

NANOMETRICS INC
Form 10-Q
October 28, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 24, 2016

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: 000-13470

NANOMETRICS INCORPORATED

(Exact name of registrant as specified in its charter)

Delaware 94-2276314
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification Number)

1550 Buckeye Drive

Milpitas, California 95035
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (408) 545-6000

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or 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 or a smaller reporting company. See the definitions of “large accelerated filer”, “accelerated filer”, and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company

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

As of October 21, 2016, there were 24,916,470 shares of common stock, \$0.001 par value, issued and outstanding.

NANOMETRICS INCORPORATED

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FOR THE QUARTER ENDED SEPTEMBER 24, 2016

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PART I — FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS
NANOMETRICS INCORPORATED

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands except share and per share amounts)

(Unaudited)

| | September 24, 2016 | December 26, 2015 |
|--|-----------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 37,421 | \$ 38,154 |
| Marketable securities | 81,106 | 44,931 |
| Accounts receivable, net of allowances of \$92 and \$150, respectively | 41,182 | 37,832 |
| Inventories | 39,260 | 47,749 |
| Inventories-delivered systems | 4,416 | 2,856 |
| Prepaid expenses and other | 5,835 | 6,592 |
| Total current assets | 209,220 | 178,114 |
| Property, plant and equipment, net | 44,324 | 44,493 |
| Goodwill | 9,665 | 9,415 |
| Intangible assets, net | 552 | 1,867 |
| Deferred income tax assets | 1,319 | 1,118 |
| Other assets | 526 | 533 |
| Total assets | \$ 265,606 | \$ 235,540 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 8,562 | \$ 11,675 |
| Accrued payroll and related expenses | 11,631 | 10,097 |
| Deferred revenue | 16,804 | 12,790 |
| Other current liabilities | 8,630 | 8,878 |
| Income taxes payable | 278 | 1,771 |
| Total current liabilities | 45,905 | 45,211 |
| Deferred revenue | 639 | 827 |
| Income taxes payable | 848 | 775 |
| Deferred tax liability | 709 | 521 |
| Other long-term liabilities | 866 | 878 |
| Total liabilities | 48,967 | 48,212 |
| Commitments and contingencies (Note 11) | | |
| Stockholders' equity: | | |

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| | | |
|---|------------|------------|
| Preferred stock, \$0.001 par value; 3,000,000 shares authorized; no shares issued or outstanding | — | — |
| Common stock, \$0.001 par value, 47,000,000 shares authorized: 24,897,878 and 24,224,286, respectively, issued and outstanding | 25 | 24 |
| Additional paid-in capital | 268,553 | 258,715 |
| Accumulated deficit | (48,828) | (66,209) |
| Accumulated other comprehensive income | (3,111) | (5,202) |
| Total stockholders' equity | 216,639 | 187,328 |
| Total liabilities and stockholders' equity | \$ 265,606 | \$ 235,540 |

See Notes to Condensed Consolidated Financial Statements

NANOMETRICS INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands except per share amounts)

(Unaudited)

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|--------------------|--------------------|--------------------|
| | September 26, 2016 | September 26, 2015 | September 26, 2016 | September 26, 2015 |
| Net revenues: | | | | |
| Products | \$49,631 | \$ 36,414 | \$136,290 | \$ 113,689 |
| Service | 9,083 | 9,264 | 25,680 | 30,993 |
| Total net revenues | 58,714 | 45,678 | 161,970 | 144,682 |
| Costs of net revenues: | | | | |
| Cost of products | 22,810 | 19,242 | 62,625 | 59,106 |
| Cost of service | 5,066 | 3,749 | 14,714 | 15,158 |
| Amortization of intangible assets | 434 | 468 | 1,311 | 1,557 |
| Total costs of net revenues | 28,310 | 23,459 | 78,650 | 75,821 |
| Gross profit | 30,404 | 22,219 | 83,320 | 68,861 |
| Operating expenses: | | | | |
| Research and development | 7,868 | 8,579 | 23,447 | 24,896 |
| Selling | 7,495 | 6,760 | 22,567 | 20,905 |
| General and administrative | 5,975 | 5,590 | 17,150 | 16,901 |
| Amortization of intangible assets | — | 26 | 24 | 89 |
| Restructuring charge | — | — | — | 56 |
| Total operating expenses | 21,338 | 20,955 | 63,188 | 62,847 |
| Income from operations | 9,066 | 1,264 | 20,132 | 6,014 |
| Other (income) expense: | | | | |
| Interest income | 12 | 7 | 33 | 63 |
| Interest expense | (92) | (86) | (276) | (252) |
| Other income, net | 229 | 346 | 60 | 740 |
| Total other income (expense), net | 149 | 267 | (183) | 551 |
| Income before income taxes | 9,215 | 1,531 | 19,949 | 6,565 |
| Provision for income taxes | 1,332 | 713 | 2,568 | 1,847 |
| Net income | \$7,883 | \$ 818 | \$17,381 | \$ 4,718 |
| Net income per share: | | | | |
| Basic | \$0.32 | \$ 0.03 | \$0.71 | \$ 0.20 |
| Diluted | \$0.31 | \$ 0.03 | \$0.70 | \$ 0.19 |
| Weighted average shares used in per share calculation: | | | | |
| Basic | 24,826 | 24,145 | 24,550 | 24,010 |
| Diluted | 25,282 | 24,352 | 24,979 | 24,347 |

See Notes to Condensed Consolidated Financial Statements

NANOMETRICS INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

(Unaudited)

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|--------------------|--------------------|--------------------|
| | September 24, 2016 | September 26, 2015 | September 24, 2016 | September 26, 2015 |
| Net income | \$7,883 | \$ 818 | \$17,381 | \$ 4,718 |
| Other comprehensive income (loss): | | | | |
| Change in foreign currency translation adjustment | 519 | (235) | 2,018 | (1,980) |
| Net change on unrealized gains on available-for-sale investments | 1 | 17 | 73 | 42 |
| Other comprehensive income (loss): | 520 | (218) | 2,091 | (1,938) |
| Comprehensive income | \$8,403 | \$ 600 | \$19,472 | \$ 2,780 |

See Notes to Condensed Consolidated Financial Statements

NANOMETRICS INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

| | Nine Months Ended | |
|--|-------------------|----------------|
| | September 2016 | September 2015 |
| Cash flows from operating activities: | | |
| Net income | \$17,381 | \$ 4,718 |
| Reconciliation of net income to net cash provided | | |
| by operating activities: | | |
| Depreciation and amortization | 6,440 | 6,826 |
| Stock-based compensation | 5,432 | 4,664 |
| Disposal of fixed assets | 162 | 578 |
| Inventory write-down | 1,451 | 1,971 |
| Deferred income taxes | (14) | 173 |
| Changes in fair value of contingent payments to Zygo Corporation | 158 | 137 |
| Changes in assets and liabilities: | | |
| Accounts receivable | (986) | (14,873) |
| Inventories | 6,652 | (15,893) |
| Inventories-delivered systems | (1,560) | 370 |
| Prepaid expenses and other | 889 | 4,436 |
| Accounts payable, accrued and other liabilities | (4,310) | 9,634 |
| Deferred revenue | 3,825 | (688) |
| Income taxes payable | (1,419) | 295 |
| Net cash provided by operating activities | 34,101 | 2,348 |
| Cash flows from investing activities: | | |
| Sales of marketable securities | 2,093 | 2,884 |
| Maturities of marketable securities | 25,461 | 30,279 |
| Purchases of marketable securities | (63,840) | (27,298) |
| Purchases of property, plant and equipment | (3,349) | (1,365) |
| Net cash provided by (used in) investing activities | (39,635) | 4,500 |
| Cash flows from financing activities: | | |
| Payments to Zygo Corporation related to acquisition | (315) | (614) |
| Proceeds from sale of shares under employee stock option | | |
| plans and purchase plan | 5,984 | 3,642 |
| Taxes paid on net issuance of stock awards | (1,578) | (1,104) |
| Repurchases of common stock | — | (1,721) |
| Net cash provided by financing activities | 4,091 | 203 |
| Effect of exchange rate changes on cash and cash equivalents | 710 | (166) |
| Net increase (decrease) in cash and cash equivalents | (733) | 6,885 |

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| | | |
|---|----------|-----------|
| Cash and cash equivalents, beginning of period | 38,154 | 34,676 |
| Cash and cash equivalents, end of period | \$37,421 | \$ 41,561 |
| Supplemental disclosure of non-cash investing activities: | | |
| Transfer of inventory to property, plant and equipment, net | \$1,699 | \$ 1,068 |
| Transfer of property, plant and equipment to inventory, net | \$491 | \$ — |

See Notes to Consolidated Financial Statements

NANOMETRICS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Nature of Business and Basis of Presentation

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

Basis of Presentation – The accompanying condensed consolidated financial statements (“financial statements”) have been prepared on a consistent basis with the audited consolidated financial statements as of December 26, 2015, and include all normal recurring adjustments necessary to fairly state the information set forth therein. All significant intercompany accounts and transactions have been eliminated in consolidation.

The financial statements have been prepared in accordance with the regulations of the United States Securities and Exchange Commission (“SEC”) for interim periods in accordance with S-X Article 10, and, therefore, omit certain information and footnote disclosure necessary to present the statements in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”). The operating results for interim periods are not necessarily indicative of the operating results that may be expected for the entire year. These financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the fiscal year ended December 26, 2015, which were included in the Company’s Annual Report on Form 10-K filed with the SEC on February 24, 2016.

Fiscal Period – The Company uses a 52/53 week fiscal year ending on the last Saturday of the calendar year. All references to the quarter refer to Nanometrics’ fiscal quarter. The fiscal quarters reported herein are 13 week periods.

Upgrade Revenue and Related Cost - Beginning the first quarter of 2016, revenues associated with upgrade sales are now included under Products Revenues, and the related costs in Cost of Products Revenue. This change was due to the types of upgrades currently being sold, which are primarily system software and hardware performance upgrades to extend the features and functionality of a product. Previously upgrades consisted of a group of parts and/or software that change the existing configuration of a product. For the three months ended September 26, 2015, \$0.8 million related to upgrade sales, and \$0.1 million of costs, are included in Service Revenues and Costs of Service Revenues, respectively, in the accompanying Condensed Consolidated Statement of Operations. For the nine months ended

September 26, 2015, \$7.6 million related to upgrade sales, and \$2.9 million of costs, are included in Service Revenues and Costs of Service Revenues, respectively, in the accompanying Condensed Consolidated Statement of Operations.

Use of Estimates – 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 the reported amounts of revenues and expenses during the reported period. Actual results could differ materially from those estimates. Estimates are used for, but not limited to, revenue recognition, the provision for doubtful accounts, the provision for excess, obsolete, or slow moving inventories, valuation of intangible and long-lived assets, warranty accruals, income taxes, valuation of stock-based compensation, and contingencies.

Revenue Recognition – The Company derives revenue from the sale of process control metrology and inspection systems and related upgrades (“product revenue”) as well as spare part sales, billable service and service contracts (together “service revenue”). Upgrades are system software and hardware performance upgrades that extend the features and functionality of a product. As discussed above, commencing in the first quarter of 2016, upgrades are included in product revenue, which consists of sales of complete, advanced process control metrology and inspection systems (the “system(s)”). Nanometrics’ systems consist of hardware and software components that function together to deliver the essential functionality of the system. Arrangements for sales of systems often include defined customer-specified acceptance criteria.

NANOMETRICS INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

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

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

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

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

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

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

The Company regularly evaluates its revenue arrangements to identify deliverables and to determine whether these deliverables are separable into multiple units of accounting. The Company allocates the arrangement consideration among the deliverables based on relative selling prices. The Company has established VSOE for some of its products and services when a substantial majority of selling prices falls within a narrow range when sold separately. For deliverables with no established VSOE, the Company uses best estimate of selling price to determine standalone selling price for such deliverable. The Company does not use third party evidence to determine standalone selling price since this information is not widely available in the market as the Company's products contain a significant element of proprietary technology and the solutions offered differ substantially from competitors. The Company has established a process for developing estimated selling prices, which incorporates historical selling prices, the effect of market conditions, gross margin objectives, pricing practices, as well as entity-specific factors. The Company monitors and evaluates estimated selling price on a regular basis to ensure that changes in circumstances are accounted for in a timely manner.

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

NANOMETRICS INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Note 2. Recent Accounting Pronouncements

In August 2016, the Financial Accounting Standards Board (the "FASB") issued an accounting standard which addresses eight specific cash flow classification issues. This update is effective for public companies for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. Early adoption is permitted, including in an interim period. If early adopted in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period, and all the amendments must be adopted in the same period. The standard is to be applied through a retrospective transition method to each period presented. If it is impracticable to apply retrospectively for some of the issues, the amendments for those issues would be applied prospectively as of the earliest date practicable. The Company is currently evaluating the impact of adopting this update on its consolidated statements of cash flows.

In June 2016, the FASB issued an accounting standard which requires measurement and timely recognition of expected credit losses for financial assets. The update is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The standard is to be applied through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. The Company is currently evaluating the effect of this update on its consolidated financial statements.

In March 2016, the FASB issued an accounting standards update that simplifies several aspects of the accounting for share-based payment award transactions, including income tax consequences, classification of awards as equity or liability, and classification on the statement of cash flows. The standard is effective for public companies for annual reporting periods beginning after December 16, 2016, and interim periods within those annual periods. Early adoption is permitted. The Company is currently evaluating the timing and effects of the adoption of this standard on its consolidated financial statements.

In February 2016, the FASB issued an accounting standards update which requires lessees to record a right-of-use asset and a corresponding lease liability on the balance sheet (with the exception of short-term leases). For lessees, leases will continue to be classified as either operating or financing in the income statement. The standard is effective for public companies for annual reporting periods beginning after December 15, 2018, including interim periods within those fiscal years. This standard is required to be applied with a modified retrospective transition approach. Early adoption is permitted. The Company is currently evaluating the effect of this standard on its Consolidated Financial Statements and related disclosures.

In May 2014, the FASB issued an accounting standards update which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. This guidance clarifies the principles of revenue recognition to improve operability and understandability of the guidance. The standard will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. In July 2015, the FASB deferred for one year the effective date of the revenue standard update, but early adoption will be permitted. The standard will be effective for the Company on January 1, 2018. The standard permits the use of either the retrospective or cumulative effect transition method. The Company has not yet selected a transition method and is currently evaluating the timing and effects of the adoption of this standard and related updates on its consolidated

financial statements and related disclosures.

Note 3. Fair Value Measurements and Disclosures

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

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

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

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

NANOMETRICS INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

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

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

| | September 24, 2016 | | | | December 26, 2015 | | | |
|--|-------------------------|-----------------|------------|-----------------|-------------------------|-----------------|------------|-----------------|
| | Fair Value Measurements | | | | Fair Value Measurements | | | |
| | Using Input Types | | | | Using Input Types | | | |
| | Level 1 | Level 2 | Level 3 | Total | Level 1 | Level 2 | Level 3 | Total |
| Assets: | | | | | | | | |
| Cash equivalents: | | | | | | | | |
| Money market funds | \$840 | \$— | \$— | \$840 | \$590 | \$— | \$— | \$590 |
| Commercial paper and corporate debt securities | — | 4,244 | — | 4,244 | — | 4,568 | — | 4,568 |
| Total cash equivalents | \$840 | \$4,244 | \$— | \$5,084 | \$590 | \$4,568 | \$— | \$5,158 |
| Marketable securities: | | | | | | | | |
| U.S. Treasury securities and U.S. Government agency debt securities | | | | | | | | |
| Certificates of deposits | — | 16,008 | — | 16,008 | — | — | — | — |
| Commercial paper | — | 23,848 | — | 23,848 | — | 1,884 | — | 1,884 |
| Municipal securities and corporate debt securities | — | 12,526 | — | 12,526 | — | 18,482 | — | 18,482 |
| Asset-backed Securities | — | 7,468 | — | 7,468 | — | — | — | — |
| Total marketable securities | \$— | \$81,106 | \$— | \$81,106 | \$4,401 | \$40,530 | \$— | \$44,931 |
| Total⁽¹⁾ | \$840 | \$85,350 | \$— | \$86,190 | \$4,991 | \$45,098 | \$— | \$50,089 |
| Liabilities: | | | | | | | | |
| Contingent consideration payable | \$— | \$— | \$1,333 | \$1,333 | \$— | \$— | \$1,490 | \$1,490 |

⁽¹⁾Excludes \$32.3 million and \$33.0 million held in operating accounts as of September 24, 2016 and December 26, 2015, respectively.

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

| | |
|---|-------------------|
| | (in thousands) |
| Changes in Level 3 liabilities | |
| Fair value at December 26, 2015 | \$ 1,490 |
| Payments made to Zygo Corporation | (315) |
| Change in fair value included in earnings | 158 |
| Fair value at September 24, 2016 | \$ 1,333 |

As of September 24, 2016, the Company had liabilities of \$1.3 million resulting from the acquisition of certain assets from Zygo Corporation, a wholly-owned subsidiary of AMETEK, Inc. (“Zygo”), which are measured at fair value on a recurring basis, and changes in fair value recorded in other income (expense), net. Of the \$1.3 million of Zygo liabilities at September 24, 2016, \$0.8 million was a current liability and \$0.5 million was a long-term liability. As of December 26, 2015, the liabilities totaled \$1.5 million

NANOMETRICS INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

of which \$0.9 million was a current liability and \$0.6 million was a long-term liability. The fair values of these liabilities were determined using Level 3 inputs applying a discounted cash flow model incorporating assumptions that market participants would use in their estimates of fair value. Some of these assumptions included estimates for discount rate, and timing and the amount of cash flows.

Derivatives

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. These derivatives are carried at fair value with changes recorded in other income (expense), net in the consolidated statements of operations. Changes in the fair value of these derivatives are largely offset by re-measurement of the underlying assets and liabilities. The derivatives have maturities of approximately 30 days.

The settlement of forward foreign currency contracts included in the three months ended September 24, 2016 and September 26, 2015 was a gain of \$0.1 million and a loss of \$0.3 million, respectively. The loss on settlement of forward foreign currency contracts included in the nine months ended September 24, 2016 and September 26, 2015 was \$1.2 million and \$0.3 million respectively. These are included in other income (expense), net, in the consolidated statements of operations.

The following table summarizes the Company's outstanding derivative instruments on a gross basis as of September 24, 2016:

| | Notional Principal (in millions) |
|------------------------------------|---|
| Undesignated Hedges: | |
| Forward Foreign Currency Contracts | \$ 15.9 |

NANOMETRICS INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Note 4. Cash and Investments

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

| | September 24, 2016 | | | Estimated |
|---|--------------------|------------|------------|-----------|
| | Amortized | Gross | Gross | Fair |
| | Cost | Unrealized | Unrealized | Market |
| | | Gains | Losses | Value |
| Cash | \$32,337 | \$ — | \$ — | 32,337 |
| Cash equivalents: | | | | |
| Money market funds | 840 | — | — | 840 |
| Commercial paper and corporate debt securities | 4,245 | — | (1) | 4,244 |
| Marketable securities: | | | | |
| U.S. Treasury securities | 6,935 | 9 | — | 6,944 |
| U.S. Government agency securities | 14,301 | 11 | — | 14,312 |
| Certificate of deposits | 15,997 | 11 | — | 16,008 |
| Commercial paper | 23,845 | 3 | — | 23,848 |
| Municipal securities | 765 | — | — | 765 |
| Corporate debt securities | 11,762 | — | (1) | 11,761 |
| Asset-backed securities | 7,470 | — | (2) | 7,468 |
| Total cash, cash equivalents, and marketable securities | \$118,497 | \$ 34 | \$ (4) | \$118,527 |

| | December 26, 2015 | | | Estimated |
|--|-------------------|------------|------------|-----------|
| | Amortized | Gross | Gross | Fair |
| | Cost | Unrealized | Unrealized | Market |
| | | Gains | Losses | Value |
| Cash | \$32,996 | \$ — | \$ — | \$32,996 |
| Cash equivalents: | | | | |
| Money market funds | 590 | — | — | 590 |
| Commercial paper and corporate debt securities | 4,568 | — | — | 4,568 |
| Marketable securities: | | | | |
| U.S. Treasury securities | 4,411 | — | (10) | 4,401 |
| U.S. Government agency securities | 20,193 | 1 | (29) | 20,165 |
| Commercial paper | 1,884 | — | — | 1,884 |

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| | | | | |
|---|----------|------|----------|----------|
| Municipal securities | 3,747 | 1 | (3) | 3,745 |
| Corporate debt securities | 14,759 | — | (23) | 14,736 |
| Total cash, cash equivalents, and marketable securities | \$83,148 | \$ 2 | \$ (65) | \$83,085 |

Available-for-sale marketable securities, readily convertible to cash, with maturity dates of 90 days or less are classified as cash equivalents, while those with maturity dates greater than 90 days are classified as marketable securities within short-term assets. All marketable securities as of September 24, 2016 and December 26, 2015, were available-for-sale and reported at fair value based on the estimated or quoted market prices as of the balance sheet date.

Realized gains and losses on sale of securities are recorded in other income, net, in the Company's statement of operations. Net realized gains and losses for three and nine months ended September 24, 2016 and September 26, 2015 were not material.

Unrealized gains or losses, net of tax effect, are recorded in accumulated other comprehensive income (loss) within stockholders' equity. Both the gross unrealized gains and gross unrealized losses for the three and nine months ended September 24, 2016 and September 26, 2015 were insignificant and no marketable securities had other than temporary impairment.

All marketable securities as of September 24, 2016 and December 26, 2015, had maturity dates of less than two years.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Note 5. Accounts Receivable

The Company maintains arrangements under which eligible accounts receivable in Japan are sold without recourse to unrelated third-party financial institutions. These receivables were not included in the consolidated balance sheets as the criteria for sale treatment had been met. The Company pays administrative fees as well as interest ranging from 0.76% to 1.68% based on the anticipated length of time between the date the sale is consummated and the expected collection date of the receivables sold. The Company sold \$10.1 million and \$4.3 million of receivables during the three months ended September 24, 2016 and September 26, 2015, respectively and \$29.6 million and \$7.3 million of receivables during the nine months ended September 24, 2016 and September 26, 2015, respectively. There were no material gains or losses on the sale of such receivables. There were no amounts due from such third party financial institutions at September 24, 2016 and December 26, 2015.

Note 6. Financial Statement Components

The following tables provide details of selected financial statement components as of the following dates (in thousands):

| | At | |
|--|--------------------|-------------------|
| | September 24, 2016 | December 26, 2015 |
| Inventories: | | |
| Raw materials and sub-assemblies | \$21,953 | \$26,784 |
| Work in process | 9,508 | 12,862 |
| Finished goods | 7,799 | 8,103 |
| Inventories | 39,260 | 47,749 |
| Inventories-delivered systems | 4,416 | 2,856 |
| Total inventories | \$43,676 | \$50,605 |
| Property, plant and equipment, net:⁽¹⁾ | | |
| Land | \$15,570 | \$15,569 |
| Building and improvements | 20,511 | 20,158 |
| Machinery and equipment | 36,109 | 32,995 |
| Furniture and fixtures | 2,357 | 2,266 |
| Software | 9,007 | 8,245 |
| Capital in progress | 2,091 | 1,328 |
| Total property, plant and equipment, gross | 85,645 | 80,561 |
| Accumulated depreciation and amortization | (41,321) | (36,068) |

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| | | |
|--|----------|----------|
| Total property, plant and equipment, net | \$44,324 | \$44,493 |
|--|----------|----------|

⁽¹⁾ Total depreciation and amortization expense was \$1.7 million and \$1.8 million for the three months ended September 24, 2016 and September 26, 2015, respectively and \$5.1 million and \$5.2 million for the nine months ended September 24, 2016 and September 26, 2015, respectively.

Other Current Liabilities:

| | | |
|---|---------|---------|
| Accrued warranty | \$4,185 | \$4,504 |
| Accrued restructuring | — | 256 |
| Accrued professional services | 492 | 481 |
| Accrued royalties | 1,029 | 437 |
| Fair value of current portion of contingent payments to | | |
| Zygo Corporation related to acquisition | 814 | 945 |
| Other | 2,110 | 2,255 |
| Total other current liabilities | \$8,630 | \$8,878 |

NANOMETRICS INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Components of Accumulated Other Comprehensive Income (Loss)

| | Years Ended | | Unrealized Income (Loss) | Accumulated Other Comprehensive Income |
|----------------------------------|------------------------------------|-------------------------------------|--------------------------------|---|
| | Foreign Currency Translation | Defined Benefit Pension Plans | | |
| Balance as of December 26, 2015 | \$ (4,948) | \$ (210) | \$ (44) | \$ (5,202) |
| Current period change | 2,018 | — | 73 | 2,091 |
| Balance as of September 24, 2016 | \$ (2,930) | \$ (210) | \$ 29 | \$ (3,111) |

The items above, except for unrealized income (loss) on investment, did not impact the Company's income tax provision. The amounts reclassified from each component of accumulated other comprehensive income into income statement line items were insignificant.

Note 7. Goodwill and Intangible Assets

The following table summarizes the activity in the Company's goodwill during the nine months ended September 24, 2016:

| | (in thousands) |
|----------------------------------|-------------------|
| Balance as of December 26, 2015 | \$ 9,415 |
| Foreign currency movements | 250 |
| Balance as of September 24, 2016 | \$ 9,665 |

Finite-lived intangible assets are recorded at cost, less accumulated amortization. Finite-lived intangible assets as of September 24, 2016 and December 26, 2015 consisted of the following (in thousands):

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September 24, 2016

| | Adjusted cost | Accumulated amortization | Net carrying amount |
|------------------------|------------------|-----------------------------|---------------------------|
| Developed technology | \$16,336 | \$ (15,867) | \$ 469 |
| Customer relationships | 9,387 | (9,387) | — |
| Brand names | 1,927 | (1,927) | — |
| Patented technology | 2,252 | (2,169) | 83 |
| Trademark | 80 | (80) | — |
| Total | \$29,982 | \$ (29,430) | \$ 552 |

December 26, 2015

| | Adjusted cost | Accumulated amortization | Net carrying amount |
|------------------------|------------------|-----------------------------|---------------------------|
| Developed technology | \$16,098 | \$ (14,387) | \$ 1,711 |
| Customer relationships | 9,364 | (9,364) | — |
| Brand names | 1,927 | (1,903) | 24 |
| Patented technology | 2,252 | (2,120) | 132 |
| Trademark | 80 | (80) | — |
| Total | \$29,721 | \$ (27,854) | \$ 1,867 |

The amortization of finite-lived intangibles is computed using the straight-line method. Estimated lives of finite-lived intangibles range from two to ten years. The total amortization expense for the three months ended September 24, 2016 and September 26, 2015 was \$0.4 million and \$0.5 million, respectively. Total amortization expense for the nine months ended September 24, 2016 and September 26, 2015 was \$1.3 million and \$1.6 million, respectively.

NANOMETRICS INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

There were no impairment charges related to intangible assets recorded during the three and nine months ended September 24, 2016 and September 26, 2015.

The estimated future amortization expense of finite intangible assets as of September 24, 2016 is as follows (in thousands):

| Fiscal Years | Amounts |
|-----------------------------------|---------|
| 2016 (remaining three months) | \$ 140 |
| 2017 | 206 |
| 2018 | 140 |
| 2019 | 66 |
| Thereafter | — |
| Total future amortization expense | \$ 552 |

Note 8. Warranties

The Company sells the majority of its products with a 12 months repair or replacement warranty from the date of acceptance or shipment date. The Company provides an accrual for estimated future warranty costs based upon the historical relationship of warranty costs to the cost of products sold. The estimated future warranty obligations related to product sales are recorded in the period in which the related revenue is recognized. The estimated future warranty obligations are affected by the warranty periods, sales volumes, product failure rates, material usage, and labor and replacement costs incurred in correcting a product failure. If actual product failure rates, material usage, labor or replacement costs were to differ from the Company's estimates, revisions to the estimated warranty obligations would be required. For new product introductions where limited or no historical information exists, the Company may use warranty information from other previous product introductions to guide it in estimating its warranty accrual.

Components of the warranty accrual, which were included in the accompanying condensed consolidated balance sheets with other current liabilities, were as follows (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|--------------------|--------------------|--------------------|
| | September 24, 2016 | September 26, 2015 | September 24, 2016 | September 26, 2015 |
| Balance as of beginning of period | \$4,556 | \$ 3,792 | \$4,504 | \$ 2,953 |
| Accruals for warranties issued during period | 1,100 | 2,288 | 3,529 | 6,240 |
| Settlements during the period | (1,471) | (1,789) | (3,848) | (4,902) |
| Balance as of end of period | \$4,185 | \$ 4,291 | \$4,185 | \$ 4,291 |

Note. 9. Restructuring

There were no restructuring charges recorded during the nine months ended September 24, 2016.

The Company recorded a restructuring charge of approximately \$0.1 million during the nine months ended September 26, 2015 as a result of its decision to consolidate and reorganize certain of its operations, primarily in the U.K. The Company completed this restructuring plan in March 2015. Other related costs will be recognized as incurred.

As of September 24, 2016, the components of the Company's restructuring reserves were included in other current liabilities and were as follows (in thousands):

| | Employee severance and benefits | Facility costs | Other | Total |
|----------------------------------|--|-------------------|-------|-------|
| Balance as of December 26, 2015 | \$ — | \$ 249 | \$ 7 | \$256 |
| Charges | — | — | — | — |
| Cash Payments | — | (249) | (7) | (256) |
| Balance as of September 24, 2016 | \$ — | \$ — | \$ — | \$— |

NANOMETRICS INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

| | Employee severance and benefits | Facility termination costs | Other | Total |
|----------------------------------|--|----------------------------------|-------|-------|
| Balance as of December 27, 2014 | \$ 383 | \$ 583 | \$ 31 | \$997 |
| Charges | 45 | — | 11 | 56 |
| Cash Payments | (428) | (249) | (35) | (712) |
| Balance as of September 26, 2015 | \$ — | \$ 334 | \$ 7 | \$341 |

Note 10. Line of Credit and Debt Obligations

Line of Credit - The Company's revolving line of credit facility of up to \$12.0 million expired on May 30, 2016 and was not renewed.

Note 11. Commitments and Contingencies

Intellectual Property Indemnification Obligations – The Company will, from time to time, in the normal course of business, agree to indemnify certain customers, vendors or others against third party claims that the Company's products, when used for their intended purpose(s), or the Company's intellectual property, infringe the intellectual property rights of such third parties or other claims made against parties with whom it enters into contractual relationships. It is not possible to determine the maximum potential amount of liability under these indemnification obligations due to the limited history of prior indemnification claims and the unique facts and circumstances that are likely to be involved in each particular claim. Historically, the Company has not made payments under these obligations and believes that the estimated fair value of these agreements is immaterial. Accordingly, no liabilities have been recorded for these obligations in the accompanying condensed consolidated balance sheets as of September 24, 2016 and December 26, 2015.

Note 12. Net Income Per Share

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

A reconciliation of the share denominator of the basic and diluted net income per share computations for three and nine months ended September 24, 2016 and September 26, 2015 is as follows (in thousands):

| | Three Month Ended | | Nine Months Ended | |
|--|--------------------|--------------------|--------------------|--------------------|
| | September 24, 2016 | September 26, 2015 | September 24, 2016 | September 26, 2015 |
| Weighted average common shares outstanding used in | | | | |
| basic net income (loss) per share calculation | 24,826 | 24,145 | 24,550 | 24,010 |
| Potential dilutive common stock equivalents, | | | | |
| using treasury stock method | 456 | 207 | 429 | 337 |
| Weighted average shares used in diluted net income | | | | |
| (loss) per share calculation | 25,282 | 24,352 | 24,979 | 24,347 |

NANOMETRICS INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Note 13. Stockholders' Equity and Stock-Based Compensation

Options and Employee Stock Purchase Plan ("ESPP") Awards

The fair value of each option and ESPP award is estimated on the grant date using the Black-Scholes valuation model and the assumptions noted in the following table. The expected lives of options granted were calculated using the simplified method allowed by the Staff Accounting Bulletin No. 107, Share-Based Payment. The risk-free rates were based on the U.S Treasury rates in effect during the corresponding period of grant. The expected volatility was based on the historical volatility of the Company's stock price. The dividend yield reflects that the Company has not paid any cash dividends since inception and does not intend to pay any cash dividends in the foreseeable future.

| | Three Months Ended September 24, 2016 | | Nine Months Ended September 26, 2015 | |
|-------------------------------|---|--------------|--|--------------|
| Employee Stock Purchase Plan: | | | | |
| Expected life | 0.5 years | 0.5 years | 0.5 years | 0.5 years |
| Volatility | 38.2% | 36.7% | 38.7% | 36.9% |
| Risk free interest rate | 0.37% | 0.13% | 0.44% | 0.12% |
| Dividends | — | — | — | — |

No stock options were awarded during the nine months ended September 24, 2016 and September 26, 2015, respectively.

A summary of activity of stock options during the nine months ended September 24, 2016 is as follows:

| | Number of Shares Outstanding (Options) | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value (in Thousands) |
|---|---|--|--|---|
| Options Outstanding at December 26, 2015 | 1,051,867 | \$ 14.60 | 2.46 | \$ 1,916 |

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| | | | | |
|-----------------------------------|------------|----------|------|----------|
| Exercised | (352,996) | \$ 13.33 | | |
| Cancelled | (166,849) | \$ 15.79 | | |
| Outstanding at September 24, 2016 | 532,022 | \$ 15.06 | 2.32 | \$ 3,849 |
| Exercisable at September 24, 2016 | 480,462 | \$ 14.91 | 2.15 | \$ 3,546 |

The aggregate intrinsic value in the above table represents the total pretax intrinsic value, based on the Company's closing stock price of \$22.29 as of September 23, 2016, the last trading day of the quarter, which would have been received by the option holders had all option holders exercised their options as of that date. The total intrinsic value of options exercised during the three months ended September 24, 2016 and September 26, 2015 was \$0.5 million and \$0.1 million, respectively, and during the nine months ended September 24, 2016 and September 26, 2015 was \$1.9 million and \$1.4 million, respectively.

NANOMETRICS INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Restricted Stock Units (“RSUs”)

Time-based RSUs are valued using the market value of the Company’s common stock on the date of grant, assuming no expectation of dividends paid.

A summary of activity for RSUs is as follows:

| | | Weighted |
|---|-----------|--------------|
| | Number | Average Fair |
| Summary of activity for RSUs | of RSUs | Value |
| Outstanding RSUs as of December 26, 2015 | 713,243 | \$ 15.99 |
| Granted | 455,907 | \$ 17.15 |
| Released | (286,260) | \$ 16.11 |
| Cancelled | (45,852) | \$ 16.00 |
| Outstanding RSUs as of September 24, 2016 | 837,038 | \$ 15.58 |

Market-Based Performance Stock Units (“PSUs”)

In addition to granting RSUs that vest on the passage of time only, the Company granted PSUs to an executive. The PSUs will vest in three equal tranches over one, two and three years based on the relative performance of the Company’s stock during those periods, compared to a peer group over the same period. If target stock price performance is achieved, 66.7% of the shares of the Company’s common stock subject to the PSUs will vest, and up to a maximum of 100% of the shares subject to the PSUs will vest if the maximum stock price performance is achieved for each tranche.

A summary of activity for PSUs is as follows:

| | | Weighted |
|---|-----------|--------------|
| | Number | Average Fair |
| Summary of activity for PSUs | of PSUs | Value |
| Outstanding PSUs as of December 26, 2015 | 60,000 | \$ 18.35 |
| Granted | 67,500 | \$ 8.52 |
| Released | (13,333) | \$ 18.04 |
| Cancelled | (6,667) | \$ 18.04 |
| Outstanding PSUs as of September 24, 2016 | 107,500 | \$ 12.24 |

The preceding table reflects the maximum awards that can be achieved upon full vesting.

Valuation of PSUs

On the date of grant, the Company estimated the fair value of PSUs using a Monte Carlo simulation model. The assumptions for the valuation of PSUs are summarized as follows:

| | 2016 | |
|---|---------|------------|
| | Award | 2015 Award |
| Grant Date Fair Value Per Share | \$ 8.52 | \$ 18.35 |
| Weighted-average assumptions/inputs: | | |
| Expected Dividend | — | — |
| Range of risk-free interest rates | 0.92% | 0.25%-1.1% |
| Range of expected volatilities for peer group | 22%-93% | 23%-65% |

NANOMETRICS INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Stock-based Compensation Expense

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

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|----------------|-------------------|----------------|
| | September 2016 | September 2015 | September 2016 | September 2015 |
| Cost of products | \$ 116 | \$ 96 | \$ 273 | \$ 229 |
| Cost of service | 138 | 104 | 355 | 195 |
| Research and development | 387 | 300 | 985 | 796 |
| Selling | 537 | 511 | 1,492 | 1,403 |
| General and administrative | 822 | 671 | 2,327 | 2,041 |
| Total stock-based compensation expense related to employee stock options and employee stock purchases | \$2,000 | \$ 1,682 | \$5,432 | \$ 4,664 |

Note 14. Income Taxes

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

The provision for income taxes consists of the following (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|----------------------------|--------------------|----------------|-------------------|----------------|
| | September 2016 | September 2015 | September 2016 | September 2015 |
| Provision for income taxes | \$1,332 | \$ 713 | \$2,568 | \$ 1,847 |

The Company recorded a tax provision of \$1.3 million and \$0.7 million for the three months ended September 24, 2016 and September 26, 2015, respectively, and \$2.6 million and \$1.8 million for the nine months ended September 24, 2016 and September 26, 2015, respectively. The increase in the tax provision for 2016 from 2015 was primarily related to an increase in the Company's earnings for the three and nine months ended September 24, 2016.

As of September 24, 2016, the Company continues to maintain a valuation allowance against its U.S. and certain foreign deferred tax assets as a result of uncertainties regarding the realization of the asset due to cumulative losses and uncertainty of future taxable income. The Company will continue to assess the realizability of the deferred tax assets in each of the applicable jurisdictions and maintain the valuation allowances until sufficient positive evidence exists to support a reversal. In the event the Company determines that the deferred tax assets are realizable, an adjustment to the valuation allowance will be reflected in the tax provision for the period such determination is made.

The Company is subject to taxation in the U.S. and various states including California, and foreign jurisdictions including Korea, Japan, Taiwan, and China. Due to tax attribute carry-forwards, the Company is subject to examination for tax years 2003 forward for U.S. tax purposes. The Company is also subject to examination in various states for tax years 2002 forward. The Company is subject to examination for tax years 2007 forward for various foreign jurisdictions.

The Company accrues interest and penalties related to unrecognized tax benefits in its provision for income taxes. The total amount of penalties and interest were not material as of September 24, 2016 and September 26, 2015. During the next twelve months, the Company anticipates increases in its unrecognized tax benefits of approximately \$0.1 million.

NANOMETRICS INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Note 15. Segment, Geographic, Product and Significant Customer Information

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

| | Three Months Ended | | Nine Months Ended | |
|-------------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 24, 2016 | September 26, 2015 | September 24, 2016 | September 26, 2015 |
| Total net revenues ⁽¹⁾ : | | | | |
| China | \$ 15,710 | \$ 6,731 | \$ 35,226 | \$ 12,357 |
| South Korea | 11,765 | 6,794 | 24,669 | 28,807 |
| United States | 8,211 | 7,985 | 24,306 | 32,115 |
| Singapore | 7,364 | 2,988 | 33,883 | 15,875 |
| Taiwan | 6,334 | 11,331 | 16,962 | 35,173 |
| Japan | 5,078 | 7,778 | 18,645 | 15,919 |
| Other | 4,252 | 2,071 | 8,279 | 4,436 |
| Total net revenues | \$ 58,714 | \$ 45,678 | \$ 161,970 | \$ 144,682 |

| | September 24, 2016 | December 26, 2015 |
|----------------------------------|-----------------------|----------------------|
| Long-lived tangible assets: | | |
| United States | \$ 42,603 | \$ 42,581 |
| International | 1,721 | 1,912 |
| Total long-lived tangible assets | \$ 44,324 | \$ 44,493 |

The following customers accounted for 10% or more of total accounts receivable, net:

| | At | |
|--|-----------------------|----------------------|
| | September 24, 2016 | December 26, 2015 |
| Taiwan Semiconductor Manufacturing Company Limited | 20.0 % | 25.6 % |
| Micron | 15.3 % | *** |
| Intel | 13.6 % | *** |
| United Semiconductor (Xiamen) Co., Ltd. | 10.6 % | *** |
| Toshiba Corporation | *** | 27.1 % |

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***The customer accounted for less than 10% of total accounts receivable, net, as of that period end.
The following customers accounted for 10% or more of total net revenues:

| | Three Months Ended | | Nine Months Ended | | | |
|--|--------------------|----------------|-------------------|----------------|------|---|
| | September 2016 | September 2015 | September 2016 | September 2015 | | |
| SK Hynix | 18.8% | 15.0 | % | 14.0% | 13.0 | % |
| Intel Corporation | 18.5% | *** | | 19.4% | *** | |
| Micron | 14.6% | 14.0 | % | 25.2% | 18.0 | % |
| Toshiba Corporation | *** | 13.0 | % | *** | *** | |
| Taiwan Semiconductor Manufacturing Company Limited | *** | 17.0 | % | *** | 19.0 | % |
| Samsung Electronics Co. Ltd. | *** | *** | | *** | 16.0 | % |

***The customer accounted for less than 10% of total net revenues during the period.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. The statements contained in this document that are not purely historical are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, including, without limitation, statements regarding future periods, financial results, revenues, margins, growth, customers, tax rates, product performance, and the impact of accounting rules on our business and the future implications of our statements regarding goals, strategy, and similar terms. We may identify these statements by the use of words such as “anticipate,” “believe,” “continue,” “could,” “estimate,” “expect,” “may,” “might,” “project,” “will,” and other similar expressions. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements, except as may otherwise be required by law.

Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain risks, uncertainties and changes in circumstances, many of which may be difficult to predict or beyond our control, including those factors referenced in this document, and in Part I, Item 1A, Risk Factors, in our Annual Report on Form 10-K for the fiscal year ended December 26, 2015, filed with the Securities and Exchange Commission (“SEC”) on February 24, 2016 (our “Annual Report”). In particular, our results could vary significantly based on: changes in customer and industry spending; rate and extent of changes in product mix; adoption of new products; timing of orders, shipments, and acceptance of products; our ability to secure volume supply agreements; and general economic conditions. In evaluating our business, investors should carefully consider these factors in addition to any other risks and uncertainties set forth elsewhere. The occurrence of the events described in the risk factors of our Annual Report and elsewhere in this report as well as other risks and uncertainties could materially and adversely affect our business, operating results and financial condition. While management believes that the discussion and analysis in this report is adequate for a fair presentation of the information presented, we recommend that you read this discussion and analysis in conjunction with (i) our audited consolidated financial statements and notes thereto for the fiscal year ended December 26, 2015, which were included in our Annual Report, (ii) the section captioned “Risk Factors” in our Annual Report, and (iii) our other filings with the SEC.

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

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

Our revenues are derived primarily from product sales and system upgrades but are also derived from customer service for the installed base of our products. For the nine months ended September 24, 2016, we derived 84% of our total net revenues from product sales and upgrades, and 16% of our total net revenues from services.

Overview

Together with our subsidiaries, we are a leading provider of advanced, high-performance process control metrology and inspection systems used primarily in the fabrication of integrated circuits, sensors, discrete components, high-brightness LEDs (“HB-LED”), and data storage devices. Our automated and integrated systems address numerous process control applications, including critical dimension and film thickness measurement, device topography, defect inspection, and analysis of various other film properties such as optical, electrical and material characteristics. Our process control solutions are deployed throughout the fabrication process, from front-end-of-line substrate manufacturing, to high-volume production of semiconductors and other devices, to advanced wafer-scale packaging applications. Our systems enable device manufacturers to improve yields, increase productivity and lower their manufacturing costs.

Nanometrics Products

We offer a diverse line of systems to address the broad range of process control requirements of the semiconductor manufacturing industry. In addition, we believe that our engineering expertise and strategic acquisitions enable us to develop and offer advanced process control solutions that, in the future, should address industry advancement and trends.

Automated Systems

Our automated systems primarily consist of fully automated metrology systems that are employed in semiconductor production environments. The Atlas® III, Atlas II+, Atlas II and Atlas XP/Atlas XP+ represent our line of high-performance metrology systems providing optical critical dimension (“OCD”), thin film metrology and wafer stress for transistor and interconnect metrology applications. The OCD technology is supported by our NanoCD® suite of solutions including our NanoDiffract® software and NanoGen™ scalable computing engine that enables visualization, modeling, and analysis of complex structures. The UniFire™ system measures multiple parameters at any given process step in the advanced packaging process flow for critical dimension, overlay, and topography applications as well as added inspection capabilities for both front-end-of-line (“FEOL”) patterned wafer and advanced packaging related applications.

Integrated Systems

Our integrated metrology (“IM”) systems are installed directly onto wafer processing equipment to provide near real-time measurements for improved process control and maximum throughput. Our IM systems are sold directly to end customers. The IMPULSE+ and IMPULSE® systems represent our latest metrology platform for OCD and thin film metrology, and have been successfully qualified on numerous independent Wafer Fabrication Equipment Suppliers’ platforms. Our NanoCD suite of solutions is sold in conjunction with our IMPULSE® systems. Our Trajectory® system provides in-line measurement of layers in thin film thickness and composition in semiconductor applications and is qualified in production with major device makers.

Materials Characterization

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

Our Imperia™ is a photoluminescence (“PL”) full wafer imaging and mapping system designed for high-volume compound semiconductor metrology applications including power control and photonics applications adding significant inspection and substrate metrology capability to the established PL fleet. The RPMBlue™ is our latest PL mapping system designed specifically for the HB-LED market, and is complemented by the RPMBlue-FS, enabling a breadth of research and development configurability. We sell Fourier-Transform Infrared (“FTIR”) automated and manual systems in the QS2200/3300 and QS1200 respectively. The FTIR systems are spectrometers designed for non-destructive wafer analysis for various applications. The NanoSpec® line, including the NanoSpec II, supports thin film measurement across all applications in both low volume production and research applications.

We are continually working to strengthen our competitive position by developing new technologies and products in our market segment. We have expanded our product offerings to address growing applications within the semiconductor manufacturing and adjacent industries. In pursuit of our goals, we have:

- Introduced new products, applications, and upgrades in every core product line and primary market served;
- Diversified our product line and served markets through acquisitions, such as: the 2006 acquisition of Accent Optical Technologies, Inc., a supplier of overlay and thin film metrology and process control systems; the 2008 acquisition of Tevet Process Control Technologies (“Tevet”), an integrated metrology supplier; the 2009 acquisition of the UniFire™ product line from Zygo Corporation, a wholly owned subsidiary of AMETEK, Inc.; and the 2011 acquisition of Nanda Technologies GmbH, a supplier of high sensitivity, high throughput defect inspection systems;

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

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Important Themes and Significant Trends

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

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

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

• **Adoption of New Types of Thin Film Materials.** The need for ever increasing device circuit speed coupled with lower power consumption has pushed semiconductor device manufacturers to begin the replacement of traditional aluminum etch back interconnect flows, as well as conventional gate dielectric materials, with new materials and processes that are driving broader adoption of thin film and OCD metrology systems. To achieve greater semiconductor device speed, manufacturers have adopted copper in Logic/IDM and it is now proliferating in next generation DRAM and Flash nodes. Additionally, to achieve improved transistor performance in logic devices and higher cell densities in memory devices, new materials including high dielectric constant (or high-k) gate materials are increasingly being substituted for traditional silicon-oxide gate dielectric materials. High-k materials comprise complex thin films including layers of hafnium oxide and a bi-layer of thin film metals. Our advanced metrology and inspection solutions are required for control of process steps, which are critical to enable the device performance improvements that these new materials allow.

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

• **Need for Improved Process Control to Drive Process Efficiencies.** Competitive forces influencing semiconductor device manufacturers, such as price-cutting, shorter product life cycles and time to market, place pressure on manufacturers to rapidly achieve production efficiency. Device manufacturers are using our integrated and automated systems throughout the fabrication process to ensure that manufacturing processes scale rapidly, are accurate and can be repeated on a consistent basis.

Critical Accounting Policies

The preparation of our financial statements conforms to accounting principles generally accepted in the United States of America, which requires management to make estimates and judgments in applying our accounting policies that have an important impact on our reported amounts of assets, liabilities, revenue, expenses and related disclosures at the date of our financial statements. On an ongoing basis, management evaluates its estimates including those related to bad debts, inventory valuations, warranty obligations, impairment and income taxes. Management bases its

estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from management's estimates.

There were no significant changes in our critical accounting policies during the nine months ended September 24, 2016. Please refer to Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," in our Annual Report for a complete discussion of our critical accounting policies.

Recent Accounting Pronouncements

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

Upgrade Revenue and Related Cost

Beginning the first quarter of 2016, revenues associated with upgrade sales are now included under Products Revenues, and the related costs in Cost of Products Revenue. This change was due to the types of upgrades currently being sold, which are primarily system software and hardware performance upgrades to extend the features and functionality of a product. Previously, upgrades consisted of a group of parts and/or software that change the existing configuration of a product. For the three months ended September 26, 2015, \$0.8 million related to upgrade sales, and \$0.1 million of costs, are included in Service Revenues and Costs of Service Revenues. For the nine months ended September 26, 2015, \$7.6 million related to upgrade sales, and \$2.9 million of costs, are included in Service Revenues and Costs of Service Revenues.

Results of Operations

Net Revenues

Our net revenues comprised the following product lines (in thousands, except percentages):

| | Three Months Ended | | | | Nine Months Ended | | | |
|------------------------------------|--------------------|--------------------|----------|--------|--------------------|--------------------|----------|---------|
| | September 24, 2016 | September 26, 2015 | Change | | September 24, 2016 | September 26, 2015 | Change | |
| Automated systems | \$34,914 | \$ 20,975 | \$13,939 | 66.5 % | \$90,502 | \$ 80,808 | \$9,694 | 12.0 % |
| Integrated systems | 10,233 | 11,135 | (902) | -8.1 % | 37,038 | 22,036 | 15,002 | 68.1 % |
| Materials characterization systems | 4,484 | 4,304 | 180 | 4.2 % | 8,750 | 10,845 | (2,095) | -19.3 % |
| Total product revenue | 49,631 | 36,414 | 13,217 | 36.3 % | 136,290 | 113,689 | 22,601 | 19.9 % |
| Service | 9,083 | 9,264 | (181) | -2.0 % | 25,680 | 30,993 | (5,313) | -17.1 % |
| Total net revenues | \$58,714 | \$ 45,678 | \$13,036 | 28.5 % | \$161,970 | \$ 144,682 | \$17,288 | 11.9 % |

For the three months ended September 24, 2016, total net revenues increased by \$13.0 million relative to the comparable 2015 period. For 2016, upgrade sales are included in Product Revenues. For the three months ended September 26, 2015, Product Revenues do not include \$0.8 million related to upgrade sales, which are included in Service Revenues. Had upgrade sales been included in Product Revenues in 2015, Product Revenues would have increased by \$12.5 million. The increase was primarily attributable to increase in sales of Automated Systems (principally the Atlas® line) due primarily to a higher revenue from our customers in the Foundry and DRAM markets and an increase in sales of Materials Characterization, partially offset by lower Integrated Systems sales. Capital spending by our customers is dependent on the timing of new semiconductor fabrication plants, capacity expansion within existing plants, and the adoption of new technology for current and future manufacturing needs. Future results will vary significantly based on changes in any of these factors.

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For the nine months ended September 24, 2016, as compared to the same period in 2015, revenues increased by \$17.3 million. For 2016, upgrade sales are included in Product Revenues. For the nine months ended September 26, 2015, Product Revenues do not include \$7.6 million related to upgrade sales, which are included in Service Revenues. Had upgrade sales been included in Product Revenues in 2015, Product Revenues would have increased by \$15.0 million. The increase was primarily attributable to increase in Integrated Systems sales and Automated Systems sales, partially offset by decrease in sales of our Materials Characterization systems.

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

Gross margin

Our gross margin breakdown was as follows:

| | Three Months Ended | | Nine Months Ended | | | |
|----------|--------------------|---------------|-------------------|---------------|------|---|
| | September 24, | September 26, | September 24, | September 26, | | |
| | 2016 | 2015 | 2016 | 2015 | | |
| Products | 53.2 % | 45.9 | % | 53.1 % | 46.6 | % |
| Service | 44.2 % | 59.5 | % | 42.7 % | 51.1 | % |

The calculation of product gross margin includes both cost of products and in 2016, related upgrades, and amortization of intangibles.

The gross margin on product revenue increased to 53.2% in the three months ended September 24, 2016 from 45.9% in the three months ended September 26, 2015, reflecting an increase of 7.3 percentage points from the comparable 2015 period. Had upgrade sales and related cost been included in Product Revenues and Cost of Product Revenues, Product Gross Margin for the three months ended September 26, 2015 would have been 46.9%. The increase in 2016 of 6.3 percentage points over this amount was due to a lower installation and warranty costs and a change in product mix to higher margin products and upgrades during the three months ended September 24, 2016. The gross margin on our services business decreased to 44.2% in the three months ended September 24, 2016 from 59.5% in the three months ended September 26, 2015, reflecting a decrease of 15.3 percentage points. Had upgrade sales and related cost been excluded from Service Revenues and Cost of Service Revenues, Service Gross Margin for the three months ended September 26, 2015, would have been 56.4%. The decrease in 2016 over this amount was due to decrease in the service revenues, a lower mix of labor service, and a lower level of labor utilizations.

The gross margin on product revenue increased to 53.1% in the nine months ended September 24, 2016 from 46.6% in the nine months ended September 26, 2015, reflecting an increase of 6.5 percentage points from the comparable 2015 period. Had upgrade sales and related cost been included in Product Revenues and Cost of Product Revenues, Product Gross Margin for the nine months ended September 26, 2015 would have been 47.6%. The increase in 2016 of 5.5 percentage points over this amount was due to a change in product mix to higher margin products and upgrades during the nine months ended September 24, 2016. The gross margin on our services business decreased to 42.7% in the nine months ended September 24, 2016 from 51.1% in the nine months ended September 26, 2015, reflecting a decrease of 8.4 percentage points. Had upgrade sales and related cost been excluded from Service Revenues and Cost of Service Revenues, Service Gross Margin for the nine months ended September 26, 2015, would have been 47.6%. The decrease in 2016 over this amount was due to decrease in the service revenues, a lower mix of labor service, and higher service contract part costs.

Operating expenses

Our operating expenses comprised the following categories (in thousands, except percentages):

| | Three Months Ended | | | Nine Months Ended | | |
|-----------------------------------|--------------------|--------------------|----------------|--------------------|--------------------|------------------|
| | September 24, 2016 | September 26, 2015 | Change | September 24, 2016 | September 26, 2015 | Change |
| Research and Development | \$7,868 | \$ 8,579 | \$(711) -8.3 % | \$23,447 | \$ 24,896 | \$(1,449) -5.8 % |
| Selling | 7,495 | 6,760 | 735 10.9 % | 22,567 | 20,905 | 1,662 8.0 % |
| General and administrative | 5,975 | 5,590 | 385 6.9 % | 17,150 | 16,901 | 249 1.5 % |
| Amortization of intangible assets | — | 26 | (26) -100.0% | 24 | 89 | (65) -73.0 % |
| Restructuring charge | — | — | — 0.0 % | — | 56 | (56) -100.0% |

| | | | | | | | | | | |
|--------------------------|----------|-----------|-------|-----|---|----------|-----------|-------|-----|---|
| Total operating expenses | \$21,338 | \$ 20,955 | \$383 | 1.8 | % | \$63,188 | \$ 62,847 | \$341 | 0.5 | % |
|--------------------------|----------|-----------|-------|-----|---|----------|-----------|-------|-----|---|

Research and development

Investments in research and development personnel and associated projects are part of our strategy to ensure our products remain competitive and meet customers' needs. For the three months ended September 24, 2016, research and development costs decreased by \$0.7 million or 8.3%, compared to the same period in 2015. The decrease related primarily to lower spending for material expenses and related costs associated with research and development investments for our next generation systems.

For the nine months ended September 24, 2016, research and development costs decreased by \$1.4 million or 5.8%, compared to the same period in 2015. The decrease related primarily to lower spending for non-recurring engineered program expenses and related material expenses, partially offset by an increase in variable compensation costs.

Selling

Selling expenses increased by \$0.7 million or 10.9% and \$1.7 million or 8.0%, in the three and nine months ended September 24, 2016, respectively, compared to the same periods in 2015. The increases were due to a decrease in utilization of our sales application personnel, which is included in cost of net revenues and higher variable compensation costs.

General and administrative

General and administrative expenses increased by \$0.4 million or 6.9% in the three months ended September 24, 2016 compared to the three months ended September 26, 2015. The increase was primarily due to higher variable compensation costs, and the timing of certain legal expenditures.

General and administrative expenses were higher by \$0.2 million or 1.5% in the nine months ended September 24, 2016 compared to the nine months ended September 26, 2015 primarily due to higher variable compensation costs, partially offset by a reduction in information technology infrastructure related costs.

Amortization of intangible assets

Amortization of intangible assets included in operating expenses in the three and nine months ended September 24, 2016 compared to the three and nine months ended September 26, 2015 decreased as a result of the reduction in amortization due to intangible assets that became fully amortized.

Restructuring charge.

No restructuring charges were recorded during the three and nine months ended September 24, 2016.

We recorded a restructuring charge of \$0.1 million in the nine months ended September 26, 2015 related to our efforts to improve operating efficiencies. We completed the restructuring plan in March 2015.

Other income, net.

Our other income, net, consisted of the following items (in thousands, except percentages):

| | Three Months Ended | | | Change | Nine Months Ended | | | Change |
|-----------------------------------|--------------------|--------------------|---------|---------|--------------------|--------------------|----------|----------|
| | September 24, 2016 | September 26, 2015 | Change | | September 24, 2016 | September 26, 2015 | Change | |
| Interest Income | \$ 12 | \$ 7 | \$ 5 | 71.4 % | \$ 33 | \$ 63 | \$ (30) | -47.6 % |
| Interest Expense | (92) | (86) | (6) | 7.0 % | (276) | (252) | (24) | 9.5 % |
| Other income (expense) | 229 | 346 | (117) | -33.8 % | 60 | 740 | (680) | -91.9 % |
| Total other income (expense), net | \$ 149 | \$ 267 | \$(118) | -44.2 % | \$(183) | \$ 551 | \$(734) | -133.2 % |

Other income decreased by \$0.2 million in the three months ended September 24, 2016, and other expense increased by \$0.8 million in the nine months ended September 24, 2016 relative to the comparable 2015 period. These changes were principally due to the revaluation of inter-company balances based on fluctuations in foreign exchange rates relative to the U.S. dollar, and hedging gains and losses.

Provision for income taxes.

We recorded a tax provision of \$1.3 million and \$0.7 million in three months ended September 24, 2016 and September 26, 2015, respectively, and \$2.6 million and \$1.8 million in nine months ended September 24, 2016 and September 26, 2015, respectively. The increase in the tax provision for 2016 from 2015 was primarily related to an increase in our earnings for the three and nine months ended September 24, 2016.

Our provision for income taxes for the three months ended September 24, 2016 of \$1.3 million reflects an effective tax rate of 14.5%. Our provision for income taxes for the nine months ended September 24, 2016 of \$2.6 million reflects an effective tax rate of 12.9%. The tax rate for both the three and nine months ended September 24, 2016 differs from the Federal statutory rate of 35.0% primarily due to all our foreign income being subject to tax at lower rates and a tax benefit associated with a change in our valuation allowance as we continue to utilize our deferred tax assets.

As of September 24, 2016, we continue to maintain a valuation allowance against our U.S. and certain foreign deferred tax assets as a result of uncertainties regarding the realization of the asset due to cumulative losses and uncertainty of future taxable income. We will continue to assess the realizability of the deferred tax assets in each of the applicable jurisdictions and maintain the valuation allowances until sufficient positive evidence exists to support a reversal. In the event we determine that the deferred tax assets are realizable, an adjustment to the valuation allowance will be reflected in the tax provision for the period such determination is made. It is reasonably possible that within the next 12 months that positive evidence will be sufficient to release a material amount of our valuation allowance. Release of the valuation allowance would result in the recognition of certain deferred tax assets and a decrease to income tax expense for the period the release is recorded. The exact timing and amount of the valuation allowance release

are subject to change on the basis of the level of profitability that we are able to actually achieve. We will continue to evaluate the release of the valuation allowance on a quarterly basis.

We are subject to taxation in the U.S. and various states including California, and foreign jurisdictions including Korea, Japan, Taiwan, and China. Due to tax attribute carry-forwards, we are subject to examination for tax years 2003 forward for U.S. tax purposes. We are also subject to examination in various states for tax years 2002 forward. We are subject to examination for tax years 2007 forward for various foreign jurisdictions.

We accrue interest and penalties related to unrecognized tax benefits in our provision for income taxes. The total amount of penalties and interest were not material as of September 24, 2016 and September 26, 2015. During the next twelve months, we anticipate increases in our unrecognized tax benefits of approximately \$0.1 million.

Liquidity and Capital Resources

The following tables present selected financial information and statistics as of September 24, 2016 and December 26, 2015 and for the nine months ended September 24, 2016 and September 26, 2015 (in millions):

| | As of | |
|--|--------------------|-------------------|
| | September 24, 2016 | December 26, 2015 |
| Cash, cash equivalents and marketable securities | \$ 118.5 | \$ 83.1 |
| Working capital | \$ 163.3 | \$ 132.9 |

| | Nine Months Ended | |
|---|--------------------|--------------------|
| | September 24, 2016 | September 26, 2015 |
| Cash provided by operating activities | \$ 34.1 | \$ 2.3 |
| Cash provided by (used in) investing activities | \$ (39.6) | \$ 4.5 |
| Cash provided by financing activities | \$ 4.1 | \$ 0.2 |

Our principal sources of liquidity are cash and cash equivalents, and marketable securities, and cash flow generated from our operations. Our liquidity is affected by many factors, including those that relate to our specific operations and those that relate to the uncertainties of global and regional economies and the sectors of the semiconductor industry in which we operate in. Although our cash requirements will fluctuate based on the timing and extent of these factors, we believe our existing cash, cash equivalents and marketable securities, combined with cash currently projected to be generated from our operations, will be sufficient to satisfy our working capital needs, capital asset purchases, outstanding commitments and other liquidity requirements associated with our existing operations over the next twelve months.

During the nine months ended September 24, 2016, cash provided by operating activities of \$34.1 million was a result of \$17.4 million of net income, non-cash adjustments to net income of \$13.6 million and a net change in operating assets and liabilities of \$3.1 million. The increase for the nine months ended September 24, 2016 was primarily attributable to higher net income decreased inventory levels and increased deferred revenue. This was partially offset by the other changes to operating assets and liabilities, which is generally driven by the timing of customer payments for accounts receivable and timing of vendor payments for accounts payable. Cash used in investing activities of \$39.6

million during the nine months ended September 24, 2016 consisted primarily of \$63.8 million purchases of marketable securities, net of sales and maturities, of \$27.5 million, and acquisition of property, plant and equipment of \$3.3 million. Cash provided by financing activities of \$4.1 million during the nine months ended September 24, 2016 consisted primarily of \$6.0 million in proceeds from the issuance of common stock from the employee stock purchase program and the exercise of stock options, partially offset by cash paid for taxes on net issuance of stock awards of \$1.6 million, and royalty payments to Zygo of \$0.3 million.

During the nine months ended September 26, 2015, cash provided by operating activities of \$2.3 million was a result of \$4.7 million of net income, non-cash adjustments to net income of \$ 14.3 million and a net change in operating assets and liabilities of \$ 16.7 million. Changes to operating assets and liabilities were generally driven by the timing of customer payments for accounts receivable, the timing of inventory purchases and the timing of vendor payments. Cash provided by investing activities of \$4.5 million during the nine months ended September 26, 2015, consisted primarily of cash provided by sales and maturities of marketable securities, net of purchases, of \$5.9 million, partially offset by cash used to acquire property, plant and equipment of \$1.4 million. Cash provided by financing activities of \$0.2 million during the nine months ended September 26, 2015 consisted primarily of \$3.6 million in proceeds from the issuance of common stock from the employee stock purchase program and the exercise of stock options, partially offset by cash used to repurchase common stock of \$1.7 million, royalty and other payments to Zygo of \$0.6 million, and cash paid for taxes on net issuance of stock awards of \$1.1 million. As we move away from issuing stock options to employees, we anticipate that cash provided by the proceeds from the issuance of common stock may continue to decrease, and the cash paid on net issuance of stock awards to increase

Debt and Business Partnership Payments

Line of Credit - Our revolving line of credit facility with Comerica expired on May 30, 2016 and was not renewed.

Business Partnership - On June 17, 2009, we announced a strategic business partnership with Zygo Corporation, a wholly-owned subsidiary of AMETEK, Inc. whereby we have purchased inventory and certain other assets from Zygo Corporation, and the two companies entered into a supply agreement. We will make payments to Zygo Corporation (with an estimated present value of \$1.3 million as of September 24, 2016 and \$1.5 million as of December 26, 2015) over a period of time as aspects of the supply agreement are executed. We made royalty payments of \$0.3 million and \$0.6 million to Zygo in nine months ended September 24, 2016 and September 26, 2015, respectively.

We have evaluated and will continue to evaluate the acquisitions of products, technologies or businesses that are complementary to our business. These activities may result in product and business investments, which may affect our cash position and working capital balances. Some of these activities might require significant cash outlays.

Off-Balance Sheet Arrangements

As of September 24, 2016, we had no off-balance sheet arrangements or obligations.

Contractual Obligations

There have been no material changes outside the ordinary course of our business from those reported in our Annual Report on Form 10-K.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk does not differ materially from that discussed in our Annual Report on Form 10-K for the fiscal year ended December 26, 2015, filed with the SEC on February 24, 2016. However, we cannot give any assurance as to the effect that future changes in interest rates or foreign currency rates will have on our consolidated financial position, results of operations or cash flows.

Foreign Currency Risk

Our exposure to foreign currency exchange rate fluctuations arises in part from intercompany balances in which costs are charged between our U.S. headquarters and our foreign subsidiaries. On our consolidated balance sheet these intercompany balances are eliminated and thus no consolidated balances are associated with these intercompany balances; however, since each foreign entity's functional currency is generally its respective local currency, there is exposure to foreign exchange risk on a consolidated basis. Intercompany balances are denominated primarily in U.S. dollars and, to a lesser extent, other local currencies.

We enter into foreign currency forward exchange contracts to protect against currency exchange risks associated with existing assets and liabilities. A foreign currency forward exchange contract acts as a hedge by increasing in value when underlying assets decrease in value or underlying liabilities increase in value due to changes in foreign exchange rates. Conversely, a foreign currency forward exchange contract decreases in value when underlying assets increase in value or underlying liabilities decrease in value due to changes in foreign exchange rates. These forward contracts are not designated as accounting hedges, so the unrealized gains and losses are recognized in other income, net, in advance of the actual foreign currency cash flows with the fair value of these forward contracts being recorded as accrued liabilities or other current assets.

We do not use forward contracts for trading purposes. Our forward contracts generally have maturities of 30 days or less. We enter into foreign currency forward exchange contracts based on estimated future asset and liability exposures, and the effectiveness of our hedging program depends on our ability to estimate these future asset and liability exposures. Recognized gains and losses with respect to our current hedging activities will ultimately depend on how accurately we are able to match the amount of foreign currency forward exchange contracts with actual underlying asset and liability exposures.

The following table provides information about our foreign currency forward exchange contracts as of September 24, 2016. The information is provided in United States dollar equivalent amounts. The table presents the notional amounts, at contract exchange rates, and the weighted average contractual foreign currency exchange rates expressed as units of the foreign currency per United States dollar, which in some cases may not be the market convention for quoting a particular currency. All of these forward contracts mature during October 2016.

| | Notional Principal (in millions) | Contract Rate |
|----------------------|---|------------------|
| Forward Contracts | | |
| Korean won | \$ 2.6 | 1,115 |
| European Union euro | 4.1 | 1.13 |
| Israeli shekel | 1.1 | 3.75 |
| Singapore dollar | 0.9 | 1.35 |
| Chinese yuan | 1.9 | 6.69 |
| Japanese yen | 3.0 | 100.98 |
| New Taiwan dollar | 0.9 | 31.16 |
| British Pound | 1.4 | 1.31 |
| Total | 15.9 | |
| Estimated Fair Value | 15.9 | |

This compares to the information about our foreign currency forward contracts as of December 26, 2015, which is set forth in the table below. All of these forward contracts matured during January 2016.

| | Notional Principal (in millions) | Contract Rate |
|---------------------|---|------------------|
| Forward Contracts | | |
| Korean won | \$ 7.0 | 1,174 |
| European Union euro | 4.1 | 1.10 |
| Israeli shekel | 2.1 | 3.88 |
| Singapore dollar | 2.7 | 1.41 |
| Chinese yuan | 1.4 | 6.52 |
| Japanese yen | 13.2 | 121.27 |
| Total | 30.5 | |

Estimated Fair Value 30.4

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management evaluated, with the participation of our Chief Executive Officer, Timothy J. Stultz, and our Chief Financial Officer, Jeffrey Andreson, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that as of September 24, 2016, our disclosure controls and procedures were effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 were (i) recorded, processed, summarized and reported within the time periods specified in SEC rules and forms; and (ii) accumulated and reported to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely discussions regarding required disclosures.

Changes in Internal Control over Financial Reporting

During the quarter ended September 24, 2016, there were no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Inherent Limitations on Effectiveness of Controls

Our management, including our Chief Executive Officer and Chief Financial Officer, has designed our disclosure controls and procedures and our internal control over financial reporting to provide reasonable assurances that the controls' objectives will be met. However, management does not expect that disclosure controls and procedures or our internal control over financial reporting will prevent or detect 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. 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. Further, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within Nanometrics 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 system's design will succeed in achieving its stated goals under all potential future conditions. Projections of any evaluation of a system's control effectiveness into future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

PART II — OTHER INFORMATION

ITEM 1A. RISK FACTORS

Investing in our securities involves a high degree of risk. In assessing these risks, you should carefully consider the information included in this report, including our financial statements and the related notes thereto. You should carefully review and consider all of the risk factors set forth in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 26, 2015, filed with the SEC on February 24, 2016. The risks described in our Annual Report on Form 10-K are not the only ones we face. Additional risks and uncertainties that are not currently known to us or that we currently believe are immaterial may also impair our business operations. Our business, operating results and financial conditions could be materially harmed by any of these risks. The trading price of our common stock could decline due to any of these risks and investors may lose all or part of their investment. There have been no material changes in our risk factors from those discussed in our Annual Report on Form 10-K for the fiscal year ended December 26, 2015.

ITEM 6. EXHIBITS

The following exhibits are filed, furnished or incorporated by reference with this Quarterly Report on Form 10-Q:

| Exhibit No. | Description |
|-------------|---|
| 3.(i) | Certificate of Incorporation |
| 3.1(1) | Certificate of Incorporation of the Registrant |
| 3.(ii) | Bylaws |
| 3.2(2) | Bylaws of the Registrant |
| 4 | Instruments Defining the Rights of Security Holders, Including Indentures |
| 4.1 | Reference is made to Exhibits 3.1 and 3.2 |
| 10 | Material Contracts |
| 31 | Rule 13a-14(a)/15d-14(a) Certifications |
| 31.1(3) | Certification of Timothy J. Stultz, principal executive officer of the Registrant, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2(3) | Certification of Jeffrey Andreson, principal financial officer and principal accounting officer of the Registrant, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32 | Section 1350 Certifications |
| 32.1(3) | Certification of Timothy J. Stultz, principal executive officer of the Registrant, and Jeffrey Andreson, principal financial officer and principal accounting officer of the Registrant pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101(4) | The following financial statements, formatted in XBRL: (i) Condensed Consolidated Balance Sheets at September 24, 2016, and December 26, 2015, (ii) Condensed Consolidated Statements of Operations for the three and nine months ended September 24, 2016 and September 26, 2015, (iii) Condensed Consolidated Statements of Cash Flows for the nine months ended September 24, 2016 and September 26, 2015, and (v) Notes to Unaudited Condensed Consolidated Financial Statements. |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |

101.LAB XBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

(1) Incorporated by reference to Exhibit 3.1 filed with the Registrant's Current Report on Form 8-K (File No. 000-13470) filed on October 5, 2006.

(2) Incorporated by reference to Exhibit 3.1 filed with the Registrant's Current Report on Form 8-K (File No. 000-13470) filed on April 12, 2012.

(3) Filed herewith.

(4) Furnished herewith.

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.

NANOMETRICS INCORPORATED
(Registrant)

By: /S/ JEFFREY ANDRESON
Jeffrey Andreson
Chief Financial Officer
(Duly Authorized and Principal Financial Officer)

Dated: October 28, 2016

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