INTEVAC INC
Form 10-Q
July 31, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended June 30, 2018

OR

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

For the transition period from ________ to ________

Commission file number 0-26946

INTEVAC, INC.

(Exact name of registrant as specified in its charter)

Delaware	**94-3125814**
(State or other jurisdiction of	**(IRS Employer**
incorporation or organization)	**Identification No.)**

3560 Bassett Street

Santa Clara, California 95054

(Address of principal executive office, including Zip Code)

Registrant s telephone number, including area code: (408) 986-9888

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

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

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

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

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

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

On July 27, 2018, 22,583,325 shares of the Registrant s Common Stock, $0.001 par value, were outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. ***Financial Statements***

INTEVAC, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2018	December 30, 2017
	(Unaudited) (In thousands, except par value)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 13,731	$ 19,941
Short-term investments	20,069	15,698
Trade and other accounts receivable, net of allowances of $0 at both June 30, 2018 and at December 30, 2017	24,691	20,474
Inventories	33,036	33,792
Prepaid expenses and other current assets	2,434	2,524
Total current assets	93,961	92,429
Property, plant and equipment, net	11,079	12,478
Long-term investments	4,279	6,849
Restricted cash	1,000	1,000
Intangible assets, net of amortization of $7,191 at June 30, 2018 and $6,884 at December 30, 2017	1,196	1,503
Deferred income taxes and other long-term assets	746	764
Total assets	$ 112,261	$ 115,023
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 5,218	$ 3,949
Accrued payroll and related liabilities	4,825	6,818
Other accrued liabilities	10,538	7,688
Customer advances	10,552	11,026
Total current liabilities	31,133	29,481
Other long-term liabilities	2,542	2,879
Stockholders equity:		
Common stock, $0.001 par value	23	22

Additional paid-in capital	180,426	177,521
Treasury stock, 4,845 shares at both June 30, 2018 and December 30, 2017	(28,489)	(28,489)
Accumulated other comprehensive income	444	490
Accumulated deficit	(73,818)	(66,881)
Total stockholders equity	78,586	82,663
Total liabilities and stockholders equity	$ 112,261	$ 115,023

Note: Amounts as of December 30, 2017 are derived from the December 30, 2017 audited consolidated financial statements.

See accompanying notes to the condensed consolidated financial statements.

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INTEVAC, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended		Six Months Ended	
	June 30, 2018	**July 1, 2017**	**June 30, 2018**	**July 1, 2017**
	(Unaudited)			
	(In thousands, except per share amounts)			
Net revenues:				
Systems and components	$ 23,335	$ 29,863	$ 38,807	$ 58,286
Technology development	2,763	1,100	5,265	3,065
Total net revenues	26,098	30,963	44,072	61,351
Cost of net revenues:				
Systems and components	13,868	18,345	24,596	34,018
Technology development	2,469	1,148	4,840	2,816
Total cost of net revenues	16,337	19,493	29,436	36,834
Gross profit	9,761	11,470	14,636	24,517
Operating expenses:				
Research and development	4,984	4,418	9,151	9,100
Selling, general and administrative	4,712	5,713	10,541	11,987
Total operating expenses	9,696	10,131	19,692	21,087
Income (loss) from operations	65	1,339	(5,056)	3,430
Interest income and other income (expense), net	133	127	278	237
Income (loss) before income taxes	198	1,466	(4,778)	3,667
Provision for income taxes	365	366	525	738
Net income (loss)	$ (167)	$ 1,100	$ (5,303)	$ 2,929
Net income (loss) per share:				
Basic	$ (0.01)	$ 0.05	$ (0.24)	$ 0.14
Diluted	$ (0.01)	$ 0.05	$ (0.24)	$ 0.13
Weighted average common shares outstanding:				
Basic	22,461	21,495	22,284	21,356
Diluted	22,461	23,209	22,284	22,999

See accompanying notes to the condensed consolidated financial statements.

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INTEVAC, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

	Three Months Ended		Six Months Ended	
	June 30, 2018	July 1, 2017	June 30, 2018	July 1, 2017
	(Unaudited) (In thousands)			
Net income (loss)	$ (167)	$ 1,100	$ (5,303)	$ 2,929
Other comprehensive income (loss), before tax:				
Change in unrealized net loss on available-for-sale investments	22	(1)	(6)	3
Foreign currency translation gains (losses)	(144)	41	(40)	75
Other comprehensive income (loss), before tax	(122)	40	(46)	78
Income taxes related to items in other comprehensive income (loss)				
Other comprehensive income (loss), net of tax	(122)	40	(46)	78
Comprehensive income (loss)	$ (289)	$ 1,140	$ (5,349)	$ 3,007

See accompanying notes to the condensed consolidated financial statements.

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INTEVAC, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six months ended June 30, 2018	Six months ended July 1, 2017
	(Unaudited) (In thousands)	
Operating activities		
Net income (loss)	$ (5,303)	$ 2,929
Adjustments to reconcile net income (loss) to net cash and cash equivalents used in operating activities:		
Depreciation and amortization	2,557	1,973
Net amortization of investment premiums and discounts	(42)	54
Equity-based compensation	1,602	1,864
Change in the fair value of acquisition-related contingent consideration	8	102
Deferred income taxes		(1)
Loss on disposal of fixed assets	442	
Changes in operating assets and liabilities	(3,598)	(10,937)
Total adjustments	969	(6,945)
Net cash and cash equivalents used in operating activities	(4,334)	(4,016)
Investing activities		
Purchases of investments	(17,743)	(15,608)
Proceeds from sales and maturities of investments	15,978	14,967
Purchases of leasehold improvements and equipment	(1,375)	(2,553)
Net cash and cash equivalents used in investing activities	(3,140)	(3,194)
Financing activities		
Net proceeds from issuance of common stock	2,118	1,452
Taxes paid related to net share settlement	(814)	(1,985)
Payment of acquisition-related contingent consideration		(2)
Net cash and cash equivalents provided by (used in) financing activities	1,304	(535)
Effect of exchange rate changes on cash and cash equivalents	(40)	75
Net decrease in cash, cash equivalents and restricted cash	(6,210)	(7,670)
Cash, cash equivalents and restricted cash at beginning of period	20,941	28,645
Cash, cash equivalents and restricted cash at end of period	$ 14,731	$ 20,975

See accompanying notes to the condensed consolidated financial statements.

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Description of Business and Basis of Presentation

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

In the opinion of management, except for the changes below, the unaudited interim condensed consolidated financial statements of Intevac included herein have been prepared on a basis consistent with the December 30, 2017 audited consolidated financial statements and include all material adjustments, consisting of normal recurring adjustments, necessary to fairly present the information set forth therein. The Company adopted Accounting Standards Codification (ASC) 606, Revenue from Contracts with Customers, with a date of the initial application of December 31, 2017. As a result, the Company has changed its accounting policy for revenue recognition as detailed below. These unaudited interim condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in Intevac s Annual Report on Form 10-K for the fiscal year ended December 30, 2017 (2017 Form 10-K). Intevac s results of operations for the three and six months ended June 30, 2018 are not necessarily indicative of future operating results.

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

2. Recent Accounting Pronouncements

Recently Issued Accounting Standards Not Yet Adopted

In February 2018, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) 2018-02, Income Statement Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. ASU 2018-02 allows a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act (Tax Reform). The guidance states that because the adjustment of deferred taxes due to the reduction of the historical corporate income tax rate to the newly enacted corporate income tax rate is required to be included in income from continuing operations, the tax effects of items within accumulated other comprehensive income (stranded tax effects) do not reflect the appropriate tax rate. As stated within the guidance, the amendments in this update should be applied retrospectively to each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax

Reform is recognized. This update becomes effective in the first quarter of fiscal 2019. Early adoption is permitted. At this time, the Company is in the process of evaluating the impact of the provisions of ASU 2018-02 on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases. The new standard requires lessees to record assets and liabilities on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement.

Intevac leases certain facilities under non-cancelable operating leases that expire at various times up to March 2024 and has options to renew most leases, with rentals to be negotiated. Certain of Intevac s leases contain provisions for rental adjustments. Operating lease rentals are expensed on a straight-line basis over the life of the lease beginning on the date we take possession of the property. At lease inception, we determine the lease term by assuming the exercise of those renewal options that are reasonably assured. The exercise of lease renewal options is at our sole discretion. The lease term is used to determine whether a lease is capital or operating and is used to calculate straight-line rent expense. Additionally, the depreciable life of leasehold improvements is limited by the expected lease term.

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

We plan to adopt the standard as of December 30, 2018, the beginning of fiscal 2019. We will elect the package of practical expedients permitted under the transition guidance within the new standard, which, among other things, allows us to carry forward the historical lease classification. In addition, we are electing the hindsight practical expedient to determine the reasonably certain lease term for existing leases. We will make an accounting policy election to keep leases with an initial term of 12 months or less off of the balance sheet. We will recognize those lease payments in the consolidated statements of operations on a straight-line basis over the lease term. We also plan to elect the proposed practical expedient that will allow us to apply the new lease guidance at its effective date, December 30, 2018, without adjusting the comparative financial statements.

We are currently completing the assessment phase of the implementation project and are finalizing our review of the impact of adoption. We expect the adoption of these accounting changes will materially increase our assets and liabilities, but will not have a material impact on our results of operations, equity, or cash flows.

Adoption of New Accounting Standard

On December 31, 2017, we adopted the new accounting standard ASC 606, Revenue from Contracts with Customers and all the related amendments (new revenue standard) to all contracts using the modified retrospective method. We recognized the cumulative effect of initially applying the new revenue standard as an adjustment to the opening balance of the accumulated deficit. The comparative information has not been restated and continues to be reported under the accounting standards in effect for those periods. We expect the impact of the adoption of the new standard to be immaterial to our net income on an ongoing basis.

In our TFE segment, a majority of our equipment sales revenue continues to be recognized when products are shipped from our manufacturing facilities. Revenue recognition for our equipment sales arrangements, which includes systems, technology upgrades, service and spare parts, remains materially consistent with our historical practice.

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

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

The majority of our contracts in our Photonics segment have a single performance obligation as the promise to transfer the individual goods or services is not separately identifiable from other promises in the contracts and, therefore, not distinct. Some of our contracts have multiple performance obligations, most commonly due to the contract covering multiple phases of the product lifecycle (development and production). For contracts with multiple performance obligations, we allocate the contract s transaction price to each performance obligation using our best estimate of the standalone selling price of each distinct good or service in the contract. The primary method used to estimate standalone selling price is the expected cost plus a margin approach, under which we forecast our expected costs of satisfying a performance obligation and then add an appropriate margin for that distinct good or service.

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Under the new revenue standard, in our Photonics segment, we recognize revenue for homogenous manufactured military products sold to the U.S. government and its contractors over time under the units-of-delivery method because of the continuous transfer of control to the customer. Intevac believes that the units-of-delivery method is an appropriate measure for measuring progress for the manufactured units as an equal amount of value is individually transferred to the customer upon delivery. The Company previously recognized revenue for substantially all manufactured military products sold to the U.S. government and its contractors when the customers took delivery of the products, which was generally upon shipment.

The nature of our contracts in our Photonics segment gives rise to several types of variable consideration including tiered pricing. Allocation of contract revenues among Photonics military products, and the timing of the recognition of those revenues, is impacted by agreements with tiered pricing or variable rate structures. We include variable consideration in the estimated transaction price when there is a basis to reasonably estimate the amount of the consideration. These estimates are based on historical experience, anticipated performance and our best judgment at the time. Because of our certainty in estimating these amounts, they are included in the transaction price of our contracts and the associated remaining performance obligations.

Accounting for CPFF and FFP contracts and programs involves the use of various techniques to estimate total contract revenue and costs. For these contracts, we estimate the profit on a contract as the difference between the total estimated revenue and expected costs to complete a contract and recognize that profit over the life of the contract. Contract estimates are based on various assumptions to project the outcome of future events. These assumptions include the complexity of the work to be performed; the cost and availability of materials; the performance of subcontractors; and the availability and timing of funding from the customer.

As a significant change in one or more of these estimates could affect the profitability of our contracts, we review and update our contract-related estimates regularly. We recognize adjustments in estimated profit on contracts under the cumulative catch-up method. Under this method, the impact of the adjustment on profit recorded to date on a contract is recognized in the period the adjustment is identified. Revenue and profit in future periods of contract performance are recognized using the adjusted estimate. If at any time the estimate of contract profitability indicates an anticipated loss on the contract, we recognize the total loss in the quarter it is identified.

We recorded a cumulative effect adjustment to the beginning balance of our consolidated December 31, 2017 balance sheet for the impact of the allocation and the timing of the recognition of revenues for an open Photonics military product agreement with a tiered pricing structure. This change will also result in increased revenue in subsequent periods from this agreement. The cumulative effect of the changes made to our consolidated December 31, 2017 balance sheet for the adoption of the new revenue standard were as follows (in thousands):

	Balance at December 30,	Adjustments Due to	Balance at December 31,

	2017	ASC 606	2017
Other accrued liabilities	$ 7,688	$ 1,634	$ 9,322
Accumulated deficit	$ (66,881)	$ (1,634)	$ (68,515)

In accordance with the new revenue standard requirements, the disclosure of the impact of adoption on select condensed consolidated statement of operations line items was as follows (in thousands):

	Three Months Ended June 30, 2018			Six Months Ended June 30, 2018		
	As Reported	Balances without ASC 606	Effect of Change	As Reported	Balances without ASC 606	Effect of Change
	(In thousands)					
Systems and components revenues	$ 23,335	$ 23,235	$ 100	$ 38,807	$ 38,578	$ 229
Total net revenues	$ 26,098	$ 25,998	$ 100	$ 44,072	$ 43,843	$ 229
Gross profit	$ 9,761	$ 9,661	$ 100	$ 14,636	$ 14,407	$ 229
Income (loss) from operations	$ 65	$ (35)	$ 100	$ (5,056)	$ (5,285)	$ 229
Income (loss) before income taxes	$ 198	$ 98	$ 100	$ (4,778)	$ (5,007)	$ 229
Net loss	$ (167)	$ (267)	$ 100	$ (5,303)	$ (5,532)	$ 229

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

In accordance with the new revenue standard requirements, the disclosure of the impact of adoption on select condensed consolidated balance sheet line items was as follows (in thousands):

	As of June 30, 2018		
	As Reported	Balances without ASC 606	Effect of Change
Other accrued liabilities	$ 10,538	$ 9,133	$ 1,405
Total current liabilities	$ 31,133	$ 29,728	$ 1,405
Accumulated deficit	$ (73,818)	$ (72,413)	$ (1,405)
Total stockholders equity	$ 78,586	$ 79,991	$ (1,405)

3. Revenue

The following tables represent a disaggregation of revenue from contracts with customers for the three and six months ended June 30, 2018 and July 1, 2017 along with the reportable segment for each category. As noted above, the prior period amounts have not been adjusted under the modified retrospective method.

Major Products and Service Lines

TFE	Three Months Ended June 30, 2018			(In thousands)	Three Months Ended July 1, 2017			
	HDD	DCP	PV	Total	HDD	DCP	PV	Total
Systems, upgrades and spare parts	$ 19,221	$	$ 1	$ 19,222	$ 11,975	$ 351	$ 8,996	$ 21,322
Field service	1,625		1	1,626	1,104			1,104
Total TFE net revenues	$ 20,846	$	$ 2	$ 20,848	$ 13,079	$ 351	$ 8,996	$ 22,426

	Six Months Ended June 30, 2018				Six Months Ended July 1, 2017			
	(In thousands)							
	HDD	DCP	PV	Total	HDD	DCP	PV	Total
Systems, upgrades and spare parts	$ 29,614	$ 1	$ 3	$ 29,618	$ 19,256	$ 13,138	$ 8,996	$ 41,390
Field service	3,980		39	4,019	2,520			2,520
Total TFE net revenues	$ 33,594	$ 1	$ 42	$ 33,637	$ 21,776	$ 13,138	$ 8,996	$ 43,910

Photonics	Three Months Ended June 30, 2018	Three Months Ended July 1, 2017	Six Months Ended June 30, 2018	Six Months Ended July 1, 2017
	(In thousands)			
Products:				
Military products	$ 2,145	$ 7,213	$ 4,399	$ 13,920
Commercial products	54	16	54	62
Repair and other services	288	208	717	394
Total Photonics product net revenues	2,487	7,437	5,170	14,376
Technology development:				
CPFF	2,220	187	4,010	1,068
FFP	540	913	1,232	1,997
Time and materials	3		23	
Total technology development net revenues	2,763	1,100	5,265	3,065
Total Photonics net revenues	$ 5,250	$ 8,537	$ 10,435	$ 17,441

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Primary Geographical Markets

	Three Months Ended June 30, 2018			Three Months Ended July 1, 2017		
	(In thousands)					
	TFE	Photonics	Total	TFE	Photonics	Total
United States	$ 1,351	$ 4,998	$ 6,349	$ 2,050	$ 8,333	$ 10,383
Asia	19,497	31	19,528	20,376	8	20,384
Europe		187	187		196	196
Rest of World		34	34			
Total net revenues	$ 20,848	$ 5,250	$ 26,098	$ 22,426	$ 8,537	$ 30,963

	Six Months Ended June 30, 2018			Six Months Ended July 1, 2017		
	(In thousands)					
	TFE	Photonics	Total	TFE	Photonics	Total
United States	$ 3,262	$ 9,760	$ 13,022	$ 2,663	$ 16,922	$ 19,585
Asia	30,375	31	30,406	41,247	8	41,255
Europe		480	480		511	511
Rest of World		164	164			
Total net revenues	$ 33,637	$ 10,435	$ 44,072	$ 43,910	$ 17,441	$ 61,351

Timing of Revenue Recognition

	Three Months Ended June 30, 2018			Six Months Ended June 30, 2018		
	(In thousands)					
	TFE	Photonics	Total	TFE	Photonics	Total
Products transferred at a point in time	$ 20,848	$ 288	$ 21,136	$ 33,637	$ 717	$ 34,354
Products and services transferred over time		4,962	4,962		9,718	9,718
	$ 20,848	$ 5,250	$ 26,098	$ 33,637	$ 10,435	$ 44,072

The following table reflects the changes in our contract assets, which we classify as accounts receivable, unbilled or retainage, and our contract liabilities, which we classify as deferred revenue and customer advances, for the six months ended June 30, 2018:

	June 30, 2018	December 30, 2017	Six Months Change
		(In thousands)	
TFE:			
Contract assets:			
Accounts receivable, unbilled	$ 529	$ 1,368	$ (839)
Contract liabilities:			
Deferred revenue	$ 5,246	$ 5,190	$ 56
Customer advances	9,672	10,204	(532)
	$ 14,918	$ 15,394	$ (476)
Photonics:			
Contract assets:			
Accounts receivable, unbilled	$ 1,523	$ 1,346	$ 177
Retainage	294	281	13
	$ 1,817	$ 1,627	$ 190
Contract liabilities:			
Deferred revenue	$ 1,443	$ 97	$ 1,346
Customer advances	880	822	58
	$ 2,323	$ 919	$ 1,404

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Accounts receivable, unbilled in our TFE segment represents a contract asset for revenue that has been recognized in advance of billing the customer. For our system and certain upgrade sales, our TFE customers generally pay in three installments, with a portion of the system price billed upon receipt of an order, a portion of the price billed upon shipment, and the balance of the price due upon completion of installation and acceptance of the system at the customer s factory. Accounts receivable, unbilled in our TFE segment generally represents the balance of the system price that is due upon completion of installation and acceptance less the amount that has been deferred as revenue for the performance of the installation tasks. During the six months ended June 30, 2018, contract assets in our TFE segment decreased by $839,000 primarily due to the final billing on four systems that were pending acceptance as of December 30, 2017 that completed installation and were accepted by the customer, offset by the accrual of revenue for an additional two systems delivered during the first half of fiscal 2018 that were pending acceptance as of June 30, 2018.

Customer advances in our TFE segment generally represent amounts billed to the customer prior to transferring goods which represents a contract liability. We have elected to use the practical expedient to disregard the effect of the time value of money in a significant financing component when its payment terms are less than one year. These contract advances are liquidated when revenue is recognized. Deferred revenue in our TFE segment generally represents amounts billed to a customer for completed systems at the customer site that are undergoing installation and acceptance testing where transfer of control has not yet occurred as we do not yet have a demonstrated history of meeting the acceptance criteria upon the customer s receipt of product and represents a contract liability. During the six months ended June 30, 2018, we recognized revenue in our TFE segment of $6.6 million and $69,000 that was included in customer advances and deferred revenue, respectively, at the beginning of the period.

Accounts receivable, unbilled in our Photonics segment represents a contract asset for revenue that has been recognized in advance of billing the customer, which is common for contracts in the defense industry. In our Photonics segment, amounts are billed as work progresses in accordance with agreed-upon contractual terms, either at periodic intervals (e.g., monthly) or upon achievement of contractual milestones. Generally, billing occurs subsequent to revenue recognition, resulting in contract assets. Our contracts with the U.S. government may also contain retainage provisions. Retainage represents a contract asset for the portion of the contract price earned by us for work performed, but held for payment by the U.S. government as a form of security until satisfactory completion of the contract. The retainage is billable upon completion of the contract performance and approval of final indirect expense rates by the government. During the six months ended June 30, 2018, contract assets in our Photonics segment increased by $190,000 primarily due to the accrual of revenue for incurred costs under CPFF contracts.

Customer advances in our Photonics segment generally represent deposits from customers upon contract execution and upon achievement of contractual milestones which represents a contract liability. These deposits are liquidated when revenue is recognized. Deferred revenue in our Photonics segment includes $1.4 million deferred for the impact of the allocation and the timing of the recognition of revenues for a military product agreement with a tiered pricing structure. Deferred revenue in our Photonics segment also includes incurred costs under CPFF contracts pending approval of final indirect expense rates by the government and represents a contract liability. During the six months ended June 30, 2018, we recognized revenue in our Photonics segment of $206,000 and $229,000 that was included in customer advances and deferred revenue, respectively, at the beginning of the period.

On June 30, 2018 we had $64.6 million of remaining performance obligations, which we also refer to as total backlog. Backlog at June 30, 2018 consisted of $54.2 million of TFE backlog and $10.3 million of Photonics backlog. We expect to recognize approximately 72.8% of our remaining performance obligations as revenue in 2018, and the balance in 2019.

4. Inventories

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

	June 30, 2018	December 30, 2017
	(In thousands)	
Raw materials	$ 16,106	$ 19,881
Work-in-progress	12,622	9,433
Finished goods	4,308	4,478
	$ 33,036	$ 33,792

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

5. Equity-Based Compensation

At June 30, 2018, Intevac had equity-based awards outstanding under the 2012 Equity Incentive Plan and the 2004 Equity Incentive Plan (together, the Plans) and the 2003 Employee Stock Purchase Plan (the ESPP). Intevac s stockholders approved all of these plans. The Plans permit the grant of incentive or non-statutory stock options, restricted stock, stock appreciation rights, restricted stock units (RSUs) and performance shares.

The ESPP provides that eligible employees may purchase Intevac s common stock through payroll deductions at a price equal to 85% of the lower of the fair market value at the entry date of the applicable offering period or at the end of each applicable purchase interval. Offering periods are generally two years in length, and consist of a series of six-month purchase intervals. Eligible employees may join the ESPP at the beginning of any six-month purchase interval. Under the terms of the ESPP, employees can choose to have up to 15% of their base earnings withheld to purchase Intevac common stock.

Compensation Expense

The effect of recording equity-based compensation for the three and six months ended July 30, 2018 and July 1, 2017 was as follows:

	Three Months Ended		Six Months Ended	
	June 30, 2018	July 1, 2017	June 30, 2018	July 1, 2017
	(In thousands)			
Equity-based compensation by type of award:				
Stock options	$ 216	$ 202	$ 350	$ 458
RSUs	230	495	636	1,212
Employee stock purchase plan	339	90	616	194
Total equity-based compensation	$ 785	$ 787	$ 1,602	$ 1,864

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

$1.1 million increase to the accumulated deficit as of January 1, 2017.

Stock Options and ESPP

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

Option activity as of June 30, 2018 and changes during the six months ended June 30, 2018 were as follows:

	Shares	Weighted Average Exercise Price	
Options outstanding at December 30, 2017	2,925,861	$	7.62
Options granted	384,875	$	5.15
Options cancelled and forfeited	(667,384)	$	9.60
Options exercised	(256,889)	$	4.89
Options outstanding at June 30, 2018	2,386,463	$	6.96
Options exercisable at June 30, 2018	1,643,069	$	6.84

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Intevac issued 216,988 shares under the ESPP during the six months ended June 30, 2018.

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

	Three Months Ended		Six Months Ended	
	June 30, 2018	**July 1, 2017**	**June 30, 2018**	**July 1, 2017**
Stock Options:				
Weighted-average fair value of grants per share	$ 1.87	$ 4.64	$ 1.99	$ 4.63
Expected volatility	44.50%	41.79%	43.80%	40.43%
Risk free interest rate	2.58%	1.87%	2.58%	1.77%
Expected term of options (in years)	4.5	4.4	4.5	4.1
Dividend yield	None	None	None	None

	Six Months Ended	
	June 30, 2018	**July 1, 2017**
Stock Purchase Rights:		
Weighted-average fair value of grants per share	$ 2.36	$ 2.74
Expected volatility	46.60%	40.66%
Risk free interest rate	1.82%	1.14%
Expected term of purchase rights (in years)	1.25	0.74
Dividend yield	None	None

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

RSUs

A summary of the RSU activity is as follows:

	Shares	Weighted Average Grant Date Fair Value
Non-vested RSUs at December 30, 2017	769,451	$ 7.84
Granted	196,291	$ 5.07
Vested	(422,236)	$ 7.12
Cancelled and forfeited	(90,880)	$ 8.92
Non-vested RSUs at June 30, 2018	452,626	$ 7.10

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

INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

In fiscal 2016, the annual bonus for certain participants in the Company s annual incentive plan was settled with RSUs with one-year vesting. The bonus accrual was classified as a liability until the number of shares was determined on the date the awards were granted, at which time the Company classified the awards into equity. In February 2017, the annual 2016 bonus for certain participants was settled with RSUs with one-year vesting. 33 participants were granted stock awards to receive an aggregate of 134,000 shares of common stock with a weighted average grant date fair value of $9.63 per share. The Company recorded equity-based compensation expense related to the annual incentive plans of $102,000 for the six months ended July 1, 2017.

6. Purchased Intangible Assets

Details of finite-lived intangible assets by segment as of June 30, 2018, are as follows.

	June 30, 2018		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
		(In thousands)	
TFE	$ 7,172	$ (6,077)	$ 1,095
Photonics	1,215	(1,114)	101
	$ 8,387	$ (7,191)	$ 1,196

Total amortization expense of finite-lived intangibles for the three and six months ended June 30, 2018 was $154,000 and $307,000.

As of June 30, 2018, future amortization expense is expected to be as follows.

(In thousands)	
2018	$ 307
2019	615
2020	274
	$ 1,196

7. Acquisition-Related Contingent Consideration

In connection with the acquisition of Solar Implant Technologies, Inc. (SIT), Intevac agreed to pay to the selling shareholders in cash a revenue earnout on Intevac s net revenue from commercial sales of certain products over a specified period up to an aggregate of $9.0 million. Intevac estimated the fair value of this contingent consideration on June 30, 2018 based on forecasted revenues reflecting Intevac s own assumptions concerning future revenue from such products. As of June 30, 2018, payments made associated with the revenue earnout obligation have not been significant.

The fair value measurement of contingent consideration is based on significant inputs not observed in the market and thus represents a Level 3 measurement. Any change in fair value of the contingent consideration subsequent to the acquisition date is recognized in operating income within the condensed consolidated statements of operations. The following table represents a reconciliation of the change in the fair value measurement of the contingent consideration liability for the three and six months ended June 30, 2018 and July 1, 2017:

	Three Months Ended		**Six Months Ended**	
	June 30, 2018	**July 1, 2017**	**June 30, 2018**	**July 1, 2017**
	(In thousands)			
Opening balance	$ 361	$ 837	$ 362	$ 759
Changes in fair value	9	22	8	102
Cash payments made				(2)
Closing balance	$ 370	$ 859	$ 370	$ 859

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table displays the balance sheet classification of the contingent consideration liability account at June 30, 2018 and at December 30, 2017:

	June 30, 2018	December 30, 2017
	(In thousands)	
Other accrued liabilities	$ 370	$ 103
Other long-term liabilities		259
Total acquisition-related contingent consideration	$ 370	$ 362

The following table represents the quantitative range of the significant unobservable inputs used in the calculation of fair value of the contingent consideration liability as of June 30, 2018. Significant increases (or decreases) in any of these inputs in isolation would result in a significantly lower (or higher) fair value measurement.

	Quantitative Information about Level 3 Fair Value Measurements at June 30, 2018			
	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
	(In thousands, except for percentages)			
Revenue Earnout	$ 370	Discounted cash flow	Weighted average cost of capital	12.1%

8. Warranty

Intevac provides for the estimated cost of warranty when revenue is recognized. Intevac s warranty is per contract terms and for its HDD, DCP and solar cell manufacturing systems the warranty typically ranges between 12 and 24 months from customer acceptance. During this warranty period any defective non-consumable parts are replaced and installed at no charge to the customer. Intevac uses estimated repair or replacement costs along with its historical warranty experience to determine its warranty obligation. The provision for the estimated future costs of warranty is based upon historical cost and product performance experience. Intevac exercises judgment in determining the underlying estimates.

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

The following table displays the activity in the warranty provision account for the three and six months ended June 30, 2018 and July 1, 2017:

	Three Months Ended		Six Months Ended	
	June 30, 2018	July 1, 2017	June 30, 2018	July 1, 2017
	(In thousands)			
Opening balance	$ 866	$ 1,106	$ 994	$ 1,007
Expenditures incurred under warranties	(182)	(138)	(418)	(280)
Accruals for product warranties issued during the reporting period	174	256	278	506
Adjustments to previously existing warranty accruals	53	(4)	57	(13)
Closing balance	$ 911	$ 1,220	$ 911	$ 1,220

The following table displays the balance sheet classification of the warranty provision account at June 30, 2018 and at December 30, 2017:

	June 30, 2018	December 30, 2017
	(In thousands)	
Other accrued liabilities	$ 685	$ 757
Other long-term liabilities	226	237
Total warranty provision	$ 911	$ 994

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INTEVAC, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

9. Guarantees

Officer and Director Indemnifications

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

Other Indemnifications

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

Letters of Credit

As of June 30, 2018, we had letters of credit and bank guarantees outstanding totaling $1.0 million, including the standby letter of credit outstanding under the Santa Clara, California facility lease and various other guarantees with our bank. These letters of credit and bank guarantees are collateralized by $1.0 million of restricted cash.

10. Cash, Cash Equivalents and Investments

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

	June 30, 2018			
	Amortized Cost	Unrealized Holding Gains	Unrealized Holding Losses	Fair Value
	(In thousands)			
Cash and cash equivalents:				

Cash	$ 8,563	$	$	$ 8,563
Money market funds	5,168			5,168
Total cash and cash equivalents	$ 13,731	$	$	$ 13,731
Short-term investments:				
Certificates of deposit	$ 7,145	$ 2	$ 2	$ 7,145
Commercial paper	493			493
Corporate bonds and medium-term notes	6,060		25	6,035