

NANOMETRICS INC
Form 10-Q
November 12, 2010
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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 October 2, 2010

OR

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____

Commission file number 0-13470

NANOMETRICS INCORPORATED

(Exact name of registrant as specified in its charter)

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Delaware
(State or other jurisdiction of
incorporation or organization)

94-2276314
(I. R. S. Employer
Identification No.)

1550 Buckeye Drive, Milpitas, CA
(Address of principal executive offices)

95035
(Zip Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of regulation S-T (§232.405 of this chapter) during the preceding 12 months (or such shorter period that the registrant was required to submit and post such file) Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

As of November 09, 2010 there were 22,218,110 shares of common stock, \$0.001 par value, issued and outstanding.

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FOR QUARTER ENDED OCTOBER 2, 2010

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NANOMETRICS INCORPORATED****CONDENSED CONSOLIDATED BALANCE SHEETS****(Dollars in thousands except per share amounts)****(Unaudited)**

| | As of October 2, 2010 | As of January 2, 2010 |
|--|-----------------------------|-----------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 63,996 | \$ 43,526 |
| Accounts receivable, net of allowances of \$59 and \$241, respectively | 41,692 | 23,047 |
| Inventories | 38,217 | 31,472 |
| Inventories- delivered systems | 320 | 1,175 |
| Assets held for sale | | 220 |
| Prepaid expenses and other | 2,704 | 2,182 |
| Deferred income tax assets | 245 | 245 |
| Total current assets | 147,174 | 101,867 |
| Property, plant and equipment, net | 34,477 | 36,365 |
| Intangible assets, net | 5,899 | 7,067 |
| Deferred income tax assets | 537 | 612 |
| Other assets | 1,263 | 1,559 |
| Total assets | \$ 189,350 | \$ 147,470 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 11,865 | \$ 5,762 |
| Accrued payroll and related expenses | 8,715 | 4,012 |
| Deferred revenue | 2,284 | 5,162 |
| Other current liabilities | 7,551 | 8,952 |
| Income taxes payable | 489 | 173 |
| Current portion of debt obligations | 561 | 343 |
| Total current liabilities | 31,465 | 24,404 |
| Deferred revenue | 3,036 | 646 |
| Other long-term liabilities | 2,958 | 2,927 |
| Debt obligations | 9,612 | 12,739 |
| Total liabilities | 47,071 | 40,716 |

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Commitments and contingencies (Note 19)

Stockholders' equity:

| | | |
|--|------------|------------|
| 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; 22,170,083 and 21,506,791, respectively, issued and outstanding | 22 | 21 |
| Additional paid-in capital | 223,436 | 218,308 |
| Accumulated deficit | (83,128) | (112,948) |
| Accumulated other comprehensive income | 1,949 | 1,373 |
| | | |
| Total stockholders' equity | 142,279 | 106,754 |
| | | |
| Total liabilities and stockholders' equity | \$ 189,350 | \$ 147,470 |

See Notes to Condensed Consolidated Financial Statements

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NANOMETRICS INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in thousands except per share amounts)

(Unaudited)

| | Three-Months Ended | | Nine-Months Ended | |
|--------------------------------------|--------------------|-----------------------|--------------------|-----------------------|
| | October 2, 2010 | September 26, 2009 | October 2, 2010 | September 26, 2009 |
| Net revenues: | | | | |
| Products | \$ 44,403 | \$ 16,303 | \$ 116,355 | \$ 29,140 |
| Service | 9,532 | 9,511 | 25,580 | 21,248 |
| Total net revenues | 53,935 | 25,814 | 141,935 | 50,388 |
| Costs of net revenues: | | | | |
| Cost of products | 19,159 | 8,348 | 50,043 | 17,249 |
| Cost of service | 5,379 | 3,533 | 13,941 | 10,353 |
| Total costs of net revenues | 24,538 | 11,881 | 63,984 | 27,602 |
| Gross profit | 29,397 | 13,933 | 77,951 | 22,786 |
| Operating expenses: | | | | |
| Research and development | 4,601 | 4,100 | 14,101 | 10,394 |
| Selling | 5,734 | 3,959 | 15,822 | 10,832 |
| General and administrative | 4,801 | 3,967 | 13,740 | 11,427 |
| Amortization of intangible assets | 368 | 418 | 1,168 | 1,124 |
| Asset impairment | 75 | | 463 | 1,899 |
| Restructuring charge | | | | 1,134 |
| Total operating expenses | 15,579 | 12,444 | 45,294 | 36,810 |
| Income (loss) from operations | 13,818 | 1,489 | 32,657 | (14,024) |
| Other income (expense) | | | | |
| Interest income | 31 | 12 | 78 | 39 |
| Interest expense | (355) | (559) | (1,192) | (1,106) |
| Other, net | (53) | 546 | 705 | (1,395) |
| Total other income (expense), net | (377) | (1) | (409) | (2,462) |
| Income (loss) before income taxes | 13,441 | 1,488 | 32,248 | (16,486) |
| Provision (benefit) for income taxes | 1,114 | (83) | 2,428 | (463) |
| Net income (loss) | \$ 12,327 | \$ 1,571 | \$ 29,820 | \$ (16,023) |
| Net income (loss) per share: | | | | |
| Basic | \$ 0.56 | \$ 0.08 | \$ 1.37 | \$ (0.87) |

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| | | | | |
|---------|---------|---------|---------|-----------|
| Diluted | \$ 0.53 | \$ 0.08 | \$ 1.30 | \$ (0.87) |
|---------|---------|---------|---------|-----------|

Shares used in per share calculation:

| | | | | |
|-------|--------|--------|--------|--------|
| Basic | 21,978 | 18,598 | 21,729 | 18,513 |
|-------|--------|--------|--------|--------|

| | | | | |
|---------|--------|--------|--------|--------|
| Diluted | 23,168 | 19,398 | 22,890 | 18,513 |
|---------|--------|--------|--------|--------|

See Notes to Condensed Consolidated Financial Statements

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NANOMETRICS INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

| | Nine-Months Ended | |
|---|--------------------|-----------------------|
| | October 2, 2010 | September 26, 2009 |
| Cash flows from operating activities: | | |
| Net income (loss) | \$ 29,820 | \$ (16,023) |
| Reconciliation of net income (loss) to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 4,462 | 4,484 |
| Asset impairment | 463 | 1,899 |
| Stock-based compensation | 2,741 | 1,573 |
| Excess tax benefit from equity awards | (664) | |
| Loss (gain) on disposal of fixed assets | (193) | 67 |
| Provision for doubtful accounts receivable | 136 | 430 |
| Inventory write down | 1,156 | 283 |
| Deferred income taxes | 113 | (263) |
| Foreign exchange transaction (gain) loss | (523) | 593 |
| Changes in fair value of contingent payments to Zygo Corporation | 471 | 288 |
| Changes in assets and liabilities: | | |
| Accounts receivable | (18,443) | (4,366) |
| Inventories | (7,620) | 1,862 |
| Inventories-delivered systems | 855 | (1,090) |
| Prepaid expenses and other | (485) | 30 |
| Other assets | 345 | 100 |
| Accounts payable, accrued and other liabilities | 11,477 | (1,567) |
| Deferred revenue | (517) | 1,990 |
| Income taxes payable | 1,093 | (351) |
| Net cash provided by (used in) operations | 24,687 | (10,061) |
| Cash flows from investing activities: | | |
| Cash received from Tevet on escrow settlement | | 215 |
| Payments to Zygo Corporation related to acquisition | (3,478) | |
| Purchases of property, plant and equipment | (1,953) | (576) |
| Proceeds from sale of property, plant and equipment | 492 | 9 |
| Net cash used in investing activities | (4,939) | (352) |
| Cash flows from financing activities: | | |
| Borrowings from line of credit | | 7,000 |
| Repayment of line of credit | | (3,500) |
| Repayments of debt obligations | (2,909) | (236) |
| Proceeds from sale of shares under employee stock option plans and purchase plan | 3,883 | 268 |
| Stock offering cost | (28) | |
| Excess tax benefit from equity awards | 664 | |
| Taxes paid on net issuance of stock awards | (249) | |

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| | | |
|--|-----------|-----------|
| Repurchases of common stock | (1,320) | |
| Net cash provided by financing activities | 41 | 3,532 |
| Effect of exchange rate changes on cash and cash equivalents | 681 | 108 |
| Net increase (decrease) in cash and cash equivalents | 20,470 | (6,773) |
| Cash and cash equivalents, beginning of period | 43,526 | 23,980 |
| Cash and cash equivalents, end of period | \$ 63,996 | \$ 17,207 |

See Notes to Unaudited Condensed Consolidated Financial Statements.

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NANOMETRICS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Nature of Business and Basis of Presentation

Nature of Business Nanometrics Inc. and its wholly-owned subsidiaries (collectively, Nanometrics or the Company) is a leading supplier of advanced process control metrology systems used primarily in the manufacturing of semiconductors, solar photo-voltaics (PV), high-brightness LEDs (HB-LED), advanced wafer scale packaging, as well as by customers in the silicon wafer and data storage industries. Nanometrics standalone and integrated metrology systems measure various thin film properties, critical dimensions, overlay control and optical, electrical and material properties, including the structural composition of silicon, compound semiconductor and PV devices, during various steps of the manufacturing process. These systems enable device manufacturers to improve yields, increase productivity and lower their manufacturing costs.

Nanometrics was incorporated in California in 1975, and reincorporated in Delaware in 2006. The Company is a pioneer and innovator in the field of optical metrology, and has an extensive installed base of over 6,000 systems in over 150 production factories worldwide.

Basis of Presentation - The accompanying Condensed Consolidated Financial Statements (financial statements) of the Company have been prepared on a consistent basis with the audited condensed consolidated financial statements as of January 2, 2010 and include all adjustments, necessary to fairly present the information set forth therein (which include only normal recurring adjustments). 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), 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. 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 year ended January 2, 2010, which were included in the Company's Annual Report on Form 10-K filed with the SEC on March 26, 2010.

Subsequent Events On October 8, 2010, the State of California legislature approved the 2010-2011 budget bills, which included various income tax provisions, including suspending utilization of net operating loss carry forwards. The Company is currently evaluating the impact of this legislation on its financial statements.

Fiscal Period Nanometrics uses a 52/53 week fiscal year ending on the Saturday nearest to December 31. All references to the quarter refer to Nanometrics' fiscal quarter. The fiscal quarters presented herein include 13 weeks.

Reclassification Certain 2009 amounts have been reclassified to conform to the current year presentation.

Use of Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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, the provision for doubtful accounts, the provision for excess, obsolete, or slow moving inventories, depreciation and amortization, valuation of intangible assets and long-lived assets, warranty reserves, income taxes, valuation of stock-based compensation, and contingencies.

Revenue Recognition 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. The Company derives revenue from the sale of process control metrology systems (Product revenue) as well as spare part sales, billable service, service contracts, and upgrades (together Service revenue). Upgrades are a group of parts that change the existing configuration of a product and are included in Service revenue. They are distinguished from Product revenue, which consists of complete, standalone process control metrology systems (the system(s)). Nanometrics' systems consist of hardware and of software which is incidental to the systems; and the Company periodically reviews

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the software element of the systems to ascertain whether the software continues to be incidental. Arrangements for sales of systems often include defined customer-specified acceptance criteria.

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NANOMETRICS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

For product sales to existing customers, revenue recognition occurs at the time title and risk of loss transfer, which usually occurs upon delivery, if it can be reliably demonstrated that the product has successfully met the defined customer specified acceptance criteria, and all other recognition criteria has been met. This occurs at the time of shipment as the terms are FOB shipping point. For initial sales of product where the Company 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. Upon recognition of product revenue, a liability is recorded for anticipated warranty costs.

As part of its customer service, the Company sells software that is considered to be an upgrade to the customer's existing system. Such software is specific to the type of tool being upgraded and cannot be used in other tools. Software is not a significant focus of the Company's product offerings and marketing efforts, and the Company does not provide post-sale customer service. Revenue on software upgrades is recognized when the software is delivered to the customer, provided that all other recognition criteria have been met.

All of the Company's products are assembled prior to shipment to customers. The Company often performs installation for its customers; however such installation is immaterial to the Company's revenue and operations as it may also be performed by third parties and is not considered essential to the functionality of the equipment.

Revenue related to spare part sales is recognized upon shipment. Revenue related to billable service is recognized as the services are performed and, if billable service and spare parts are sold together, revenue is recognized when both the parts are delivered and the service is completed. Service contracts may be purchased by the customer during or after the warranty period, and for service contracts, revenue is recognized ratably over the service contract period. Revenue on upgrades (including software upgrades) is recognized when the upgrade has been delivered to the customer. For initial upgrade sales where the Company has not previously met the defined customer specified acceptance criteria, if any, revenue is recognized upon the earlier of receipt of written customer acceptance or the expiration of the contractual acceptance period. On occasion, customers request a warranty period longer than the Company's standard 12 month 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 generally does not provide customers with any return rights.

In cases where the Company can ascertain the fair value of all the elements, and certain elements of a sales arrangement are not delivered and accepted at the same time, the relative fair value of the undelivered element is deferred until that element is delivered and accepted by the customer. In multiple-element arrangements where the Company only has fair value of the undelivered elements, the residual method is applied. In order to recognize revenue associated with delivered elements, the following criteria must be met: (a) the delivered item(s) has value to the customer on a standalone basis; (b) there is objective and reliable evidence of the fair value of the undelivered item(s); and (c) delivery or performance of the undelivered item(s) is considered probable and is substantially in the control of the Company. If the arrangement does not meet all the above criteria, the entire amount of the sales contract is deferred until the above criteria have been met or all elements have been delivered to the customer. Objective and reliable evidence of the fair value of an element is based on the amounts for which the Company sells equivalent products or services on a standalone basis.

Foreign Currency Translation The assets and liabilities of foreign subsidiaries are translated from their respective local functional currencies at exchange rates in effect at the balance sheet date and income and expense accounts are translated at average exchange rates during the reporting period. Resulting translation adjustments are reflected in accumulated other comprehensive income as a component of stockholders' equity. Foreign currency transaction gains and losses are reflected in Other Income in the condensed consolidated statements of operations in the quarter incurred and consist of a \$0.2 million loss and \$0.3 million gain for the three and nine month periods ended October 2, 2010, respectively, and a gain of \$0.5 million and a loss of \$1.4 million for the three and nine month periods ended September 26, 2009, respectively. In accordance with FASB Accounting Standards Codification (ASC) 830 *Foreign Currency Matters* (ASC 830), which requires that when intercompany loans are no longer considered to be of a long-term investment nature, any changes in foreign currency rates for such loans are to be recorded as a period

charge in the statement of operations rather than a component in equity.

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NANOMETRICS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 2. Recent Accounting Pronouncements

In January 2010, the FASB issued ASU 2010-06, *Improving Disclosures about Fair Value Measurements*, which amends ASC 820 to add two new disclosures: (1) transfers in and out of Level 1 and 2 measurements and reasons for the transfers, and (2) a gross presentation of activity within Level 3 roll forward. The ASU also includes clarifications to existing disclosure requirements on the level of disaggregation and disclosures regarding inputs and valuation techniques. The ASU is effective for interim and annual reporting periods beginning after December 15, 2009, except for the separate disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. In the period of initial adoption, entities will not be required to provide the amended disclosures for any previous periods presented for comparative purposes. However, comparative disclosures are required for periods after initial adoption. The Company is currently evaluating the impact of this arrangement on its revenue recognition policies, as well as the impact on its financial statements.

In September 2009, the FASB ratified Accounting Standards Update (ASU) 2009-13 (ASU 2009-13) previously Emerging Issues Task Force (EITF) Issue No. 08-1, *Revenue Arrangements with Multiple Deliverables* (ASC 605-25) which provides principles and application guidance on whether multiple deliverables exist, how the arrangement should be separated, and how the consideration should be allocated. It also requires an entity to allocate revenue in an arrangement using estimated selling prices of deliverables if a vendor does not have vendor-specific objective evidence or third-party evidence of the selling price. The guidance eliminates the use of the residual method, requires entities to allocate revenue using relative pricing and significantly expands the disclosure requirements for multiple-deliverable revenue arrangements.

Also in September 2009, the FASB ratified ASU 2009-14 (previously EITF Issue No. 09-3, *Certain Revenue Arrangement That Include Software Elements*). ASU 2009-14 modifies the scope of software revenue recognition to remove tangible products from the scope of the software revenue guidance if the products contain both software and non-software components that function together to deliver a product's essential functionality, and provides guidance on determining whether software deliverables in an arrangement that includes a tangible product are within the scope of the software revenue guidance.

The new standards are effective for revenue recognition arrangements that began or are changed in fiscal years starting after June 15, 2010, and early adoption is permitted. The Company is currently evaluating the impact of these amendments on its revenue recognition policies, as well as the impact on its financial statements.

Note 3. Fair Value Measurements and Disclosures

Fair value is defined as the price that would be received to sell 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 Company determines the fair values of its financial instruments based on the fair value hierarchy established in ASC 820, 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 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

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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 our discounted present value analysis of future cash flows, which reflects our 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.

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The following table presents the Company's fair value measurements that are measured at the estimated fair value, on a recurring basis, categorized in accordance with the fair value hierarchy (in thousands):

| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
|---|---|---|--|-----------|
| As of October 2, 2010 | | | | |
| Cash and cash equivalents: | | | | |
| Cash | \$ 13,310 | \$ | \$ | \$ 13,310 |
| Money market account | 50,686 | | | 50,686 |
| Total cash and cash equivalents | 63,996 | | | 63,996 |
| Total financial assets | \$ 63,996 | \$ | \$ | \$ 63,996 |
| Fair value of contingent payments to Zygo Corporation | \$ | \$ | \$ 2,713 | \$ 2,713 |
| Total financial liabilities | \$ | \$ | \$ 2,713 | \$ 2,713 |

| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
|---|---|---|--|-----------|
| As of January 2, 2010 | | | | |
| Cash and cash equivalents: | | | | |
| Cash | \$ 8,609 | \$ | \$ | \$ 8,609 |
| Money market account | 34,917 | | | 34,917 |
| Total cash and cash equivalents | 43,526 | | | 43,526 |
| Total financial assets | \$ 43,526 | \$ | \$ | \$ 43,526 |
| Fair value of contingent payments to Zygo Corporation | \$ | \$ | \$ 5,688 | \$ 5,688 |
| Total financial liabilities | \$ | \$ | \$ 5,688 | \$ 5,688 |

Changes in the Company's Level 3 liabilities were as follows (in thousands):

| | Level 3 |
|---|----------------|
| Fair value at December 27, 2008 | \$ |
| Fair value of deferred and contingent payment related to Zygo acquisition | 5,092 |
| Change in fair value included in earnings | 596 |
| | |
| Fair value of Level 3 liability at January 2, 2010 | 5,688 |
| Payments made to Zygo Corporation | (3,446) |
| Adjustments and change in the fair value of contingent payments | 471 |
| | |
| Fair value at October 2, 2010 | \$ 2,713 |

Note 4. Acquisitions*Zygo acquisition*

On June 17, 2009 (acquisition date), Nanometrics announced that it had purchased inventory and certain other assets of Zygo Corporation (Zygo) and that the two companies had entered into a supply agreement. The supply agreement is an exclusive Original Equipment Manufacturer (OEM) arrangement in which Zygo will provide interferometer sensors to Nanometrics for incorporation into the Unifire line of products as well as the Nanometrics family of automated metrology systems. The arrangement is structured as an asset transfer and exclusive OEM supply agreement aimed at wafer-based markets. Nanometrics will assume all inventory and customer sales and support responsibilities and Zygo will provide measurement sensors for integration by Nanometrics. By completing this acquisition, Nanometrics anticipates expanding its served markets to include the high end of dimensional control metrology for the rapidly-growing back-end-of-line packaging market, while also enhancing our product offerings to front-end-of-line metrology customers.

Table of Contents**NANOMETRICS INCORPORATED****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

In addition to the applications currently addressed by Nanometrics and Zygo products, the business partnership allows for the joint development of additional technology solutions targeted at the semiconductor and related industries. This transaction met the conditions of a business combination as defined in ASC 805, and as such is accounted for under ASC 805. The results from the Unifire line of business were included in the Company's condensed consolidated statements of operations from the acquisition date.

The following table summarizes the fair value of consideration recorded and the fair value of acquired assets (in thousands):

| | Amounts |
|---|-----------------|
| Assets acquired: | |
| Tangible assets: | |
| Inventories - raw materials | \$ 2,014 |
| Property, plant and equipment - machinery and equipment | 1,378 |
| Total tangible assets acquired | 3,392 |
| Intangible assets: | |
| Developed technology | 1,362 |
| Customer relationships | 338 |
| Total intangible assets acquired | 1,700 |
| Total assets acquired | \$ 5,092 |

The fair value of the purchase consideration at the time of the acquisition was \$5.1 million, which consisted of deferred payments to Zygo for inventory and fixed assets, as well as future royalty and sustaining engineering support fees. The future royalty and sustaining engineering support fees are considered contingent consideration. On the acquisition date, the consideration was recorded as a liability on the Company's consolidated balance sheet at January 2, 2010, with \$3.1 million being recorded as a current liability and \$2.0 million being recorded as a long term liability.

The Company was required to make payment to Zygo after each sale of the Company's product which incorporates inventory acquired from Zygo. If the Company did not sell sufficient products that incorporate the acquired inventory from Zygo, within one year from the acquisition date, the Company was required to remit the remaining unpaid portion relating to inventory and fixed assets at that time. The purchase agreement also stipulated that if the Company received greater than \$5.0 million in a financing transaction, 20% of the financing proceeds, not to exceed \$2.0 million, must be paid to Zygo for any unpaid portion of the amounts related to inventory and fixed assets. In December 2009, the Company completed a common stock offering with net proceeds of \$23.3 million, therefore, \$2.0 million became immediately due and payable to Zygo. The \$2.0 million payment was made to Zygo on January 7, 2010. In March 2010, the Company sold products that incorporate the acquired inventory from Zygo, and therefore, the remaining unpaid portion relating to inventory and fixed assets of \$1.4 million became due and was paid by the Company to Zygo on April 15, 2010.

In addition, the Company agreed to pay Zygo a royalty based on net revenues of approved products and the expected sustaining engineering payments based on volumes of heads purchased from Zygo starting in 2010 and over a 10 year period. Our payments to Zygo Corporation over the next 10 years may be up to \$6.8 million depending on the numbers of tools sold. For the nine-month period ended October 2, 2010, the Company made royalty payments of \$0.1 million to Zygo. The fair value of the future royalty and sustaining engineering support fees was determined using a relief from royalty method based on the following: (a) the amount of the acquired assets that the business will generate, and (b) a discount rate of 20 percent, which was utilized to adjust the royalty and sustaining engineering payments to their present value, based on

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the consideration of both a weighted average cost of capital calculation and venture capital rates.

The fair value of inventory acquired from Zygo, which consisted of raw materials, was \$2.0 million. Recent purchases by the Company of raw material were considered a reasonable proxy for fair value. The fair value of demonstration equipment was \$1.4 million as determined by considering the purchase date and recent usage of the products. Fair value of developed technology of \$1.4 million and customer relationships of \$0.3 million were determined by a similar methodology to the methodology used above for calculating contingent consideration, with the following assumptions of (a) royalty rate of 3 percent, and (b) discount rate of 30 percent, and will be amortized over a period of 10 years on a straight-line basis and over a two years on an accelerated basis, respectively. Amortization expense of \$0.4 million was recorded for the acquired intangible assets from the Zygo transaction from the acquisition date to October 2, 2010, including \$0.2 million during the nine-month period ended October 2, 2010.

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NANOMETRICS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following unaudited pro forma summary presents consolidated information of Nanometrics as if the business combination had occurred at the beginning of the respective periods (in thousands, except per share amounts):

| | Proforma | |
|---------------------|--------------------|--------------------|
| | Three months ended | Nine months ended |
| | September 26, 2009 | September 26, 2009 |
| Net revenues | \$ 25,814 | \$ 52,545 |
| Net income (loss) | 1,571 | (19,751) |
| Net loss per share: | | |
| Basic | \$ 0.08 | \$ (1.07) |
| Diluted | \$ 0.08 | \$ (1.07) |

Note 5. Asset Held for Sale

In May 2009, the Company decided to close the Pyeongtek, South Korea manufacturing facility due to the prevailing industry and economic conditions facing the semiconductor industry at that time. The premises were vacated prior to the end of the second quarter 2009. The facility in South Korea met all the requirements as long-lived assets held for sale and the Company ceased recording depreciation on the facility. The fair value of the South Korean manufacturing facility was determined using a cost approach and a sale comparison approach. The cost approach uses the characteristics of the facility to determine the cost of replacement if the facility were new, adjusted for depreciation to date considering the age of the facility. The sale comparison approach considers market comparable sales activity. An average of the two approaches was used to determine the facility fair value of approximately \$0.2 million, which included an estimate for selling costs at 10% of the building fair value. An impairment loss of \$1.9 million was recorded on the South Korean facility for the second quarter of 2009. On April 29, 2010, the sale of the property was completed and a gain on the sale of \$0.2 million was recorded in the second quarter of 2010.

Note 6. Restructuring Charge

The Company did not incur a restructuring charge for the nine-month period ended October 2, 2010.

For the nine-month period ended September 26, 2009, the Company reduced the global workforce by a total of 76 employees, and recorded a restructuring charge of \$1.1 million.

| | Severance and Other Benefits (in thousands) |
|---------------------------------------|--|
| Reserve balance at December 27, 2008 | \$ 80 |
| Restructuring charges | 1,134 |
| Cash paid | (1,214) |
| Reserve balance at September 26, 2009 | \$ |

Note 7. Accounts Receivable

The Company maintains arrangements under which eligible accounts and notes receivable 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. After transfer of financial assets, an entity stops recognizing the financial assets when the control has been surrendered. These agreements met the criteria of a sale of such assets since the acquiring party retained the title to these receivables and had assumed the risk that the receivables will not be collectible. The Company pays administrative fees as well as interest rates ranging from 1.35% 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 \$3.9 million and \$6.9 million of receivables, respectively, during the three months periods ended October 2, 2010 and September 26, 2009 and sold \$0.8 million and \$5.3 million of receivables, respectively during the six month periods ended October 2, 2010 and September 26, 2009. 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 October 2, 2010 and January 2, 2010.

Table of Contents**NANOMETRICS INCORPORATED****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 8. Inventories**

Inventories are stated at the lower of standard cost (which approximates actual cost on a first-in, first-out basis), or market and consist of the following (in thousands):

| | October 2, 2010 | January 2, 2010 |
|----------------------------------|----------------------------|----------------------------|
| Raw materials and sub-assemblies | \$ 18,481 | \$ 19,006 |
| Work in process | 9,783 | 4,286 |
| Finished goods | 9,953 | 8,180 |
| Total inventories | \$ 38,217 | \$ 31,472 |

The Company reflects the cost of systems that were invoiced upon shipment but deferred for revenue recognition purposes separate from its inventory held for sale as Inventories delivered systems.

Note 9. Property, Plant and Equipment

Property, plant and equipment consist of the following (in thousands):

| | October 2, 2010 | January 2, 2010 |
|--|----------------------------|----------------------------|
| Land | \$ 15,570 | \$ 15,583 |
| Building and improvements | 18,659 | 18,575 |
| Machinery and equipment | 13,634 | 14,424 |
| Furniture and fixtures | 2,398 | 2,295 |
| Capital in progress | 2,486 | 1,850 |
| Total property, plant and equipment, gross | 52,747 | 57,727 |
| Accumulated depreciation and amortization | (18,270) | (16,362) |
| Total property, plant and equipment, net | \$ 34,477 | \$ 36,365 |

Note 10. Intangible Assets

On June 17, 2009, Nanometrics purchased inventory and certain other assets of Zygo Corporation and the two companies have entered into a supply agreement. As a result, the Company recorded \$1.4 million of developed technology and \$0.3 million of customer relationships. The Company amortizes the developed technology on a straight line basis over a period of ten years and the customer relationships on an accelerated basis over a period of two years from the date of acquisition.

Finite-lived intangible assets are recorded at cost, less accumulated amortization. Finite-lived intangible assets as of October 2, 2010 and January 2, 2010 consist of the following (in thousands):

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| | Adjusted cost as of October 2, 2010 | Accumulated amortization as of October 2, 2010 | Net carrying amount as of October 2, 2010 |
|------------------------|---|--|--|
| Developed technology | \$ 8,681 | \$ (4,581) | \$ 4,100 |
| Customer relationships | 8,521 | (7,331) | 1,190 |
| Brand names | 1,927 | (1,340) | 587 |
| Patented technology | 1,790 | (1,790) | |
| Trademark | 80 | (58) | 22 |
| Total | \$ 20,999 | \$ (15,100) | \$ 5,899 |

Table of Contents**NANOMETRICS INCORPORATED****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

| | Adjusted cost as of January 2, 2010 | Accumulated amortization as of January 2, 2010 | Net carrying amount as of January 2, 2010 |
|------------------------|---|--|--|
| Developed technology | \$ 8,681 | \$ (3,934) | \$ 4,747 |
| Customer relationships | 8,521 | (6,924) | 1,597 |
| Brand names | 1,927 | (1,232) | 695 |
| Patented technology | 1,790 | (1,790) | |
| Trademark | 80 | (52) | 28 |
| Total | \$ 20,999 | \$ (13,932) | \$ 7,067 |

The amortization of finite-lived intangibles is computed using the straight-line method except for customer relationships which are computed using an accelerated method. Estimated lives of finite-lived intangibles range from two to ten years. Total amortization expense for the three-month period ended October 2, 2010 and September 26, 2009 was \$0.4 million and \$0.4 million, respectively.

The estimated future amortization expense as of October 2, 2010 is as follows (in thousands):

| Fiscal Years | |
|-------------------------------|-----------------|
| 2010 (remaining three months) | \$ 389 |
| 2011 | 1,362 |
| 2012 | 1,185 |
| 2013 | 1,027 |
| 2014 | 668 |
| 2015 | 597 |
| Thereafter | 671 |
| Total amortization | \$ 5,899 |

Note 11. Other Current Liabilities

Other current liabilities consist of the following (in thousands):

| | October 2, 2010 | January 2, 2010 |
|--|--------------------|--------------------|
| Accrued warranty | \$ 2,997 | \$ 1,200 |
| Accrued professional services | 880 | 1,021 |
| Customer deposits | 692 | 1,601 |
| Fair value of deferred payments to Zygo Corporation related to acquisition (Note 4) | 764 | 3,655 |
| Other | 2,218 | 1,475 |

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Total other current liabilities \$ 7,551 \$ 8,952

Note 12. Line of Credit and Debt Obligations

Debt obligations consist of the following (in thousands):

| | October 2, 2010 | January 2, 2010 |
|-------------------------------------|--------------------|--------------------|
| Line of Credit | | |
| Borrowing from Line of Credit | \$ | \$ |
| Debt Obligations | | |
| Milpitas building mortgage | 10,173 | 13,082 |
| Total debt obligations | 10,173 | 13,082 |
| Current portion of debt obligations | (561) | (343) |
| Long-term debt obligations | \$ 9,612 | \$ 12,739 |

Table of Contents**NANOMETRICS INCORPORATED****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

In February 2007, the Company entered into a two-year agreement for a revolving line of credit facility in a maximum principal amount of \$15.0 million. On April 30, 2009, Nanometrics re-negotiated its revolving line of credit facility to extend the maturity date of the facility by an additional two years, to April 30, 2011. On June 15, 2009, the Company amended the financial covenants governing the credit facility to reduce the net tangible net worth requirements, effective as of June 27, 2009. On April 13, 2010, the Company amended the revolving line of credit facility to (i) increase the maximum principal amount available thereunder from \$15.0 million to \$20.0 million, (ii) extend the maturity date of such facility by one year to April 30, 2012, and (iii) decrease the unused revolving line commitment fee from 0.25% per annum to 0.1875% per annum.

The instrument governing the facility includes certain financial covenants regarding net tangible net worth. The revolving line of credit agreement includes a provision for the issuance of commercial or standby letters of credit by the bank on behalf of the Company. The value of all letters of credit outstanding reduces the total line of credit available. The revolving line of credit is collateralized by a blanket lien on all of the Company's domestic assets excluding intellectual property and real estate. The minimum borrowing interest rate is 5.75% per annum. The maximum borrowing allowed on the line of credit is \$20.0 million. Borrowing is limited to the lesser of (a) \$7.5 million plus the borrowing base or (b) \$20.0 million. The borrowing base available as of October 2, 2010 was \$20.0 million. As of October 2, 2010, the Company was not in breach of any restrictive covenants in connection with its line of credit and debt obligations. There are no outstanding amounts drawn on this facility as of October 2, 2010. Although the Company has no current plans to request advances under this credit facility, we may use the proceeds of any future borrowing for general corporate purposes, future acquisitions or expansion of the Company's business.

In July 2008, the Company entered into a mortgage agreement with General Electric Commercial Finance pursuant to which it borrowed \$13.5 million. The mortgage initially bears interest at the rate of 7.18% per annum, which rate will be reset after five years to 3.03% over the then weekly average yield of five-year U.S. Dollar Interest Rate Swaps as published by the Federal Reserve. Monthly principal and interest payments are based on a twenty year amortization for the first sixty months and fifteen year amortization thereafter. The remaining principal balance of the mortgage and any accrued but unpaid interest will be due on August 1, 2018. The mortgage is secured, in part, by a lien on and security interest in the building and land comprised of the Company's principal offices in Milpitas, California.

According to the terms of the loan agreement, the Company can make pre-payments of up to 20% of the outstanding principal balance without incurring any penalty. During the three month period ended October 2, 2010, in addition to the monthly principal and interest payments due under the agreement, the Company made a \$2.6 million pre-payment towards the principal amount of the loan.

At October 2, 2010, future annual maturities of all debt obligations were as follows (in thousands):

| Fiscal years | |
|-------------------------------|------------------|
| 2010 (remaining three months) | \$ 135 |
| 2011 | 572 |
| 2012 | 614 |
| 2013 | 538 |
| 2014 | 393 |
| 2015 | 414 |
| Thereafter | 7,507 |
| Total | \$ 10,173 |

Table of Contents**NANOMETRICS INCORPORATED****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 13. Net Income (Loss) Per Share**

Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average common shares outstanding for the period. Diluted net income per shares gives effect to all potentially dilutive common shares outstanding during the period, including contingently issuable shares and certain stock options, calculated using the treasury stock method. A reconciliation of the share denominator of the basic and diluted net income (loss) per share computations is as follows (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|-----------------------|--------------------|-----------------------|
| | October 2, 2010 | September 26, 2009 | October 2, 2010 | September 26, 2009 |
| Weighted average common shares outstanding used in basic net loss per share calculation | 21,978 | 18,598 | 21,729 | 18,513 |
| Potential dilutive common stock equivalents, using treasury stock method | 1,190 | 800 | 1,161 | |
| Shares used in diluted net income (loss) per share computation | 23,168 | 19,398 | 22,890 | 18,513 |

For the three and nine month periods ended October 2, 2010 and September 26, 2009, the Company had securities outstanding which could potentially dilute basic earnings per share in the future, which were excluded from the computation of diluted net loss per share in the periods presented as their impact would have been anti-dilutive. Weighted average common share equivalents, consisting of stock options excluded from the calculation of diluted net loss per share were 0.8 million and 0.6 million in the three and nine month periods ended October 2, 2010 and 2.3 million and 2.5 million for three and nine month periods ended September 26, 2009.

Note 14: Stock Repurchase Program

During the third fiscal quarter of 2007, the Company's Board of Directors authorized a stock repurchase program pursuant to which the Company may repurchase shares of its common stock with an aggregate value of up to \$4.0 million. During the fiscal year 2009, the Company did not repurchase any of its common shares in the open market. During the three month period ended October 2, 2010, the Company repurchased and retired 96,492 of its common shares at an average price of \$13.62 per share, for a total consideration of \$1.3 million, thereby utilizing all remaining funds available under the 2007 Stock Repurchase Program.

Note 15. Stock-Based Compensation

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 were as follows (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|----------------------------|--------------------|-----------------------|--------------------|-----------------------|
| | October 2, 2010 | September 26, 2009 | October 2, 2010 | September 26, 2009 |
| Cost of products | \$ 30 | \$ 78 | \$ 90 | \$ 30 |
| Cost of service | 44 | 30 | 149 | 136 |
| Research and development | 135 | 218 | 387 | 330 |
| Selling | 170 | 142 | 417 | 421 |
| General and administrative | 231 | 384 | 1,698 | 656 |

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| | | | | |
|--|--------|--------|----------|----------|
| Total stock-based compensation expense | \$ 610 | \$ 852 | \$ 2,741 | \$ 1,573 |
|--|--------|--------|----------|----------|

The fair value of each option award is estimated on the date of grant using the Black-Scholes valuation model and the assumptions noted in the following table. The expected term of options granted was calculated using the simplified method. The risk-free rate is based on the U.S. Treasury rates in effect during the corresponding period of grant. The expected volatility is based on the historical volatility of Nanometrics 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. The assumptions in the following table do not include the assumptions used in the Option Exchange Program.

Table of Contents**NANOMETRICS INCORPORATED****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

| | Three-Months Ended | | Nine-Months Ended | |
|-------------------------------------|--------------------|-----------------------|--------------------|-----------------------|
| | October 2, 2010 | September 26, 2009 | October 2, 2010 | September 26, 2009 |
| Stock Options | | | | |
| Expected life | 4.56 years | 3.68 years | 4.48 years | 3.92 years |
| Volatility | 74.88% | 70.20% | 73.48% | 65.49% |
| Risk free interest rate | 1.56% | 1.74% | 2.28% | 1.91% |
| Dividends | | | | |
| Employee Stock Purchase Plan | | | | |
| Expected life | 0.5 years | 0.5 years | 0.5 years | 0.5 years |
| Volatility | 67.43% | 89.56% | 80.34% | 89.56% |
| Risk free interest rate | 0.22% | 0.94% | 0.20% | 0.94% |
| Dividends | | | | |

The weighted average fair value per share of the stock options awarded in the three and nine month periods ended October 2, 2010 was \$7.30 and \$6.19, respectively, based on the fair market value of the Company's common stock on the grant dates.

A summary of activity under the Company's stock option plans during the quarter ended October 2, 2010 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 January 2, 2010 | 2,953,294 | \$ 5.95 | 5.10 | \$ 16,692 |
| Exercised | (665,058) | 5.36 | | |
| Granted | 566,968 | | | |
| Cancelled | (85,534) | | | |
| Outstanding at October 2, 2010 | 2,769,670 | \$ 6.94 | 5.14 | \$ 22,427 |
| Exercisable at October 2, 2010 | 1,400,610 | \$ 7.02 | 4.58 | \$ 11,269 |

During the three-month period ended October 2, 2010, the Company granted 16,666 Restricted Stock Units (RSUs), which vest on the one year anniversary of the vesting commencement date identified in the applicable grant document. During the first quarter of this year, 33,920 RSUs were issued to settle accrued bonus liabilities. As of October 2, 2010, there were 74,705 RSUs outstanding.

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company's closing stock price of \$15.00 as of October 2, 2010, 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 and nine month periods ended October 2, 2010 was \$3.3 million and \$4.7 million, respectively, and for the three and nine month periods ended September 26, 2009 was \$0.1 million each.

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In September 2009, the Company completed an offer to exchange certain employee stock options under Nanometrics' Option Exchange Program (the Option Exchange Program). Under the Option Exchange Program, certain previously granted options were exchanged by eligible option holders for new options with a lower exercise price using the following exchange ratios: (a) 2 replacement options were provided for every 3 options surrendered with an original exercise price less than or equal to \$10.00, and (b) 1 replacement option was provided for every 2 options surrendered with an original exercise price greater than \$10.00.

Table of Contents**NANOMETRICS INCORPORATED****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

As a result of the Option Exchange Program, a total of 448,945 options to purchase shares of common stock were tendered for exchange, and 237,838 options to purchase shares of common stock were issued. A total of 103 employees participated in the Option Exchange Program. Options granted pursuant to the Option Exchange Program have an exercise price of \$7.50, which price is based on the NASDAQ closing price of the Company's common stock on September 3, 2009. For options granted pursuant to the Option Exchange Program, one third vested immediately on the re-grant date, and the remaining two thirds will vest on a monthly basis beginning on the 13th month anniversary through the 36th month anniversary of the re-grant date; provided, that the individual remains employed by the Company during that period. The incremental stock based compensation from the Option Exchange Program was \$0.2 million which will be recorded ratably over the requisite service period of three years.

Note 16. Comprehensive Income (Loss)

The Company's comprehensive income (loss) was as follows (in thousands):

| | Three-Months Ended | | Nine-Months Ended | |
|--|--------------------|-----------------------|--------------------|-----------------------|
| | October 2, 2010 | September 26, 2009 | October 2, 2010 | September 26, 2009 |
| Net income (loss) | \$ 12,327 | \$ 1,571 | \$ 29,820 | \$ (16,023) |
| Foreign currency translation adjustments, net of tax | 1,141 | (196) | 576 | 1,497 |
| Total comprehensive income (loss) | \$ 13,468 | \$ 1,375 | \$ 30,396 | \$ (14,526) |

All of the accumulated other comprehensive income reflected as a separate component of stockholders' equity consists of accumulated foreign currency translation adjustment for all periods presented.

Note 17. Warranties

Product Warranty The Company sells the majority of its products with a 12-month repair or replacement warranty from the date of acceptance. 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 differ from the Company's estimates, revisions to the estimated warranty obligations would be required. The warranty accrual represents the best estimate of the amount necessary to settle future and existing claims on products sold as of the balance sheet date. The Company periodically assesses the adequacy of its reported warranty reserve and adjusts such amounts in accordance with changes in these factors. Components of the warranty accrual, which was included in the accompanying consolidated balance sheets with other current liabilities, were as follows (in thousands):

| Nine Months Ended | |
|--------------------|-----------------------|
| October 2, 2010 | September 26, 2009 |

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| | | |
|--|----------|----------|
| Balance as of beginning of period | \$ 1,200 | \$ 2,075 |
| Actual warranty costs incurred | (1,881) | (1,416) |
| Accruals for warranties issued during the period | 3,648 | 1,065 |
| Aggregate changes in liability relating to pre-existing warranties | 30 | (466) |
| Balance as of end of period | \$ 2,997 | \$ 1,258 |

Note 18. Income Taxes

The Company accounts for income taxes under the provisions of ASC 740, Accounting for Income Taxes, (formerly known as FAS 109). The Company's effective tax rate as of the 3 months ended October 2, 2010 is based on the estimated annual effective tax rate. The estimated annual effective tax rate for the year ending January 1, 2011 is currently expected to be approximately 7%. The Company's income tax provision (benefit) for the three-month period ended October 2, 2010 and September 26, 2009 was \$1.1 million and (\$0.1 million), respectively.

Table of Contents**NANOMETRICS INCORPORATED****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The Company's income tax provision (benefit) for the nine month period ended October 2, 2010 and September 26, 2009, was \$2.4 million and (\$0.5 million), respectively. The effective income tax rate for the nine month period ended October 2, 2010 was different from the statutory United States federal income tax rate of 35% primarily due to non-deductible share-based compensation expense, state income taxes, foreign tax withholding, and subpart F income which were offset by change in valuation allowance, domestic manufacturing deduction, and federal income tax rates in excess of foreign income tax rate. The effective income tax rate for the nine month period ended September 26, 2009 was different from the statutory United States federal income tax rate of 35% primarily due to non-deductible share-based compensation expense, state income taxes, and foreign tax withholding which were offset by valuation allowance and federal income tax rates in excess of foreign income tax rate.

As of October 2, 2010, the Company continued to have a valuation allowance against its net deferred tax assets in the US and certain foreign jurisdictions as a result of uncertainties regarding the realization of the asset balance due to losses during the year ended January 2, 2010 and prior, the variability of operating results, and uncertainty of future results. In the event that the Company determines that the deferred tax assets are realizable, an adjustment to the valuation allowance may adjust the effective tax rate in the period such determination is made. The valuation allowance does not impact the Company's ability to utilize the underlying net operating loss carry-forwards and tax credits. The Company is currently projecting to utilize a significant portion of their US and state net operating loss carry-forward in the current fiscal year.

On October 8, 2010 the California legislature approved the 2010-2011 budget bills, which included various income tax provisions, including suspending utilization of net operating loss carry-forwards. The Company is currently evaluating the impact of this legislation on its financial statements.

Note 19. Contingencies

In August 2005, KLA-Tencor Corporation (KLA) filed a complaint against the Company in the United States District Court for the Northern District of California. The complaint alleges that certain of the Company's products infringe two of KLA's patents. On January 30, 2006, KLA added a third patent to its complaint. The complaint seeks a preliminary and permanent injunction against the sale of these products as well as the recovery of monetary damages and attorneys' fees. As part of its defense, the Company has filed requests for re-examinations of the allegedly infringed KLA patents with the U.S. Patent & Trademark Office (PTO). In March 2006, the Company filed a motion for and was granted a stay in the patent litigation case until such re-examinations are completed. On November 4, 2008, the PTO issued an Ex Parte Reexamination Certificate on one of the three patents-in-suit. On December 8, 2009, the PTO issued an Ex Parte Reexamination Certificate for another of the KLA patents-in-suit. On September 21, 2009, while the reexamination of the third patent-in-suit was still pending, the Company filed a second request for re-examination relating to the third patent. On March 30, 2010, the PTO issued an Ex Parte Reexamination Certificate as to the first reexamination of the third patent. The second reexamination of the third patent remains pending. In all four of the reexamination proceedings, the PTO has issued Office Actions rejecting numerous claims and KLA has amended the claims in response.

Intellectual Property Indemnification Obligations The Company will, from time to time, in the normal course of business, agree to indemnify certain customers with whom it enters into contractual relationships. The Company has agreed to hold these customers harmless against third party claims that Nanometrics' products, when used for their intended purpose(s), infringe the intellectual property rights of such third parties or other claims made against the customer. 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 de minimis. Accordingly, no liabilities have been recorded for these obligations in the accompanying unaudited consolidated balance sheets as of October 2, 2010 and September 26, 2009.

Note 20. Geographic and Significant Customer Information

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

Table of Contents**NANOMETRICS INCORPORATED****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

| | Three-Months Ended | | Nine-Months Ended | |
|----------------------------|--------------------|-----------------------|--------------------|-----------------------|
| | October 2, 2010 | September 26, 2009 | October 2, 2010 | September 26, 2009 |
| Total net revenues: | | | | |
| United States | \$ 22,801 | \$ 6,311 | \$ 57,204 | \$ 15,196 |
| Japan | 3,355 | 1,900 | 13,133 | 8,803 |
| South Korea | 13,318 | 13,853 | 40,628 | 17,970 |
| Taiwan | 4,930 | 1,257 | 11,445 | 2,107 |
| China | 6,518 | 1,491 | 13,452 | 2,313 |
| Europe | 2,016 | 414 | 3,883 | 2,917 |
| All other | 997 | 588 | 2,190 | 1,082 |
| Total net revenues* | \$ 53,935 | \$ 25,814 | \$ 141,935 | \$ 50,388 |

* Net revenues are attributed to countries based on the deployment and service locations of systems.

| | October 2, 2010 | January 2, 2010 |
|----------------------------------|--------------------|--------------------|
| Long lived assets | | |
| United States | \$ 32,716 | \$ 34,252 |
| Japan | 542 | 819 |
| South Korea | 1,174 | 1,148 |
| Taiwan | 65 | 66 |
| Europe | 1,063 | 1,450 |
| China | 7 | 12 |
| All Other | 173 | 177 |
| Total long lived assets** | \$ 35,740 | \$ 37,924 |

** Long-lived assets include tangible assets only.

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

| | October 2, 2010 | January 2, 2010 |
|----------------------------|--------------------|--------------------|
| Hynix Semiconductor, Inc | 21.6% | 12.7% |
| Intel Corporation | 11.3% | 16.1% |
| Samsung Semiconductor, Inc | 10.9% | 30.5% |

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The following customers accounted for 10% or more of total revenue:

| | Three-Months Ended | | Nine-Months Ended | |
|------------------------------|--------------------|-----------------------|--------------------|-----------------------|
| | October 2, 2010 | September 26, 2009 | October 2, 2010 | September 26, 2009 |
| Samsung Electronics Co. Ltd. | 19.1% | 48.5% | 23.3% | 31.7% |
| Intel Corporation | 16.4% | 14.8% | 20.3% | *** |
| Hynix Semiconductor, Inc. | 13.3% | *** | 14.6% | 10.7% |

*** The customer accounted for less than 10% of revenue during the period.

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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 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, without limitation, statements regarding our expectations, beliefs, intentions or strategies regarding our business in future periods. We may identify these statements by the use of words such as anticipate, believe, continue, could, estimate, expect, intend, may, might, plan, potential, predict, project, should, will, would 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 risk factors, including those set forth in Part II Item 1A Risk Factors and elsewhere in this document. In evaluating our business, investors should carefully consider these factors in addition to the other information set forth in this document. The occurrence of the events described in the risk factors 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 the (i) audited consolidated financial statements and notes thereto for the year January 2, 2010 which were included in our 2009 Annual Report on Form 10-K filed with the Securities Exchange Commission on March 26, 2010 and (ii) our other filings with the Securities and Exchange Commission.

Overview

The semiconductor industry is cyclical in nature and has historically experienced periodic downturns and upturns. Today's leading indicators of changes in customer investment patterns may not be any more reliable than in prior years. Demand for our equipment can vary significantly from period to period as a result of various factors, requirements, and our ability to develop, acquire, and market competitive products. For these and other reasons, our current results of operations may not necessarily be indicative of future operating results.

Nanometrics is a leading provider of high-performance process control metrology systems used primarily in the fabrication of semiconductors, high-brightness LEDs (HB-LED), data storage devices and solar photovoltaics. Nanometrics' automated and integrated metrology systems measure critical dimensions, device structures, overlay registration, topography and various thin film properties, including film thickness as well as optical, electrical and material properties. 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. Nanometrics' systems enable device manufacturers to improve yields, increase productivity and lower their manufacturing costs. Our systems are categorized as:

- 1) **Automated Metrology.** Our Automated Metrology systems are made up of manual, semi-automated and fully automated metrology systems which are employed in high-volume and low-volume production environments. The Automated Metrology systems incorporate automated material handling interface options for a variety of fabrication automation environments and implement multiple measurement technologies including film measurement, overlay, topography and optical critical dimension (OCD) for a broad range of substrate sizes and applications.
- 2) **Integrated Metrology.** Our Integrated Metrology systems are installed inside wafer processing equipment to provide near real-time measurements for improving process control and increasing throughput. Our Integrated Metrology systems are sold directly to customers and through our OEM channels.
- 3) **Materials Characterization.** Our Materials Characterization products include systems that are used to monitor the physical, optical, electrical and material characteristics of HB-LED, compound semiconductor, including composition, crystal structure, layer thickness, dopant concentration, contamination and electron mobility. Tabletop systems are used to manually or semi-automatically measure thin films in engineering and low-volume production environments.

Our Business

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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 industry. We have:

Introduced new products in every core product line and primary market served;

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Restructured our business and practices for operational and earnings leverage;

Diversified our product line and served markets through acquisitions, such as the 2006 acquisition of Accent Optical Technologies, Inc.; the 2008 acquisition of Tevet Process Control Technologies (Tevet), an integrated metrology supplier serving both semiconductor and solar PV industries; and the acquisition of the Unifire product line from Zygo Corporation in June 2009;

Continued development of new integrated measurement technologies for advanced fabrication processes; and

Researched innovative applications of existing technology to new market opportunities within the solar PV, HB-LED, and data storage industries.

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 on-going basis, management evaluates its estimates including those related to bad debts, inventory valuations, warranty obligations 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 have been no significant changes to our critical accounting policies discussed in our Annual Report on Form 10-K for the fiscal year ended January 2, 2010.

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 on results of operations and financial condition.

Results of Operations**Three and nine-month periods ended October 2, 2010 and September 26, 2009**

Total net revenues - Our net revenues were comprised of the following categories (in thousands):

| | Three Months Ended | | | | Nine-Months Ended | | | |
|---------------------------|--------------------|-----------------------|------------|--------|--------------------|-----------------------|------------|--------|
| | October 2, 2010 | September 26, 2009 | Changes In | | October 2, 2010 | September 26, 2009 | Changes In | |
| | | | Amount | % | | | Amount | % |
| Automated Metrology | \$ 33,347 | \$ 13,509 | \$ 19,838 | 146.9% | \$ 89,181 | \$ 20,234 | \$ 68,947 | 340.7% |
| Integrated Systems | 5,386 | 1,214 | 4,172 | 343.6% | 10,288 | 2,276 | 8,012 | 352.0% |
| Material Characterization | 5,670 | 1,580 | 4,090 | 258.9% | 16,886 | 6,630 | 10,256 | 154.7% |
| Total Product Revenue | 44,403 | 16,303 | 28,100 | 172.4% | 116,355 | 29,140 | 87,215 | 299.3% |
| Service | 9,532 | 9,511 | 21 | 0.2% | 25,580 | 21,248 | 4,332 | 20.4% |
| Total Net Revenues | \$ 53,935 | \$ 25,814 | \$ 28,121 | 108.9% | \$ 141,935 | \$ 50,388 | \$ 91,547 | 181.7% |

For the three and nine month periods ended October 2, 2010, net revenues from automated metrology increased by \$19.8 million and \$68.9 million from the comparable periods of 2009. The increase in Automated Metrology was largely driven by multi-system orders and technology upgrades from leading worldwide semiconductor companies in both the memory and logic sectors, and strong sales of our thin-film and OCD

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systems, increasing traction with our Caliper overlay product and Lynx platform, and further penetration into high-growth segments such as high-brightness LEDs. Net revenues from our integrated systems increased by \$4.2 million and \$8.0 million from the comparable periods of 2009, net revenues from our material characterization increased by \$4.1 million and \$10.3 million from comparable periods of 2009, due mainly to increased market demand. Sales of our Integrated Systems and our Material Characterization systems are highly dependent on, and driven by, manufacturing companies expanding their capacity. Product revenues increased by \$28.1 million and \$87.2 million for the three month period and nine month periods ended October 2, 2010, respectively.

Service revenues were relatively flat for the three month period ended October 2, 2010 from the comparable period of 2009, but increased by \$4.3 million for the nine month period ended October 2, 2010 over the comparable period of 2009 as a result of higher in-the-field tool upgrades.

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Gross margins. Our gross margin breakdown was as follows:

| | Three-Months Ended | | Nine-Months Ended | |
|----------|--------------------|--------------------|-------------------|--------------------|
| | October 2, 2010 | September 26, 2009 | October 2, 2010 | September 26, 2009 |
| Products | 56.9% | 48.8% | 57.0% | 40.8% |
| Services | 43.6% | 62.9% | 45.5% | 51.3% |

The product gross margin for the three and nine month periods ended October 2, 2010 of 56.9% and 57.0%, respectively, increased from 48.8% and 40.8% from the comparable periods of 2009. For the three month comparative periods the 8.1% increase in gross margin was comprised of a 0.6% increase due to a product mix favoring higher margin products and a 7.5% increase due to a combination of higher absorption due to larger manufacturing volumes, lower warranty and installation costs as a percentage of product sales and lower manufacturing material variances as a percentage of product revenue related to purchase price variances, work order variances and scrap which was partially offset by increased royalty payments. For the nine month comparative periods the 16.2% increase in gross margin was comprised of a 2.1% increase due to a product mix favoring higher margin products and a 14.1% increase due to a combination of higher absorption due to larger manufacturing volumes, lower manufacturing material variances as a percentage of product revenue related to purchase price variances, work order variances and scrap which was partially offset by increased royalty payments.

The gross margin for our services business decreased to 43.6% and 45.5% for the three and nine month periods ended October 2, 2010 as compared to gross margins of 62.9% and 51.3% for the comparable periods of 2009, which was due to a shift from higher margin upgrades to lower margin upgrades.

Operating expenses. Our operating expenses were comprised of the following (in thousands):

| | Three-Months Ended | | | | Nine-Months Ended | | | |
|-----------------------------------|--------------------|--------------------|-----------------|--------------|-------------------|--------------------|-----------------|--------------|
| | October 2, 2010 | September 26, 2009 | Changes in | | October 2, 2010 | September 26, 2009 | Changes in | |
| | | | Amount | % | | | Amount | % |
| Research and development | \$ 4,601 | \$ 4,100 | \$ 501 | 12.2% | \$ 14,101 | \$ 10,394 | \$ 3,707 | 35.7% |
| Selling | 5,734 | 3,959 | 1,775 | 44.8% | 15,822 | 10,832 | 4,990 | 46.1% |
| General and administrative | 4,801 | 3,967 | 834 | 21.0% | 13,740 | 11,427 | 2,313 | 20.2% |
| Amortization of intangible assets | 368 | 418 | (50) | (11.9)% | 1,168 | 1,124 | 44 | 3.9% |
| Asset impairment | 75 | | 75 | 100.0% | 463 | 1,899 | (1,436) | (75.6)% |
| Restructuring charge | | | | | | 1,134 | (1,134) | (100.0)% |
| Total operating expenses | \$ 15,579 | \$ 12,444 | \$ 3,135 | 25.2% | \$ 45,294 | \$ 36,810 | \$ 8,484 | 23.1% |

Research and development. Research and development expenses increased by \$0.5 million for the three month period ended October 2, 2010 over the comparable period in 2009 primarily due to increases in labor costs of \$0.5 million, consulting costs of \$0.2 million and facilities costs of \$0.2 million. These increases were partially offset by a decrease in depreciation of \$0.2 million and a \$0.1 million decrease in stock based compensation.

Research and development expenses increased by \$3.7 million for the nine month period ended October 2, 2010 over the corresponding period in 2009 primarily due to a \$1.8 million increase in labor costs, a \$0.8 million increase in development costs due to consulting, a \$0.6 million increase in facilities costs and a \$0.4 million increase in the cost of materials.

Selling. Selling expenses increased by \$1.8 million for the three month period ended October 2, 2010 as compared to the corresponding period in 2009; which increase was a result of increased labor cost of \$0.9 million, a \$0.4 million increase in travel expenses, an increase of \$0.3 million in bonus and commissions (as a result of increased revenue and headcount), and a \$0.1 million increase each in the categories of materials and depreciation.

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Selling expenses increased by \$5.0 million for the nine month period ended October 2, 2010 over the corresponding period in 2009 as a result of increased labor costs of \$3.8 million due to increased salaries, bonuses and commissions, a \$0.9 million increase in travel costs, and \$0.2 million attributed to expensing small tools and laptops.

General and administrative. General and administrative expenses increased by \$0.8 million for the three month period ended October 2, 2010 compared to the corresponding period in 2009, which increase was primarily due to a \$0.4 million increase in labor costs, \$0.6 million in increased bonuses and commissions, and a \$0.1 million increase in travel expenses. These increases were partially offset by decreased legal and professional expenses of \$0.3 million.

General and administrative expenses increased by \$2.3 million for the nine month period ended October 2, 2010 over the comparable period in 2009 mainly due to a \$1.0 million increase in stock based compensation, \$0.9 million in increased bonus expenses, \$0.6 million in increased labor costs and \$0.6 million in increased facilities cost. This increase was partially offset by a decrease in professional and consulting fees of \$0.5 million.

Amortization of intangible assets. Amortization of intangible assets were relatively flat for the three and nine month periods ended October 2, 2010 when compared to the same periods in 2009.

Asset impairment. During the three and nine month periods ended October 2, 2010, we recognized impairment charges of \$0.1 million and \$0.5 million related to write-offs of various in-house developed software.

During the comparable nine month periods ended September 26, 2009, we recognized impairment charges of \$1.9 million which were related to the write-off of fixed assets and the closure of our manufacturing facility in South Korea.

Restructuring charge. There were no restructuring charges during the nine months ended October 2, 2010. During the nine month period ended September 26, 2009, the Company recorded a total of \$1.1 million in restructuring charges related to personnel downsizing and other measures taken by the Company in response to declining global economic conditions.

Operating Income (Loss):

Other income (expense). Our net other income (expense) consisted of the following categories (in thousands):

| | Three-Months Ended | | | | Nine-Months Ended | | | |
|----------------------------------|--------------------|-----------------------|----------|-----------------|--------------------|-----------------------|----------|-----------------|
| | October 2, 2010 | September 26, 2009 | Amount | Changes in % | October 2, 2010 | September 26, 2009 | Amount | Changes in % |
| Interest income | \$ 31 | \$ 12 | \$ 19 | 157.3% | \$ 78 | \$ 39 | \$ 39 | 100.0% |
| Interest expense | (355) | (559) | 204 | 36.4% | (1,192) | (1,106) | (86) | 7.8% |
| Other, net | (53) | 546 | (599) | (109.6)% | 705 | (1,395) | 2,100 | (150.6)% |
| Total operating income (expense) | \$ (377) | \$ (1) | \$ (376) | (37600.0)% | \$ (409) | \$ (2,462) | \$ 2,053 | (83.4)% |

For the nine month periods ended October 2, 2010 compared to the comparable periods of 2009, we incurred higher interest expense due to interest accrual on the Zygo liability and the Company's borrowing of \$13.5 million in connection with a mortgage against our headquarter premises. Interest expense for the three month period ended October 2, 2010 was lower than the interest expense in the comparative prior year period because we made a \$2.6 million pre-payment during the quarter, which reduced the principal amount under the loan. Also included in interest expense is the imputed interest of \$0.3 million on fair value of deferred payments to Zygo Corporation related to our acquisition of certain assets from Zygo. Foreign exchange losses for the nine month period ended September 26, 2009 of \$1.4 million were due mainly to the recategorization of a loan between the Company and our subsidiary in Japan as the loan was no longer considered to be of a long-term investment nature as of the last day of the 2008 fiscal year.

Provision for income taxes. We account for income taxes under the provisions of ASC 740, Accounting for Income Taxes, (formerly known as FAS 109). Our effective tax rate as of the three months ended October 2, 2010 is based on the estimated annual effective tax rate. The estimated

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annual effective tax rate for the year ending January 1, 2011 is currently expected to be approximately 7%. The Company's income tax provision (benefit) for the three-month period ended October 2, 2010 and September 26, 2009 was \$1.1 million and (\$0.1 million), respectively. Our income tax provision (benefit) for the nine month period ended October 2, 2010 and September 26, 2009, was \$2.4 million and (\$0.5 million), respectively. The effective income tax rate for the nine month period ended October 2, 2010 was different from the statutory United States federal income tax rate of 35% primarily due to non-deductible share-based compensation

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expense, state income taxes, foreign tax withholding, and subpart F income which were offset by change in valuation allowance, domestic manufacturing deduction, and federal income tax rates in excess of foreign income tax rate. The effective income tax rate for the nine month period ended September 26, 2009 was different from the statutory United States federal income tax rate of 35% primarily due to non-deductible share-based compensation expense, state income taxes, and foreign tax withholding which were offset by valuation allowance and federal income tax rates in excess of foreign income tax rate.

As of October 2, 2010, we continue to have a valuation allowance against our net deferred tax assets in the US and certain foreign jurisdictions as a result of uncertainties regarding the realization of the asset balance due to losses during the year ended January 2, 2010 and prior, the variability of operating results, and uncertainty of future results. In the event we determine that the deferred tax assets are realizable, an adjustment to the valuation allowance may adjust the effective tax rate in the period such determination is made. The valuation allowance does not impact our ability to utilize the underlying net operating loss carry-forwards and tax credits. We are currently projecting to utilize a significant portion of our US and state net operating loss carry-forward in the current fiscal year.

On October 8, 2010 the California legislature approved the 2010-2011 budget bills, which included various income tax provisions, including suspending utilization of net operating loss carry-forwards. We are evaluating the impact of this legislation on our financial statements.

Liquidity and Capital Resources

At October 2, 2010, our cash and cash equivalents totaled \$64.0 million compared to \$43.5 million as of January 2, 2010; we had working capital (current assets less current liabilities) of \$115.7 million as of January 2, 2010 compared to \$77.5 million at January 2, 2010

Cash provided by operating activities for the nine month period ended October 2, 2010 was \$24.7 million, which was primarily due to net income of \$29.8 million, and for non-cash charges related to depreciation and amortization of \$4.5 million, stock based compensation of \$2.7 million and \$1.2 million from the write down of inventory. This was offset by an increase in working capital of \$13.3 million primarily the result of an increase in accounts receivable of \$18.4 million and inventory of \$7.6 million, offset by a \$11.5 million increase in trade payables.

Investing activities for the nine-month period ended October 2, 2010 required a cash outlay of \$4.9 million, and included \$3.5 million of payments to Zygo as a result of the acquisition and \$2.0 million of cash outlays for capital equipment, which amounts were offset by \$0.5 million in proceeds from the sale of our manufacturing facility in South Korea.

For the nine month period ended October 2, 2010, cash provided by financing activities was attributable to \$3.9 million of cash receipts from stock option exercises and \$0.7 million excess tax benefit. A total of \$2.9 million of this cash was used to repay part of the principal on the mortgage on our headquarter building, \$1.3 million was used for the repurchase of our stock, and \$0.3 million was attributed to taxes paid on the net issuance of stock options.

In July 2008, we entered into a loan agreement pursuant to which we borrowed \$13.5 million. The loan initially bears interest at the rate of 7.18% per annum, which rate will be reset after five years to 3.03% over the weekly average yield of five-year U.S Dollar Interest Rate Swaps as published by the Federal Reserve. Monthly principal and interest payments are based on a twenty year amortization for the first sixty months and fifteen year amortization thereafter. The remaining principal balance of the loan, and any accrued but unpaid interest, will be due on August 1, 2018. The loan is secured, in part, by a lien on and security interest in the building and land comprising our principal offices in Milpitas, California.

On June 17, 2009, we announced a strategic business partnership with Zygo Corporation whereby Nanometrics has purchased inventory and certain other assets relating to Zygo business and the two companies have entered into a supply agreement. The Company will make payments to Zygo over a period of time as acquired inventory is sold and other aspects of the supply agreement are executed.

We have evaluated and will continue to evaluate the acquisitions of products, technologies or business 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. We believe our cash, cash equivalents and borrowing availability will be sufficient to meet our liquidity needs through at least the next twelve months.

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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 January 2, 2010 filed with the SEC on March 26, 2010. 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.

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, James P. Moniz, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. As of October 2, 2010, our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, concluded that our disclosure controls and procedures were effective to ensure that information that we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 were recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the three-month period ended October 2, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In August 2005, KLA-Tencor Corporation (KLA) filed a complaint against the Company in the United States District Court for the Northern District of California. The complaint alleges that certain of the Company's products infringe two of KLA's patents. On January 30, 2006, KLA added a third patent to its complaint. The complaint seeks a preliminary and permanent injunction against the sale of these products as well as the recovery of monetary damages and attorneys' fees. As part of its defense, the Company has filed requests for re-examinations of the allegedly infringed KLA patents with the U.S. Patent & Trademark Office (PTO). In March 2006, the Company filed a motion for and was granted a stay in the patent litigation case until such re-examinations are completed. On November 4, 2008, the PTO issued an Ex Parte Reexamination Certificate on one of the three patents-in-suit. On December 8, 2009, the PTO issued an Ex Parte Reexamination Certificate for another of the KLA patents-in-suit. On September 21, 2009, while the reexamination of the third patent-in-suit was still pending, the Company filed a second request for re-examination relating to the third patent. On March 30, 2010, the PTO issued an Ex Parte Reexamination Certificate as to the first reexamination of the third patent. The second reexamination of the third patent remains pending. In all four of the reexamination proceedings, the PTO has issued Office Actions rejecting numerous claims and KLA has amended the claims in response.

Table of Contents**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 or incorporated by reference into 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 January 2, 2010, filed with the Securities and Exchange Commission on March 26, 2010. 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 presently 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.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

On July 26, 2007, our Board of Directors approved the repurchase up to \$4.0 million of our common stock. Share repurchases under this program may be made through open market and privately negotiated transactions, at times and in such amounts as management deems appropriate. The timing and actual number of shares repurchased depended on a variety of factors including price, corporate and regulatory requirements and other market conditions.

We repurchased and retired 96,492 shares of our common stock in the month ended August 28, 2010 for an aggregate consideration of \$1.3 million.

As of October 2, 2010 the entire \$4.0 million approved for the repurchase of our shares had been used for the purpose.

ITEM 6. EXHIBITS

The following exhibits are filed 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(1) | Bylaws of the Registrant |
| 31 | Rule 13a-14(a)/15d-14(a) Certifications |
| 31.1(2) | Certification of Timothy J. Stultz, principal executive officer of the Registrant, pursuant to rule 13a-14(a) or rule 15a-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2(2) | Certification of James P. Moniz, principal financial officer of the Registrant, pursuant to rule 13a-14(a) or rule 15a-14(a) of the Securities Exchange Act of 1934, as amended, as adopted 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 James P. Moniz, principal financial officer of the Registrant, pursuant to rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

(1) Incorporated by reference to exhibits filed with the Registrant's Current Report on Form 8-K filed on October 5, 2006.

- (2) Filed herewith.
- (3) Furnished herewith.

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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/* JAMES P. MONIZ
James P. Moniz
Chief Financial Officer

Dated: November 12, 2010

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EXHIBIT INDEX

Exhibit

| No. | Description |
|--------------|---|
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- (2) Filed herewith.
- (3) Furnished herewith.