FSI INTERNATIONAL INC
Form 10-Q
January 08, 2001

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended NOVEMBER 25, 2000

or

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

For the transition period from ______________________ to ______________________

Commission File Number: 0-17276

FSI INTERNATIONAL, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| MINNESOTA | 41-1223238 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 322 LAKE HAZELTINE DRIVE, CHASKA, MINNESOTA | 55318 |
| (Address of principal executive offices) | (Zip Code) |

952-448-5440
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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.

[X] YES [ ] NO

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practical date:

COMMON STOCK, NO PAR VALUE - 25,443,831 SHARES OUTSTANDING AS OF DECEMBER 18, 2000





FSI INTERNATIONAL, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

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PART I. Item 1. FINANCIAL INFORMATION

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
CONSOLIDATED CONDENSED BALANCE SHEETS
NOVEMBER 25, 2000 AND AUGUST 26, 2000
(unaudited)

ASSETS

| | November 25, 2000 |
|---|---|
| Current assets: | |
| Cash and cash equivalents | $31,456,250 |
| Marketable securities | 8,037,540 |
| Trade accounts receivable, net of allowance for doubtful accounts of $2,893,000 and $3,229,000, respectively | 27,428,343 |
| Trade accounts receivable from affiliates | 39,539,216 |
| Inventories | 55,291,778 |
| Prepaid expenses and other current assets | 4,548,913 |
| Total current assets | 166,302,040 |
| Property, plant and equipment, at cost | 123,579,608 |
| Less accumulated depreciation and amortization | (64,702,741) |
| | 58,876,867 |
| Investment in affiliates | 20,624,470 |
| Intangibles | 18,471,200 |
| Deposits and other assets | 4,246,017 |
| | $268,520,594 |

See accompanying notes to consolidated condensed financial statements.

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FSI INTERNATIONAL, INC. AND SUBSIDIARIES
CONSOLIDATED CONDENSED BALANCE SHEETS
NOVEMBER 25, 2000 AND AUGUST 26, 2000
(continued)
(unaudited)

LIABILITIES AND STOCKHOLDERS' EQUITY

| | November 25, 2000 |
|---|---|
| Current liabilities: | |
| Current maturities of long-term debt | $ - |
| Trade accounts payable | 21,259,690 |
| Accrued expenses | 24,632,314 |
| Customer deposits | 2,161,870 |
| Deferred revenue | 10,934,920 |
| Total current liabilities | 58,988,794 |
| Long-term debt, less current maturities | - |
| Stockholders' equity: | |
| Preferred stock, no par value; 9,700,000 shares authorized, none issued and outstanding | - |
| Series A Junior Participating Preferred Stock, no par value: 300,000 shares authorized; none issued and outstanding. | - |
| Common stock, no par value; 50,000,000 shares authorized; issued and outstanding, 25,425,269 and 25,375,332 shares at November 25, 2000 and August 26, 2000, respectively | 190,444,675 |
| Retained earnings | 19,858,935 |
| Accumulated other comprehensive income (loss) | (771,810) |
| Total stockholders' equity | 209,531,800 |
| | $268,520,594 |

See accompanying notes to consolidated condensed financial statements.

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FSI INTERNATIONAL, INC. AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
FOR THE QUARTERS ENDED NOVEMBER 25, 2000 AND NOVEMBER 27, 1999
(Unaudited)

November 25,
2000

| | |
|---|---|
| Sales (including sales to affiliates of $34,230,000 and $11,930,000, respectively) | $70,429,769 |
| Cost of goods sold | 41,768,554 |
| Gross profit | 28,661,215 |
| Selling, general and administrative expenses | 13,530,353 |
| In-process research and development write-off | - |
| Research and development expenses | 9,301,913 |
| Operating income (loss) | 5,828,949 |
| Gain on sale of investment in affiliates | - |
| Interest expense | (22,015) |
| Interest income | 704,675 |
| Other income (expense), net | 43,730 |
| Income (loss) before income taxes | 6,555,339 |
| Income taxes | - |
| Income (loss) before equity in earnings (losses) of affiliates | 6,555,339 |
| Equity in earnings (losses) of affiliates | 1,109,387 |
| Net income (loss) from continuing operations | 7,664,726 |
| Discontinued operations: | |
| Loss on sale of discontinued operations | - |
| Net income (loss) | $7,664,726 |
| Net income (loss) per common share - Basic | |
| Continuing operations | $0.30 |
| Discontinued operations | - |
| Net income (loss) | $0.30 |
| Net income (loss) per common share - Diluted | |
| Continuing operations | $0.29 |
| Discontinued operations | - |
| Net income (loss) | $0.29 |
| Weighted average common shares | 25,407,383 |
| Weighted average common and potential common shares | 26,080,111 |

See accompanying notes to consolidated condensed financial statements.

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
FOR THE QUARTERS ENDED NOVEMBER 25, 2000 AND NOVEMBER 27, 1999

(Unaudited)

| | November 25, 2000 |
|---|---|
| OPERATING ACTIVITIES: | |
| Net income (loss) | $7,664,72 |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | |
| Loss from discontinued operations | |
| Gain on sale of investment in affiliate | |
| Write off of in-process research and development | |
| Depreciation | 2,883,15 |
| Amortization | 1,259,88 |
| Provision for allowance for doubtful accounts | (336,18 |
| Provision for inventory reserves | 809,00 |
| Disposal of inventory | (831,40 |
| Equity in (earnings) losses of affiliates | (1,109,38 |
| Changes in operating assets and liabilities: | |
| Trade accounts receivable | (11,154,69 |
| Inventories | (4,459,48 |
| Refundable income taxes | |
| Prepaid expenses and other current assets | 154,13 |
| Trade accounts payable | 2,285,18 |
| Accrued expenses | 406,28 |
| Customer deposits | 2,161,87 |
| Deferred revenue | 723,71 |
| Net cash provided by (used in)operating activities | 456,79 |
| INVESTING ACTIVITIES: | |
| Acquisition of YieldUP International Corporation, net of cash acquired | |
| Proceeds from sale of investment in affiliate | |
| Acquisition of property, plant and equipment | (2,947,28 |
| Purchases of marketable securities | (472,31 |
| Maturities of marketable securities | |
| Increase in deposits and other assets | (349,94 |
| Proceeds from sale of equipment | |
| Net cash (used in) provided by investing activities | (3,769,54 |
| FINANCING ACTIVITIES: | |
| Principal payments on long-term debt | (60,34 |
| Net proceeds from issuance of common stock | 191,36 |
| Net cash provided by (used in) financing activities | 131,02 |
| Decrease in cash and cash equivalents | (3,181,72 |
| Cash and cash equivalents at beginning of period | 34,637,97 |

| | |
|---|---|
| Cash and cash equivalents at end of period | $31,456,25 |

See accompanying notes to consolidated condensed financial statements.





FSI INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Unaudited)

(1) CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

The accompanying consolidated condensed financial statements have been prepared by the Company without audit and reflect all adjustments (consisting only of normal and recurring adjustments) which are, in the opinion of management, necessary to present a fair statement of the results for the interim periods presented. The statements have been prepared in accordance with the regulations of the Securities and Exchange Commission but omit certain information and footnote disclosures necessary to present the statements in accordance with generally accepted accounting principles. The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the full fiscal year. These consolidated condensed financial statements should be read in conjunction with the Consolidated Financial Statements and footnotes thereto included in the Company's Annual 10-K Report for the fiscal year ended August 26, 2000 previously filed with the Securities and Exchange Commission.

(2) INVENTORIES

Inventories are summarized as follows:

| | November 25, 2000 |
|---|---|
| Finished products | $6,445,442 |
| Work-in-process | 19,174,742 |
| Subassemblies | 6,641,183 |
| Raw materials and purchased parts | 23,030,411 |
| | $55,291,778 |

(3) SUPPLEMENTARY CASH FLOW INFORMATION

| | Quarters En |
|---|---|
| | November 25, 2000 |

Schedule of interest paid and income taxes paid (refunds received):

| | |
|---|---|
| Interest | $22,015 |
| Income taxes | $29,111 |





(4) RECONCILIATION OF EARNINGS AND SHARE AMOUNTS USED IN EPS CALCULATION

| FOR THE QUARTERS ENDED | Net Income (Loss) | Basic Income (Loss) Per Share<br>Income (Loss) Available To Common Stockholders | Effect of Dilutive Securities*<br>Stock Options |
|---|---|---|---|
| NOVEMBER 25, 2000 | | | |
| Income | $7,664,726 | $ 7,664,726 | - |
| Shares | - | 25,407,383 | 672,728 |
| Per share amount | - | $0.30 | $0.01 |
| NOVEMBER 27, 1999 | | | |
| Loss | ($10,624,181) | ($10,624,181) | - |
| Shares | - | 23,955,747 | - |
| Per share amount | - | ($0.44) | - |

* The effect of stock options were not included in the calculation of dilutive earnings per share for the quarter ended November 27, 1999 because their inclusion would have been anti-dilutive.

(5) COMPREHENSIVE INCOME (LOSS)

Other comprehensive income (loss) pertains to revenues, expenses, gains and losses that are not included in the net income (loss) but rather are recorded directly in stockholders' equity. For quarters ended November 25, 2000 and November 27, 1999 the only item of other comprehensive income (loss) related to foreign currency translation adjustment. For the quarters ended November 25, 2000 and November 27, 1999 the net income (loss), items of other comprehensive income (loss) and comprehensive income (loss) are as follows:

| | November 25, 2000 |
|---|---|

| | |
|---|---|
| Net income (loss) | $7,664,726 |
| Items of other comprehensive income (loss): | |
| Foreign currency translation | (112,989) |
| Comprehensive income (loss) | $7,551,737 |

(6) ACQUISITION OF YIELDUP

On October 20, 1999 the Company acquired YieldUP International Corporation (YieldUP renamed SCD Mountain View, Inc.) by paying approximately $6,083,000 in cash and issuing 1,303,000 shares of common stock to YieldUP shareholders.

Under the definitive agreement, the YieldUP shareholders received $0.7313 and 0.1567 of a share of FSI common stock for each share of YieldUP stock. The Company also issued options covering 209,278 shares of company common stock in substitution for previously outstanding options to acquire shares of YieldUP's common stock.





The acquisition was accounted for under the purchase method of accounting. FSI incurred an in-process R&D write-off of $6,370,000 in the first quarter of fiscal 2000 related to the acquisition.

Prior to the acquisition, two patent infringement lawsuits were filed against YieldUP, which if resolved unfavorably could have a material adverse impact on the Company. The probability of loss and related amount cannot be presently estimated. For a discussion of the litigation, See Part II, Item 1.

(7) SALE OF INVESTMENT IN AFFILIATE

During the quarter ended November 27, 1999, the Company sold approximately 612,000 shares of its investment in Metron Technology N.V. (Metron) stock as part of Metron's initial public offering. As a result of the sale, the Company received proceeds of $7,398,621 and recognized a gain of $5,409,744. The Company's ownership percentage decreased from 32.7% to 21.7% as a result of this sale and the public offering.

As of November 25, 2000 the Company owns approximately 2,690,000 shares of Metron Technology, N.V. with a total cost basis of approximately $15,419,000.

(8) REALIGNMENT COSTS

During the fourth quarter of fiscal 2000, the Company announced a realignment program closing its Mountain View and Fremont, California facilities and the discontinuance of production of the nickel iron-plating product. The Company recorded realignment charges of approximately $4,100,000 consisting of approximately $1,000,000 in reduction in its workforce which included $500,000 related to the assembled workforce intangible asset established at the time of the YieldUP acquisition. Additionally the realignment charges also included approximately $1,400,000 for consolidation of facilities, approximately $1,300,000 for liabilities associated with the discontinuance of a product and approximately $400,000 for additional inventory reserves. During the fourth quarter of fiscal 2000, $100,000 of the realignment cost was paid or utilized resulting in a balance of $4,000,000. During the first quarter of fiscal 2001, $1,900,000 was paid or utilized. The remaining balance of $2,100,000 to be paid or utilized in future periods.

(9) NEW ACCOUNTING PRONOUNCEMENTS

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities," which establishes appropriate accounting for derivative instruments and hedging activities. SFAS No. 133 must be adopted for financial statements issued for fiscal years beginning after June 15, 2000. FSI adopted SFAS No. 133 in the first quarter of fiscal 2001. The impact of the adoption of SFAS No. 133 did not have a material impact on FSI's financial statements. Equity in earnings of affiliates may be more volatile due to their international operations.*

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements." SAB 101 provides guidance on the recognition, presentation, and disclosure of revenue in financial statements of all public registrants. The Company is evaluating various practical implementation considerations. Changes in our revenue recognition policy resulting from the interpretation of SAB 101, to the extent applicable, would be effective in the fourth quarter of fiscal 2001. Since most of the equipment the Company sells includes installation, it is anticipated, under SAB 101, a portion of revenue recognition may be deferred, particularly where the equipment is integrated with other equipment. Management believes that SAB 101, to the extent applicable to us, will not





affect the underlying strength or weakness of our business operations as measured by the dollar value of our product shipments and cash flows.*





FSI INTERNATIONAL, INC. AND SUBSIDIARIES

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

FIRST QUARTER OF FISCAL 2001 COMPARED WITH THE FIRST QUARTER OF FISCAL 2000.

The information in this Management's Discussion and Analysis of Financial Condition and Results of Operations, except for the historical information contained herein, contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and is subject to the safe harbor created by that statute. Such statements are subject to various risks and uncertainties, both known and unknown. Factors that could cause actual results to differ include overall industry and general economic conditions; changes in customer capacity requirements and the demand for semiconductors; global trade policies, worldwide political stability, particularly in Asia; the demand and price for semiconductors; the Company's successful execution of internal performance plans; cost reduction efforts; the cyclical nature of the Company's business; volatility of the market for certain products; the timing and success of current and future product and process development programs; performance issues with key suppliers and subcontractors; an ability to meet demand; the transition to 300 mm products; the success of the Company's affiliated distributors; the level of new orders and order delays or cancellations; legal proceedings and the timing and extent of any industry upturn or downturn. In addition, readers are also directed to the Risk Factors discussion found in the Company's Report on Form 10-K for the year ended August 26, 2000. Readers also are cautioned not to place undue reliance on these forward-looking statements as actual results could differ materially. FSI assumes no obligation to publicly release any revisions or updates to these forward-looking statements to reflect future events or unanticipated occurrences. Such forward-looking statements are marked with an asterisk (*).

This discussion and analysis should be read in conjunction with the Consolidated Financial Statements and footnotes thereto appearing elsewhere in this report.

The following table sets forth for the fiscal quarter indicated, certain income and expense items as a percent of total sales.

| | PERCENT OF SALES | |
|---|---|---|
| FIRST QUARTER ENDED: | NOVEMBER 25, 2000 | NOVEMBER 199 |
| Sales | 100.0% | |
| Cost of goods sold | 59.3 | |
| Gross profit | 40.7 | |
| Selling, general and administrative | 19.2 | |
| In-process research and development | - | |
| Research and development | 13.2 | |
| Operating income (loss) | 8.3 | |
| Other income (expense), net | 1.0 | |
| Income (loss) before income taxes | 9.3 | |
| Income taxes | - | |
| Equity in earnings (losses) of affiliates | 1.6 | |
| Net income (loss) from continuing operations | 10.9 | |
| Discontinued Operations: | | |
| Net loss from discontinued operations | - | |
| Net income (loss) | 10.9% | |

SALES:

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Sales increased 128 percent to $70.4 million for the first quarter of fiscal 2001 as compared to $30.9 million for the first quarter of fiscal 2000. Both the Microlithography and Surface Conditioning Divisions experienced year over year sales increases, with the Surface Conditioning Division recording the largest dollar increase. The Microlithography and Surface Conditioning division sales, including their spare parts and support, each generally represent about half of total sales. With its much larger installed base, the Surface Conditioning

Division has a more significant spare parts and support business than the Microlithography Division.

International sales were $39.4 million and $12.2 million for the first quarter of fiscal 2001 and 2000, respectively, and represented approximately 56% and 40%, respectively of sales during these periods. Because of its broader customer base, the Surface Conditioning Division has a higher percentage of international sales than the Microlithography Division.

As a result of the orders that were pulled into the fourth quarter of fiscal 2000, due to our sales incentive plan design and because of, certain customer requested pushouts and a few cancellations in the first quarter, our book-to-bill ratio was slightly below 1.0 for the first quarter of 2001. Without the pushouts and cancellations, our book to bill would have been nicely above 1.0 for the first quarter of 2001. FSI continues to maintain a strong backlog. Based upon current quote activity, the promising 300 mm opportunities we are pursuing and anticipated back-end-of-line application wins, we expect bookings to be up sequentially in the second quarter of fiscal 2001.*

Sales in the second quarter of fiscal 2001 are expected to be up sequentially and approximate $75 million as a result of an increase in the number of POLARIS (R) systems shipping and the continued strong sales of our Surface Conditioning products.* FSI expects annual sales to increase in fiscal 2001 as compared to fiscal 2000*

GROSS PROFIT:

Gross profit as a percentage of sales for the first quarter of fiscal 2001 and 2000 was 40.7% and 32.7%, respectively. The improvement in margins is due to higher utilization of manufacturing capacity, a strong mix of higher margin products, and cost reduction efforts, offset by higher international sales which generally carry a lower margin.

We expect gross margins to be in the range of 40.0 to 41.0 percent in the second quarter of fiscal 2001, as a proportionately higher percentage of sales will be from lower margin products.* Our goal is to achieve approximately a 42% gross margin rate by the fourth quarter of fiscal 2001.*

FSI's gross profit margin may fluctuate as a result of a number of factors, including the mix of products sold as some products have higher margins than others, the proportion of international sales as international sales generally have lower margins, competitive pricing pressures and utilization of manufacturing capacity.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES:

Selling, general and administrative expenses were 19.2% of sales for the first quarter of fiscal 2001 as compared to 35.8% of sales for the first quarter of fiscal 2000. The dollar increase in the amount of SG&A primarily relates to the increased sales, specifically customer service costs and incentive compensation. We expect the dollar amount of second quarter SG&A expenses to increase sequentially from the first quarter level but to decrease to below 19% of sales.* As a percentage of sales, FSI expects SG&A expenses for fiscal 2001 to be in a range of 18.5% to 19.0%.*





RESEARCH AND DEVELOPMENT EXPENSES:

Research and development expenses were $9.3 million for the first quarter of fiscal 2001 as compared to $8.4 million for the same period in fiscal 2000. Also in the first quarter of fiscal 2000, the Company recorded a $6.4 million in-process R&D write-off relating to the acquisition of YieldUP International Corporation.

We expect R&D expenses to increase to approximately 14% of sales in the second quarter of fiscal 2001.* We expect full year fiscal R&D expense as a percentage of sales to decrease in 2001 as compared to 2000 to a range of 14.0% to 14.5%.* We will continue to remain focused on critical technologies and strategically invest R&D dollars in the immersion technology for Surface Conditioning products, the CALYPSO(TM) spin-on dielectric product, 300mm products for both resist processing and surface conditioning and other new applications.*

OTHER INCOME (EXPENSE), NET:

Other income (expense), net was approximately $726,000 for the first quarter of fiscal 2001 as compared to $6.0 million for the first quarter of fiscal 2000. The decrease is primarily due to the $5.4 million gain recognized on the sale of approximately 612,000 shares of Metron Technology's (our affiliate) stock in its initial public offering during the first quarter of fiscal 2000, offset by reduced interest expense as a result of the debt repayment.

Interest income is expected to be between $500,000 and $700,000 per quarter for the remainder of fiscal 2001, depending upon the level of investments and the interest rates.*

INCOME TAX (BENEFIT) EXPENSE:

FSI recorded no tax benefit or expense related to its operating losses for the first quarter of fiscal 2001 or fiscal 2000.

The Company's deferred tax assets on the balance sheet as of November 25, 2000 have been fully reserved for with a valuation allowance. We will not be significantly reducing our valuation allowance in the future until we are consistently profitable on a quarterly basis. The Company anticipates it will record approximately $125,000 of tax expense for the remaining quarters of fiscal 2001 as it utilizes the YieldUP net operating loss (NOL) carryforward. Although the NOL asset was reserved for with a valuation allowance, the reduction of the valuation allowance will be offset to goodwill.

Overall, the Company has net operating loss carryforwards for federal purposes of approximately $23,800,000, which will begin to expire in fiscal year 2011 if not utilized. Of this amount, approximately $17,700,000 is subject to Internal Revenue Code Section 382 limitations on utilization. This limitation is approximately $1,400,000 per year.

EQUITY IN EARNINGS (LOSSES) OF AFFILIATES:

The equity in earnings (losses) of affiliates was approximately $1.1 million of income for the first quarter of fiscal 2001, compared to approximately $473,000 of losses for the first quarter of fiscal 2000. The improvement in 2001 is due to improved operations at both affiliates.

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We expect equity in earnings of affiliates to be in the $500,000 to $1.0 million range in each quarter of fiscal 2001. Second quarter of fiscal 2001 equity in earnings of affiliates is expected to be at the high end of the range.*

LIQUIDITY AND CAPITAL RESOURCES

FSI's cash and cash equivalents and marketable securities were approximately

$39.5 million as of November 25, 2000 a decrease of $2.7 million from the end of fiscal 2000. The decrease in cash, cash equivalents, and marketable securities is primarily due to $2.6 million of property, plant and equipment acquisitions.

FSI's accounts receivable increased by approximately 20.7%, or $11.5 million, from the end of fiscal 2000. The majority of the increase is due to an increase in accounts receivable from affiliates of $9.1 million. The increased level of accounts receivables from affiliates was due to a higher percentage of international sales which generally have a longer collection period.

FSI's inventory increased approximately $4.5 million to $55.3 million at November 25, 2000 compared to $50.8 million at the end of fiscal 2000. The increase in inventory was primarily in work-in process and raw materials due to FSI's backlog.

As of November 25, 2000, FSI's current ratio of current assets to current liabilities was 2.8 to 1.0 and working capital was $107.3 million.

FSI had acquisitions of property, plant and equipment of approximately $2.6 million and $414,000 for the first quarter of fiscal 2001 and fiscal 2000, respectively. It is anticipated FSI will invest between $12 and $14 million in fiscal 2001 in property, plant and equipment.*

FSI believes that with existing cash, cash equivalents, marketable securities and internally generated funds, there will be sufficient funds to meet FSI's currently projected working capital and other cash requirements through at least mid fiscal 2002.*

FSI believes that success in its industry requires substantial capital to maintain the flexibility to take advantage of opportunities as they arise. One of FSI's strategic objectives is, as market and business conditions warrant, consider divestitures, investments or acquisitions of businesses, products or technologies particularly those that are complementary to our surface conditioning business.* FSI may fund such activities with additional equity or debt financings.* The sale of additional equity or debt securities could result in additional dilution to our shareholders.*

NEW ACCOUNTING PRONOUNCEMENTS

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities," which establishes appropriate accounting for derivative instruments and hedging activities. SFAS No. 133 must be adopted for financial statements issued for fiscal years beginning after June 15, 2000. FSI adopted SFAS No. 133 in the first quarter of fiscal 2001. The impact of the adoption of SFAS No. 133 did not have a material impact on FSI's financial statements. Equity in earnings of affiliates may be more volatile due to their international operations.*

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements." SAB 101 provides guidance on the recognition, presentation, and disclosure of revenue in financial statements of all public registrants. The Company is evaluating various practical implementation considerations. Changes in our revenue recognition policy

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resulting from the interpretation of SAB 101, to the extent applicable, would be effective in the fourth quarter of fiscal 2001. Since most of the equipment the Company sells includes installation, it is anticipated, under SAB 101, a portion of revenue recognition may be deferred, particularly where the equipment is integrated with other equipment. Management believes that SAB 101, to the extent applicable to us, will not affect the underlying strength or weakness of our business operations as measured by the dollar value of our product shipments and cash flows.*

RISK FACTORS

Due to the nature of business and the industry in which we operate the following risk factors should be considered in addition to others described above. Our business faces significant risks. These risks include those described below and may include additional risks and uncertainties not presently known to us or that we currently believe are immaterial. If any of the events or circumstances described in the following risks occurs, our business, operating results or financial condition could be materially adversely affected. These risks should be read in conjunction with the other information set forth in this report.

BECAUSE OUR BUSINESS DEPENDS ON THE AMOUNT THAT MANUFACTURERS OF MICROELECTRONICS SPEND ON CAPITAL EQUIPMENT, DOWNTURNS IN THE MICROELECTRONICS INDUSTRY MAY ADVERSELY AFFECT OUR RESULTS

The microelectronics industry experiences periodic slowdowns, which may have a negative effect on our sales and operating results. Our business depends on the amount that manufacturers of microelectronics spend on capital equipment. The amount they spend on capital equipment depends on the existing and expected demand for semiconductor devices and products that use semiconductor devices. The microelectronics industry has experienced alternating upturns and downturns in business activity. When this occurs, some semiconductor manufacturers experience lower demand and increased pricing pressure for their products. As a result, they are likely to purchase less semiconductor processing equipment and have sometimes delayed making decisions to purchase capital equipment. In some cases, semiconductor manufacturers have cancelled or delayed orders for our products.

IF WE DO NOT CONTINUE TO DEVELOP NEW PRODUCTS, WE WILL NOT BE ABLE TO COMPETE EFFECTIVELY

Our business and results of operations could decline if we do not develop and successfully introduce new or improved products that the market accepts. The technology used in microelectronics manufacturing equipment and processes changes rapidly. Industry standards change constantly and equipment manufacturers frequently introduce new products. We believe that microelectronics manufacturers increasingly rely on equipment manufacturers like us to:

- Design and develop more efficient manufacturing equipment
- Design and implement improved processes for microelectronics manufacturers to use
- Make their equipment compatible with equipment made by other equipment manufacturers

To compete, we must continue to develop, manufacture, and market new or improved products that meet changing industry standards. To do this successfully, we must:

- Select appropriate products
- Design and develop our products efficiently and quickly

- Implement our manufacturing and assembly processes efficiently and on time

- Make products that perform well for our customers

- Market and sell our products effectively; and

- Introduce our new products in a way that does not reduce sales of our existing products

FUTURE ACQUISITIONS MAY DILUTE OUR STOCKHOLDERS' OWNERSHIP INTERESTS AND HAVE OTHER ADVERSE CONSEQUENCES.

Because of consolidations in the semiconductor equipment industry served by us and other competitive factors, our management will seek to acquire additional product lines, technologies, and businesses if suitable opportunities develop. Acquisitions may result in the issuance of our stock, which may dilute our stockholders' ownership interests and reduce earnings per share. Acquisitions may also increase debt levels and the amortization of goodwill and other intangible assets, which could have a significant negative effect on our financial condition and operating results. In addition, acquisitions involve numerous risks, including:

- Difficulties in absorbing the new business, product line, or technology

- Diversion of management's attention from other business concerns

- Entering new markets in which we have little or no experience

- Possible loss of key employees of the acquired business

BECAUSE OF THE VOLATILITY OF OUR STOCK PRICE, THE ABILITY TO TRADE FSI SHARES MAY BE ADVERSELY AFFECTED AND OUR ABILITY TO RAISE CAPITAL THROUGH FUTURE EQUITY FINANCING MAY BE REDUCED.

The price of our stock has been volatile in the past and may continue to be so in the future. In the 2000 fiscal year, for example, our stock price ranged from $6.19 to $24.00 per share.

The trading price of our common shares is subject to wide fluctuations in response to various factors, some of which are beyond our control, including factors discussed elsewhere in this report and the following:

- Failure to meet the published expectations of securities analysts for a given quarterly period

- Changes in financial estimates by securities analysts

- Press releases or announcements by or changes in market values of comparable companies

- Stock market price and volume fluctuations, which is particularly common among securities of high technology companies

- Stock market price and volume fluctuations attributable to inconsistent trading volume levels

- Additions or departures of key personnel; and

- Involvement in litigation

The prices of technology stocks, including ours, have been particularly affected by extreme fluctuations in price and volume in the stock market generally. These fluctuations have often been unrelated to the operating performance of the companies whose stock is traded. These broad stock market fluctuations may have a negative effect on our future stock price.

In the past, securities class action litigation has often been brought against a company following periods of volatility in the market price of its securities. To date we have not been subject to such claims, however we may in the future be the target of this type of litigation. Securities litigation may result in substantial costs and divert management's attention and resources, which can seriously harm our business.

BECAUSE OUR QUARTERLY OPERATING RESULTS ARE VOLATILE, OUR STOCK PRICE COULD DECREASE.

In the past, our operating results have fluctuated from quarter to quarter and are likely to do so in the future. These fluctuations may have a significant impact on our stock price. The reasons for the fluctuations in our operating results, such as sales, gross profits, and net income, include:

- The Timing of Significant Customer Orders and Customer Spending Patterns. During industry downturns, our customers may ask us to delay or even cancel the shipment of previously firm orders. Delays and cancellations may adversely affect our operating results in any particular quarter if we are unable to recognize revenue for particular sales in the quarter in which those sales were expected.

- The Timing of New Product and Service Announcements By Us or Our Competitors. New product announcements by us and our competitors could cause our customers to delay a purchase or to decide to purchase products of one of our competitors, which would adversely affect our revenue and, therefore, our results of operations. New product announcements by others may make it necessary for us to reduce prices on our products or offer more service options, which could adversely impact operating margins and net income.

- The Mix of Products Sold And The Market Acceptance of Our New Product Lines. The mix of products we sell varies from period to period, and because margins vary among or within different product lines, this can adversely affect our results of operations. If we fail to sell our products which generate higher margins, our average gross margins may be lower than expected. If we fail to sell our new product lines, our revenue may be lower than expected.

- General Global Economic Conditions or Economic Conditions in a Particular Region. When economic conditions in a region or worldwide worsen, customers may delay or cancel their orders. There may also be an increase in the time it takes to collect from our customers or even outright defaults in payments. This can negatively affect our cash flow and our results.

As a result of the factors listed above, our future operating results are difficult to predict. Further, we base our current and future expense plans in significant part on our expectations of our longer-term future revenue. As a result, we expect our expense levels to be relatively fixed in the short-run. An unanticipated decline in revenue for a particular quarter may disproportionately affect our net income in that quarter. If our revenue is below our projections, then our operating results will also be below expectations and, as we have in the past, we may even have losses in the short-run. Any one of the factors listed above, or a combination thereof, could adversely affect our quarterly results of operations, and consequently may cause a decline in our share price.





BECAUSE INTERNATIONAL SALES ARE IMPORTANT TO US, AND BECAUSE MOST OF OUR INTERNATIONAL SALES ARE THROUGH OUR AFFILIATED DISTRIBUTORS, REDUCTIONS IN THE SALES EFFORTS OF THESE AFFILIATES COULD ADVERSELY AFFECT OUR RESULTS.

The profits or losses of our affiliated distributors, Metron Technology B.V. and moFSI Ltd., can also significantly affect our financial results. We make most of our international sales through these affiliated distributors. As of November 25, 2000 we have a 20.2% ownership interest in Metron and a 49% interest in moFSI. Fiscal 2000 sales through moFSI were $11.1 million or 5.1% of our total sales. Fiscal 2000 sales through Metron were $89.7 million or 40.8% of our total sales. In addition, these affiliates also provide service and support to many of our international customers. Metron and moFSI also distribute or sell products for companies other than us. It could have a negative effect on our operating results if either of these affiliates reduced its sales efforts, lost the business of a significant company for which it distributes or sells products, lost a significant customer, or otherwise became less financially viable.

We cannot guarantee that Metron or moFSI will continue to successfully distribute our products or the products of other companies. The failure of Metron or moFSI to do so could have a significant negative effect on our results of operations.

CHANGES IN DEMAND CAUSED BY FLUCTUATIONS IN INTEREST AND CURRENCY EXCHANGE RATES MAY REDUCE OUR INTERNATIONAL SALES.

Almost all of our direct international sales are denominated in U.S. dollars. Nonetheless, changes in demand caused by fluctuations in interest and currency exchange rates may affect our international sales. Most of our international sales, however, are through our affiliated distributors. Metron's sales of our products and other companies' products are primarily denominated in U.S. dollars, but its expenses are generally denominated in foreign currencies. Accordingly, fluctuations in interest and currency exchange rates may affect Metron's financial results. Sales for moFSI are denominated in yen. As a result, U.S. dollar/yen exchange rates may affect our equity interest in moFSI's earnings.

Metron and moFSI sometimes engage in so-called "hedging" or risk-reducing transactions to try to limit the negative effects that the devaluation of foreign currencies relative to the U.S. dollar could have on operating results. They will do so if a sale denominated in a foreign currency is sufficiently large to justify the costs of hedging. To hedge a sale, Metron or moFSI will typically commit to buy U.S. dollars and sell the foreign currency at a given price at a future date. If the customer cancels the sale, Metron or moFSI may be forced to buy U.S. dollars and sell the foreign currency at market rates to meet its hedging obligations and may incur a loss in doing so. To date, the hedging activities of Metron and moFSI have not had any significant negative effect on us. The adoption of SFAS 133 by Metron and moFSI may cause more volatility in our equity in earnings of affiliates.*

BECAUSE OF THE NEED TO MEET AND COMPLY WITH NUMEROUS FOREIGN REGULATIONS AND POLICIES, THE CHANGEABILITY OF THE POLITICAL AND ECONOMIC ENVIRONMENTS IN FOREIGN JURISDICTIONS AND THE DIFFICULTY OF MANAGING BUSINESS OVERSEAS, WE MAY NOT BE ABLE TO SUSTAIN OUR HISTORICAL LEVEL OF INTERNATIONAL SALES.

We and our affiliates operate in a global market. In fiscal 2000, approximately 53% of our sales revenue derived from sales outside the United States. In fiscal 1999, this figure was 29%, and in fiscal 1998 it was 39%. These figures include sales through Metron and moFSI, which accounted for 87% of international sales in 2000, 92% in 1999 and 95% in 1998. We expect that international sales will continue to represent a significant portion of total sales. Sales to customers outside the United States involve a number of risks, including the following:





- Imposition of government controls
- Compliance with U.S. export laws and foreign laws
- Political and economic instability
- Trade restrictions
- Changes in taxes and tariffs
- Longer payment cycles
- Difficulty of administering business overseas; and
- General economic conditions

In particular, the Japanese and Asia Pacific markets are extremely competitive. The semiconductor device manufacturers located there are very aggressive in seeking price concessions from suppliers, including equipment manufacturers like us. In fiscal 2000, approximately 25% of our international sales were attributable to these markets.

We seek to meet technical standards imposed by foreign regulatory bodies. However, we cannot guarantee that we will be able to comply with those standards in the future. Any failure by us to design products to comply with foreign standards could have a significant negative impact on us.

BECAUSE OF THE SIGNIFICANT FINANCIAL RESOURCES NEEDED TO OFFER A BROAD RANGE OF PRODUCTS, TO MAINTAIN CUSTOMER SERVICE AND SUPPORT AND TO INVEST IN RESEARCH AND DEVELOPMENT, WE MAY BE UNABLE TO COMPETE WITH LARGER, BETTER ESTABLISHED COMPETITORS.

The microelectronics equipment industry is highly competitive. We face substantial competition throughout the world. We believe that to remain competitive, we will need significant financial resources to offer a broad range of products, to maintain customer service and support, and to invest in research and development. We believe that the microelectronics industry is becoming increasingly dominated by large manufacturers who have the resources to support customers on a worldwide basis. Some of our competitors have substantially greater financial, marketing, and customer-support capabilities than us. Large equipment manufacturers may enter the market areas in which we compete. In addition, smaller, emerging microelectronics equipment companies provide innovative technology. We expect that our competitors will continue to improve the design and performance of their existing products and processes. We also expect them to introduce new products and processes with better performance and pricing. We cannot guarantee that we will continue to compete effectively in the United States or elsewhere.

BECAUSE WE DO NOT HAVE LONG-TERM SALES COMMITMENTS WITH OUR CUSTOMERS, IF THESE CUSTOMERS DECIDE TO REDUCE, DELAY OR CANCEL ORDERS OR CHOOSE TO DEAL WITH OUR COMPETITORS, THEN OUR RESULTS WILL BE ADVERSELY AFFECTED.

If our significant customers, including IBM, Texas Instruments, STMicroelectronics, 1st Silicon or Seagate Technology, reduce, delay, or cancel orders, then our operating results could suffer. Our largest customers have changed from year to year. Sales to FSI's top five customers accounted for approximately 45%, 49% and 41% of total sales in fiscal 2000, 1999 and 1998, respectively. STMicroelectronics represented 11% of revenues in fiscal 2000. Texas Instruments accounted for 15% of revenues in fiscal 2000 and 13% of revenues during fiscal 1999. IBM accounted for 24% of revenues during fiscal 1999 and 14% of revenues during fiscal 1998. National Semiconductor accounted for 12% of revenues in fiscal 1998. We currently have no long-term sales commitments with any of our customers. Instead, we generally make sales under purchase orders. Our backlog at August 26, 2000 was $184 million of which 51% was comprised of orders from three customers. As of August 26, 2000 we had received approximately $48 million in orders from two customers that are scheduled to ship in fiscal 2002 and 2003. All orders are subject to cancellation or delay by the customer.

BECAUSE WE RETAINED CERTAIN LIABILITIES FROM THE DIVESTITURE OF THE CHEMICAL MANAGEMENT DIVISION OR AGREED TO INDEMNIFY BOC WITH RESPECT TO SPECIFIED OBLIGATIONS AND LIABILITIES, WE MAY EXPERIENCE CHARGES IN EXCESS OF THE RESERVES ESTABLISHED AT THE TIME OF THE DIVESTITURE WHICH COULD NEGATIVELY IMPACT RESULTS FROM OPERATIONS.

In connection with the divestiture of the Chemical Management Division, we retained certain liabilities and agreed to indemnify BOC with respect to certain specified obligations and liabilities. During the first quarter of 2000, FSI continued to negotiate the final closing balance sheet for the CMD divestiture to BOC. Upon the completion of those negotiations, FSI established an additional $400,000 accrual for expected costs associated with completing two projects that were in process when BOC purchased the division. During the second quarter, the parties settled on a final closing balance sheet and no additional reserves were recorded. If we experience liabilities or charges in excess of established reserves and it is ultimately determined that an adjustment in favor of BOC is warranted, our results of operations could be adversely impacted due to additional costs associated with those reserves or the request to return to BOC a portion of the purchase price because of such adjustments.

IT MAY BE DIFFICULT FOR US TO COMPETE WITH STRONGER COMPETITORS RESULTING FROM INDUSTRY CONSOLIDATION.

In the past several years, we have seen a trend toward consolidation in the microelectronics equipment industry We expect the trend toward consolidation to continue as companies seek to strengthen or maintain their market positions in a rapidly changing industry. We believe that industry consolidations may result in competitors that are better able to compete. This could have a significant negative impact on our business, operating results, and financial condition

BECAUSE WE DEPEND UPON OUR MANAGEMENT AND TECHNICAL PERSONNEL FOR OUR SUCCESS, THE LOSS OF KEY PERSONNEL COULD PLACE US AT A COMPETITIVE DISADVANTAGE.

Our success depends to a significant extent upon our management and technical personnel. The loss of a number of these key persons could have a negative effect on our operations. Competition is high for such personnel in our industry in all locations. We periodically review our compensation and benefit packages to ensure that they are competitive in the marketplace and make adjustments or implement new programs for that purpose, as appropriate. We cannot guarantee that we will continue to attract and retain the personnel we require to continue to grow and operate profitably.

OUR EMPLOYMENT COSTS IN THE SHORT-TERM ARE TO A LARGE EXTENT FIXED, AND THEREFORE ANY UNEXPECTED REVENUE SHORTFALL COULD ADVERSELY AFFECT OUR OPERATING RESULTS.





Our operating expense levels are based in significant part on our head count, which is generally driven by longer-term revenue goals. For a variety of reasons, particularly the high cost and disruption of lay-offs and the costs of recruiting and training, our head count in the short-term is, to a large extent, fixed. Accordingly, we may be unable to reduce employment costs in a timely manner to compensate for any unexpected revenue or gross margin shortfall, which could have a material adverse effect on our operating results.

BECAUSE OUR INTELLECTUAL PROPERTY IS IMPORTANT TO OUR SUCCESS, THE LOSS OR DIMINUTION OF OUR INTELLECTUAL PROPERTY RIGHTS THROUGH LEGAL CHALLENGE BY OTHERS OR FROM INDEPENDENT DEVELOPMENT BY OTHERS, COULD ADVERSELY AFFECT OUR BUSINESS.

We attempt to protect our intellectual property rights through patents, copyrights, trade secrets, and other measures. However, we believe that our financial performance will depend more upon the innovation, technological expertise, and marketing abilities of our employees than on such protection. In connection with our intellectual property rights, we face the following risks:

- Our pending patent applications may not be issued or may be issued with more narrow claims

- Patents issued to us may be challenged, invalidated, or circumvented

- Rights granted under issued patents may not provide competitive advantages to us

- Foreign laws may not protect our intellectual property rights

- Others may independently develop similar products, duplicate our products, or design around our patents

As is typical in the semiconductor industry, we occasionally receive notices from others alleging infringement claims. We have been involved in patent infringement litigation in the past and SCD Mountain View is currently involved in such litigation. We could become involved in similar lawsuits or other patent infringement claims in the future. We cannot guarantee the outcome of such lawsuits or claims, which may have a significant negative effect on our business or operating results.

OUR SALES CYCLE IS LONG AND UNPREDICTABLE, WHICH COULD REQUIRE US TO INCUR HIGH SALES AND MARKETING EXPENSES WITH NO ASSURANCE THAT A SALE WILL RESULT.

Sales cycles for some of our products can run as long as 12 to 18 months. As a result, we may not recognize revenue from efforts to sell particular products for extended periods of time. We believe that the length of the sales cycle may increase as some current and potential customers centralize purchasing decisions into one decision-making entity. We expect this may intensify the evaluation process and require us to make additional sales and marketing expenditures with no assurance that a sale will result.

WE DO NOT INTEND TO PAY DIVIDENDS.

We have never declared or paid any cash dividends on our common stock. We currently intend to retain any future earnings for funding growth and, therefore, do not expect to pay any dividends in the foreseeable future.





ADOPTION OF THE COMMON EUROPEAN CURRENCY MAY ADVERSELY AFFECT US AND OUR AFFILIATED DISTRIBUTORS BY REQUIRING SYSTEMS MODIFICATIONS AND POSSIBLY INCREASING THEIR CURRENCY EXCHANGE RISKS.

We are in the process of analyzing the issues raised by the introduction of the common European currency unit, the "Euro." The use of the Euro began on January 1, 1999 and will be phased-in through January 1, 2002. We do not expect the cost of any necessary systems modification to be material and do not anticipate that the introduction and use of the Euro will materially affect our results or those of our affiliated distributors' international business operations.* Nor do we expect the Euro to have a material effect on the currency exchange risks of our or our affiliated distributors' businesses.* Our management will continue to monitor the effect of the implementation of the Euro.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS.

Some of the statements under the captions "Risk Factors," "Management's Discussion and Analysis of Financial Condition and Results of Operations," "Business" and elsewhere in this report are "forward-looking statements." These statements involve known and unknown risks, uncertainties, and other factors that may cause our, or our industry's, actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by the forward-looking statements. These factors are listed under "Risk Factors' and elsewhere in this report.

In some cases, you can identify forward-looking statements by terminology such as "expects," "anticipates," "intends," "may," should," "plans," "believes," "seeks," "estimates," "could," would" or the negative of such terms or other comparable terminology.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we nor any other person assumes responsibility for the accuracy and completeness of these statements. We are under no duty to update any of the forward-looking statements after the date of this report to conform these statements to actual results.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our cash flows and earnings are subject to fluctuations in foreign exchange rates due to investments in foreign-based affiliates. As of November 25, 2000 our investments in affiliates include a 20.2% interest in Metron Technology (Metron) and a 49% interest in moFSI Ltd. Metron operates mainly in Europe, Asia Pacific and the United States. moFSI Ltd. operates in Japan. Approximately 89% of fiscal 2000 sales to affiliates were to Metron. We denominate all U.S. export sales in U.S. dollars.

Metron attempts to limit its exposure to changing foreign currency exchange rates through operational and financial market actions. Products are sold in a number of countries throughout the world resulting in a diverse portfolio of transactions denominated in foreign currencies. Certain short-term foreign currency exposures are managed by the purchase of forward contracts to offset the earnings and cash flow impact of non-functional currency denominated receivables and payables.

We do not have significant exposure to changing interest rates as all material outstanding debt was repaid on September 3, 1999 and all marketable securities consist of debt instruments, 100% of which mature within one year. As of year-end, amortized cost approximates market value for all outstanding marketable securities. We do not undertake any specific actions to cover our exposure to interest rate risk and we are not party to any interest rate risk management transactions. The impact of a 1% change





in short-term interest rates would be approximately $400,000 based on cash, cash equivalents and marketable security balances as of August 26, 2000.

Our investment in our affiliate, Metron, is accounted for by the equity method of accounting and has a carrying value on the balance sheet of approximately $15.4 million. The fair value of Metron is subject to stock market fluctuations. Based on the closing stock price of Metron of $7.13 per share on November 24, 2000, the fair value of our investment in Metron, was approximately $19.2 million. The stock price of Metron ranged from $6.63 to $36.00 per share during fiscal 2000 and from $7.13 to $13.75 per share during the first quarter of fiscal 2001.





FSI INTERNATIONAL, INC. AND SUBSIDIARIES

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

We generate minor amounts of liquid and solid hazardous waste and use licensed haulers and disposal facilities to ship and dispose of such waste. In the past, we have received notice from state or federal enforcement agencies that we are a potentially responsible party ("PRP") in connection with the investigation of several hazardous waste disposal sites owned and operated by third parties. In each matter, we have elected to participate in settlement offers made to all de minimis parties with respect to such sites. The risk of being named a PRP is that if any of the other PRP's are unable to contribute their proportionate share of the liability, if any, associated with the site, those PRP's that are able could be held financially responsible for the shortfall.

There has recently been substantial litigation regarding patent and other intellectual property rights in the microelectronics industry. Commercialization of new products or further commercialization of our current products could provoke claims of infringement by third parties. In the future, litigation may be necessary to enforce patents issued to us, to protect trade secrets or know-how owned by us or to defend us against claimed infringement of the rights of others and to determine the scope and validity of our proprietary rights. Any such litigation could result in substantial costs and diversion of effort by us, which by itself could have a material adverse impact on our financial condition and operating results. Further, adverse determinations in such litigation could result in our loss of proprietary rights, subject us to significant liabilities to third parties, require us to seek licenses from third parties or prevent us from manufacturing or selling one or more products, any of which could have a material adverse effect on our financial condition and results of operations.

Certain of our product lines are intended for use with hazardous chemicals. As a result, we are notified by our customers from time to time of incidents involving our equipment that have resulted in a spill or release of a hazardous chemical. In some cases it may be alleged that we or our equipment are at fault. There can be no assurance that any future litigation resulting from such claims would not have a material adverse effect on our business or financial results.

In October 1996, Eric C. and Angie L. Hsu (the "plaintiffs") filed a lawsuit in the Superior Court of California, County of Alameda, Southern Division, against Semiconductor Systems, Inc. ("SSI"), a wholly-owned subsidiary of FSI that was acquired in April 1996, and the former shareholders of SSI. In the fall of 1995, pursuant to the Employee Stock Purchase and Shareholder Agreement dated November 30, 1990 between Mr. Hsu and SSI (the "Shareholder Agreement") and in connection with Mr. Hsu's termination of his employment with SSI in August 1995, the former shareholders of SSI purchased the shares of SSI common stock then held by Mr. Hsu. The plaintiffs claimed, among other things, that such purchase breached the Shareholder Agreement and violated the California Corporations Code, breached the fiduciary duty owed plaintiffs by the individual defendants and constituted fraud.

In September and October of this year, certain of Mr. Hsu's claims were tried to a jury in Alameda County Superior Court in Oakland, California. At the conclusion of the trial, the jury made the following findings. The jury found that SSI breached the Shareholder Agreement between it and Eric Hsu either by allowing the other shareholders to purchase Mr. Hsu's shares or by allowing an untimely purchase of Mr. Hsu's shares and that the damages that resulted were $2.4 million. This finding may allow Mr. Hsu to seek recovery of certain of his attorney's fees. In addition, each of the individual defendant shareholders





was found liable for conversion and damages of $4.2 million were awarded. Certain individual defendants were also found to have intentionally interfered with Mr. Hsu's prospective economic advantage and damages of $3.2 million were awarded. Finally, several individual defendants and SSI were found to have violated certain provisions of the California Corporations Code and damages of $2.4 million were awarded. The judge has not yet heard arguments regarding the jury verdict but SSI believes the damages awards will be found to be duplicative and not cumulative and that certain of these damages awards may be subject to reduction, including for among other things, on account of the amount paid to Mr. Hsu in connection with the purchase of his shares.

Certain equitable claims of Mr. Hsu still must be tried to and decided by the court. For this reason, damages have not yet been allocated among the respective defendants and final judgment has not yet been entered. Once judgment is entered, the matter is appealable and SSI and the individual defendants are likely to appeal the verdict on a variety of grounds. Thus, there is considerable uncertainty as to the ultimate resolution of this matter and the respective liability, if any, of the individual defendants or SSI.

We, on behalf of SSI, have made a claim with respect to the lawsuit under the escrow created at the time of our acquisition of SSI. The escrow was established to secure certain indemnification obligations of the former shareholders of SSI. The escrow consists of an aggregate of 250,000 shares of our Common Stock paid to the former shareholders of SSI as consideration in the acquisition. There is no cash in the escrow. The former shareholders have agreed to hold FSI and SSI harmless from any claim arising out of any securities transactions between SSI and the shareholders or former shareholders of SSI. The indemnification obligations of the individual SSI shareholders are capped at approximately $4.2 million in the aggregate. Any shares in the escrow returned to FSI to satisfy any indemnification obligations will be valued at $12.125 per share, the per-share price of FSI Common Stock at the time of the SSI acquisition. Depending on the ultimate resolution of the case, it is possible that the escrow and indemnity obligations of the individual shareholders may not be sufficient to fully protect SSI against any judgment that may be entered in the matter.

CFM Technologies, Inc. and CFMT, Inc. (collectively "CFM") filed a complaint against YieldUP in United States District Court for the District of Delaware in September 1995. The complaint alleged that the drying process incorporated in certain YieldUP products infringes a patent held by CFM. On October 14, 1997, a federal court for the District of Delaware ruled in YieldUP's favor. In a written opinion granting summary judgment for YieldUP, the United States District Court held that CFM had failed to produce evidence on three separate elements of the patent claim. To establish infringement, evidence of all three elements was required. On June 30, 1998, the United States District Court of Delaware granted CFM's petition for re-argument of the summary judgment motion, and the re-argument briefs have been filed by both parties. The judge has not yet ruled as to whether to sustain his earlier ruling. If the original order is overturned, the litigation may proceed to trial, and the litigation and the associated costs may, and an unfavorable adjudication could, have a material adverse impact on FSI.* CFM is asking for monetary damages and an injunction against YieldUP's use of the products at issue. A loss, if any, resulting from an unfavorable adjudication, cannot presently be estimated.

CFM filed an additional complaint against YieldUP in United States District Court for the District of Delaware on December 30, 1998. The complaint alleged that the cleaning process incorporated in certain of YieldUP's products infringes two patents held by CFM: U.S. Patent Nos. 4,917,123 and 4,778,532. YieldUP plans to vigorously defend its intellectual property rights against any and all claims. FSI believes that the additional CFM patent infringement lawsuit is without merit and that none of YieldUP's technology and products infringes any of the CFM patents asserted in that litigation. FSI believes YieldUP's technology is substantially different from CFM's patented technology. YieldUP has filed an





answer to the complaint and a counter claim for non-infringement and invalidity of CFM's patents. CFM is asking for monetary damages and an injunction against YieldUP's use of those products at issue. A loss, if any, resulting from an unfavorable adjudication, cannot presently be estimated. The associated costs may, and an unfavorable adjudication could, have a material adverse impact on FSI.

On April 4, 2000 the United States District Court for the District of Delaware granted YieldUP's motion for summary judgment that the `123 and `532 patents are invalid. CFM's motion for rehearing has been denied. On July 29, the issue of whether CFM and its inventors had engaged in inequitable conduct in prosecuting the `123 and `532 patents was tried before the court. In early September the parties filed their briefs on the matter of inequitable conduct. The judge has yet to rule on the issue. If the judge finds CFM engaged in inequitable conduct, YieldUP will request the court to order CFM to pay YieldUP's attorneys fees in defending this suit. Once judgment is entered based upon the District Court's granting YieldUP's summary judgment motion, the District Court's order may be appealed by CFM.

Other than the litigation described above or routine litigation incidental to our business, there is no material litigation to which we are a party or of which any of our property is subject.

ITEM 2. CHANGE IN SECURITIES

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

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

None

ITEM 5. OTHER INFORMATION

None





FSI INTERNATIONAL, INC. AND SUBSIDIARIES

ITEM 6 EXHIBITS AND REPORTS ON FORM 8-K

(a)(3) Exhibits

* An asterisk next to a listed Exhibit indicates it is an executive compensation pl

2.0 Agreement and Plan of Reorganization, dated as of January 21, 1999 among FSI I
International, Inc. and YieldUP International, Corporation (16)
2.1 License Agreement for Microelectronic Technology between YieldUP International
International, Inc. dated January 21, 1999. (16)
2.2 Agreement and Plan of Reorganization by and Among FSI International, Inc., Spe
and Semiconductor Systems, Inc. (1)
2.3 Asset Purchase Agreement dated as of June 9, 1999 between FSI International, I
Inc. (15)
3.1 Restated Articles of Incorporation of the Company. (2)
3.2 Restated and amended By-Laws. (3)
3.5 Articles of Amendment of Restated Articles of Incorporation (17)
4.1 Form of Rights Agreement dated as of May 22, 1997 between FSI International, I
and Savings Bank, National Association, as Rights Agent (6)
4.2 Amendment dated March 26, 1998 to Rights Agreement dated May 22, 1997 by and b
International, Inc. and Harris Trust and Saving Bank,, National Association as
4.3 Amendment dated March 9, 2000 to Rights Agreement dated May 22, 1997, as amend
and between FSI International, Inc. and Harris Trust and Savings Bank as Right
*10.1 FSI International, Inc. 1997 Omnibus Stock Plan (5)
*10.2 Split Dollar Insurance Agreement and Collateral Assignment Agreement dated Dec
between the Company and Joel A. Elftmann. (Similar agreements between the Comp
each of Patricia M. Hollister, Luke R. Komarek, Benno G. Sand, Benjamin J. Slo
Mark Ahmann and John Ely have been omitted, but will be filed if requested in
the Commission): (8)
10.3 Lease dated June 27, 1985, between the Company and Lake Hazeltine Properties.
10.4 Lease dated September 1, 1985, between the Company and Elftmann, Wyers, Blackw
Partnership. (3)
10.5 Lease dated September 1, 1985, between the Company and Elftmann, Wyers Partner
10.6 Amendment No. 1 dated February 11, 1991 to lease between the Company and Elftm

Partnership (17)
10.7 Amendment No. 2 dated July 31, 1999 to lease between the Company and Elftmann, Partnership (17)
*10.8 1989 Stock Option Plan. (4)
*10.9 Amended and Restated Employees Stock Purchase Plan.(14)
10.10 Shareholders Agreement among FSI International, Inc. and Mitsui & Co., Ltd. an Chlorine Engineers Corp. Ltd. dated as of August 14, 1991. (8)
10.11 FSI Exclusive Distributorship Agreement dated as of August 14, 1991 between FSI International, Inc. and moFSI, Ltd. (8)
10.12 FSI Licensing Agreement dated as of August 14, 1991, between FSI International and moFSI, Ltd. (8)
10.13 Amendment to FSI/Metron Distribution Agreement dated July 31, 1999 (18)





10.15 License Agreement, dated October 15, 1991, between the Company and Texas Instr Incorporated. (9)
10.16 Amendment No. 1, dated April 10, 1992, to the License Agreement, dated October between the Company and Texas Instruments Incorporated. (9)

10.17 Amendment effective October 1, 1993 to the License Agreement, dated October 15, 1991 between the Company and Texas Instruments Incorporated (10)
*10.18 Amended and Restated Directors' Nonstatutory Stock Option Plan. (11)
*10.19 Management Agreement between FSI International, Inc. and Joel A. Elftmann, eff June 5, 1998 (filed herewith) (Similar agreements between the Company and its have been omitted but will be filed if requested in writing by the commission.
*10.20 FSI International, Inc. 1994 Omnibus Stock Plan. (12)
10.22 First Amendment to Lease made and entered into October 31, 1995 by and between Lake Hazeltine Properties and FSI International, Inc. (13)
10.23 Distribution Agreement made and entered into as of March 31, 1998 by and betwe FSI International, Inc. and Metron Technology B.V. (Exhibits to Agreement omit
10.24 Lease dated August 9, 1995 between Skyline Builders, Inc. and FSI Internationa
10.25 Lease Rider dated August 9, 1995 between Skyline Builders, Inc. and FSI Intern
*10.26 Summary of Employment Arrangement between the Company and Don Mitchell dated D
10.27 Distribution Agreement between FSI International, Inc.'s. Surface Conditioning Technology B.V. effective July 10, 2000. (21)
10.29 Lease Amendment dated November, 1995 between Roland A. Stinski and FSI Interna Inc. (Exhibits to Amendment omitted) (13)
*10.30 Employment Agreement entered into as of December 12, 1999 by and between FSI I Donald S. Mitchell. (19)

(1) Filed as an Exhibit to the Company's Registration Statement on Form S-4 (as amended) 1996, SEC File No. 333-1509 and incorporated by reference.
(2) Filed as an Exhibit to the Company's Report on Form 10-Q for the quarter ended Februa File No. 0-17276, and incorporated by reference.
(3) Filed as an Exhibit to the Company's Registration Statement on Form S-1, SEC File No. 33-25035, and incorporated by reference.
(4) Filed as an Exhibit to the Company's Report on Form 10-K for the fiscal year ended Augu File No. 0-17276, and incorporated by reference.
(5) Filed as an Exhibit to the Company's Report on Form 10-Q for the fiscal quarter ended M File No. 0-17276, and incorporated by reference.
(6) Filed as an Exhibit to the Company's Report on Form 8-K, filed by the Company on June No. 0-17276, and incorporated by reference.
(7) Filed as an Exhibit to the Company's Report on Form 8-A/A-1, filed by the Company on Ap File No. 0-17276 and incorporated by reference.
(8) Filed as an Exhibit to the Company's Report on Form 10-K for the fiscal

year ended August 31, 1991, as amended by Form 8 dated January 7, 1992, SEC File No. 0-17276, and incorporated by reference.

(9) Filed as an Exhibit to the Company's Report on Form 10-K for the fiscal year ended Augu No. 0-17276, and incorporated by reference.

(10) Filed as an Exhibit to the Company's Report on Form 10-K for the fiscal year ended Augu File No. 0-17276, and incorporated by reference.

(11) Filed as an Exhibit to the Company's Report on Form 10-Q for the fiscal quarter ended File No. 0-17276, and incorporated by reference.

(12) Filed as an Exhibit to the Company's Report on Form 10-K for the fiscal year ended Augu File No. 0-17276, and incorporated by reference.





(13) Filed as an Exhibit to the Company's Report on Form 10-K for the fiscal year ended Augu No. 0-17276 and incorporated by reference.

(14) Filed as an Exhibit to the Company's Report on Form 10-K for the fiscal year ended Augu No. 0-17276, and incorporated by reference.

(15) Filed as an Exhibit to the Company's Report on Form 8-K, filed by the Company on June 0-17276 and incorporated by reference.

(16) Filed as an Exhibit to the Company's Report on Form S-4, filed by the Company on Septem No. 333-87003 and incorporated by reference.

(17) Filed as an Exhibit to the Company's Report on Form 10-K for the fiscal year ended Augus No. 0-17276, and incorporated by reference.

(18) Filed as an Exhibit to the Company's Report on Form 10-Q for the fiscal quarter ended No File No. 0-17276 and incorporated by reference.

(19) Filed as an Exhibit to the Company's Report on Form 10-Q for the fiscal quarter ended Fe File No. 0-17276 and incorporated by reference.

(20) Filed as an Exhibit to the Company's Report on Form 10-Q for the fiscal quarter ended Ma No. 0-17276 and incorporated by reference.

(21) Filed as an Exhibit to the Company's Report on Form 10-K for the fiscal year ended Augus No. 0-17276, and incorporated by reference.

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(b) Reports on Form 8-K

No reports on Form 8-K were filed during the first quarter ended November 25, 2000.





FSI INTERNATIONAL, INC. AND SUBSIDIARIES

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.

FSI INTERNATIONAL, INC.
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[Registrant]

DATE: January 8, 2001

By: /s/Patricia M. Hollister
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Patricia M. Hollister,
Chief Financial Officer
on behalf of the
Registrant and as
Principal Financial and Accounting Officer

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