. The termination of or failure to fund one or more of these contracts could have a negative impact on our operations.***

We sell many of our Imaging products and services directly to the U.S. government, as well as to prime contractors for various U.S. government programs. Our revenues from government contracts totaled \$10.2 million, \$6.9 million, and \$8.2 million in 2006, 2005, and 2004, respectively. Generally, government contracts are subject to oversight audits by government representatives and contain provisions permitting termination, in whole or in part, without prior notice at the government's convenience upon the payment of compensation only for work done and commitments made at the time of termination. We cannot assure you that one or more of the government contracts under which our customers or we operate will not be terminated under these circumstances. Also, we cannot assure you that we or our customers would be able to procure new government contracts to offset the revenues lost as a result of any termination of existing contracts, nor can we assure you that we or our customers will continue to remain in good standing as federal contractors.

Furthermore, the funding of multi-year government programs is subject to congressional appropriations, and there is no guarantee that the U.S. government will make further appropriations. The loss of funding for a government program would result in a loss of anticipated future revenues attributable to that program. That could increase our overall costs of doing business.

In addition, sales to the U.S. government and its prime contractors may be affected by changes in procurement policies, budget considerations and political developments in the United States or abroad. The influence of any of these factors, which are beyond our control, could also negatively impact our financial condition. We also may experience problems associated with advanced designs required by the government, which may result in unforeseen technological difficulties and cost overruns. Failure to overcome these technological difficulties or occurrence of cost overruns would have a material adverse effect on our business.

***Unexpected increases in the cost to develop or manufacture our products under fixed-price contracts may cause us to experience un-reimbursed cost overruns.***

A portion of our revenue is derived from fixed-price development and production contracts. Under fixed-price contracts, unexpected increases in the cost to develop or manufacture a product, whether due to inaccurate estimates in the bidding process, unanticipated increases in material costs, inefficiencies or other factors, are borne by us. We have experienced cost overruns in the past that have resulted in losses on certain contracts, and may experience additional cost overruns in the future. We are required to recognize the total estimated impact of cost overruns in the period in which they are first identified. Such cost overruns could have a material adverse effect on our results of operation and financial condition.

***Our sales of disk sputtering systems are dependent on substantial capital investment by our customers, far in excess of the cost of our products.***

Our customers must make extremely large capital expenditures in order to purchase our systems and other related equipment and facilities. These costs are far in excess of the cost of our systems alone. The magnitude of such capital expenditures requires that our customers have access to large amounts of capital and that they be willing to invest that capital over long periods of time to be able to purchase our equipment. The magnetic disk manufacturing industry has made significant additions to its production capacity in the last few years. Our customers may not be willing or able to continue this level of capital investment, especially during a downturn in either the overall economy or the hard disk drive industry.

***Our stock price is volatile.***

The market price and trading volume of our common stock has been subject to significant volatility, and this trend may continue. Over the last 12 months, the closing price of our common stock, as traded on The Nasdaq

**Table of Contents**

National Market, fluctuated from a low of \$14.81 per share to a high of \$30.60 per share. The value of our common stock may decline regardless of our operating performance or prospects. Factors affecting our market price include:

our perceived prospects;

hard disk drive market expectations;

variations in our operating results and whether we achieve our key business targets;

sales or purchases of large blocks of our stock;

changes in, or our failure to meet, our revenue and earnings estimates;

changes in securities analysts' buy or sell recommendations;

differences between our reported results and those expected by investors and securities analysts;

announcements of new contracts, products or technological innovations by us or our competitors;

market reaction to any acquisitions, joint ventures or strategic investments announced by us or our competitors;

our high fixed operating expenses, including research and development expenses;

developments in the financial markets; and

general economic, political or stock market conditions in the United States and other major regions in which we do business.

In addition, the general economic, political, stock market and hard drive industry conditions that may affect the market price of our common stock are beyond our control. The market price of our common stock at any particular time may not remain the market price in the future. In the past, securities class action litigation has been instituted against companies following periods of volatility in the market price of their securities. Any such litigation, if instituted against us, could result in substantial costs and a diversion of management's attention and resources.

***Changes in tax rates or tax liabilities could affect future results.***

As a global company, we are subject to taxation in the United States and various other countries. Significant judgment is required to determine and estimate worldwide tax liabilities. Our future tax rates could be affected by changes in the applicable tax laws, composition of earnings in countries with differing tax rates, changes in the valuation of our deferred tax assets and liabilities, or changes in the tax laws. Although we believe our tax estimates are reasonable, there can be no assurance that any final determination will not be materially different from the treatment reflected in our historical income tax provisions and accruals, which could materially and adversely affect our results of operations.

Our effective tax rate in both 2006 and 2005 was well below the applicable statutory rates due primarily to the utilization of net operating loss carry-forwards and deferred credits. We are currently projecting an effective tax rate of 31.6% for 2007.

***Our future success depends on international sales and the management of global operations***

In 2006, approximately 90% of our revenues came from regions outside the United States. We currently have international customer support offices in Singapore, China, Malaysia, Korea and Japan. We expect that international sales will continue to account for a significant portion of our total revenue in future years. Certain manufacturing facilities and suppliers are also located outside the United States. Managing our global operations presents challenges including, but not limited to, those arising from:

varying regional and geopolitical business conditions and demands;

global trade issues;

variations in protection of intellectual property and other legal rights in different countries;

**Table of Contents**

rising raw material and energy costs;

variations in the ability to develop relationships with suppliers and other local businesses;

changes in laws and regulations of the United States (including export restrictions) and other countries, as well as their interpretation and application;

fluctuations in interest rates and currency exchange rates;

the need to provide sufficient levels of technical support in different locations;

political instability, natural disasters (such as earthquakes, hurricanes or floods), pandemics, terrorism or acts of war where we have operations, suppliers or sales;

cultural differences; and

shipping delays.

***Changes in existing financial accounting standards or practices or taxation rules or practices may adversely affect our results of operations.***

Changes in existing accounting or taxation rules or practices, new accounting pronouncements or taxation rules, or varying interpretations of current accounting pronouncements or taxation practice could have a significant adverse effect on our results of operations or the manner in which we conduct our business. Further, such changes could potentially affect our reporting of transactions completed before such changes are effective. In December 2004, the Financial Accounting Standards Board ( FASB ) enacted Statement of Financial Accounting Standards 123 (Revised 2004) ( SFAS 123R ), Share-Based Payment, which replaces SFAS No. 123 ( SFAS 123 ), Accounting for Stock-Based Compensation. SFAS 123R requires the measurement of all share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such compensation expense in our statements of income. We adopted SFAS 123R in the first quarter of fiscal year 2006. In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN 48 ). FIN 48, which was effective January 1, 2007, clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. We adopted FIN 48 in the first quarter of fiscal year 2007.

***We are required to evaluate our internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act of 2002, and any adverse results from such evaluation could result in a loss of investor confidence in our financial reports and have an adverse effect on our stock price.***

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, our management must perform evaluations of our internal control over financial reporting. Beginning in 2004, our Form 10-K has included a report by management of their assessment of the adequacy of such internal control. Additionally, our independent registered public accounting firm must publicly attest to the adequacy of management's assessment and the effectiveness of our internal control.

We have completed the evaluation of our internal controls over financial reporting as required by Section 404 of the Sarbanes-Oxley Act of 2002. Although our assessment, testing, and evaluation resulted in our conclusion that as of December 31, 2006, our internal controls over financial reporting were effective, we cannot predict the outcome of our testing in future periods. If our internal controls are ineffective in future periods, our financial results or the market

price of our shares could be adversely affected. We will incur additional expenses and commitment of management's time in connection with further evaluations.

***Our dependence on suppliers for certain parts, some of them sole-sourced, makes us vulnerable to manufacturing interruptions and delays, which could affect our ability to meet customer demand.***

We are a manufacturing business. Purchased parts constitute the largest component of our product cost. Our ability to manufacture depends on the timely delivery of parts, components and subassemblies from suppliers. We obtain some of the key components and sub-assemblies used in our products from a single supplier or a limited

**Table of Contents**

group of suppliers. If any of our suppliers fail to deliver quality parts on a timely basis, we may experience delays in manufacturing, which could result in delayed product deliveries or increased costs to expedite deliveries or develop alternative suppliers. Development of alternative suppliers could require redesign of our products.

***Our business depends on the integrity of our intellectual property rights and failure to protect our intellectual property rights adequately could have a material adverse effect on our business.***

The success of our business depends upon integrity of our intellectual property rights, and we cannot assure you that:

any of our pending or future patent applications will be allowed or that any of the allowed applications will be issued as patents or will issue with claims of the scope we sought;

any of our patents will not be invalidated, deemed unenforceable, circumvented or challenged;

the rights granted under our patents will provide competitive advantages to us;

other parties will not develop similar products, duplicate our products or design around our patents; or

our patent rights, intellectual property laws or our agreements will adequately protect our intellectual property or competitive position.

***We may be subject to claims of intellectual property infringement.***

From time to time, we have received claims that we are infringing third parties' intellectual property rights. We cannot assure you that third parties will not in the future claim that we have infringed current or future patents, trademarks or other proprietary rights relating to our products. Any claims, with or without merit, could be time-consuming, result in costly litigation, cause product shipment delays or require us to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us.

***Our success is dependent on recruiting and retaining a highly talented work force.***

Our employees are vital to our success, and our key management, engineering and other employees are difficult to replace. We generally do not have employment contracts with our key employees. Further, we do not maintain key person life insurance on any of our employees. The expansion of high technology companies worldwide has increased demand and competition for qualified personnel, and has made companies increasingly protective of prior employees. It may be difficult for us to locate employees who are not subject to non-competition and other restrictions.

Our U.S. operations are located in Santa Clara, California and Fremont, California, where the cost of living and recruiting employees is high. Additionally, our operating results depend, in large part, upon our ability to retain and attract qualified management, engineering, marketing, manufacturing, customer support, sales and administrative personnel. Furthermore, we compete with similar industries, such as the semiconductor industry, for the same pool of skilled employees. If we are unable to retain key personnel, or if we are not able to attract, assimilate or retain additional highly qualified employees to meet our needs in the future, our business and operations could be harmed.

***Changes in demand caused by fluctuations in interest and currency exchange rates may reduce our international sales.***

Sales and operating activities outside of the United States are subject to inherent risks, including fluctuations in the value of the U.S. 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. We earn a significant portion of our revenue from international sales, and there can be no assurance that any of these factors will not have an adverse effect on our ability to sell our products or operate outside the United States.

We currently quote and sell the majority of our products in U.S. dollars. From time to time, we may enter into foreign currency contracts in an effort to reduce the overall risk of currency fluctuations to our business. However,

**Table of Contents**

there can be no assurance that the offer and sale of products denominated in foreign currencies, and the related foreign currency hedging activities, will not adversely affect our business.

Our principal competitor for disk sputtering equipment is based in Japan and has a cost structure based on the Japanese yen. Accordingly, currency fluctuations could cause the price of our products to be more or less competitive than our principal competitor's products. Currency fluctuations will decrease or increase our cost structure relative to those of our competitors, which could lessen the demand for our products and affect our competitive position.

***Difficulties in integrating past or future acquisitions could adversely affect our business.***

We have completed a number of acquisitions during our operating history and we recently announced the acquisition of certain assets of DeltaNu, LLC. We have spent and will continue to spend significant resources identifying and acquiring businesses. The efficient and effective integration of our acquired businesses into our organization is critical to our growth. Any future acquisitions involve numerous risks including difficulties in integrating the operations, technologies and products of the acquired companies, the diversion of our management's attention from other business concerns and the potential loss of key employees of the acquired companies. Failure to achieve the anticipated benefits of these and any future acquisitions or to successfully integrate the operations of the companies we acquire could also harm our business, results of operations and cash flows. Any future acquisitions may also result in potentially dilutive issuance of equity securities, acquisition- or divestiture-related write-offs or the assumption of debt and contingent liabilities.

***We use hazardous materials and are subject to risks of non-compliance with environmental and safety regulations.***

We are subject to a variety of governmental regulations relating to the use, storage, discharge, handling, emission, generation, manufacture, treatment and disposal of toxic or otherwise hazardous substances, chemicals, materials or waste. If we fail to comply with current or future regulations, such failure could result in suspension of our operations, alteration of our manufacturing process, or substantial civil penalties or criminal fines against us or our officers, directors or employees. Additionally, these regulations could require us to acquire expensive remediation or abatement equipment or to incur substantial expenses to comply with them. Failure to properly manage the use, disposal or storage of, or adequately restrict the release of, hazardous or toxic substances could subject us to significant liabilities.

***Future sales of shares of our common stock by our officers, directors and affiliates could cause our stock price to decline.***

Substantially all of our common stock may be sold without restriction in the public markets, although shares held by our directors, executive officers and affiliates may be subject to volume and manner of sale restrictions. Sales of a substantial number of shares of common stock in the public market by our officers, directors or affiliates or the perception that these sales could occur could materially and adversely affect our stock price and make it more difficult for us to sell equity securities in the future at a time and price we deem appropriate.

***Anti-takeover provisions in our charter documents and under California law could prevent or delay a change in control, which could negatively impact the value of our common stock by discouraging a favorable merger or acquisition of us.***

Our articles of incorporation authorize our board of directors to issue up to 10,000,000 shares of preferred stock and to determine the powers, preferences, privileges, rights, including voting rights, qualifications, limitations and restrictions of those shares, without any further vote or action by the shareholders. The rights of the holders of our common stock will be subject to, and may be adversely affected by, the rights of the holders of any preferred stock

that we may issue in the future. The issuance of preferred stock could have the effect of delaying, deterring or preventing a change in control and could adversely affect the voting power of your shares. In addition, provisions of California law and our bylaws could make it more difficult for a third party to acquire a majority of our outstanding voting stock by discouraging a hostile bid, or delaying or deterring a merger, acquisition or tender offer in which our

**Table of Contents**

shareholders could receive a premium for their shares or a proxy contest for control of our company or other changes in our management.

***We could be involved in litigation***

From time to time we may be involved in litigation of various types, including litigation alleging infringement of intellectual property rights and other claims. For example, in July 2006, we filed a patent infringement lawsuit against Unaxis USA, Inc. and its affiliates Unaxis Balzers AG and Unaxis Balzers, Ltd. alleging infringement by Unaxis of a patent relating to our 200 Lean system. Litigation tends to be expensive and requires significant management time and attention and could have a negative effect on our results of operations or business if we lose or have to settle a case on significantly adverse terms.

***Business interruptions could adversely affect our operations.***

Our operations are vulnerable to interruption by fire, earthquake or other natural disaster, quarantines or other disruptions associated with infectious diseases, national catastrophe, terrorist activities, war, disruptions in our computing and communications infrastructure due to power loss, telecommunications failure, human error, physical or electronic security breaches and computer viruses, and other events beyond our control. We do not have a fully implemented detailed disaster recovery plan. Despite our implementation of network security measures, our tools and servers are vulnerable to computer viruses, break-ins and similar disruptions from unauthorized tampering with our computer systems and tools located at customer sites. Political instability could cause us to incur increased costs in transportation, make such transportation unreliable, increase our insurance costs and cause international currency markets to fluctuate. This same instability could have the same effects on our suppliers and their ability to timely deliver their products. In addition, we do not carry sufficient business interruption insurance to compensate us for all losses that may occur, and any losses or damages incurred by us could have a material adverse effect on our business and results of operations. For example, we self-insure earthquake risks, because we believe this is the prudent financial decision based on the high cost of the limited coverage available in the earthquake insurance market. An earthquake could significantly disrupt our operations, most of which are conducted in California. It could also significantly delay our research and engineering effort on new products, most of which is also conducted in California. We take steps to minimize the damage that would be caused by an earthquake, but there is no certainty that our efforts will prove successful in the event of an earthquake.

**Item 2. *Unregistered Sales of Equity Securities and Use of Proceeds***

None.

**Item 3. *Defaults upon Senior Securities***

None.

**Item 4. *Submission of Matters to a Vote of Security-Holders***

None.

**Item 5. *Other Information***

None.



**Table of Contents**

**Item 6. Exhibits**

The following exhibits are filed herewith:

<b>Number</b>	<b>Exhibit Description</b>
31.1	Certification of President and Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Vice President, Finance and Administration, Chief Financial Officer, Treasurer and Secretary Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification Pursuant to U.S.C. 1350 adopted Pursuant to Section 906 of the Sarbanes- Oxley Act of 2002.

**Table of Contents**

**SIGNATURES**

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

INTEVAC, INC.

By: /s/ KEVIN FAIRBAIRN

Kevin Fairbairn  
President, Chief Executive Officer and Director  
(Principal Executive Officer)

Date: May 10, 2007

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)

Date: May 10, 2007

**Table of Contents**

**Exhibit Index**

<b>Number</b>	<b>Exhibit Description</b>
31.1	Certification of President and Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Vice President, Finance and Administration, Chief Financial Officer, Treasurer and Secretary Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification Pursuant to U.S.C. 1350 adopted Pursuant to Section 906 of the Sarbanes- Oxley Act of 2002.