INTEVAC INC
Form 10-Q
October 31, 2017
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UNITED STATES

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 September 30, 2017

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)

Delaware	**94-3125814**
(State or other jurisdiction of incorporation or organization)	**(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

On October 31, 2017, 21,789,007 shares of the Registrant s Common Stock, $0.001 par value, were outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. ***Financial Statements***

INTEVAC, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2017	December 31, 2016
	(Unaudited)	
	(In thousands, except par value)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 19,197	$ 27,043
Short-term investments	18,037	17,602
Trade and other accounts receivable, net of allowances of $0 at both September 30, 2017 and at December 31, 2016	22,311	17,447
Inventories	32,581	24,876
Prepaid expenses and other current assets	2,825	1,768
Total current assets	94,951	88,736
Property, plant and equipment, net	12,509	11,237
Long-term investments	6,165	3,593
Restricted cash	1,400	1,602
Intangible assets, net of amortization of $6,725 at September 30, 2017 and $6,129 at December 31, 2016	1,662	2,258
Deferred income taxes and other long-term assets	745	898
Total assets	$ 117,432	$ 108,324
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 7,036	$ 5,323
Accrued payroll and related liabilities	5,781	4,220
Other accrued liabilities	7,856	17,011
Customer advances	12,347	5,422
Total current liabilities	33,020	31,976
Other long-term liabilities	2,994	3,082
Stockholders equity:		
Common stock, $0.001 par value	22	21
Additional paid-in capital	176,282	171,314

Treasury stock, 4,845 shares at both September 30, 2017 and December 31, 2016	(28,489)	(28,489)
Accumulated other comprehensive income	443	321
Accumulated deficit	(66,840)	(69,901)
Total stockholders equity	81,418	73,266
Total liabilities and stockholders equity	$ 117,432	$ 108,324

Note: Amounts as of December 31, 2016 are derived from the December 31, 2016 audited consolidated financial statements.

See accompanying notes to the condensed consolidated financial statements.

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INTEVAC, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended		Nine Months Ended	
	September 30, 2017	October 1, 2016	September 30, 2017	October 1, 2016
	(Unaudited) (In thousands, except per share amounts)			
Net revenues:				
Systems and components	$ 24,537	$ 20,961	$ 82,822	$ 47,326
Technology development	2,189	1,598	5,255	3,816
Total net revenues	26,726	22,559	88,077	51,142
Cost of net revenues:				
Systems and components	13,402	13,025	47,419	29,490
Technology development	2,026	1,019	4,842	3,155
Total cost of net revenues	15,428	14,044	52,261	32,645
Gross profit	11,298	8,515	35,816	18,497
Operating expenses:				
Research and development	4,535	4,067	13,635	14,220
Selling, general and administrative	5,495	4,772	17,482	14,724
Total operating expenses	10,030	8,839	31,117	28,944
Income (loss) from operations	1,268	(324)	4,699	(10,447)
Interest income and other income (expense), net	28	60	265	184
Income (loss) before income taxes	1,296	(264)	4,964	(10,263)
Provision for income taxes	66	217	805	13
Net income (loss)	$ 1,230	$ (481)	$ 4,159	$ (10,276)
Net income (loss) per share:				
Basic	$ 0.06	$ (0.02)	$ 0.19	$ (0.50)
Diluted	$ 0.05	$ (0.02)	$ 0.18	$ (0.50)
Weighted average common shares outstanding:				
Basic	21,714	20,869	21,475	20,704
Diluted	22,970	20,869	22,989	20,704

See accompanying notes to the condensed consolidated financial statements.

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INTEVAC, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

	Three Months Ended		Nine Months Ended	
	September 30, 2017	October 1, 2016	September 30, 2017	October 1, 2016
	(Unaudited) (In thousands)			
Net income (loss)	$ 1,230	$ (481)	$ 4,159	$ (10,276)
Other comprehensive income (loss), before tax				
Change in unrealized net gain on available-for-sale investments	5	(16)	8	41
Foreign currency translation gains (losses)	39	(17)	114	5
Other comprehensive income (loss), before tax	44	(33)	122	46
Income tax (expense) benefit related to items in other comprehensive income (loss)				
Other comprehensive income (loss), net of tax	44	(33)	122	46
Comprehensive income (loss)	$ 1,274	$ (514)	$ 4,281	$ (10,230)

See accompanying notes to the condensed consolidated financial statements.

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INTEVAC, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine months ended September 30, 2017	Nine months ended October 1, 2016
	(Unaudited) (In thousands)	
Operating activities		
Net income (loss)	$ 4,159	$ (10,276)
Adjustments to reconcile net income (loss) to net cash and cash equivalents used in operating activities:		
Depreciation and amortization	2,877	3,744
Net amortization of investment premiums and discounts	53	96
Equity-based compensation	3,012	2,896
Change in the fair value of acquisition-related contingent consideration	(181)	(90)
Deferred income taxes	(1)	9
Gain on disposal of equipment		(8)
Changes in operating assets and liabilities	(11,658)	577
Total adjustments	(5,898)	7,224
Net cash and cash equivalents used in operating activities	(1,739)	(3,052)
Investing activities		
Purchases of investments	(21,968)	(10,433)
Proceeds from sales and maturities of investments	18,916	22,180
Proceeds from sale of equipment		8
Purchases of leasehold improvements and equipment	(3,553)	(2,535)
Decrease (increase) in restricted cash	202	(178)
Net cash and cash equivalents (used in) provided by investing activities	(6,403)	9,042
Financing activities		
Net proceeds from issuance of common stock	2,344	1,482
Taxes paid related to net share settlement	(1,988)	(403)
Payment of acquisition-related contingent consideration	(174)	
Net cash and cash equivalents provided by financing activities	182	1,079
Effect of exchange rate changes on cash	114	8
Net increase (decrease) in cash and cash equivalents	(7,846)	7,077
Cash and cash equivalents at beginning of period	27,043	13,746
Cash and cash equivalents at end of period	$ 19,197	$ 20,823

See accompanying notes to the condensed consolidated financial statements.

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

In the opinion of management, the unaudited interim condensed consolidated financial statements of Intevac, Inc. and its subsidiaries (Intevac or the Company) included herein have been prepared on a basis consistent with the December 31, 2016 audited consolidated financial statements and include all material adjustments, consisting of normal recurring adjustments, necessary to fairly present the information set forth therein. These unaudited interim condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in Intevac s Annual Report on Form 10-K for the fiscal year ended December 31, 2016 (2016 Form 10-K). Intevac s results of operations for the three and nine months ended September 30, 2017 are not necessarily indicative of future operating results.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ materially from those estimates.

2. Recent Accounting Pronouncements

In May 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2017-09, *Compensation Stock Compensation: Scope of Modification Accounting*, which provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting. An entity will account for the effects of a modification unless the fair value of the modified award is the same as the original award, the vesting conditions of the modified award are the same as the original award and the classification of the modified award as an equity instrument or liability instrument is the same as the original award. This update becomes effective and will be adopted by Intevac in the first quarter of fiscal 2019. The update is to be adopted prospectively to an award modified on or after the adoption date. Early adoption is permitted. Intevac does not expect the adoption of this update to have a material impact on its consolidated financial statements.

In March 2017, the FASB issued ASU 2017-08, *Receivables Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities*. ASU 2017-08 amends the amortization period for certain purchased callable debt securities held at a premium, shortening such period to the earliest call date. This update becomes effective and will be adopted by Intevac in the first quarter of fiscal 2019. Intevac does not expect the adoption of this update to have a material impact on its consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, *Intangibles Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. ASU 2017-04 eliminates Step 2 from the goodwill impairment test. Under Step 2, an entity had to perform procedures to determine the fair value at the impairment testing date of its assets and liabilities (including unrecognized assets and liabilities) following the procedure that would be required in determining the fair value of assets acquired and liabilities assumed in a business combination. Instead, under the amendments in ASU 2017-04, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit s fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. Additionally, an entity should consider income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit when measuring the goodwill impairment loss, if applicable. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. This update becomes effective and will be adopted by Intevac in the first quarter of fiscal 2020. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. Intevac does not expect the adoption of this update to have a material impact on its consolidated financial statements.

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

In March 2016, the FASB issued ASU 2016-09 *Compensation Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*. We have adopted these amendments beginning in the first quarter of 2017. Starting in the first quarter of fiscal 2017, stock-based compensation excess tax benefits or deficiencies are reflected in the Condensed Consolidated Statements of Operations as a component of the provision for income taxes, whereas they previously were recognized in equity. Additionally, our Condensed Consolidated Statements of Cash Flows now presents excess tax benefits as an operating activity. Finally, we have elected to account for forfeitures as they occur, rather than estimate expected forfeitures. The net cumulative effect of this change was recognized as a $1.1 million charge to the accumulated deficit as of January 1, 2017.

In May 2014, the FASB issued ASU 2014-09 *(Topic 606) Revenue from Contracts with Customers.* Topic 606 supersedes the revenue recognition requirements in Accounting Standards Codification Topic 605, Revenue Recognition , and requires entities to recognize revenue when they transfer control of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. We expect revenue recognition for our equipment sales arrangements, which includes systems, technology upgrades, service and spare parts, to remain materially consistent with our historical practice.

We expect to recognize revenue for equipment sales at a point in time following the transfer of control of such products to the customer, which typically occurs upon shipment or delivery depending on the terms of the underlying contracts. Our contracts with customers may include multiple performance obligations. For such arrangements, we expect to allocate revenue to each performance obligation based on its relative standalone selling price. We generally determine standalone selling prices based on the prices charged to customers or using expected cost plus margin. The expected costs associated with our base warranties will continue to be recognized as expense when the equipment is sold.

We expect to recognize revenue for cost plus fixed fee and firm fixed priced government contracts over time under the cost-to-cost method for the majority of our government contracts, which is consistent with our current revenue recognition model. Revenue on the majority of our government contracts will continue to be recognized over time because of the continuous transfer of control to the customer. For U.S. government contracts, this continuous transfer of control to the customer is supported by clauses in the contract that allow the customer to unilaterally terminate the contract for convenience, pay us for costs incurred plus a reasonable profit and take control of any work in process. Similarly, for non-U.S. government contracts, the customer typically controls the work in process as evidenced either by contractual termination clauses or by our rights to payment for work performed to date to deliver products or services that do not have an alternative use to the company. Under the new standard, the cost-to-cost measure of progress continues to best depict the transfer of control of assets to the customer, which occurs as we incur costs.

The new standard must be adopted by Intevac in our fiscal year beginning December 31, 2017. We intend to adopt the new standard as of December 31, 2017, using the modified retrospective transition method applied to those contracts which were not completed as of that date. Upon adoption, we will recognize the cumulative effect of adopting this guidance as an adjustment to our opening balance of the accumulated deficit. Prior periods will not be retrospectively adjusted. Based on our preliminary assessment, we expect the adoption of Topic 606 will not have a material impact to our consolidated financial statements, including the presentation of revenues in our Consolidated Statements of Operations. We also do not expect the standard to have a material impact on our Consolidated Balance Sheet. The immaterial impact primarily relates to reclassifications among financial statement accounts to align with the new standard. Most notably, contracts in process, net will be reclassified as receivables or contract assets based on amounts billed or unbilled, respectively. Advance payments and billings in excess of costs incurred and deferred revenue will be combined and reclassified as contract liabilities. Our contract balances will be reported in a net contract asset or liability position on a contract-by-contract basis at the end of each reporting period.

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

3. Inventories

Inventories are stated at the lower of average cost or market and consist of the following:

	September 30, 2017	December 31, 2016
	(In thousands)	
Raw materials	$ 16,385	$ 10,290
Work-in-progress	12,452	6,470
Finished goods	3,744	8,116
	$ 32,581	$ 24,876

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

4. Equity-Based Compensation

At September 30, 2017, Intevac had equity-based awards outstanding under the 2012 Equity Incentive Plan and the 2004 Equity Incentive Plan (together, the Plans) and the 2003 Employee Stock Purchase Plan (the ESPP). Intevac s stockholders approved all of these plans. The Plans permit the grant of incentive or non-statutory stock options, restricted stock, stock appreciation rights, restricted stock units (RSUs) and performance shares.

The ESPP provides that eligible employees may purchase Intevac s common stock through payroll deductions at a price equal to 85% of the lower of the fair market value at the entry date of the applicable offering period or at the end of each applicable purchase interval. 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. Under the terms of the ESPP, employees can choose to have up to 15% of their base earnings withheld to purchase Intevac common stock.

Compensation Expense

The effect of recording equity-based compensation for the three and nine months ended September 30, 2017 and October 1, 2016 was as follows:

	Three Months Ended	Nine Months Ended

	September 30, 2017	October 1, 2016	September 30, 2017	October 1, 2016
		(In thousands)		
Equity-based compensation by type of award:				
Stock options	$ 350	$ 211	$ 808	$ 696
RSUs	731	543	1,943	1,657
ESPP awards	67	151	261	543
Total equity-based compensation	$ 1,148	$ 905	$ 3,012	$ 2,896

Equity-based compensation expense is based on awards ultimately expected to vest and such amount has been historically reduced for estimated forfeitures. Beginning January 1, 2017, Intevac accounts for forfeitures as they occur, rather than estimating expected forfeitures. The net cumulative effect of this change was recognized as a $1.1 million increase to the accumulated deficit as of January 1, 2017.

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Stock Options and ESPP

The fair value of stock options and ESPP awards is estimated at the grant date using the Black-Scholes option valuation model. The determination of fair value of stock options and ESPP awards on the date of grant using an option-pricing model is affected by Intevac s 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.

Option activity as of September 30, 2017 and changes during the nine months ended September 30, 2017 were as follows:

	Shares	Weighted Average Exercise Price
Options outstanding at December 31, 2016	2,740,364	$ 7.00
Options granted	413,075	$ 12.33
Options cancelled and forfeited	(61,753)	$ 12.07
Options exercised	(115,273)	$ 6.88
Options outstanding at September 30, 2017	2,976,413	$ 7.64
Options exercisable at September 30, 2017	2,127,940	$ 7.16

Intevac issued 405,659 shares under the ESPP during the nine months ended September 30, 2017.

Intevac estimated the weighted-average fair value of stock options and employee stock purchase rights using the following weighted-average assumptions:

	Three Months Ended		Nine Months Ended	
	September 30, 2017	October 1, 2016	September 30, 2017	October 1, 2016
Stock Options:				
Weighted-average fair value of grants per share	$ 3.89	$ 1.90	$ 4.54	$ 1.75
Expected volatility	42.10%	40.53%	40.54%	44.00%
Risk free interest rate	1.84%	0.97%	1.77%	0.94%
Expected term of options (in years)	4.08	3.96	4.10	4.29
Dividend yield	None	None	None	None

	Three Months Ended		Nine Months Ended	
	September 30, 2017	October 1, 2016	September 30, 2017	October 1, 2016
Stock Purchase Rights:				
Weighted-average fair value of grants per share	$ 2.76	$ 1.69	$ 2.75	$ 1.55
Expected volatility	48.59%	37.51%	43.51%	39.22%
Risk free interest rate	1.36%	0.63%	1.22%	0.75%
Expected term of purchase rights (in years)	0.50	1.00	0.65	1.87
Dividend yield	None	None	None	None

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The computation of the expected volatility assumptions used in the Black-Scholes calculations for new stock option grants and employee stock purchase rights is based on the historical volatility of Intevac s stock price, measured over a period equal to the expected term of the stock option 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 term 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 equity-based awards and vesting schedules. The expected term of purchase rights represents the period of time remaining in the current offering period. The dividend yield assumption is based on Intevac s history of not paying dividends and the assumption of not paying dividends in the future.

RSUs

A summary of the RSU activity is as follows:

	Shares	Weighted Average Grant Date Fair Value
Non-vested RSUs at December 31, 2016	949,455	$ 4.64
Granted	363,846	$ 11.44
Vested	(500,621)	$ 4.46
Cancelled and forfeited	(14,292)	$ 7.97
Non-vested RSUs at September 30, 2017	798,388	$ 7.79

Time-based RSUs are converted into shares of Intevac common stock upon vesting on a one-for-one basis. Time-based RSUs typically are scheduled to vest over three or four years. Vesting of time-based RSUs is subject to the grantee s continued service with Intevac. The compensation expense related to these awards is determined using the fair market value of Intevac common stock on the date of the grant, and the compensation expense is recognized over the vesting period.

Market condition-based RSUs vest upon the achievement of certain market conditions (our stock performance) during a set performance period (typically five years) subject to the grantee s continued service with Intevac through the date the applicable market condition is achieved. The fair value is based on the values calculated under the Monte Carlo simulation model on the grant date. Compensation cost is not adjusted in future periods for subsequent changes in the expected outcome of market related conditions. The compensation expense is recognized over the derived service period. We granted 125,000 of such awards to certain executive officers in the nine months ended October 1, 2016. These awards have a derived service period of 2.8 years.

Intevac estimated the weighted-average fair value of market condition-based RSUs using the following weighted-average assumptions:

	Nine Months Ended October 1, 2016
Weighted-average fair value of grants per share	$ 2.46
Expected volatility	47.65%
Risk free interest rate	1.35%
Expected term (in years)	4.79
Dividend yield	None

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

In fiscal 2016, the annual bonus for certain participants in the Company s annual incentive plan was settled with RSUs with one year vesting. The Company accrued for the payment of bonuses at the expected company-wide payout percentage amount at October 1, 2016, which amounts were less than the target bonus amounts for each participant. The bonus accrual was classified as a liability until the number of shares was determined on the date the awards were granted, at which time the Company classified the awards into equity. In February 2017, the annual 2016 bonus for certain participants was settled with RSUs with one-year vesting. 33 participants were granted stock awards to receive an aggregate of 134,000 shares of common stock with a weighted average grant date fair value of $9.63 per share. In February 2016, the annual 2015 bonus for certain participants was settled with RSUs with one year vesting.
34 participants were granted stock awards to receive an aggregate of 266,000 shares of common stock with a weighted average grant date fair value of $4.40 per share. The Company recorded equity-based compensation expense related to the annual incentive plans of $102,000 for the nine months ended September 30, 2017. The Company recorded equity-based compensation expense related to the annual incentive plan of $120,000 and $364,000, respectively, for the three and nine months ended October 1, 2016.

5. Purchased Intangible Assets

Details of finite-lived intangible assets by segment as of September 30, 2017 are as follows.

	September 30, 2017		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
		(In thousands)	
Equipment	$ 7,172	$ (5,648)	$ 1,524
Photonics	1,215	(1,077)	138
	$ 8,387	$ (6,725)	$ 1,662

Total amortization expense of finite-lived intangibles for the three and nine months ended September 30, 2017 was $169,000 and $596,000, respectively.

As of September 30, 2017, future amortization expense is expected to be as follows.

(In thousands)	
2017	$ 159

2018	615
2019	615
2020	273
	$ 1,662

6. Acquisition-Related Contingent Consideration

In connection with the acquisition of Solar Implant Technologies, Inc. (SIT), Intevac agreed to pay to the selling shareholders in cash a revenue earnout on Intevac s net revenue from commercial sales of certain products over a specified period up to an aggregate of $9.0 million. Intevac estimated the fair value of this contingent consideration on September 30, 2017 based on probability-based forecasted revenues reflecting Intevac s own assumptions concerning future revenue from such products.

The fair value measurement of contingent consideration is based on significant inputs not observed in the market and thus represents a Level 3 measurement. Any change in fair value of the contingent consideration subsequent to the acquisition date is recognized in income (loss) from operations within the condensed consolidated statement of operations. The following table represents a reconciliation of the change in the fair value measurement of the contingent consideration liability for the three and nine month periods ended September 30, 2017 and October 1, 2016:

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30, 2017	October 1, 2016	September 30, 2017	October 1, 2016
	(In thousands)			
Opening balance	$ 859	$ 748	$ 759	$ 890
Changes in fair value	(283)	52	(181)	(90)
Cash payments made	(172)		(174)	
Closing balance	$ 404	$ 800	$ 404	$ 800

The following table displays the balance sheet classification of the contingent consideration liability account at September 30, 2017 and at December 31, 2016:

	September 30, 2017	December 31, 2016
	(In thousands)	
Other accrued liabilities	$ 36	$ 329
Other long-term liabilities	368	430
Total acquisition-related contingent consideration	$ 404	$ 759

The following table represents the quantitative range of the significant unobservable inputs used in the calculation of fair value of the continent consideration liability as of September 30, 2017. Significant increases or decreases in any of these inputs in isolation would result in a significantly lower or higher fair value measurement.

	Quantitative Information about Level 3 Fair Value Measurements at September 30, 2017			
	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
	(In thousands, except for percentages)			
Revenue Earnout			Weighted average cost of capital	11.9%
	$ 404	Discounted cash flow	Probability weighting of achieving revenue forecasts	10.0% - 80.0% (30.0%)

7. Warranty

Intevac provides for the estimated cost of warranty when revenue is recognized. Intevac s warranty is per contract terms and for its disk manufacturing, solar photovoltaic (PV) manufacturing and display cover panel (DCP) manufacturing 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. Intevac uses estimated repair or replacement costs along with its historical warranty experience to determine its warranty obligation. Intevac generally provides a twelve month warranty on its Photonics products. The provision for the estimated future costs of warranty is based upon historical cost and product performance experience. Intevac exercises judgment in determining the underlying estimates.

On the condensed consolidated balance sheets, the short-term portion of the warranty provision is included in other accrued liabilities, while the long-term portion is included in other long-term liabilities. The expense associated with product warranties issued or adjusted is included in cost of net revenues on the condensed consolidated statements of operations.

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table displays the activity in the warranty provision account for the three and nine months ended September 30, 2017 and October 1, 2016:

	Three Months Ended		Nine Months Ended	
	September 30, 2017	October 1, 2016	September 30, 2017	October 1, 2016
	(In thousands)			
Opening balance	$ 1,220	$ 592	$ 1,007	$ 982
Expenditures incurred under warranties	(360)	(80)	(640)	(384)
Accruals for product warranties issued during the reporting period	169	320	675	494
Adjustments to previously existing warranty accruals	106	(110)	93	(370)
Closing balance	$ 1,135	$ 722	$ 1,135	$ 722

The following table displays the balance sheet classification of the warranty provision account at September 30, 2017 and at December 31, 2016:

	September 30, 2017	December 31, 2016
	(In thousands)	
Other accrued liabilities	$ 915	$ 829
Other long-term liabilities	220	178
Total warranty provision	$ 1,135	$ 1,007

8. Guarantees

Officer and Director Indemnifications

As permitted or required under Delaware law and to the maximum extent allowable under that law, Intevac has certain obligations to indemnify its current and former officers and directors for certain events or occurrences while the officer or director is, or was, serving at Intevac s request in such capacity. These indemnification obligations are valid as long as the director or officer acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the Company and, with respect to any criminal action or proceeding, had no reasonable cause to believe his or her conduct was unlawful. The maximum potential amount of future payments Intevac could be required to make under these indemnification obligations is unlimited; however, Intevac has a director and officer insurance policy that mitigates Intevac s exposure and enables Intevac to recover a portion of any future amounts paid. As a result of Intevac s insurance policy coverage, Intevac believes the estimated fair value of these indemnification obligations is not material.

Other Indemnifications

As is customary in Intevac s industry, many of Intevac s contracts provide remedies to certain third parties such as defense, settlement, or payment of judgments for intellectual property claims related to the use of its products. Such indemnification obligations may not be subject to maximum loss clauses. Historically, payments made related to these indemnifications have been immaterial.

Letters of Credit

As of September 30, 2017, we had letters of credit and bank guarantees outstanding totaling $1.4 million, including a standby letter of credit outstanding under the Santa Clara, California facility lease and various other guarantees with our bank. These letters of credit and bank guarantees are collateralized by $1.4 million of restricted cash.

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

9. Cash, Cash Equivalents and Investments

Cash and cash equivalents, short-term investments and long-term investments consist of:

	September 30, 2017			
	Amortized Cost	Unrealized Holding Gains	Unrealized Holding Losses	Fair Value
	(In thousands)			
Cash and cash equivalents:				
Cash	$ 14,159	$	$	$ 14,159
Money market funds	5,038			5,038
Total cash and cash equivalents	$ 19,197	$	$	$ 19,197
Short-term investments:				
Certificates of deposit	$ 4,498	$ 1	$ 1	$ 4,498
Commercial paper	1,990			1,990
Corporate bonds and medium-term notes	6,252	1	5	6,248
Municipal bonds	1,004		3	1,001
U.S. treasury and agency securities	4,300			4,300
Total short-term investments	$ 18,044	$ 2	$ 9	$ 18,037
Long-term investments:				
Corporate bonds and medium-term notes	$ 3,576	$	$ 3	$ 3,573
U.S. treasury and agency securities	2,596		4	2,592
Total long-term investments	$ 6,172	$	$ 7	$ 6,165
Total cash, cash equivalents, and investments	$ 43,413	$ 2	$ 16	$ 43,399

	December 31, 2016			
	Amortized Cost	Unrealized Holding Gains	Unrealized Holding Losses	Fair Value
	(in thousands)			
Cash and cash equivalents:				
Cash	$ 18,726	$	$	$ 18,726
Money market funds	8,317			8,317

Total cash and cash equivalents	$ 27,043	$	$	$ 27,043
Short-term investments:				
Commercial paper	$ 1,992	$	$ 1	$ 1,991
Corporate bonds and medium-term notes	8,586		6	8,580
Municipal bonds	600			600
U.S. treasury and agency securities	6,432		1	6,431
Total short-term investments	$ 17,610	$	$ 8	$ 17,602
Long-term investments:				
Corporate bonds and medium-term notes	$ 2,510	$	$ 11	$ 2,499
Municipal bonds	500		4	496
U.S. treasury and agency securities	597	1		598
Total long-term investments	$ 3,607	$ 1	$ 15	$ 3,593
Total cash, cash equivalents, and investments	$ 48,260	$ 1	$ 23	$ 48,238

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The contractual maturities of available-for-sale securities at September 30, 2017 are presented in the following table.

	Amortized Cost	Fair Value
	(In thousands)	
Due in one year or less	$ 23,082	$ 23,075
Due after one through two years	6,172	6,165
	$ 29,254	$ 29,240

The following table provides the fair market value of Intevac s investments with unrealized losses that are not deemed to be other-than temporarily impaired as of September 30, 2017.

	September 30, 2017			
	In Loss Position for Less than 12 Months		In Loss Position for Greater than 12 Months	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
	(In thousands)			
Certificates of deposit	$ 1,249	$ 1	$	$
Corporate bonds and medium-term notes	5,882	7	1,200	1
Municipal bonds	504	1	497	2
U.S. treasury and agency securities	4,118	4		
	$ 11,753	$ 13	$ 1,697	$ 3

All prices for the fixed maturity securities including U.S. Treasury and agency securities, certificates of deposit, commercial paper, corporate bonds and municipal bonds are received from independent pricing services utilized by Intevac s outside investment manager. This investment manager performs a review of the pricing methodologies and inputs utilized by the independent pricing services for each asset type priced by the vendor. In addition, on at least an annual basis, the investment manager conducts due diligence visits and interviews with each pricing vendor to verify the inputs utilized for each asset class. The due diligence visits include a review of the procedures performed by each vendor to ensure that pricing evaluations are representative of the price that would be received for a security in an orderly sale. Any pricing where the input is based solely on a broker price is deemed to be a Level 3 price. Intevac uses the pricing data obtained from its outside investment manager as the primary input to make its assessments and determinations as to the ultimate valuation of the above-mentioned securities and has not made, during the periods presented, any material adjustments to such inputs.

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table represents the fair value hierarchy of Intevac s available-for-sale securities measured at fair value on a recurring basis as of September 30, 2017.

	Fair Value Measurements at September 30, 2017		
	Total	Level 1	Level 2
	(In thousands)		
Recurring fair value measurements:			
Available-for-sale securities			
Money market funds	$ 5,038	$ 5,038	$
U.S. treasury and agency securities	6,892	4,865	2,027
Certificates of deposit	4,498		4,498
Commercial paper	1,990		1,990
Corporate bonds and medium-term notes	9,821		9,821
Municipal bonds	1,001		1,001
Total recurring fair value measurements	$ 29,240	$ 9,903	$ 19,337

10. Derivative Instruments

The Company uses foreign currency forward contracts to mitigate variability in gains and losses generated from the re-measurement of certain monetary assets and liabilities denominated in foreign currencies and to offset certain operational exposures from the impact of changes in foreign currency exchange rates. These derivatives are carried at fair value with changes recorded in interest income and other income (expense), net in the condensed consolidated statements of operations. Changes in the fair value of these derivatives are largely offset by re-measurement of the underlying assets and liabilities. Cash flows from such derivatives are classified as operating activities. The derivatives have original maturities of approximately 30 days.

The following table summarizes the Company s outstanding derivative instruments on a gross basis as recorded in its condensed consolidated balance sheets as of September 30, 2017 and December 31, 2016:

	Notional Amounts		Derivative Liabilities	
Derivative Instrument	September 30, 2017	December 31, 2016	September 30, 2017	December 31, 2016

			Balance Sheet Line	Fair Value	Balance Sheet Line	Fair Value
			(in thousands)			
Undesignated Hedges:						
Forward Foreign Currency Contracts	$ 1,418	$ 1,146	(a)	$ 2	(a)	$ 8
Total Hedges	$ 1,418	$ 1,146		$ 2		$ 8

(a) Other accrued liabilities

11. Equity

Stock Repurchase Program

On November 21, 2013, Intevac s Board of Directors approved a stock repurchase program authorizing up to $30.0 million in repurchases. At September 30, 2017, $1.5 million remains available for future stock repurchases under the repurchase program. Intevac did not make any stock repurchases during the three and nine months ended September 30, 2017 and October 1, 2016, respectively.

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Intevac records treasury stock purchases under the cost method using the first-in, first-out (FIFO) method. Upon reissuance of treasury stock, amounts in excess of the acquisition cost are credited to additional paid-in capital. If Intevac reissues treasury stock at an amount below its acquisition cost and additional paid-in capital associated with prior treasury stock transactions is insufficient to cover the difference between the acquisition cost and the reissue price, this difference is recorded against retained earnings.

Accumulated Other Comprehensive Income

The changes in accumulated other comprehensive income by component for the three and nine months ended September 30, 2017 and October 1, 2016, are as follows.

	Three Months Ended			Nine Months Ended		
	September 30, 2017					
	Foreign currency	Unrealized holding losses on available-for-sale investments	Total	Foreign currency	Unrealized holding losses on available-for-sale investments	Total
	(In thousands)					
Beginning balance	$ 418	$ (19)	$ 399	$ 343	$ (22)	$ 321
Other comprehensive income before reclassification	39	5	44	114	8	122
Amounts reclassified from other comprehensive income						
Net current-period other comprehensive income	39	5	44	114	8	122
Ending balance	$ 457	$ (14)	$ 443	$ 457	$ (14)	$ 443

	Three Months Ended			Nine Months Ended		
	October 1, 2016					
	Foreign currency	Unrealized holding gains on available-for-sale investments	Total	Foreign currency	Unrealized holding gains on available-for-sale investments	Total

			(In thousands)			
Beginning balance	$ 474	$ 17	$ 491	$ 452	$ (40)	$ 412
Other comprehensive income (loss) before reclassification	(17)	(16)	(33)	5	41	46
Amounts reclassified from other comprehensive income						
Net current-period other comprehensive income (loss)	(17)	(16)	(33)	5	41	46
Ending balance	$ 457	$ 1	$ 458	$ 457	$ 1	$ 458

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

12. Net Income (Loss) Per Share

The following table sets forth the computation of basic and diluted net income (loss) per share:

	Three Months Ended		Nine Months Ended	
	September 30, 2017	October 1, 2016	September 30, 2017	October 1, 2016
	(In thousands, except per share amounts)			
Net income (loss)	$ 1,230	$ (481)	$ 4,159	$ (10,276)
Weighted-average shares basic	21,714	20,869	21,475	20,704
Effect of dilutive potential common shares	1,256		1,514	
Weighted-average shares diluted	22,970	20,869	22,989	20,704
Net income (loss) per share basic	$ 0.06	$ (0.02)	$ 0.19	$ (0.50)
Net income (loss) per share diluted	$ 0.05	$ (0.02)	$ 0.18	$ (0.50)

The following potentially dilutive securities were excluded (as common stock equivalents) from the computation of diluted net income (loss) per share for the periods presented as their effect would have been antidilutive:

	Three Months Ended		Nine Months Ended	
	September 30, 2017	October 1, 2016	September 30, 2017	October 1, 2016
	(In thousands)			
Stock options to purchase common stock	826	2,743	834	2,743
RSUs		955		955
Employee stock purchase plan		82		82

13. Segment Reporting

Intevac s two reportable segments are: Thin-film Equipment and Photonics. Intevac s chief operating decision-maker has been identified as the President and CEO, who reviews operating results to make decisions about allocating resources and assessing performance for the entire Company. Segment information is presented based upon Intevac s management organization structure as of September 30, 2017 and the distinctive nature of each segment. Future changes to this internal financial structure may result in changes to the reportable segments disclosed.

Each reportable segment is separately managed and has separate financial results that are reviewed by Intevac s chief operating decision-maker. Each reportable segment contains closely related products that are unique to the particular segment. Segment operating profit is determined based upon internal performance measures used by the chief operating decision-maker.

Intevac derives the segment results from its internal management reporting system. The accounting policies Intevac uses to derive reportable segment results are substantially the same as those used for external reporting purposes. Management measures the performance of each reportable segment based upon several metrics, including orders, net revenues and operating income. Management uses these results to evaluate the performance of, and to assign resources to, each of the reportable segments. Intevac manages certain operating expenses separately at the corporate level. Intevac allocates certain of these corporate expenses to the segments in an amount equal to 3% of net revenues. Segment operating income excludes interest income/expense and other financial charges and income taxes according to how a particular reportable segment s management is measured. Management does not consider impairment charges, gains and losses on divestitures and sales of intellectual property, and unallocated costs in measuring the performance of the reportable segments.

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The Thin-film Equipment segment designs, develops and markets vacuum process equipment solutions for high-volume manufacturing of small substrates with precise thin-film properties, such as for the hard drive, solar cell and DCP industries, as well as other adjacent thin-film markets.

The Photonics segment develops compact, cost-effective, high-sensitivity digital-optical products for the capture and display of low-light images. Intevac provides sensors, cameras and systems for government applications such as night vision.

Information for each reportable segment for the three and nine months ended September 30, 2017 and October 1, 2016 is as follows:

Net Revenues

	Three Months Ended		Nine Months Ended	
	September 30, 2017	October 1, 2016	September 30, 2017	October 1, 2016
	(In thousands)			
Thin-film Equipment	$ 17,177	$ 14,272	$ 61,087	$ 25,941
Photonics	9,549	8,287	26,990	25,201
Total segment net revenues	$ 26,726	$ 22,559	$ 88,077	$ 51,142

Operating Income (Loss)

	Three Months Ended		Nine Months Ended	
	September 30, 2017	October 1, 2016	September 30, 2017	October 1, 2016
	(In thousands)			
Thin-film Equipment	$ 1,213	$ (998)	$ 4,821	$ (10,117)
Photonics	1,417	1,737	3,646	3,656
Total segment operating income (loss)	2,630	739	8,467	(6,461)
Unallocated costs	(1,362)	(1,063)	(3,768)	(3,986)
Income (loss) from operations	1,268	(324)	4,699	(10,447)

Interest income and other income (expense), net	28	60	265	184
Income (loss) before income taxes	$ 1,296	$ (264)	$ 4,964	$ (10,263)

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Total assets for each reportable segment as of September 30, 2017 and December 31, 2016 are as follows:

Assets

	September 30, 2017	December 31, 2016
	(In thousands)	
Thin-film Equipment	$ 52,620	$ 39,503
Photonics	16,563	16,071
Total segment assets	69,183	55,574
Cash, cash equivalents and investments	43,399	48,238
Restricted cash	1,400	1,602
Deferred income taxes	4	3
Other current assets	1,024	997
Common property, plant and equipment	1,698	1,039
Other assets	724	871
Consolidated total assets	$ 117,432	$ 108,324

14. Income Taxes

Intevac recorded income tax provisions of $66,000 and $805,000 for the three and nine months ended September 30, 2017, respectively, and $217,000 and $13,000 for the three and nine months ended October 1, 2016, respectively. The income tax provision for the nine months ended September 30, 2017 includes $506,000 for withholding taxes on royalties payable to the United States from Intevac s Singapore subsidiary and $200,000 for audit considerations in foreign jurisdictions, both recorded as discrete items. The income tax provisions for the three and nine month periods are based upon estimates of annual income (loss), annual permanent differences and statutory tax rates in the various jurisdictions in which Intevac operates. Intevac did not recognize benefits on the U.S. net operating loss for the three and nine month period ended September 30, 2017 due to having full valuation allowances on the U.S. deferred tax assets. Intevac did not recognize benefits on the U.S. net operating loss or on the Singapore net operating loss for the three and nine month period ended October 1, 2016 due to having full valuation allowances on the U.S. deferred tax assets and on the Singapore deferred tax assets. Intevac s tax rate differs from the applicable statutory rates due primarily to establishment of a valuation allowance, the utilization of deferred and current credits and the effect of permanent differences and adjustments of prior permanent differences. Intevac s future effective income tax rate depends on various factors, including the level of Intevac s 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 Intevac s tax planning strategies. Management carefully monitors these factors and timely adjusts the effective income tax rate.

The Inland Revenue Authority of Singapore (IRAS) is currently conducting a review of the fiscal 2009 through 2012 tax returns of the Company s wholly-owned subsidiary, Intevac Asia Pte. Ltd. IRAS has challenged the Company s tax position with respect to certain aspects of the Company s transfer pricing. Under Singapore tax law, the Company must pay all contested taxes and the related interest to have the right to defend its position. The contested tax deposits of $724,000 at September 30, 2017 and $871,000 at December 31, 2016 are included in other long-term assets on the condensed consolidated balance sheets. The Company s management and its advisors continue to believe that the Company is more likely than not to successfully defend that the tax treatment was proper and in accordance with Singapore tax regulations. Presently, there are no other active income tax examinations in the jurisdictions where Intevac operates.

15. Contingencies

From time to time, Intevac may have certain contingent liabilities that arise in the ordinary course of its business activities. Intevac accounts for contingent liabilities when it is probable that future expenditures will be made and such expenditures can be reasonably estimated.

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 Intevac s shipments, projected revenue recognition, product costs, gross margin, operating expenses, interest income, income taxes, cash balances and financial results in 2017 and beyond; projected customer requirements for Intevac s new and existing products, and when, and if, Intevac s customers will place orders for these products; Intevac s ability to proliferate its Photonics technology into major military programs and to develop and introduce commercial imaging products; the timing of delivery and/or acceptance of the systems and products that comprise Intevac s backlog for revenue and the Company s ability to achieve cost savings. Intevac s 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 our Annual Report on Form 10-K filed on February 15, 2017, and our periodic Form 10-Q s and Form 8-K s.

Overview

Intevac is a provider of vacuum deposition equipment for a wide variety of thin-film applications, and a leading provider of digital night-vision technologies and products to the defense industry. The Company leverages its core capabilities in high-volume manufacturing of small substrates to provide process manufacturing equipment solutions to the hard disk drive (HDD), display cover panel (DCP), and solar cell industries. Intevac also provides sensors, cameras and systems for government applications such as night vision. Intevac s customers include manufacturers of hard disk media, DCPs and solar cells as well as the U.S. government and its agencies, allies and contractors. Intevac reports two segments: Thin-film Equipment and Photonics.

Product development and manufacturing activities occur in North America and Asia. Intevac has field offices in Asia to support its Thin-film Equipment customers. Intevac s products are highly technical and are sold primarily through Intevac s direct sales force. Intevac also sells its products through distributors in Japan and China.

Intevac s results are driven by a number of factors including success in its equipment growth initiatives in the DCP and solar markets and by worldwide demand for HDDs. Demand for HDDs depends on the growth in digital data creation and storage, the rate of areal density improvements, the end-user demand for PCs, enterprise data storage, nearline cloud applications, video players and video game consoles that include such drives. Intevac continues to execute its strategy of equipment diversification into new markets by introducing new products, such as for a thin-film physical vapor deposition (PVD) application for protective coating for DCP manufacturing and a thin-film PVD application for PV solar cell manufacturing. Intevac believes that expansion into these markets will result in incremental equipment revenues for Intevac and decrease Intevac s dependence on the HDD industry. Intevac s equipment business is subject to cyclical industry conditions, as demand for manufacturing equipment and services can change depending on supply and demand for HDDs, cell phones, and PV cells as well as other factors such as global economic conditions and technological advances in fabrication processes.

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The following table presents certain significant measurements for the three and nine months ended September 30, 2017 and October 1, 2016:

	Three months ended			Nine months ended		
	September 30, 2017	**October 1, 2016**	**Change over prior period**	**September 30, 2017**	**October 1, 2016**	**Change over prior period**
	(In thousands, except percentages and per share amounts)					
Net revenues	$ 26,726	$ 22,559	$ 4,167	$ 88,077	$ 51,142	$ 36,935
Gross profit	$ 11,298	$ 8,515	$ 2,783	$ 35,816	$ 18,497	$ 17,319
Gross margin percent	42.3%	37.7%	4.6 points	40.7%	36.2%	4.5 points
Income (loss) from operations	$ 1,268	$ (324)	$ 1,592	$ 4,699	$ (10,447)	$ 15,146
Net income (loss)	$ 1,230	$ (481)	$ 1,711	$ 4,159	$ (10,276)	$ 14,435
Net income (loss) per diluted share	$ 0.05	$ (0.02)	$ 0.07	$ 0.18	$ (0.50)	$ 0.68

Net revenues for the third quarter of fiscal 2017 increased compared to the same period in the prior year primarily due to higher technology upgrade and spare parts sales to HDD manufacturers and to higher Photonics product sales and higher Photonics contract research and development (R&D). Thin-film Equipment recognized revenue on two 200 Lean® HDD systems in both the third quarter of fiscal 2017 and third quarter of fiscal 2016. Thin-film Equipment also recognized revenue on one pilot ENERG*i* solar ion implant system in the third quarter of fiscal 2016. Net income for the third quarter of fiscal 2017 increased compared to the same period in the prior year due to higher revenues and higher gross profit offset in part by higher spending on research and development and higher selling, general and administrative expenses as the Company recorded higher variable compensation expenses as a result of the return to profitability.

Net revenues for the first nine months of fiscal 2017 increased compared to the same period in the prior year primarily due to higher equipment sales to HDD, PV and cell phone manufacturers, higher Photonics contract R&D and by higher Photonics product sales. Thin-film Equipment recognized revenue in the first nine months of fiscal 2017 on four 200 Lean HDD systems, one pilot INTEVAC MATRIX solar ion implant system, two ENERG*i* solar ion implant systems and four INTEVAC VERTEX coating systems for DCP. Thin-film Equipment recognized revenue in the first nine months of fiscal 2016 on two 200 Lean HDD systems, one pilot ENERG*i* solar ion implant system and one VERTEX system. The net income for the first nine months of fiscal 2017 increased compared to the same period in the prior year due to higher revenues, higher gross profit, and lower spending on research and development offset in part by higher selling, general and administrative expenses as the Company recorded higher variable compensation expenses as a result of the return to profitability and higher legal fees related to patents and contracts.

Given the momentum we have built in our business, we believe that we are currently on the path to profitability in fiscal 2017. Intevac expects higher sales of new Thin-film Equipment products for DCP and PV and higher sales of HDD equipment. For fiscal 2017, Intevac expects that Photonics business levels will be at about the same levels as 2016 as Photonics continues to deliver production shipments of the pilot night-vision systems for the Apache helicopter and night-vision camera modules for the F35 Joint Strike Fighter program. Deliveries under the current multi-year Apache arrangement are expected to be completed in the fourth quarter of 2017.

Intevac s trademarks, include the following: 200 Lean®, AccuLuber , EBAPS®, ENERG*i* , I-Port ®, LIVAR®, INTEVAC LSMA , INTEVAC MATRIX , MicroVista®, NightVista®, Night Port , oDLC and INTEVAC VERTEX .

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Results of Operations

Net revenues

	Three months ended			Nine months ended		
	September 30, 2017	October 1, 2016	Change over prior period	September 30, 2017	October 1, 2016	Change over prior period
	(In thousands)					
Thin-film Equipment	$ 17,177	$ 14,272	$ 2,905	$ 61,087	$ 25,941	$ 35,146
Photonics:						
Products	$ 7,360	$ 6,689	$ 671	$ 21,735	$ 21,385	$ 350
Contract R&D	2,189	1,598	591	5,255	3,816	1,439
	9,549	8,287	1,262	26,990	25,201	1,789
Total net revenues	$ 26,726	$ 22,559	$ 4,167	$ 88,077	$ 51,142	$ 36,935

Thin-film Equipment revenue for the three months ended September 30, 2017 increased over the same period in the prior year as a result of higher sales of technology upgrades and spare parts. Thin-film Equipment revenue for the three months ended September 30, 2017 included revenue recognized for two 200 Lean HDD systems. Thin-film Equipment revenue for the three months ended October 1, 2016 included two 200 Lean systems and a pilot ENERG*i* solar ion implant tool. Thin-film Equipment revenue for the nine months ended September 30, 2017 increased over the same period in the prior year as a result of higher sales of systems, technology upgrades, service and spare parts. Thin-film Equipment recognized revenue in the first nine months of fiscal 2017 on four 200 Lean HDD systems, one pilot MATRIX solar ion implant system, two ENERG*i* solar ion implant systems and four VERTEX coating systems for DCP. Thin-film Equipment recognized revenue in the first nine months of fiscal 2016 on two 200 Lean HDD systems, one pilot ENERG*i* solar ion implant system and one VERTEX system.

Photonics revenue for the three and nine month periods ended September 30, 2017 increased from the same periods in the prior year as a result of higher product sales revenues and by increased contract R&D work.

Backlog

	September 30, 2017	December 31, 2016	October 1, 2016
	(In thousands)		
Thin-film Equipment	$ 59,375	$ 46,283	$ 49,234
Photonics	13,457	22,244	23,703
Total backlog	$ 72,832	$ 68,527	$ 72,937

Thin-film Equipment backlog at September 30, 2017 included five 200 Lean HDD systems and twelve ENERG*i* solar ion implant systems. Thin-film Equipment backlog at December 31, 2016 included four 200 Lean HDD systems, four

VERTEX systems for DCP, one pilot MATRIX solar ion implant system, and two ENERG*i* solar ion implant systems. Thin-film Equipment backlog at October 1, 2016 included four 200 Lean HDD systems, one MATRIX solar PVD system, three VERTEX systems for DCP, one pilot MATRIX solar ion implant system, and two ENERG*i* solar ion implant systems.

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Revenue by geographic region

	Three months ended			Nine months ended		
	September 30, 2017	October 1, 2016	Change over prior period	September 30, 2017	October 1, 2016	Change over prior period
	(In thousands)					
United States	$ 10,294	$ 9,066	$ 1,228	$ 29,879	$ 27,603	$ 2,276
Asia	15,807	13,311	2,496	57,062	22,801	34,261
Europe	94	182	(88)	605	738	(133)
Rest of World	531		531	531		531
Total net revenues	$ 26,726	$ 22,559	$ 4,167	$ 88,077	$ 51,142	$ 36,935

International sales include products shipped to overseas operations of U.S. companies. The increase in sales to the U.S. region in 2017 versus 2016 reflected higher Photonics contract R&D work and higher Photonics product sales. The increase in sales to the Asia region in 2017 versus 2016 reflected higher system sales. Sales to the Asia region in 2017 included four 200 Lean HDD systems, four VERTEX coating systems for DCP, one pilot MATRIX solar ion implant system and two ENERG*i* solar ion implant systems versus two 200 Lean HDD systems, one pilot ENERG*i* solar ion implant tool one and VERTEX coating system in 2016. Sales to the Europe region in 2017 and 2016 were not significant. Rest of World includes contract R&D for the Australian government as part of a program under the Department of Defense s Coalition Warfare Program, which is funded by the U.S. government and several foreign nation coalition partners.

Gross profit

	Three months ended			Nine months ended		
	September 30, 2017	October 1, 2016	Change over prior period	September 30, 2017	October 1, 2016	Change over prior period
	(In thousands, except percentages)					
Thin-film Equipment gross profit	$ 7,812	$ 4,628	$ 3,184	$ 25,686	$ 7,337	$ 18,349
% of Thin-film Equipment net revenues	45.5%	32.4%		42.0%	28.3%	
Photonics gross profit	$ 3,486	$ 3,887	$ (401)	$ 10,130	$ 11,160	$ (1,030)
% of Photonics net revenues	36.5%	46.9%		37.5%	44.3%	
Total gross profit	$ 11,298	$ 8,515	$ 2,783	$ 35,816	$ 18,497	$ 17,319
% of net revenues	42.3%	37.7%		40.7%	36.2%	

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.

Thin-film Equipment gross margin was 45.5% in the three months ended September 30, 2017 compared to 32.4% in the three months ended October 1, 2016 and was 42.0% in the nine months ended September 30, 2017 compared to

28.3% in the nine months ended October 1, 2016. The improvement in gross margin for the three and nine months ended September 30, 2017 was due primarily to higher revenue, increased shipments of higher-margin upgrades and higher factory utilization. Thin-film Equipment gross margin for the nine months ended September 30, 2017 reflects the release of $2.2 million on previously-recognized inventory provisions upon the sale of two ENERG*i* solar ion implant systems, offset in part by the lower margin on the pilot MATRIX solar ion implant system. Gross margin for the three and nine months ended October 1, 2016 reflected the lower margin on a pilot ENERG*i* solar implant tool sold to an R&D facility. Gross margins in the Thin-film 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.

Photonics gross margin was 36.5% in the three months ended September 30, 2017 compared to 46.9% in the three months ended October 1, 2016 and was 37.5% in the nine months ended September 30, 2017 compared to 44.3% in the nine months ended October 1, 2016. The decline in gross margin for the three months ended September 30, 2017 was due to lower margins on contract R&D, higher inventory provisions and higher manufacturing engineering spending. The lower gross margin for the nine months ended September 30, 2017 was due to loss provisions recorded on firm fixed price contracts, higher inventory provisions and higher manufacturing engineering spending. Gross margins in the Photonics business will vary depending on a number of factors, including sensor yield, product mix, product cost, pricing, factory utilization, provisions for warranty and inventory reserves.

Research and development

	Three months ended			Nine months ended		
	September 30, 2017	October 1, 2016	Change over prior period	September 30, 2017	October 1, 2016	Change over prior period
	(In thousands)					
Research and development expense	$ 4,535	$ 4,067	$ 468	$ 13,635	$ 14,220	$ (585)

Research and development spending in Thin-film Equipment during the three and nine months ended September 30, 2017 increased compared to the same periods in the prior year. Thin-film Equipment spending consisted primarily of PV and DCP development. Research and development spending decreased in Photonics during the three and nine months ended September 30, 2017 as compared to the same periods in the prior year. Photonics spending during the three and nine months ended October 1, 2016 reflected incremental spending on demonstrators developed for evaluation by the U.S. Army and U.S. Navy which were self-funded by Intevac. Research and development expenses do not include costs of $2.0 million and $4.8 million for the three and nine months ended September 30, 2017 respectively, or $1.0 million and $3.2 million for the three and nine months ended October 1, 2016 respectively, which are related to customer-funded contract R&D programs at Photonics and therefore included in cost of net revenues.

Selling, general and administrative

	Three months ended			Nine months ended		
	September 30, 2017	October 1, 2016	Change over prior period	September 30, 2017	October 1, 2016	Change over prior period
	(In thousands)					
Selling, general and administrative expense	$ 5,495	$ 4,772	$ 723	$ 17,482	$ 14,724	$ 2,758

Selling, general and administrative expense consists primarily of selling, marketing, customer support, financial and management costs. Selling, general and administrative expenses for the three and nine months ended September 30, 2017 increased compared to the same periods in the prior year primarily due to higher variable compensation costs as a result of the Company s return to profitability, increased legal expenses for patent applications and increased spending for strategic consulting. Selling, general and administrative expense for the three months ended September 30, 2017 is net of a benefit of $283,000 compared to a charge of $52,000 for the three months ended October 1, 2016 associated with changes in the fair value of the contingent consideration related to a revenue earnout obligation. Selling, general and administrative expense for the nine months ended September 30, 2017 is net of a benefit of $181,000 compared to a benefit of $90,000 for the nine months ended October 1, 2016 associated with changes in the fair value of the contingent consideration related to the revenue earnout obligation.

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Interest income and other income (expense), net

	Three months ended			Nine months ended		
	September 30, 2017	October 1, 2016	Change over prior period	September 30, 2017	October 1, 2016	Change over prior period
	(In thousands)					
Interest income and other income (expense), net	$ 28	$ 60	$ (32)	$ 265	$ 184	$ 81

Interest income and other income (expense), net is comprised of interest income, foreign currency gains and losses, and other income and expense such as gains and losses on sales of fixed assets and earnout income from divestitures.

Provision for income taxes

	Three months ended			Nine months ended		
	September 30, 2017	October 1, 2016	Change over prior period	September 30, 2017	October 1, 2016	Change over prior period
	(In thousands)					
Provision for income taxes	$ 66	$ 217	$ (151)	$ 805	$ 13	$ 792

Intevac recorded income tax provisions of $66,000 and $805,000 for the three and nine months ended September 30, 2017, respectively, and $217,000 and $13,000 for the three and nine months ended October 1, 2016, respectively. The income tax provision for the nine months ended September 30, 2017 includes $506,000 for withholding taxes on royalties payable to the United States from Intevac s Singapore subsidiary and $200,000 for audit considerations in foreign jurisdictions, both recorded as discrete items. The income tax provisions for the three and nine month periods are based upon estimates of annual income (loss), annual permanent differences and statutory tax rates in the various jurisdictions in which Intevac operates. Intevac did not recognize benefits on the U.S. net operating loss for the three and nine month period ended September 30, 2017 due to having full valuation allowances on the U.S. deferred tax assets. Intevac did not recognize benefits on the U.S. net operating loss or on the Singapore net operating loss for the three and nine month period ended October 1, 2016 due to having full valuation allowances on the U.S. deferred tax assets and on the Singapore deferred tax assets. Intevac s tax rate differs from the applicable statutory rates due primarily to establishment of a valuation allowance, the utilization of deferred and current credits and the effect of permanent differences and adjustments of prior permanent differences. Intevac s future effective income tax rate depends on various factors, including the level of Intevac s 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 Intevac s tax planning strategies. Management carefully monitors these factors and timely adjusts the effective income tax rate.

Liquidity and Capital Resources

At September 30, 2017, Intevac had $43.4 million in cash, cash equivalents, and investments compared to $48.2 million at December 31, 2016. During the first nine months of 2017, cash, cash equivalents and investments decreased by $4.8 million due primarily to cash used by operating activities, purchases of fixed assets and tax payments related to the net share settlement of restricted stock units, partially offset by cash received from the sale of

Intevac common stock to Intevac s employees through Intevac s employee benefit plans.

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Cash, cash equivalents and investments consist of the following:

	September 30, 2017	December 31, 2016
	(In thousands)	
Cash and cash equivalents	$ 19,197	$ 27,043
Short-term investments	18,037	17,602
Long-term investments	6,165	3,593
Total cash, cash equivalents and investments	$ 43,399	$ 48,238

Operating activities used cash of $1.7 million during the first nine months of 2017 and used cash of $3.1 million during the first nine months of 2016. The improvement in operating cash flows was due primarily to higher net income as a result of the return to profitability, offset in part by additional investments in working capital during the first nine months of 2017.

Accounts receivable totaled $22.3 million at September 30, 2017 compared to $17.4 million at December 31, 2016 primarily as a result of billings for third quarter revenue and customer advances. At September 30, 2017, customer advances for products that had not been shipped to customers and included in accounts receivable were $4.0 million. Net inventories totaled $32.6 million at September 30, 2017 compared to $24.9 million at December 31, 2016. The increase was due primarily to three Energ*i* systems that were undergoing installation and acceptance testing and included in finished goods at September 30, 2017 and higher levels of production inventories for planned 2017 and 2018 shipments, offset in part by recognition of previously deferred revenue on four VERTEX systems and two Energ*i* systems that were undergoing installation and acceptance testing and included in finished goods at December 31, 2016. Accounts payable totaled $7.0 million at September 30, 2017 compared to $5.3 million at December 31, 2016. The increase was due primarily to increased materials purchases to support planned shipments. Accrued payroll and related liabilities increased to $5.8 million at September 30, 2017 compared to $4.2 million at December 31, 2016 due primarily to higher accruals for 2017 bonuses and profit sharing due to the return to profitability, offset in part by the settlement of 2016 bonuses. Other accrued liabilities decreased to $7.9 million at September 30, 2017 compared to $17.0 million at December 31, 2016 due primarily to the recognition of previously deferred revenue. Customer advances increased from $5.4 million at December 31, 2016 to $12.3 million at September 30, 2017, primarily due to the receipt of new customer orders.

Investing activities used cash of $6.4 million during the first nine months of 2017. Purchases of investments net of proceeds from sales totaled $3.1 million. Capital expenditures for the nine months ended September 30, 2017 were $3.6 million.

Financing activities generated cash of $182,000 in the first nine months of 2017. The sale of Intevac common stock to Intevac s employees through Intevac s employee benefit plans generated cash of $2.3 million. Tax payments related to the net share settlement of restricted stock units were $2.0 million.

Intevac s investment portfolio consists principally of investment grade money market mutual funds, U.S. Treasury and agency securities, certificates of deposit, commercial paper, municipal bonds and corporate bonds. Intevac regularly monitors the credit risk in its investment portfolio and takes measures, which may include the sale of certain securities, to manage such risks in accordance with its investment policies.

As of September 30, 2017, approximately $10.9 million of cash and cash equivalents and $3.3 million of short-term investments were domiciled in foreign tax jurisdictions. Intevac expects a significant portion of these funds to remain offshore in the short term. If the Company chose to repatriate these funds to the United States, it would be required to accrue and pay additional taxes on any portion of the repatriation where no United States income tax had been previously provided.

Intevac believes that its existing cash, cash equivalents and investments will be sufficient to meet its cash requirements for the foreseeable future. Intevac intends to undertake approximately $2.0 million to $3.0 million in capital expenditures during the remainder of 2017.

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Off-Balance Sheet Arrangements

Off-balance sheet firm commitments relating to outstanding letters of credit amounted to approximately $1.4 million as of September 30, 2017. These letters of credit and bank guarantees are collateralized by $1.4 million of restricted cash. We do not maintain any other off-balance sheet arrangements, transactions, obligations, or other relationships that would be expected to have a material current or future effect on the consolidated financial statements.

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. Intevac s significant accounting policies are described in Note 1 to the consolidated financial statements included in Item 8 of Intevac s Annual Report on Form 10-K filed on February 15, 2017. 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 Intevac s financial statements and requires management to make difficult, subjective or complex judgments that could have a material effect on Intevac s financial conditions and results of operations. Specifically, critical accounting estimates have the following attributes: 1) Intevac is required to make assumptions about matters that are highly uncertain at the time of the estimate; and 2) different estimates Intevac could reasonably have used, or changes in the estimate that are reasonably likely to occur, would have a material effect on Intevac s financial condition or results of operations.

Estimates and assumptions about future events and their effects cannot be determined with certainty. Intevac bases its estimates on historical experience and on