

NOVA MEASURING INSTRUMENTS LTD  
Form 20-F  
March 30, 2009

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UNITED STATES  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**Form 20-F**

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REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) or (g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

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

For the fiscal year ended December 31, 2008

OR

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

OR

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

**Commission File Number 000-30668**

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**NOVA MEASURING INSTRUMENTS LTD.**

(Exact name of Registrant as specified in its charter)

**Nova Measuring Instruments Ltd.**  
(Translation of Registrant's name into English)

**Israel**  
(Jurisdiction of incorporation or organization)

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**Weizmann Science Park, Einstein St., Building 22, 2nd Floor, Ness-Ziona, Israel**  
(Address of principal executive offices)

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**Dror David, +972-8-9387572, +972-8-9407776, P.O.B 266, Rehovot 76100, Israel**  
(Name, Telephone, E-mail and/or Facsimile number and Address of the Registrant's Contact Person)

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Securities registered or to be registered pursuant to Section 12(b) of the Act.

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
Ordinary Shares, nominal value NIS 0.01 per share	The Nasdaq Global Market

Securities registered or to be registered pursuant to Section 12(g) of the Act:

None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report: 19,378,339 Ordinary Shares, NIS 0.01 nominal (par) value per share, as of December 31, 2008, of which 2,229 Ordinary Shares held by the Registrant which have no voting or equity rights.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP

International Financing Reporting Standards as issued by the International Accounting Standards Board

Other

If Other has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow:

Item 17  Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Item 17  Item 18

Yes  No 


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## **Introduction**

In this Annual Report, the "Company", "Nova", "we" or "our" refers to Nova Measuring Instruments Ltd. and its consolidated subsidiaries, when the context requires.

The consolidated financial statements and selected consolidated financial data as of December 31, 2004, 2005, 2006, 2007 and 2008 and for each of the years in the five-year period ended December 31, 2008 (the Consolidated Financial Statements), included in this Annual Report have been prepared in accordance with accounting principles generally accepted in the United States of America ( U.S. GAAP ).

### **Our Functional Currency**

Unless otherwise indicated, all amounts herein are expressed in United States dollars ("U.S. dollars", "dollars", "USD", "US\$" or "\$").

The currency of the primary economic environment in which we operate is the U.S. dollar, since substantially all our revenues to date have been denominated in U.S. dollars and over 50% of our expenses are in U.S. dollars or in New Israeli Shekels linked to the dollar. Transactions and balances denominated in dollars are presented at their original amounts. Non-dollar transactions and balances have been re-measured into dollars as required by the principles in Statement No. 52 of the Financial Accounting Standards Board (FASB) of the United States of America. All exchange gains and losses from such re-measurement are included in the net financial income when they arise.

### **Cautionary Statement Regarding Forward-Looking Statements**

Certain information contained herein, which does not relate to historical financial information, may be deemed to constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The words or phrases "will likely result", "are expected to", "will continue", "is anticipated", "estimate", "project", "believe", "plan", or similar expressions identify forward looking statements, including without limitation, statements relating to our anticipated sales, revenues and expenses in 2009, our expectations with respect to our business and operations and our ability to gain market share, and expected changes in the semiconductor industry in light of the global economic crises, are subject to certain risks and uncertainties that could cause actual results to differ materially from historical results and those presently anticipated or projected. We wish to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. We cannot guarantee future results, levels of activity, performance or achievements. We also undertake no obligation to release publicly any revisions to these forward looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. Among the factors that could cause our actual results in the future to differ materially from any opinions or statements expressed with respect to future periods are competitive industry conditions and the ability to forecast the needs of the semiconductor industry with respect to the very cyclical nature of the industry and the very fast pace of technology evolutions and factors related to the conditions of the global markets and the global economy. Various other factors that could cause our actual results to differ materially are set forth in Risk Factors starting on page 2 and elsewhere herein.

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## PART I

**Item 1. Identity of Directors, Senior Management and Advisors**

Not applicable.

**Item 2. Offer Statistics and Expected Timetable**

Not applicable.

**Item 3. Key Information****3A. Selected Financial Data**

The following selected consolidated financial data as of December 31, 2007 and 2008 and for the years ended December 31, 2006, 2007 and 2008 have been derived from our audited Consolidated Financial Statements included elsewhere in this annual report. These financial statements have been prepared in accordance with U.S. GAAP, and audited by our independent registered public accounting firm. The consolidated selected financial data as of December 31, 2006, 2005 and 2004 and for the years ended December 31, 2005 and 2004 have been derived from other consolidated financial statements not included in this Form 20-F that were also prepared in accordance with U.S. GAAP and audited by our independent registered public accounting firm. The selected consolidated financial data set forth below should be read in conjunction with and are qualified by reference to Item 5. Operating and Financial Review and Prospects and the Consolidated Financial Statements and notes thereto and other financial information included elsewhere in this annual report on Form 20-F.

**Summary of Consolidated Financial Data**

	Year ended December 31,				
	2004	2005	2006	2007	2008
	(in thousands, except per share data)				
<b>Consolidated Statement of Operations Data:</b>					
Revenues	\$ 36,806	\$ 30,142	\$ 48,292	\$ 58,077	\$ 38,969
Cost of revenues	21,111	19,306	27,743	33,251	25,986
Gross profit	15,695	10,836	20,549	24,826	12,983
Operating expenses:					
Research and development expenses, net	8,665	9,301	9,166	9,143	8,606
Sales and marketing expenses	6,647	6,950	8,754	10,175	7,503
General and administrative expenses	2,331	3,626	5,136	4,830	3,199
Other operating expenses	-	-	-	3,831	633
Total operating expenses	17,643	19,877	23,056	27,979	19,941
Operating loss	(1,948)	(9,041)	(2,507)	(3,153)	(6,958)
Financing income (expenses), net	528	627	573	(764)	1,537
Net loss for the year	\$ (1,420)	\$ (8,414)	\$ (1,934)	\$ (3,917)	\$ (5,421)

Loss per share:

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	Year ended December 31,				
Basic and diluted loss per share	\$ (0.09)	\$ (0.55)	\$ (0.12)	\$ (0.21)	\$ (0.28)
Shares used in calculation of basic and diluted loss per share	15,259	15,437	15,976	18,606	19,369

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	December 31,				
	2004	2005	2006	2007	2008
	(in thousands)				
<b>Consolidated Balance Sheet Data:</b>					
Working capital	25,709	14,834	15,873	20,660	20,246
Total assets	49,966	42,339	44,419	48,385	35,791
Capital stock (including additional paid-in capital)	73,379	73,682	76,735	83,456	84,024
Shareholders' equity	31,581	23,444	24,575	27,584	22,341

**3B. Capitalization and Indebtedness**

Not applicable.

**3C. Reasons for the Offer and Use of Proceeds**

Not applicable.

**3D. Risk Factors**

**Risks Related to Our Business and Our Industry**

**Recent difficult conditions in the global capital markets and the global economy materially affected our business and results of operations and harm our ability to raise capital or debt.**

Our results of operations are materially affected by conditions in the global capital markets and the economy generally, both in the U.S. and elsewhere around the world. The stress experienced by global capital markets substantially increased in recent quarters. The global economic instability and uncertainty, accompanied with the credit crisis and reduced demand for semiconductors, affect the willingness and ability of semiconductors manufacturers to make capital investments, and are causing a severe slow-down in the semiconductor industry as a whole. These events have an adverse effect on our revenues, as well as on our ability to raise capital or debt at an attractive cost of capital.

**Because substantially most of our current sales are dependent on a single product line, factors that adversely affect the pricing and demand for this product line could substantially reduce our sales.**

Although we have expanded our product offering, we are still currently dependent on a single integrated process control product line targeting the chemical mechanical polishing market. We expect revenues from this product line to continue to account for a substantial portion of our revenues for at least the next year. As a result, factors adversely affecting the pricing of or demand for integrated process controls for the chemical mechanical polishing equipment field, such as competition and technological change, could significantly reduce our sales.

**The markets we target are highly cyclical and it is difficult to predict the length and strength of any downturn or expansion period.**

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The semiconductor capital equipment market and industries, which are highly cyclical, experienced in 2008 a significant decline in sales, after significant increases in sales in 2007 and 2006. According to Gartner, Inc., a market research company, the forecast for year 2009 predicts a further significant decline in capital spending. Although we rely on market research companies, we cannot predict the length and strength of the downturns or expansions, including the current downturn.

### **Our inability to reduce spending during a protracted slowdown in the semiconductor industry could reduce our prospects of achieving profitability.**

Historically, we have derived all of our revenues, and we expect to continue to derive practically all of our revenues, from sales of our products and related services to the semiconductor industry. Our business depends in large part upon capital expenditures by semiconductor manufacturers, which in turn depend upon the current and anticipated demand for semiconductors. The semiconductor industry has experienced severe and protracted cyclical downturns and upturns. Specifically, during 2008 the semiconductor industry experienced a severe downturn, as a result of the slowdown in the general economy and the industry overcapacity build-ups in years 2006 and 2007. During cyclical downturns, as those we have experienced in the past, are currently experiencing and are likely to experience in the future, material reductions in the demand for the type of capital equipment and process technology that we offer and our sales and revenues might decline. In addition, our ability to reduce expenses in response to any downturn or slowdown in the rate of capital investment by manufacturers in these industries may be limited because of:

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- our continuing need to invest in research and development;
  - our continuing need to market our new products to new and existing customers; and
  - our extensive ongoing customer service and support requirements worldwide.

As a result, we may have difficulty achieving profitability.

### **If we do not respond effectively and on a timely basis to rapid technological change, our ability to attract and retain customers could be diminished, which would hurt our sales and ability to remain competitive.**

The semiconductor manufacturing industry is characterized by rapid technological change, new product introductions and enhancements and evolving industry standards. Our ability to remain competitive and generate sales revenue will depend in part upon our ability to develop new and enhanced systems at competitive prices in a timely and cost-effective manner and to accurately predict technology transitions. Because new product development commitments must be made well in advance of sales, new product decisions must anticipate the future demand for products. If we fail to correctly anticipate future demand for products, our sales and competitive position will suffer. In addition, the development of new measurement technologies, new product introductions or enhancements by our competitors could cause a decline in our sales or loss of market acceptance of our existing products.

### **We may not be able to develop or market new products, which could slow or prevent our growth.**

Our business plan requires the introduction of several new product lines. Our plans to introduce process control products for photolithography, etch, metal deposition and other processes will require development of new capabilities. Some of these projects are in the early stages of development, and we cannot be certain that we will be able to develop or bring to market these new product lines or, if we do, that these products will be well received or profitable. If we are unable to successfully introduce new product lines, our future growth could be adversely affected.

### **If any of our systems fail to meet or exceed our internal quality specifications, we cannot ship them until such time as they have met such specifications. If we experience significant delays or are unable to ship our products to our customers as a result of our internal processes or for any other reason, our business and reputation may suffer.**

Our products are complex and require technical expertise to design and manufacture. Various problems occasionally arise during the manufacturing process that may cause delays and/or impair product quality. We actively monitor our manufacturing processes to ensure that our products meet our internal quality specifications. Any significant delays stemming from the failure of our products to meet or exceed our internal quality specifications, or for any other reasons, would delay our shipments. Shipment delays could harm our business, revenues and reputation in the industry.

**New product lines that we may introduce in the future may contain defects, which will require us to allocate time and financial resources to correct.**

Our new product lines may contain defects when first introduced. If there are defects, we will need to divert the attention of our personnel from our product development efforts to address the detection and correction of the defects. In the past, no liability claims have been filed against us for damages related to product defects, and we have not experienced any material delays as a result of product defects. However, we cannot provide assurances that we will not incur these costs or liabilities or experience these lags or delays in the future. Moreover, the occurrence of such defects, whether caused by our products or the products of another vendor, may result in significant customer relations problems and injury to our reputation and may impair the market acceptance of our products.

**We have historically generated losses and may incur future losses.**

Since our inception in 1993, we have had several years of losses and only one profitable year. We may incur a net loss in 2009 or in future years. As of December 31, 2008, we had an accumulated deficit of approximately \$61 million. We plan to reduce our aggregate operating expenses in 2009 relative to 2008. However, our ability to generate profits is dependent mainly on our ability to maintain or increase sales. In the future, our sales may not grow and we may not achieve profitability.

**Our dependence on a single manufacturing facility magnifies the risk of an interruption in our production capabilities.**

We have only one manufacturing facility, which is located in Ness-Ziona, Israel. Any event affecting this site, including natural disaster, labor stoppages or armed conflict, may disrupt or indefinitely discontinue our manufacturing capabilities and could significantly impair our ability to fulfill orders and generate revenues, thus negatively impacting our business.

**We experience quarterly fluctuations in our operating results, which may adversely impact our stock price.**

Our quarterly operating results have fluctuated significantly in the past. This trend may continue. A principal reason is that we derive a substantial portion of our revenue from the sale of a relatively small number of systems to a relatively small number of customers. As a result, our revenues and results of operations for any given quarter may decrease due to factors relating to the timing of orders, the timing of shipments of systems, and the timing of recognizing these revenues. Furthermore, our quarterly results are affected by the highly cyclical nature of the semiconductor capital equipment market and industries.

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We also have a limited ability to predict revenues for future quarterly periods and, as a result, face risks of revenue shortfalls. If the number of systems we actually ship, and thus the amount of revenues we are able to record in any particular quarter, is below our expectations, the adverse effect may be magnified by our inability to adjust spending quickly enough to compensate for the revenue shortfall.

**We depend on a small number of large customers, and the loss of one or more of them would lower our revenues.**

Like our peers serving the semiconductor market, our customer base is highly concentrated among a limited number of large customers, primarily because the semiconductor industry is dominated by a small number of large companies. We anticipate that our revenues will continue to depend on a limited number of major customers, although the companies considered to be our major customers and the percentage of our revenue represented by each major customer may vary from period to period. The loss of any one of our major customers would adversely affect our sales and revenues. Furthermore, if any of our customers become insolvent or have difficulties meeting their financial obligations to us for any reason, we may suffer losses.

**We operate in an extremely competitive market, and if we fail to compete effectively, our revenues and market share will decline.**

Although the market for integrated process control systems used in semiconductor manufacturing is currently concentrated and characterized by relatively few participants, the semiconductor capital equipment industry is intensely competitive. We compete mainly with Nanometrics, Inc., Rudolph Technologies, Inc., and KLA-Tencor Corp. which manufacture and sell integrated and/or stand-alone process control systems. In addition, we compete with original semiconductor equipment manufacturers, such as Tokyo Electron Ltd., which manufacture integrated metrology products and with original semiconductor equipment manufacturers, such as Applied Materials, Inc., which develop in-situ sensors and products. Established companies, both domestic and foreign, compete with our product lines, and new competitors are entering our market. Some of our competitors have greater financial, engineering, manufacturing and marketing resources than we do. If a particular customer selects a competitor's capital equipment, we expect to experience difficulty in selling to that customer for a significant period of time. A substantial investment is required by customers to evaluate, test, select and integrate capital equipment into a production line. As a result, once a manufacturer has selected a particular vendor's capital equipment, we believe that the manufacturer generally relies upon that



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equipment for the specific production line application and frequently will attempt to consolidate its other capital equipment requirements with the same vendor. Accordingly, unless our systems offer performance or cost advantages that outweigh a customer's expense of switching to our systems, it will be difficult for us to achieve significant sales from that customer once it has selected another vendor's system for an application. We believe that our ability to compete successfully depends on a number of factors both within and outside of our control, including:

- the contribution of our equipment to our customers' productivity;
- our product quality and performance;
- our global technical service and support;
- the return on investment (ROI) of our equipment and its cost of ownership;
- the breadth of our product line;
- our success in developing and marketing new products; and
- the extendibility of our product.

If we fail to compete in a timely and cost-effective manner against current or future competitors, our revenues and market share will decline.

**The ongoing consolidation in our industry may harm us if our competitors are able to offer a broader range of products and greater customer support than we can offer.**

We believe that the semiconductor capital equipment market is undergoing consolidation. A number of capital equipment suppliers have been acquired by larger equipment manufacturers. For example, in 2005 Rudolph Technologies, Inc. acquired August Technologies, Inc., in 2006 Nanometrics, Inc. acquired Soluris, Inc. and Accent Technologies, Inc., and in 2007 KLA-Tencor Corp. acquired Therma-Wave, Inc. and Nanometrics, Inc. acquired Tevet Ltd. We believe that similar acquisitions and business combinations involving our competitors and customers may occur in the future. These acquisitions could adversely impact our competitive position by enabling our competitors and potential competitors to expand their product offerings and customer service, which could provide them an advantage in meeting customers' needs, particularly with those customers that seek to consolidate their capital equipment requirements with a smaller number of vendors. The greater resources, including financial, marketing and support resources, of competitors involved in these acquisitions could allow them to accelerate the development and commercialization of new competitive products and the marketing of existing competitive products to their larger installed bases. Accordingly, such business combinations and acquisitions by competitors or customers could jeopardize our competitive position.

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**We may not be successful in our efforts to identify, complete and integrate future acquisitions, which could disrupt our current business activities and adversely affect our results of operations or future growth.**

Any future acquisitions may involve many risks, including the risks of:

- diverting management's attention and other resources from our ongoing business concerns;
- entering markets in which we have no direct prior experience;
- improperly evaluating new services, products and markets;
- being unable to maintain uniform standards, controls, procedures and policies;
- being unable to integrate new technologies or personnel;
- incurring the expenses of any undisclosed or potential liabilities; and

the departure of key management and employees.

If we are unable to successfully complete future acquisitions or to effectively integrate any future acquisitions, our ability to grow our business or to operate our business effectively could be reduced, and our business, financial condition and operating results could suffer. Even if we are successful in completing acquisitions, we cannot assure you that we will be able to integrate the operations of the acquired business without encountering difficulty regarding different business strategies with respect to marketing, integration of personnel with disparate business backgrounds and corporate cultures, integration of different point-of-sale systems and other technology and managing relationships with other business partners.

**One of our major customers has no cancellation fee with regard to cancellation of orders, and we have been facing difficulties to collect cancellation fees from another customer.**

Our supply agreement with one of our largest customers does not include cancellation fee with regard to cancellation of this customer's orders. In addition, during the recent slowdown in the semiconductors industry, another customer cancelled his orders and we were unable to collect cancellation fees from that customer. Because of that, our ability to rely on our backlog for future forecasting and planning is impaired and harm our ability to forecast our financial results.

**Because we are small, we depend on a small number of employees who possess both executive and technical expertise, and the loss of any of these key employees would hurt our ability to implement our strategy and to compete effectively.**

Because of our small size and our reliance on employees with both executive and advanced technical skills, our success depends significantly upon the continued contributions of our officers and key personnel. All of our key management and technical personnel have expertise, which is in high demand among our competitors, and the loss of any of these individuals could cause our business to suffer. We do not maintain life insurance policies for our officers and directors.

**Our lengthy sales cycle increases our exposure to customer delays in orders, which may result in obsolete inventory and volatile quarterly revenues.**

Sales of our systems depend, in significant part, upon our customers adding new manufacturing capacity or expanding existing manufacturing capacity, both of which involve a significant capital commitment. We may experience delays in finalizing sales following initial system qualification while a customer evaluates and approves an initial purchase of our systems. In general, for new customers or applications, our normal sales cycle takes between 12 and 24 months to complete. During this time, we may expend substantial funds and management effort, but fail to make any sales. Lengthy sales cycles subject us to a number of significant risks, including inventory obsolescence and fluctuations in operating results, over which we have limited control.

**Because of the technical nature of our business, our intellectual property is extremely important to our business, and our inability to protect our intellectual property would harm our competitive position.**

As of March 2, 2008, we have obtained 77 U.S. patents and have 24 U.S. patent applications pending. In addition, we have obtained more than 40 non-U.S. patents and have more than 50 non-U.S. patent applications pending including 6 PCT applications.

We cannot assure that:

pending patent applications will be approved;

any patents will be broad enough to protect our technology, will provide us with competitive advantages or will not be challenged or invalidated by third parties; or

the patents of others will not have an adverse effect on our ability to do business.

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We also cannot assure that others will not independently develop similar products, duplicate our products or, if patents are issued to us, design around these patents. Furthermore, because patents may afford less protection under foreign law than is available under U.S. law, we cannot assure that any foreign patents issued to us will adequately protect our proprietary rights.

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In addition to patent protection, we also rely upon trade secret protection, employee and third-party nondisclosure agreements and other intellectual property protection methods to protect our confidential and proprietary information. Despite these efforts, we cannot be certain that others will not otherwise gain access to our trade secrets or disclose our technology.

Furthermore, we may be required to institute legal proceedings to protect our intellectual property. If such legal proceedings are resolved adversely to us, our competitive position and/or results of operations could be harmed. For additional information on our intellectual property, including information regarding a patent infringement lawsuit we commenced against Nanometrics, Inc., information regarding patent infringement lawsuits Nanometrics commenced against us, and information with respect to the settlement agreement we have recently reached with Nanometrics, see *Intellectual Property* starting on page 18 of this report.

**There has been significant litigation involving intellectual property rights in the semiconductor and related industries, and similar litigation involving Nova could force us to divert resources to defend against this litigation or deter our customers from purchasing our systems.**

We have been, and may in the future be, notified of allegations that we may be infringing intellectual property rights possessed by others. In addition, we may be required to commence legal proceedings against third parties, which may be infringing our intellectual property, in order to defend our intellectual property. In the future, protracted litigation and expense may be incurred to defend ourselves against alleged infringement of third party rights or to defend our intellectual property against infringement by third parties. Adverse determinations in that type of litigation could:

result in our loss of proprietary rights;

subject us to significant liabilities, including treble damages in some instances;

require us to seek licenses from third parties, which licenses may not be available on reasonable terms or at all; or

prevent us from selling our products.

Any litigation of this type, even if we are ultimately successful, could result in substantial cost and diversion of time and effort by our management, which by itself could have a negative impact on our profit margin, competitive position and ability to develop and market new and existing products. For additional information on our intellectual property, including information regarding a civil action we commenced against Nanometrics, Inc. information regarding civil actions Nanometrics commenced against us, and information with respect to the settlement agreement we have reached with Nanometrics, see *Intellectual Property* on page 18 of this annual report.

**We depend on a limited number of suppliers, and in some cases a sole supplier. Any disruption or termination of these supply channels may adversely affect our ability to manufacture our products and to deliver them to our customers.**

We purchase components, subassemblies and services from a limited number of suppliers and occasionally from a single source. Disruption or termination of these sources could occur, and these disruptions could have at least a temporary adverse effect on our operations. To date, we have not experienced any material disruption or termination of our supply sources. A prolonged inability on our part to obtain components included in our systems on a cost-effective basis could adversely impact our ability to deliver products on a timely basis, which could harm our sales and customer relationships.

**We are dependent on international sales, which expose us to foreign political and economic risks that could impede our plans for expansion and growth.**

Our principal customers are located in the United States, Japan, Taiwan, Singapore, Europe and South Korea and we produce our products in Israel. International operations expose us to a variety of risks that could seriously impact our financial condition and impede our growth. For instance, trade restrictions, changes in tariffs and import and export license requirements could adversely affect our ability to sell our products in the countries adopting or changing those restrictions, tariffs or requirements. This could reduce our sales by a material amount.

**Because we derive a significant portion of our revenues from sales in Asia, our sales could be hurt by the instability of Asian economies.**

A number of Asian countries have experienced political and economic instability. For instance, Taiwan and China have had a number of disputes, as have North and South Korea, and Japan has for a number of years experienced significant economic instability. We have a subsidiary in Taiwan and we have significant customers in Japan and South Korea as well as in China. An outbreak of hostilities or other political upheaval or economic downturns in these or other Asian countries would likely harm the operations of our customers in these countries, causing our sales to suffer.

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**A large number of our ordinary shares continue to be owned by a relatively small number of shareholders, whose future sales of our stock, if substantial, may depress our share price.**

If our principal shareholders sell substantial amounts of our ordinary shares, including shares issued upon the exercise of outstanding options, the market price of our ordinary shares may fall. As of December 31, 2008, we had 19,378,339 ordinary shares outstanding, and based on reports filed with the Securities and Exchange Commission and on the information provided to us by our transfer agent, 10,201,516 of such shares were held by five shareholders.

**Because as of March 2, 2009, five of our shareholders control approximately 53% of our ordinary shares, they can control the outcome of matters submitted to a vote of our shareholders, including the election of directors.**

As of March 2, 2009, five of our shareholders controlled approximately 53% of our outstanding ordinary shares (not including warrants currently exercisable or exercisable within 60 days of March 2, 2009). As a result, and although we are currently not aware of any voting agreement between such shareholders, if these shareholders voted together or in the same manner, they would have the ability to control the outcome of corporate actions requiring an ordinary majority vote of shareholders as set in the Company's articles of association. Even if these five shareholders do not vote together, each has the ability to influence the outcome of corporate actions requiring the vote of shareholders as set in the Company's article of association. For additional information on our major shareholders, see "Major shareholders" on page 37.

**The market price of our ordinary shares may be affected by a limited trading volume and may fluctuate significantly**

There has been a limited public market for our ordinary shares and there can be no assurance that an active trading market for our ordinary shares will continue. An absence of an active trading market could adversely affect our shareholders' ability to sell our ordinary shares in short time periods. Our ordinary shares have experienced, and are likely to experience in the future, significant price and volume fluctuations, which could adversely affect the market price of our ordinary shares without regard to our operating performance.

**We manage our available cash through various bank institutions and invest portions of our cash reserves in bank deposits. Recently, following the global financial crisis, few bank institutions announced bankruptcy or were on the verge of bankruptcy. A bankruptcy of one of the banks in which or through which we hold or invest our cash reserves, might prevent us to access that cash for an uncertain period of time.**

We manage our available cash through various bank institutions and invest portions of our cash reserves in bank deposits. Recently, following the global financial crisis, few bank institutions announced bankruptcy or were on the verge of bankruptcy. As of December 31, 2008, approximately 36% of our cash reserves were invested in or through US based bank institutions, and 59% of our cash was invested in or through Israeli based bank institutions. A bankruptcy of one of the banks in which we hold our cash reserves or through which we invest our cash reserves, might prevent us to access that cash for an uncertain period of time.

**We may fail to maintain effective internal control over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act of 2002.**

The Sarbanes-Oxley Act of 2002 imposes certain duties on us and our executives and directors. Our efforts to comply with the requirements of Section 404, which started in connection with our Annual Report on Form 20-F for the fiscal year ended December 31, 2007, have resulted in increased general and administrative expense and a diversion of management time and attention, and we expect these efforts to require the continued commitment of resources. Section 404 of the Sarbanes-Oxley Act of 2002 requires (i) management's annual review and evaluation of our internal control over financial reporting and (ii) an attestation report issued by an independent registered public accounting firm on our internal control over financial reporting, in connection with the filing of our Annual Report on Form 20-F for each fiscal year (such requirement is currently expected to be applicable to us starting with our Annual Report on Form 20-F for the fiscal year ending December 31, 2009). We have documented and tested our internal control systems and procedures in order for us to comply with the requirements of Section 404. While our assessment of our internal control over financial reporting resulted in our conclusion that as of December 31, 2008, our internal control over financial reporting was effective, we cannot predict the outcome of our testing in future periods. If we fail to maintain the adequacy of our internal controls, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal controls over financial reporting. Failure to maintain effective internal control over financial reporting could result in investigation or sanctions by regulatory authorities, and could have a material adverse effect on our operating results, investor confidence in our reported financial information, and the market price of our ordinary shares.

## **Risks Related to Operations in Israel**

### **Potential political, economic and military instability in Israel may adversely affect our growth and revenues.**

Our principal offices and manufacturing facilities and many of our suppliers are located in Israel. Although most of our sales are currently being made outside Israel, political, economic and military conditions in Israel directly affect our operations. Following the recession and the instability that characterized the Israeli economy during the years 2001 and 2003, the Israeli economy showed signs of improvement during 2004, 2005, 2006 and 2007. However, in recent quarters, the global economic recession, instability and uncertainty has affected the economic conditions in Israel and it is currently expected that such conditions will continue in Israel throughout 2009. If the economic deterioration in Israel continues, it may adversely affect our financial conditions, the results of operations and our ability to obtain financing from Israeli banks.

In addition, since the establishment of the State of Israel in 1948, a number of armed conflicts have occurred between Israel and its Arab neighbors. In July 2006, there have been extensive hostilities along Israel's northern border with Lebanon and to a lesser extent in the Gaza Strip. Since June 2007, the Hamas militant group has taken over the Gaza Strip from the Palestinian Authority, and the hostilities along Israel's border with the Gaza Strip have increased, escalating to a wide scale attack by Israel in December 2008, in retaliation to rocket attacks into southern Israel. The resumption of hostilities in the region, and the on-going tension in the region, have a negative effect on the stability of the region which might have a negative effect on our business and harm our growth and revenues. For further detail see "Political and economic conditions in Israel" starting on page 21.

### **Our operations may be disrupted by the obligation of key personnel to perform military service.**

Some of our executive officers and employees in Israel are obligated to perform up to 36 days of military reserve duty annually until the age of 40 for soldiers and until the age of 45 for officers. This time-period may be extended by the Military Chief of the General Staff and the approval of the Minister of Defense or by a directive of the Minister of Defense in the event of a declared national emergency. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees due to military service. To date, our operations have not been materially disrupted as a result of these military service obligations. Any disruption in our operations due to such obligations would adversely affect our ability to produce and market our existing products and to develop and market future products.

### **Provisions of our articles of association and Israeli law may delay, prevent or make difficult an acquisition of Nova, which could prevent a change of control and negatively affect the price of our ordinary shares.**

Israeli corporate law regulates mergers, requires tender offers for acquisitions of shares above specified thresholds, requires special approvals for transactions involving directors, officers or significant shareholders and regulates other matters that may be relevant to these types of transactions. Furthermore, Israeli tax considerations may make potential transactions unappealing to us or to some of our shareholders. See Item 10.B, "Additional Information - Memorandum and Articles of Association," for a more detailed discussion regarding some anti-takeover effects of Israeli law.

These provisions of Israeli law may delay, prevent or make difficult an acquisition of Nova, which could prevent a change of control and therefore depress the price of our shares.

### **The rights and responsibilities of our shareholders are governed by Israeli law and differ in some respects from the rights and responsibilities of shareholders under U.S. law.**

We are incorporated under Israeli law. The rights and responsibilities of holders of our ordinary shares are governed by our articles of association and by the Israeli Companies Law, 5759-1999 (the "Companies Law"). These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in typical U.S. corporations. In particular, pursuant to the Companies Law each shareholder of an Israeli company has to act in good faith in exercising his or her rights and fulfilling his or her obligations toward the company and other shareholders and to refrain from abusing his power in the company, including, among other things, in voting at the general meeting of shareholders and class meetings, on amendments to a company's articles of association, increases in a company's authorized share capital, mergers, and transactions requiring shareholders' approval under the Companies Law. In addition, a controlling shareholder of an Israeli company or a shareholder who knows that it possesses the power to determine the outcome of a shareholder vote or who has the power to appoint or prevent the appointment of a director or officer in the company, or has other powers toward the company has a duty of fairness toward the company. However, Israeli law does not define the substance of this duty of fairness. Because Israeli corporate law has undergone extensive revision in recent years, there is little case law available to assist in understanding the implications of these provisions that govern shareholder behavior.

**Because most of our revenues are generated in U.S. dollars, but a significant portion of our expenses is incurred in currencies other than U.S. dollars, and mainly New Israeli Shekels, our profit margin may be seriously harmed by currency fluctuations.**

We generate most of our revenues in U.S. dollars, but incur a significant portion of our expenses in currencies other than U.S. dollars, and mainly New Israeli Shekels, commonly referred to as NIS. As a result, we are exposed to risk of devaluation of the U.S. dollar in relation to the NIS and other currencies. In that event, the dollar cost of our operations in countries other than the U.S. will increase and our dollar measured results of operations will be adversely affected. During 2008, the U.S. dollar appreciated against the NIS by 1%, after devaluating approximately 9% in 2007 and approximately 8% in 2006. We cannot predict the future trends in the rate of devaluation or revaluation of the U.S. dollar against the NIS, and our operations also could be adversely affected if we are unable to hedge against currency fluctuations in the future.

**We participate in government programs under which we receive tax and other benefits. These programs impose restrictions on our ability to use the technologies developed under these programs. In addition, the reduction or termination of these programs would increase our costs.**

We receive grants from the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor for research and development programs that meet specified criteria. We are also eligible to receive tax benefits under Israeli law for capital investments that are designated as approved enterprises. To maintain our eligibility for these programs and tax benefits, we must continue to meet certain conditions, including paying royalties related to grants received and making specified investments in fixed assets. Some of these programs also restrict our ability to manufacture particular products and transfer particular technology, which was developed as part of the approved enterprises outside of Israel, by requiring approval of the research and development committee nominated by the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor under applicable law. Such approval may be given only if the recipient abides by all the provisions of the law and related regulations. Approval to manufacture products outside of Israel or consent to the transfer of technology, if requested, might not be granted.

If we fail to comply with these conditions in the future, the benefits received could be cancelled. We could also be required to pay increased taxes or refund any benefits previously received, adjusted for inflation and interest. In 2007 and in 2006, we recorded an aggregate of \$2.4 million and \$1.9 million, respectively, in grants under Israeli government programs, and in 2008 we recorded \$1.9 million in grants under Israeli government programs. As of December 31, 2008, our contingent liability to the Office of the Chief Scientist for grants received was approximately \$8.2 million. See also Note 8A to our consolidated financial statements contained elsewhere in this report. From time to time, we submit requests for new grants from the Office of the Chief Scientist and for expansion of our approved enterprise programs. These requests might not be approved. Also, the Israeli government may reduce or eliminate these benefits in the future. The termination or reduction of these grants or tax benefits could harm our business, financial condition and results of operations. In addition, if we increase our activities outside Israel due to, for example, future acquisitions, our increased activities generally will not be eligible for inclusion in Israeli tax benefit programs. Accordingly, our effective corporate tax rate could increase significantly in the future.

**Any shareholder with a cause of action against us as a result of buying, selling or holding our ordinary shares may have difficulty asserting a claim under U.S. securities laws or enforcing a U.S. judgment against us or our officers, directors or Israeli auditors.**

We are organized under the laws of the State of Israel, and we maintain most of our operations in Israel. Most of our officers and directors as well as our Israeli auditors reside outside of the United States and a substantial portion of our assets and the assets of these persons are located outside the United States. Therefore, if you wish to enforce a judgment obtained in the United States against us, or our officers, directors and auditors, you will probably have to file a claim in an Israeli court. Additionally, you might not be able to bring civil actions under U.S. securities laws if you file a lawsuit in Israel. We have been advised by our Israeli counsel that Israeli courts generally enforce a final executory judgment of a U.S. court for liquidated amounts in civil matters after a hearing in Israel. If a foreign judgment is enforced by an Israeli court, it will be payable in Israeli currency. However, payment in the local currency of the country where the foreign judgment was given shall be acceptable, subject to applicable foreign currency restrictions.

**Our ordinary shares may be delisted from trading on the Nasdaq Global Market, which may adversely affect the liquidity and price of our ordinary shares and may adversely affect our ability to secure additional financing.**

Recently, the bid price for our ordinary shares listed on the Nasdaq Global Market has closed below the \$1.00 minimum requirement for continued listing under Nasdaq Marketplace Rule 4450(a)(5) (the Rule). Due to the current extraordinary market conditions, on October 16, 2008, Nasdaq filed an immediately effective rule change with the SEC providing that companies will be deemed to be in compliance with the continuing listing standards related to bid price or market value of publicly held shares. The relief, as extended in March 2009, is currently in effect through July 19, 2009. If we fail to meet the continued listing criteria defined under the Rule following the expiration of the relief, our ordinary shares may be delisted from trading on the Nasdaq Global Market.

Delisting from the Nasdaq Global Market could have an adverse effect on our business and on the trading of our ordinary shares. If a delisting of our ordinary shares were to occur, our shares would continue to trade on Tel Aviv Stock Exchange and may trade in the U.S. on the OTC Bulletin Board or on the pink sheets. The OTC Bulletin Board and pink sheets are generally considered to be less efficient markets, and this could diminish investors' interest in our ordinary shares as well as significantly impact our share price and the liquidity of our ordinary shares. Delisting may also make it more difficult for us to issue additional securities or secure additional financing.

**Our shares are listed for trade on more than one stock exchange, and this may result in price variations.**

Our ordinary shares are listed for trading on the Nasdaq Global Market and on the Tel Aviv Stock Exchange. This may result in price variations. Our ordinary shares are traded on these markets in different currencies, U.S. dollars on the Nasdaq Global Market and New Israeli Shekels on the Tel Aviv Stock Exchange. These markets have different opening times and close on different days. Different trading times and differences in exchange rates, among other factors, may result in our shares being traded at a price differential on these two markets. In addition, market influences in one market may influence the price at which our shares are traded on the other.

**We may be classified as a passive foreign investment Company and, as a result, our U.S. shareholders may suffer adverse tax consequences.**

Generally, if for any taxable year 75% or more of our gross income is passive income, or at least 50% of our assets are held for the production of, or produce, passive income, we may be characterized as a passive foreign investment company for U.S. federal income tax purposes. Our passive income would not include income derived from the sale of our products, but would include amounts derived by reason of a temporary investment of any cash amounts. Characterization as a passive foreign investment company could result in adverse U.S. tax consequences to our shareholders, including having gain realized on the sale of our shares being treated as ordinary income, as opposed to capital gain income, and having potentially punitive interest charges applied to such sales proceeds. U.S. shareholders should consult with their own U.S. tax advisors with respect to the U.S. tax consequences of investing in our ordinary shares.

We believe that in 2008 we were not a passive foreign investment company. Nonetheless, because of the difficulty determining the value of our assets, there is a risk that we were a passive foreign investment company in 2008. Currently we expect that we will not be a passive foreign investment company in 2009. However, passive foreign investment company status is determined as of the end of the full tax year and is dependent on a number of factors, including the value of a corporation's assets, the trading price of our ordinary shares and the amount and type of its gross income. Therefore, there can be no assurances that we will not become a passive foreign investment company for the current fiscal year ending on December 31, 2009, or any future year. For a discussion on how we might be characterized as a passive foreign investment company and related tax consequences, please see the section of this annual report entitled "U.S. Taxation - Passive Foreign Investment Companies."

**Item 4. Information on the Company**

**4.A History and Development of the Company**

Nova Measuring Instruments Ltd. was incorporated in May 1993 under the laws of the State of Israel. We commenced operations in October 1993 to design, develop and produce integrated process control systems for use in the manufacture of semiconductors, also known as integrated circuits or chips. In October 1995, we began manufacturing and marketing systems for chemical mechanical polishing processes.

In April 2000, we conducted an initial public offering pursuant to which we sold 3,000,000 ordinary shares for consideration of net proceeds of \$49 million. In connection with the public offering, our shares were listed for trading on the Nasdaq Global Market (formally known as the Nasdaq National Market).

In June 2002, we listed our shares in the Tel-Aviv Stock Exchange in Israel, pursuant to legislation which enables Israeli companies whose shares are traded on certain stock exchanges outside of Israel to be registered on the Tel Aviv Stock Exchange, while reporting, in substance, in accordance with the provision of the relevant foreign securities law applicable to the Company.

During 2003, we began expanding our product offerings to include stand-alone systems. The new offerings of stand-alone products have contributed approximately \$4 million to our sales in each of the years 2007 and 2008.

In August 2006, we completed the purchase of substantially all the assets of HyperNex, Inc., or HyperNex, a Delaware corporation, located at State College, Pennsylvania, and assumed certain liabilities, including liabilities accruing after the closing relating to contracts assumed by us.

HyperNex developed wide angle x-Ray diffraction technology which enables the measurement of the microstructure of polycrystalline materials. In April 2008, we closed the x-ray product group and related activities globally due to lack of tangible business progress in that activity.

In the first quarter of 2007, we entered into an agreement with several investors for the private placement of 1,937,984 ordinary shares, at a price of \$2.58 per share, for gross proceeds of \$5 million. As part of the transaction, we issued warrants to the investors for the purchase of approximately 1,453,488 additional ordinary shares at an exercise price of \$3.05 per share.

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We have four wholly owned subsidiaries in the U.S., Japan, Taiwan and Netherlands. These subsidiaries are engaged in marketing activities and provide technical support to our customers.

Our main office, research and development and production facilities are located in Israel at the Weizmann Science Park, Building 22, 2nd Floor, Ness-Ziona. Our telephone number at our main office is +1-972-8-938-7505.

#### **4.B Business Overview**

We are a worldwide leading designer, developer and producer of integrated process control metrology systems and design, manufacture and sell leading edge stand-alone metrology used in the manufacturing process of semiconductors. Metrology systems measure various thin film properties and critical circuit dimensions during various steps in the semiconductor manufacturing process, allowing semiconductor manufacturers to increase quality, productivity and yields, lower their manufacturing costs and increase their profitability. We supply our metrology systems to major semiconductor manufacturers worldwide, either directly or through process equipment manufacturers. Of the 20 semiconductor manufacturers that had the highest capital equipment expenditures in 2008, 17 use our systems. The majority of our integrated metrology systems are sold to process equipment manufacturers. These process equipment manufacturers integrate our metrology systems into their process equipment which is then sold to the semiconductor manufacturers. Our systems were first installed in 1995 and, since that time, we have sold more than 1,900 metrology systems.

The semiconductor manufacturing process starts with a silicon wafer that has been highly polished on one side to a mirror finish, upon which circuits are constructed. To construct the circuits, a series of layers of thin films that act as conductors, semiconductors or insulators are applied to the polished side of the wafer. During the manufacturing process, these film layers are subjected to processes which remove portions of the film layers, create circuit patterns and perform other functions. The semiconductor manufacturing process requires exacting steps and strict control of equipment performance and process sequences. Tight control can be achieved through monitoring silicon wafers and measuring relevant parameters after each process step with metrology tools such as those we produce.

Prior to the introduction of our integrated metrology systems, process control was achieved through stand-alone measurement equipment. Stand-alone measurement equipment requires semiconductor manufacturers to interrupt the manufacturing process sequence, remove sample silicon wafers from the process equipment and place the silicon wafers on the stand-alone measuring or inspection tool. In contrast, our integrated metrology approach is based upon patented measuring methods that enable us to produce optical measuring systems that are small enough to be integrated directly inside many types of semiconductor process equipment. We believe that in several instances during the manufacturing process, our integrated approach offers considerable advantages over the conventional stand-alone approach to metrology control, enabling manufacturers using our integrated equipment to reduce costs and to improve production efficiency, yield and quality.

We have always emphasized our integrated metrology solutions as this continues to be an area where we have a leading position. In addition, in the past few years we developed and started manufacturing stand-alone metrology systems as well. We plan to leverage our technology, methods, metrology expertise and market position in the integrated metrology field to expand our offerings of stand-alone metrology systems. Today, both stand alone and integrated metrology solutions have reached a level of maturity allowing semiconductor manufactures to choose how to use either technology and make decisions based on merit specific to the process step in question, always balancing between the amount of data attained and the use made of the data for capabilities such as automated process control. Our long-term strategy is focused on advanced metrology and process control solutions where our integrated process control products and stand alone products are compatible or complementary and used in a customized way to meet specific customer needs.

Demand for metrology systems, whether integrated or stand-alone, is driven by capital equipment purchases by semiconductor manufacturers, which in turn are driven by worldwide demand for semiconductors. Industry data indicates that through the years, the worldwide demand for semiconductors is growing (although slowing down in recent quarters due to the global economy crisis). We believe that this growth in demand will drive demand for process control equipment, including metrology systems, as semiconductor manufacturers add capacity. Demand for metrology systems will also be driven by the increasing cost to manufacture semiconductors and the demands of semiconductor manufacturers for process equipment that provides better film uniformity, increased dimensional control, tool-to-tool matching and within-tool



uniformity.

## Our Market

### *Semiconductor Industry and the Metrology Market*

The increased use of semiconductors has been accompanied by an increase in their complexity. Due to the creation of new applications and markets for semiconductors, suppliers and manufacturers are faced with an increasing demand for new products that provide greater functionality and higher performance at lower prices. As a result, many new complex materials, structures and processes are being introduced to semiconductor manufacturing. New materials include copper, low- and high-k dielectrics, silicon-on-insulator, silicon-germanium, strained silicon and raised source/drain. Manufacturers are also increasingly moving toward 300 mm silicon wafers from 200 mm silicon wafers. While 300 mm wafers can yield up to twice as many integrated circuits as 200 mm wafers, larger wafers increase manufacturing challenges. For example, because 300 mm wafers can bend or bow more than twice as much as 200 mm wafers, they are more susceptible to damage. The larger area of 300 mm wafers also makes it more difficult to maintain film uniformity across the entire wafer. Semiconductors also continue to move toward smaller feature sizes and more complex multi-level circuitry. The increase in complexity of semiconductors and the resulting increase in the complexity and cost of the semiconductor manufacturing process has also been a driver of demand for metrology systems.

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The ever-increasing level of complexity and the decrease in feature sizes has also significantly increased the cost and performance requirements of semiconductor fabrication equipment. The cost of wafer fabrication equipment has also increased due to the higher levels of automation being utilized by manufacturers. Thus, semiconductor manufacturers must increase their investment in capital equipment in order to sustain technological leadership, to expand manufacturing capacity and maintain profitability. According to published reports by an industry market research firm, the cost of building a state-of-the-art semiconductor manufacturing facility has grown from approximately \$200 million in 1983 to over \$3 billion in 2008 for facilities capable of manufacturing 300 mm wafers. We believe that the process control equipment market, which includes the metrology segment, will grow in the future at a rate greater than the overall process equipment market since process control equipment is in the future expected to consume a larger portion of the overall costs of semiconductor manufacturing equipment.

### *The Semiconductor Manufacturing Process*

Semiconductors typically consist of transistors or other components connected by an intricate system of circuitry on flat silicon discs known as wafers. Integrated circuit manufacturing involves well over a dozen individual steps, some of which are repeated several times, through which numerous copies of an integrated circuit are formed on a single silicon wafer. Typically, up to 30 very thin patterned layers are created on each wafer during the manufacturing process. At the end of the manufacturing process, the wafer is cut into individual chips or dies. Because semiconductor specifications are extremely exacting, and integrated circuits are becoming more complex, requiring ever more sophisticated manufacturing processes, the process steps are constantly monitored, and critical parameters are measured at each step using metrology equipment.

Many of the manufacturing steps involve the controlled application or removal of layers of materials to or from the wafer. The application of materials to the wafer, known as deposition, involves the layering of extremely thin films of electrically insulating, conducting or semi-conducting materials. These layers can range from one-thousandth to less than one-hundred-thousandth of a millimeter in thickness and create electrically active regions on the wafer and its surface. A wide range of materials and deposition processes are used to build up thin film layers on wafers to achieve specific performance characteristics. One of the principal methods of thin film layer deposition is chemical vapor deposition (CVD). In CVD, a chemical is introduced into the chamber where the wafer is being processed and is deposited using heat and a chemical reaction to form a layer of solid material on the surface of the silicon wafer. Metrology systems monitor the thickness and uniformity of thin film layers during the deposition process.

Once the thin film has been deposited on the wafer to form a solid material, circuit patterns are created using a process known as photolithography. During this process, a light-sensitive coating called photoresist is applied to the wafer, which is then exposed to intense light through a patterned, opaque piece of glass. For the photolithography process to work properly, the thickness of the photoresist must be precise and uniform. In addition, to control the photolithography process, the film thickness, reflectivity, overlay registration and critical dimensions are all measured and verified. The exposed photoresist is developed when it is subjected to a chemical solution. The developed wafer is then exposed to another chemical solution, or plasma, that etches away any areas not covered by the photoresist to create the structure of the integrated circuit. Semiconductor manufacturers use metrology systems to verify the removal of material through the etch process and the critical dimensions of the structures created.

To meet the processing challenges posed by ever smaller feature sizes and because of the use of new materials such as copper in the manufacture of integrated circuits, manufacturers are increasingly using a process technology known as chemical mechanical polishing.

Chemical mechanical polishing, or CMP, removes uneven film material deposited on the surface of the wafer from processes such as CVD and photolithography by carefully sanding the wafer with abrasives and chemicals, creating an extremely flat and even surface for the patterning of subsequent film layers. Metrology systems are used to control and verify the results of the CMP process by measuring the thin film layer to determine when the correct thickness has been achieved.

The processes described above are repeated in sequence until the last layer of structures on the wafer has been completed. Each integrated circuit on the wafer is then inspected and its functionality tested before shipment. Measurements taken by metrology systems during the manufacturing process help insure process uniformity and help semiconductor manufacturers avoid costly rework and mis-processing, thereby increasing efficiency and profitability.

#### *The World Economy is Entering a Recession*

Today, at the beginning of 2009, the world is in the midst of a financial crisis, and some countries already face a recession. In its January World Economic Situation and Prospects 2009 publication, the UN forecasts world GDP growth for 2009 to be 1% compared to 2.5% forecasted for 2008. Analyst company Global Insight, forecasts the US GDP to be negative 1% in 2009, in line with the UN forecasted trend. A direct result of the recession is a significant drop in consumer spending, volatility in exchange rates and reduced visibility into the future.

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The effect of the global recession on semiconductor sales is severe. Analyst company Gartner forecasts semiconductor revenues to decline by 24.1% in 2009 after an estimated decline of 4.1% in 2008. Semiconductor manufacturers have quickly reacted to the slowdown by stopping or postponing expansion plans and reducing capital expenditure. Gartner now forecasts Wafer Fab Equipment (WFE) sales in 2009 to decline by 46.1% compared to 2008, after an estimated decline of 31.1% in 2008 compared to 2007. In addition, due to low fab utilization rates, we expect pressure on service revenues throughout year 2009.

In addition to the above global economy conditions, 2008 started with an oversupply of memory, DRAM and NAND, since during 2007, the largest memory manufacturers fought for a market share and a market position. The direct result was falling memory prices and, consequently, significant losses to memory suppliers.

The memory oversupply together with the deteriorating economy forced memory manufacturers to reduce capacity and reduce capital expenditures, and approximately 17 200mm fabs were closed down or are expected to be closed down during 2008 and 2009. As a result, a consolidation process between different manufacturers is expected, as exemplified in the consolidation of the Micron group, Inotera and Nanya.

#### *The Need for Greater Overall Equipment Efficiency*

We believe that one of the major challenges to achieving improvements in semiconductor manufacturing cost productivity is continuously improving equipment productivity. Overall equipment efficiency, that is, the percentage of time that processing equipment is utilized to produce wafers, is used as a metric to quantify the productivity of a processing tool. The major factors affecting productivity are equipment downtime, qualification time, mis-processing and operator skills. We believe that in order to improve cost productivity, earn an acceptable return on their investment in capital equipment and to meet the demand for improved semiconductor device performance, semiconductor manufacturers must find ways to improve overall equipment efficiency.

Process Control. The steps used to create semiconductors are exacting processes that require strict control of equipment performance and process sequences for the resulting semiconductors to function properly. Tight control is achieved through monitoring of the in-process wafers and by measuring relevant parameters after each process step. These procedures are usually carried out on a small sample of the wafers. The monitoring may include measurement of several parameters, such as the thickness of the layers of thin film deposited, the sizes of the features that are patterned through the photolithography process, as well as the registration or alignment between two consecutive layers, known as overlay. Monitoring also includes inspection of the wafer for irregularities, defects or scratches. If parameters are out of specification or if defects or contamination are present, the manufacturer adjusts the process and measures another sample of wafers thereby allowing manufacturers to reduce costs and improve device performance.

The Need for Effective Process Control Tools. A number of technical and operational trends within the semiconductor manufacturing industry are strengthening the need for more effective process control solutions. These trends include:

*Development of Smaller Semiconductor Features.* The development of smaller features, now as small as 65 nm and 45nm in production, enables semiconductor manufacturers to produce larger numbers of circuits per wafer and to achieve higher circuit performance. As feature geometries decrease, manufacturing yields become increasingly sensitive to processing deviations and defects, as more integrated circuits are lost with every discarded wafer. In addition, the increased complexity and number of layers

of the integrated circuits increase the chance of error during the manufacture of the wafer.

*Shortening of Technology Life Cycles.* The technology life cycle of integrated circuits continues to shorten as semiconductor manufacturers strive to adopt new processes that allow a faster transition to smaller, faster and more complex devices. In the past, the technology life cycle was approximately three years; it is now only two years. The accelerating rate of obsolescence of technology makes early achievement of enhanced productivity and high manufacturing yields an even more critical component of a semiconductor manufacturer's profitability.

*Transition to Copper and other New Materials.* Copper metal layers and other new materials such as low and high k-dielectrics and silicon on insulator are increasingly replacing aluminum for advanced integrated circuits in order to increase performance and reduce the cost of integrated circuits. Copper and low-K materials make it possible to build higher speed devices using fewer layers. The use of copper and other new materials, requires new processing and metrology equipment and thus represents challenging developments for the semiconductor manufacturing industry.

*Transition to High-K Metal Gate.* In order to overcome limitations in the continued shrink of transistor dimensions, leading edge integrated circuit manufacturers are introducing new materials in the transistor gate stack. The use of high-k dielectrics, combined with metal layers, requires new processing and metrology equipment and thus represents challenging developments for the semiconductor manufacturing industry.

*Change to 300-millimeter Wafers.* The transition in wafer size from 200-millimeter diameter to 300-millimeter diameter that began in 1999 more than doubles the number of integrated circuits per wafer. Maintaining process uniformity across these larger wafers is more difficult. Processing larger wafers also increases the cost of mistakes caused by both the larger number of integrated circuits per wafer and the greater complexity (and, therefore, cost) of processing larger wafers. Thus, with 300 mm wafers, the need for effective metrology to quickly detect and correct errors in the manufacturing process has increased. In addition, new metrology equipment is needed to accommodate the larger wafer size. It is estimated that in 2007, most equipment sales have moved towards 300mm processing.

*Increase in Foundry Manufacturing.* As a result of the rising investment needed for semiconductor production and the proliferation of different types of semiconductors, semiconductor manufacturing is increasingly being outsourced to large semiconductor contract manufacturers, or foundries. A foundry typically runs several different processes and makes hundreds to thousands of different semiconductor product types in one facility, making the maintenance of a constant high production yield and overall equipment efficiency more difficult to achieve. This trend of shifting to foundries for manufacturing needs has progressed even further during recent years with technology leaders such as Texas Instruments Incorporated announcing that they will also be outsourcing process development to Taiwan Semiconductor Instruments, Limited.

*Increase in Automation.* In an effort to achieve greater operating efficiencies, semiconductor manufacturers are increasingly relying upon automation. Automation represents the fastest growing segment of the semiconductor manufacturing industry.

In order to address the increasing costs associated with these trends, we believe semiconductor manufacturers must enhance manufacturing productivity. One way to enhance productivity is through improvements in process control, with a greater emphasis on metrology as part of process control. As part of this emphasis on metrology, manufacturers are taking more measurements to characterize each step of the semiconductor manufacturing process, new and enhanced measurement techniques are being used to provide meaningful data and the data provided is being used in new ways to enhance the manufacturing process. We believe that the demand for advanced process control systems that address the evolving needs of semiconductor manufacturers will continue to drive the growth in the market for process control systems.

We believe that in certain process steps, integrated metrology systems provide semiconductor manufacturers with the greatest opportunity to increase the productivity and yields of their equipment, thereby increasing their profitability. Therefore, we plan to continue to maintain a major focus on the integrated metrology market. However, recognizing that a significant number of process steps will continue to rely upon stand-alone equipment, we intend to continue leveraging our market leading position in the integrated metrology market and our metrology expertise to deepen our penetration of the stand-alone metrology market. Furthermore, the technological and operational trends within the semiconductor manufacturing industry that are strengthening the need for more effective process control solutions can sometimes be addressed through the use of stand-alone metrology equipment or a combination of both stand-alone and integrated metrology.

*Expected equipment spending in 2009*

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We believe that in 2009 equipment spending will be focused around two main areas:

1. Technology buys of equipment enabling us to move to the next technology node, as we believe that the move up Moore's law will continue despite the recession.
2. Retrofits of equipment that will improve yield or efficiency reduce overall manufacturing cost or enable using older process equipment for advanced technology nodes.

Metrology plays an important role in both. We believe that we are well positioned for technology buys with our newer stand-alone products, the NovaScan 3090Next and the Nova T500, and are well positioned for the retrofit opportunity with its well proven NovaScan 2040 and the accompanying Closed Loop Control (CLC) solutions. However, we cannot assure you that either of these two segments will generate significant revenues in the coming year.

### *Expected growth in the future*

Undoubtedly, the semiconductor industry is being hurt by the conditions described above. However, demand for semiconductors is expected to rebound. Gartner forecasts semiconductor revenues to grow by 14.6% in 2010 and spending on WFE to grow by 14.6% in the same year. Given current low visibility conditions, these forecasts bear a high uncertainty factor. We believe that future demand drivers include Solid State Drives (SSD), 64bit Windows Operating System proliferation, increased storage requirements of multimedia devices, network PCs, increased complexity of cellular devices, handheld devices, GPS, automotive computers and others. However, there is a risk that equipment spending will not reach the high levels of 2007 in the foreseeable future.

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## **The Nova Approach**

### *Integrated Metrology*

Our integrated metrology systems provide semiconductor manufacturers with effective and efficient process control by measuring wafers and their properties without removing the wafer from the process equipment. All our products use our patented measuring methods that enable us to produce optical measuring systems that are small enough to be incorporated directly inside many types of equipment used in semiconductor processing. Integrated systems measure the wafer within the actual process environment, reducing labor and wafer handling as well as the risk of contamination of or damage to the wafer. In addition, we believe that our systems deliver significant increases in overall equipment efficiency through advanced process control, along with improving wafer-to-wafer uniformity, all with minimal operator intervention.

We provide our customers with flexible integrated process control solutions by offering systems that meet thin film as well as Optical CD measurement needs in critical applications in the fabrication process. Our integrated process control platform can be deployed to multiple processes and applications of semiconductor manufacturing.

Our systems can be installed directly in new equipment or used to upgrade existing equipment with minimal integration costs, extending the useful life of existing process equipment and saving significant capital costs. To our knowledge, only our metrology systems can be used to retrofit older 200 mm semiconductor manufacturing equipment, giving us a unique opportunity as manufacturers seek to increase production quickly to meet the increasing demand for semiconductors. Our pioneering approach, centered on our NovaReady integration package, later adopted by the process equipment manufacturers, allows process equipment manufacturers to prepare their equipment to accept our measurement and inspection systems, which can then be integrated with a simple plug-and-play installation.

We believe our integrated process control systems and solutions provide several important advantages to semiconductor manufacturers, enabling manufacturers to:

utilize the process equipment wafer handling system to allow measurement of the sample wafers while processing other wafers and avoid the need for the costly additional wafer handling required by stand-alone metrology systems;

perform the measurements without removing the wafer from the process equipment, increasing the efficiency of the process and decreasing the risk of contamination;

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reduce capital costs of the fabrication facility by increasing overall equipment efficiency and reducing labor costs and necessary clean room area;

reduce the amount of time required to qualify process equipment that is usually idle during qualification steps, thus, minimizing costly equipment down-time;

reduce the number of test wafers; and

detect processing errors as early as possible.

We believe that as semiconductor manufacturers demand greater efficiency from their manufacturing equipment, process equipment manufacturers will increasingly seek to offer their customers integrated metrology in their tools to lower costs and increase overall efficiency. We believe the drive toward more efficient manufacturing operations in the face of increasing complexity will continue the trend of adopting integrated metrology solutions such as those we offer to multiple processes.

In 2008 and prior years, most of our integrated metrology products were sold to process equipment manufacturers (such as Applied Materials, Inc.). These products are later sold by the process equipment manufacturers to the semiconductor manufacturers. In recent quarters, we have made efforts to enable us to sell our integrated metrology products directly to the semiconductor manufacturers, in order to improve our profitability. These efforts resulted in some success and our direct sales presented higher average selling prices in 2008. However, we can not foresee the long-term impact of a move to direct sales, due to the competitive landscape and overall market conditions.

### *Stand-Alone Metrology*

As stated above, we pioneered the area of integrated metrology and to-date revenues from that product continue to represent the larger portion of our overall revenues. With the adoption of our technology and the formation of long standing relationships with leading manufacturers, we have come to realize that our technology can be extended beyond integrated metrology into areas such as stand alone metrology. Accordingly, in the past few years we developed a stand alone metrology tool to perform measurements similar to those performed by our integrated metrology tools. The expression stand alone metrology generically describes free standing metrology equipment which sits inline, i.e., next to the processing equipment and receives cassettes or FOUPS of wafers to allow sampling of a few or several wafers from each cassette it receives. There are several types of stand alone metrology tools each of which performs a distinct type of measurement, e.g., defect inspection, electrical performance, microscopic analysis, cross sections, etc. Our specific focus is in the area of optical CD measurement which is generally utilized in order to characterize critical dimensions on a wafer, their width, shape and profile. This technology is utilized today in several areas of the fab such as photolithography, etch, CMP, selective deposition of thin films, etc. The key advantage offered by this technique is that it is non destructive and extremely fast with very high accuracy and repeatability.

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We introduced this concept in 2006 and we were successful in penetrating several accounts. However, the penetration cycle is long and we still haven't seen a significant increase in our overall market share with the stand alone products.

### **Our Technology**

We believe that our technological and engineering expertise and research and development capabilities allow us to develop and offer new products and technologies to meet the ever-changing demands of the semiconductor industry. We have applied our technological and engineering expertise to develop a wide range of integrated and stand-alone products for the Dielectric CMP, copper CMP, Tungsten CMP etch and lithography processes as well as Cu electroplating and sputtering of Cu barrier and seed materials. Because of our open architecture policy, our integrated metrology solutions can work with most models of CMP and etch tools made by the major process equipment manufacturers, for both 200 mm and 300 mm applications.

Our scatterometry capabilities have enabled us to penetrate new customers with Stand-Alone Optical CD metrology systems. Our combined offering of advanced measurement hardware and advanced modeling software place us in a position to offer an advantageous solution to our customers.

Our suite of technological capabilities includes:

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*Broadband Spectrophotometry.* Our broadband Spectrophotometry capabilities range from deep ultraviolet to near infrared. This technology enables fast, accurate and small spot size film thickness measurement in a large range of applications on a very cost effective basis, both as an integrated system and as a stand-alone system.

*Scatterometry.* Our Scatterometry systems are based on our broadband Spectrophotometry technology. These systems use a fully polarized deep ultraviolet to near-infrared spectral light source. This technology enables fast and cost effective system development. Scatterometry provides two and three dimensional characterization of very fine geometries on patterned product wafers. These profiling and critical dimension capabilities are key enablers of advanced process control, allowing almost real time metrology of the most advanced design rules, down to 32 nm and below.

*Imaging and image processing.* This technology has three different applications: 1) navigating on product wafers to perform measurements on very small selected sites; 2) detecting defects on product wafers after critical process steps, such as lithography and etch; and 3) measurement of the accuracy of registration between two layers (overlay measurement), mostly used in lithography.

The measurement techniques used in our metrology products are unique and protected by a number of patents.

Throughout our history, we have been a technological leader in the integrated metrology field. We were the first to offer integrated metrology solutions for semiconductor manufacturers and are the only provider of integrated metrology solutions that can measure wafers in water, which allows for more efficient and accurate metrology. Our systems have also been recognized by the industry: in 1998 we received the prestigious Editors' Choice Best Product Award from Semiconductor International magazine for our NovaScan 420 integrated thickness measurement tool for CMP process monitoring, in 2004 received the award for our NovaScan 2020Cu and 3030Cu for Copper CMP process monitoring, and in 2007 we received the award for our NovaScan 3090CD for thin-film metrology of dielectric CMP and copper applications, CD control and shape profiling.

### Products

Our products include metrology systems for thin film measurement in chemical mechanical polishing and chemical vapor deposition applications; optical CD and Metal Line Thickness (MLT) systems for use in post-copper chemical mechanical polishing applications and optical critical dimension systems for lithography and etch applications. Our integrated thickness monitoring system for chemical mechanical polishing process control enables wafer-to-wafer closed loop control. We offer several models of this integrated thickness monitoring systems, depending on polisher type and end-user requirements. These metrology systems address a broad range of metrology requirements of our end-user and process equipment manufacturer customers. Both our integrated and stand-alone systems incorporate patented optical scanning, dynamic auto-focus, unique pattern recognition for arbitrarily oriented wafers and proprietary algorithms for in-water measuring of two layers simultaneously. We offer several different product models that are tailored to conventional chemical mechanical polishing equipment as well as to newer, high throughput polishers. Following is a summary of our products.

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#### Thin Film Process Control

The NovaScan 2020 and 2040 are the second generation of integrated thickness monitoring systems with enhanced spectral range, responding to the needs of the industry for emerging chemical mechanical polishing high-end applications of thin films and complex layer stacks. The 2020 model was introduced to the market at the end of 2000, and since then has replaced the NovaScan 840 and accounted for the majority of our sales for 200 mm production lines.

The NovaScan 3030 and 3060 are the second generation of the 300mm measuring system, with improved optics and motion system enabling high speed measurement, and with broad spectral range (ultraviolet to infrared) allowing accurate measurements on complex structures and thin film layers. The 3030 model was introduced to the market in 2001 and since then has replaced the NovaScan 3000 and accounts for the major portion of our sales for the 300 mm production lines. The NovaScan 3060 was introduced in 2002.

The NovaScan 2020Cu has the same basic platform as the NovaScan 2040, with additional hardware and software improvements, enabling the system to answer the unique requirements of copper chemical mechanical polishing monitoring. The system went through several beta tests during 2001 and 2002 and was released for sale in the beginning of 2003.

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The NovaScan 3030Cu has the same basic platform as the NovaScan 3030, with additional hardware and software improvements, enabling the system to answer the unique requirements of 300 mm copper CMP monitoring. The system went through field-testing during 2002 and was released for sale in the beginning of 2003.

The NovaScan 3090 CMP system is a broad spectral range system for chemical mechanical polishing metrology needs, measuring thin film thickness at high throughput. The system went through field-testing and was released for sale in 2005.

The NovaScan 3090 CD system is a scatterometry-based system for measuring the critical dimensions (CD) and profiling lines and trenches on 200 mm and 300 mm wafers. The system went through field-testing during 2003 and was released for sale in 2004. The systems are sold as integrated metrology systems and as stand-alone systems with third-party automation modules.

The NovaScan 3090 SA is similar in performance to the NovaScan 3090 CD, providing full two and three dimensional profiling capabilities in a stand-alone configuration. The systems are utilized in lithography, etch, thin film deposition and chemical mechanical polishing process. The system was released for sale in 2005.

The NovaScan 3090Next system is the next generation metrology targeted at 45nm and 32nm technology nodes. The NovaScan 3090Next provides up to 50% throughput improvement, better accuracy and tool to tool matching and higher polarized spectral range enabling measurement of smaller features. The NovaScan 3090Next is available as integrated metrology and as standalone metrology systems.

The Nova T500 is the latest addition to the stand-alone family. The Nova T500 features improved metrology performance, improving both accuracy and tool to tool matching, industry leading throughput of 250WPH and the ability to combine up to three metrology units (MU) on the same tool.

NovaMars is an advanced scatterometry modeling and application development software tool enabling complex 2D, 3D and in-die measurements. Process engineers can harness the power and flexibility of the tool to develop their own scatterometry applications by themselves thus keeping the details of their process within the fab. Its user interface and high level of automation provide for easier and faster application development and eliminate discrepancies between different developers, enabling the best solution, independent of user proficiency. The NovaMars is offered as an option together with the 3090, 3090Next and the Nova T500 product families.

A closed loop control option for the NovaScan systems delivers reliable, highly automated wafer-to-wafer uniformity over chemical mechanical polishing manufacturing processes. The thickness data of every processed wafer is obtained and process parameters are fed back to adjust the next wafer polish.

NovaNet is a highly sophisticated computer network, connecting all NovaScan systems on a factory floor. The network is managed by a dedicated server, running with proprietary software developed by Nova, and insuring safe recipe distribution and recipe integrity across the factory. The NovaNet also includes a report generator (NSA) that allows the creation of reports from all the systems connected and allows programmable cross sections.

NovaHPC (High Power Computer) supports the NovaMars Application Development Tool and enables effective and timely results. Scalable and user configurable infrastructure with Nova's proprietary task management software addresses the growing needs of IC manufacturing metrology. NovaHPC is just one of the few solutions available for cost effectiveness and computation power growth flexibility. The standalone modular rack:

- n HPC
- n TurboHPC
- n Grid computing connectivity enabled

- 
- n Web-based management SW

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NovaHPC Value-Added Benefits includes: accelerated recipe set-up library building, Scalable infrastructure, invest as you grow and Low-cost entry level using grid computing with existing computation resources.

While we continue to emphasize our integrated metrology solutions, we offer our products as stand-alone equipment as well, thereby significantly expanding our potential available markets. While we have succeeded in penetrations of stand-alone metrology, our revenues remain substantially dependent on sales of our CMP integrated metrology product line.

### Research and Development

We have assembled a core team of experienced scientists and engineers who are highly skilled in their particular field or discipline. Our research and development core competencies, technologies and disciplines are in scatterometry, thin film metrology, and include measurement instruments, optical modeling, image acquisition, pattern recognition, equipment integration and fab automation. Our research and development staff consists of about 70 highly skilled members, including independent contractors. Since June 2003, our research and development operations have been certified as ISO9001/2000 quality standard.

The process control market is characterized by continuous technological development and product innovations. We believe that the rapid and ongoing development of new products and enhancements to our existing product line is critical to our success. Accordingly, we devote a significant portion of our technical, management and financial resources to developing new applications and emerging technologies. In 2006, 2007 and 2008, our research and development expenses, net of participation by the Office of the Chief Scientist of the Ministry of Industry, Trade and Labor, were \$9.2 million, \$9.1 million and \$8.6 million respectively, representing, 19%, 16% and 22% of our respective total revenues for those years. We anticipate that our research and development expenses, net, will decline in 2009 as part of our efforts to reduce our overall operating costs. The decrease in R&D expenses in the past year and the coming year is a result of the economical crisis and the slow down in the semiconductor equipment market which started in the beginning of 2008. However, by focusing on our core technology and using a series of organizational changes we believe that we have mitigated the effect of the budget decrease and maintained effective R&D policy, enabling us to drive forward the next generation of products, in light of future market needs. Such organizational changes included the closing of projects that are outside our core technology and unifying all R&D activities under one roof in a way that enables the efficiency of a matrix organization.

Our research and development policy is based on a structured process of initiating new projects and on-going review of existing development projects. Our vision is to continue to be a market leader in the semiconductor process control market and our research and development policies and activities are designed to support this vision. Our launch of new development projects is based on market requirement specifications, generated through our marketing activities and research of customer needs, followed by a proposed detailed business plan, a detailed development plan with milestones, risk analysis, profit and loss model goals and required budget. Each development project is monitored through a structured process, including design reviews and project management reviews.

### Intellectual Property

Our success depends in part upon our ability to protect our intellectual property. We therefore have an extensive program devoted to seeking patent protection for our inventions and discoveries that we believe will provide us with competitive advantages. As of March 2, 2009, we have been granted 77 U.S. patents and more than 40 non-U.S. patents and hold an exclusive license to one U.S. patent. The U.S. patents we hold have expiration dates ranging from 2014 to 2024. We also have 24 U.S. patent applications pending and more than 50 applications pending in other countries including 6 PCT applications. Our patents and applications principally cover various aspects of optical measurement systems and methods, integrated process control implementation concepts, and optical, opto-mechanical and mechanical design. We have also registered 4 trademarks in the U.S. and 7 trademarks in countries other than the U.S.

To protect our proprietary rights, we also rely on a combination of copyrights, trademarks, trade secret laws, contractual provisions and licenses. Our copyrights include software copyrights. We also enter into confidentiality agreements with our employees and some of our consultants, business partners and customers, and seek to control access to and distribution of our proprietary information, such as our proprietary algorithms.

While we attempt to protect our intellectual property through patents, copyrights and non-disclosure and confidentiality agreements, we may not be able to adequately protect our technology. Competitors may be able to develop similar technology independently or design around our patents and, despite our efforts, our trade secrets may be disclosed to others. Furthermore, the laws of countries other than the U.S. may not protect our intellectual property to the same extent as the laws in the U.S. We also cannot assure that: (i) our pending patent applications will be approved; (ii) any patents granted will be broad enough to protect our technology or provide us with competitive advantages or will not be successfully challenged or invalidated by third parties; or (iii) that the patents of others will not have an adverse effect on our ability to do business. We may also have to commence legal proceedings against third parties to protect our intellectual property, as we have done recently.



In March 2005, we filed a civil action in the United States District Court for the Northern District of California against Nanometrics seeking to enforce our U.S. Patent No. 6,752,689. This patent relates to an integrated optical measuring system. In the civil action, we sought an injunction against Nanometrics from infringing Patent No. 6,752,689, monetary damages for infringement, attorneys' fees and costs and expenses. Nanometrics has filed a counterclaim seeking judgment declaring the patent invalid, that Nanometrics does not infringe the patent and awarding Nanometrics costs and fees.

In April 2006, Nanometrics filed a civil action in the United States District Court for the Northern District of California against us and our wholly-owned subsidiary, Nova Measuring Instruments Inc., alleging infringement of its U.S. No. Re 34,783 Patent. In October 2006, Nanometrics filed another lawsuit with the United States District Court for the Northern District of California alleging Nova is infringing U.S. Patent Numbers 5,867,276 and 7,115,858.

On August 18, 2006, we filed a request for re-examination of the Nanometrics U.S. No. Re 34,783 Patent with the U.S. Patent & Trademark Office (PTO). On May 25, 2007 the PTO rejected all 5 claims of U.S. No. Re 34,783 Patent filed by Nanometrics and, in view of Nanometrics failure to file an appropriate response to the rejection, on August 16, 2007, the PTO issued a Notice of Intent to Issue a Re-examination Certificate, cancelling all 5 claims of the patent.

In April 2007, we reached a settlement with Nanometrics regarding all three patent suits between the companies. We agreed to dismiss, without prejudice, all pending patent litigation between the two parties, and have further agreed not to file patent suits against the other and/or any supplier or customer of the other party for patent infringement based on offers to sell, actual sales, manufacturing, purchase or use of any equipment of the other party for a period of one year. The settlement, which received the court approval, terminated the three lawsuits pending in the U.S. District Court for the Northern District of California. No permanent settlement has been reached in these suits. Should the disputes be reopened, even if we are ultimately successful, it could result in substantial costs and diversion of time and effort by our management. This in and of itself could have a negative impact on us.

From time to time, we receive communications from others asserting that our products infringe or may infringe their intellectual property rights. Typically, our in-house patent counsel investigates these matters and, where appropriate, retains outside counsel to provide assistance. We are not presently involved in any material legal proceedings in which a third party has asserted that we have violated their intellectual property rights. If, however, we become involved in any such litigation and its outcome is adverse to us, it may result in a loss of proprietary rights, subject us to significant liabilities, including treble damages in some instances, require us to seek licenses from third parties which may not be available on reasonable terms or at all, or prevent us from selling our products. Furthermore, any litigation relating to intellectual property, even if we are ultimately successful, could result in substantial costs and diversion of time and effort by our management. This in and of itself could have a negative impact on us.

While we believe that we would be successful in any litigation seeking to enforce our patent rights, the ultimate outcome of any litigation or other legal proceedings cannot be predicted.

In September 2006, we invited companies to submit bids to license or buy some of our patents. These patents have substantial value because the industry is on the threshold of widespread adoption of integrated metrology and the methods covered by the patents are critical for advanced manufacturing of semiconductors. We were pioneering the use of an auction model to set a market price for patent licenses by offering to the highest bidder licenses for six of our patents pertaining to the use of a lithography tool with integrated metrology in semiconductor processing lines. Participants in the auction also have the option to bid for full ownership of the patents, which represent only a small portion of Nova's extensive patent portfolio. The auction covers two groups of patents:

Integrated Metrology group which consists of four patents that generally relate to a lithography track with an integrated optical measurement capability that can be used for various types of metrology applications including overlay registration, critical dimensions, and macro defect inspection.

Advanced Process Control group which consists of two patents related to methods for photolithographic processing involving making a spectrophotometric measurement and using it to influence the processing time, focus or exposure of a processing tool.

Bids may be as follows:

A license for a particular model of semiconductor processing equipment, including customer rights to use.

A license for practice of the patents at a particular semiconductor fabrication facility or set of facilities.

Complete acquisition of the patents (or one of the two groups).

In July 13, 2007, Nova reached an agreement to license the patents to a large semiconductor manufacturer for a total consideration of more than US\$1 million. We are still under a process of ongoing interactions with a number of other entities for sale or license of the patents.

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For additional information regarding our intellectual property, see [Our Technology](#) starting on page 16.

### Our Customers, Sales and Marketing

Our two pronged, integrated sales and marketing strategy involves marketing our products directly to semiconductor manufacturers in addition to process equipment manufacturers in order to create demand for our products. We believe that the pricing structure of our NovaReady integration package enables process equipment manufacturers to increase their margins, and that the features and benefits of our systems can improve equipment yields, overall equipment efficiency and increase productivity, creating an incentive for process equipment manufacturers to promote our products to semiconductor manufacturers. At the same time, we believe that semiconductor manufacturers, eager to improve their own margins through increased factory throughput and yield improvements, will demand that the equipment they employ incorporate or use metrology systems such as those we manufacture. We believe that by marketing directly to end users as well as to process equipment manufacturers, we are able to ensure that both parties are aware of the wide range of benefits that our products can deliver, and that we are able to continuously enhance our products with functionality demanded by these two distinct types of customers.

To further enhance our marketing efforts, we have established a system of integrated sales and support activities with key process equipment manufacturers. This allows us to provide comprehensive and long-term application support directly to semiconductor manufacturers. We expect to continue to add new process equipment manufacturers as partners as we introduce new integrated process control systems that can be integrated with different types of equipment.

We also seek to establish and maintain close and mutually beneficial relationships with our customers by consistently providing them with a high level of service, support and new capabilities. We have established a global network of direct sales and marketing, customer service and applications support offices. We maintain sales, service or applications offices in Europe, Israel, Japan, Korea, Singapore, Taiwan, and the U.S., with a total staff of 92 people. These offices provide highly qualified application support specialists, training to process equipment manufacturer customers and end users, marketing, demonstrations and evaluations, spare parts hubs and sales and support engineers.

We serve all sectors of the integrated circuit manufacturing industry including logic, ASIC, foundries and memory manufactures. Our end user and process equipment manufacturer customers are located in different countries, including Japan, Korea, Singapore, Taiwan, the U.S. and various European countries.

The table below describes the distribution of our total revenues, from systems and services, according to the geographic location of the actual installation of our systems in end-user sites:

	Year ended December 31,		
	2006	2007	2008
	(in thousands)		
U.S.	\$ 16,525	\$ 15,861	\$ 9,671
Europe	4,800	7,405	3,712
Japan	3,214	2,686	3,776
Asia-Pacific (excluding Japan)	23,753	32,125	21,810
<b>Total</b>	<b>\$ 48,292</b>	<b>\$ 58,077</b>	<b>\$ 38,969</b>

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The semiconductor industry is dominated by a small number of large companies. As a result, while our overall customer base is diverse, our sales are highly concentrated among a relatively small number of customers. The following table indicates the percentage of our total revenues derived from sales to our five largest customers and the range of these revenues from these customers for the periods indicated.

	Year ended December 31,		
	2006	2007	2008
Total revenues from five largest customers	79%	87%	67%
Range of revenues from five largest customers	1%-46%	1%-47%	3%-37%

We anticipate that our revenues will continue to depend on a limited number of major customers, although the companies considered to be our major customers and the percentage of our revenue represented by each major customer may vary from year to year. As our customer base is highly concentrated, if any of our customers becomes insolvent or has difficulties meeting its financial obligations to us, we may suffer losses that may be material in amount. A loss of any of our major customers may likewise cause us to suffer a material decrease in sales and revenue.

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The highly competitive nature of the market for semiconductor capital equipment affects our ability to successfully implement our marketing and sale efforts. Competitive factors in the market for integrated process control systems include technological leadership, system performance, ease of use, reliability, cost of ownership, technical support and customer relationships. For integrated process control, an adequate business model, internal organization and unique process equipment manufacturer agreements and partnerships are also significant factors. We believe we compete favorably on the basis of these factors in the markets we serve.

Our current integrated products primarily compete with products manufactured by Nanometrics, Inc. We have gained market share with the successful launch of NovaScan 3090 but we expect our integrated products to face intense competition in the coming years. In the scatterometry field, we face intense competition in both integrated and stand-alone metrology, from several companies.

### Manufacturing

In order to leverage the relatively high volume of integrated systems we manufacture, and in order to decrease production costs, we continue to focus our internal manufacturing activities on processes that add significant value or require unique technology or specialized knowledge and outsource others. Our manufacturing operations received the ISO 9002 quality mark by an international certification institute in October 1999. Since then, we have upgraded our quality systems to conform to ISO 9001/2000 requirements.

Our principal manufacturing activities include assembly, integration, final testing and calibration. Our production activities are conducted in our manufacturing and service facility in Israel. We rely and expect to continue to rely on subcontractors and turnkey suppliers to fabricate components, build assemblies and perform other non-core activities in a cost-effective manner. While we use standard components and subassemblies wherever possible, most mechanical parts, metal fabrications and critical components used in our products are engineered and manufactured to our specifications. A small portion of these components and subassemblies are obtained from a limited group of suppliers, and occasionally from a single source supplier.

We have our manufacturing facility, which is located in Ness-Ziona, Israel, divided into 2 buildings. Any event affecting this facility, including natural disaster, labor stoppages or armed conflict, may disrupt or indefinitely discontinue our manufacturing capabilities and could significantly impair our ability to fulfill orders and generate revenues.

### Capital Expenditures

Our capital expenditures are primarily for network infrastructure, computer hardware and software, leasehold improvements of our facilities and system demonstration and development tools. None of these assets are held as collateral or guarantee other obligations. For additional information on our capital expenditures, see [Liquidity and Capital Resources](#) starting on page 28.

**Political and Economic Conditions in Israel**

We are incorporated under the laws of the State of Israel, and our principal offices and manufacturing facilities are located in Israel. We are, therefore, directly influenced by the political, economic and military conditions affecting Israel. Any major hostilities involving Israel, the interruption or curtailment of trade between Israel and its trading partners or a significant downturn in the economic or financial condition of Israel could have a material adverse effect on our business, financial condition and results of operations. Additionally, many of our male employees in Israel are currently obligated to perform annual reserve duty in the Israel Defense Force and virtually all such employees are subject to being called to active duty at any time under emergency circumstances. While we have operated effectively under these requirements since we began our operations, no assessment can be made as to the full impact of such requirements on our workforce or business if conditions should change, and no prediction can be made as to the effect of the expansion or reduction of such obligations.

**Government Regulation**

For information relating to the impact of certain government regulations on our business, see Grants from the Office of the Chief Scientist starting on page 29.

**4.C Organizational Structure****Our Subsidiaries**

Our subsidiaries and the countries of their incorporation are as follows:

<u>Name of Subsidiary</u>	<u>Country of Incorporation</u>
Nova Measuring Instruments Inc.	Delaware, U.S.
Nova Measuring Instruments K.K.	Japan
Nova Measuring Instruments Taiwan Ltd.	Taiwan
Nova Measuring Instruments Netherlands B.V.	Netherlands

**4.D Property, Plant and Equipment**

Our main facilities, located in Ness-Ziona, Israel, occupy approximately 5,200 square meters, including: approximately 1,000 square meters of production facilities, approximately 3,000 square meters of research and development offices (including approximately 300 square meters of laboratories) and approximately 1,200 square meters of headquarters, sales and marketing, service and support and administration facilities. Our current lease commitment relating to our facilities in Israel expires at the end of January 2013.

Our U.S. subsidiary leases approximately 300 square meters in Santa Clara, California, for use as a pre-sale and support facility. Our Japanese and Taiwan subsidiaries lease approximately 200 and 400 square meters for use as a service and pre-sale facility, respectively. In the first quarter of 2009, we closed our facility in Phoenix, Arizona, USA. The costs related to the closing of this facility were included in 2008 financials.

We believe that our facilities and equipment are in good operating condition and adequate for their present usage.

**Item 4A. Unresolved Staff Comments**

Not applicable.

**Item 5. Operating and Financial Review and Prospects**

Information in this Operating Review and Financial Prospects Section should be read in conjunction with our Consolidated Financial Statements and notes thereto which are included elsewhere in this report.

**Executive Overview**

We are a worldwide leading designer, developer and producer of integrated metrology systems for the semiconductor manufacturing industry and a designer, developer and producer of stand-alone metrology systems for the semiconductor industry. Our metrology systems are used to take precise measurements of semiconductors during the manufacturing process to control the manufacturing process and increase the productivity of the manufacturing equipment. We market and sell our metrology systems to semiconductor process equipment manufacturers and directly to semiconductor manufacturers.

Our business is greatly affected by the level of spending on capital equipment by semiconductor manufacturers. Capital expenditures by semiconductor manufacturers tend to be cyclical in nature and depend on numerous factors, many of which are beyond our control. Factors affecting the semiconductor industry, which are beyond our control, include general economic conditions throughout the world and the demand and perceived demand for semiconductors. In addition, demand for our products and services is affected by the timing of new product announcements and releases by us and our competitors, market acceptance of our new or enhanced products and changes or advances in semiconductor design or manufacturing processes.

In 2003, demand for semiconductors started to increase and, as a result, demand for capital equipment by semiconductor manufacturers also increased. This increased demand continued in 2004. Accordingly, our financial results for 2003 and 2004 improved. In 2005, however, demand for capital equipment decreased and the decrease is reflected in our financial results for 2005, in which we suffered steeper losses than in 2003 and 2004. In 2006 we experienced significant growth and our sales grew 60% compared to 2005. This growth was a result of an overall upturn in the industry as well as successful proliferation of our latest model the NovaScan 3090. In 2007 we experienced a 20% growth in sales compared to 2006. However, over the past year, demand for our metrology products decreased as a result of the overall slow-down in the semiconductor industry and global recession, and we have experienced a 33% decline in revenues in 2008 compared to 2007. The existing industry reports indicate a downturn in 2009. Due to the expected downturn, we have made cost reductions including head-count reduction of our work force.

We derive our revenues principally from sales of our metrology systems and services relating to our systems. In 2008, product sales accounted for 66% of our total revenues and services accounted for 34%. Presently, we have no significant long-term debt, and during 2008 we used \$2.9 million of our overall cash reserves. As of the end of 2008, we had working capital of \$20 million.

From quarter to quarter and from year to year, our revenues can vary significantly for a number of reasons. Importantly, we do not have long-term or multi-unit purchase contracts with our customers. Therefore, while most of our customers have purchased multiple systems from us and we anticipate that our customers will continue to do so, our customers can determine at any time to stop doing business with us. In addition, primarily because the semiconductor industry is dominated by a small number of large companies, our customer base is concentrated among a limited number of customers. A loss of any single customer could cause our revenues to decrease by a material amount. Furthermore, because our systems range in price from approximately \$0.1 million to approximately \$1 million, the loss of relatively few sales could also cause our revenue to decrease by a material amount. Our service revenues, which in the past tended to be more predictable and less subject to wide fluctuations, helped us decrease the volatility in our revenues.

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Our service organization is operated on a profit and loss basis and is measured as a cost center in each territory and on a global basis. The objectives of our service organization are defined and measured by: customer satisfaction; quality parameters, such as time to repair and mean time between failures; and by profit and loss criteria. The service organization provides support to all products we sell, during both the warranty period and the post warranty period.

When evaluating the performance of the Company, our management tends to focus on several financial metrics and several qualitative areas such as: gross margins; warranty cost per system and warranty costs as a percentage of sale price; inventory as a percentage of yearly sales; days sales outstanding; and the mixture of our sales and geographical distribution of installations of our systems at end users sites compared to industry capital equipment trends. Blended gross margins in 2008 were 33%, while product sales presented gross margins of approximately 46% and services presented gross margins of 9%. In 2008, warranty costs amounted to approximately 8% of the average sale price of our products. Factors that affect warranty costs include the number of systems installed in a specific site or territory and the maturity of the products. Our average inventory levels in 2008 were approximately 15% of yearly sales. In 2008, average days sales outstanding for total revenues were 57 and ranged between 52 and 67 days over the four quarters of 2008. Geographical distribution analysis of installation at end user sites of our

products reveals some increase in the installations of our products in Asia Pacific (excluding Japan) from 55% in 2007 to 56% in 2008 and a corresponding decrease in installations mainly in the U.S. and Japan.

### Significant Events in 2008 and Outlook for 2009

The year 2008 had several significant events:

A decrease in revenues of approximately 33% from the previous year as a result of the severe business downturn suffered by the semiconductor equipment sector as well as the global economic conditions.

A significant increase in the number of stand alone metrology customers.

The release and shipment of a new stand alone metrology tool called the NovaT500 which offers a significant breakthrough in measurement throughput and tool cost of ownership.

Final closure of the x-ray product group and related activities globally.

Cost reduction programs which were necessary to realign the operation with the decline in business volumes.

In 2009, Nova will focus on continuing development of its current technology for both stand alone and integrated metrology product sectors both in hardware and software. Over the next three years, Nova anticipates introducing future generations of its current products and new products to address the advancing technology trends toward feature sizes of 45 nm and below and new processes and materials. We believe that in 2009 our business opportunities will most likely come from the increased need for monitoring and controlling which result from decreasing feature sizes, and the accelerated move to new materials. The main challenges and risks we see are to be on time with the right process control solutions to meet the needs of our existing and new customers. In order to address these risks and challenges, we are working closely with leading customers development process groups and with the leading process equipment manufacturers. The purpose of working closely with customers and process equipment manufacturers is to receive from them as early as possible information and feedback on the metrology and process needs of the upcoming new manufacturing processes and materials. We believe that receiving this information as early as possible will assist us in developing metrology solutions to meet the new needs of the semiconductor industry. In tandem with this type of long term development, our ongoing marketing activity supports our current products with short term improvements to answer the customers ongoing needs and to make required changes. Given the continuation of the difficult economic conditions felt globally and across all industries, we will continue to take measures to control our expenses and to reduce our cash expenditures.

Currently, our main revenue generator continues to be the oxide CMP integrated metrology product line and sales of our integrated metrology oxide CMP product line are affected by the total number of process tools sold in this segment. In years prior to 2003, the oxide CMP represented more than 50% of the entire CMP equipment market. Since 2004, this percentage decreased and we expect it to continue to decrease as copper CMP equipment is expected to increase its relative portion of the overall CMP equipment market. Given this shift, we have spent development resources with both customers and process equipment manufacturers to accommodate the needs of the Copper CMP process. These needs are different from those of Oxide CMP. We have been offering and will continue to offer a solution for Copper CMP, which has been adopted on a smaller scale than the Oxide CMP solution. We continue to strive to increase its proliferation, though we can not foresee what will ultimately be the process control needs for copper CMP, and whether the products and solutions we introduce for the copper CMP market will be accepted.

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In the past few years we have also worked collaboratively with two of the three leading etch manufacturers to integrate our metrology for a process control scheme similar to the concept used in CMP. Though this integration offers advanced capabilities, its adoption in the market place has been slow. In 2008 we saw an increased interest in this solution and added some new customers. We also took part in the further development of process control solutions for this integration. The growth in interest is very much related to the move to a more advanced patterning technique called double patterning. This method was developed by both etch and lithography tool manufacturers and though it offers unique ways to advance technology shrinks it increases the need for closer process monitoring and control. We are constantly monitoring technological advancements and the applicability of our technology to those advancements, but we cannot foresee the extent to which our solutions will ultimately be adopted. We also started collaborative work with a lithography track manufacturer, again, utilizing our integrated metrology platform. First customer installations took place in 2008. As per the situation of the etch market, this market is at its early stages and its advancement to a larger scale has not yet taken place.

## Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon our Consolidated Financial Statements, which have been prepared in accordance with accounting principals generally accepted in the United States of America. We believe the following critical accounting policies, among others, affect our more significant judgments and estimates used in the preparation of our Consolidated Financial Statements.

### *Use of Estimates General*

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### *Revenue Recognition*

We recognize revenues from the sale of products when all the following criteria have been met: a persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed or determinable, collection of resulting receivables is probable and there are no remaining significant obligations.

In accordance with EITF 00-21 for arrangements containing multiple elements, fair value of each element is determined based on specific objective evidence and revenue is allocated to each element based upon its fair value. The revenue relating to the undelivered elements is deferred at estimated fair value until delivery of the deferred elements. If specific objective evidence of fair value does not exist for all elements to support the allocation of the total fee among all delivered and undelivered elements of the arrangement, revenue is deferred until such evidence exists for the undelivered elements, or until all elements are delivered, whichever is earlier. Service contracts generally specify fixed payment amounts for periods longer than one month, and are recognized on a straight line basis over the term of the contract.

### *Allowances for Doubtful Accounts*

We review on an on-going basis the need for allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. When determining what allowance, if any, to make for doubtful accounts, we review many factors, including our history of relatively few write-offs, customer relationships and customers' creditworthiness. Based on this review, we estimate the amount of accounts receivable, if any, we may be unable to collect and allowances for doubtful accounts may be required. If the financial condition of our customers were to deteriorate, their ability to make payments could be impaired and our estimates could prove to be inaccurate. If significant, allowances for doubtful accounts could have a material adverse effect on our financial results.

### *Warranty Provisions*

We provide for the estimated cost of product warranties at the time revenue is recognized. While we are engaged in extensive product quality programs and processes, including actively monitoring and evaluating the quality of our component suppliers, our warranty obligations are affected by product failure rates, material usage and service delivery costs incurred in correcting product failures at our locations or at customer sites. Should actual product failure rates, material usage or service delivery costs differ from our estimates, revisions to the estimated warranty liability may be required.

### *Inventories Write-Off*

We value our inventory at the lower of either the actual cost or the current estimated market value of the inventory. We regularly review inventory quantities on hand and record a provision for excess and obsolete inventory based primarily on our estimated forecast of product demand and production requirements for the next twelve months. As demonstrated during 2008, demand for our products can fluctuate significantly. A significant increase in the demand for our products could result in a short-term increase in inventory purchases while a significant decrease in demand could result in an increase in the amount of excess inventory quantities on hand, which could lead to losses. In addition, our industry is characterized by rapid technological change, frequent new product developments, and rapid product obsolescence that could result in an increase in the amount of obsolete inventory quantities on hand. Additionally, our estimates of future product demand may prove to be inaccurate, in which case we may have understated or overstated the provision required for excess and obsolete inventory. In the future, if our inventory is determined to be overvalued, we would be required to recognize such costs in our cost of goods sold at the time of such determination. Likewise, if our inventory is determined to be undervalued, we may have over-reported our costs of goods sold in previous periods and would be required to recognize such additional operating income at the time of sale. Therefore, although we make every effort to ensure the accuracy of our forecasts of future product demand, any significant unanticipated changes in demand or technological developments could have a significant impact on the value of our inventory and our reported operating results.

For a discussion of other significant accounting policies used in the preparation of our financial statements and recent accounting pronouncements, see Note 2 to our Consolidated Financial Statements contained elsewhere in this report.

## 5.A Operating Results

### Overview

A significant portion of our revenues historically has been derived from customers in the U.S., however, we expect that U.S. sales as a percentage of total sales may decrease if the portion of our sales directly to semiconductor manufacturers, rather than through process equipment manufacturers, will increase. In 2006, 68% of our revenues were derived from U.S. customers, 10% were from European customers, 13% were from Japanese customers, and 9% were derived mainly from Asian (other than Japanese) customers. In 2007, 63% of our revenues were derived from U.S. customers, 8% were from European customers, 20% were from Japanese customers, and 9% were derived mainly from Asian (other than Japanese) customers. In 2008, 50% of our revenues were derived from U.S. customers, 8% were from European customers, 17% were from Japanese customers, and 25% were derived mainly from Asian (other than Japanese) customers.

The table below describes the distribution of our total revenues, from systems and services, by geographic areas of our product installations at semiconductor manufacturing facilities. As our customers include both semiconductor manufacturers and process equipment manufactures, this distribution is different from the distribution of our revenues by customer location discussed in the immediately preceding paragraph.

	2006	2007	2008
USA	34%	27%	25%
Europe	10%	13%	9%
Japan	7%	5%	10%
Asia-Pacific (excluding Japan)	49%	55%	56%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

Historically, a substantial portion of our revenues has come from a small number of customers. In 2006, 2007 and 2008 our five largest customers accounted for 79%, 87% and 67% of our revenues, respectively. In 2006, 2007 and 2008 our single largest customer accounted for 46%, 47% and 37% of our revenues, respectively. We anticipate that our revenues will continue to depend on a limited number of major customers, although the companies considered being major customers and the percentage of our revenue represented by each major customer may vary from period to period. Therefore, the loss of any one of our major customers could materially and adversely affect us.

The sales cycle for our systems typically ranges from 3 to 24 months and depends upon the status of our system's integration with a particular manufacture and model of process equipment, the evaluation criteria of our customers, and the technology or application of the process. Additionally, the rate and timing of customer orders may vary significantly from month to month as a function of the introduction of a new type of system to a production line. We have a relatively low backlog. Accordingly, if sales of our products do not occur when we expect or we are unable to adjust our estimates on a timely basis, our expenses and inventory levels may fluctuate relative to revenues and total assets. In 2008, our inventory levels at the end of each quarter ranged from \$10 million to \$7 million. We planned our 2008 inventories for sales of 200 mm systems and 300 mm systems according to our expectation that approximately 90% of equipment sales would be for 300 mm equipment and that the NovaScan 3090 would account for most of our sales of 300 mm systems. Actual sales in 2008 were similar to this plan. In 2009, we anticipate continued proliferation of the new NovaScan 3090 Next product for the 300 mm market, and expect that overall 300mm sales will continue to account for over 90% of our revenues. If our actual sales are significantly different from our expectations, we may have to write-off some of our inventory.

We schedule production of our systems based upon order backlog and customer forecasts. We include in backlog only those orders to which the customer has assigned a purchase order number and for which delivery has been specified. In general, because shipment dates may be changed and customers may cancel or delay orders with little or no penalty, our backlog as of any particular date may not be a reliable indicator of actual sales for any succeeding period.

Our revenues decreased by 33% in 2008 following a 20% increase in 2007 and a 60% decrease in 2006.



The following table shows the relationship, expressed as a percentage, of the listed items from our consolidated statements of operations to our total revenues for the periods indicated:

	Percentage of Total Revenues		
	Year ended December 31,		
	2006	2007	2008
Revenues from product sales	79.2%	78.5%	65.9%
Revenues from services	20.8%	20.2%	34.1%
Revenues from IP Licensing	-	1.3%	-
Total revenues	100.0%	100.0%	100.0%
Cost of products sale	38.8%	38.3%	32.2%
Inventory write-off and inventory purchase commitments losses	-	0.5%	3.6%
Cost of services	18.7%	18.4%	30.9%
Total cost of revenues	57.5%	57.2%	66.7%
Gross profit	42.5%	42.8%	33.3%
Operating expenses:			
Research and development expenses, net	19.0%	15.8%	22.1%
Sales and marketing expenses	18.1%	17.5%	19.2%
General and administrative expenses	10.6%	8.3%	8.2%
Impairment loss on intangibles and equipment related to Hypernex assets and liabilities acquisition	-	6.6%	1.7%
Total operating expenses	47.7%	48.2%	51.2%
Operating loss	(5.2)%	(5.4)%	(17.9)%
Financing income (expenses), net	1.2%	(1.3)%	4.0%
Net loss	(4.0)%	(6.7)%	(13.9)%

#### Comparison of Years Ended December 31, 2008 and 2007

**Revenues.** Our revenues in 2008 decreased by \$19.1 million, or 33%, compared to 2007, with revenues attributable to product sales accounted for \$25.7 million, a decrease of \$19.9 million, or 44%, compared to 2007, and revenues attributable to services accounted for \$13.3 million, an increase of \$1.6 million, or 13.6%, compared to 2007. Revenues in 2007 also included \$0.8 million attributable to IP licensing. The decrease in product sales revenue in 2008 was attributed mainly to the decrease in demand for our integrated metrology products resulting from an overall slow-down in the semiconductor industry. The increase in services revenues is attributed mainly to new service contracts and higher time and materials sales in 2008 compared to 2007.

**Cost of Revenues and Gross Profit.** Cost of revenues consists of the labor, material and overhead costs of manufacturing our systems, and the costs associated with our worldwide service and support infrastructure. It also consists of inventory write-offs and provisions for estimated future warranty costs for systems we have sold. Our cost of revenues attributable to product sales in 2008 was \$13.9 million, a decrease of \$8.7 million, or 38.5%, compared to 2007. This decrease is attributable mainly to the decrease in the number of systems sold in 2008. Our cost of revenues attributable to product sales, as a percentage of product revenues in 2008, was 54.2%, compared to 49.5% in 2007. Our cost of goods sold in 2008 and 2007 include inventory write-off of \$1.4 million and \$0.3 million, respectively. Our gross margin attributable to product

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revenues in 2008 was 45.8%, compared to 50.5% in 2007. This decrease in gross margins in 2008 is related mainly to the decrease in our integrated metrology products revenues and to the need to write-off inventories as a result of this decrease.

Our cost of revenues attributable to services in 2008 was \$12.1 million, an increase of \$1.4 million, or 12.7%, compared to 2007. This increase is attributable mainly to labor and material costs relating to the supply of new service contracts and spare parts. Our gross margin attributable to services revenues in 2008 was 9.3%, compared to 8.6% in 2007.

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Our overall gross profit decreased by 47.7% to \$13.0 million in 2008, compared to \$24.8 million in 2007. Our overall gross margin was 33.3% and 42.7% of our total revenues in 2008 and 2007, respectively. The decrease in overall gross margins in year 2008 is attributable mainly to the decrease in our products revenues.

*Research and Development Expenses, Net.* Research and development expenses, net, consist primarily of salaries and related expenses and also include consulting fees, subcontracting costs, related materials and overhead expenses, after offsetting grants received or receivable from the Israel Office of the Chief Scientist. Our net research and development expenses decreased by 5.9% to \$8.6 million in 2008, compared to \$9.1 million in 2007, after offsetting grants received or receivable from the Office of the Chief Scientist of \$2.0 million in 2008 and \$2.4 million in 2007. In 2008, net research and development expenses represented 22.1% of our revenues compared to 15.7% of our revenues in 2007, due to the significant decrease in our revenues in 2008.

Approximately \$4.5 million of our net research and development expenses in 2008 resulted from our research and development efforts relating to current integrated metrology and stand alone products activities. Approximately \$4.1 million of our net research and development expenses in 2008 were related to developing a technology infrastructure for next generation metrology tools platforms, mainly for the stand alone metrology market segments, including x-ray technology, and to creating a new technology infrastructure for scatterometry based metrology solutions.

*Sales and Marketing.* Sales and marketing expenses are mainly comprised of salaries and related costs for sales and marketing personnel, related travel expenses, and overhead. They also include commissions to our representatives and sales personnel and royalties. Our sales and marketing expenses decreased by 26% to \$7.5 million in 2008, compared to \$10.2 million in 2007. This decrease is attributable to a decrease in expenses associated with evaluations, commissions and the levels of sales activity. Sales and marketing expenses represented 19.2% and 17.5%, of our revenues in 2008 and 2007, respectively. The increase as a percentage of revenue is related to the lower volume of revenues in 2008, which was partially offset by the significant decrease in sales and marketing costs.

*General and Administrative.* General and administrative expenses are comprised of salaries and related expenses and other non-personnel related expenses such as legal expenses. Our general and administrative expenses decreased by 33.8% to \$3.2 million in 2008, compared to \$4.8 million in 2007. This decrease is primarily attributed to a decrease in legal expenses related to the intellectual property infringement law suits which were settled in April 2007. General and administrative expenses represented 8.2% and 8.3% of our revenues in 2008 and 2007, respectively.

*Other Operating Expenses.* During 2008, we incurred a \$0.6 million impairment loss related to the acquisition of HyperNex assets and liabilities, compared with \$3.8 million in 2007.

*Financial Income, Net.* Financial income, net, for year 2008, includes a gain of \$1.4 million related to the sale of short term investments (Auction Rate Securities) that were impaired at the same amount in 2007. Excluding the gain or loss related to the Auction Rate Securities, financial income, net, decreased to \$0.2 million in 2008 from \$0.6 million in 2007. This decrease is attributable to the decrease in interest rates in year 2008 relative to 2007, as well as to the impact of currency exchange rate fluctuations.

### Comparison of Years Ended December 31, 2007 and 2006

*Revenues.* Our revenues in 2007 increased by \$9.8 million, or 20.3%, compared to 2006, with revenues attributable to product sales accounting for \$45.6 million, an increase of \$7.3 million, or 19%, compared to 2006, and with revenues attributable to services accounting for \$11.7 million, an increase of \$1.7 million, or 16.6%, compared to 2007. Revenues in 2007 also included \$0.8 million attributable to IP licensing. The increase in product sales revenue in 2007 was attributed mainly to the increased demand for our integrated metrology products from existing and new customers. Revenues from services accounted for 20.2% of total revenues in 2007, compared to 20.8% of total revenues in 2006. The increase in service revenues is attributed mainly to new service contracts.

We expect that sales from our main integrated process control product line targeting the CMP market, including dielectric CMP, copper CMP and etch, will continue to account for a substantial portion of our revenues for at least the next year, and that the new stand alone product

lines sales will gradually become more significant following wider market penetration. As our revenues are largely dependent upon the sale of systems for CMP processing, any decrease in demand for our CMP products would have a material adverse affect on our revenues.

*Cost of Revenues and Gross Profit.* Cost of revenues consists of the labor, material and overhead costs of manufacturing our systems, and the costs associated with our worldwide service and support infrastructure. It also consists of inventory write-offs and provision for estimated future warranty costs for systems we have sold. Our cost of revenues attributable to product sales in 2007 was \$22.2 million, an increase of \$3.5 million, or 18.8%, compared to 2006. This increase is attributable to the increased volume of systems sold in 2007. Our cost of revenues attributable to product sales, as a percentage of total revenues in 2007, was 38.3%, compared to 38.8% in 2006. In the years ended December 31, 2007 and 2006, we wrote-off inventories in the amounts of \$0.6 million (including \$0.3 million related to the acquisition of HyperNex assets and liabilities) and \$0.4 million, respectively. Our cost of revenues attributable to services in 2007 was \$10.7 million, an increase of \$1.7 million, or 18.7%, compared to 2006. This increase is attributable mainly to labor and material costs relating to the supply of new service contracts.

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Our gross profit increased by 21% to \$24.8 million in 2007, compared to \$20.5 million in 2006. Our gross profit represented 42.7% and 42.6% of our total revenues in 2007 and 2006, respectively.

*Research and Development Expenses, Net.* Research and development expenses, net, consist primarily of salaries and related expenses and also include consulting fees, subcontracting costs, related materials and overhead expenses, after offsetting grants received or receivable from the Israel Office of the Chief Scientist. Our net research and development expenses decreased by 0.3% to \$9.1 million in 2007 from \$9.2 million in 2006, after offsetting grants received or receivable from the Office of the Chief Scientist of \$2.4 million in 2007 and \$1.9 million in 2006. In 2007, net research and development expenses represented 15.8% of our revenues compared to 19% of our revenues in 2006, due to the significant increase in our revenues in 2007.

Approximately \$6 million of our net research and development expenses in 2007, resulted from our research and development efforts relating to the introduction of the new NovaScan 3090 models, to current products activities, and to creating a new technology infrastructure for scatterometry based metrology solutions. We believe that meeting the needs of semiconductor manufacturers with respect to the manufacture of semiconductors with features ranging from 90 nm to below 45 nm will allow us to maintain our position as a market leader in integrated process control equipment. Approximately \$3 million of our net research and development expenses in 2007, was related to developing a technology infrastructure for next generation metrology tools platforms, for integrated metrology market segments and for stand alone metrology market segments, including x-ray technology.

*Sales and Marketing.* Sales and marketing expenses are comprised mainly of salaries and related costs for sales and marketing personnel, related travel expenses, and overhead. They also include commissions to our representatives and sales personnel and royalties. Our sales and marketing expenses increased by 16% to \$10.2 million in 2007 from \$8.8 million in 2006. This increase is attributable to increased expenses associated with evaluations, commissions and sales activity mainly in the Asia Pacific region. Sales and marketing expenses represented 17.5% and 18.1%, of our revenues in 2007 and 2006, respectively. The decrease as a percentage of revenue is related to the higher volume of revenues in 2007.

*General and Administrative.* General and administrative expenses are comprised of salaries and related expenses and other non-personnel related expenses such as legal expenses. Our general and administrative expenses decreased 6% to \$4.8 million in 2007 from \$5.1 million in 2006. This decrease is primarily attributed to a decrease in legal expenses related to the Nanometrics intellectual property infringement law suits which were settled in April 2007. General and administrative expenses represented 8.3% and 10.6% of our revenues in 2007 and 2006, respectively. The decrease in general and administrative expenses as a percentage of revenues from 2006 to 2007 is a result of the increase in our revenues in 2007 and the decrease in legal expenses in year 2007.

*Other Operating Expenses.* During the third quarter of 2007, we incurred a \$3.8 million impairment loss on intangibles and equipment related to the acquisition of HyperNex assets and liabilities.

*Financial Income, Net.* Financial income, net, for year 2007, includes \$1.4 million impairment charge, related to short term investments in Auction Rate Securities. Excluding this charge, financial income, net, in year 2007 amounted to \$0.6 million, similar to year 2006.

## 5.B Liquidity and Capital Resources

As of December 31, 2008, we had working capital of approximately \$20 million compared to working capital of \$21 million as of December 31, 2007.

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Cash and cash equivalents, short-term and long-term deposits and securities held to maturity as of December 31, 2008 were \$20.0 million compared to \$22.9 million as of December 31, 2007.

Trade accounts receivable decreased from \$9.1 million as of December 31, 2007 to \$2.8 million as of December 31, 2008. This decrease is attributable mainly to the decrease in revenues in the fourth quarter of 2008 relative to the fourth quarter of 2007. Inventories decreased from \$8.5 million as of December 31, 2007 to \$6.9 million as of December 31, 2008, mainly due to a \$1.4 million inventory write-off in year 2008.

Operating activities in 2008 generated negative cash flow of \$3.3 million compared to a positive cash flow of \$4.6 million in 2007. The decrease in cash flow is associated mainly with the decrease in revenues and related loss in 2008.

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The following table describes our investments in capital expenditures during the last three years:

	2006		2007		2008	
	Domestic	Abroad	Domestic	Abroad	Domestic	Abroad
(in dollar thousands)						
Electronic equipment	955	81	1,953	51	968	3
Office furniture and equipment	14	14	27	32	11	8
Leasehold improvements	288	12	11	97	21	21
Total	1,227	107	1,991	180	1,000	32

In 2008, the investment in capital expenditures was financed from our cash reserves. The decrease in capital expenditures for electronic equipment in 2008 is attributable mainly to a decrease in capital expenditure of electronic equipment used for our research and development labs and systems for our demonstration centers and application development, following the extensive investments in such equipment in 2007. Although we currently have no significant capital commitments, we expect to spend approximately \$0.5 million on capital expenditures in year 2009, mainly for information systems improvements (software and hardware) and electronic equipment used in our research and development labs.

Our principal liquidity requirement is expected to be for working capital. We believe that our current cash reserves will be adequate to fund our activities for at least the next 12 months. Our long-term capital requirements will be affected by many factors, including the success of our current products, our ability to enhance our current products and our ability to develop and introduce new products that will be accepted by the semiconductor industry. We plan to finance our long-term capital needs with the remaining net proceeds of our initial public offering, together with positive cash flow from operations, if any. If these funds are insufficient to finance our activities, we will have to raise additional funds through the issuance of additional equity or debt securities, through borrowing or through other means. We cannot assure that additional financing will be available on acceptable terms.

Presently, we have no long-term debt, nor any readily available source of long-term debt financing such as a line of credit.

During 2007, short-term investments in the amount of \$2.9 million in Auction Rate Securities experienced failed auctions. Accordingly, these investments were classified as long-term investments in our financial statements as of December 31, 2007. During 2008, our Auction Rate Securities were repurchased at their full par value, by the custodian of these investments, as part of a repurchase arrangement with that custodian. We did not incur any costs in connection with this repurchase arrangement, as it was based on a settlement arrangement between the custodian and the US authorities. Accordingly, in our financial statements for 2008, we have reported a one-time gain of \$1.4 million as a result of this arrangement. For additional information see Note 2G in the financial statements.

With regard to usage of hedging financial instruments and the impact of inflation and currency fluctuations, see Quantitative and Qualitative Disclosures about Market Risk starting on page 55.

### 5.C Research and Development, Patents and Licenses, etc.

For information regarding our research and development activities, see [Research and Development](#) starting on page 18.

### Grants from the Office of the Chief Scientist

Under the Law for the Encouragement of Industrial Research and Development, 1984, a qualifying research and development program is eligible for grants of up to 50% of the program's expenses. The program must be approved by a committee of the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor. The recipient of the grants is required to return the grants by the payment of royalties on the revenues derived from using the grants. Current regulations promulgated under the law provide for the payment of royalties to the Office of the Chief Scientist ranging from 3% to 5% on the revenues derived from using the grants until 100% of the grants are repaid. Grants received under programs approved after January 1, 1999 will accrue interest at an annual rate of the 12-month LIBOR applicable to dollar deposits. Royalties are paid in NIS linked to the dollar at the exchange rate in effect at the time of payment. Following the full payment of such royalties and interest, there is generally no further liability for payment.

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The terms of the grants under the law require that we manufacture the products developed with these grants in Israel. These restrictions apply even after grants are fully repaid. Under the regulations promulgated under the law, the products may be manufactured outside Israel by us or by another entity and know-how may be transferred outside of Israel, only if prior approval is received from the Office of the Chief Scientist. This approval may be given only if we abide by all the provisions of the law and related regulations. Ordinarily, as a condition to obtaining approval to manufacture outside Israel, we would be required to pay increased royalties and as a condition to obtaining approval to transfer know-how outside Israel, ordinarily we would be required to pay a lump sum, all as defined under the relevant law. If we perform the manufacturing, the increased royalties would ordinarily be one percentage point above the otherwise applicable royalty rate. If the manufacturing is performed by an entity other than us, the rate would depend on the amount of manufacturing performed outside of Israel and the size of the grants in relation to the investments made by us in the project. The total amount to be repaid to the Office of the Chief Scientist would also be adjusted to between 120% and 300% of the grants, depending on the manufacturing volume that is performed outside Israel. If we wish to transfer know-how, the terms for approval shall be determined according to the character of the transaction and the consideration paid to us for such transfer. Approval of the transfer of technology to another Israeli company may be granted only if the recipient abides by all the provisions of the law and related regulations, including the restrictions on the transfer of know-how outside of Israel and the obligation to pay royalties in an amount that may be increased. Approval to manufacture products outside of Israel or consent to the transfer of technology, if requested, might not be granted.

As of December 31, 2008, we received grants from the Office of the Chief Scientist totaling \$14 million. Because the implementation of regulations raising royalty rates to between 3% and 6% has been deferred, we are obligated to pay royalties of 3%-3.5% of revenues derived from sales of products funded with these grants. As of December 31, 2008, our contingent liability to the Office of the Chief Scientist for grants received was approximately \$8 million. See also Note 8A to our consolidated financial statements contained elsewhere in this report.

The funds available for grants from the Office of the Chief Scientist were reduced for 2004 and 2005, and the Israeli authorities have indicated that the government may further reduce or abolish grants of this kind in the future. Even if these grants are maintained, we might not receive them in the future and cannot presently predict the amount of any grants we might receive.

In addition to royalty-bearing grants from the Office of the Chief Scientist, in 2008, we participated in two programs sponsored by the Office of Chief Scientist. In one program, we are a member of a research consortium comprised of several Israeli high technology companies, which are engaged in the development of multimedia on-line technology. In the other program, we are cooperating with a research institute in Israel for the development of advanced measurement techniques. In both programs, the Office of the Chief Scientist contributes 66% of the approved research and development budget for the research consortium and the members of the research consortium contribute the remaining 34%. No royalties from this funding are payable to the Israeli government, however, the provisions of the law and related regulations regarding the restrictions on the transfer of know-how outside of Israel apply to these programs. Expenses in excess of the approved budget are borne by the consortium members. In general, any consortium member that develops technology as part of the consortium retains the intellectual property rights to the technology developed by this member, and all the members of the consortium have the right to utilize and implement such technology without having to pay royalties to the developing consortium member. As of December 31, 2008, we had received approximately \$4 million in grants from the Office of Chief Scientist in connection with these programs.

### 5.D Trend Information

For Information regarding most significant recent trends in our market, see [The World Economy is Entering a Recession](#) starting on page 12.

**5.E Off-Balance Sheet Arrangements**

We do not have and are not party to any off-balance sheet arrangements.

**5.F Tabular Disclosure of Contractual Obligations**

As of December 31, 2008 we had contractual obligations as described in the following table:

	Payment due by Period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Operating Lease Obligations	3,280	931	2,199	150	-
Purchase Obligations	3,228	3,067	161	-	-
Other Long Term Liabilities	40	-	40	-	-
Total	6,548	3,998	2,400	150	-

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**Item 6. Directors, Senior Management and Employees****6.A Directors and Senior Management**

The following is the list of senior management and directors as of March 2, 2009:

<u>Name</u>	<u>Age</u>	<u>Position</u>
Micha Brunstein	65	Chairman of the board of directors
Giora Dishon	64	Director and co-founder
Moshe Finarov	56	Director and co-founder
Avi Kerbs	62	Director
Alon Dumanis	58	Director
Dan Falk	64	External Director
Naama Zeldis	45	External Director
Nicolas Bright	53	Director
Avi Cohen	55	Director
Gabi Seligsohn	42	President and Chief Executive Officer
Dror David	39	Chief Financial Officer
Avi Magid	47	Executive Vice President Global Business Management Group
Gabi Sharon	46	Vice President Operations
Boaz Brill	44	Vice President Technology Development
Hila Mukevisius	34	Vice President Human Resources

Our directors (other than the external directors) serve as such until the next annual general meeting of our shareholders. Our external directors, in accordance with Israeli law, serve for a three-year term, which may be renewed for one additional three-year term and thereafter for additional three-year terms, if both the audit committee and the board of directors confirm that in light of the expertise and contribution of the external director, the extension of such external director's term would be in the interest of our company. Mr. Dan Falk was elected in 2005 to

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serve for a three-year term that expired in 2008 and was re-elected in 2008 for an additional three-year term. Ms. Zeldis was elected in 2006 and her term expires on August 30, 2009.

*Dr. Micha Brunstein* was named chairman of our board of directors in June 2006, after serving as member of our board of directors from November 2003. During the years 1990 and 1999, Dr. Brunstein served as Managing Director of Applied Materials Israel Ltd. Prior to that, Dr. Brunstein served as President of Opal Inc., and as a Director of New Business Development in Optrotech Ltd. At present, Dr. Brunstein serves as a board member of Ham-let Ltd., a company listed on the Tel Aviv Stock Exchange and Valor Computerized Systems Ltd., a company listed on the Frankfurt Stock Exchange. He is a chairman and serves on boards of directors of several privately owned companies. Dr. Brunstein holds a B.Sc. in Mathematics and Physics from the Hebrew University, Jerusalem, and a M.Sc. and a Ph.D. in Physics from Tel Aviv University.

*Dr. Giora Dishon* is a co-founder of Nova and served as President and Chief Executive Officer since Nova's formation in 1993 until August 2006. From 1989 to 1993 he served as Thin Film and Flat Panel Display Product Line Manager at Orbot Systems and Orbotech Ltd., a manufacturer of automated optical inspection equipment. From 1986 to 1988 he was a Visiting Scientist at the Microelectronics Center of North Carolina, and from 1982 to 1986 he served as Managing Director at AVX Israel Ltd., a manufacturer of electronic devices. Dr. Dishon holds a B.Sc. in Chemistry, a M.Sc. and a Ph.D. in Materials Science from the Hebrew University, Jerusalem, Israel.

*Dr. Moshe Finarov* is a co-founder of Nova and a member of our board of directors. He has served as Chief Technology Officer and VP Technology from Nova's formation in 1993 until August 2006. From 1989 to 1993 he served as Senior Physicist at Orbotech Ltd. and from 1974 to 1988 he was employed at PULSAR and ENIMS Scientific Research Institutes in Moscow. Dr. Finarov holds a Ph.D. in Semiconductor Physics and a M.Sc. in Microelectronics from Moscow Steel & Alloys Institute. He is named on approximately 50 U.S. patents and published approximately 40 papers.

*Mr. Avi Kerbs* has served as a director of Nova since 1993. He serves as the President and Chief Executive Officer of Teuza Management & Development Ltd., the management company of Teuza-A Fairchild Technology Venture Ltd., a venture capital company and has served in this capacity since 1991. Teuza-A Fairchild Technology Venture Ltd. is a major shareholder of Nova. He serves as a director of most of the companies comprising the investment portfolio of the Teuza Fund. Mr. Kerbs holds a B.Sc. in Industrial Engineering and Management and a M.Sc. in Management from the Technion - Israel Institute of Technology. Mr. Kerbs serves as a member of the Technion's Board of Governors and the Haifa University Board of Governors. Mr. Kerbs is also a member of the Board of CPI - Cerebral Palsy International Foundation in the U.S. Mr. Kerbs was originally appointed to our board of directors by Teuza.

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*Dr. Alon Dumanis*, has served as a director of Nova from 2002. He is the Chief Executive Officer of Docor International Management, a Dutch investment company, subsidiary of The Van-Leer Group Foundation. Dr. Dumanis is a member of the board of directors of Tadiran Communications (TASE-TDCM), a former member of the board of directors of El Al Israel Airlines (TASE-LY), and a former member of the board of directors of Inventech Investments Co. Ltd. (TASE-IVTC). Previously, Dr. Dumanis was the Head of the Material Command in the Israel Air Force at the rank of Brigadier General. Dr. Dumanis currently serves as chairman and member of several national steering committees and is the author of many papers published in a number of subject areas, including technology and management. Dr. Dumanis holds a Ph.D. in Aerospace Engineering from Purdue University, West Lafayette, Indiana, USA.

*Mr. Dan Falk* was elected as the Company's external director in accordance with the provisions of the Companies Law in 2005, and was re-elected for an additional term on September 25, 2008. Mr. Falk is a business consultant to public and private companies. During 1999 to 2000, Mr. Falk served as Chief Executive Officer and Chief Operating Officer of Sapiens International NV. Prior to that, Mr. Falk served as Executive Vice President and Chief Financial Officer of Orbotech Ltd. Mr. Falk serves as a member of various companies' boards of directors such as Orbotech Ltd., Nice Systems Ltd., Ormat Technologies, Inc., Attunity Ltd., ClickSoftware Technologies, Ltd., Jacada Ltd., (all of which are companies publicly traded in the United States). Mr. Falk also serves as the chairman of the board of directors of Orad Hi-tech Systems Ltd. and as a board member of Dmatek Ltd., AVT Ltd., Amiad Filtration Systems Ltd., Oridion Medical Ltd. (all of which are companies publicly traded in Europe) and Plastopil Ltd. (traded in TASE). Mr. Falk's son-in-law is a junior partner at Gross, Kleinhendler, Hodak, Halevy, Greenberg & Co., our outside counsel.

*Ms. Naama Zeldis* was elected as the Company's external director in accordance with the provisions of the Companies Law in 2006 and her term expires on August 30, 2009. Ms. Zeldis has been serving as Chief Financial Officer of Netafim Ltd. since December 2005. Prior to that, she served as Chief Financial Officer of EDS Israel, Radguard, and Director of Finance of RAD Data Communications. Ms. Zeldis has been serving as a member of the board of directors and of the audit committee of Metalink since Dec. 2006. Metalink is traded both on Nasdaq and on the Tel Aviv Stock Exchange. Ms. Zeldis holds a B.A. in Economics and an M.A. in Business Administration, majoring in Financing, from the Hebrew University of Jerusalem and a B.A. in Accounting from Tel-Aviv University.

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*Mr. Nicolas Bright* has served as a director of Nova since August 2007. Mr. Bright was Executive Vice President of Products at Lam Research Corporation, focusing on new business opportunities and markets. Mr. Bright joined Lam in 1998 and successfully led Lam's 2300® businesses from research and development to market positioning and penetration. He has held various management positions within Lam, including Executive Vice President of Global Products and Regional Operations, Vice President of Technology and Engineering, and Senior Vice President and General Manager of Products. Prior to joining Lam, Mr. Bright spent 16 years at Applied Materials, Inc., where he held a variety of management positions in engineering and technology groups within etch, ion implant, and automation. In 2008 Mr. Bright rejoined Applied Materials, Inc.. Previously, Mr. Bright held management positions at General Electric Co. in the United Kingdom and ABB in Sweden. Mr. Bright holds B.Sc. and M.Sc. degrees in electrical and electronics engineering from Brunel University in England.

*Mr. Avi Cohen* was elected to serve as a director of Nova by its board of directors on February 18, 2008. Mr. Cohen serves as President and Chief Executive Officer at Orbit Technology Group. Orbit develops, manufactures and supplies a wide range of superior performance communication equipment solutions for Mobile SatCom, Tracking and Audio Communication Management that are intended both for military and commercial applications and are used by leading global defense and commercial companies. Prior to joining Orbit in December 2008, Mr. Cohen served as Chief Operating Officer and Deputy to the CEO at ECI Telecom Ltd. a leading supplier of best-in-class networking infrastructure equipment for carrier and service provider networks worldwide. Prior to joining ECI in September 2006, Mr. Cohen served in a variety of management positions at KLA-Tencor. From 2003 he was a Group Vice President, Corporate Officer and Member of the Executive Management Committee based at the corporate headquarters in the U.S. During his tenure, he successfully led the creation of KLA-Tencor's global Metrology Group. From 1995 he was the President of KLA-Tencor Israel responsible for the Optical Metrology Division. Before joining KLA-Tencor, Mr. Cohen also spent three years as Managing Director of Octel Communications, Israel, after serving as Chief Executive Officer of Allegro Intelligent Systems, which he founded and which was acquired by Octel. Mr. Cohen holds B.Sc. and M.Sc. degrees in electrical engineering and applied physics from Case Western Reserve University, USA.

*Mr. Gabi Seligsohn* has served as the President and Chief Executive Officer since August 2006. Having joined Nova in 1998, Mr. Seligsohn has served in several key positions in the Company including as the Executive Vice President, Global Business Management Group from August 2005 to August 2006. From August 2002 until August 2005 he was President of Nova's U.S. Subsidiary, Nova Measuring Instruments Inc. Prior to that he was Vice President Strategic Business Development at Nova Measuring Instruments Inc. where he established Nova's OEM group managing the Applied Materials and Lam Research accounts between the year 2000 to 2002. From 1998 to 2000 he served as Global Strategic Account Manager for the Company's five leading customers. Mr. Seligsohn joined Nova after two years service as Sales Manager for key financial accounts at Digital Equipment Corporation. Mr. Seligsohn holds an LL.B. from the University of Reading, Reading, England.

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*Mr. Dror David* has served as the Chief Financial Officer since November 2005. Mr. David joined Nova in April 1998, as the Company's Controller, and since then served in various financial and operational positions, including the position of Vice President of Resources, in which he was responsible for the finance, operations, information systems and human resources functions of the Company. Mr. David was also a leading member in the Company's initial public offering in Nasdaq in 2000 and the Company's private placement in 2007. Prior to joining Nova, Mr. David spent five years in public accounting with Deloitte Touch in Tel Aviv, specializing in industrial high-tech companies. Mr. David is a Certified Public Accountant in Israel, holds a B.A. in Accounting and Economics from Bar Ilan University, and an M.B.A. from Derby University of Britain.

*Mr. Avi Magid* has served as Executive Vice President Global Business Management since November 2006. From 2001 to 2006, Mr. Magid served as Managing Director and Vice President at Kulicke & Soffa, a leading supplier of semiconductor assembly equipment. From 2000 to 2001, Mr. Magid served as Deputy Managing Director for Business Development at K&S Micro Swiss LTD. Prior to that, Mr. Magid served as Managing Director and Deputy Managing Director for Sales & Marketing at Semitec, Santa Clara, CA. Mr. Magid holds a B.A. in Industrial Engineering from Polytechnic University-Pomona, Pomona, California.

*Mr. Gabi Sharon* is serving as Vice President of Operations since September 2006. Having joined Nova in 1995, Mr. Sharon served in several key positions in the Company including as Global Customer Support Manager from September 1995 to September 2004. From September 2004 until September 2006 Mr. Sharon managed the Product Development Division, and spearheaded the NovaScan 3090 product line and its successful market launch. For a period of 2 years, from 2004 to 2006, he also served as the Product Marketing Manager and led the initial penetration of the Copper CMP market. Prior to joining Nova Mr. Sharon served as Project Manager in ECI Israel. Mr. Sharon holds a B.Sc. in Computer Science from Northeastern University, Boston, Massachusetts, and a M.Sc. in Technology Management from Polytechnic University, New York.

*Dr. Boaz Brill* is serving as Vice President Technology Development since September 2006. Dr. Brill has been with Nova since 1999 and was the lead scientist who managed Nova's entry into the Optical CD market and developed the NovaScan 3090 platform. A well-known technologist, he headed Nova's Physics department. From 1995 until 1999, Dr. Brill served as System Engineer and Project Manager at El-Op Ltd. Dr. Brill holds a B.Sc. in Physics and Mathematics from the Hebrew University, Jerusalem, M.Sc and Ph.D in Physics from the Weizmann



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Institute of Science, Rehovot, Israel and MBA from Bradford University, UK. He has published over 10 patents and patent applications, mostly in the field of Optical CD.

*Ms. Hila Mukevisius* is serving as Vice President Human Resources since May 2008. Ms. Mukevisius joined Nova after 8 years at Amdocs, a market leader in customer experience systems innovations, where she held several positions as HR Director of large scale global groups. Ms. Mukevisius holds a B.A. in Behavioral Science from the College of Management, Academic Studies, Tel Aviv, Israel, specializing in organization development.

### Voting Agreement

We are not aware of any voting agreement currently in effect.

### 6.B Compensation

The aggregate direct remuneration paid or payable to all persons who served in the capacity of executive officer during 2008 was approximately \$1.7 million including approximately \$0.5 million, which was set aside for pension and retirement benefits and including amounts expended by us for automobiles made available to our executive officers.

The total amount paid or payable to the directors, including external directors, for 2008 was \$0.9 million. This sum includes \$0.6 million paid during 2008 to two of our directors who were employed by the Company during 2007, according to the termination provisions of their employment agreements.

As of March 2, 2009, 1,301,965 options to purchase our ordinary shares were outstanding to certain executive officers and directors (consisting of 15 persons), of which 772,968 options are currently exercisable or exercisable within 60 days of March 2, 2009. See *Share Ownership* starting on p. 35.

At the 2007 annual general meeting of the Company's shareholders, the shareholders approved a new compensation arrangement for the Company's directors (excluding the external directors, the chairman of the Board of Directors and, unless approved otherwise, any other director who is also an employee of the Company). At the 2008 annual general meeting of the Company's shareholders, the shareholders approved the same compensation arrangement for the Company's external directors. The compensation arrangement includes:

1. An annual payment of US\$ 12,000 (in an equivalent amount in NIS), subject to the minimal and maximal payment restrictions applicable to the Company under the Companies Regulations (Rules Regarding Compensation and Expenses to an External Director), 2000, and the Companies Regulations (Relief for Public Companies with Shares Listed for Trading on a Stock Market Outside of Israel), 2000 (collectively, the Regulations).
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2. Additionally, the following payments (subject to the minimal and maximal payment restrictions applicable to the Company under the Regulations):
    - a. for each meeting that the director or external director attends in person, an amount of US\$ 600 (in an equivalent amount in NIS);
    - b. for each execution of a written consent in lieu of a meeting, an amount of US\$ 300 (in an equivalent amount in NIS); and
    - c. for each meeting that the director or external director attends by teleconference, an amount of US\$ 360 (in an equivalent amount in NIS).
  3. An annual award of an option to purchase up to 10,000 ordinary shares to be granted to each director or external director on the date of each annual general meeting at which such director or external director is elected or reelected. The exercise price of each option shall be determined pursuant to the Company's Equity Based Compensation Policy.

In addition, at the 2008 annual general meeting, the shareholders approved a one-time additional award of an option to purchase up to 10,000 ordinary shares to each of Mr. Dan Falk and Ms. Naama Zeldis, our external directors. The exercise price of the option was determined pursuant to the Company's Equity Based Compensation Policy.

In addition, at the 2008 annual general meeting, the shareholders approved an addition to the compensation package of Dr. Micha Brunstein, the chairman of our board of directors, of the following items: (i) an annual award of an option to purchase up to 10,000 ordinary shares to be granted to Dr. Brunstein on the date of each annual general meeting at which the chairman of the board of directors is elected or reelected. The exercise price of each option shall be determined pursuant to the Company's Equity Based Compensation Policy. The proposed terms of the options (i.e., the amount, exercise price and vesting schedule) are identical to the terms of the options currently granted to other directors on an annual basis; and (ii) a one-time additional award of an option to purchase up to 10,000 ordinary shares granted to Dr. Brunstein on September 25, 2008. The exercise price of the option was determined pursuant to the Company's Equity Based Compensation Policy.

Effective November 1, 2008, the Company resolved to temporarily reduce the compensation of all directors and officers of the Company, but excluding the compensation of external directors, whose compensation cannot be modified during the term of service under the Israeli law.

## 6.C Board Practices

### Board of Directors Committees

The Company's board of directors has appointed the following committees:

The Audit Committee is comprised of Dan Falk, Naama Zeldis and Avi Cohen. The functions of the audit committee according to Israeli Law are to locate and monitor deficiencies in the management of the Company, including in consultation with the independent auditors and the internal auditor, and to advise the board of directors on how to correct such deficiencies. The audit committee is also responsible to assist the board of directors in fulfilling its responsibility for oversight of the quality and integrity of accounting, auditing and financial reporting practices of the Company. Furthermore, the audit committee is also responsible for approving related party transactions. In addition, as described under Item 16, the audit committee is responsible for the approval of all audit and non-audit services provided to the Company by Brightman Almagor Zohar & Co. a member of Deloitte Touche Tohmatsu and to oversee the qualifications, independence, appointment, compensation and performance of the Company's independent auditors. The audit committee operates under a charter adopted by the board of directors.

The *Compensation Committee* is comprised of Avi Cohen, Dan Falk and Micha Brunstein. The function of the compensation committee is described in the approved charter of the committee, and includes assisting the board of directors in discharging its responsibilities relating to compensation of the Company's directors and executives and the overall compensation programs. The primary objective of the committee is to develop and implement compensation policies and plans that are appropriate for the Company in light of all relevant circumstances and which provide incentives that further the Company's long-term strategic plans and are consistent with the culture of the Company and the overall goal of enhancing enduring shareholder value.

The *Nominating and Corporate Governance Committee* is comprised of Alon Dumanis, Dan Falk and Micha Brunstein. The function of the nominating committee is described in the approved charter of the committee, and includes responsibility for identifying individuals qualified to become board members and recommending that the board select the director nominees for election at the general meeting of shareholders. The Nominating and Corporate Governance Committee is also responsible for developing and recommending to the board of directors a set of corporate governance guidelines applicable to the Company, periodically reviewing such guidelines and recommending any changes thereto.

The *Strategic Committee* is comprised of Alon Dumanis, Micha Brunstein, Avi Kerbs, Giora Dishon, Moshe Finarov, Nicolas Bright, Avi Cohen and Gabi Seligsohn. The function of the strategic committee is described in the approved charter of the committee, and includes assisting the board in fulfilling its responsibilities for overseeing and facilitating the development and implementation of the Company's long-term and short-term strategic planning.

On December 18, 2008, our board of directors resolved to abolish the Investment Committee. The matters that were under the scope of the Investment Committee will be brought under the direct authority of our board of directors.

All committees are acting according to written charters that were approved by our board of directors.

**Internal Auditor**

Under the Companies Law, the board of directors must also appoint an internal auditor nominated by the audit committee. Our internal auditor is Guy Sapir, C.P.A (Isr) of Kesselman &Kesselman PwC Israel. The role of the internal auditor is to examine whether a company's actions comply with the law and proper business procedure. The internal auditor may not be an interested party or office holder, or a relative of any interested party or office holder, and may not be a member of the company's independent accounting firm or its representative. The Companies Law defines an interested party as a holder of 5% or more of the shares or voting rights of a company, any person or entity that has the right to nominate or appoint at least one director or the general manager of the company or any person who serves as a director or as the general manager of a company.

**6.D Employees**

Set forth below is a chart showing the number of people we employed at the times indicated:

	as of December 31,		
	2006	2007	2008
Total Personnel	280	288	225
Located in Israel	168	181	147
Located abroad	112	107	78
In operations	60	71	56
In research and development	83	76	59
In global business	116	117	92
In general and administration	21	24	18

We were a member of the Industrialists Association in Israel, an employer's union until December 31, 2006. As a result of this membership, a number of collective bargaining agreements apply to us. Collective bargaining agreements principally deal with cost of living wage increases, paid vacation and holidays, length of the workday, wage tariffs, termination and severance payments. As of December 31, 2008, to the best of our knowledge, we have been providing our employees with benefits and working conditions that are at least as favorable as those found in the collective bargaining agreements. In Israel, Nova is subject to the instructions of the Extension Order in the Industrial Field for Extensive Pension Insurance 2006 according to the Israeli Collective Bargaining Agreements Law, 1957 (the Extension Order). The Extension Order ensures the pension insurance of certain employees which fall under its criteria.

Israeli labor laws and regulations apply to all employees employed by Nova. The laws are principally concerned with matters such as paid vacation, paid sick days, length of workday, payment for overtime and severance payments upon the retirement or death of an employee or termination of employment.

**6.E Share Ownership**

The following table sets forth information regarding the beneficial ownership of our ordinary shares as of March 2, 2009 by our executive officers and directors:

Beneficial ownership of shares is determined in accordance with the rules of the Securities and Exchange Commission (the Commission) and generally includes any shares over which a person exercises sole or shared voting or investment power. Ordinary shares that are subject to warrants or options that are presently exercisable or exercisable within 60 days of the date of March 2, 2009 are deemed to be outstanding and beneficially owned by the person holding the options for the purpose of computing the percentage ownership of that person, but are not treated as outstanding for the purpose of computing the percentage of any other person.

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Each shareholder in the table has sole voting and investment power for the shares shown as beneficially owned by them. Percentage ownership is based on 19,376,110 ordinary shares outstanding as of March 2, 2009, which excludes 2,229 ordinary shares held by us as dormant shares without voting or equity rights.

<b>Executive Officers and Directors:</b>	<b>Number</b>	<b>Percent</b>
Giora Dishon <sup>(1)</sup>	681,802	3.51%
Moshe Finarov <sup>(2)</sup>	700,701	3.61%
Gabi Seligsohn <sup>(3)</sup>	231,886	1.18%
15 directors and officers as a group <sup>(4)</sup>	2,087,902	10.36%

\* All other directors and executive officers each beneficially owned less than 1% of the Company's shares.

(1) Includes 61,100 shares held by a trustee pursuant to Israeli tax laws and 63,760 shares subject to options that are immediately exercisable or exercisable within 60 days of March 2, 2009 (expiration dates: 2010-2014; exercise prices (\$/share): 2.06-2.83).

(2) Includes 53,760 shares subject to options that are immediately exercisable or exercisable within 60 days of March 2, 2009 (expiration dates: 2010-2014; exercise prices (\$/share): 2.06-2.83).

(3) Includes 220,735 shares subject to options that are immediately exercisable or exercisable within 60 days of March 2, 2009 (expiration dates: 2010-2014; exercise prices (\$/share): 1.79-4.01).

(4) Includes 772,968 shares subject to options that are immediately exercisable or exercisable within 60 days of March 2, 2009 (expiration dates: 2009-2014; exercise prices (\$/share): 1.13-5.15).

### ***Employee Benefit Plans***

We currently have five active share option plans. As of December 31, 2008, options to acquire 5,076,061 ordinary shares had been issued under these plans, of which 550,537 options to acquire shares have been exercised, 2,402,990 have been cancelled, 1,385,700 were exercisable and 736,834 options were unvested. The active share option plans are described below:

**Option Plan 5** As of December 31, 2008, options to purchase 972,161 ordinary shares at an exercise prices which range from \$1.13 to \$2.46, the fair market value of Nova's stock on the date of grant were granted; 222,995 options were exercised, 14,500 options were exercisable and 734,666 options had been cancelled;

**Option Plan 6** As of December 31, 2008, options to purchase 960,000 ordinary shares at an exercise price of \$2.06, the fair market value of Nova's stock on the date of grant were granted; 296,622 options were exercised, 395,505 options were exercisable and 267,873 options had been cancelled. On September 29, 2005, our shareholders approved amendments to the plan allowing our board of directors to accelerate the vesting dates and to determine an exercise price which is different from the fair market value of our shares at the date of grant;

**Option Plan 7A** As of December 31, 2008, options to purchase 600,000 ordinary shares at exercise prices of \$4.01 and \$5.15, the fair market value of Nova's stock on the date of grant, were granted; 199,060 were exercisable and 400,940 options had been cancelled. On September 29, 2005, our shareholders approved amendments to the plan allowing our board of directors to accelerate the vesting dates and to determine an exercise price which is different from the fair market value of our shares at the date of grant;

**Option Plan 7B** As of December 31, 2008, options to purchase 650,000 shares at an exercise price of \$3.40, the fair market value of Nova's stock on the date of grant, were granted; 221,000 were exercisable and 429,000 had been cancelled. On September 29, 2005, our shareholders approved amendments to the plan allowing our board of directors to accelerate the vesting dates and to determine an exercise price which is different from the fair market value of our shares at the date of grant;

**Option Plan 7C** As of December 31, 2008, options to purchase 153,000 ordinary shares at an exercise price of \$2.20, the fair market value of Nova's stock on the date of grant, were granted; 3,548 options were exercised, 21,924 options were exercisable, 122,452 options had been cancelled and 5,076 were unvested. We do not intend to grant any further options or shares under this plan;

**Option Plan 8** As of December 31, 2008 options to purchase 1,496,900 ordinary shares at an exercise prices which range from \$1.79 to \$2.87 the fair market value of Nova's stock based on the date of grant, were granted. As of December 31, 2008, 27,372 options were exercised, 533,711 options were exercisable, 436,059 options had been cancelled and 499,758 were unvested. We do not intend to grant any further options or shares under this plan; and

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**2007 Incentive Plan** The maximum number of ordinary shares to be issued under the plan, which was adopted by our shareholders on October 25, 2008, is 2,500,000, subject to future increases or decreases by the Company. As of December 31, 2008, options to purchase 244,000 ordinary shares at an exercise prices which range from \$0.80 to \$2.54, the fair market value of Nova's stock based on the date of grant, were granted under this plan; 12,000 options had been cancelled and 232,000 were unvested. On February 17, 2009, options to purchase 155,000 ordinary shares were granted to our officers under this plan at an exercise price of \$0.43. In addition, On February 17, 2009, 263,130 restricted shares units were granted to our senior employees.

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On December 20, 2006, the board of directors resolved to amend the Company's incentive plans to clarify that the blackout period pursuant to the Company's blackout policy shall be excluded from the 30-day exercise period allowed under the various incentive plans following the termination of employment.

On February 19, 2007, the board of directors adopted an Equity Based Compensation Policy, according to which the exercise price of granted options will be as provided by the applicable incentive plan, provided, however, that in the event that the grant approval takes place during a blackout period, the exercise price of the options granted will be equal to the closing price of our ordinary shares on Nasdaq on the trading day immediately following the last day of the blackout period (with the exception of approvals subject to shareholder approvals, in which case, the exercise price shall be the closing price on the day of the shareholder approval).

The following table summarizes information about share options outstanding as of December 31, 2008:

Range of exercise prices	Outstanding as of December 31, 2008			Exercisable as of December 31, 2008	
	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price
(US dollars)		(in years)	(US dollars)		(US dollars)
0.8-1.95	812,469	4.45	1.67	370,036	1.82
2.06-2.87	890,005	3.39	2.47	595,604	2.29
3.40	221,000	2.92	3.40	221,000	3.40
4.01	169,060	2.42	4.01	169,060	4.01
5.15	30,000	2.21	5.15	30,000	5.15
	2,122,534	3.65	2.42	1,385,700	2.61

On August 8, 2006, pursuant to the Amended and Restated Asset Purchase Agreement with HyperNex and its stockholders, we issued 1,208,000 ordinary shares to HyperNex, which were distributed by HyperNex to its stockholders and 392,000 restricted shares were allocated to managers and employees of HyperNex. The Amended and Restated Asset Purchase Agreement, also provides the recipients of our ordinary shares with certain limited piggy-back registration rights. These piggy-back registration rights are subject to certain customary carve-outs and limitations as well as other limitations set forth in the Amended and Restated Asset Purchase Agreement. As of December 31, 2008, 388,979 of the shares allocated to managers and employees of HyperNex are fully vested.

### **Item 7. Major Shareholder and Related Party Transactions**

#### **A. Major Shareholders**

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The following table sets forth certain information regarding the beneficial ownership of our outstanding ordinary shares as of March 2, 2009 for each person who we know beneficially owns five percent or more of the outstanding ordinary shares.

Beneficial ownership of shares is determined under rules of the Commission and generally includes any shares over which a person exercises sole or shared voting or investment power. In addition, the following table includes the number of shares underlying warrants that are currently exercisable. Ordinary shares subject to these warrants are deemed to be outstanding for the purpose of computing the ownership percentage of the person holding these options, but are not deemed to be outstanding for the purpose of computing the ownership percentage of any other person. Applicable percentages are based on 19,376, 110 ordinary shares outstanding as of March 2, 2009, which excludes 2,229 ordinary shares held by us as dormant shares without voting or equity rights.

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Name	Number of Ordinary Shares Beneficially Owned	Percentage of Ordinary Shares Beneficially Owned
Clal Electronics Industries Ltd. <sup>(1)</sup>	5,010,434	24.75%
Austin W. Marx & David Greenhouse <sup>(2)</sup>	2,405,237	12.41%
Teuza - A Fairchild Technology Venture Ltd. <sup>(3)</sup>	1,453,407	7.50%
Teuza Management & Development (1991) Ltd. <sup>(3)</sup>	1,453,407	7.50%
Tamir Fishman Ventures II, L.L.C. <sup>(4)</sup>	1,175,600	6.07%
Shai Saul <sup>(4)</sup>	1,175,600	6.07%
Michael Elias <sup>(4)</sup>	1,182,850	6.10%
Tamir Fishman & Co. Ltd. <sup>(4)</sup>	1,180,700	6.09%
Eldad Tamir <sup>(4)</sup>	1,180,700	6.09%
Danny Fishman <sup>(4)</sup>	1,180,700	6.09%
Rima Management, LLC <sup>(5)</sup>	1,643,672	8.24%
Richard Mashaal <sup>(5)</sup>	1,643,672	8.24%

- (1) The information is based upon Amendment No. 3 to Schedule 13D filed with the Commission by, among others, Clal Electronics Industries Ltd., or CEI, on December 11, 2007 and information that was provided by Clal. The principal parent companies of the IDB Group are IDB Holding Corporation Ltd., or IDBH, and its majority-owned subsidiary, IDBD Corporation Ltd., or IDBD. Clal Industries and Investments Ltd., or Clal and CEI (a wholly owned subsidiary of Clal) are majority-owned subsidiaries of IDBD. IDBH is controlled as follows:

Ganden Holdings Ltd., or Ganden, which is a private Israeli company controlled by Nochi Dankner (who is also the chairman of IDBH, IDBD and Clal) and his sister Shelly Bergman, holds, as of September 6, 2007, directly and through a wholly-owned subsidiary, approximately 50% of the outstanding shares of IDBH (of which, approximately 12.31% of the outstanding shares of IDBH are held directly and approximately 37.7% of the outstanding shares of IDBH are held through Ganden Investments I.D.B. Ltd., or Ganden Investment, a private Israeli company, which is an indirect wholly owned subsidiary of Ganden). In addition, Shelly Bergman holds, through a wholly owned company, approximately 4.2% of the outstanding shares of IDBH;

Avraham Livnat Ltd., or Livnat, which is a private company controlled by Avraham Livnat (one of whose sons, Zvi Livnat, is a director and executive vice president of IDBH, Deputy Chairman of IDBD, co-chief executive officer of Clal, and another son, Shay Livnat, is a director of IDBD and Clal) holds, directly and through a wholly-owned subsidiary, approximately 11.7% of the outstanding shares of IDBH (of which, approximately 1.35% are held directly and approximately 10.37% of the outstanding shares of IDBH are held through Avraham Livnat Investments (2002) Ltd., or Livnat Investment, a private Israeli company, which is a wholly owned subsidiary of Livnat); and

Manor Holdings BA Ltd., or Manor, a private company controlled by Ruth Manor (whose husband, Isaac Manor, is deputy chairman of IDBH and a director of IDBD and Clal, and whose son, Dori Manor, is a director of IDBH, IDBD and Clal) holds, directly and through a majority-owned subsidiary, approximately 11.7% of the outstanding shares of IDBH (of which, approximately 1.3% are held directly and approximately 10.4% of the outstanding shares of IDBH are held through Manor Investments IDB Ltd., or Manor Investments, a private Israeli company which is controlled by Manor). Manor also holds directly approximately 0.3% of the outstanding shares of IDB Development.

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Subsidiaries of Ganden, Livnat and Manor have entered into a shareholders agreement with respect to shares of IDBH constituting 31.02%, 10.34% and 10.34%, respectively, of the outstanding shares of IDBH for the purpose of maintaining and exercising control of IDBH as a single group of shareholders. Their additional holdings in IDBH are not subject to the shareholders agreement. The term of the shareholders agreement expires in May 2023.

Based on the foregoing, IDBH (by reason of its control of IDBD and by reason of IDBD's control of Clal and CEI), Ganden, Livnat and Manor (by reason of their control of IDBH), Mr. Nochi Dankner, Ms. Shelly Bergman, Mr. Avraham Livnat and Ms. Ruth Manor (by reason of their control of Ganden, Livnat and Manor, respectively) may be deemed to share with CEI the power to vote and dispose of our shares held by CEI. The address of CEI is: 3 Azrieli Center, Tel Aviv 67021, Israel.

Including 872,092 ordinary shares currently issuable upon the exercise of warrants.

- (2) The information is based upon Amendment No. 5 to Schedule 13G filed with the Commission by Messrs. Marx and Greenhouse on February 13, 2009. Includes 548,125 shares held by Special Situations Cayman Fund, L.P., 79,263 shares held by Special Situations Technology Fund, L.P., 406,233 shares held by Special Situations Technology Fund II, L.P., 91,724 shares held by Special Situations Fund III, L.P. and 1,279,892 shares held by Special Situations Fund III, QP, L.P.
- (3) The information was provided by Teuza Management & Development (1991) Ltd.

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- (4) The information is based upon Amendment No. 2 to Schedule 13G filed with the Commission by, among others, Tamir Fishman Ventures II, LLC (TFV), on March 30, 2005: (i) five limited partnerships and a corporation directly beneficially own, in the aggregate, 1,175,600 shares; (ii) TFV beneficially owns 1,175,600 shares as the sole general partner of the five limited partnerships and by virtue of its management rights with respect to the corporation; (c) Shai Saul, is one of the managing members of TFV; (d) Michael Elias is one of the managing members of TFV and reports having sole voting and dispositive power over an additional 7,250 shares; (e) Tamir Fishman & Co. Ltd is one of the managing members of TFV and reports directly owning 5,100 additional shares; (f) Eldad Tamir and Danny Fishman are each Co-President and Co-CEO of Tamir Fishman & Co. Ltd. The total number of shares beneficially owned collectively by this group is 1,182,850.
  - (5) The information is based upon Amendment No. 2 to Schedule 13G filed with the Commission by Rima Management, LLC and Richard Mashaal on February 17, 2009. Based upon such Amendment No. 2, the reporting persons disclaim beneficial ownership in the shares reported therein except to the extent of their pecuniary interest therein. Includes 581,393 ordinary shares issuable upon exercise of warrants currently exercisable.

All the shareholders of the Company have the same voting rights.

To our knowledge, the only significant change in the percentage of ownership held by our major shareholders during the past three years has been the increase in the percentage of ownership held by CEI following the consummation of the transactions under that certain Share Purchase Agreement entered into by the Company and four investors, including CEI, on February 28, 2007. For additional information regarding this Share Purchase Agreement, see "Related Party Transactions" starting on page 37.

As of December 31, 2008, our ordinary shares were held by 58 registered holders. Based on the information provided to us by our transfer agent, as of December 31, 2008, 45 registered holders were U.S. holders and held approximately 11% of outstanding ordinary shares.

### Control of Registrant

To the Company's knowledge, it is not owned or controlled by a foreign government. Except for the shareholders identified above owning more than ten percent of the Company's ordinary shares, the Company has no knowledge of any corporation or other natural or legal person owning a controlling interest in the Company.

### B. Related Party Transactions

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In 2005 we obtained directors and officers liability insurance for our officers and directors with coverage in an aggregate amount of \$5,000,000. In 2006, we obtained directors and officers liability insurance for our officers and directors for the period from November 1, 2006 until October 31, 2007 with coverage in an aggregate amount of \$7,500,000. This directors and officers liability insurance was presented and approved and ratified at the 2007 Annual General Meeting pursuant to requirements of the Companies Law. Furthermore, at the 2007 Annual General Meeting of Shareholders, the Company's shareholders authorized the Company to renew the directors and officers liability insurance policies, provided, that the aggregate annual premium to be paid by the Company will not exceed 2% of the aggregate coverage of the directors and officers insurance policies and the aggregate coverage of the directors and officers insurance policies will not exceed the greater of \$10 million or 20% of the Company's shareholder equity. The insurer, the aggregate coverage amount under the directors and officers insurance policies and the annual premium to be paid for such coverage shall be determined prior to each renewal by the audit committee and the board of directors, which shall determine that the amounts are reasonable under the circumstances, taking into considerations market conditions. This resolution shall be valid until the termination of, and shall cover the purchase of, the directors and officers insurance policies that are to be purchased by the Company prior to the annual general meeting of the Company's shareholders to be held in 2010. In 2007 and 2008, we obtained directors and officers liability insurance for our officers and directors with coverage in an aggregate amount of \$7,500,000. This directors and officers liability insurance was presented and approved by the audit committee and the board according to the resolution of the 2007 Annual General Meeting pursuant to requirements of the Companies Law. In addition, we undertook to indemnify our officers and directors. Following the 2005 amendment to the Companies Law, on August 31, 2006, the shareholders at the Annual General Meeting approved an amended letter of indemnification to be given to our directors and officers. The aggregate indemnification amount that the Company will pay to all its officers and directors pursuant to these letters of indemnification shall not exceed \$10,000,000 or 30% of the Company's shareholders equity, according to the most recent consolidated financial statement prior to the date of indemnification payment, the higher of the two. Prior to that, we undertook to indemnify our officers and directors up to an aggregate amount of \$15,000,000.

For information relating to option granted to officers and directors, see Share Ownership starting on page 35.

Until June 2007 Dr. Giora Dishon and Dr. Moshe Finarov, our directors and co-founders, served as advisors to our Chief Executive Officer pursuant to employment agreements that were in effect as of July 1, 2006. Pursuant to his employment agreement, Dr. Dishon was paid a gross monthly salary of \$15,000 payable in NIS and was granted options to purchase up to 100,000 ordinary shares under our Stock Option Plan No. 8. Pursuant to the employment agreement with Dr. Finarov, Dr. Finarov was paid a gross monthly salary of \$14,000 payable in NIS and was granted options to purchase up to 100,000 ordinary shares under our Stock Option Plan No. 8. The employment agreements contain a change of control provision pursuant to which the vesting of the 100,000 options shall be accelerated in certain circumstances. In June 2007, the Company terminated the employment agreements with Dr. Giora Dishon and Dr. Moshe Finarov, pursuant to the termination provisions of such employment agreements.

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On August 31, 2006, our shareholders approved an agreement with Dr. Micha Brunstein, our Chairman of the Board of Directors. The term of engagement commenced as of June 19, 2006 and continues for an unlimited period, unless terminated in certain circumstances as stated in the agreement. Pursuant to the agreement, Dr. Brunstein is being paid a gross annual fee of \$110,000 payable monthly in NIS and was granted options to purchase up to 150,000 ordinary shares under our Stock Option Plan No. 8. The employment agreement contains a change of control provision pursuant to which the vesting of the 150,000 options shall be accelerated in certain circumstances.

On February 28, 2007, we entered into a Share Purchase Agreement with four investors, including Clal Electronics Industries Ltd., pursuant to which such investors purchased in the aggregate 1,937,983 ordinary shares of the Company, at a price of \$2.58 per share, for gross proceeds of \$5 million. In connection with this transaction, we issued warrants to these investors to purchase 1,453,485 additional ordinary shares at an exercise price of \$3.05 per share.

On October 25, 2007, our shareholders approved a new compensation arrangement for the Company's directors (excluding the external directors, the Chairman of the Board of Directors and, unless approved otherwise, any other director who is also an employee of the Company), pursuant to which the director compensation package shall include the following items: (1) An annual payment of \$12,000 (in an equivalent amount in NIS), however, not more than the annual payment allowed under the Companies Regulations (Rules Regarding Compensation and Expenses to an External Director), 2000, or the Regulations, in the case of dually listed companies; (2) the following payments (but in each case not more than the applicable payment allowed under the Regulations in the case of dually listed companies): (i) for each meeting that the director attends in person, an amount of \$600 (in an equivalent amount in NIS); (ii) for each execution of a written consent in lieu of a meeting, an amount of \$300 (in an equivalent amount in NIS); and (iii) for each meeting that the director attends by teleconference, an amount of \$360 (in an equivalent amount in NIS); and (3) an annual grant of options to purchase up to 10,000 ordinary shares of the Company to be granted to each director on the date of each annual general meeting at which such director is elected or reelected. The exercise price of the options shall be determined pursuant to the Company's Equity Based Compensation Policy.

On October 25, 2007, our shareholders approved the following consulting arrangement with Mr. Nicolas Bright, a director of the Company, effective as of August 1, 2007. Mr. Bright has agreed to dedicate to his duties as a consultant of the Company not more than five days a month.



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The engagement as a consultant is at will and may be terminated at any time. Pursuant to the consulting arrangement with him, Mr. Bright is entitled as of August 1, 2007 to a fee of \$1,000 per working day but in any case not more than \$60,000 during any period of twelve consecutive months. The consulting fee payable to Mr. Bright is in addition to the fee payable to him as a director of the Company. Additionally, Mr. Bright was granted an option to purchase 40,000 ordinary shares of the Company at an exercise price equal to the closing price of the Company's ordinary shares on Nasdaq on the date of the meeting. The option is subject to the provisions of the applicable incentive plan and the Company's Equity Based Compensation Policy. In addition, the Company undertook, subject to the approval of the Company's Chief Executive Officer or Chairman of the Board of Directors, to reimburse Mr. Bright for all reasonable out-of-pocket expenses incurred by him in connection with his participation in meetings of the board of directors and its committees and the services provided by him.

On October 25, 2007, our shareholders approved to accelerate the options received by Mr. Joseph Ciechanover that were not vested at the date of his resignation from the board of directors and to extend the period in which Mr. Ciechanover may exercise the accelerated options to 180 days from the date of resignation.

On September 25, 2008, our shareholders approved the same compensation arrangement as was approved to the other directors on October 25, 2007 for the Company's external directors. In addition, on September 25, 2008 our shareholders approved a one-time additional award of an option to purchase up to 10,000 ordinary shares to each of Mr. Dan Falk and Ms. Naama Zeldis, our external directors. The exercise price of the option was determined pursuant to the Company's Equity Based Compensation Policy.

In addition, on September 25, 2008, our shareholders approved an addition to the compensation package of Dr. Micha Brunstein, the chairman of our board of directors, of the following items: (i) an annual award of an option to purchase up to 10,000 ordinary shares to be granted to Dr. Brunstein on the date of each annual general meeting at which the chairman of the board of directors is elected or reelected. The exercise price of each option shall be determined pursuant to the Company's Equity Based Compensation Policy. The proposed terms of the options (i.e., the amount, exercise price and vesting schedule) are identical to the terms of the options currently granted to other directors on an annual basis; and (ii) a one-time additional award of an option to purchase up to 10,000 ordinary shares granted to Dr. Brunstein on September 25, 2008. The exercise price of the option was determined pursuant to the Company's Equity Based Compensation Policy.

Effective November 1, 2008, we resolved to temporarily reduce the compensation of all directors and officers of the Company, but excluding the compensation of external directors, whose compensation cannot be modified during the term of service under the Israeli law.

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### 7.C Interest of Experts and Counsel

Not applicable.

## **Item 8. Financial Information**

### 8.A Consolidated Statements and Other Financial Information

See Financial Statements on page 57 of this report and pages F-1 through F-22.

### Legal Proceedings

From time to time, we are a party to legal proceedings and claims in the ordinary course of business. We are not currently a party to any significant legal proceedings, apart from those mentioned below.

In March 2005, we filed a civil action in the United States District Court for the Northern District of California against Nanometrics, Inc. seeking to enforce our U.S. Patent No. 6,752,689 and in April 2006 Nanometrics filed a civil action in the United States District Court for the Northern District of California against us and our wholly-owned subsidiary, Nova Measuring Instruments Inc., seeking to enforce their U.S. Patent No. Re 34,783. Nova had filed a request for re-examination of the Nanometrics' patent with the PTO. This request for re-examination was accepted by the PTO for review in December 2006. Nova filed with the court a motion for a stay in the patent litigation case pending completion of the re-examination process of the patent in the lawsuit by the PTO. After reading and considering the arguments presented by the parties, the Court granted Nova's motion to stay. On May 25, 2007 the PTO rejected all 5 claims of U.S. Patent No. Re 34,783 filed by Nanometrics and, in view of Nanometrics' failure to file an appropriate response to the rejection, on August 16, 2007, the PTO issued a Notice of Intent to Issue a

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Re-examination Certificate, cancelling all 5 claims of the patent. In October 2006, Nanometrics filed a lawsuit with the District Court of Northern California alleging that Nova infringes U.S. Patent Numbers 5,867,276, and 7,115,858 B1. In April 2007, we reached a settlement with Nanometrics regarding all three patent suits between the companies. We agreed to dismiss, without prejudice, all pending patent litigation between the two parties, and have further agreed not to file patent suits against the other party and/or any supplier or customer of the other party for patent infringement based on offers to sell, actual sales, manufacturing, purchase or use of any equipment of the other party for a period of one year. The settlement, which received court approval, terminated the three lawsuits pending in the U.S. District Court for the Northern District of California. No permanent settlement has been reached in these suits. Should the disputes be reopened, even if we are ultimately successful, it could result in substantial costs and diversion of time and effort by our management. This in and of itself could have a negative impact on us. For additional information regarding this litigation, see [Intellectual Property](#) starting on page 18.

### Dividend Policies

We anticipate that, for the foreseeable future, we will retain any earnings to support operations and to finance the growth and development of our business. Therefore, we do not expect to pay cash dividends for at least the next several years.

We obtained the status of [approved enterprise](#) under the Law for the Encouragement of Capital Investments, 1959, under which we may take advantage of certain tax exemptions. We may further obtain such status in the future. If we distribute a cash dividend from income which is tax exempt, we would have to pay corporate tax at a rate of up to 25% on the amount equal to the amount distributed and on the amount of corporate tax which would have been due in the absence of the tax exemption, in addition to withholding tax on such dividends paid. For further description of the conditions limiting our ability to declare and pay dividends see [Israeli Taxation](#) starting on page 47.

The distribution of dividends may also be limited by the Companies Law, which permits the distribution of dividends only out of retained earnings or earnings derived over the two most recent fiscal years, whichever is higher, provided that there is no reasonable concern that payment of a dividend will prevent a company from satisfying its existing and foreseeable obligations as they become due. Our articles of association provide that dividends will be paid at the discretion of, and upon resolution by, our board of directors however, the board of directors at its discretion, may transfer the decision in this matter to the general meeting.

### Export Sales

Substantially all of our products are sold to customers located outside Israel.

### 8.B Significant Changes

Not applicable.

## Item 9. The Offer and Listing

### 9.A Offer and Listing Details

The information presented in the table below presents, for the periods indicated, the reported high and low closing sales prices on the NASDAQ Global Market of our ordinary shares. The shares began trading on Nasdaq on April 11, 2000 at a price of \$18 per share. Our ordinary shares were registered for trading on the Tel Aviv Stock Exchange in 2002 and the table below presents, for the periods indicated, the reported high and low sales prices on the Tel Aviv Stock Exchange.

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### Nasdaq Global Market

Price per share (US\$)

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High	Low
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		Price per share (US\$)	
<b><u>Yearly highs and lows</u></b>			
<b>2004</b>		8.21	3.00
<b>2005</b>		3.91	1.94
<b>2006</b>		2.90	1.45
<b>2007</b>		3.10	2.10
<b>2008</b>		2.55	0.41
<b><u>Quarterly highs and lows</u></b>			
<b>2007</b>			
	Second quarter	3.09	2.54
	Third quarter	3.05	2.21
	Fourth quarter	2.99	2.10
<b>2008</b>			
	First quarter	2.55	1.70
	Second quarter	2.17	1.25
	Third quarter	1.60	1.11
	Fourth quarter	1.27	0.41
<b>2009</b>			
	First quarter (until March 24, 2009)	1.00	0.37
<b><u>Monthly highs and lows</u></b>			
	September 2008	1.49	1.15
	October 2008	1.27	0.80
	November 2008	1.00	0.52
	December 2008	0.98	0.41
	January 2009	0.78	0.42
	February 2009	0.60	0.34

**Tel Aviv Stock Exchange\***

		Price per share (NIS)	
		High	Low
<b><u>Yearly highs and lows</u></b>			
<b>2005</b>		14.89	9.56
<b>2006</b>		12.79	8.08
<b>2007</b>		13.75	8.50
<b>2008</b>		9.79	1.85
<b><u>Quarterly highs and lows</u></b>			
<b>2007</b>			
	Second quarter	12.74	10.02
	Third quarter	13.75	9.256
	Fourth quarter	13.20	8.50
<b>2008</b>			
	First quarter	9.79	6.67
	Second quarter	8.50	4.796
	Third quarter	5.356	4.283
	Fourth quarter	4.50	1.85
<b>2009</b>			
	First quarter (until March 24, 2009)	2.84	2.05
<b><u>Monthly highs and lows</u></b>			

	Price per share (NIS)	
September 2008	5.35	4.28
October 2008	4.50	3.40
November 2008	3.55	2.002
December 2008	3.703	1.85
January 2009	2.52	1.993
February 2009	2.37	1.53

\*During 2004 there was no market activity on the TASE

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### **9.B Plan of Distribution**

Not applicable.

### **9.C Markets**

Our ordinary shares are quoted on the Nasdaq Global Market and the Tel Aviv Stock Exchange under the symbol NVMI.

### **9.D Selling Shareholders**

Not applicable.

### **9.E Dilution**

Not applicable.

### **9.F Expenses on the Issue**

Not applicable.

## **Item 10. Additional Information**

### **10.A Share Capital**

Not applicable.

### **10.B Memorandum and Articles of Association**

Set forth below is a summary of certain provisions of the Company's Amended and Restated Articles of Association, as adopted by the Company's shareholders on September 25, 2008, and Israeli law affecting shareholders of the Company. This summary does not purport to be complete and is qualified in its entirety by reference to our memorandum and amended and restated articles of association and such law. On September 25, 2008 our shareholders adopted the amended and restated articles of association of the Company (for the purposes of this Item, the

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Amended Articles )

*Registration.* The Company was incepted and registered in the Israeli Registrar of Companies on May 17, 1993, under registration number 51-181-246-3.

*Purpose of the Company.* The purposes of the Company, as provided by Article 4 of our Amended Articles, are (a) to invent, design, plan, develop, manufacture, market and trade in the field of measuring instruments in electronics, micro-electronics, medicine, chemistry, metallurgy, ceramics and any other field, (b) to initiate, participate, manage, execute, import and export any kind of project within the borders of the State of Israel and/or outside Israel, (c) to register patents, trademarks, trade names intellectual property rights marketing rights and any other right of any kind whatsoever, both in Israel and abroad and (d) to engage in any legal activity, both in Israel and abroad.

*Approval of Related Party Transaction; Corporate Borrowings.* The Companies Law, to which the Company is subject, requires that an office holder of a company, including directors and executive officers, promptly disclose to the board of directors of that company any personal interest that the office holder may have and all related material information known about any existing or proposed transaction with the company. The approval of the board of directors is required for a transaction between the company and its office holder or between the company and another person in which the office holder has a personal interest that is not an extraordinary transaction, unless the Amended Articles provide otherwise. If the transaction is an extraordinary transaction, it also requires the approval of the audit committee prior to its being approved by the board of directors. In the event that the transaction is between the company and a director regarding the director's terms of engagement with the company, including with regard to other positions in the company filled by the director and including with respect to indemnification, insurance and exemptions, the transaction requires the approval of the audit committee, the board of directors and the shareholders.

The Companies Law applies the same disclosure requirements to a controlling shareholder of a public company. A controlling shareholder is a shareholder who has the ability to direct the activities of a company, including a shareholder that owns 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights, but excluding a shareholder whose power derives solely from his or her position on the board of directors or any other position with the company. Approving an extraordinary transaction with a controlling shareholder requires the approval of the company's audit committee, the board of directors and the company's shareholders. Approval by the company's shareholder must be by the affirmative vote of a majority of the shares attending in person or by proxy and, in addition, at least one third of the holders of shares who do not have a personal interest in approving the transaction attending in person or represented by proxy must vote in favor of the proposal (shares held by abstaining shareholders are not considered), or the aggregate number of shares voted against the proposal must not exceed one per cent (1%) of a company's voting rights.

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Under our Amended Articles, a transaction by the Company with an office holder including transactions concerning compensation of non-director office holders, and a transaction between the Company and a third person in which an office holder of the Company has a personal interest, which is not an extraordinary transaction, will require only the approval of our board of directors or a committee authorized by our board of directors.

Interested board members may not vote on extraordinary transactions. Arrangements regarding the compensation of directors require approval by the audit committee, board of directors and shareholders. Arrangements as to compensation of officer employment terms, if considered extraordinary transaction, require approval by the audit committee and board of directors.

Under regulations promulgated under the Companies Law regarding payment of compensation to external directors, compensation of external directors shall be comprised of annual compensation and a per meeting payment ranging as stated in the regulations. These amounts are adjusted twice a year in accordance with the Israeli consumer price index. With regard to a company, which shares are traded in an exchange outside of Israel, and is subject to laws which impose upon the external directors duties which exceed the duties imposed upon them under Israeli law, the maximum amount payable to the external directors is NIS 115,400 per annum and NIS 3,470 per meeting. The approval of the shareholders of the Company is required for such compensation, unless it is between the maximum and fixed amounts set forth in these regulations. Alternatively, the compensation of external directors may be linked to the compensation of other directors subject to certain restrictions. Additionally, external directors may be entitled to compensation in stock (including by way of granting options to purchase the Company's stock), provided that such compensation is granted within the framework of a stock incentive plan applicable to all other directors and further provided the amount of stock granted or purchasable shall not fall below the lowest amount granted to any other director and shall not exceed the average amount of stock granted to all other directors. In 2008, these regulations were amended to allow an increased compensation to external directors who are considered expert external directors under these regulations.

*Share Capital.* The Company currently has one class of ordinary shares, 0.01 NIS par value per share. The Amended Articles provide that the board of directors may decide on a distribution, subject to the provisions set forth under the Companies Law and the Amended Articles. Under the Companies Law, dividends may be paid out of net earnings, as calculated under that law, for the two years preceding the distribution of the dividend and retained earnings, provided that there is no reasonable concern that the dividend will prevent the company from satisfying its

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existing and foreseeable obligations as they become due. For more information, see the Company's balance sheet and the statement of shareholders' equity in the financial statements. Each ordinary share is entitled to one vote at all shareholders meetings.

*Changes of Rights of Holders of the Shares.* According to the Amended Articles, any change in the rights and privileges of the holders of any class of shares shall require the approval of a class meeting of such class of shares by a simple majority (unless otherwise provided by the Companies Law or the regulations thereto or by the terms of issue of the shares of that class).

*Shareholders Meetings.* An annual meeting shall be convened at least once every calendar year, and no later than 15 months after the preceding annual meeting, to review the Company's financial statements and to transact any other business required pursuant to the Amended Articles or to the Companies Law, and any other matter which the board of directors places on the agenda of the annual meeting, at a time and place that the board of directors shall determine. A special meeting may be called by the board of directors and at the demand of any of the following: two directors or one-quarter of the directors then serving; one or more shareholders who hold at least five per cent of the issued and outstanding capital stock and at least one percent of the voting rights in the Company; or one or more shareholders who hold at least five percent of the voting rights in the Company.

According to the Amended Articles, the quorum required for an ordinary meeting of shareholders is at least two shareholders present in person or by proxy who together hold or represent in the aggregate more than one third (33.33%) of the voting power. A meeting adjourned for lack of a quorum is adjourned one day thereafter at the same time and place or to such other day, time and place as our board of directors may indicate in a notice to the shareholders. At the reconvened meeting, the required quorum consists of any number of members present in person or by proxy, regardless of the number of shares represented. The Companies Law and regulations determine that prior notice of no less than 21 days should be given to the company's shareholders, prior to convening a meeting. In the event that the issue to be resolved is an issue listed in Article 87 to the Companies Law, a notice of no less than 35 days should be given to the company's shareholders.

Subject to anti-terror legislations, there are no limitations on the rights of non-resident or foreign owners to hold or vote ordinary shares imposed under Israeli law or under the Amended Articles.

*Board of Directors.* The Amended Articles provide that directors may be elected either at our annual general meeting or a special meeting of shareholders by a vote of the holders of more than 50% of the total number of votes represented at such meeting. In addition, our board of directors is authorized to appoint directors, at its discretion, provided that the total number of directors shall not exceed the maximum number of directors permitted by the Amended Articles. Each of our directors holds office until the next annual general meeting of shareholders. However, in accordance with the Companies Law, our external directors serve for three years, which may be renewed for additional three year terms, if both the audit committee and the board of directors confirm that in light of the expertise and contribution of the external director, the extension of such external director's term would be in the interest of our company (such requirement is not applicable to the first three-year renewal). The Companies Law requires that the offices of the Chief Executive Officer and the Chairman of the Board of Directors be held by different persons. However, the Companies Law further provides that those positions may be held by the same person for a period not exceeding three years if approved by a majority of the company's shareholder, including at least two thirds of the voting shareholders present (shares held by abstaining shareholders are not considered) which are not controlling shareholders or the aggregate number of shares voting against the proposal shall not exceed 1% of company voting shareholders.

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The Companies Law provides that Israeli public companies must have at least two external directors. External directors may be elected at our annual general meeting or a special meeting of our shareholders in a number and manner stipulated by law, namely, for a term of three years which may be renewed for additional three year terms and requires the affirmative vote of a majority of the shares and in addition either that (i) at least one third (33.33%) of the holders of shares who are not controlling shareholders attending in person or represented by proxy have voted in favor of the proposal (shares held by abstaining shareholders shall not be considered) or (ii) the aggregate number of shares voting against the proposal has not exceeded 1% of the company's voting shareholders. External directors may be removed from office only under the following circumstances: (i) an external director ceases to meet the legal requirements for appointment as an external director or breaches his or her fiduciary duty to the company and a resolution to remove such external director is made by the shareholders at a meeting at which such external director is granted a reasonable opportunity to express his position (such a resolution requires the same majority of votes that elected the external director); (ii) an external director ceases to meet the legal requirements for appointment as an external director or breaches his or her fiduciary duty to the Company and a court orders that such director be removed; or (iii) an external director is unable to perform his or her duties or is convicted of certain felonies and a court orders that such director be removed.

An external director is qualified for nomination as an external director, only if he/she has either professional qualifications or accounting and financial expertise. At least one of the external directors must have accounting and financial expertise. However, a company whose shares are traded in certain exchanges outside of Israel, including the Nasdaq Global Market, such as our company, is not required to nominate at least one external director who has accounting and financial expertise as long as another independent director for audit committee purposes who has such expertise serves on the board of directors pursuant to the applicable foreign securities laws. In such case all external directors will have

professional qualification.

Regulations adopted under the Companies Law provide that a director with accounting and financial expertise is a director that due to his education, experience and skills has high expertise and understanding in business-accounting matters and financial statements in a way that enables him to deeply understand the financial statements of the company and to facilitate discussion with respect to the way the financial data should be presented. The assessment of the accounting and financial expertise of a director shall be made by the board of directors, who shall take into consideration, *inter alia*, the education, experience and knowledge of the director in the following subjects:

- (1) Accounting matters and audit accounting matters, which are typical to the sector in which the company works and of companies with the same size and complexity as of the company;
- (2) The duties and obligations of the auditing accountant; and
- (3) Preparing of financial statements and their approval according to applicable law, including securities law.

The regulations also provide that a director with professional qualifications is a director who meets one of the following conditions:

- (1) A holder of an academic degree in one of the following: economics, business administration, accounting, law, or public administration;
- (2) A holder of another academic degree or is otherwise a graduate of higher education in a major field of business of the company or in other field which is relevant to the role;
- (3) He has experience of at least five years in one of the following, or that he has cumulative experience of at least five years in two or more of the following:
  - (a) A senior position in the business management of a corporation which has a significant scope of business;
  - (b) A senior public position or in a senior role in the public service; or
  - (c) A senior position in the company's major fields of business.

According to the Companies Law, the board of directors of a public company must establish the minimum number of board members that are to have accounting and financial expertise while considering, *inter alia*, the nature of the company, its size, the scope and complexity of its operations and the number of directors stated in the Amended Articles.

In April 2006, the board of directors resolved that the minimum number of board members that need to have accounting and financial expertise, including the external director with accounting and financial expertise is one (1).

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The board of directors determined that each of Mr. Dan Falk and Ms. Naama Zeldis has accounting and financial expertise as described in the regulations promulgated pursuant to Companies Law, and that, therefore, the requirements of the minimum number of board members that need to have accounting and financial expertise, as set by the board of directors, has been met.

On September 29, 2008, Amendment No. 8 to the Companies Law came into effect. The amendment states that a publicly traded company will be able to determine the number of independent directors that will serve on the company's board of directors. The amendment also sets a recommendation as to the number of independent directors a public company should appoint to their board: (i) companies with a controlling shareholder – one third; and (ii) other companies – a majority of the board. A Majority of our board members are independent as required by Nasdaq rules which are different than the independence standard of the Companies Law.

*Changes in Capital.* Our share capital may be increased or decreased by a vote of our shareholders in accordance with the Companies Law.

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*Acquisition of a Controlling Stake.* According to the Companies Law, an acquisition pursuant to which a purchaser shall hold a controlling stake, that is defined as 25% or more of the voting rights if no other shareholder holds a controlling stake, or an acquisition pursuant to which such purchaser shall hold more than 45% of the voting rights of the company if no other shareholder owns more than 45% of the voting rights, may not be performed by way of market accumulation, but only by way of a tender offer made to all of the company's shareholders on a pro rata basis. Such offer needs to be approved by the company's shareholders. A shareholder may be free to object to such an offer without such objection being deemed as a waiver of his right to sell its respective shares if the transaction is approved by a majority of the company's shareholders despite his objection. Shares purchased not in accordance with those provisions shall become dormant shares and shall not grant the purchaser any rights so long as they are held by the purchaser.

*Acquisition.* The Companies Law requires an acquirer of a public company's shares who wishes to acquire all of the company's shares without the approval of its minority shareholders to acquire at least 95% of all outstanding shares. Even if the acquirer acquires 95% of the outstanding shares, the remaining minority shareholders may seek to block the acquisition in court.

The Companies Law provides that corporate mergers require the approval of both companies' boards of directors and shareholders. In the event, however that shares of the target company are held by the acquiring company or by a person holding 25% or more of any type of controlling means of the acquiring company, the merger will not be approved if a majority of the shareholders of the target company attending and voting at the meeting at which the merger is considered (without taking into account, for that purpose, the shares held by the acquiring company or by a person holding 25% or more of any type of controlling means of the acquiring company) object to and do not vote in favor of the merger. If a person holds 25% or more of any type of controlling means of more than one merging company, the same provisions shall apply with regard to the shareholders' vote with respect to each such company. Upon the request of a creditor of either party to the proposed merger, the court may delay or prevent the merger if the court concludes that there exists a reasonable concern that as a result of the merger the surviving company will be unable to satisfy the target company's obligations. Furthermore, a merger may not close unless at least 30 days have passed from the time that the general meeting of each of the merging companies was held and at least 50 days have passed from the date on which the merger proposal was sent to the Israeli Registrar of Companies.

In addition, the Companies Law preserves provisions of its predecessor, the Companies Ordinance, dealing with arrangements between a company and its shareholders. These arrangements may be used to effect squeeze out transactions in which the target company becomes a wholly owned subsidiary of the acquirer. These provisions generally require that the merger be approved by at least 75% of the shares of participating shareholders and a majority of the shareholders voting at a shareholders meeting. In addition to shareholder approval, court approval of the transaction is required, which entails further delay.

A merger, the acquisition of a controlling stake or any transaction in which all or substantially all the assets of a company are de facto transferred to another company, may require the approval of the Israeli Commissioner of Restrictive Trade Practices, in the event that the aggregate annual sales volume in Israel of all the companies which are parties to such transaction in the year preceding the merger, exceeds NIS 150 million (approximately \$38 million an amount which is adjusted on an annual basis) and the annual sales volume in Israel of at least two of the companies which are parties to such transaction exceeds NIS 10 million each (approximately \$2.6 million an amount which is adjusted on an annual basis), and also if after the consummation of such transactions, the joint market, in Israel, or at any identified geographic part of Israel will be in excess of 50% with respect to such products and services.

### 10.C Material Contracts

On February 28, 2007, we entered into a Share Purchase Agreement with four investors, including Clal Electronics Industries Ltd., pursuant to which such investors purchased in the aggregate 1,937,983 ordinary shares of the Company, at a price of \$2.58 per share, for gross proceeds of \$5 million. In connection with this transaction, we issued warrants to these investors to purchase 1,453,485 additional ordinary shares at an exercise price of \$3.05 per share.

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### 10.D Exchange Controls

Non-residents of Israel who purchase our ordinary shares outside of Israel with U.S. dollars or other foreign currency will be able to convert dividends (if any) thereon, and any amounts payable upon the dissolution, liquidation or winding up of the affairs of the Company, as well as the proceeds of any sale in Israel of the ordinary shares to an Israeli resident, into freely repatriable dollars, at a rate of exchange prevailing at the time of conversion, pursuant to regulations issued under the Currency Control Law, 1978, provided that Israeli income tax has been withheld by the Company with respect to such amounts. Israeli residents are eligible to purchase securities of certain companies, including our ordinary shares, if they are listed on a foreign exchange in a designated country, which is defined to include the Nasdaq.



**10.E Taxation****Israeli Taxation**

The following is a summary of the principal Israeli tax laws applicable to us, and of the Israeli government programs benefiting us. This summary does not discuss all the acts of Israeli tax law that may be relevant to a particular investor in light of his or her personal investment circumstances or to some types of investors subject to special treatment under Israeli law. Examples of this kind of investor include residents of Israel, traders in securities or persons that own, directly or indirectly, 10% or more of our outstanding voting capital, all of whom are subject to special tax regimes not covered in this discussion. Some parts of this discussion are based on new tax legislation which has not been subject to judicial or administrative interpretation. The discussion should not be construed as legal or professional tax advice and does not cover all possible tax consequences.

Shareholders are urged to consult their own tax advisors as to the Israeli or other tax consequences of the purchase, ownership and disposition of our ordinary shares, including, in particular, the effect of any foreign, state or local taxes.

**General Corporate Tax Structure in Israel**

The corporate tax rate applicable in 2008 was 27%. This rate was reduced to 26% in 2009 and had been scheduled to be reduced to 25% in 2010 and beyond.

However, as discussed below, the rate is effectively reduced for income derived from an Approved Enterprise/Privileged Enterprise.

**Law for the Encouragement of Capital Investments, 1959**

*General.* The Law for the Encouragement of Capital Investments, 1959 (the Investment Law ) provides that a capital investment in eligible facilities may, upon application to the Investment Center of the Ministry of Industry Trade, and Labor of the State of Israel, or the Investment Center, be designated as an Approved Enterprise. Each certificate of approval for an Approved Enterprise relates to a specific investment program delineated both by its financial scope, including its capital sources, and by its physical characteristics, e.g., the equipment to be purchased and utilized pursuant to the program. The tax benefits derived from any such certificate of approval relate only to taxable income attributable to the specific Approved Enterprise.

Subject to certain provisions concerning income and subject to the Alternative Benefits (see below), any distributed dividends are deemed attributable to the entire enterprise, and the effective tax rate and the effective withholding tax rates represent the weighted combination of the various applicable tax rates.

*Tax Benefits.* Taxable income of a company derived from an Approved Enterprise is subject to company tax at the rate of up to 25%, instead of the tax rates under the General Corporate Tax Structure above, for a certain period of time. The benefit period is a period of seven years commencing in the year in which the Approved Enterprise first generates taxable income. The benefits may be shorter as it is limited to 12 years from the commencement of production of the Approved Enterprise or 14 years from the date of approval, whichever is earlier. Under certain circumstances (as further detailed below), the benefit period may extend to a maximum of ten years from the commencement of the benefit period. A company which operates under more than one approval or that has capital investments which are only partly approved (such a company being designated as a Mixed Enterprise), may have an effective company tax rate that is the result of a weighted combination of the various applicable rates.

A company owning an Approved Enterprise which was approved after April 1, 1986 may elect to forego the entitlement to grants or state guarantees and apply for an alternative package of tax benefits. These benefits provide that undistributed income from the Approved Enterprise is fully tax exempt from corporate tax for a defined period, which ranges between two and ten years from the first year of taxable income, subject to the limitations described above, depending principally upon the geographic location within Israel and the type of the Approved Enterprise. Upon expiration of such period, the Approved Enterprise is eligible for a beneficial tax rate (25% or lower in the case of an FIC, as described below), for the remainder of the otherwise applicable period of benefits, as described above.

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Should the percentage of share capital of the companies having Approved Enterprises held by foreign shareholders exceed 25%, future Approved Enterprises of such companies would qualify for reduced tax rates for an additional three years, after the seven years mentioned above. The company tax rate applicable to income earned from Approved Enterprise programs in the benefit period by a company meeting these

qualifications is as follows:

% of Foreign Ownership	Tax Rate
Over 25% but less than 49%	25%
49% or more but less than 74%	20%
74% or more but less than 90%	15%
90% or more	10%

Entitlement to these tax benefits for enterprises to which Investment Center granted an Approved Enterprise status prior to December 31, 2004 is subject to the final ratification of the Investment Center, and is conditioned upon fulfillment of all terms of the approved program. However, there can be no assurance that our company, which currently enjoys Approved Enterprise benefits, will obtain approval for additional Approved Enterprises, or that the provisions of the Investment Law will not change with respect to future approvals, or that the above-mentioned shareholding portion will be reached for each subsequent year. In the event of our failure to comply with these conditions, the tax and other benefits could be canceled, in whole or in part, and we might be required to refund the amount of the canceled benefits, together with the addition of CPI linkage difference and interest. We believe that our Approved Enterprise substantially complies with all such conditions at present, but there can be no assurance that it will continue to do so.

A company that pays a dividend out of income derived from the Approved Enterprise(s) during the tax exemption period will be subject to deferred company tax in respect of the amount distributed (including the recipient's tax thereon) at the rate which would have been applicable had such company not elected the Alternative Package. This rate is generally 10% to 25%, depending, as described above, on the extent to which non-Israeli shareholders hold such company's shares.

The dividend recipient is taxed at the reduced rate applicable to dividends from Approved Enterprises (generally 15% as compared to 20%/25% for individuals or an exemption for Israeli resident companies), if the dividend is distributed during the tax benefit period or within 12 years after this period. However, the limitation does not apply if the company qualifies as a foreign investors' company. This tax must be withheld by such company at source, regardless of whether the dividend is converted into foreign currency.

Subject to certain provisions concerning income subject to Mixed Enterprises, all dividends are considered to be attributable to the entire enterprise and the effective tax rate on the dividend is the result of a weighted combination of the various applicable tax rates. However, such company is not obliged to distribute exempt retained profits under the Alternative Package, and such company may generally decide from which year's profits to declare dividends.

Each application to the Investment Center is reviewed separately, and a decision as to whether or not to approve such application is based, among other things, on the then prevailing criteria set forth in the Investment Law, on the specific objectives of the applicant company set forth in such application and on certain financial criteria of the applicant company. Accordingly, there can be no assurance that any such application by our company will be approved. In addition, the benefits available to an Approved Enterprise are conditional upon the fulfillment of certain conditions stipulated in the Investment Law and its regulations and the criteria set forth in the certificate of approval, as described above. In the event that these conditions are violated, in whole or in part, a company with an Approved Enterprise would be required to refund the amount of tax benefits, with the addition of the Israeli consumer price index linkage differences and interest.

A company which qualifies as a foreign investment company (FIC) is a company in which more than 25% of the share capital (in terms of shares, rights to profit, voting rights and appointment of directors) and of the combined share and loan capital is owned, directly or indirectly, by non-residents of Israel and is therefore entitled to further tax benefits relating to its approved enterprises. Such a company will be eligible for an extension of the period of tax benefits for its approved enterprises (up to ten years) and further tax benefits, should the level of foreign ownership in it increase above 49%.

From time to time, the government of Israel has discussed reducing the benefits available to companies under the Investment Law and currently such proposal is pending.

*Amendment no. 60.* Notwithstanding the foregoing, an amendment to the Investments Law, which effective as of April 1, 2005, has changed certain provisions of the Investments Law. The amendment includes revisions to the criteria for investments qualified to receive tax benefits as an approved enterprise. This amendment applies to new investment programs and investment programs commencing after 2004, and does not apply to investment programs approved prior to December 31, 2004. However, a company that was granted benefits according to section 51 of the Investments Law prior to the amendment would not be allowed to apply for benefits under the new amendment for a period of three years from the date of commencement of the beginning of the year the privileged enterprise was operated (reduced to a period of two years under certain conditions). According to the amendment, only approved enterprises receiving cash grants require the prior approval of the Investment Center.

The Amendment does not apply to benefits included in any certificate of approval that was granted before the amendment came into effect, which will remain subject to the provisions of the Investments Law as they were on the date of such approval.

The basic condition for receiving the benefits under this track is that the enterprise contributes to the country's economic independence and is a competitive factor for the Gross Domestic Product (a 'Competitive Enterprise'). In order to comply with this condition, the Investment Law prescribes various requirements regarding industrial enterprises. In each tax year during the benefit period, one of the following conditions must be met:

1. The enterprise's main activity is in the area of biotechnology or nanotechnology as approved by the Head of the Administration of Industrial Research and Development, prior to the approval of the aforementioned plan.
2. The enterprise's revenues during the tax year from the plant's sales in a certain market do not exceed 75% of total revenues from the plant's total sales during that tax year. A 'market' is defined as a distinct country or customs territory.
3. 25% or more of the enterprise's total revenues from the plant's sales during the tax year are from sales to a certain market that numbers at least 12 million residents.

An industrial enterprise that sells a specific product that constitutes a component in another product manufactured by another industrial enterprise (which is, or was, a beneficiary enterprise or an approved enterprise), the enterprise must meet the conditions stipulated in the relevant regulations regarding the encouragement of capital investments.

In order to receive the tax benefits, the amendment states that a company must make an investment in the Privileged Enterprise exceeding a certain percentage or a minimum amount specified in the Investments Law. Such investment may be made over a period of no more than three years, ending at the end of the year in which the company requested to have the tax benefits apply to the Privileged Enterprise (the 'Year of Election'). Where the company requests to have the tax benefits apply to an expansion of existing facilities, then only the expansion will be considered a Privileged Enterprise and the company's effective tax rate will be the result of a weighted combination of the applicable rates. In this case, the minimum investment required in order to qualify as a Privileged Enterprise is required to exceed a certain percentage or a minimum amount of the company's production assets before the expansion.

The duration of these tax benefits is limited to the earlier of 7 to 10 years from the Commencement Year or 12 years from the first day of the Year of Election. Commencement Year is defined as the later of the first tax year in which a company had derived liable income for tax purposes from the Privileged Enterprise, or the year of election which is the year in which a company requested to have the tax benefits apply to the Privileged Enterprise. The tax benefits granted to a Privileged Enterprise are determined, depending on the geographic location of the Privileged Enterprise within Israel, inter alia, according to one of the following:

1. Similar to the currently available Alternative Track, exemption from corporate tax may be available on undistributed income for a period of two to ten years, depending on the geographic location of the Privileged Enterprise within Israel, and a reduced corporate tax rate of 10% to 25% for the remainder of the benefit period, depending on the level of foreign investment in each year. Benefits may be granted for a term of seven to ten years, depending on the level of foreign investment in the company. If the company pays a dividend out of income derived from the Privileged Enterprise during the tax exemption period, such income will be subject to corporate tax at the applicable rate (10%-25%) with respect to the gross amount of the dividend that we may distribute. The company is required to withhold tax on such distribution at a rate of 15%; or
2. A special track which enables companies owning facilities in certain geographical locations in Israel to pay corporate tax at the flat rate of 11.5% on income of the Privileged Enterprise (the 'Ireland Track'). The benefit period is for ten years. Upon payment of dividends, the company is required to withhold tax on such dividend at a rate of 15% for Israeli residents and at a rate of 4% for foreign residents.

Generally, a company that is abundant in foreign investment (owned by at least 74% foreign shareholders and has undertaken to invest a minimum sum of \$20 million in the Privileged Enterprise) is entitled to an extension of the benefit period by an additional five years, depending on the rate of its income that is derived in foreign currency.

The amendment changes the definition of foreign investment in the Investments Law so that the definition now requires a minimal investment of NIS 5 million by foreign investors. Furthermore, such definition now also includes the purchase of shares of a company from another shareholder, provided that the company's outstanding and paid-up share capital exceeds NIS 5 million. Such changes to the aforementioned definition will take effect retroactively from 2003.

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### Law for the Encouragement of Industry (Taxes), 1969

Pursuant to the Law for the Encouragement of Industry (Taxes), 1969, a company qualifies as an Industrial Company if it is a resident of Israel and at least 90% of its gross income in any tax year (exclusive of income from certain defense loans, capital gains, interest and dividends) is derived from an industrial enterprise it owns. An industrial enterprise is defined as an enterprise whose major activity, in a given tax year, is industrial manufacturing.

Industrial Company is entitled to certain tax benefits, including a deduction of 12.5% per annum on the purchase of patents or certain other intangible property rights (other than goodwill) used for the development or promotion of the industrial enterprise over a period of eight years beginning with the year in which such rights were first used.

The tax laws and regulations dealing with the adjustment of taxable income for local inflation provide that an industrial enterprise is eligible for special rates of depreciation deductions. These rates vary in the case of plant and machinery according to the number of shifts in which the equipment is being operated and range from 20% to 40% on a straight-line basis, or 30% to 50% on a declining balance basis (instead of the regular rates which are applied on a straight-line basis).

Moreover, industrial enterprises which are Approved Enterprises (see above) can choose between (a) the special rates referred to above and (b) accelerated regular rates of depreciation applied on a straight-line basis with respect to property and equipment, generally ranging from 200% (with respect to equipment) to 400% (with respect to buildings) of the ordinary depreciation rates during the first five years of service of these assets, provided that the depreciation on a building may not exceed 20% per annum. In no event may the total depreciation exceed 100% of the cost of the asset.

In addition, Industrial Companies may (i) elect to file consolidated tax returns with additional related Israeli Industrial Companies and (ii) deduct expenses related to public offerings in equal amounts over a period of three-years.

Eligibility for benefits under the Encouragement of Industry Law is not contingent upon the approval of any governmental authority.

### Taxation of Shareholders

#### Capital Gains

Capital gain tax is imposed on the disposal of capital assets by an Israeli resident, and on the disposal of such assets by a non-Israel resident if those assets are either (i) located in Israel; (ii) are shares or a right to a share in an Israeli resident corporation, or (iii) represent, directly or indirectly, rights to assets located in Israel. The Israeli Tax Ordinance distinguishes between Real Gain and the Inflationary Surplus. Real Gain is the excess of the total capital gain over Inflationary Surplus computed generally on the basis of the increase in the Israeli CPI between the date of purchase and the date of disposal.

The capital gain accrued by individuals on the sale of an asset purchased on or after January 1, 2003 will be taxed at the rate of 20%. However, if the individual shareholder is a Controlling Shareholder (i.e., a person who holds, directly or indirectly, alone or together with other, 10% or more of one of the Israeli resident company's means of control at the time of sale or at any time during the preceding 12 months period) such gain will be taxed at the rate of 25%. In addition, capital gain derived by an individual claiming deduction of financing expenses in respect of such gain will be taxed at the rate of 25%. The real capital gain derived by corporation will be generally subject to tax at the rate of 25%. However, the real capital gain derived from sale of securities, as defined in Section 6 of the Inflationary Adjustment Law, by a corporation, which was subject on August 10, 2005 to the provisions of Section 6 of the Inflationary Adjustment Law, will be taxed at the corporate tax rate (27% in 2008 and 26% in 2009). The capital gain accrued on the sale of an asset purchased prior to January 1, 2003 will be subject to tax at a blended rate. The marginal tax rate for individuals (up to 47% in 2008 and 46% in 2009) and the regular corporate tax rate for corporations (27% in 2008 and 26% in 2009) will be applied to the portion of the gain amount which bears the same ratio to the total gain realized as the ratio which the holding period commencing at the acquisition date and terminating on January 1, 2003 bears to the total holding period. The remainder of the gain realized will be subject to capital gains tax at the rates applicable to an asset purchased after January 1, 2003 (see aforementioned).

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Individual and corporate shareholder dealing in securities in Israel are taxed at the tax rates applicable to business income (27% in 2008 and 26% in 2009 tax rate for a corporation and a marginal tax rate of up to 47% in 2008 and 46% in 2009 for individual). Notwithstanding the foregoing, if the shareholder is a non-Israeli resident, then such taxation is subject to the provision of any applicable double tax treaty. Moreover, capital gain derived from the sale of securities by a non-Israeli shareholder may be exempt under the Israeli income tax ordinance from Israeli taxation provided the following cumulative conditions are met: (i) the securities were purchased upon or after the registration of the securities on the stock exchange (this condition shall not apply to shares purchased on or after 1.1.2009), (ii) the seller doesn't have a permanent establishment in Israel to which the derived capital gain is attributed, and (iii) if the seller is a corporation, less than 25% of its means of control are held by Israeli resident shareholders. In addition, the sale of the securities may be exempt from Israeli capital gain tax under an applicable tax treaty. Thus, the U.S.-Israel Double Tax Treaty exempts U.S. resident from Israeli capital gain tax in connection with such sale, provided (i) the U.S. resident owned, directly or indirectly, less than 10% of an Israeli resident company's voting power at any time within the 12 month period preceding such sale; (ii) the seller, being an individual, is present in Israel for a period or periods of less than 183 days at the taxable year; and (iii) the capital gain from the sale was not derived through a permanent establishment of the U.S. resident in Israel.

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Either the seller, the Israeli stockbrokers or financial institution through which the sold securities are held are obliged, subject to the above mentioned exemptions, to withhold tax upon the sale of securities from the real capital gain at the rate of 25% in respect of a corporation and 20% in respect of an individual.

At the sale of traded securities a detailed return, including a computation of the tax due, should be filed and an advanced payment should be paid on January 31 and June 31 of every tax year in respect of sales of securities made within the previous six months. However, if all tax due was withheld at source according to applicable provisions of the Israeli Income Tax Ordinance and regulations promulgated thereunder the aforementioned return should not be filed and no advance payment should be paid. Capital gain is also reportable on the annual income tax return.

### Dividends

A distribution of dividend from income attributed to an Approved Enterprise will be subject to tax in Israel at the rate of 15%, subject to a reduced rate under any applicable double tax treaty. A distribution of dividend from income, which is not attributed to an Approved Enterprise to an Israeli resident individual, will generally be subject to income tax at a rate of 20%. However, a 25% tax rate will apply if the dividend recipient is a Controlling Shareholder (i.e., a person who holds, directly or indirectly, alone or together with other, 10% or more of one of the Israeli resident company's means of control at the time of distribution or at any time during the preceding 12 months period). If the recipient of the dividend is an Israeli resident corporation, such dividend will be exempt from income tax provided the income from which such dividend is distributed was derived or accrued within Israel.

Under the Israeli income tax ordinance, a non-Israeli resident (either individual or corporation) is generally subject to an Israeli income tax on the receipt of dividends at the rate of 20% (25% if the dividends recipient is a Controlling Shareholder (as defined above)); those rates are subject to a reduced tax rate under an applicable double tax treaty. Thus, under the Double Tax Treaty concluded between the State of Israel and the U.S. the following rates will apply in respect of dividends distributed by an Israeli resident company to a U.S. resident: (i) if the U.S. resident is a corporation which holds during that portion of the taxable year which precedes the date of payment of the dividend and during the whole of its prior taxable year (if any), at least 10% of the outstanding shares of the voting stock of the Israeli resident paying corporation and not more than 25% of the gross income of the Israeli resident paying corporation for such prior taxable year (if any) consists of certain type of interest or dividends the tax rate is 12.5%, (ii) if both the conditions mentioned in section (i) above are met and the dividend is paid from an Israeli resident company's income which was entitled to a reduced tax rate applicable to an Approved Enterprise the tax rate is 15%, and (iii) in all other cases, the tax rate is 25%. The aforementioned rates under the Israel U.S. Double Tax Treaty will not apply if the dividend income was derived through a permanent establishment of the U.S. resident in Israel.

An Israeli resident company whose shares are listed in a stock exchange is obligated to withhold tax, upon the distribution of a dividend attributed to an Approved Enterprise's/Privileged Enterprise income, from the amount distributed, at the following rates: (i) Israeli resident corporation 15%, (ii) Israeli resident individual 15%, and (iii) non-Israeli resident 15% (4% under the Ireland Track), subject to a reduced tax rate under an applicable double tax treaty. If the dividend is distributed from an income not attributed to the Approved Enterprise/Privileged Enterprise, the following withholding tax rates will apply: (i) Israeli resident corporation 0%, (ii) Israeli resident individual 20% (iii) non-Israeli resident 20%, subject to a reduced tax rate under an applicable double tax treaty.

### Estate and Gift Tax

The Israeli law presently does not impose estate or gift tax.

## U.S. Taxation

The following describes the material U.S. federal income tax consequences of the purchase, ownership and disposition of our ordinary shares to a U.S. holder.

For purposes of this discussion, a U.S. holder is:

a natural person who is a citizen or resident of the U.S.;

a corporation or another entity taxable as a corporation created or organized under the laws of the U.S. or any political subdivision of the U.S.;

an estate, the income of which is includable in gross income for U.S. federal income tax purposes regardless of its source; or

a trust, if (a) a U.S. court is able to exercise primary supervision over its administration and (b) one or more U.S. persons have the authority to control all of its substantial decisions.

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This summary is for general information purposes only and does not purport to be a comprehensive description of all of the U.S. federal income tax considerations that may be relevant to a decision to purchase, hold or dispose of the Company's ordinary shares. This summary generally considers only U.S. holders that will own the ordinary shares as capital assets and does not consider the U.S. tax consequences to a person that is not a U.S. holder or the tax treatment of persons who hold the ordinary shares through a partnership or other pass-through entity. In addition, the possible application of U.S. federal estate or gift taxes or any aspect of state, local or non-U.S. tax laws is not considered. This discussion is based on current provisions of the Internal Revenue Code of 1986, as amended (the Code), current and proposed Treasury Regulations promulgated under the Code, and administrative and judicial interpretations of the Code, all as in effect today and all of which may change, possibly with a retroactive effect.

This discussion does not address all aspects of U.S. federal income taxation that may be relevant to any particular U.S. holder based on the holder's particular circumstances, such as,

persons who own, directly, indirectly or constructively, 10% or more of our outstanding voting shares;

persons who hold the ordinary shares as part of a hedging, straddle or conversion transaction;

persons whose functional currency is not the dollar;

persons who acquire their ordinary shares in a compensatory transaction;

broker-dealers;

insurance companies;

tax-exempt organizations;

financial institutions; and

persons subject to the alternative minimum tax.

## Availability of Reduced Tax Rates

U.S. legislation enacted in 2003 reduced to 15% the maximum U.S. Federal income tax rate on certain long-term capital gains and on qualifying dividends. Long-term capital gains from the sale of our ordinary shares would be eligible for this reduced rate. Dividends, if any, would also be eligible for this reduced rate, provided that we do not constitute a passive foreign investment company.

**Distributions on the Ordinary Shares**

We currently do not intend to pay dividends for at least the next several years. However, if we make any distributions of cash or other property to a U.S. holder of our ordinary shares, the amount of the distribution for U.S. federal income tax purposes will equal the amount of cash and the fair market value of any property distributed and will also include the amount of Israeli taxes withheld, if any, as described above under "Dividends" starting on page 51. In general, a distribution paid by us on the ordinary shares to a U.S. holder will be treated as dividend income if the distribution does not exceed our current or accumulated earnings and profits, as determined for U.S. federal income tax purposes. The amount of any distribution which exceeds these earnings and profits will be treated first as a non-taxable return of capital, reducing the U.S. holder's tax basis in its ordinary shares to the extent thereof, and then as capital gain from the deemed disposition of the ordinary shares. Corporate holders generally will not be allowed a deduction for dividends received on the ordinary shares.

A dividend paid by us in NIS will be included in the income of U.S. holders at the U.S. dollar value of the dividend, based upon the spot rate of exchange in effect on the date of the distribution. U.S. holders will have a tax basis in NIS for U.S. federal income tax purposes equal to that U.S. dollar value. Any subsequent gain or loss resulting from exchange rate fluctuations between the day the dividend was included in the income of U.S. holders and the day the NIS are converted into U.S. dollars or are otherwise disposed of, will be taxable as ordinary income, gain or loss from U.S. sources.

Dividends paid by us generally will be foreign source passive income for U.S. foreign tax credit purposes or, in the case of a U.S. holder that is a financial services entity, financial services income. U.S. holders may elect to claim as a foreign tax credit against their U.S. federal income tax liability the Israeli income tax withheld from dividends received on the ordinary shares. The Code provides limitations on the amount of foreign tax credits that a U.S. holder may claim. U.S. holders that do not elect to claim a foreign tax credit may instead claim a deduction for Israeli income tax withheld, but only for a year in which these U.S. holders elect to do so for all foreign income taxes. The rules relating to foreign tax credits are complex (and may also be impacted by the tax treaty between the United States and Israel), and you should consult your tax advisor to determine whether and if you would be entitled to this credit.

**Sale or Exchange of the Ordinary Shares**

Upon the sale or exchange of the ordinary shares, a U.S. holder generally will recognize capital gain or loss in an amount equal to the difference between the amount realized on the sale or exchange and the U.S. holder's tax basis in the ordinary shares. The gain or loss recognized on the sale or exchange of the ordinary shares generally will be long-term capital gain or loss if the U.S. holder's holding period of the ordinary shares is more than one year at the time of the disposition.

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Gain or loss recognized by a U.S. holder on a sale or exchange of ordinary shares generally will be treated as U.S. source income or loss for U.S. foreign tax credit purposes. Under the tax treaty between the United States and Israel, gain derived from the sale, exchange or other disposition of ordinary shares by a holder who is a resident of the U.S. for purposes of the treaty and who sells the ordinary shares within Israel may be treated as foreign source income for U.S. foreign tax credit purposes.

**Passive Foreign Investment Companies**

In general, a foreign (i.e., non-U.S.) corporation will be a passive foreign investment company (a PFIC) for any taxable year if either (1) 75% or more of its gross income in the taxable year is passive income, or (2) 50% or more of the average value of its gross assets in the taxable year is held for the production of, or produces, passive income. For purpose of the income test, passive income includes dividends, interest, royalties, rents, annuities and net gains from the disposition of assets, which produce passive income. For purposes of the assets test, assets held for the production of passive income includes assets held for the production of, or that produce dividends, interest, royalties, rents, annuities, and other income included in the income test. The income test is conducted at the taxable year-end. The asset test is conducted on a quarterly basis and the quarterly results are then averaged together.

If a corporation is treated as a PFIC for any year during a U.S. holder's holding period and the U.S. holder does not timely elect to treat the corporation as a qualified electing fund under Section 1295 of the Code or elect to mark its ordinary shares to market (both as described below), any gain on the disposition of the shares will be treated as ordinary income, rather than capital gain, and the holder will be required to compute its tax liability on that gain, as well as on dividends and other distributions, as if the income had been earned ratably over each day in the U.S. holder's holding period for the shares. The portion of the gain and distributions allocated to prior taxable years in which a corporation was a PFIC will be taxed at the highest ordinary income tax rate in effect for each taxable year to which this portion is allocated. An interest charge will be imposed on the amount of the tax allocated to these taxable years. A U.S. holder may elect to treat a corporation as a qualified electing fund only if the corporation complies with requirements imposed by the IRS to enable the shareholder and the IRS to determine the corporation's ordinary income and net capital gain. Additionally, if a corporation is a PFIC, a U.S. holder who acquires shares in the corporation from a decedent will

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be denied the normally available step-up in tax basis to fair market value for the shares at the date of death and instead will have a tax basis equal to the decedent's tax basis if lower than fair market value.

*Status of Nova as a PFIC.* Under the income test, less than 75% of our gross income was passive income in 2008. The determination of our status under the asset test is more difficult, because that test requires a quarterly determination of the fair market value of our passive and non-passive assets and there is no definitive method set forth in the Code, U.S. Treasury Regulations or administrative or judicial interpretations thereof for determining the value of a foreign corporation's assets under the asset test. While there are no definitive rules, the legislative history of the U.S. Taxpayer Relief Act of 1997 indicates that for purposes of the PFIC assets test, the total value of a publicly-traded foreign corporation's assets generally will be treated as equal to the sum of the aggregate value of its outstanding stock plus its liabilities.

For 2008, while we continued to have substantial amounts of cash and short-term deposits and the market value of our ordinary shares continued to be volatile and decreased, a determination of the value of our assets by reference to the average market value of our ordinary shares and our liabilities results in a conclusion that the average value of our passive assets did not exceed 50% of the average value of our gross assets in 2008. Nonetheless, there is a risk that we were a PFIC in 2008 or we will be a PFIC in 2009 or subsequent years because, as indicated above, there are no definitive rules regarding the manner in which a company should value its assets for purposes of the PFIC asset test.

*Available Elections.* If we will be treated as a PFIC for any taxable year, U.S. holders should consider whether or not to elect to treat us as a qualified electing fund or to elect to mark-to-market their ordinary shares. If a U.S. holder makes a qualified electing fund election (a QEF election) for all taxable years that the U.S. holder holds our ordinary shares and during which we are treated as a PFIC, the U.S. holder will be required for each taxable year to include in income a pro rata share of our undistributed ordinary earnings and net capital gain, if any, as ordinary income and long-term capital gains, respectively. In order to make (or maintain) a QEF election, the U.S. holder must annually complete and file IRS Form 8621. In addition, we must make certain information regarding our net capital gains and ordinary earnings available to the U.S. holder and permit our books and records to be examined to verify such information. Therefore, if you determine that we are a PFIC for any year and make a request to us in writing at the address on the cover of our latest Annual Report on Form 20-F, Attention Chief Financial Officer, for the information required to make a QEF election, we will promptly make the information available to you and comply with any other applicable requirements of the Code.

A QEF election, once made with respect to us, applies to the tax year for which it was made and to all subsequent tax years, unless the election is invalidated or terminated, or the IRS consents to revocation of the election. If you make a QEF election and we cease to be classified as a PFIC in a subsequent tax year, the QEF election will remain in effect, although it will not be applicable during those tax years in which we are not classified as a PFIC. Therefore, if we after ceasing to be classified as a PFIC again are classified as a PFIC in a subsequent tax year, the QEF election will be effective and you will again be subject to the rules described above for U.S. holders making QEF elections in such tax year and any subsequent tax years in which we are classified as a PFIC. A QEF election also remains in effect even after you dispose of all of your direct and indirect interest in our ordinary shares. As a result, if you subsequently acquire any of our ordinary shares or an interest in any of our ordinary shares, you will again be subject to the rules described above for U.S. holders making a QEF election for each tax year in which we are classified as a PFIC.

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Alternatively, if a U.S. holder elects to mark-to-market its ordinary shares, the U.S. holder will generally include in its income any excess of the fair market value of our ordinary shares at the close of each taxable year over the holder's adjusted basis in such ordinary shares. A U.S. holder generally will be allowed an ordinary deduction for the excess, if any, of the adjusted tax basis of the ordinary shares over the fair market value of the ordinary shares as of the close of the taxable year, or the amount of any net mark-to-market gains recognized for prior taxable years, whichever is less. A U.S. holder's adjusted tax basis in the ordinary shares will generally be adjusted to reflect the amounts included or deducted under the mark-to-market election. Additionally, any gain on the actual sale or other disposition of the ordinary shares generally will be treated as ordinary income. Ordinary loss treatment also will apply to any loss recognized on the actual sale or other disposition of ordinary shares to the extent that the amount of such loss does not exceed the net mark-to-market gains previously included with respect to such ordinary shares. An election to mark-to-market generally will apply to the taxable year in which the election is made and all subsequent taxable years. A mark-to-market election applies to the tax year for which the election is made and to each subsequent year, unless our ordinary shares cease to be marketable, as specifically defined, or the IRS consents to revocation of the election. No view is expressed regarding whether our ordinary shares are marketable for these purposes or whether the election will be available.

If a U.S. holder makes either the QEF election or the mark-to-market election, distributions and gain will not be recognized ratably over the U.S. holder's holding period or be subject to an interest charge as described above. Further, the denial of basis step-up at death described above will not apply. If a U.S. holder elects to treat us as a qualified electing fund, gain on the sale of the ordinary shares will be characterized as capital gain. However, U.S. holders making one of these two elections may experience current income recognition, even if we do not distribute any cash. The elections must be made with the U.S. holder's federal income tax return for the year of election, filed by the due date of the return (as it may be extended) or, under certain circumstances provided in applicable Treasury Regulations, subsequent to that date.



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The foregoing discussion relating to the QEF election and mark-to-market elections assumes that a U.S. holder makes the applicable election with respect to the first year in which Nova qualifies as a PFIC. If the election is not made for the first year in which Nova qualifies as a PFIC, the procedures for making the election and the consequences of election will be different.

**A number of specific rules and requirements apply to both the QEF election and the mark-to-market election, and you are urged to consult your tax advisor concerning our PFIC status and the various elections you can make.**

### **United States Information Reporting and Backup Withholding**

Dividend payments and proceeds from the sale or disposal of ordinary shares may be subject to information reporting to the Internal Revenue Service and possible U.S. federal backup withholding at the rate of 28%. Backup withholding will not apply, however, to a holder who furnishes a correct taxpayer identification number or certificate of foreign status and makes any other required certification or who is otherwise exempt from backup withholding (for example, if you are a corporation). Any U.S. holder who is required to establish exempt status generally must file Internal Revenue Service Form W-9 ( Request for Taxpayer Identification Number and Certification ). Finalized Treasury Regulations, which are applicable to payments made after December 31, 2000, have generally expanded the circumstances under which information reporting and backup withholding may apply.

Amounts withheld as backup withholding may be credited against a U.S. holder's federal income tax liability. A U.S. holder may obtain a refund of any excess amounts withheld under the backup withholding rules by filing the appropriate claim for refund with the Internal Revenue Service and furnishing any required information.

### **10.F Dividends and Paying Agents**

Not applicable.

### **10.G Statements by Experts**

Not applicable.

### **10.H Documents on Display**

The documents referred to herein, including the Amended Articles, can be obtained from the Company at its registered office at Weizmann Science Park, Building 22, 2nd Floor, Ness-Ziona 76100, Israel. In addition, the Company is subject to certain informational requirements of the Securities Exchange Act of 1934 and the rules and regulations promulgated thereunder. In accordance therewith, the Company files reports with the Commission. Reports and other information provided to the Commission by the Company may be inspected and copied at the public reference facilities maintained by the Commission at Room 1024, 100 Fifth Street, N.E., Washington, D.C. 20549. Information on the operation of the public reference facilities may be obtained by calling the Commission at 1-800-SEC-0330. In addition, certain of the Company's reports filed with the Commission are available on-line at [www.sec.gov](http://www.sec.gov).

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### **10.I Subsidiary Information**

Not applicable.

### **Item 11. Quantitative and Qualitative Disclosures About Market Risk**

## **Market Risk**

Market risk represents the risk of loss that may impact the consolidated financial position, results of operations or cash flows of the Company. The Company is exposed to market risk in the area of foreign exchange rates, as described below.

The Company does not utilize financial instruments for trading purposes and holds no derivative financial instruments that could expose it to significant market risk.

## **Impact of Currency Fluctuation**

Substantially all of our sales are made in U.S. dollars. Over 50% of our expenses in 2008 were in dollars or in NIS linked to the dollar. The remaining expenses were in currencies other than the U.S. dollar, and mainly NIS. The dollar cost of our operations in countries other than the U.S., is negatively influenced by any devaluation of the U.S. dollar against other currencies. During 2008, the value of the U.S. dollar devaluated against the NIS by 1%, and against the Yen by 19.3%. The value of the U.S. dollar revaluated against the Euro by 4.4%. During the first six months of 2008 the value of the U.S. dollar devaluated against the NIS by 12.8%, against the Yen by 5.2% and against the Euro by 6.8%. This devaluation had a negative impact on our operating expenses outside the U.S. in 2008. During the last six months of 2008 the value of the U.S. dollar revaluated against the NIS by 13.4%. During the first 2 months of 2009, the U.S. dollar continued to revalue by 10.8% against the NIS, by 11.2% against the Euro and by 8.8% against the Yen.

As of December 31, 2008, the majority of our net monetary assets were denominated in dollars and the remainder was denominated mainly in NIS. Net monetary assets that are not denominated in dollars or dollar-linked NIS were affected by the currency fluctuations in 2008 and are expected to continue to be affected by such currency fluctuations in 2009.

In 2006, the Company entered into currency-forward transactions (NIS/dollar, Euro/dollar, Yen/dollar) to insure (NIS/dollar, Euro/dollar, Yen/dollar) the rate in 2006. The total accumulated sum insured in the year was approximately \$15.2 million with settlement dates through 2006, and the results of these transactions did not have, as expected, any material effect on the operational results of the Company.

In 2007, the Company entered into currency-forward transactions (NIS/dollar, Euro/dollar, Yen/dollar) to insure (NIS/dollar, Euro/dollar, Yen/dollar) the rate in 2007. The total accumulated sum insured in the year was approximately \$29 million with settlement dates through 2007 and 2008, and the results of these transactions did not have, as expected, any material effect on the operational results of the Company.

In 2008, the Company entered into currency-forward transactions and currency-put options (NIS/dollar, Euro/dollar, Yen/dollar) of \$33.633 million with settlement date through 2008 designed to reduce cash-flow exposure to the impact of exchange-rate fluctuations on firm commitments of \$33,633. In accordance with SFAS 133 the Company recorded in 2008 a decrease of \$390 in fair market value in Other Comprehensive Income .

## **Item 12. Description of Securities Other than Equity Securities**

Not applicable.

## **PART II**

## **Item 13. Defaults, Dividend Arrearages and Delinquencies**

None.

## **Item 14. Material Modification to the Rights of Security Holders and Use of Proceeds**

The effective date of the Securities Act registration statement for which use of proceeds is being disclosed is April 11, 2000. The commission file number assigned to that registration statement is 333-11640.

We sold 3,000,000 ordinary shares for net proceeds of \$49 million. As of December 31, 2008, approximately \$20 million of the net proceeds had been used for working capital requirements and \$10 million for capital expenditures.

**Item 15T. Evaluation of disclosure controls and procedures**

(a) Our management, including our chief executive officer and chief financial officer, has evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2008. Based on such review, our chief executive officer and chief financial officer have concluded that we have in place effective controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934, as amended, is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure, and is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms.

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(b) Our management, under the supervision of our chief executive officer and chief financial officer, is responsible for establishing and maintaining adequate internal control over our financial reporting, as defined in Rules 13a-15(f) and 15d-15(f) of the Securities Exchange Act of 1934, as amended. The Company's internal control over financial reporting is defined as a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes policies and procedures that:

pertain to the maintenance of records that in reasonable detail accurately and fairly reflect our transactions and asset dispositions;

provide reasonable assurance that transactions are recorded as necessary to permit the preparation of our financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and

provide reasonable assurance regarding the prevention or timely detection of unauthorized acquisition, use or disposition of assets that could have a material effect on our financial statements.

Due to its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we evaluated the effectiveness of our internal control over financial reporting as of December 31, 2008 based on the framework for Internal Control-Integrated Framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, our management concluded that the Company's internal controls over financial reporting were effective as of December 31, 2008.

This management report on internal control over financial reporting shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended or otherwise subject to the liabilities of that Section.

This annual report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our registered public accounting firm pursuant to temporary rules of the Commission that permit us to provide only management's report in this Annual report.

(c) There were no changes in our internal controls over financial reporting identified with the evaluation thereof that occurred during the period covered by this annual report that have materially affected, or are reasonable likely to materially affect our internal control over financial reporting.

**Item 16A. Audit Committee Financial Expert**

Our Board of Directors has determined that our Audit Committee includes one audit committee financial expert, as defined by Item 16A of Form 20-F, Mr. Dan Falk. Mr. Dan Falk is an independent director as such term is defined by Rule 4200(15) of the Nasdaq Stock Market.

**Item 16B. Code of Ethics**

The Company has adopted a written code of conduct that applies to all Company employees, including the Company's directors, principal executive officer, principal financial officer and principal accounting officer.

You may review our code of conduct on our website, <http://nova.co.il> under "Corporate".

**Item 16C. Principal Accountant Fees and Services**

During each of the last two fiscal years, Brightman Almagor Zohar & Co., an independent registered accounting firm and a member firm of Deloitte Touche Tohmatsu (Brightman Almagor Zohar & Co.) has acted as the our registered public accounting firm and independent auditors.

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**Audit Fees**

Brightman Almagor Zohar & Co. billed the Company approximately \$62,000 and \$58,000 for audit services for fiscal 2008 and for 2007, respectively, including fees associated with the annual audit and reviews of the Company's quarterly financial results submitted on Form 6-K, consultations on various accounting issues and performance of local statutory audits.

**Audit-Related Fees**

Brightman Almagor Zohar & Co. did not bill for any audit-related services in 2008 or 2007, except as included under the caption "Audit Fees".

**Tax Fees**

Brightman Almagor Zohar & Co. billed the Company approximately \$35,000 for tax advice, including fees associated with tax compliance services, tax planning services and other tax consulting services for fiscal year 2007. Deloitte & Touche did not bill the Company for any tax advice services for fiscal year 2008.

**All Other Fees**

Other than Audit Fees and Tax Fees described above, Brightman Almagor Zohar & Co. billed the Company approximately \$19,000 and \$11,000 for SEC compliance related services and services related to the Office of Chief Scientist and Investment Center, for fiscal 2008 and for 2007, respectively.

**Pre-Approval Policies for Non-Audit Services**

Prior to the engagement of Brightman Almagor Zohar & Co. each year, the engagement is approved by the audit committee of the board of directors. The Company's audit committee rules of procedure provide for a process with respect to the prior approval of all services, including non-audit services, to be performed by the independent auditors for the Company. In fiscal 2008 and 2007, the Company's audit committee approved all of the services provided by Brightman Almagor Zohar & Co.

**Item 16D. Exemptions from the Listing Standards for Audit Committees**

The Company has not obtained any exemption from applicable audit committee listing standards.

**Item 16E. Purchases of Equity Securities by the Issuer and Affiliates Purchasers**

In 2008, neither the Company nor any affiliated purchaser (as defined in the Exchange Act) purchased any of the Company's ordinary shares.

**Item 16F. Changes in Registrant's Certifying Accountant**

Not applicable.

**Item 16G. Corporate Governance**

There are no significant ways in which the Company's corporate governance practices differ from those followed by domestic companies listed on the Nasdaq Global Market.

**PART III**

**Item 17. Financial Statements**

Not applicable.

**Item 18. Financial Statements**

See pages F-1 through F-22.

**Item 19. Exhibits**

See Exhibit Index.

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**NOVA MEASURING INSTRUMENTS LTD.  
CONSOLIDATED FINANCIAL STATEMENTS  
AS OF DECEMBER 31, 2008**

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**NOVA MEASURING INSTRUMENTS LTD.  
CONSOLIDATED FINANCIAL STATEMENTS  
AS OF DECEMBER 31, 2008**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM  
TO THE SHAREHOLDERS OF  
NOVA MEASURING INSTRUMENTS LTD.**

We have audited the consolidated balance sheets of Nova Measuring Instruments Ltd. (the Company) and its subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of operations, shareholders' equity and comprehensive loss and cash flows for each of the three years in the period ended December 31, 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2008 and 2007, and their consolidated results of operations and cash flows for each of the three years in the period ended December 31, 2008, in conformity with accounting principles generally accepted in the United States of America

**/s/ Brightman Almagor Zohar & Co.**  
**Brightman Almagor Zohar & Co.**  
**Certified Public Accountants (Israel)**  
**A member firm of Deloitte Touche Tohmatsu**

Tel Aviv, Israel  
 March 23, 2009

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**NOVA MEASURING INSTRUMENTS LTD.**  
**CONSOLIDATED BALANCE SHEETS**  
 (In thousands, except share data)

As of December 31,	
2008	2007

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	As of December 31,	
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 19,325	\$ 15,324
Short-term interest-bearing bank deposits	97	-
Held to maturity securities	-	2,251
Trade accounts receivable, net of allowance for doubtful accounts of \$49 and \$0, respectively	2,783	9,146
Inventories (Note 4)	6,862	8,524
Other current assets	1,086	1,703
	<u>30,153</u>	<u>36,948</u>
<b>LONG-TERM ASSETS</b>		
Long-term interest-bearing bank deposits	544	2,245
Long-term investments	-	1,562
Held to maturity securities	-	1,489
Other long-term assets	157	169
Severance pay funds (Note 7)	2,141	2,488
	<u>2,842</u>	<u>7,953</u>
<b>FIXED ASSETS, NET (Note 5)</b>	<u>2,796</u>	<u>3,484</u>
<b>Total assets</b>	<b>\$ 35,791</b>	<b>\$ 48,385</b>
<b>CURRENT LIABILITIES</b>		
Trade accounts payable	\$ 3,480	\$ 7,482
Deferred revenues	2,385	1,496
Other current liabilities (Note 6)	4,042	7,310
	<u>9,907</u>	<u>16,288</u>
<b>LONG-TERM LIABILITIES</b>		
Liability for employee severance pay (Note 7)	3,152	3,561
Deferred revenue	351	901
Other long-term liability	40	51
	<u>3,543</u>	<u>4,513</u>
<b>COMMITMENTS AND CONTINGENCIES (Note 8)</b>		
<b>SHAREHOLDERS' EQUITY (Note 9)</b>		
Ordinary shares, NIS 0.01 par value - authorized 40,000,000 shares, issued and outstanding 19,378,339 and 19,369,418 shares, respectively	55	55
Additional paid-in capital	83,969	83,401
Accumulated other comprehensive income (loss)	(191)	199
Accumulated deficit	(61,492)	(56,071)
<b>Total shareholders' equity</b>	<u>22,341</u>	<u>27,584</u>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 35,791</b>	<b>\$ 48,385</b>

The accompanying notes are an integral part of the consolidated financial statements.

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**NOVA MEASURING INSTRUMENTS LTD.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except loss per share data)

	Year ended December 31,		
	2008	2007	2006
<b>REVENUES:</b>			
Products	\$ 25,673	\$ 45,604	\$ 38,258
Services	13,296	11,707	10,034
IP Licensing	-	766	-
	<u>38,969</u>	<u>58,077</u>	<u>48,292</u>
<b>COST OF REVENUES:</b>			
Products	12,527	22,251	18,728
Inventory write-off and inventory purchase commitment losses (Note 4)	1,400	303	-
Services	12,059	10,697	9,015
	<u>25,986</u>	<u>33,251</u>	<u>27,743</u>
<b>GROSS PROFIT</b>	<u>12,983</u>	<u>24,826</u>	<u>20,549</u>
<b>OPERATING EXPENSES:</b>			
Research and development, net of participation by the Office of the Chief Scientist of \$2,002, \$2,447 and \$1,862, respectively (Note 8a)	8,606	9,143	9,166
Sales and marketing	7,503	10,175	8,754
General and administrative	3,199	4,830	5,136
Impairment loss on intangibles and equipment related to Hypernex assets and liabilities acquisition (Note 3)	633	3,831	-
	<u>19,941</u>	<u>27,979</u>	<u>23,056</u>
<b>OPERATING LOSS</b>	<u>(6,958)</u>	<u>(3,153)</u>	<u>(2,507)</u>
<b>INTEREST INCOME, NET</b>	171	602	573
<b>GAIN (IMPAIRMENT) ON SHORT TERM INVESTMENTS</b>	1,366	(1,366)	-
	<u>1,537</u>	<u>(764)</u>	<u>573</u>



	Year ended December 31,		
NET LOSS FOR THE YEAR	\$ (5,421)	\$ (3,917)	\$ (1,934)
<b>LOSS PER SHARE:</b>			
Basic and diluted loss per share	\$ (0.28)	\$ (0.21)	\$ (0.12)
Shares used in calculation of basic and diluted loss per share	19,369	18,606	15,976

The accompanying notes are an integral part of the consolidated financial statements.

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**NOVA MEASURING INSTRUMENTS LTD.**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME (LOSS)**

(In thousands)

	Ordinary Shares		Additional Paid-in Capital	Deferred stock-based compensation	Accumulated other Comprehensive Income (loss)	Accumulated Comprehensive Deficit	Total Comprehensive Income (loss)	Total Shareholders' Equity (loss)
	Number	Amount						
Balance as of January 1, 2006	15,457	\$ 46	\$ 73,636	\$ -	\$ (18)	\$ (50,220)		\$ 23,444
Employee share-based plans		(*) -	83					83
Restricted shares issued to employees	392	1	346					347
Equity-based compensation	45		315					315
Shares issued in acquisition	1,211	3	2,305					2,308
Change in fair market value of hedging derivatives					12		\$ 12	12
Net loss for the year						(1,934)	(1,934)	(1,934)
Total comprehensive loss							\$ (1,922)	(1,922)
Balance as of December 31, 2006	17,105	\$ 50	\$ 76,685	\$ -	\$ (6)	\$ (52,154)		\$ 24,575
Employee share-based plans	326	(*) -	687					687
Amortization of deferred stock based compensation			1,052					1,052
Shares issued in private placement	1,938	5	4,977					4,982
Change in fair market value of hedging derivatives					205		\$ 205	205
Net loss for the year						(3,917)	(3,917)	(3,917)
Total comprehensive loss							\$ (3,712)	(3,712)
Balance as of December 31, 2007	19,369	\$ 55	\$ 83,401	\$ -	\$ 199	\$ (56,071)		27,584

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	Ordinary Shares		Additional Paid-in Capital	Deferred stock-based compensation	Accumulated other Comprehensive Income (loss)	Accumulated Deficit	Total Comprehensive Income (loss)	Total Shareholders' Equity (loss)
Employee share-based plans	9	(*) -	12					12
Amortization of deferred stock based compensation			556					556
Change in fair market value of hedging derivatives					(390)		\$ (390)	(390)
Net loss for the year						(5,421)	(5,421)	(5,421)
<b>Total comprehensive loss</b>							<b>\$ (5,811)</b>	<b>(5,811)</b>
Balance as of December 31, 2008	19,378	\$ 55	\$ 83,969	\$ -	\$ (191)	\$ (61,492)		\$ 22,341

(\*) Less than \$1

The accompanying notes are an integral part of the consolidated financial statements.

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**NOVA MEASURING INSTRUMENTS LTD.  
CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

	Year ended December 31,		
	2008	2007	2006
<b>CASH FLOWS - OPERATING ACTIVITIES</b>			
Net loss for the year	\$ (5,421)	\$ (3,917)	\$ (1,934)
Adjustments to reconcile net loss to net cash used in operations:			
Depreciation and amortization	1,320	1,743	1,413
Impairment of intangibles and fixed assets	643	3,918	-
Amortization of deferred stock-based compensation	556	1,052	662
Increase in liability for employee termination benefits, net	33	219	254
Impairment (gain) on short-term investments	(1,366)	1,366	-
Net recognized losses (gains) on investments	66	6	(226)
Decrease (increase) in trade accounts receivables	6,363	1,106	(3,411)
Decrease (Increase) in inventories	1,330	(1,890)	(786)
Decrease (increase) in other short and long term assets	247	529	(736)
Increase (decrease) in trade accounts payables and other long term liabilities	(4,013)	(1,058)	137
Increase (decrease) in other current liabilities	(3,371)	1,014	(1,089)
Increase (decrease) in short and long term deferred income	339	(1,630)	604
Net cash from (used in) operating activities	(3,274)	4,574	(5,112)
<b>CASH FLOWS - INVESTING ACTIVITIES</b>			
Decrease (increase) in short-term interest-bearing bank deposits	(97)	466	567
Decrease (Increase) in short term investments	32	(528)	1,100
Proceeds from held to maturity securities	3,701	3,205	5,261
Proceeds from long term investments	2,928	-	-

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	Year ended December 31,		
	2008	2007	2006
Investment in short-term held to maturity securities	-	(491)	(664)
Investment in long-term held to maturity securities	-	(1,491)	-
Proceeds from long-term interest-bearing bank deposits	1,643	2,000	-
Investment in long-term interest-bearing bank deposits	-	(1,073)	(25)
Acquisition of assets and liabilities - Schedule B	-	-	(1,577)
Additions to fixed assets	(944)	(1,183)	(1,233)
Net cash - investing activities	7,263	905	3,429
<b>CASH FLOWS - FINANCING ACTIVITIES</b>			
Shares issued in private placement	-	4,982	-
Shares issued under employee share-based plans	12	687	83
Net cash - financing activities	12	5,669	83
Increase (decrease) in cash and cash equivalents	4,001	11,148	(1,600)
Cash and cash equivalents - beginning of year	15,324	4,176	5,776
Cash and cash equivalents - end of year	\$ 19,325	\$ 15,324	\$ 4,176

The accompanying notes are an integral part of the consolidated financial statements.

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**NOVA MEASURING INSTRUMENTS LTD.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands)

**SCHEDULE A - NON CASH ACTIVITIES**

	Year ended December 31,		
	2008	2007	2006
Transfer of assets from inventory to fixed assets	\$ 402	\$ 2,334	\$ -

**SCHEDULE B - ACQUISITION OF ASSETS AND LIABILITIES**

	Year ended December 31,		
	2008	2007	2006
Working Capital	\$ -	\$ -	\$ 665
Long lived assets	-	-	101
Other identifiable intangible assets	-	-	2,408
Long term liabilities	-	-	(81)
Goodwill arising on acquisition	-	-	792

	Year ended December 31,		
	2002	2001	2000
Issuance of shares	-	-	3,885 (2,308)
Cash paid, net	\$ -	\$ -	\$ 1,577

The accompanying notes are an integral part of the consolidated financial statements.

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**NOVA MEASURING INSTRUMENTS LTD.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
(in thousands, except share and per share data)

**NOTE 1 GENERAL**

**A. Business Description**

Nova Measuring Instruments (the Company) was incorporated in May 1993 and commenced operations in October 1993 in the design, development and production of integrated process control systems, used in the manufacturing of semiconductors. In October 1995, the Company began manufacturing and marketing its systems. In addition, the Company is continuing research and development for the next generation of its products and additional applications for such products. The Company operates in one operating segment.

The Company has wholly owned subsidiaries in the United States of America (the U.S.), Japan, The Netherlands and Taiwan. All companies (the subsidiaries) are engaged in pre-sale activities and providing technical support to customers.

The industry in which the Company operates is characterized by rapid technological development in a competitive environment. Substantially most of the Company's current sales are derived from a single product line used exclusively by the semiconductor industry, whose business is highly cyclical. The Company depends on a limited number of suppliers, and at times a sole supplier. Any disruption or termination of the suppliers' operations may adversely affect the Company's production capabilities. In addition, certain of the Company's development projects are in the early stages and there can be no assurance that these projects will be successful.

The ordinary shares of the Company are traded on the NASDAQ Global Market since April, 2000 and on the Tel-Aviv Stock Exchange since June, 2002.

**B. Use of Estimates in the Preparation of Financial Statements**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements, and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

**C. Financial Statements in U.S. Dollars**

The currency of the primary economic environment in which the operations of the Company and its subsidiaries are conducted is the U.S. dollar (the dollar). Accordingly, the Company uses the dollar as its functional and reporting currency. Certain of the dollar amounts in the financial statements may represent the dollar equivalent of other currencies, including the New Israeli Shekel (NIS), and may not be exchangeable for dollars.

Transactions and balances denominated in dollars are presented at their dollar amounts. Non-dollar transactions and balances are remeasured into dollars in accordance with the principles set forth in Statement of Financial Accounting Standards ( SFAS ) No. 52, Foreign Currency Translation of the Financial Accounting Standards Board ( FASB ). Net financing income includes translation gains (losses), which were immaterial for all years presented.

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**NOVA MEASURING INSTRUMENTS LTD.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
(in thousands, except share and per share data)

**NOTE 2 SIGNIFICANT ACCOUNTING POLICIES**

**D. Principles of Consolidation and Basis of Presentation**

The Company's consolidated financial statements include the financial statements of the Company and its wholly owned subsidiaries ( the Group ), after elimination of material intercompany transactions and balances.

The Company's consolidated financial statements have been prepared in accordance with generally accepted accounting principles ( GAAP ) in the United States of America.

The following is a summary of the significant accounting policies, which were applied in the preparation of these financial statements, on a consistent basis:

**E. Cash and Cash Equivalents**

Cash and cash equivalents are comprised of cash and demand deposits in banks and other short-term, highly liquid investments (primarily interest-bearing time deposits and commercial papers) with maturity dates not exceeding three months from the date of deposit.

**F. Allowance for Doubtful Accounts**

The allowance for doubtful accounts is computed on the specific identification basis.

**G. Held to Maturity, Short-Term and Long-Term Investments**

Securities held to maturity include investments in debt securities that the Company has positive intent and ability to hold to maturity. Securities held to maturity are measured at amortized cost.

Short-term investments include investments in debt securities with maturities of more than three months but less than one year. Long-term investments include investments in debt securities with maturities of more than one year.

Auction-rate securities represent interests in collateralized debt obligations, a portion of which are collateralized by pools of residential and commercial mortgages, interest-bearing corporate debt obligations, and dividend-yielding preferred stock. Liquidity for these auction-rate securities typically is provided by an auction process that resets the applicable interest rate at pre-determined intervals, usually every 7, 28, 35 or 90 days. Because of the short interest rate reset period, the Company has historically recorded auction-rate securities in current short-term investments. As of December 31, 2007, the Company held auction-rate securities which have experienced a failed reset process and were deemed to have experienced an other-than-temporary decline in fair value. Accordingly, the Company recorded an impairment charge of \$1,366 to reduce the carrying value of the auction-rate securities the Company holds, and the Company determined that the impairment charge is other-than-temporary in nature in accordance with FSP FAS 115-1 and 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments .

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As of December 31, 2007, the Company classified the remaining of \$1,562 of auction-rate securities, which were previously classified as short-term investments, as long-term investments. In October 2008, the Company sold all of its remaining auction-rate securities to a third party, at their original par value. As a result, the Company recorded a gain on investments of \$1,366 million in year 2008.

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### NOVA MEASURING INSTRUMENTS LTD. NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (in thousands, except share and per share data)

#### NOTE 2 SIGNIFICANT ACCOUNTING POLICIES (CONT.)

##### H. Inventories

Inventories are presented at the lower of cost or market. Cost is determined as follows: Raw materials-on the average cost basis.

Finished goods and work in process on actual production cost basis (materials, labor and indirect manufacturing costs).

##### I. Fixed assets

Fixed assets are presented at cost, net of accumulated depreciation. Annual depreciation is calculated based on the straight-line method over the shorter of the estimated useful lives of the related assets or terms of the related leases. Estimated useful life, in years, is as follows:

	<u>Years</u>
Electronic equipment	2-7
Office furniture and equipment	7-17

Leasehold improvements are amortized using the straight-line method, over the shorter of the lease term or the useful lives of the improvements.

In accordance with SFAS No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets* of the FASB, management reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable based on estimated future undiscounted cash flows. If so indicated an impairment loss would be recognized for the difference between the carrying amount of the asset and its fair value. During 2008 and 2007 the Company recorded impairment charges of \$633 and \$1,217, respectively, with respect to fixed assets acquired in 2006. See also Note 3.

##### J. Acquisition-related intangible assets

The Company accounts for its business combinations in accordance with SFAS No. 141 *Business Combinations* ( SFAS 141 ) and the related acquired intangible assets and goodwill in accordance with SFAS No. 142 *Goodwill and Other Intangible Assets* ( SFAS 142 ). SFAS 141 specifies the accounting for business combinations and the criteria for recognizing and reporting intangible assets apart from goodwill.

Goodwill is the amount by which the acquisition cost exceeds the fair values of identifiable acquired net assets on the date of acquisition. SFAS 142 requires that goodwill not be amortized but instead be tested for impairment in accordance with the provisions of SFAS 142 at least annually and more frequently upon the occurrence of certain events. Acquisition-related intangible assets are reported at cost, net of accumulated amortization and impairment. Purchased technology and customer base are presented at cost, net of accumulated amortization, and are amortized over their estimated useful lives of 4 to 6 years using the straight-line method. During 2007 impairment charges of \$2,702 were recorded with respect to intangible assets acquired in 2006. See also Note 3.

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**NOVA MEASURING INSTRUMENTS LTD.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
(in thousands, except share and per share data)

**NOTE 2 SIGNIFICANT ACCOUNTING POLICIES (CONT.)**

**K. Accrued Warranty Costs**

Accrued warranty costs are calculated in respect of the warranty period on the Company's products (generally one year) and are based on the Company's prior experience and in accordance with management's estimate. See Note 6b for disclosure with regard to accrued warranty costs.

**L. Revenue Recognition**

Revenues from the sale of products are recognized when all the following criteria have been met: a persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed or determinable, collection of resulting receivables is probable and there are no remaining significant obligations. In accordance with EITF 00-21 for arrangements containing multiple elements, fair value of each element is determined based on specific objective evidence and revenue is allocated to each element based upon its fair value. The revenue relating to the undelivered elements is deferred at estimated fair value until delivery of the deferred elements. If specific objective evidence of fair value does not exist for all elements to support the allocation of the total fee among all delivered and undelivered elements of the arrangement, revenue is deferred until such evidence exists for all undelivered elements, or until all elements are delivered, whichever is earlier.

Service contracts generally specify fixed payment amounts for periods longer than one month, and are recognized on a straight line basis over the term of the contract.

**M. Research and Development**

Research and development costs are charged to operations as incurred. Amounts received or receivable from the Government of Israel through the Office of the Chief Scientist (OCS) as participation in certain research and development programs are offset against research and development costs. The accrual for grants receivable is determined based on the terms of the programs, provided that the criteria for entitlement have been met.

**N. Income Taxes**

The Company accounts for income taxes utilizing the asset and liability method in accordance with SFAS No. 109, Accounting for Income Taxes of the FASB. Current tax liabilities are recognized for the estimated taxes payable on tax returns for the current year. Deferred tax liabilities or assets are recognized for the estimated future tax effects attributable to temporary differences between the income tax bases of assets and liabilities and their reported amounts in the financial statements, and for tax loss carryforwards. Measurement of current and deferred tax liabilities and assets is based on provisions of enacted tax laws, and deferred tax assets are reduced, if necessary, by the amount of tax benefits, the realization of which is not considered more likely than not based on available evidence.

**NOTE 2 SIGNIFICANT ACCOUNTING POLICIES (Cont.)****N. Income Taxes (cont.)**

In 2007 the Company adopted Interpretation No. 48, Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109 (FIN 48). The interpretation contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109, Accounting for Income Taxes. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. The adoption of FIN 48 did not have a material effect on the Company's financial statements.

**O. Equity-Based Compensation**

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, (SFAS 123(R)) which requires companies to recognize the cost of employee services received in exchange for awards of equity instruments based upon the grant-date fair value of those awards.

SFAS 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25).

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006. In accordance with the modified prospective transition method, the Company's Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R).

The following table summarizes the effects of equity-based compensation related to stock based compensation and restricted stock awards included in Statement of Operations as follows:

	Year ended December 31,		
	2008	2007	2006
Cost of Revenues:			
Product Sales	\$ 43	\$ 47	\$ 19
Services	28	107	57
Research and Development expenses	103	589	487
Sales and Marketing expenses	55	151	40
General and Administration expenses	327	158	59
<b>Total</b>	<b>\$ 556</b>	<b>\$ 1,052</b>	<b>\$ 662</b>

**Stock Options**

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. This model was developed for use in estimating the value of publicly traded options that have no vesting restrictions and are fully transferable. The weighted average assumptions used in the model are outlined in the following table

	2008
Risk-free interest rate	3.31%
Expected life of options	6.25 years
Expected volatility	62.67%
Expected dividend yield	0



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**NOVA MEASURING INSTRUMENTS LTD.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
(in thousands, except share and per share data)

**NOTE 2 SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

**P. Loss per Share**

Loss per share is presented in accordance with SFAS 128 of the FASB, Earnings per Share. Pursuant to this standard, basic earnings (loss) per share excludes the dilutive effects of convertible securities and is computed by dividing income (loss) available to common shareholders by the weighted-average number of ordinary shares outstanding for the period. Diluted earnings (loss) per share reflects the potential dilutive effect of all convertible securities. Due to the anti-dilutive effect, basic loss per share was equal to diluted loss per share for years 2008, 2007 and 2006. The number of potentially dilutive securities excluded from diluted earnings per share due to the anti-dilutive effect amounted to 226,500, 1,697,343 and 1,362,037 in 2008, 2007 and 2006, respectively.

**Q. Derivative Financial Instruments**

SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities as amended by SFAS No. 138 and SFAS 149, requires, principally, the presentation of all derivatives as either assets or liabilities on the balance sheet and the measurement of those instruments at fair value.

For derivative instruments that are designated and qualify as a cash flow hedge (i.e., hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The remaining gain or loss on the derivative instrument in excess of the cumulative change in the present value of future cash flows of the hedged item, if any, is recognized in current earnings during the period of change. For derivative instruments not designated as hedging instruments, the gain or loss is recognized in current earnings during the period of change.

See Note 13 for disclosure of the derivative financial instruments in accordance with such pronouncements.

**R. New Accounting Pronouncements**

In April 2008, Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. 142-3, Determination of the Useful Life of Intangible Assets (FSP 142-3). FSP 142-3 amends the factors an entity should consider in developing renewal or extension assumptions used in determining the useful life of recognized intangible assets under FASB Statement No. 142,

Goodwill and Other Intangible Assets. This new guidance applies prospectively to intangible assets that are acquired individually or with a group of other assets in business combinations and asset acquisitions. FSP 142-3 is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008. Early adoption is prohibited. The adoption of FSP 142-3 is not expected to have a significant impact on the Company's consolidated financial statements.

In March 2008, the FASB issued Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 (SFAS 161). SFAS 161 requires disclosures of how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for, and how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. SFAS 161 will be effective for the Company in 2009. The Company is evaluating the potential impact of the implementation of SFAS 161 on its financial position and results of operations.

**NOVA MEASURING INSTRUMENTS LTD.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
(in thousands, except share and per share data)

**NOTE 2 SIGNIFICANT ACCOUNTING POLICIES (Cont.)****R. New Accounting Pronouncements (Cont.)**

In December 2007, the FASB issued SFAS No. 141(R) Business Combinations ( SFAS 141(R) ) and SFAS No. 160, Non-controlling Interests in Consolidated Financial Statement ( SFAS 160 ). SFAS 141(R) requires the acquiring entity in a business combination to record all assets acquired and liabilities assumed at their respective acquisition-date fair values and changes other practices under FAS 141, some of which could have a material impact on how the Company accounts for business combinations. SFAS 141(R) also requires additional disclosure of information surrounding a business combination, such that users of the entity's financial statements can fully understand the nature and financial impact of the business combination. SFAS 160 requires entities to report non-controlling (minority) interests in subsidiaries as equity in the consolidated financial statements. The Company is required to adopt SFAS 141(R) and SFAS 160 simultaneously in 2009. The provisions of SFAS 141(R) will only impact the Company if it is a party to a business combination after the pronouncement has been adopted. The adoption of SFAS 160 is not expected to have a significant impact on the Company's consolidated financial statements.

**NOTE 3 BUSINESS COMBINATION AND IMPAIRMENT OF ACQUISITION RELATED ASSETS**

On August 8, 2006, the Company completed the acquisition of substantially all of HyperNex Inc.'s ( HyperNex ) assets and assumed responsibility of most of HyperNex liabilities. HyperNex, a privately held company focused on Wide-angle X-Ray Diffraction systems. The total purchase price was \$3,885, and it included the issuance of 1.2 million shares of the Company's ordinary shares valued at \$2,308, \$789 funds remitted to HyperNex and estimated direct transaction costs of \$788. The acquisition has been accounted for under the purchase method of accounting in accordance with SFAS No. 141 and SFAS No. 142. Under the purchase method of accounting, the total estimated purchase price is allocated to the net tangible and identifiable intangible assets and to liabilities assumed based on their respective estimated fair values.

In September 2007, following significant delays in execution of the related product business plan, the Company conducted an impairment test of the assets and liabilities acquired from HyperNex. Based on the test results, the Company concluded that the carrying amounts of these assets were lower than net cost. As a result, the Company recorded a \$3,831 impairment loss and a \$303 inventory write off. In 2008, as a result of lack of business progress and sales, the Company closed the activities related to this business unit, and recorded a final \$633 impairment loss related to remaining equipment of that business unit.

The valuation and write-off of the intangible assets and goodwill, fixed assets and inventory were performed in accordance with SFAS No. 144, SFAS No. 142 and ARB 43, respectively. See also Note 4 and Note 5.

**NOTE 4 INVENTORIES****A.**

	As of December 31,	
	2008	2007
Raw materials	\$ 1,683	\$ 2,076
Work in process	1,908	3,562
Finished goods	3,271	2,886
	\$ 6,862	\$ 8,524

- B. In the years ended December 31, 2008 and 2007 the Company wrote-off inventories in the amounts of \$1,400 and \$303, respectively. See also Note 3.

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**NOVA MEASURING INSTRUMENTS LTD.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
(in thousands, except share and per share data)

**NOTE 5 FIXED ASSETS, NET**

	As of December 31,	
	2008	2007
<b>Cost:</b>		
Electronic equipment	\$ 7,561	\$ 7,483
Office furniture and equipment	676	514
Leasehold improvements	2,075	2,040
	<u>10,312</u>	<u>10,037</u>
<b>Accumulated depreciation and amortization:</b>		
Electronic equipment	5,117	4,313
Office furniture and equipment	632	496
Leasehold improvements	1,767	1,744
	<u>7,516</u>	<u>6,553</u>
<b>Net book value</b>	<u>\$ 2,796</u>	<u>\$ 3,484</u>

During 2008 and 2007 the Company recorded impairment charges of \$633 and \$1,217 respectively, to reduce the book value of fixed assets acquired from HyperNex in 2006. See also Note 3.

**NOTE 6 OTHER CURRENT LIABILITIES**

- A. Consists of:

	As of December 31,	
	2008	2007
Accrued salaries and fringe benefits	\$ 2,260	\$ 4,389
Accrued warranty costs (See B below)	877	2,343
Governmental institutions	530	529
Other	375	49
	<u>\$ 4,042</u>	<u>\$ 7,310</u>

**b. Accrued warranty costs:**

	As of December 31,	
	2008	2007
Balance as of beginning of year	\$ 2,343	\$ 2,120
Services provided under warranty	(1,784)	(3,510)
Changes in provision	318	3,733
Balance as of end of year	\$ 877	\$ 2,343

**NOTE 7 LIABILITY FOR EMPLOYEE SEVERANCE PAY, NET**

Israeli law and labor agreements determine the obligations of the Company to make severance payments to dismissed employees and to employees leaving employment under certain other circumstances. The obligation for severance pay benefits, as determined by Israeli law, is based upon length of service and the employee's most recent salary. The liability is partially covered through insurance policies purchased by the Company and deposits in a severance fund. Severance-pay expenses amounted to \$858, \$796 and \$597 for year 2008, 2007 and 2006, respectively.

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**NOVA MEASURING INSTRUMENTS LTD.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
(in thousands, except share and per share data)

**NOTE 8 COMMITMENTS AND CONTINGENCIES**

- A.** The Company has received grants in the aggregate amount of \$14,022 from the OCS, as its participation of up to 60% of certain development costs. In consideration for such grants, the Company has undertaken to pay royalties amounting to 3%-3.5% of the net sales of products developed, directly or indirectly, from the projects financed, not to exceed 100% of the grants received. Refund of the grants thereon is contingent on future sales and the Company has no obligation to refund grants if sufficient sales are not generated. Royalty expense amounted to \$204 and \$75 for the years 2008 and 2007, respectively. The balance of the contingent liability to the OCS as of December 31, 2008 was approximately \$8,162 (December 31, 2007: \$6,245).
- B.** The Group rents its facilities under various operating lease agreements, which expire on various dates, the latest of which is in 2013. The minimum rental payments are as follows:

<u>Year</u>	
2009	\$ 848
2010	\$ 705
2011	\$ 701
2012	\$ 701
2013	\$ 150

Rental expense for the facilities amounted to \$1,239, \$1,247 and \$1,060 for 2008, 2007 and 2006, respectively.

- C.** In March 2005 the Company filed a complaint in the United States District Court for the Northern District of California against one of its competitors (hereinafter-the Competitor) for infringing its US Patent. The patent relates to the Company's Integrated Metrology (IM) tools and the fundamental aspects of these systems. The Competitor has filed two counter claims for patent

infringement. In April 2007, the Company reached a settlement with the Competitor regarding all patent suits between the companies. The parties agreed to dismiss, without prejudice, all pending patent litigation between the two parties, and have further agreed not to file patent suits against the other party and/or any supplier or customer of the other party for patent infringement based on offers to sell, actual sales, manufacturing, purchase or use of any equipment of the other party for a period of one year.

**NOTE 9 SHAREHOLDERS EQUITY**

**A. Rights of Shares**

Holders of ordinary shares are entitled to participate equally in the payment of cash dividends and bonus shares (stock dividends) and, in the event of the liquidation of the Company, in the distribution of assets after satisfaction of liabilities to creditors. Each ordinary share is entitled to one vote on all matters to be voted on by shareholders.

**B. Share Purchase Agreement**

On February 28, 2007, the Company entered into Share Purchase Agreement with four investors for the private placement of 1,937,983 ordinary shares of the Company, at a price of \$2.58 per share, for gross proceeds of \$5 million. As part of the transaction, the Company issued warrants to the investors for the purchase of 1,453,485 additional ordinary shares at an exercise price of \$3.05 per share. On March 13, 2007 the shares were issued and the proceeds from the private placement were received.

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**NOVA MEASURING INSTRUMENTS LTD.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
(in thousands, except share and per share data)

**NOTE 9 SHAREHOLDERS EQUITY (Cont.)**

**C. Employee Incentive Plans**

The Company's Board of directors approves, from time to time, employee incentive plans, the last of which was approved in October 2007. The options usually vest over four years and their term may not exceed 7 years. The exercise price of each option is usually the market price of the underlying share at the date of each grant.

Through December 31, 2008, 7,624,722 share options have been issued under the plans, of which 2,109,652 options have been exercised, 3,392,536 options have been cancelled, and 1,385,700 options were exercisable as of December 31, 2008.

The weighted average fair value (in dollars) of the options granted during 2008 and 2007, according to Black-Scholes option-pricing model, amounted to \$0.82 and \$1.53 per option, respectively. Fair value was determined on the basis of the price of the Company's share.

**Summary of the status of the Company's share option plans as of December 31, 2008, 2007 and 2006, as well as changes during each of the years then ended, is presented below:**

	2008		2007		2006	
	Share options	Weighted average exercise price	Share options	Weighted average exercise price	Share options	Weighted average exercise price
Outstanding - beginning of year	2,910,368	2.69	3,579,840	\$ 3.07	3,179,004	\$ 3.57
Granted	244,000	1.35	474,000	2.86	1,175,900	2.03
Exercised	(8,921)	2.03	(326,918)	2.10	(45,252)	1.85

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	2008		2007		2006	
Cancelled	(1,022,913)	2.93	(816,554)	4.68	(729,812)	3.61
Outstanding - year end	2,122,534	2.42	2,910,368	2.69	3,579,840	3.07
Options exercisable at year-end	1,385,700	2.61	1,822,861	2.86	2,477,770	3.53

The following table summarizes information about share options outstanding as of December 31, 2008:

Range of exercise prices	Outstanding as of December 31, 2008			Exercisable as of December 31, 2008		
	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price	
(US dollars)		(in years)	(US dollars)		(US dollars)	
0.8-1.95	812,469	4.45	1.67	370,036	1.82	
2.06-2.87	890,005	3.39	2.47	595,604	2.29	
3.40	221,000	2.92	3.40	221,000	3.40	
4.01	169,060	2.42	4.01	169,060	4.01	
5.15	30,000	2.21	5.15	30,000	5.15	
	2,122,534	3.65	2.42	1,385,700	2.61	

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NOVA MEASURING INSTRUMENTS LTD.  
 NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
 (in thousands, except share and per share data)

NOTE 9 SHAREHOLDERS' EQUITY (Cont.)

D. Restricted Stock Awards

As part of the acquisition of HyperNex's assets and the assumption of most of its liabilities (see Note 3) the Company granted 392,000 restricted stock awards to certain of its employees who were formerly employed by HyperNex. The restricted stock awards (the Award Shares) are ordinary shares of the Company that vest over a period of up to 3 years from the grant date. Vesting of the Award Shares is subject to each employee's continuing service to the Company. The compensation expense related to these awards was determined using the market value of the Company's ordinary shares on the date of the grant; compensation is recognized over the service period.

NOTE 10 INCOME TAXES

A. Law for the Encouragement of Capital Investments 1959

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Part of the Company's investment in equipment has received approvals in accordance with the Law for the Encouragement of Capital Investments, 1959 (Approved Enterprise status) in three separate investment plans. The Company has chosen to receive its benefits through the Alternative Benefits track, and, as such, is eligible for various benefits. These benefits include accelerated depreciation of fixed assets used in the investment program, as well as a full tax exemption on undistributed income in relation to income derived from the first plan for a period of 4 years and for the second and third plans for a period of 2 years. Thereafter a reduced tax rate of 25% will be applicable for an additional period of up to 3 years for the first plan and 5 years for the second and third plans, commencing with the date on which taxable income is first earned but not later than certain dates. The first plan benefit period has already expired. The benefit periods of the second and third plans have not yet commenced.

The period in which the Company is entitled to the abovementioned tax benefits is limited to seven years from the first year that taxable revenues are generated, and such benefits must be utilized within 12 years from the year that operation (as defined) of the approved enterprise commences, or 14 years from the year the approval is granted, whichever is earlier.

In the case of foreign investment of more than 25%, the tax benefits are extended to 10 years, and in the case of foreign investment ranging from 49% to 100% the tax rate is reduced on a sliding scale to 10%. The benefits are subject to the fulfillment of the conditions of the letter of approval.

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### NOVA MEASURING INSTRUMENTS LTD. NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (in thousands, except share and per share data)

#### NOTE 10 -INCOME TAXES (Cont.)

##### A. Law for the Encouragement of Capital Investments 1959 (Cont.)

On April 1, 2005, an amendment to the Investment Law came into effect (the Amendment) and has significantly changed the provisions of the Investment Law. The Amendment limits the scope of enterprises which may be approved by the Investment Center by setting criteria for the approval of a facility as a Privileged Enterprise, such as provisions generally requiring that at least 25% of the Privileged Enterprise's Income will be derived from export. Additionally, the Amendment enacted major changes in the manner in which tax benefits are awarded under the Investment Law so that companies no longer require Investment Center approval in order to qualify for tax benefits. However, the Investment Law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. Therefore, the Israeli companies with Approved Enterprise status will generally not be subject to the provisions of the Amendment.

As a result of the amendment, tax-exempt income generated under the provisions of the new law, will subject the Company to taxes upon distribution or liquidation.

The above tax benefits are conditioned upon fulfillment of the requirements stipulated by the aforementioned law and the regulations promulgated there under, as well as the criteria set forth in the certificates of approval. In the event of failure by the Company to comply with these conditions, the tax benefits could be canceled, in whole or in part, and the Company would be required to refund the amount of the canceled benefits, plus interest and certain inflation adjustments.

The income of the Company that is not derived from assets, which are eligible for reduced taxation benefits, as described above, is taxed at the statutory rate for Israeli companies (see H below).

In the event of distribution by the Company of a cash dividend out of retained earnings that were tax exempt due to its approved enterprise status, the Company would have to pay a 25% corporate tax on the income from which the dividend was distributed. A 15% withholding tax may be deducted from dividends distributed to the recipients.

To date, the Company has not had earnings attributable to Approved Enterprise programs.

##### B. Law for the Encouragement of Industry (Taxation), 1969

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The Company is an Industrial Company under the Law for the encouragement of Industry (Taxation), 1969 and, therefore, is entitled to certain tax benefits, mainly accelerated rates of depreciation.

### C. Taxation Under Inflationary Conditions

The Company reports for tax purposes in accordance with the provisions of the Income Tax Law (Adjustments Due to Inflation) 1985, under which taxable income is measured in terms of NIS adjusted for changes in the Israeli Consumer Price Index.

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**NOVA MEASURING INSTRUMENTS LTD.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
(in thousands, except share and per share data)

### NOTE 10 INCOME TAXES (Cont.)

#### D. Deferred Taxes

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company and its subsidiary deferred tax assets are as follows:

	As of December 31,	
	2008	2007
Israel net operating loss carry-forwards*	\$ 18,180	\$ 16,515
U.S. net operating loss carry-forwards	92	151
Temporary differences relating to reserve and allowances	2,208	2,692
	20,480	19,358
Total net deferred tax asset before valuation allowance	20,480	19,358
Valuation allowance	(20,480)	(19,358)
	\$ -	\$ -
Net deferred tax asset		

\*Deferred taxes were calculated based on 25% tax rate.

Under SFAS No. 109, deferred tax assets are to be recognized for the anticipated tax benefits associated with net operating loss carry-forwards and deductible temporary differences, unless it is more-likely-than-not that some or all of the deferred tax assets will not be realized. The adjustment is made by a valuation allowance. Since the realization of the net operating loss carry-forwards and deductible temporary differences is not considered more likely than not, a valuation allowance has been established for the full amount of the tax benefits.

The Company has accumulated losses for Israeli income tax purposes as of December 31, 2008 and 2007, in the amount of approximately \$ 72,000 and \$ 66,000, respectively. These losses may be carried forward and offset against taxable income in the future for an indefinite period.

#### E. Effective Tax Rates

The Company's effective tax rates differ from the statutory rates applicable to the Company for all years presented due primarily to its approved enterprise status (see A above) and the tax loss carry-forward.



**F. Tax Assessments**

The Company received final tax assessments through tax year 2001. The subsidiaries did not receive final tax assessments since their incorporation.

**H. Tax Rates**

In 2005 the Israeli Knesset approved a law for the amendment of the Income Tax Ordinance, according to which the regular corporate tax rate is to be reduced gradually and annually from 27% for the 2008 tax year ending at 25% for the 2010 tax year.

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**NOVA MEASURING INSTRUMENTS LTD.**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
(in thousands, except share and per share data)

**NOTE 11 GEOGRAPHIC AREAS AND MAJOR CUSTOMERS****A. Sales by geographic area (as percentage of total sales):**

	Year ended December 31,		
	2008	2007	2006
	%	%	%
USA	50	63	68
Europe - primarily Italy, France and Germany	8	8	10
Japan	17	20	13
Asia Pacific excluding Japan	25	9	9
Total	100	100	100

**B. Sales by major customers (as percentage of total sales):**

	Year ended December 31,		
	2008	2007	2006
	%	%	%
Customer A	37	47	46
Customer B	9	17	9
Customer C	10	17	10
Others	44	19	35
Total	100	100	100

**C. Assets by location**

Substantially all fixed assets are located in Israel.

**NOTE 12 TRANSACTIONS AND BALANCES WITH RELATED PARTIES**

The total directors' fees (including the chairman of the Board) for the year 2008 amounted to \$247 (2007 \$139, 2006 \$193). The number of options granted to directors in 2008 amounted 120,000 (110,000 were granted in 2007 and 562,000 were granted in 2006).

**NOTE 13 FINANCIAL INSTRUMENTS**

**A. Fair value of financial instruments**

A financial instrument is defined as cash, evidence of an ownership interest in an entity, or a contract that impose on one entity a contractual obligation either to deliver cash or receive cash or another financial instrument to or from a second entity. Examples of financial instruments include cash and cash equivalents, short-term interest-bearing bank deposits, held to maturity securities, trade accounts receivable, investments, trade accounts payable, accrued expenses, options and forward contracts.

At December 31, 2008 and 2007 the fair market value of the Company's financial instruments did not materially differ from their respective book value.

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**NOVA MEASURING INSTRUMENTS LTD.  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
(in thousands, except share and per share data)

**NOTE 13 FINANCIAL INSTRUMENTS (Cont.)**

**B. Hedging activities**

In 2006, the Company entered into currency-forward transactions, (NIS/dollar, Euro/dollar, Yen/dollar) of \$15,220 with settlement date through 2006 designed to reduce cash-flow exposure to the impact of exchange-rate fluctuations on firm commitments of \$15,220. In 2007 this decrease was charged to operations on the relevant settlement dates. In accordance with SFAS 133 the Company recorded in 2006 an increase of \$12 in fair market value in Other Comprehensive Income .

In 2007, the Company entered into currency-forward transactions and currency-put options (NIS/dollar, Euro/dollar, Yen/dollar) of \$28,997 with settlement date through 2008 designed to reduce cash-flow exposure to the impact of exchange-rate fluctuations on firm commitments of \$28,997. In accordance with SFAS 133 the Company recorded in 2007 an increase of \$205 in fair market value in Other Comprehensive Income .

In 2008, the Company entered into currency-forward transactions and currency-put options (NIS/dollar, Euro/dollar, Yen/dollar) of \$33,633 with settlement date through 2008 designed to reduce cash-flow exposure to the impact of exchange-rate fluctuations on firm commitments of \$33,633. In accordance with SFAS 133 the Company recorded in 2008 a decrease of \$390 in fair market value in Other Comprehensive Income .

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**SIGNATURES**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and has duly caused and authorized the undersigned to sign this annual report on its behalf.

**NOVA MEASURING INSTRUMENTS LTD.**

By: */s/ Gabi Seligsohn*

Gabi Seligsohn  
President and Chief Executive Officer

**Date: March 30, 2009**

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**EXHIBIT INDEX**

<b><u>Number</u></b>	<b><u>Description</u></b>
1.1	Amended and Restated Articles of Association (filed herewith).
4.1	1997 Stock Option Plan (Plan 2) (incorporated by reference to Exhibit 10.1 to the Company's Registration Statement on Form F-1 (File No. 333-11640)).
4.2	Option Plan 3 (incorporated by reference to Exhibit 10.2 to the Company's Registration Statement on Form F-1 (File No. 333-11640)).
4.3	Option Plan 4A and 4B (incorporated by reference to Exhibit 10.3 to the Company's Registration Statement on Form F-1 (File No. 333-11640)).
4.4	Option Plan 5 (incorporated by reference to Exhibit 4.4 to the Company's Annual Report for 20-F for 2002 filed May 9, 2002).
4.5	Option Plan 6 (incorporated by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8 filed December 24, 2002 (File No. 333-102193)).
4.6	Employment Agreement, dated November 30, 2006, between Nova and Giora Dishon (incorporated by reference to Appendix A to Exhibit 99.1 to the Company's Report on Form 6-K filed October 26, 2006).
4.7	Employment Agreement, dated November 30, 2006, between Nova and Moshe Finarov (incorporated by reference to Appendix A to Exhibit 99.1 to the Company's Report on Form 6-K filed October 26, 2006).
4.8	Summary of Lease Agreements between Nova and Ef-Shar Ltd. (incorporated by reference to Exhibit 4.10 to the Company's Annual Report for 20-F for 2007 filed March 28, 2008).
4.9	Employee Stock Purchase Plan 1 (incorporated herein by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8 filed on March 24, 2003 (File No. 33-103981)).
4.10	Letter of Indemnification and Exculpation for certain directors, officers and/or employees (incorporated herein by reference to Appendix C to the Company's Report on Form 6-K filed on July 7, 2006).
4.11	Option Plan 7A (incorporated by reference to Exhibit 4.1. to the Company's Registration Statement on Form S-8 filed on May 17, 2004 (File No. 333-115554)).

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- 4.12 Option Plan 7B (incorporated by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8 filed on March 7, 2005 (File No. 333-123158)).
- 4.13 Option Plan 7C (incorporated by reference to Exhibit 4.20 of the Company's Annual Report on Form 20-F filed on June 29, 2006).
- 4.14 Option Plan 8 (incorporated by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8 filed on December 29, 2005 (File No. 333-130745)).
- 4.15 Share Purchase Agreement, dated as of February 28, 2007, by and between the Company and the investors identified on the signature pages thereto, including the form of warrant (incorporated by reference to Exhibit 4.19 to the Company's Annual Report on Form 20-F filed on May 11, 2007).
- 4.16 2007 Incentive Plan (incorporated by reference to Exhibit 99.1 to the Company's Registration Statement on Form S-8 filed on November 5, 2007 (File No. 333-147140)).
- 8.1 List of Subsidiaries (incorporated by reference to Exhibit 8 of the Company's Annual Report on Form 20-F filed on June 29, 2006).
- 12.1 Certification required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended (filed herewith).
- 12.2 Certification required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended (filed herewith).
- 13.1 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).
- 13.2 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).
- 15.1 Consent of Brightman Almagor & Co. (filed herewith).