

KLA TENCOR CORP
Form 10-Q
January 27, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended December 31, 2016
or

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

For the transition period from _____ to _____
Commission File Number 000-09992
KLA-Tencor Corporation
(Exact name of registrant as specified in its charter)

Delaware	04-2564110
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

One Technology Drive, Milpitas, California	95035
(Address of Principal Executive Offices)	(Zip Code)
(408) 875-3000	
(Registrant's telephone number, including area code)	

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 x No

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, 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, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

As of January 17, 2017, there were 156,729,320 shares of the registrant's Common Stock, \$0.001 par value, outstanding.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS
KLA-TENCOR CORPORATION
Condensed Consolidated Balance Sheets
(Unaudited)

(In thousands)	December 31, 2016	June 30, 2016
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 937,033	\$ 1,108,488
Marketable securities	1,655,944	1,382,806
Accounts receivable, net	663,852	613,233
Inventories	671,172	698,635
Other current assets	103,638	64,870
Total current assets	4,031,639	3,868,032
Land, property and equipment, net	279,966	278,014
Goodwill	335,170	335,177
Deferred income taxes	259,507	302,219
Purchased intangibles, net	2,551	4,331
Other non-current assets	185,623	174,659
Total assets	\$ 5,094,456	\$ 4,962,432
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 116,163	\$ 106,517
Deferred system profit	193,942	174,551
Unearned revenue	56,750	59,147
Current portion of long-term debt	249,958	—
Other current liabilities	570,923	662,208
Total current liabilities	1,187,736	1,002,423
Non-current liabilities:		
Long-term debt	2,729,239	3,057,936
Unearned revenue	62,619	56,336
Other non-current liabilities	149,766	156,623
Total liabilities	4,129,360	4,273,318
Commitments and contingencies (Note 11 and Note 12)		
Stockholders' equity:		
Common stock and capital in excess of par value	483,077	452,974
Retained earnings	534,175	284,825
Accumulated other comprehensive income (loss)	(52,156)	(48,685)
Total stockholders' equity	965,096	689,114
Total liabilities and stockholders' equity	\$ 5,094,456	\$ 4,962,432

See accompanying notes to condensed consolidated financial statements (unaudited).

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KLA-TENCOR CORPORATION

Condensed Consolidated Statements of Operations
(Unaudited)

	Three months ended December 31,		Six months ended December 31,	
(In thousands, except per share amounts)	2016	2015	2016	2015
Revenues:				
Product	\$683,733	\$527,780	\$1,245,486	\$988,519
Service	193,152	182,465	382,072	364,370
Total revenues	876,885	710,245	1,627,558	1,352,889
Costs and expenses:				
Costs of revenues	318,507	280,980	596,343	551,224
Research and development	130,912	118,272	260,145	238,215
Selling, general and administrative	93,532	96,532	187,920	188,195
Interest expense	30,624	30,539	61,356	61,103
Other expense (income), net	(3,535)	(1,553)	(7,271)	(5,622)
Income before income taxes	306,845	185,475	529,065	319,774
Provision for income taxes	68,594	33,268	112,713	62,670
Net income	\$238,251	\$152,207	\$416,352	\$257,104
Net income per share:				
Basic	\$1.52	\$0.98	\$2.66	\$1.65
Diluted	\$1.52	\$0.98	\$2.65	\$1.64
Cash dividends declared per share	\$0.54	\$0.52	\$1.06	\$1.04
Weighted-average number of shares:				
Basic	156,335	155,252	156,232	156,036
Diluted	157,123	155,996	157,071	156,971

See accompanying notes to condensed consolidated financial statements (unaudited).

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KLA-TENCOR CORPORATION

Condensed Consolidated Statements of Comprehensive Income
(Unaudited)

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2016	2015	2016	2015
Net income	\$238,251	\$152,207	\$416,352	\$257,104
Other comprehensive income (loss):				
Currency translation adjustments:				
Change in currency translation adjustments	(11,305)	(2,144)	(7,381)	(8,268)
Change in income tax benefit or expense	1,086	380	1,868	1,764
Net change related to currency translation adjustments	(10,219)	(1,764)	(5,513)	(6,504)
Cash flow hedges:				
Change in net unrealized gains or losses	13,969	707	12,131	(1,154)
Reclassification adjustments for net gains or losses included in net income	1,305	165	2,684	(237)
Change in income tax benefit or expense	(5,494)	(314)	(5,329)	500
Net change related to cash flow hedges	9,780	558	9,486	(891)
Net change related to unrecognized losses and transition obligations in connection with defined benefit plans	819	576	1,064	806
Available-for-sale securities:				
Change in net unrealized gains or losses	(7,037)	(4,715)	(9,914)	(4,234)
Reclassification adjustments for net gains or losses included in net income	(30)	(26)	(234)	(43)
Change in income tax benefit or expense	1,164	989	1,640	920
Net change related to available-for-sale securities	(5,903)	(3,752)	(8,508)	(3,357)
Other comprehensive income (loss)	(5,523)	(4,382)	(3,471)	(9,946)
Total comprehensive income	\$232,728	\$147,825	\$412,881	\$247,158

See accompanying notes to condensed consolidated financial statements (unaudited).

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KLA-TENCOR CORPORATION

Condensed Consolidated Statements of Cash Flows
(Unaudited)

(In thousands)	Six months ended December 31,	
	2016	2015
Cash flows from operating activities:		
Net income	\$416,352	\$257,104
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	29,314	36,264
Asset impairment charges	358	358
Non-cash stock-based compensation expense	23,922	23,573
Excess tax benefit from equity awards	—	(11,541)
Net gain on sales of marketable securities and other investments	(885)	(1,258)
Changes in assets and liabilities:		
Decrease (increase) in accounts receivable, net	(62,627)	157,023
Decrease (increase) in inventories	14,319	(67,911)
Increase in other assets	(8,838)	(3,663)
Increase in accounts payable	10,239	19,205
Increase (decrease) in deferred system profit	19,391	(16,843)
Decrease in other liabilities	(49,355)	(98,205)
Net cash provided by operating activities	392,190	294,106
Cash flows from investing activities:		
Acquisition of non-marketable securities	(2,370)	—
Capital expenditures, net	(18,512)	(15,279)
Proceeds from sale of assets	2,582	1,215
Purchases of available-for-sale securities	(830,462)	(624,861)
Proceeds from sale of available-for-sale securities	189,242	485,087
Proceeds from maturity of available-for-sale securities	356,177	326,335
Purchases of trading securities	(73,278)	(35,005)
Proceeds from sale of trading securities	68,465	35,576
Net cash provided by (used in) investing activities	(308,156)	173,068
Cash flows from financing activities:		
Repayment of debt	(80,000)	(60,000)
Issuance of common stock	23,694	21,908
Tax withholding payments related to vested and released restricted stock units	(17,455)	(22,021)
Common stock repurchases	—	(181,711)
Payment of dividends to stockholders	(173,842)	(183,054)
Excess tax benefit from equity awards	—	11,541
Net cash used in financing activities	(247,603)	(413,337)
Effect of exchange rate changes on cash and cash equivalents	(7,886)	(5,271)
Net increase (decrease) in cash and cash equivalents	(171,455)	48,566
Cash and cash equivalents at beginning of period	1,108,488	838,025
Cash and cash equivalents at end of period	\$937,033	\$886,591
Supplemental cash flow disclosures:		
Income taxes paid, net	\$110,575	\$59,475
Interest paid	\$60,016	\$59,860
Non-cash activities:		
Purchase of land, property and equipment, net - investing activities	\$1,985	\$2,253

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Dividends payable - financing activities	\$ 12,763	\$ 20,284
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See accompanying notes to condensed consolidated financial statements (unaudited).

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KLA-TENCOR CORPORATION

Notes to Condensed Consolidated Financial Statements
(Unaudited)

NOTE 1 – DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

Description of Business. KLA-Tencor Corporation (“KLA-Tencor” or the “Company”) is a leading supplier of process control and yield management solutions for the semiconductor and related nanoelectronics industries. KLA-Tencor’s broad portfolio of inspection and metrology products, and related service, software and other offerings primarily supports integrated circuit, which is referred to as an “IC” or “chip,” manufacturers throughout the entire semiconductor fabrication process, from research and development to final volume production. KLA-Tencor provides leading-edge equipment, software and support that enable IC manufacturers to identify, resolve and manage significant advanced technology manufacturing process challenges and obtain higher finished product yields at lower overall cost. In addition to serving the semiconductor industry, KLA-Tencor also provides a range of technology solutions to a number of other high technology industries, including the LED and data storage industries, as well as general materials research. Headquartered in Milpitas, California, KLA-Tencor has subsidiaries both in the United States and in key markets throughout the world.

Terminated Merger Agreement. On October 20, 2015, the Company entered into an Agreement and Plan of Merger and Reorganization (the “Merger Agreement” or “Merger”) with Lam Research Corporation (“Lam Research”) which was subject to regulatory approvals. On October 5, 2016, the parties mutually agreed to terminate the Merger Agreement and no termination fees were payable by either party.

Basis of Presentation. The condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the unaudited interim financial statements reflect all adjustments (consisting only of normal, recurring adjustments) necessary for a fair statement of the financial position, results of operations, comprehensive income, and cash flows for the periods indicated. These financial statements and notes, however, should be read in conjunction with Item 8, “Financial Statements and Supplementary Data” included in the Company’s Annual Report on Form 10-K for the fiscal year ended June 30, 2016, filed with the SEC on August 5, 2016.

The condensed consolidated financial statements include the accounts of KLA-Tencor and its majority-owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

The results of operations for the three and six months ended December 31, 2016 are not necessarily indicative of the results that may be expected for any other interim period or for the full fiscal year ending June 30, 2017.

Certain reclassifications have been made to the prior year’s Condensed Consolidated Balance Sheet and notes to conform to the current year presentation. The reclassifications had no effect on the prior year’s Condensed Consolidated Statements of Operations, Comprehensive Income and Cash Flows.

Management Estimates. The preparation of the condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions in applying the Company’s accounting policies that affect the reported amounts of assets and liabilities (and related disclosure of contingent assets and liabilities) at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Revenue Recognition. The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the selling price is fixed or determinable, and collectibility is reasonably assured. The Company derives revenue from three sources—sales of systems, spare parts and services. In general, the Company recognizes revenue for systems when the system has been installed, is operating according to predetermined specifications and is accepted by the customer. When the Company has demonstrated a history of successful installation and acceptance, the Company recognizes revenue upon delivery and customer acceptance. Under certain circumstances, however, the Company recognizes revenue prior to acceptance from the customer, as follows:

- When the customer fab has previously accepted the same tool, with the same specifications, and when the Company can objectively demonstrate that the tool meets all of the required acceptance criteria.
- When system sales to independent distributors have no installation requirement, contain no acceptance agreement, and 100% of the payment is due based upon shipment.

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When the installation of the system is deemed perfunctory.

When the customer withholds acceptance due to issues unrelated to product performance, in which case revenue is recognized when the system is performing as intended and meets predetermined specifications.

In circumstances in which the Company recognizes revenue prior to installation, the portion of revenue associated with installation is deferred based on estimated fair value, and that revenue is recognized upon completion of the installation.

In many instances, products are sold in stand-alone arrangements. Services are sold separately through renewals of annual maintenance contracts. The Company has multiple element revenue arrangements in cases where certain elements of a sales arrangement are not delivered and accepted in one reporting period. To determine the relative fair value of each element in a revenue arrangement, the Company allocates arrangement consideration based on the selling price hierarchy. For substantially all of the arrangements with multiple deliverables pertaining to products and services, the Company uses vendor-specific objective evidence (“VSOE”) or third-party evidence (“TPE”) to allocate the selling price to each deliverable. The Company determines TPE based on historical prices charged for products and services when sold on a stand-alone basis. When the Company is unable to establish relative selling price using VSOE or TPE, the Company uses estimated selling price (“ESP”) in its allocation of arrangement consideration. The objective of ESP is to determine the price at which the Company would transact a sale if the product or service were sold on a stand-alone basis. ESP could potentially be used for new or customized products. The Company regularly reviews relative selling prices and maintains internal controls over the establishment and updates of these estimates.

In a multiple element revenue arrangement, the Company defers revenue recognition associated with the relative fair value of each undelivered element until that element is delivered to the customer. To be considered a separate element, the product or service in question must represent a separate unit of accounting, which means that such product or service must fulfill the following criteria: (a) the delivered item(s) has value to the customer on a stand-alone basis; and (b) if the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the Company. If the arrangement does not meet all the above criteria, the entire amount of the sales contract is deferred until all elements are accepted by the customer.

Trade-in rights are occasionally granted to customers to trade in tools in connection with subsequent purchases. The Company estimates the value of the trade-in right and reduces the revenue recognized on the initial sale. This amount is recognized at the earlier of the exercise of the trade-in right or the expiration of the trade-in right.

Spare parts revenue is recognized when the product has been shipped, risk of loss has passed to the customer and collection of the resulting receivable is probable.

Service and maintenance contract revenue is recognized ratably over the term of the maintenance contract. Revenue from services performed in the absence of a maintenance contract, including consulting and training revenue, is recognized when the related services are performed and collectibility is reasonably assured.

The Company sells stand-alone software that is subject to software revenue recognition guidance. The Company periodically reviews selling prices to determine whether VSOE exists, and in situations where the Company is unable to establish VSOE for undelivered elements such as post-contract service, revenue is recognized ratably over the term of the service contract.

The Company also defers the fair value of non-standard warranty bundled with equipment sales as unearned revenue. Non-standard warranty includes services incremental to the standard 40-hour per week coverage for 12 months.

Non-standard warranty is recognized ratably as revenue when the applicable warranty term period commences.

The deferred system profit balance equals the value of products that have been shipped and billed to customers which have not met the Company’s revenue recognition criteria, less applicable product and warranty costs. Deferred system profit does not include the profit associated with product shipments to certain customers in Japan, to whom title does not transfer until customer acceptance. Shipments to such customers in Japan are classified as inventory at cost until the time of acceptance.

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Recent Accounting Pronouncements.

Recently Adopted

In April 2015, the Financial Accounting Standards Board (“FASB”) issued an accounting standard update for customer’s cloud based fees. The guidance changes what a customer must consider in determining whether a cloud computing arrangement contains a software license. If the arrangement contains a software license, the customer would account for the fees related to the software license element in accordance with guidance related to internal use software; if the arrangement does not contain a software license, the customer would account for the arrangement as a service contract. The Company adopted this update beginning in the first quarter of its fiscal year ending June 30, 2017 on a prospective basis and there was no impact of adoption on its condensed consolidated financial statements.

In March 2016, the FASB issued an accounting standard update to simplify certain aspects of share-based payment awards to employees, including the accounting for income taxes, an option to recognize gross stock-based compensation expense with actual forfeitures recognized as they occur and statutory tax withholding requirements, as well as certain classifications in the statement of cash flows. The update is effective for the Company beginning in the first quarter of its fiscal year ending June 30, 2018, with early adoption permitted and all of the guidance must be adopted in the same period. However, the Company elected to early-adopt this standard update beginning in the first quarter of its fiscal year ending June 30, 2017.

Impact to Condensed Consolidated Statements of Operations

The primary impact of adopting the standard update is a change in the recording of the excess tax benefits or deficiencies from share-based payments. Before adoption, the Company recognized the excess tax benefits or deficiencies related to stock-based compensation as a credit or charge to additional paid-in capital (“APIC”) in the Company’s Condensed Consolidated Balance Sheets. Under the standard update, these excess tax benefits or deficiencies are recognized as a discrete tax benefit or discrete tax expense in the income tax provision in the Company’s Condensed Consolidated Statement of Operations. For the three and six months ended December 31, 2016, the Company recognized a discrete tax benefit of \$0.1 million and \$5.8 million, respectively, related to net excess tax benefits mainly from stock-based compensation and dividend equivalents. The standard update requires companies to adopt the amendment related to accounting for excess tax benefits or deficiencies on a prospective basis only and as a result, prior periods were not retrospectively adjusted.

Impact to Condensed Consolidated Statements of Cash Flows

In addition to the income tax consequence as described above, the standard update for share-based payment requires that cash flows from excess tax benefits related to share-based payments be reported as operating activities in the Condensed Consolidated Statements of Cash Flows. Previously, cash flows from excess tax benefit related to share-based payments were reported as financing activities. The standard update allows for two methods of adoption which are prospective or retrospective application. The Company elected to adopt this amendment on a prospective basis and as a result, prior periods were not retrospectively adjusted.

Updates Not Yet Effective

In May 2014, the FASB issued an accounting standard update regarding revenue from customer contracts to transfer goods and services or non-financial assets unless the contracts are covered by other standards (for example, insurance or lease contracts). Under the new guidance, an entity should recognize revenue in connection with the transfer of promised goods or services to customers in an amount that reflects the consideration that the entity expects to be entitled to receive in exchange for those goods or services. In addition, the new standard requires that reporting companies disclose the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. In August 2015, the FASB issued an amendment to defer the effective date of the update by one year, with early adoption on the original effective date permitted. With this amendment, the updates are effective for the Company beginning in the first quarter of the fiscal year ending June 30, 2019, with early adoption permitted beginning in the first quarter of the fiscal year ending June 30, 2018. Subsequent to this amendment, the FASB has issued additional clarifying implementation guidance. The new revenue standard may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of adoption. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

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In July 2015, the FASB issued an accounting standard update for the subsequent measurement of inventory. The amended guidance requires entities to measure inventory at the lower of cost or net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. The requirement would replace the current lower of cost or market evaluation and the accounting guidance is unchanged for inventory measured using last-in, first-out (“LIFO”) or the retail inventory method. The update is effective for the Company beginning in the first quarter of the Company’s fiscal year ending June 30, 2018 and should be applied prospectively with early adoption permitted as of the beginning of an interim or annual reporting period. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

In January 2016, the FASB issued an accounting standard update that changes the accounting for financial instruments primarily related to equity investments (other than those accounted for under the equity method of accounting or those that result in consolidation of the investee), financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. The accounting standard update is effective for the Company beginning in the first quarter of its fiscal year ending 2019, and early adoption is permitted. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

In February 2016, the FASB issued an accounting standard update which amends the existing accounting standards for leases. Consistent with current guidance, the recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification. Under the new guidance, a lessee will be required to recognize assets and liabilities for all leases with lease terms of more than 12 months. The update is effective for the Company beginning in the first quarter of its fiscal year ending June 30, 2020 using a modified retrospective transition method. Early adoption is permitted. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

In June 2016, the FASB issued an accounting standard update that changes the accounting for recognizing impairments of financial assets. Under the update, credit losses for certain types of financial instruments will be estimated based on expected losses. The update also modifies the impairment models for available-for-sale debt securities and for purchased financial assets with credit deterioration since their origination. The update is effective for the Company beginning in the first quarter of its fiscal year ending June 30, 2021, with early adoption permitted starting in the first quarter of fiscal year ending 2020. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

In October 2016, the FASB issued an accounting standard update to recognize the income tax consequences of intra-entity transfers of assets other than inventory when they occur. This eliminates the exception to postpone recognition until the asset has been sold to an outside party. This standard is effective for the Company beginning in the first quarter of its fiscal year ending 2019, and early adoption is permitted. It is required to be applied on a modified retrospective basis through a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

NOTE 2 – FAIR VALUE MEASUREMENTS

The Company’s financial assets and liabilities are measured and recorded at fair value, except for certain equity investments in privately-held companies. These equity investments are generally accounted for under the cost method of accounting and are periodically assessed for other-than-temporary impairment when an event or circumstance indicates that an other-than-temporary decline in value may have occurred. The Company’s non-financial assets, such as goodwill, intangible assets, and land, property and equipment, are recorded at cost and are assessed for impairment when an event or circumstance indicates that an other-than-temporary decline in value may have occurred.

Fair Value of Financial Instruments. KLA-Tencor has evaluated the estimated fair value of financial instruments using available market information and valuations as provided by third-party sources. The use of different market assumptions and/or estimation methodologies could have a significant effect on the estimated fair value amounts. The fair value of the Company’s cash equivalents, accounts receivable, accounts payable and other current assets and liabilities approximate their carrying amounts due to the relatively short maturity of these items.

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Fair Value Hierarchy. The authoritative guidance for fair value measurements establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are described below:

- Level 1 Valuations based on quoted prices in active markets for identical assets or liabilities that the entity has the ability to access.
- Level 2 Valuations based on quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable data for substantially the full term of the assets or liabilities.
- Level 3 Valuations based on inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

The Company's financial instruments were classified within Level 1 or Level 2 of the fair value hierarchy as of December 31, 2016, because they were valued using quoted market prices, broker/dealer quotes or alternative pricing sources with reasonable levels of price transparency. As of December 31, 2016, the types of instruments valued based on quoted market prices in active markets included money market funds, U.S. Treasury securities, certain U.S. Government agency securities and certain sovereign securities. Such instruments are generally classified within Level 1 of the fair value hierarchy.

As of December 31, 2016, the types of instruments valued based on other observable inputs included corporate debt securities, municipal securities, and certain sovereign securities. The market inputs used to value these instruments generally consist of market yields, reported trades and broker/dealer quotes. Such instruments are generally classified within Level 2 of the fair value hierarchy.

The principal market in which the Company executes its foreign currency contracts is the institutional market in an over-the-counter environment with a relatively high level of price transparency. The market participants generally are large financial institutions. The Company's foreign currency contracts' valuation inputs are based on quoted prices and quoted pricing intervals from public data sources and do not involve management judgment. These contracts are typically classified within Level 2 of the fair value hierarchy.

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Financial assets (excluding cash held in operating accounts and time deposits) and liabilities measured at fair value on a recurring basis, as of the date indicated below, were presented on the Company's Condensed Consolidated Balance Sheet as follows:

As of December 31, 2016 (In thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Assets			
Cash equivalents:			
Money market and other	\$552,189	\$ 552,189	\$ —
U.S. Treasury securities	33,646	33,646	—
Marketable securities:			
Corporate debt securities	933,247	—	933,247
Municipal securities	1,004	—	1,004
Sovereign securities	58,024	1,991	56,033
U.S. Treasury securities	277,660	277,660	—
U.S. Government agency securities	378,632	378,632	—
Total cash equivalents and marketable securities ⁽¹⁾	2,234,402	1,244,118	990,284
Other current assets:			
Derivative assets	13,978	—	13,978
Other non-current assets:			
Executive Deferred Savings Plan	173,490	130,692	42,798
Total financial assets ⁽¹⁾	\$2,421,870	\$ 1,374,810	\$ 1,047,060
Liabilities			
Other current liabilities:			
Derivative liabilities	\$(4,103)) \$ —	\$ (4,103)
Total financial liabilities	\$(4,103)) \$ —	\$ (4,103)

(1) Excludes cash of \$327.8 million held in operating accounts and time deposits of \$30.8 million as of December 31, 2016.

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Financial assets (excluding cash held in operating accounts and time deposits) and liabilities measured at fair value on a recurring basis, as of the date indicated below, were presented on the Company's Condensed Consolidated Balance Sheet as follows:

As of June 30, 2016 (In thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Assets			
Cash equivalents:			
Corporate debt securities	\$20,569	\$ —	\$ 20,569
Money market and other	626,156	626,156	—
U.S. Treasury securities	68,748	68,748	—
Marketable securities:			
Corporate debt securities	657,905	—	657,905
Municipal securities	5,016	—	5,016
Sovereign securities	41,257	6,426	34,831
U.S. Treasury securities	258,754	258,754	—
U.S. Government agency securities	405,705	385,731	19,974
Total cash equivalents and marketable securities ⁽¹⁾	2,084,110	1,345,815	738,295
Other current assets:			
Derivative assets	1,095	—	1,095
Other non-current assets:			
Executive Deferred Savings Plan	162,160	106,149	56,011
Total financial assets ⁽¹⁾	\$2,247,365	\$ 1,451,964	\$ 795,401
Liabilities			
Other current liabilities:			
Derivative liabilities	\$(11,647)	\$ —	\$ (11,647)
Total financial liabilities	\$(11,647)	\$ —	\$ (11,647)

(1) Excludes cash of \$330.1 million held in operating accounts and time deposits of \$77.1 million as of June 30, 2016. There were no transfers between Level 1 and Level 2 fair value measurements during the six months ended December 31, 2016. The Company did not have any assets or liabilities measured at fair value on a recurring basis within Level 3 fair value measurements as of December 31, 2016 or June 30, 2016.

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NOTE 3 – FINANCIAL STATEMENT COMPONENTS

Balance Sheet Components

(In thousands)	As of December 31, 2016	As of June 30, 2016
Accounts receivable, net:		
Accounts receivable, gross	\$685,454	\$634,905
Allowance for doubtful accounts	(21,602)	(21,672)
	\$663,852	\$613,233
Inventories:		
Customer service parts	\$238,446	\$234,712
Raw materials	197,641	208,689
Work-in-process	182,342	187,733
Finished goods	52,743	67,501
	\$671,172	\$698,635
Other current assets:		
Prepaid expenses	\$33,456	\$37,127
Income tax related receivables	47,658	18,190
Other current assets	22,524	9,553
	\$103,638	\$64,870
Land, property and equipment, net:		
Land	\$40,601	\$40,603
Buildings and leasehold improvements	315,558	313,239
Machinery and equipment	528,351	507,378
Office furniture and fixtures	21,091	21,737
Construction-in-process	6,255	5,286
	911,856	888,243
Less: accumulated depreciation and amortization	(631,890)	(610,229)
	\$279,966	\$278,014
Other non-current assets:		
Executive Deferred Savings Plan ⁽¹⁾	\$173,490	\$162,160
Other non-current assets	12,133	12,499
	\$185,623	\$174,659
Other current liabilities:		
Compensation and benefits	\$137,614	\$224,496
Executive Deferred Savings Plan ⁽¹⁾	174,071	162,289
Customer credits and advances	79,519	81,994
Interest payable	19,427	19,395
Warranty	40,673	34,773
Income taxes payable	23,223	27,964
Other accrued expenses	96,396	111,297
	\$570,923	\$662,208
Other non-current liabilities:		
Pension liabilities	\$66,255	\$69,418
Income taxes payable	57,315	50,365
Other non-current liabilities	26,196	36,840
	\$149,766	\$156,623

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KLA-Tencor has a non-qualified deferred compensation plan (known as “Executive Deferred Savings Plan”) under which certain executives and non-employee directors may defer a portion of their compensation. Participants are credited with returns based on their allocation of their account balances among measurement funds. The Company controls the investment of these funds, and the participants remain general creditors of the Company. The Company invests these funds in certain mutual funds and such investments are classified as trading securities in the condensed consolidated balance sheets. Distributions from the Executive Deferred Savings Plan commence following a participant’s retirement or termination of employment or on a specified date allowed per the Executive Deferred Savings Plan provisions, except in cases where such distributions are required to be delayed in order to avoid a prohibited distribution under Internal Revenue Code Section 409A. Participants can generally elect the distributions to be paid in lump sum or quarterly cash payments over a scheduled period for up to 15 years and are (1) allowed to make subsequent changes to their existing elections as permissible under the Executive Deferred Savings Plan provisions. Changes in the Executive Deferred Savings Plan liability are recorded in selling, general and administrative expense in the condensed consolidated statements of operations. The expense (benefit) associated with changes in the liability included in selling, general and administrative expense was \$1.2 million and \$6.8 million during the three months ended December 31, 2016 and 2015, respectively, and was \$7.0 million and \$(3.3) million during the six months ended December 31, 2016 and 2015, respectively. Changes in the Executive Deferred Savings Plan assets are recorded as gains (losses), net in selling, general and administrative expense in the condensed consolidated statements of operations. The amount of gains (losses), net included in selling, general and administrative expense was \$0.8 million and \$6.9 million during the three months ended December 31, 2016 and 2015, respectively, and was \$6.7 million and \$(3.1) million during the six months ended December 31, 2016 and 2015, respectively.

Accumulated Other Comprehensive Income (Loss)

The components of accumulated other comprehensive income (loss) (“OCI”) as of the dates indicated below were as follows:

(In thousands)	Currency Translation Adjustments	Unrealized Gains (Losses) on Available-for-Sale Securities	Unrealized Gains (Losses) on Cash Flow Hedges	Unrealized Gains (Losses) on Defined Benefit Plans	Total	
Balance as of December 31, 2016	\$ (37,937)	\$ (5,057)	\$ 10,261	\$(19,423)	\$(52,156)	
Balance as of June 30, 2016	\$ (32,424)	\$ 3,451	\$ 775	\$(20,487)	\$(48,685)	
The effects on net income of amounts reclassified from accumulated OCI to the Condensed Consolidated Statement of Operations for the indicated period were as follows (in thousands):						
		Location in the Condensed Consolidated Statements of Operations	Three months ended December 31, 2016	2015	Six months ended December 31, 2016	2015
Accumulated OCI Components						
Unrealized gains (losses) on cash flow hedges from foreign exchange and interest rate contracts		Revenues	\$(1,425)	\$324	\$(2,906)	\$1,009
		Costs of revenues	(69)	(678)	(156)	(1,150)
		Interest expense	189	189	378	378
		Net gains (losses) reclassified from accumulated OCI	\$(1,305)	\$(165)	\$(2,684)	\$237
Unrealized gains (losses) on available-for-sale securities		Other expense (income), net	\$30	\$26	\$234	\$43

The amounts reclassified out of accumulated OCI related to the Company's defined benefit pension plans, which were recognized as a component of net periodic cost for the three and six months ended December 31, 2016 were \$0.9 million and \$1.3 million, respectively. The amounts reclassified out of accumulated OCI related to the Company's defined benefit pension plans, which were recognized as a component of net periodic cost for the three and six months ended December 31, 2015 were \$0.7 million and \$1.0 million, respectively. For additional details, refer to Note 10, "Employee Benefit Plans" in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2016.

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NOTE 4 – MARKETABLE SECURITIES

The amortized cost and fair value of marketable securities as of the dates indicated below were as follows:

As of December 31, 2016 (In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate debt securities	\$936,011	\$ 205	\$ (2,969)	\$933,247
Money market and other	552,189	—	—	552,189
Municipal securities	1,004	—	—	1,004
Sovereign securities	58,129	1	(106)	58,024
U.S. Treasury securities	312,438	71	(1,203)	311,306
U.S. Government agency securities	380,532	57	(1,957)	378,632
Subtotal	2,240,303	334	(6,235)	2,234,402
Add: Time deposits ⁽¹⁾	30,814	—	—	30,814
Less: Cash equivalents	609,272	—	—	609,272
Marketable securities	\$1,661,845	\$ 334	\$ (6,235)	\$1,655,944

As of June 30, 2016 (In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate debt securities	\$676,259	\$ 2,372	\$ (157)	\$678,474
Money market and other	626,156	—	—	626,156
Municipal securities	5,014	2	—	5,016
Sovereign securities	41,224	38	(5)	41,257
U.S. Treasury securities	326,321	1,181	—	327,502
U.S. Government agency securities	404,889	830	(14)	405,705
Subtotal	2,079,863	4,423	(176)	2,084,110
Add: Time deposits ⁽¹⁾	77,131	—	—	77,131
Less: Cash equivalents	778,451	1	(17)	778,435
Marketable securities	\$1,378,543	\$ 4,422	\$ (159)	\$1,382,806

(1) Time deposits excluded from fair value measurements.

KLA-Tencor's investment portfolio consists of both corporate and government securities that have a maximum maturity of three years. The longer the duration of these securities, the more susceptible they are to changes in market interest rates and bond yields. As yields increase, those securities with a lower yield-at-cost show a mark-to-market unrealized loss. All unrealized losses are due to changes in market interest rates, bond yields and/or credit ratings. The Company believes that it has the ability to realize the full value of all of these investments upon maturity. The following table summarizes the fair value and gross unrealized losses of the Company's investments that were in an unrealized loss position as of the date indicated below:

As of December 31, 2016 (In thousands)	Fair Value	Gross Unrealized Losses ⁽¹⁾
Corporate debt securities	\$702,366	\$ (2,969)
U.S. Government agency securities	310,258	(1,957)
U.S. Treasury securities	173,202	(1,203)
Sovereign securities	43,433	(106)
Municipal securities	1,004	—
Total	\$1,230,263	\$ (6,235)

(1) As of December 31, 2016, the amount of total gross unrealized losses related to investments that had been in a continuous loss position for 12 months or more was immaterial.

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The contractual maturities of securities classified as available-for-sale, regardless of their classification on the Company's Condensed Consolidated Balance Sheet, as of the date indicated below were as follows:

As of December 31, 2016 (In thousands)	Amortized Cost	Fair Value
Due within one year	\$673,708	\$673,484
Due after one year through three years	988,137	982,460
	\$1,661,845	\$1,655,944

Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Realized gains and losses on available-for-sale securities for the three and six months ended December 31, 2016 and 2015 were immaterial.

NOTE 5 – GOODWILL AND PURCHASED INTANGIBLE ASSETS**Goodwill**

Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in prior business combinations. The Company has four reporting units: Wafer Inspection, Patterning, Global Service and Support, and Others. The following table presents goodwill balances and movements by reporting unit during the six months ended December 31, 2016:

(In thousands)	Wafer Inspection	Patterning	Others	Total
Balance as of June 30, 2016	\$281,026	\$ 53,255	\$ 896	\$335,177
Goodwill adjustment	(7)	—	—	(7)
Balance as of December 31, 2016	\$281,019	\$ 53,255	\$ 896	\$335,170

Goodwill is net of accumulated impairment losses of \$277.6 million, which were recorded prior to the fiscal year ended June 30, 2014. The changes in the goodwill balance during the six months ended December 31, 2016 resulted from foreign currency translation adjustments.

The Company performed a qualitative assessment of the goodwill by reporting unit as of November 30, 2016 during the three months ended December 31, 2016 and concluded that it was more likely than not that the fair value of each of the reporting units exceeded its carrying amount. As a result of the Company's determination following its qualitative assessment, it was not necessary to perform the two-step quantitative goodwill impairment test at this time. In assessing the qualitative factors, the Company considered the impact of key factors, including changes in the industry and competitive environment, market capitalization, stock price, earnings multiples, budgeted-to-actual revenue performance from prior year, gross margin and cash flows from operating activities.

Based on the Company's assessment, goodwill in the reporting units was not impaired as of December 31, 2016 or June 30, 2016.

Purchased Intangible Assets

The components of purchased intangible assets as of the dates indicated below were as follows:

(In thousands)		As of December 31, 2016			As of June 30, 2016		
Category	Range of Useful Lives	Gross Carrying Amount	Accumulated Amortization and Impairment	Net Amount	Gross Carrying Amount	Accumulated Amortization and Impairment	Net Amount
Existing technology	4-7 years	\$141,659	\$ 139,161	\$ 2,498	\$141,659	\$ 138,160	\$ 3,499
Trade name/Trademark	4-10 years	19,893	19,893	—	19,893	19,743	150
Customer relationships	6-7 years	54,980	54,927	53	54,980	54,298	682
Total		\$216,532	\$ 213,981	\$ 2,551	\$216,532	\$ 212,201	\$ 4,331

Intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable.

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For the three months ended December 31, 2016 and 2015, amortization expense for purchased intangible assets was \$0.5 million and \$1.3 million, respectively. For the six months ended December 31, 2016 and 2015, amortization expense for purchased intangible assets was \$1.8 million and \$5.0 million, respectively. Based on the intangible assets recorded as of December 31, 2016, and assuming no subsequent additions to, or impairment of, the underlying assets, the remaining estimated amortization expense is expected to be as follows:

Fiscal year ending June 30:	Amortization (In thousands)
2017 (remaining 6 months)	\$ 1,026
2018	1,525
Total	\$ 2,551

NOTE 6 – DEBT

The following table summarizes the debt of the Company as of December 31, 2016 and June 30, 2016:

	As of December 31, 2016		As of June 30, 2016	
	Amount (In thousands)	Effective Interest Rate	Amount (In thousands)	Effective Interest Rate
Fixed-rate 2.375% Senior notes due on November 1, 2017	\$250,000	2.396 %	\$250,000	2.396 %
Fixed-rate 3.375% Senior notes due on November 1, 2019	250,000	3.377 %	250,000	3.377 %
Fixed-rate 4.125% Senior notes due on November 1, 2021	500,000	4.128 %	500,000	4.128 %
Fixed-rate 4.650% Senior notes due on November 1, 2024 ⁽¹⁾	1,250,000	4.682 %	1,250,000	4.682 %
Fixed-rate 5.650% Senior notes due on November 1, 2034	250,000	5.670 %	250,000	5.670 %
Term loans	496,250	2.000 %	576,250	1.714 %
Total debt	2,996,250		3,076,250	
Unamortized discount	(3,107)		(3,312)	
Unamortized debt issuance costs	(13,946)		(15,002)	
Total long-term debt	\$2,979,197		\$3,057,936	
Reported as:				
Current portion of long-term debt	\$249,958		\$—	
Long-term debt	2,729,239		3,057,936	
Total debt	\$2,979,197		\$3,057,936	

The effective interest rate disclosed above for this series of Senior Notes excludes the impact of the treasury rate (1)lock hedge discussed below. The effective interest rate including the impact of the treasury rate lock hedge was 4.626%.

As of December 31, 2016, future principal payments for the long-term debt are summarized as follows. There are no scheduled payment for the term loans for fiscal years ending 2017 and 2018, since the Company made \$178.8 million of principal prepayments as of December 31, 2016.

	Amount
Fiscal year ending June 30: (In thousands)	
2017 (remaining 6 months)	\$—
2018	250,000
2019	30,000
2020	716,250
2021	—
Thereafter	2,000,000
Total payments	\$2,996,250

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Senior Notes:

In November 2014, the Company issued \$2.50 billion aggregate principal amount of senior, unsecured long-term notes (collectively referred to as “Senior Notes”). The Company issued the Senior Notes as part of the leveraged recapitalization plan under which the proceeds from the Senior Notes in conjunction with the proceeds from the term loans (described below) and cash on hand were used (x) to fund a special cash dividend of \$16.50 per share, aggregating to approximately \$2.76 billion, (y) to redeem \$750.0 million of 2018 Senior Notes, including associated redemption premiums, accrued interest and other fees and expenses and (z) for other general corporate purposes, including repurchases of shares pursuant to the Company’s stock repurchase program. The interest rate specified for each series of the Senior Notes will be subject to adjustments from time to time if Moody’s Investor Service, Inc. (“Moody’s”) or Standard & Poor’s Ratings Services (“S&P”) or, under certain circumstances, a substitute rating agency selected by us as a replacement for Moody’s or S&P, as the case may be (a “Substitute Rating Agency”), downgrades (or subsequently upgrades) its rating assigned to the respective series of Senior Notes such that the adjusted rating is below investment grade. If the adjusted rating of any series of Senior Notes from Moody’s (or, if applicable, any Substitute Rating Agency) is decreased to Ba1, Ba2, Ba3 or B1 or below, the stated interest rate on such series of Senior Notes as noted above will increase by 25 bps, 50 bps, 75 bps or 100 bps, respectively (“bps” refers to Basis Points and 1% is equal to 100 bps). If the rating of any series of Senior Notes from S&P (or, if applicable, any Substitute Rating Agency) with respect to such series of Senior Notes is decreased to BB+, BB, BB- or B+ or below, the stated interest rate on such series of Senior Notes as noted above will increase by 25 bps, 50 bps, 75 bps or 100 bps, respectively. The interest rates on any series of Senior Notes will permanently cease to be subject to any adjustment (notwithstanding any subsequent decrease in the ratings by any of Moody’s, S&P and, if applicable, any Substitute Rating Agency) if such series of Senior Notes becomes rated “Baa1” (or its equivalent) or higher by Moody’s (or, if applicable, any Substitute Rating Agency) and “BBB+” (or its equivalent) or higher by S&P (or, if applicable, any Substitute Rating Agency), or one of those ratings if rated by only one of Moody’s, S&P and, if applicable, any Substitute Rating Agency, in each case with a stable or positive outlook. In October 2014, the Company entered into a series of forward contracts to lock the 10-year treasury rate (“benchmark rate”) on a portion of the Senior Notes with a notional amount of \$1.00 billion in aggregate. For additional details, refer to Note 14, “Derivative Instruments and Hedging Activities.”

The original discount on the Senior Notes amounted to \$4.0 million and is being amortized over the life of the debt. Interest is payable semi-annually on May 1 and November 1 of each year. The debt indenture (the “Indenture”) includes covenants that limit the Company’s ability to grant liens on its facilities and enter into sale and leaseback transactions, subject to certain allowances under which certain sale and leaseback transactions are not restricted. As of December 31, 2016, the Company was in compliance with all of its covenants under the Indenture associated with the Senior Notes.

In certain circumstances involving a change of control followed by a downgrade of the rating of a series of Senior Notes by at least two of Moody’s, S&P and Fitch Inc., unless the Company has exercised its right to redeem the Senior Notes of such series, the Company will be required to make an offer to repurchase all or, at the holder’s option, any part, of each holder’s Senior Notes of that series pursuant to the offer described below (the “Change of Control Offer”). In the Change of Control Offer, the Company will be required to offer payment in cash equal to 101% of the aggregate principal amount of Senior Notes repurchased plus accrued and unpaid interest, if any, on the Senior Notes repurchased, up to, but not including, the date of repurchase.

Based on the trading prices of the Senior Notes on the applicable dates, the fair value of the Senior Notes as of December 31, 2016 and June 30, 2016 was approximately \$2.62 billion and \$2.68 billion, respectively. While the Senior Notes are recorded at cost, the fair value of the long-term debt was determined based on quoted prices in markets that are not active; accordingly, the long-term debt is categorized as Level 2 for purposes of the fair value measurement hierarchy.

Table of Contents**Credit Facility (Term Loans and Unfunded Revolving Credit Facility):**

In November 2014, the Company entered into \$750.0 million of five-year senior unsecured prepayable term loans and a \$500.0 million unfunded revolving credit facility (collectively, the “Credit Facility”) under the Credit Agreement (the “Credit Agreement”). The interest under the Credit Facility will be payable on the borrowed amounts at the London Interbank Offered Rate (“LIBOR”) plus a spread, which is currently 125 bps, and this spread is subject to adjustment in conjunction with the Company’s credit rating downgrades or upgrades. The spread ranges from 100 bps to 175 bps based on the Company’s then effective credit rating. The Company is also obligated to pay an annual commitment fee of 15 bps on the daily undrawn balance of the revolving credit facility, which is also subject to an adjustment in conjunction with the Company’s credit rating downgrades or upgrades by Moody’s and S&P. The annual commitment fee ranges from 10 bps to 25 bps on the daily undrawn balance of the revolving credit facility, depending upon the then effective credit rating. Principal payments with respect to the term loans will be made on the last day of each calendar quarter, and any unpaid principal balance of the term loans, including accrued interest, shall be payable on November 14, 2019 (the “Maturity Date”). The Company may prepay the term loans and unfunded revolving credit facility at any time without a prepayment penalty. During the second quarter of the fiscal year ending June 30, 2017, the Company made term loan principal payments of \$40.0 million.

Future principal payments for the Company’s term loans (without giving effect to \$178.8 million of principal prepayments as of December 31, 2016 that shall be applied to the future scheduled quarterly payments) as of December 31, 2016, are as follows:

Fiscal Quarters Ending	Quarterly Payment (In thousands)
March 31, 2017 through December 31, 2017	\$ 14,063
March 31, 2018 through September 30, 2019	\$ 18,750
December 31, 2019	\$ 487,500

The Credit Facility requires the Company to maintain an interest expense coverage ratio as described in the Credit Agreement, on a quarterly basis, covering the trailing four consecutive fiscal quarters of no less than 3.50 to 1.00. In addition, the Company is required to maintain the maximum leverage ratio as described in the Credit Agreement, on a quarterly basis, covering the trailing four consecutive fiscal quarters for the fiscal quarters as described below.

Fiscal Quarters Ending	Maximum Leverage Ratio
December 31, 2016 and March 31, 2017	3.50:1.00
Thereafter	3.00:1.00

The Company was in compliance with the financial covenants under the Credit Agreement as of December 31, 2016 and had no outstanding borrowings under the unfunded revolving credit facility.

NOTE 7 – EQUITY AND LONG-TERM INCENTIVE COMPENSATION PLANS**Equity Incentive Program**

As of December 31, 2016, the Company had two plans under which the Company was able to issue equity incentive awards, such as restricted stock units and stock options, to its employees, consultants and members of its Board of Directors: the 2004 Equity Incentive Plan (the “2004 Plan”) and the 1998 Director Plan (the “Outside Director Plan”).

2004 Plan:

The 2004 Plan provides for the grant of options to purchase shares of the Company’s common stock, stock appreciation rights, restricted stock units, performance shares, performance units and deferred stock units to the Company’s employees, consultants and members of its Board of Directors. As of December 31, 2016, 3.6 million shares were available for issuance under the 2004 Plan.

Any 2004 Plan awards of restricted stock units, performance shares, performance units or deferred stock units with a per share or unit purchase price lower than 100% of fair market value on the grant date are counted against the total number of shares issuable under the 2004 Plan as follows, based on the grant date of the applicable award: (a) for any such awards granted before November 6, 2013, the awards counted against the 2004 Plan share reserve as 1.8 shares for every one share subject thereto; and (b) for any such awards granted on or after November 6, 2013, the awards

count against the 2004 Plan share reserve as 2.0 shares for every one share subject thereto.

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In addition, the plan administrator has the ability to grant “dividend equivalent” rights in connection with awards of restricted stock units, performance shares, performance units and deferred stock units before they are fully vested. The plan administrator, at its discretion, may grant a right to receive dividends on the aforementioned awards which may be settled in cash or Company stock at the discretion of the plan administrator subject to meeting the vesting requirement of the underlying awards.

Outside Director Plan

The Outside Director Plan only permits the issuance of stock options to the non-employee members of the Board of Directors. As of December 31, 2016, 1.7 million shares were available for grant under the Outside Director Plan.

Equity Incentive Plans - General Information

The following table summarizes the combined activity under the Company’s equity incentive plans for the indicated periods:

(In thousands)	Available For Grant ⁽¹⁾
Balance as of June 30, 2016	6,778
Restricted stock units granted ⁽²⁾	(1,545)
Restricted stock units canceled	67
Balance as of December 31, 2016	5,300

(1) The number of restricted stock units reflects the application of the award multiplier as described above (1.8x or 2.0x depending on the grant date of the applicable award).

Includes restricted stock units granted to senior management during the six months ended December 31, 2016 with performance-based vesting criteria (in addition to service-based vesting criteria for any of such restricted stock units that are deemed to have been earned). As of December 31, 2016, it had not yet been determined the extent to which (if at all) the performance-based vesting criteria had been satisfied. Therefore, this line item includes all such performance-based restricted stock units granted during the six months ended December 31, 2016, reported at the maximum possible number of shares that may ultimately be issuable if all applicable performance-based criteria are achieved at their maximum levels and all applicable service-based criteria are fully satisfied (84 thousand shares for the six months ended December 31, 2016 after application of the multiplier described above).

The fair value of stock-based awards is measured at the grant date and is recognized as an expense over the employee’s requisite service period. For restricted stock units granted without “dividend equivalent” rights, fair value is calculated using the closing price of the Company’s common stock on the grant date, adjusted to exclude the present value of dividends which are not accrued on those restricted stock units. The fair value for restricted stock units granted with “dividend equivalent” rights is determined using the closing price of the Company’s common stock on the grant date. As of December 31, 2016, the Company accrued \$12.7 million of dividends payable, which included both a special cash dividend and quarterly cash dividends for the unvested restricted stock units outstanding as of the dividend record date. The fair value for purchase rights under the Company’s Employee Stock Purchase Plan is determined using a Black-Scholes valuation model.

The following table shows pre-tax stock-based compensation expense for the indicated periods:

(In thousands)	Three months ended December 31,		Six months ended December 31,	
	2016	2015	2016	2015
Stock-based compensation expense by:				
Costs of revenues	\$1,305	\$1,266	\$2,567	\$2,730
Research and development	2,052	2,269	4,073	4,761
Selling, general and administrative	9,087	7,790	17,282	16,082
Total stock-based compensation expense	\$12,444	\$11,325	\$23,922	\$23,573

As a result of the early adoption of the accounting standard update on accounting for share-based payment awards in the first quarter of its fiscal year ending June 30, 2017, the Company recorded excess tax benefits in the provision for

income taxes for the three and six months ended December 31, 2016 of \$0.1 million and \$5.8 million, respectively. See Note 1, "Description of Business and Basis of Presentation" for additional details.

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The following table shows stock-based compensation capitalized as inventory as of the dates indicated below:

	As of (In thousands) December 31, 2016	As of June 30, 2016
Inventory	\$ 2,659	\$2,685

Restricted Stock Units

The following table shows the applicable number of restricted stock units and weighted-average grant date fair value for restricted stock units granted, vested and released, withheld for taxes, and forfeited during the six months ended December 31, 2016 and restricted stock units outstanding as of December 31, 2016 and June 30, 2016:

Restricted Stock Units	Shares ⁽¹⁾ (In thousands)	Weighted-Average Grant Date Fair Value
Outstanding restricted stock units as of June 30, 2016 ⁽²⁾	1,849	\$ 56.41
Granted ⁽²⁾	772	\$ 70.95
Vested and released	(350)	\$ 52.78
Withheld for taxes	(238)	\$ 52.78
Forfeited	(34)	\$ 59.96
Outstanding restricted stock units as of December 31, 2016 ⁽²⁾	1,999	\$ 63.04

Share numbers reflect actual shares subject to awarded restricted stock units. As described above, under the terms of the 2004 Plan, the number of shares subject to each award reflected in this number is multiplied by either 1.8x or 2.0x (depending on the grant date of the award) to calculate the impact of the award on the share reserve under the 2004 Plan.

Includes restricted stock units granted to senior management with performance-based vesting criteria (in addition to service-based vesting criteria for any of such restricted stock units that are deemed to have been earned). As of December 31, 2016, it had not yet been determined the extent to which (if at all) the performance-based vesting criteria had been satisfied. Therefore, this line item includes all such performance-based restricted stock units, reported at the maximum possible number of shares (0.3 million shares for the fiscal year ended June 30, 2015, 0.3 million shares for the fiscal year ended June 30, 2016 and 42 thousand shares for the six months ended December 31, 2016) that may ultimately be issuable if all applicable performance-based criteria are achieved at their maximum and all applicable service-based criteria are fully satisfied.

The restricted stock units granted by the Company since the beginning of the fiscal year ended June 30, 2013 generally vest (a) with respect to awards with only service-based vesting criteria, in four equal installments on the first, second, third and fourth anniversaries of the grant date and (b) with respect to awards with both performance-based and service-based vesting criteria, in two equal installments on the third and fourth anniversaries of the grant date, in each case subject to the recipient remaining employed by the Company as of the applicable vesting date. The restricted stock units granted by the Company from the beginning of the fiscal year ended June 30, 2007 through the fiscal year ended June 30, 2012 generally vested in two equal installments on the second and fourth anniversaries of the grant date, subject to the recipient remaining employed by the Company as of the applicable vesting date. The restricted stock units granted to the independent members of the board of directors vest on the first anniversary of the date of grant.

The following table shows the weighted-average grant date fair value per unit for the restricted stock units granted and the restricted stock units vested and tax benefits realized by the Company in connection with vested and released restricted stock units for the indicated periods:

Three months ended December 31,	Six months ended December 31,
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(In thousands, except for weighted-average grant date fair value)	2016	2015	2016	2015
Weighted-average grant date fair value per unit	\$75.38	\$66.83	\$70.95	\$51.12
Grant date fair value of vested restricted stock units	\$1,843	2,299	\$31,051	\$48,021
Tax benefits realized by the Company in connection with vested and released restricted stock units	\$765	\$2,165	\$14,694	\$25,682

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As of December 31, 2016, the unrecognized stock-based compensation expense balance related to restricted stock units was \$90.5 million, excluding the impact of estimated forfeitures, and will be recognized over a weighted-average remaining contractual term and an estimated weighted-average amortization period of 1.7 years. The intrinsic value of outstanding restricted stock units as of December 31, 2016 was \$157.3 million.

Cash-Based Long-Term Incentive Compensation

The Company has adopted a cash-based long-term incentive (“Cash LTI”) program for many of its employees as part of the Company’s employee compensation program. During the six months ended December 31, 2016 and 2015, the Company approved Cash LTI awards of \$50.3 million and \$47.1 million, respectively under the Company’s Cash Long-Term Incentive Plan (“Cash LTI Plan”). Cash LTI awards issued to employees under the Cash LTI Plan will vest in four equal installments, with 25% of the aggregate amount of the Cash LTI award vesting on each anniversary of the grant date over a four-year period. In order to receive payments under a Cash LTI award, participants must remain employed by the Company as of the applicable award vesting date. Executives and non-employee Board members are not participating in this program. During the three months ended December 31, 2016 and 2015, the Company recognized \$11.2 million and \$11.5 million, respectively, in compensation expense under the Cash LTI Plan. During the six months ended December 31, 2016 and 2015, the Company recognized \$23.4 million and \$21.4 million, respectively, in compensation expense under the Cash LTI Plan. As of December 31, 2016, the unrecognized compensation balance (excluding the impact of estimated forfeitures) related to the Cash LTI Plan was \$108.4 million.

Employee Stock Purchase Plan

KLA-Tencor’s Employee Stock Purchase Plan (“ESPP”) provides that eligible employees may contribute up to 10% of their eligible earnings toward the semi-annual purchase of KLA-Tencor’s common stock. The ESPP is qualified under Section 423 of the Internal Revenue Code. The employee’s purchase price is derived from a formula based on the closing price of the common stock on the first day of the offering period versus the closing price on the date of purchase (or, if not a trading day, on the immediately preceding trading day).

The offering period (or length of the look-back period) under the ESPP has a duration of six months, and the purchase price with respect to each offering period beginning on or after such date is, until otherwise amended, equal to 85% of the lesser of (i) the fair market value of the Company’s common stock at the commencement of the applicable six-month offering period or (ii) the fair market value of the Company’s common stock on the purchase date. The Company estimates the fair value of purchase rights under the ESPP using a Black-Scholes valuation model.

The fair value of each purchase right under the ESPP was estimated on the date of grant using the Black-Scholes option valuation model and the straight-line attribution approach with the following weighted-average assumptions:

	Three months ended December 31, 2016		Six months ended December 31, 2015	
Stock purchase plan:				
Expected stock price volatility	20.6 %	23.9 %	20.6 %	23.9 %
Risk-free interest rate	0.4 %	0.1 %	0.4 %	0.1 %
Dividend yield	3.0 %	3.7 %	3.0 %	3.7 %
Expected life (in years)	0.5	0.5	0.5	0.5

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The following table shows total cash received from employees for the issuance of shares under the ESPP, the number of shares purchased by employees through the ESPP, the tax benefits realized by the Company in connection with the disqualifying dispositions of shares purchased under the ESPP and the weighted-average fair value per share for the indicated periods:

(In thousands, except for weighted-average fair value per share)	Three months ended		Six months ended	
	December 31,		December 31,	
	2016	2015	2016	2015
Total cash received from employees for the issuance of shares under the ESPP	\$23,694	\$21,908	\$23,694	\$21,908
Number of shares purchased by employees through the ESPP	384	454	384	454
Tax benefits realized by the Company in connection with the disqualifying dispositions of shares purchased under the ESPP	\$218	\$339	\$922	\$719
Weighted-average fair value per share based on Black-Scholes model	\$14.05	\$11.34	\$14.05	\$11.34

The ESPP shares are replenished annually on the first day of each fiscal year by virtue of an evergreen provision. The provision allows for share replenishment equal to the lesser of 2.0 million shares or the number of shares which KLA-Tencor estimates will be required to be issued under the ESPP during the forthcoming fiscal year. As of December 31, 2016, a total of 1.0 million shares were reserved and available for issuance under the ESPP.

Quarterly cash dividends

On November 2, 2016, the Company's Board of Directors declared a regular quarterly cash dividend of \$0.54 per share on the outstanding shares of the Company's common stock, which was paid on December 1, 2016 to the stockholders of record as of the close of business on November 15, 2016. The total amount of regular quarterly cash dividends paid by the Company during the three months ended December 31, 2016 and 2015 was \$84.5 million and \$80.8 million, respectively. The total amount of regular quarterly cash dividends paid by the Company during the six months ended December 31, 2016 and 2015 was \$166.1 million and \$162.5 million, respectively. The amount of accrued dividends payable for regular quarterly cash dividends on unvested restricted stock units with dividend equivalent rights as of December 31, 2016 and June 30, 2016 was \$3.3 million and \$2.7 million, respectively. These amounts will be paid upon vesting of the underlying unvested restricted stock units.

Special cash dividend

On November 19, 2014, the Company's Board of Directors declared a special cash dividend of \$16.50 per share on our outstanding common stock, which was paid on December 9, 2014 to the stockholders of record as of the close of business on December 1, 2014. The declaration and payment of the special cash dividend was part of the Company's leveraged recapitalization transaction under which the special cash dividend was financed through a combination of existing cash and proceeds from the debt financing disclosed in Note 6, "Debt" that was completed during the three months ended December 31, 2014. As of the declaration date, the total amount of the special cash dividend accrued by the Company was approximately \$2.76 billion, substantially all of which was paid out during the three months ended December 31, 2014, except for the aggregate special cash dividend of \$43.0 million that was accrued for the unvested restricted stock units. As of December 31, 2016 and June 30, 2016, the Company had a total of \$9.4 million and \$16.9 million, respectively, of accrued dividends payable for the special cash dividend with respect to outstanding unvested restricted stock units, which will be paid when such underlying unvested restricted stock units vest. The Company paid a special cash dividend with respect to vested restricted stock units during the three months ended December 31, 2015 of \$0.6 million. The amount paid during the three months ended December 31, 2016 was immaterial. The Company paid a special cash dividend with respect to vested restricted stock units during the six months ended December 31, 2016 and 2015 of \$7.7 million and \$20.5 million, respectively. Other than the special cash dividend declared during the three months ended December 31, 2014, the Company historically has not declared any special cash dividend.

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The Company's Board of Directors has authorized a program for the Company to repurchase shares of the Company's common stock. The intent of this program is to offset the dilution from KLA-Tencor's equity incentive plans and employee stock purchase plan, as well as to return excess cash to the Company's stockholders. Subject to market conditions, applicable legal requirements and other factors, the repurchases were made in the open market in compliance with applicable securities laws, including the Securities Exchange Act of 1934 and the rules promulgated thereunder, such as Rule 10b-18. As of December 31, 2016, an aggregate of approximately 5.9 million shares were available for repurchase under the Company's repurchase program.

Share repurchases for the indicated periods (based on the trade date of the applicable repurchase) were as follows:

	Three months ended December 31, 2015	Six months ended December 31, 2015
(In thousands)		
Number of shares of common stock repurchased	—568	—3,445
Total cost of repurchases	\$—29,509	\$—175,743

NOTE 9 – NET INCOME PER SHARE

Basic net income per share is calculated by dividing net income available to common stockholders by the weighted-average number of common shares outstanding during the period. Diluted net income per share is calculated by using the weighted-average number of common shares outstanding during the period, increased to include the number of additional shares of common stock that would have been outstanding if the shares of common stock underlying the Company's outstanding dilutive restricted stock units and stock options had been issued. The dilutive effect of outstanding restricted stock units and options is reflected in diluted net income per share by application of the treasury stock method.

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

(In thousands, except per share amounts)	Three months ended December 31, 2016		Six months ended December 31, 2016	
	2015		2015	
Numerator:				
Net income	\$238,251	\$152,207	\$416,352	\$257,104
Denominator:				
Weighted-average shares-basic, excluding unvested restricted stock units	156,335	155,252	156,232	156,036
Effect of dilutive restricted stock units and options ⁽¹⁾	788	744	839	935
Weighted-average shares-diluted	157,123	155,996	157,071	156,971
Basic net income per share	\$1.52	\$0.98	\$2.66	\$1.65
Diluted net income per share	\$1.52	\$0.98	\$2.65	\$1.64
Anti-dilutive securities excluded from the computation of diluted net income per share	2	139	56	182

(1) The Company has not had any outstanding stock options since August 2016.

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NOTE 10 – INCOME TAXES

The following table provides details of income taxes:

	Three months ended		Six months ended	
	December 31,		December 31,	
(Dollar amounts in thousands)	2016	2015	2016	2015
Income before income taxes	\$306,845	\$185,475	\$529,065	\$319,774
Provision for income taxes	\$			