

ADVANCED ENERGY INDUSTRIES INC

Form 10-Q

November 09, 2007

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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 September 30, 2007.**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

**Commission file number: 000-26966**

**ADVANCED ENERGY INDUSTRIES, INC.**

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

**Delaware**

**84-0846841**

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

**1625 Sharp Point Drive, Fort Collins, CO**

**80525**

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: **(970) 221-4670**

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

As of November 6, 2007, there were 45,273,511 shares of the registrant's Common Stock, par value \$0.001 per share, outstanding.

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Certification of CFO Pursuant to Section 302

Certification of CEO Pursuant to Section 906

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**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****ADVANCED ENERGY INDUSTRIES, INC. AND SUBSIDIARIES****Condensed Consolidated Balance Sheets (Unaudited)****(In thousands)**

|  | <b>September<br/>30,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|--|-----------------------------------|----------------------------------|
| <b>ASSETS</b>                              |                                   |                                  |
| <b>CURRENT ASSETS:</b>                     |                                   |                                  |
| Cash and cash equivalents                  | \$ 76,878                         | \$ 58,240                        |
| Marketable securities                      | 108,154                           | 85,978                           |
| Trade accounts receivable, net             | 69,704                            | 71,956                           |
| Inventories                                | 57,388                            | 52,778                           |
| Deferred income taxes                      | 21,740                            | 24,434                           |
| Assets held for sale                       | 1,345                             |                                  |
| Other current assets                       | 5,877                             | 7,341                            |
| Total current assets                       | 341,086                           | 300,727                          |
| <b>PROPERTY AND EQUIPMENT, NET</b>         | <b>30,677</b>                     | <b>33,571</b>                    |
| <b>OTHER ASSETS:</b>                       |                                   |                                  |
| Deposits and other                         | 8,296                             | 2,640                            |
| Goodwill                                   | 60,587                            | 58,679                           |
| Other intangible assets, net               | 6,426                             | 6,905                            |
| Customer service equipment, net            | 939                               | 832                              |
| Deferred income tax assets, net            | 4,222                             | 8,549                            |
| Total assets                               | \$ 452,233                        | \$ 411,903                       |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b> |                                   |                                  |
| <b>CURRENT LIABILITIES:</b>                |                                   |                                  |
| Trade accounts payable                     | \$ 15,578                         | \$ 16,310                        |
| Taxes payable                              | 4,453                             | 7,741                            |
| Accrued payroll and employee benefits      | 11,350                            | 16,899                           |
| Accrued warranty expense                   | 9,194                             | 7,845                            |
| Accrued restructuring charges              | 142                               |                                  |
| Capital lease obligations, current portion | 128                               | 131                              |
| Other current liabilities                  | 3,221                             | 4,003                            |
| Total current liabilities                  | 44,066                            | 52,929                           |
| <b>LONG-TERM LIABILITIES:</b>              |                                   |                                  |
| Capital leases, net of current portion     | 133                               | 198                              |
| Deferred income tax liabilities, net       | 1,787                             | 1,971                            |

|  |            |            |
|--|------------|------------|
| Other long-term liabilities                | 7,931      | 1,015      |
| Total long-term liabilities                | 9,851      | 3,184      |
| Total liabilities                          | 53,917     | 56,113     |
| Commitments and contingencies (Note 11)    |            |            |
| STOCKHOLDERS' EQUITY                       | 398,316    | 355,790    |
| Total liabilities and stockholders' equity | \$ 452,233 | \$ 411,903 |

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed consolidated statements.

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**ADVANCED ENERGY INDUSTRIES, INC. AND SUBSIDIARIES**  
**Condensed Consolidated Statements of Income (Unaudited)**  
(In thousands, except per share amounts)

|  | <b>Three Months Ended September</b> |             |
|--|-------------------------------------|-------------|
|  | <b>30,</b>                          |             |
|  | <b>2007</b>                         | <b>2006</b> |
| SALES  | \$ 90,491                           | \$ 107,688  |
| COST OF SALES                                      | 53,765                              | 60,674      |
| Gross profit                                       | 36,726                              | 47,014      |
| OPERATING EXPENSES:                                |                                     |             |
| Research and development                           | 12,937                              | 11,345      |
| Selling, general and administrative                | 15,738                              | 17,309      |
| Restructuring and asset impairment charges         | 556                                 | 31          |
| Total operating expenses                           | 29,231                              | 28,685      |
| INCOME FROM OPERATIONS                             | 7,495                               | 18,329      |
| OTHER INCOME                                       | 307                                 | 1,044       |
| Income before income taxes                         | 7,802                               | 19,373      |
| PROVISION FOR INCOME TAXES                         | 1,947                               | 2,381       |
| NET INCOME   | \$ 5,855                            | \$ 16,992   |
| BASIC EARNINGS PER SHARE                           | \$ 0.13                             | \$ 0.38     |
| DILUTED EARNINGS PER SHARE                         | \$ 0.13                             | \$ 0.38     |
| BASIC WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING   | 45,248                              | 44,762      |
| DILUTED WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING | 45,761                              | 45,166      |

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed consolidated statements.



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**ADVANCED ENERGY INDUSTRIES, INC. AND SUBSIDIARIES**  
**Condensed Consolidated Statements of Income (Unaudited)**  
(In thousands, except per share amounts)

|  | <b>Nine Months Ended September</b> |             |
|--|------------------------------------|-------------|
|  | <b>30,</b>                         |             |
|  | <b>2007</b>                        | <b>2006</b> |
| SALES  | \$ 300,863                         | \$ 306,209  |
| COST OF SALES                                      | 170,873                            | 175,885     |
| Gross profit                                       | 129,990                            | 130,324     |
| OPERATING EXPENSES:                                |                                    |             |
| Research and development                           | 37,883                             | 32,608      |
| Selling, general and administrative                | 46,896                             | 46,885      |
| Restructuring and asset impairment charges         | 3,505                              | 91          |
| Total operating expenses                           | 88,284                             | 79,584      |
| INCOME FROM OPERATIONS                             | 41,706                             | 50,740      |
| OTHER INCOME                                       | 3,367                              | 3,755       |
| Income before income taxes                         | 45,073                             | 54,495      |
| PROVISION FOR INCOME TAXES                         | 14,879                             | 6,580       |
| NET INCOME   | \$ 30,194                          | \$ 47,915   |
| NET INCOME PER BASIC SHARE                         | \$ 0.67                            | \$ 1.07     |
| NET INCOME PER DILUTED SHARE                       | \$ 0.66                            | \$ 1.06     |
| BASIC WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING   | 45,117                             | 44,679      |
| DILUTED WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING | 45,696                             | 45,168      |

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed consolidated statements.





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**ADVANCED ENERGY INDUSTRIES, INC. AND SUBSIDIARIES**  
**Condensed Consolidated Statements of Cash Flows (Unaudited)**  
(In thousands)

|  | Nine Months Ended September<br>30, |           |
|--|------------------------------------|-----------|
|  | 2007                               | 2006      |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                     |                                    |           |
| Net income   | \$ 30,194                          | \$ 47,915 |
| Adjustments to reconcile net income to net cash provided by operating activities |                                    |           |
| Depreciation and amortization  | 9,188                              | 11,960    |
| Stock-based compensation   | 2,807                              | 2,224     |
| Provision for deferred income taxes  | 6,848                              | 95        |
| Restructuring and asset impairment charges                                       | 3,505                              |           |
| Loss on disposal of property and equipment                                       |                                    | 154       |
| Gain on sale of marketable securities  | (32)                               | (1,670)   |
| Changes in operating assets and liabilities                                      |                                    |           |
| Accounts receivable, net   | 5,324                              | (5,528)   |
| Inventories  | (4,133)                            | (1,443)   |
| Other current assets   | (1,482)                            | 1,113     |
| Trade accounts payable   | (843)                              | (2,552)   |
| Other current liabilities and accrued expenses                                   | (5,274)                            | 5,430     |
| Income taxes payable/receivable, net   | (3,142)                            | 1,488     |
| Non-current assets   | (1,923)                            | (214)     |
| Non-current liabilities  | (772)                              | (1,214)   |
| Net cash provided by operating activities  | 40,265                             | 57,758    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                     |                                    |           |
| Purchase of marketable securities  | (110,585)                          | (57,300)  |
| Proceeds from sale of marketable securities                                      | 88,523                             | 1,992     |
| Proceeds from sales of assets  |                                    | 539       |
| Purchase of property and equipment   | (5,716)                            | (3,000)   |
| Net cash used in investing activities  | (27,778)                           | (57,769)  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                     |                                    |           |
| Payments on senior borrowings and capital lease obligations                      | (77)                               | (3,511)   |
| Proceeds from common stock transactions  | 4,126                              | 2,761     |
| Net cash provided (used in) by financing activities                              | 4,049                              | (750)     |
| EFFECT OF CURRENCY TRANSLATION ON CASH   | 2,102                              | 676       |

|  |           |           |
|--|-----------|-----------|
| INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 18,638    | (85)      |
| CASH AND CASH EQUIVALENTS, beginning of period   | 58,240    | 52,874    |
| CASH AND CASH EQUIVALENTS, end of period         | \$ 76,878 | \$ 52,789 |

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

|                            |           |          |
|----------------------------|-----------|----------|
| Cash paid for interest     | \$ 41     | \$ 316   |
| Cash paid for income taxes | \$ 11,643 | \$ 4,907 |

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed consolidated statements.

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**ADVANCED ENERGY INDUSTRIES, INC. AND SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**

**(1) BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

In the opinion of management, the accompanying unaudited condensed consolidated balance sheets, statements of income and cash flows contain all adjustments, consisting of normal, recurring adjustments necessary to present fairly the financial position of Advanced Energy Industries, Inc., a Delaware corporation, and its wholly owned subsidiaries (the Company) at September 30, 2007 and December 31, 2006, and the results of their operations for the three- and nine-month periods ended September 30, 2007 and 2006 and cash flows for the nine-month periods ended September 30, 2007 and 2006.

The unaudited condensed consolidated financial statements presented herein have been prepared in accordance with the instructions to Form 10-Q and do not include all the information and note disclosures required by accounting principles generally accepted in the United States. The condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

*ESTIMATES AND ASSUMPTIONS* The preparation of the Company's condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States requires the Company's 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 revenue and expenses during the reporting period. Significant estimates are used when establishing allowances for doubtful accounts, determining useful lives for depreciation and amortization, assessing the need for impairment charges, establishing warranty reserves, establishing the fair value and forfeiture rate of stock-based compensation, accounting for income taxes, and assessing excess and obsolete inventory and various other items. The Company evaluates these estimates and judgments on an ongoing basis and bases its estimates on historical experience, current conditions and various other assumptions that are believed to be reasonable under the circumstances. The results of these estimates form the basis for making judgments about the carrying values of assets and liabilities as well as identifying and assessing the accounting treatment with respect to commitments and contingencies. Actual results may differ from these estimates under different assumptions or conditions.

*NEW ACCOUNTING PRONOUNCEMENTS* In May 2007, the FASB issued Staff Position (FSP) No. FIN 48-1, Definition of *Settlement* in FASB Interpretation No. 48, which amends FIN 48 and provides guidance concerning how an entity should determine whether a tax position is effectively, rather than the previously required ultimately, settled for the purpose of recognizing previously unrecognized tax benefits. In addition, FSP No. FIN 48-1 provides guidance on determining whether a tax position has been effectively settled. FSP No. FIN 48-1 became effective on January 1, 2007. Companies that have not applied FSP No. FIN 48-1 must retroactively apply the provisions to January 1, 2007. The Company has adopted FSP No. FIN 48-1 and no retroactive adjustments are necessary.

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In September 2006, the FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 establishes a common definition for fair value to be applied to generally accepted accounting principles requiring use of fair value, establishes a framework for measuring fair value, and expands disclosure about such fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact of SFAS No. 157 and does not expect the adoption to have an impact on its consolidated financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159). SFAS No. 159 permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact of SFAS No. 159 and does not expect the adoption to have an impact on its consolidated financial position and results of operations.

*REVENUE RECOGNITION* The Company s standard shipping term is freight on board ( FOB ) shipping point, for which revenue is recognized upon shipment of its products, at which time title passes to the customer, the price is fixed and collectibility is reasonably assured. For certain customers, the Company has FOB destination terms, for which revenue is recognized upon receipt of the products by the customer, at which time title passes to the customer, the price is fixed and collectibility is reasonably assured. Revenues from contracts that contain customer acceptance provisions are deferred until customer acceptance occurs. Generally, the Company does not have obligations to its customers after its products are shipped under FOB shipping point terms, after its products are received by customers under FOB destination terms, and after the products are accepted by customers under contractual acceptance provisions, other than pursuant to warranty obligations. In limited instances, the Company provides installation of its products. In accordance with Emerging Issues Task Force Issue 00-21 Accounting for Revenue Arrangements With Multiple Deliverables , the Company allocates revenue based on the fair value of the delivered item, generally the product, and the undelivered item, installation, based on their respective fair values. Revenue related to the undelivered item is deferred until the services have been completed.

In certain instances, the Company requires its customers to pay for a portion or all of their purchases prior to the Company manufacturing or shipping these products. Cash payments received prior to shipment are recorded as customer deposits and deferred revenue in the condensed consolidated balance sheets, and then recognized as revenue as appropriate based upon delivery of the products. The Company does not offer price protection to its customers or allow returns, unless covered by its normal policy for repair of defective products.

*WARRANTY RESERVE POLICY* The Company generally warrants its products for periods typically ranging from 12 to 24 months after shipment. Estimated warranty costs are recorded at the time of sale of the related product, and are recorded within cost of sales in the condensed consolidated statements of income. The Company estimates the anticipated costs of repairing products under warranty based on warranties claim experience as well as the historical cost of the repairs and expected failure rates. The assumptions used to estimate warranty accruals are reevaluated periodically in light of actual experience and, when appropriate, the accruals are adjusted. The Company s determination of the appropriate level of warranty accrual is subjective and based on estimates.

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The following table summarizes the activity in the Company's warranty reserve during the 2007 and 2006 periods:

| <b>(In thousands)</b>          | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|--------------------------------|---------------------------|-------------|--------------------------|-------------|
|                                | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|                                | <b>2007</b>               | <b>2006</b> | <b>2007</b>              | <b>2006</b> |
| Balance at beginning of period | \$ 7,435                  | \$ 6,443    | \$ 7,845                 | \$ 6,313    |
| Provisions                     | 5,000                     | 2,611       | 9,225                    | 6,858       |
| Usages                         | (3,241)                   | (2,490)     | (7,876)                  | (6,607)     |
| Balance at end of period       | \$ 9,194                  | \$ 6,564    | \$ 9,194                 | \$ 6,564    |

**EXCESS AND OBSOLETE INVENTORY** Inventory is written down or written off when it is deemed excess or becomes obsolete, which generally occurs due to engineering changes to a product or discontinuance of a product line. Judgment by management is necessary in estimating the net realizable value of inventory based primarily upon forecasts of product demand. Charges for excess and obsolete inventory are recorded within cost of sales or research and development in the condensed consolidated statement of income per Company policy.

**COMMITMENTS AND CONTINGENCIES** From time to time, the Company is involved in disputes and legal actions arising in the normal course of its business. The Company accrues loss contingencies in connection with its commitments and contingencies, including litigation, when it is probable that a loss has occurred or may occur and the amount of the loss can be reasonably estimated.

**GOODWILL AND OTHER INTANGIBLE ASSETS** Goodwill represents the excess of the cost over the fair market value of net tangible and identifiable intangible assets of acquired businesses.

Goodwill is subject to periodic (at least annual) tests for impairment. Impairment testing is performed in two steps: (i) goodwill is assessed for potential impairment by comparing the fair value of the Company's reporting unit with the carrying value, and (ii) if potential impairment is indicated because the reporting unit's fair value is less than its carrying amount, the amount of impairment loss is measured by comparing the implied fair value of goodwill with the carrying amount of that goodwill.

Finite-lived intangible assets are amortized using the straight-line method over their estimated useful lives and are reviewed for impairment whenever events or circumstances indicate that their carrying amount may not be recoverable.

**(2) STOCK-BASED COMPENSATION**

The Company recognizes stock-based compensation expense in accordance with the provisions of Statement of Financial Accounting Standards No. 123R - Share-Based Payment. Stock-based compensation was \$994,000 and \$807,000 for the three months ended September 30, 2007 and 2006, respectively and \$2.8 million and \$2.2 million for the nine months ended September 30, 2007 and 2006, respectively.

**Table of Contents***Stock Options*

A summary of our stock option activity for the nine-month period ended September 30, 2007 is as follows:

| (In thousands, except fair values)        | Shares | Weighted-Average Grant-date Fair Value |
|---|--------|--|
| Options outstanding at December 31, 2006  | 3,079  | \$ 18.85                               |
| Options granted                           | 481    | 22.32                                  |
| Options exercised                         | (322)  | 13.48                                  |
| Options cancelled                         | (165)  | 24.63                                  |
| Options outstanding at September 30, 2007 | 3,073  | \$ 19.65                               |
| Exercisable at September 30, 2007         | 2,096  | \$ 20.59                               |

The total intrinsic value of options exercised during the three and nine months ended September 30, 2007 was \$51,000 and \$2.9 million, respectively, and was \$236,000 and \$1.5 million for the three and nine months ended September 30, 2006, respectively, determined as of the exercise date. As of September 30, 2007, there was \$10.7 million of total unrecognized compensation cost related to stock options granted and outstanding, which is expected to be recognized through fiscal year 2011, with a weighted average remaining vesting period of 2.8 years. Cash received from stock option exercises was \$89,000 and \$4.1 million, net of \$300,000 in tax withholdings, during the three and nine months ended September 30, 2007, respectively. The fair value of each option is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

|                               | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|-------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
|                               | 2007                                | 2006      | 2007                               | 2006      |
| Risk-free interest rates      | 4.8%                                | 4.7%      | 4.7%                               | 4.7%      |
| Expected dividend yield rates | 0.0%                                | 0.0%      | 0.0%                               | 0.0%      |
| Expected lives                | 5.5 years                           | 5.5 years | 5.5 years                          | 5.5 years |
| Expected volatility           | 60.5%                               | 65.3%     | 60.5%                              | 65.5%     |
| Expected forfeiture rate      | 22%                                 | 22%       | 22%                                | 22%       |

*Restricted Stock*

A summary of the Company's non-vested RSU activity for the nine-month period ended September 30, 2007 is as follows:

| (In thousands, except fair values)        | Shares | Weighted Average Grant Date Fair Value |
|---|--------|--|
| Balance outstanding at December 31, 2006  | 383    | \$ 11.42                               |
| RSUs granted                              | 199    | 22.70                                  |
| RSUs vested                               | (86)   | 18.90                                  |
| RSUs forfeited                            | (19)   | 11.88                                  |
| Balance outstanding at September 30, 2007 | 477    | \$ 16.05                               |

The fair value of the Company's RSUs is determined based upon the closing fair market value of the Company's common stock on the grant date. As of September 30, 2007, there was

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\$5.8 million of total unrecognized compensation cost related to non-vested RSUs granted, which cost is expected to be recognized over a weighted average period of 1.6 years. During the quarter ended September 30, 2007, the total fair value of RSUs which vested was \$232,000, based upon the closing fair market value of the Company's common stock on the date the underlying common stock was released to the recipient.

*Employee Stock Purchase Plan (the ESPP)*

As of September 30, 2007, there was \$15,000 of total unrecognized compensation cost related to the ESPP that is expected to be recognized over a remaining period of one month.

**(3) INCOME TAXES**

We adopted the provisions of Financial Accounting Standards Board Interpretation No. 48 Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No 109 ( FIN 48 ) as of January 1, 2007. Upon adoption, the Company increased the long-term liability associated with uncertain tax positions by \$6 million and also increased the long-term receivable by \$5 million consisting of offsetting tax benefits. The balance of \$1 million is an adjustment to the opening balance of retained earnings on January 1, 2007. If recognized, the \$1 million would affect our effective tax rate. There have been no changes to these amounts during the quarter ended September 30, 2007.

The tax years 2003 through 2006 remain open to examination by the United States taxing jurisdictions to which we are subject. The foreign taxing jurisdictions have open tax years from 2001 through 2006. In accordance with our accounting policy, we recognize accrued interest and penalties related to unrecognized tax benefits as a component of tax expense. This policy did not change as a result of the adoption of FIN 48. We did not have any accrued interest or penalties at December 31, 2006. We do not anticipate a material change to the amount of unrecognized tax positions within the next 12 months.

While we believe we have adequately provided for all tax positions, amounts asserted by taxing authorities could materially differ from our accrued positions as a result of uncertain and complex application of tax regulations. Additionally, the recognition and measurement of certain tax benefits includes estimates and judgment by management and inherently includes subjectivity. Accordingly, additional provisions on federal and foreign tax-related matters could be recorded in the future as revised estimates are made or the underlying matters are settled or otherwise resolved.

**(4) RESTRUCTURING**

On March 2, 2007, the Company announced that it will be closing its manufacturing, distribution, and research and development facility located in Stolberg, Germany. Related to this manufacturing transition, the Company recorded restructuring charges of \$1.9 million in the first quarter of 2007, consisting primarily of the accrual of employee severance and severance benefit costs associated with the planned reduction of employees at this facility. The Company also recorded as an asset impairment charge of approximately \$900,000 relating to the write-down of certain real and personal property located at this facility to estimated fair value in the first quarter of 2007.

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In the second quarter of 2007, the Company recorded restructuring charges of \$158,000 consisting of legal and other consulting fees.

In the third quarter of 2007, the Company recorded restructuring charges of \$556,000 consisting of \$122,000 in employee separation costs and \$434,000 in other costs including legal and transportation costs. At September 30, 2007, the Company's restructuring reserve was approximately \$142,000 primarily relating to legal and administrative services.

The following table summarizes the components of the restructuring charges, the payments and other settlements, and the remaining accrual as of September 30, 2007:

|   | <b>Employee<br/>Severance<br/>and<br/>Termination<br/>Costs</b> | <b>Other<br/>Costs<br/>(In<br/>thousands)</b> | <b>Total<br/>Restructuring<br/>Charges</b> |
|---|---|---|--|
| Accrual balance at December 31, 2006      | \$  | \$  | \$   |
| First quarter 2007 restructuring accrual  | 1,788   | 151   | 1,939                                      |
| First quarter 2007 settlements            |   |   |  |
| Accrual balance at March 31, 2007         | 1,788   | 151   | 1,939                                      |
| Second quarter 2007 restructuring accrual |   | 158   | 158  |
| Second quarter 2007 reversals             | (31)  |   | (31)                                       |
| Second quarter 2007 settlements           | (517)   | (80)  | (597)                                      |
| Accrual balance at June 30, 2007          | 1,240   | 229   | 1,469                                      |
| Third quarter 2007 restructuring accrual  | 122   | 434   | 556  |
| Third quarter 2007 settlements            | (1,355)   | (528)   | (1,883)                                    |
| Accrual balance at September 30, 2007     | \$ 7  | \$ 135  | \$ 142                                     |

The Stolberg facility closed in October 2007 and the remaining restructuring liabilities are expected to be paid over the next two months. Related to the restructuring, on October 2, 2007, the Company completed the sale of assets related to its LPPA product line for \$2.2 million. Assets related to this sale are recorded in Assets Held for Sale in the Company's Condensed Consolidated Balance Sheet as of September 30, 2007.

**(5) MARKETABLE SECURITIES**

Marketable securities consisted of the following:

|                             | <b>September<br/>30,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|-----------------------------|-----------------------------------|----------------------------------|
|                             | <b>(In thousands)</b>             |                                  |
| Commercial paper            | \$ 11,908                         | \$ 29,910                        |
| Certificates of deposit     | 7,926                             | 3,404                            |
| Municipal bonds and notes   | 81,685                            | 51,193                           |
| Institutional money markets | 6,635                             | 1,471                            |
| Total marketable securities | \$ 108,154                        | \$ 85,978                        |

These marketable securities are classified as available-for-sale and are stated at period end market value. The average weighted maturity of the instruments is maintained at approximately 180 days.

**Table of Contents****(6) ACCOUNTS RECEIVABLE**

Accounts receivable consisted of the following:

|                                  | <b>September<br/>30,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|----------------------------------|-----------------------------------|----------------------------------|
|                                  | <b>(In thousands)</b>             |                                  |
| Trade accounts receivable, gross | \$ 70,370                         | \$ 72,501                        |
| Allowance for doubtful accounts  | (666)                             | (545)                            |
| Trade accounts receivable, net   | \$ 69,704                         | \$ 71,956                        |

**(7) INVENTORIES**

Inventories consisted of the following:

|                         | <b>September<br/>30,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|-------------------------|-----------------------------------|----------------------------------|
|                         | <b>(In thousands)</b>             |                                  |
| Parts and raw materials | \$ 50,427                         | \$ 47,187                        |
| Work in process         | 3,578                             | 3,190                            |
| Finished goods          | 11,462                            | 10,995                           |
| Inventory reserves      | (8,079)                           | (8,594)                          |
| Total inventories       | \$ 57,388                         | \$ 52,778                        |

Inventories include costs of materials, direct labor and manufacturing overhead. Inventories are valued at the lower of cost or market, computed on a first-in, first-out basis and are presented net of reserves for excess and obsolete inventory as of September 30, 2007 and December 31, 2006, respectively.

**(8) GOODWILL AND OTHER INTANGIBLE ASSETS**

Goodwill and amortizable intangible assets consisted of the following as of September 30, 2007:

|                                     | <b>Gross</b>   | <b>Cumulative<br/>Effect of<br/>Changes<br/>in</b> |                                     | <b>Net</b>                 | <b>Weighted-<br/>Average<br/>Useful<br/>Life<br/>(Years)</b> |
|-------------------------------------|--|--|-------------------------------------|----------------------------|--|
|                                     | <b>Carrying<br/>Amount</b>                                     | <b>Exchange<br/>Rates</b>                          | <b>Accumulated<br/>Amortization</b> | <b>Carrying<br/>Amount</b> |  |
|                                     | <b>(In thousands, except weighted-average<br/>useful life)</b> |  |                                     |                            |  |
| Amortizable intangible assets:      |  |  |                                     |                            |  |
| Technology-based                    | \$ 7,015   | \$ 1,533   | \$ (7,874)                          | \$ 674                     | 5  |
| Trademarks and other                | 8,604  | 1,771  | (4,623)                             | 5,752                      | 17   |
| Total amortizable intangible assets | 15,619   | 3,304  | (12,497)                            | 6,426                      | 12   |
| Goodwill                            | 49,766   | 10,821   |                                     | 60,587                     |  |

|  |           |           |             |           |
|--|-----------|-----------|-------------|-----------|
| Total goodwill and amortizable intangible assets | \$ 65,385 | \$ 14,125 | \$ (12,497) | \$ 67,013 |
|--|-----------|-----------|-------------|-----------|

Goodwill and amortizable intangible assets consisted of the following as of December 31, 2006:

|  | <b>Gross</b>    | <b>Cumulative</b> |   | <b>Net</b>      | <b>Weighted-</b> |
|--|-----------------|-------------------|---|-----------------|------------------|
|  | <b>Carrying</b> | <b>Effect of</b>  |   | <b>Carrying</b> | <b>Average</b>   |
|  | <b>Amount</b>   | <b>Changes</b>    | <b>Exchange</b>                               | <b>Amount</b>   | <b>Useful</b>    |
|  |                 | <b>in</b>         | <b>Rates</b>                                  |                 | <b>Life</b>      |
|  |                 |                   | <b>(In thousands, except weighted-average</b> |                 | <b>(Years)</b>   |
|  |                 |                   | <b>useful life)</b>                           |                 |                  |
| Amortizable intangible assets:                   |                 |                   |   |                 |                  |
| Technology-based                                 | \$ 7,015        | \$ 1,477          | \$ (7,499)                                    | \$ 993          | 5                |
| Trademarks and other                             | 8,604           | 1,578             | (4,270)                                       | 5,912           | 17               |
| Total amortizable intangible assets              | 15,619          | 3,055             | (11,769)                                      | 6,905           | 12               |
| Goodwill   | 49,766          | 8,913             |   | 58,679          |                  |
| Total goodwill and amortizable intangible assets | \$ 65,385       | \$ 11,968         | \$ (11,769)                                   | \$ 65,584       |                  |

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Amortization expense related to intangible assets for the three months ended September 30, 2007 and 2006 was \$201,000 and \$453,000, respectively and \$720,000 and \$1.4 million for the nine months ended September 30, 2007 and 2006, respectively. Estimated amortization expense related to the Company's acquired intangible assets fluctuates with changes in foreign currency exchange rates between the U.S. dollar, the Japanese yen and the euro. Estimated amortization expense related to amortizable intangibles for each of the five years 2007 through 2011 is as follows:

|      | <b>Estimated<br/>Amortization<br/>Expense<br/>(In<br/>thousands)</b> |
|------|--|
| 2007 | \$ 958   |
| 2008 | 833  |
| 2009 | 521  |
| 2010 | 418  |
| 2011 | 418  |

**(9) STOCKHOLDERS' EQUITY**

Stockholders' equity consisted of the following:

| <b>(In thousands, except par value)</b>  | <b>September<br/>30,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|--|-----------------------------------|----------------------------------|
| Common stock, \$0.001 par value, 70,000 shares authorized, 45,257 and 44,855 shares issued and outstanding, respectively | \$ 45                             | \$ 45                            |
| Additional paid-in capital   | 265,631                           | 258,688                          |
| Retained earnings  | 117,546                           | 88,344                           |
| Unrealized holding gains on available-for-sale securities, net of tax  | 165                               | 323                              |
| Cumulative translation adjustments   | 14,929                            | 8,390                            |
| Total stockholders' equity   | \$ 398,316                        | \$ 355,790                       |

**(10) COMPREHENSIVE INCOME**

Comprehensive income for the Company consists of net income, foreign currency translation adjustments and net unrealized holding gains on available-for-sale marketable securities as presented below (In thousands):

|   | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2007</b>                                 | <b>2006</b> | <b>2007</b>                                | <b>2006</b> |
| Net income, as reported   | \$ 5,855                                    | \$ 16,992   | \$ 30,194                                  | \$ 47,915   |
| Adjustment to arrive at comprehensive income, net of taxes:                                   |   |             |  |             |
| Unrealized holding (loss) gain on available-for-sale marketable securities                    | (50)  | (34)        | (126)                                      | (20)        |
| Reclassification adjustment for amounts included in net income related to sales of securities |   |             | (32)                                       | (964)       |
| Cumulative translation adjustments  | 8,414                                       | (357)       | 6,539                                      | 4,059       |

|                      |           |           |           |           |
|----------------------|-----------|-----------|-----------|-----------|
| Comprehensive income | \$ 14,219 | \$ 16,601 | \$ 36,575 | \$ 50,990 |
|----------------------|-----------|-----------|-----------|-----------|

**Table of Contents****(11) COMMITMENTS AND CONTINGENCIES**

From time to time, the Company is involved in disputes and legal actions arising in the normal course of its business. The Company accrues loss contingencies in connection with its litigation when it is probable that a loss will occur and the amount of the loss can be reasonably estimated.

**(12) EARNINGS PER SHARE**

Basic earnings per share (EPS) is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding during the period. The computation of diluted EPS is similar to the computation of basic EPS except that the numerator is increased to exclude certain charges which would not have been incurred, and the denominator is increased to include the number of additional common shares that would have been outstanding (using the if-converted and treasury stock methods), if securities containing potentially dilutive common shares (convertible notes payable, stock options and restricted stock units) had been converted to such common shares, and if such assumed conversion is dilutive. As of September 30, 2007 and 2006, 3.6 million options were outstanding. Not included in the computation of diluted earnings per share are 2.8 million and 2.2 million stock options for the three months ended September 30, 2007 and 2006, respectively, and 3.2 and 2.1 million stock options for the nine months ended September 30, 2007 and 2006, respectively, due to the anti-dilutive effect of these shares.

The following is a reconciliation of the numerators and denominators used in the calculation of basic and diluted EPS for the three and nine months ended September 30, 2007 and 2006:

| <b>(In thousands, except per share data)</b>        | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|---|---------------------------|-------------|--------------------------|-------------|
|   | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|   | <b>2007</b>               | <b>2006</b> | <b>2007</b>              | <b>2006</b> |
| <b>Earnings per common share basic</b>              |                           |             |                          |             |
| Net income  | \$ 5,855                  | \$ 16,992   | \$ 30,194                | \$ 47,915   |
| Weighted average common shares outstanding          | 45,248                    | 44,762      | 45,117                   | 44,679      |
| Earnings per common share basic                     | \$ 0.13                   | \$ 0.38     | \$ 0.67                  | \$ 1.07     |
| <b>Earnings per common share assuming dilution</b>  |                           |             |                          |             |
| Net income  | \$ 5,855                  | \$ 16,992   | \$ 30,194                | \$ 47,915   |
| Weighted average common shares outstanding          | 45,248                    | 44,762      | 45,117                   | 44,679      |
| Effect of dilutive securities:                      |                           |             |                          |             |
| Stock options and restricted stock units            | 513                       | 404         | 579                      | 489         |
| Adjusted weighted average common shares outstanding | 45,761                    | 45,166      | 45,696                   | 45,168      |
| Earnings per common share assuming dilution         | \$ 0.13                   | \$ 0.38     | \$ 0.66                  | \$ 1.06     |



**Table of Contents****(13) FOREIGN OPERATIONS AND MAJOR CUSTOMERS**

The Company has operations in the United States, Asia Pacific and Europe. The following is a summary of the Company's operations by geographic region:

|               | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|---------------|-------------------------------------|------------|------------------------------------|------------|
|               | 2007                                | 2006       | 2007                               | 2006       |
|               | (In thousands)                      |            |                                    |            |
| Sales (1):    |                                     |            |                                    |            |
| United States | \$ 48,453                           | \$ 60,336  | \$ 166,629                         | \$ 177,011 |
| Asia Pacific  | 33,129                              | 34,768     | 101,975                            | 100,097    |
| Europe        | 8,909                               | 12,584     | 32,259                             | 29,101     |
|               | \$ 90,491                           | \$ 107,688 | \$ 300,863                         | \$ 306,209 |

(1) These sales amounts are calculated based on the destination for our products and do not contemplate where our customers may subsequently transfer them.

|                                |          |           |           |           |
|--------------------------------|----------|-----------|-----------|-----------|
| Income (loss) from operations: |          |           |           |           |
| United States                  | \$ 1,165 | \$ 6,455  | \$ 18,325 | \$ 31,593 |
| Asia Pacific                   | 4,587    | 8,958     | 19,201    | 15,217    |
| Europe                         | 1,649    | 2,141     | 5,176     | 3,981     |
| Intercompany elimination       | 94       | 775       | (996)     | (51)      |
|                                | \$ 7,495 | \$ 18,329 | \$ 41,706 | \$ 50,740 |

|                      | September<br>30,<br>2007 | December<br>31,<br>2006 |
|----------------------|--------------------------|-------------------------|
| Identifiable assets: |                          |                         |
| United States        | \$ 19,514                | \$ 14,954               |
| Asia Pacific         | 17,346                   | 18,616                  |
| Europe               | 1,543                    | 2,276                   |
|                      | \$ 38,403                | \$ 35,846               |

Intercompany sales between the Company's geographic areas are recorded on the basis of intercompany prices established by the Company.

Applied Materials, Inc. is the Company's largest customer and accounted for 27% and 30% of the Company's sales for the three months ended September 30, 2007 and 2006, respectively and 28% and 30% for the nine months ended September 30, 2007 and 2006, respectively. No other customer accounted for 10% or more of the Company's sales during these periods.

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

**Special Note on Forward-Looking Statements**

The following discussion contains, in addition to historical information, 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. Statements that are other than historical information are forward-looking statements. For example, statements relating to our beliefs, expectations and plans are forward-looking statements, as are statements that certain actions, conditions or circumstances will continue. Forward-looking statements involve risks and uncertainties, which are difficult to predict and many of which are beyond our control. These risks and uncertainties are described below and in other filings we make with the Securities and Exchange Commission, including our Annual Report on Form 10-K for the year ended December 31, 2006. As a result, our actual results may differ materially from the results discussed in the forward-looking statements. We assume no obligation to update any forward-looking statements or the reasons why our actual results might differ.

*OVERVIEW*

We design, manufacture and support complex power conversion and control systems, and gas flow control and thermal measurement devices used in plasma-based, thin-film processing equipment. This equipment is essential to the manufacture of products including the following:

Semiconductor devices for electronics applications;

Flat panel displays for hand-held devices and computer and television screens;

Compact discs, DVDs, magnetic hard drives and other digital storage media;

Solar panels or photovoltaics;

Optical coatings for eyeglasses;

Barrier coatings for architectural glass;

Industrial laser and medical applications; and

Other markets where thin film deposition is a critical part of the manufacturing process.

In addition to our products that address the thin film deposition market, we recently introduced a new product for the solar photovoltaic inverter market and currently have inverter products installed in grid-connected applications.

Our installed base enables a recurring revenue opportunity as we sell spare parts, repair services and field upgrades worldwide through our customer service and technical support organization.

We provide solutions to a diverse range of markets and geographic regions with the semiconductor capital market being our largest market. Sales to customers in the semiconductor capital equipment industry comprised 67% and 69% of our sales in the three months ended September 30, 2007 and 2006, respectively and 68% and 69% of our sales in the nine months ended September 30, 2007 and 2006, respectively. Other markets we sell to include flat panel display, data storage, architectural glass, solar cell and other industrial thin-film manufacturing

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equipment. Our customers in the semiconductor and other markets are large OEM s and we derive additional revenue by providing maintenance services to their customers.

**Results of Operations***OVERVIEW*

The following table summarizes our results of operations for the three and nine months ended September 30, 2007 and 2006:

|  | <b>Three Months Ended</b> |                      | <b>Increase/</b>  | <b>%</b>      | <b>Nine Months Ended</b> |                      | <b>Increase/</b>  | <b>%</b>      |
|--|---------------------------|----------------------|-------------------|---------------|--------------------------|----------------------|-------------------|---------------|
|  | <b>September 30,</b>      | <b>September 30,</b> | <b>(Decrease)</b> | <b>Change</b> | <b>September 30,</b>     | <b>September 30,</b> | <b>(Decrease)</b> | <b>Change</b> |
|  | <b>2007</b>               | <b>2006</b>          |                   |               | <b>2007</b>              | <b>2006</b>          |                   |               |
|  | <b>(In thousands)</b>     |                      |                   |               | <b>(In thousands)</b>    |                      |                   |               |
| SALES                                      | \$ 90,491                 | \$ 107,688           | \$ (17,197)       | (16)%         | \$ 300,863               | \$ 306,209           | \$ (5,346)        | (2)%          |
| COST OF SALES                              | 53,765                    | 60,674               | (6,909)           | (11)%         | 170,873                  | 175,885              | (5,012)           | (3)%          |
| Gross profit                               | 36,726                    | 47,014               | (10,288)          | (22)%         | 129,990                  | 130,324              | (334)             |               |
| OPERATING EXPENSES:                        |                           |                      |                   |               |                          |                      |                   |               |
| Research and development                   | 12,937                    | 11,345               | 1,592             | 14%           | 37,883                   | 32,608               | 5,275             | 16%           |
| Selling, general and administrative        | 15,738                    | 17,309               | (1,571)           | (9)%          | 46,896                   | 46,885               | 11                |               |
| Restructuring and asset impairment charges | 556                       | 31                   | 525               | nm            | 3,505                    | 91                   | 3,414             | nm            |
| Total operating expenses                   | 29,231                    | 28,685               | 546               | 2%            | 88,284                   | 79,584               | 8,700             | 11%           |
| INCOME FROM OPERATIONS                     | 7,495                     | 18,329               | (10,834)          | (59)%         | 41,706                   | 50,740               | (9,034)           | (18)%         |
| OTHER INCOME                               | 307                       | 1,044                | (737)             | (71)%         | 3,367                    | 3,755                | (388)             | (10)%         |
| Income before income taxes                 | 7,802                     | 19,373               | (11,571)          | (60)%         | 45,073                   | 54,495               | (9,422)           | (17)%         |

|                              |          |           |             |       |           |           |             |       |
|------------------------------|----------|-----------|-------------|-------|-----------|-----------|-------------|-------|
| PROVISION FOR INCOME TAXES   | 1,947    | 2,381     | (434)       | (18)% | 14,879    | 6,580     | 8,299       | 126%  |
| NET INCOME                   | \$ 5,855 | \$ 16,992 | \$ (11,137) | (66)% | \$ 30,194 | \$ 47,915 | \$ (17,721) | (37)% |
| NET INCOME PER BASIC SHARE   | \$ 0.13  | \$ 0.38   | \$ (0.25)   | (66)% | \$ 0.67   | \$ 1.07   | \$ (0.40)   | (37)% |
| NET INCOME PER DILUTED SHARE | \$ 0.13  | \$ 0.38   | \$ (0.25)   | (66)% | \$ 0.66   | \$ 1.06   | \$ (0.40)   | (38)% |

nm percentages greater than 200% and comparisons from positive to negative values or to zero values are considered not meaningful.

| Operating Expenses % of sales              | Three Months Ended<br>September 30, |       | Nine Months Ended<br>September 30, |       |
|--|-------------------------------------|-------|------------------------------------|-------|
|  | 2007                                | 2006  | 2007                               | 2006  |
| Research and development                   | 14.3%                               | 10.5% | 12.6%                              | 10.6% |
| Selling, general and administrative        | 17.4%                               | 16.1% | 15.6%                              | 15.3% |
| Restructuring and asset impairment charges |                                     |       | 1.2%                               |       |
| Total operating expenses                   | 31.7%                               | 26.6% | 29.4%                              | 25.9% |

*SALES*

The following tables summarize our unaudited net sales and percentages of net sales by customer type for the three- and nine-month periods ended September 30, 2007 and 2006:

|                                     | Three Months<br>Ended<br>September 30, |           | Increase/<br>(Decrease) | %<br>Change | Nine Months Ended<br>September 30, |            | Increase/<br>(Decrease) | %<br>Change |
|-------------------------------------|--|-----------|-------------------------|-------------|------------------------------------|------------|-------------------------|-------------|
|                                     | 2007                                   | 2006      |                         |             | 2007                               | 2006       |                         |             |
|                                     | (In thousands)                         |           |                         |             | (In thousands)                     |            |                         |             |
| Semiconductor capital equipment     | \$ 60,802                              | \$ 73,947 | \$ (13,145)             | (18)%       | \$ 205,274                         | \$ 212,854 | \$ (7,580)              | (4)%        |
| Non-semiconductor capital equipment | 29,689                                 | 33,741    | (4,052)                 | (12)%       | 95,589                             | 93,355     | 2,234                   | 2%          |

|             |           |            |             |       |            |            |            |      |
|-------------|-----------|------------|-------------|-------|------------|------------|------------|------|
| Total sales | \$ 90,491 | \$ 107,688 | \$ (17,197) | (16)% | \$ 300,863 | \$ 306,209 | \$ (5,346) | (2)% |
|-------------|-----------|------------|-------------|-------|------------|------------|------------|------|

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| % of sales                          | Three Months Ended<br>September 30, |      | Nine Months Ended<br>September 30, |      |
|-------------------------------------|-------------------------------------|------|------------------------------------|------|
|                                     | 2007                                | 2006 | 2007                               | 2006 |
| Semiconductor capital equipment     | 67%                                 | 69%  | 68%                                | 69%  |
| Non-semiconductor capital equipment | 33%                                 | 31%  | 32%                                | 31%  |
|                                     | 100%                                | 100% | 100%                               | 100% |

The following tables summarize our unaudited net sales and percentages of net sales by geographic region for the three- and nine-month periods ended September 30, 2007 and 2006:

| Sales (1):           | Three Months<br>Ended<br>September 30, |            | Increase/<br>(Decrease) | %<br>Change | Nine Months Ended<br>September 30, |            | Increase/<br>(Decrease) | %<br>Change |
|----------------------|--|------------|-------------------------|-------------|------------------------------------|------------|-------------------------|-------------|
|                      | 2007                                   | 2006       |                         |             | 2007                               | 2006       |                         |             |
|                      | (In thousands)                         |            |                         |             | (In thousands)                     |            |                         |             |
| United States/Canada | \$ 48,453                              | \$ 60,337  | \$ (11,884)             | (20)%       | \$ 166,629                         | \$ 177,012 | \$ (10,383)             | (6)%        |
| Asia Pacific         | 33,129                                 | 34,767     | (1,638)                 | (5)%        | 101,975                            | 100,096    | 1,879                   | 2%          |
| Europe               | 8,909                                  | 12,584     | (3,675)                 | (29)%       | 32,259                             | 29,101     | 3,158                   | 11%         |
| Total sales          | \$ 90,491                              | \$ 107,688 | \$ (17,197)             | (16)%       | \$ 300,863                         | \$ 306,209 | \$ (5,346)              | (2)%        |

(1) These sales amounts are calculated based on the destination for our products and does not contemplate where our customers may subsequently transfer them.

| % of sales           | Three Months Ended<br>September 30, |      | Nine Months Ended<br>September 30, |      |
|----------------------|-------------------------------------|------|------------------------------------|------|
|                      | 2007                                | 2006 | 2007                               | 2006 |
| United States/Canada | 53%                                 | 56%  | 55%                                | 58%  |
| Asia Pacific         | 37%                                 | 32%  | 34%                                | 33%  |
| Europe               | 10%                                 | 12%  | 11%                                | 9%   |
|                      | 100%                                | 100% | 100%                               | 100% |

The semiconductor capital equipment market is highly cyclical and is impacted by changes in the macroeconomic environment, changes in semiconductor supply and demand and rapid technological advances in both semiconductor

devices and wafer fabrication processes. Our sales to the semiconductor capital equipment industry decreased for the three and nine months ended September 30, 2007 compared to the same periods in 2006 primarily driven by the changes in demand that our semiconductor customers have experienced.

*GROSS PROFIT*

Our gross margin was 41% and 43% in the three and nine months ended September 30, 2007, respectively, compared to 44% and 43% in the three and nine months ended September 30, 2006, respectively. The decrease in our gross margin is primarily attributable to lower revenues, costs related to the transition of manufacturing from Stolberg, Germany to China and an additional charge of \$2.2 million to cost of goods sold related to a change in estimates of warranty expenses for two products.

*RESEARCH AND DEVELOPMENT EXPENSES*

The market for our products is characterized by ongoing technological changes. We believe that continued and timely development of new and differentiated products, and enhancements to existing products to support customer requirements, is necessary for us to maintain a competitive position in the markets we serve. Accordingly, we devote a significant portion of our personnel



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and financial resources to research and development projects and seek to maintain close relationships with our customers and other industry leaders in order to remain responsive to their product requirements. We believe that the continued investment in research and development and ongoing development of new products are essential to the expansion of our markets, and expect to continue to make significant investments in research and development activities. All of our research and development costs have been expensed as incurred. The increase in our research and development expenses from 2006 to 2007 was primarily due to increased spending, predominantly compensation expense, on development of new and existing platforms, such as the solar inverter, Solaron , to support business growth.

***SELLING, GENERAL AND ADMINISTRATIVE EXPENSES***

Our selling expenses support domestic and international sales and marketing activities that include personnel, trade shows, advertising, third-party sales representative commissions and other selling and marketing activities. Our general and administrative expenses support our worldwide corporate, legal, tax, financial, governance, administrative, information systems and human resource functions in addition to our general management. The decrease in our SG&A expenses for the three months ended 2007 and 2006 were primarily due to decreased employee compensation and lower commissions due to decreased sales.

***RESTRUCTURING CHARGES***

Our restructuring charges were incurred in conjunction with the closing of our manufacturing, distribution, and research and development facility located in Stolberg, Germany which was complete in October 2007. Related to this closure, we recorded restructuring charges of \$1.9 million in the first quarter of 2007, \$158,000 in the second quarter of 2007, and \$556,000 in the third quarter of 2007. These charges consisted primarily of the accrual of employee severance and severance benefit costs associated with the planned reduction of employees at this facility. Also in the first quarter of 2007, we recorded an asset impairment charge of approximately \$900,000 relating to the write-down to estimated fair value of certain real and personal property also at this facility.

***OTHER INCOME***

Other income consists primarily of interest income and expense, foreign exchange gains and losses and other miscellaneous gains, losses, income and expense items. Other income decreased from 2006 to 2007 primarily due to a net charge of \$1.4 million in the third quarter of 2007 related to a foreign exchange loss during the quarter, as the Japanese yen and euro strengthened relative to the U.S. dollar. In order to mitigate our foreign exchange risk going forward, we have implemented cash management strategies. The decrease was partially offset by increased investment income received from higher cash balances in the three and nine months ended September 30, 2007.

***PROVISION FOR INCOME TAXES***

The income tax provision and effective tax rate for the three and nine months ended September 30, 2007 was \$1.9 million and 25% and \$14.9 million and 33%, respectively. The income tax provision and effective tax rate for the three and nine months ended September 30, 2006 was \$2.4 million and 12% and \$6.6 million and 12%, respectively. The increase in the effective tax rate resulted from the inclusion of a tax expense associated with earnings taxable in the U.S. due to the reversal of our valuation allowance of approximately \$23.5 million at

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December 31, 2006 after which we no longer offset tax expense attributable to current earnings with the benefit of prior operating losses. At September 30, 2007, we had federal net operating loss carryforwards of approximately \$35 million, which expire beginning 2023 through 2025. Included in the \$35 million are \$11 million of federal net operating losses related to exercises of stock options, the benefits of which will be booked to equity when these net operating losses are utilized. In addition, we have \$14 million in net operating loss carryforwards that are subject to certain limitations under the IRS code and we have a valuation allowance booked against them.

**Liquidity and Capital Resources**

At September 30, 2007, our principal sources of liquidity consisted of cash, cash equivalents and marketable securities of \$185.0 million. During the nine months ended September 30, 2007, our cash, cash equivalents and marketable securities increased \$40.8 million, or 28%, from \$144.2 million at December 31, 2006, primarily due to cash generated from our operations. Our working capital increased \$49.2 million, or 20%, to \$297.0 million at September 30, 2007 from \$247.8 million at December 31, 2006.

Operating activities provided cash of \$40.3 million in the nine months ended September 30, 2007 primarily due to cash generated by operations partially offset by increased inventory, compared to \$57.8 million of cash provided in the nine months ended September 30, 2006.

Investing activities used \$27.8 million of cash in the nine months ended September 30, 2007 and \$57.8 million in the nine months ended September 30, 2006 primarily due to purchases of marketable securities. Capital expenditures in the first nine months of 2007 were \$5.7 million, compared to capital expenditures of \$3.0 million in the first nine months of 2006. We expect our total capital expenditures in 2007 to be approximately \$7 million to \$8 million.

Financing activities provided cash of \$4 million in the first nine months of 2007, compared to cash used of \$750,000 in the first nine months of 2006 primarily due to the payoff of our senior borrowings in 2006 and cash received from the exercise of options in 2007.

We expect our cash flows from financing activities to continue to fluctuate in the future. Our financing payments may also increase in the future if we enter into additional capital lease obligations or utilize our line of credit. A significant portion of these obligations are held in countries other than the United States; therefore, future foreign currency fluctuations, especially between the U.S. dollar and the Japanese yen, could cause significant fluctuations in our estimated payment obligations.

We believe that our working capital, together with cash anticipated to be generated by operations will be sufficient to satisfy our anticipated liquidity requirements for the next twelve months.

**Critical Accounting Policies**

The above discussion and analysis of our financial condition and results of operations is based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. In preparing our financial statements, we must make estimates and judgments that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions.

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We believe that the following critical accounting policies, as discussed in this Form 10-Q and/or our Form 10-K for the year ended December 31, 2006, affect our more significant judgments and estimates used in the preparation of our condensed consolidated financial statements:

Revenue recognition

Reserve for warranty

Reserve for excess and obsolete inventory

Stock-based compensation

Commitments and contingencies

Income taxes

Valuation of intangible assets

Long-lived assets including intangible assets subject to amortization

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

There were no material changes in the Company's exposure to market risk from December 31, 2006.

**ITEM 4. CONTROLS AND PROCEDURES**

*Evaluation of Disclosure Controls and Procedures*

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

As of the end of the period covered by this report, we conducted an evaluation, with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the disclosure controls and procedures pursuant to the Exchange Act Rule 13a-15(b). Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2007.

*Changes in Internal Control over Financial Reporting*

There was no change in our internal control over financial reporting that occurred during our most recent quarter that has materially affected, or is reasonably likely to materially affect, the internal control over financial reporting.

**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

On November 5, 2007, a complaint was filed in the U.S. District Court for the District of Colorado by Xantrex Technology, Inc., alleging various breaches of confidence and interference

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with contractual duties in connection with the Company's hiring of a former employee of Xantrex. The Company believes the allegations to be unfounded and will defend itself vigorously against the claims.

**ITEM 1A. RISK FACTORS**

Item 1A, Risk Factors, of our Annual Report on Form 10-K for the year ended December 31, 2006 describes some of the risks and uncertainties associated with our business. Other factors may also exist that we cannot anticipate or that we currently do not consider to be significant based on information that is currently available. These risks and uncertainties have the potential to materially affect our business, financial condition, results of operations, cash flows and future results.

Although we do not believe that there have been any material changes to the risk factors previously disclosed in the Risk Factors section of our Annual Report on Form 10-K, the risk factors set forth below have been updated with more current information.

***A significant portion of our sales is concentrated among a few customers.***

Our ten largest customers accounted for 58% and 58% of our total sales in the three and nine months ended September 30, 2007, respectively and 57% and 61% of our total sales in the three and nine months ended September 30, 2006, respectively. Applied Materials, Inc., the Company's largest customer, accounted for 27% and 30% of the Company's sales for the three months ended September 30, 2007 and 2006, respectively and 27% and 30% for the nine months ended September 30, 2007 and 2006, respectively. No other customer accounted for more than 10% of our sales during these periods. The loss of any of our significant customers or a material reduction in any of their purchase orders could significantly harm our business, financial condition and results of operations.

Our customers continually exert pressure on us to reduce our prices and extend payment terms. Given the nature of our customer base and the highly competitive markets in which we compete, we may be required to reduce our prices or extend payment terms to remain competitive. We may not be able to reduce our expenses in an amount sufficient to offset potential margin declines.

***Raw material, part, component and subassembly shortages, exacerbated by our dependence on sole and limited source suppliers, could affect our ability to manufacture products and systems and could delay our shipments.***

Our business depends on our ability to manufacture products that meet the rapidly changing demands of our customers. Our ability to manufacture our products timely depends in part on the timely delivery of raw materials, parts, components and subassemblies from suppliers. We rely on sole and limited source suppliers for some of our raw materials, parts, components and subassemblies that are critical to the manufacturing of our products. This reliance involves several potential risks, including the following:

Inability to obtain an adequate supply of required parts, components or subassemblies;

Supply shortages if a sole or limited source provider ceases operations;

Having to fund the operating losses of a sole or limited source provider;

Reduced control over pricing and timing of delivery of raw materials and parts; components or subassemblies;

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Need to qualify alternative suppliers which could be time consuming and lead to delays in delivery of products to our customers, as well as increased costs; and

Inability of our suppliers to develop technologically advanced products to support our growth and development of new products.

If we are unable to successfully qualify additional suppliers and manage relationships with our existing and future suppliers, if our suppliers experience financial difficulties including bankruptcy or if our suppliers cannot meet our performance or quality specifications or timing requirements, we may experience shortages, delays, or increased costs of raw materials, parts, components or subassemblies. This in turn could limit our ability to manufacture and ship our products, which could adversely and materially affect our business, financial condition and operating results and relationships with our current and prospective customers.

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

Not applicable.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

Exhibits:

- 31.1 Certification of the Chief Executive Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Chief Financial Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURE**

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.

ADVANCED ENERGY INDUSTRIES, INC.

Dated: November 9, 2007

/s/ Lawrence D. Firestone

Lawrence D. Firestone  
Executive Vice President & Chief Financial  
Officer

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