

SECURITIES AND EXCHANGE COMMISSION

FORM 10KSB

Annual and transition reports of small business issuers [Section 13 or 15(d), not S-B Item 405]

Filing Date: **1996-12-30** | Period of Report: **1996-09-30**
SEC Accession No. **0001012870-96-000878**

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FILER

PHOTON DYNAMICS INC

CIK: **1002663** | IRS No.: **943007502** | State of Incorp.: **CA** | Fiscal Year End: **1231**
Type: **10KSB** | Act: **34** | File No.: **000-27234** | Film No.: **96688267**
SIC: **3559** Special industry machinery, nec

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

FORM 10-KSB

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF
1934 For the fiscal year ended September 30, 1996

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

Commission File Number: 0-27234

PHOTON DYNAMICS, INC.
(Exact name of small business issuer as specified in its charter)

<TABLE>

<S>

<C>

CALIFORNIA

94-3007502

(State or other jurisdiction of
incorporation or organization)

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

</TABLE>

6325 SAN IGNACIO
SAN JOSE, CA 95119
(Address of principal executive offices)

(408) 226 9900
(Issuer's telephone number)

Securities registered under Section 12(b) of the Exchange Act:
NONE

Securities registered under Section 12(g) of the Exchange Act:
COMMON STOCK

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the last 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

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B is not contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

Revenue for the year ended September 30, 1996 was \$24,763,000.

The aggregate market value of the voting stock held by non-affiliates of the Registrant, based on the closing price of the Common Stock on December 27, 1996, as reported on the Nasdaq National Market was approximately \$43,361,000. Shares of Common Stock held by each officer and director and by each person who owns 5% or more of the outstanding Common Stock have been excluded from this computation in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of December 27, 1996 the Registrant had outstanding 6,955,037 shares of Common Stock.

Transitional small business Disclosure Format (check one) Yes No X [X]

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement for its 1997 Annual Meeting of Shareholders and the Registrants Annual Report to Shareholders for its fiscal year ended September 30, 1996 are incorporated by reference in Part I, II and III of this Form 10-KSB report.

PART I

ITEM 1: DESCRIPTION OF BUSINESS

THE COMPANY

Photon Dynamics, Inc. is a leading worldwide supplier of test, inspection and repair systems for the flat panel display ("FPD") industry. The Company's systems are used to control, monitor and refine the manufacturing process to increase the yield of FPDs, to reduce materials loss, to transition new FPD designs from research and development to commercial production and to assist in the rapid start-up of new FPD manufacturing facilities. While certain aspects of the manufacturing processes for FPDs are similar to manufacturing processes for semiconductor devices, materials costs represent a substantially higher percentage of the cost of an FPD as compared with semiconductor devices. As a result, the need for test and inspection of FPDs goes beyond the need to improve yields as FPD manufacturers seek to identify defects early in the manufacturing process to either avoid investment of further materials cost or to repair the defect before further manufacturing steps make it less accessible. The Company believes that more of its systems have been used by manufacturers of active matrix liquid crystal displays ("AMLCDs") and other advanced FPDs to test, inspect and repair more VGA and other higher resolution FPDs than any other currently available competitive system and that this experience has enabled it to become a leading technical innovator of test, inspection and repair equipment for advanced FPD manufacturers.

Photon Dynamics offers a suite of products to inspect virtually all current

types of FPDs and to address all key areas of AMLCD test, inspection and repair throughout all major stages of the manufacturing life cycle, from research and development to commercial production. The Company's test products include array test systems that locate, count and characterize electrical array faults, contamination and other defects on partially completed flat panel display substrates. The Company's repair product performs array laser cut and weld repair functions based upon information generated by its test and inspection products. Its inspection products perform flat panel cell and module inspection to detect and locate optical defects in FPDs. All of the Company's product lines interface with one another through software systems used to store data and generate reports and other information used by FPD manufacturers to increase their yields.

The Company's products incorporate proprietary technologies that provide FPD manufacturers with the ability to obtain information critical to yield improvement and management of manufacturing processes that had not previously been readily available to FPD manufacturers. The Company's proprietary Voltage Imaging(TM) and N-Aliasing(TM) technologies, in conjunction with its proprietary software programs, permit non-contact, full characterization and image evaluation of virtually all commercially produced FPD displays, regardless of panel size or the FPD technology employed. All of the Company's product lines are currently being used with VGA and SVGA displays and are designed for use with next generation XGA and SXGA displays.

PRODUCTS

Photon Dynamics offers a suite of products to inspect virtually all types of FPDs. All of the Company's systems use similar software based controls, processing and graphical user interfaces. Products can be networked together so FPD defect data can be stored, analyzed and used throughout the manufacturing process. All of the Company's systems are capable of providing fully automated functionality through robotics incorporated into the systems by Photon Dynamics or purchased from third party vendors.

The following table lists the Company's products:

<TABLE>

<CAPTION>

PRODUCT	FIRST COMMERCIAL SHIPMENT	FUNCTION	COMPATIBLE FPD TECHNOLOGY	STATE OF FPD MANUFACTURE
<C>	<C>	<C>	<C>	<S>
IPT-E	1994	Array test	AMLCD	Research and development Pre-production
IPT-MPS	1995	Array test	AMLCD	Research and development Pre-production Production
FIS-200*	1993	VGA inspection	ALL	Research and development Pre-production Production

FIS-250	1995	SVGA inspection	ALL	Research and development Pre-production Production
FIS-300	1995	XGA inspection	ALL	Research and development Pre-production Production
ILW(TM)	1993	Repair	AMLCD and passive matrix LCD	Production

</TABLE>

* Superseded by the FIS-250

In-Process Test Systems (IPT Systems)

The Company's In-Process Test (IPT) systems use the Company's proprietary Voltage Imaging(TM) technology to detect, locate, quantify and characterize electrical, contamination and other defects in AMLCD arrays after the completion of the first major step of production, the construction of the transistor array on the glass substrate. The systems incorporate a computer workstation and proprietary image processing software to display pixel images and information which not only allows manufacturers to determine whether individual pixels or lines of pixels are functional, but also allows them to find more subtle defects such as individual pixel voltage variations early in the production process. In addition, these systems generate point and line defect data files specifying the exact location of each defect, which data can then be used for statistical process control or downloaded to the Company's ILW(TM) system to effect repairs. The systems also perform key procedures involved in the testing process, including running test sequences and loading, unloading and sorting substrates. The IPT systems can be adapted to test different panel sizes in less than three hours, as compared with systems using probe card technology which the Company estimates can require up to 16 hours. The currently available IPT-MPS system is an enhanced version of the IPT system that uses optimized processing software, graphical user interface and materials transport features. These features have been designed to enable the IPT-MPS system to achieve throughput rates that are comparable to conventional probe card based systems while providing the same functionality, flexibility and cost-efficient features of the earlier IPT system.

Flat Panel Inspection Systems (FIS Systems)

The Company's Flat Panel Inspection (FIS) systems use the Company's proprietary N-Aliasing(TM) technology to inspect virtually any type and size of commercially available FPD panel for optical defects after the completion of the second major stage of production, the construction of color cells comprising individual pixels. FIS systems are also designed to perform inspection after final module assembly of FPD panels. The systems use a single high-resolution camera and workstation driven by the Company's N-Aliasing(TM) software to quantitatively measure critical optical qualities such as contrast, luminance and color balance and to precisely

locate mura, line, cluster and individual pixel defects. Test data generated

by the systems is displayed on a video monitor to provide immediate visual interpretation and can be stored or sent to a repair system to effect repairs. FIS systems comprise a family of products that offer different levels of resolution and flexibility to suit customers needs. The FIS-250 and the FIS-300 test FPD panels with VGA, SVGA and XGA resolution, respectively. They can currently be configured to perform as many as 100 individual tests and are adaptable to panel sizes ranging from 0.75 to 15 inches. The systems are available either as stand-alone units or as modular systems designed to be integrated with manufacturers' material handling equipment.

Integrated Laser Weld System (ILWS(TM) System)

The Company's Integrated Laser Weld (ILW(TM)) system uses a laser to repair opens and shorts in AMLCD and passive LCD panels. The ILW(TM) can use defect files downloaded from the Company's IPT or FIS systems to automatically locate the defects in the panel so that the operator can decide whether or not to repair them. This capability saves operator time searching for the defects among the hundreds of thousands of pixels on a display. The ILW(TM) repairs shorts by cutting away excess material and opens by welding a new connection to a recovery ring. New model ILW(TM) systems shipped in 1996 featured unique BeamBlender(TM) laser technology. The feature allows manufacturers to blend two laser frequencies in certain ratios for cutting or welding new materials used in low-temperature polysilicon thin-film transistors.

INTELLECTUAL PROPERTY

The Company has been issued over 21 U.S. patents with respect to its FPD test, inspection and repair technologies and has certain U.S. and foreign applications pending. The Company has a number of U.S. patents related to its Voltage Imaging(TM) technology and has applied for U.S., Japanese and Korean patents related to this technology as well as its N-Aliasing(TM) technology. No patents are scheduled to expire before 2010, subject to payment of applicable maintenance fees. In addition, Photon Dynamics and IHI have jointly filed patent applications in Japan relating to certain aspects of the IPT systems.

The Company frequently reviews its inventions and attempts to determine which inventions will provide substantial differentiation between the Company's products and those of its competitors. In certain cases, the Company may also choose to keep an invention or a process as a trade secret. Trade secrets are routinely employed in the Company's manufacturing processes. The Company has entered into non-disclosure agreements to protect its proprietary technology with its employees and consultants, and in some instances with its suppliers, its customers and IHI. Because of rapid technological developments in the electronics and FPD industries and the broad and rapidly developing patent coverage in such industries, the patent position of any manufacturer, including the Company, is subject to uncertainties and may involve complex legal and factual issues. Consequently, although the Company holds certain patents and is currently prosecuting additional patent applications, there can be no assurance that patents will issue from any pending applications or that claims allowed by any existing or future patents will issue from any pending applications or that claims allowed by any existing or future patents issued to the Company will not be challenged, invalidated, or circumvented, or that any rights granted thereunder will provide adequate protection to the Company.

Furthermore, there can be no assurance that others will not develop technologies that are similar or superior to the Company's technology, duplicate the Company's technology or design around the patents owned by the Company. In addition, effective copyright and trade secret protection may be unavailable or limited in certain foreign countries. There can be no assurance that the steps taken by the Company will prevent misappropriation of its technology. In addition, litigation may be necessary in the future to enforce the Company's patents and other intellectual property rights, to protect the Company's trade secrets, to determine the validity and scope of the proprietary rights of others or to defend against claims of infringement or invalidity. Such litigation could result in substantial costs and diversion of resources and could have a material adverse effect on the Company's results of operations or financial condition. Moreover, the Company may be required to participate in interference proceedings to determine the priority of inventions, which also could result in substantial cost to the Company. See "Factors That May Affect Future Results."

RESEARCH AND DEVELOPMENT

The market for FPD test, inspection and repair systems is characterized by rapid and continuous technological development and product innovation. The Company believes that continued and timely development of new products and enhancements to existing products is necessary to maintain its competitive position. Accordingly, the Company devotes a significant portion of its personnel and financial resources to research and development programs and seeks to maintain close relationships with customers to remain responsive to their product needs. Photon Dynamics' current research and development efforts are directed to increasing the performance of its flat panel inspection and test systems and expanding the application of its inspection systems for use in other related markets. Because the software incorporated by the Company into its products represents a significant portion of the value added by these products, over one-third of the Company's research and development personnel are focused on software development.

The Company's research and development expenses were \$4.0 million and \$1.7 million in fiscal 1996 and fiscal 1995, respectively, or 16.1% and 9.1% of revenue, respectively. Research and development expenses consist primarily of salaries, project materials and other costs associated with the Company's ongoing efforts. In addition to research and development expenses incurred for product development, the Company spent \$1.0 million in fiscal 1996 and \$4.6 million in fiscal 1995 in performance of its obligations under development contracts.

The Company has obtained substantial development funding from IHI with respect to the Company's IPT systems. IHI has provided funding for initial feasibility studies and development of the first prototypes of the IPT systems, and since 1990 IHI has provided to the Company in excess of \$6.3 million in research and development funding with respect to the IPT systems. At present, the Company and IHI are parties to a development agreement pursuant to which IHI is providing up to \$1.5 million to Photon Dynamics to

fund continuing development and improvement of the IPT-MPS systems. Under these agreements IHI is granted certain licenses and joint ownership rights to the developed technology, which rights are consistent with IHI's manufacturing and sales rights under the Company's existing agreements with IHI.

The Company has entered into contracts from the U.S. government and private companies including IHI, to develop products which Photon Dynamics is then able to sell with certain restrictions. Photon Dynamics generally owns all of the intellectual property developed under these contracts, although the Company has licensed certain rights to its IPT technology to the U.S. government which may transfer its license to a third party for use in products sold to U.S. customers in the event the Company becomes unable to delivery IPT systems to U.S. customers.

CUSTOMERS, SALES AND SERVICE

The Company sells its products to leading FPD manufacturers worldwide. Sales to Sharp Corp. represented 5% and 25% of revenue in fiscal 1996 and fiscal 1995. Sales to LG Electronics, Inc represented 19% and 24% of revenue in fiscal 1996 and fiscal 1995. Overall, the Company's top six customers contributed 78% of revenue in fiscal 1996. International sales accounted for 88% and 63% of revenue in fiscal 1996 and 1995, respectively.

Under its agreements with IHI, the Company has granted certain exclusive sales rights to IHI with respect to its IPT systems, including the IPT-MPS, for Japan, Korea and a number of other Asian countries. These exclusive rights continue until June 1997 and may be renewed by IHI and the Company for subsequent periods. In the event these exclusive sales and marketing rights of IHI are not renewed, IHI will retain a non-exclusive right to manufacture and sell IPT systems in the IHI territory. The sales and marketing provisions of the Company's relationship with IHI provide that IHI is entitled to sell IPT systems in Japan, Korea and the rest of the IHI territory and that the Company will assist IHI in a sales agent capacity in exchange for a commission. At present, IHI and Photon Dynamics share sales responsibility for Photon Dynamics manufactured IPT systems in Japan, and Photon Dynamics is directly selling all IPT systems outside Japan, which IHI has contractually agreed to allow Photon Dynamics to do through December 31, 1996. IHI performs all support and service for system

units in Japan, while Photon Dynamics provides support and service in the balance of the IHI territory. To the extent IHI determines in the future to exercise fully its contractual rights to manufacture and sell these systems for the IHI territory, such action would reduce revenue of the Company attributable to these IHI manufactured IPT systems and may have an adverse effect on the Company's results of operations. In the event IHI should determine to reduce its internal budgets, staffing levels, research and development funding or other allocations of its resources for development, manufacture, sale and support of IPT systems in its territory, such action by IHI could have a material adverse effect on the Company's ability to compete in these markets and on the Company's results of operations.

The Company primarily sells its products directly to end users, other than sales through IHI. Photon Dynamics believes that using a direct sales force provides it with a significant competitive advantage as well as control over pricing and customer satisfaction. In Taiwan, Photon Dynamics sells through a direct sales force supported by an independent sales representative. In the U.S., the Company sells direct. Sales in Europe are supported from the Company's U.S. offices.

In the U.S., the Company maintains its sales and service office at its headquarters in San Jose, California. In Asia, the Company has subsidiaries in Tokyo, Japan and Seoul, Korea that provide direct sales and service support. The Asian sales and service operations are staffed by direct marketing, sales and service personnel located in Japan and Korea. In addition, in Japan the Company's IPT systems are serviced by IHI.

The Company generally sells its products on net 30-day terms to its customers, with a small portion held back until final acceptance. However, a substantial portion of its customers, primarily foreign, remit payments on significantly longer terms. The Company generally warrants its products for a period of one year from acceptance by customers within 30 days of installation for material and labor to repair the product. Installation is generally included in the price of the product. The Company's field engineers provide customers with repair and maintenance services. Customers may enter into repair and maintenance service contracts covering the Company's products. The Company provides customer training for a fee to enable its customers to perform routine service and provides telephone consultation services generally free of charge. The Company does not consider its business to be seasonal in nature, but it may become cyclical with respect to the capital equipment procurement practices of major FPD manufacturers.

MANUFACTURING AND SUPPLIERS

The Company's principal manufacturing activities take place in San Jose, California and consist primarily of assembling and testing components and subassemblies which are acquired from third party vendors and then integrated into Photon Dynamics finished products. Certain of the components and subassemblies included in the Company's systems are obtained from a single source or a limited group of suppliers. For example, the Company has obtained all of the high speed image processing systems, materials handling platforms and ultra-high resolution cameras used in its products from single source suppliers, including Kodak Corporation and Anorad Corporation. The Company has not entered into any formal agreements with such suppliers, other than long term purchase orders and, in some cases, volume pricing agreements. The partial or complete loss of such suppliers could increase the Company's manufacturing costs or delay product shipments while the Company qualifies a new supplier, could require redesigning the Company's products and could therefore have an adverse effect on the Company's results of operations and damage customer relationships. Further, a significant increase in the price of one or more of the components supplied by such suppliers could adversely affect the Company's results of operations.

The Company schedules production based upon firm customer commitments and anticipated orders during the planning cycle. The Company generally expects to be able to accept a customer order, build the required machinery and ship to

the customer within 16 weeks. Quality control is maintained through incoming inspection of components, in-process inspection during equipment assembly and final inspection and operation of all manufactured equipment prior to shipment. The Company works in close collaboration with its employees, customers and suppliers and trains all of its employees in basic quality skills and regularly participates in quality

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sharing meetings with other equipment manufacturers and customer quality audits of procedures and personnel. The Company conducts final testing of its systems and assembles certain components under limited clean room conditions, but most manufacturing is done in standard manufacturing space. The Company believes that additional manufacturing space to respond to higher demand is therefore readily available.

The Company has granted certain exclusive rights to IHI to manufacture IPT systems, including the IPT-MPS, for Japan, Korea and the rest of the IHI territory. Under the terms of the Company's agreements with IHI, Photon Dynamics retains the right to manufacture certain critical components for the IPT systems and to sell these components to IHI at prices that are established annually, and IHI has the right to manufacture and assemble the balance of the IPT systems to be sold in its territories. To date, IHI has allowed Photon Dynamics to manufacture all IPT systems for IHI, which has acted as a distributor in Japan and performed customization of the IPT systems for the Japanese market and its individual customers in that market. To the extent IHI determines in the future to exercise fully its contractual right to manufacture and sell these systems for the IHI territory, such action would reduce revenue of the Company attributable to these IHI manufactured IPT systems and may have a material adverse effect on the Company's results of operations.

BACKLOG

As of September 30, 1996, the Company's backlog was approximately \$4.9 million as compared to approximately \$5.4 million as of September 30, 1995. In addition, approximately 82% of the Company's backlog at fiscal 1996 year-end was comprised of orders from three customers. The Company's backlog consists of those customer orders for which it has accepted purchase orders and assigned shipment dates within the next 12 months. All orders are subject to delay or cancellation with limited or no penalty. Because of possible changes in product delivery schedules and cancellation of product orders, because orders received by the Company in any particular quarter may vary significantly and because the Company's sales will often reflect orders shipped in the same quarter they are received, the Company's backlog may vary significantly and at any particular date is not necessarily indicative of actual sales for any succeeding period.

COMPETITION

The FPD equipment industry is highly competitive. The Company faces the prospect of substantial future competition from established companies, some of which are expected to be larger companies, or parts thereof, some of which are

expected to have greater financial, engineering and manufacturing resources than the Company and some of which are expected to have larger service organizations and long-standing customer relationships with major FPD manufacturers. In the event that the Company's agreements with IHI are not extended in 1997, IHI may compete with the Company selling the Company's IPT systems in Japan, Korea and the rest of the IHI territory. The Company also expects it may face additional competition from new entrants into the FPD equipment industry and from competitors utilizing new technologies. The Company's competitors can be expected to continue to improve the design and performance of their products and to introduce new products with competitive price/performance characteristics. In addition, the Company's customers may choose to develop proprietary technology and FPD equipment which may obviate or lessen their need to purchase the Company's products. The Company's customers may also use multiple technologies and solutions, including competitors' products, to replicate the functionality of the Company's systems. Competitive pressures may necessitate price reductions which could adversely affect the Company's results of operations. Although the Company believes that it has certain technological and other advantages over its competitors, realizing and maintaining such advantages will require a continued high level of investment by the Company in engineering, research and development, marketing and customer service and support. There can be no assurance that the Company will have sufficient resources to continue to make such investments or that the Company will be able to make the technological advances necessary to maintain such competitive advantages.

EMPLOYEES

As of September 30, 1996, the Company employed 104 persons, all full time. Many of the Company's employees are highly skilled, and the Company's success will depend in part upon its ability to attract and retain such employees, who are in great demand. The Company has never had a work stoppage or strike and no employees are represented by a labor union or covered by a collective bargaining agreement. The Company considers its employee relations to be good.

FACTORS THAT MAY AFFECT FUTURE RESULTS

FACTORS AFFECTING EARNINGS AND STOCK PRICE

The statements contained in this report on Form 10-KSB that are not purely historical are forward looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding the Company's expectations, hopes, intentions or strategies regarding the future. All forward looking statements included in this document are based on information available to the Company on the date hereof, and the Company assumes no obligation to update any such forward looking statements. It is important to note that the Company's actual results could differ materially from those in such forward looking statements. You should consult the risk factors listed from time to time in the Company's reports on Form 10-QSB, and annual reports to shareholders. Among the factors that could cause actual results to differ materially are the following risk factors:

VARIABILITY OF QUARTERLY RESULTS OF OPERATIONS; LIMITED HISTORY OF PROFITABILITY

The Company has experienced and expects to continue to experience significant fluctuations in its quarterly results of operations. The Company derives substantially all of its revenue from the sale of a relatively small number of systems, which typically range in price from \$400,000 to \$1,500,000. As a result, the timing of the sale of a single system could have a significant impact on the Company's quarterly revenue and results of operations. The failure to receive anticipated orders or delays in shipments in a particular quarter, due, for example, to unanticipated shipment reschedulings, cancellations by customers or unexpected manufacturing difficulties, may cause revenue for that quarter to fall significantly below the Company's expectations, which would have a material adverse effect on the Company's results of operations for such quarter. The Company's backlog at the beginning of each quarter is not necessarily indicative of actual sales for any succeeding period. All orders are subject to delay or cancellation with limited or no penalty. The Company's sales will often reflect orders shipped in the same quarter that they are received. Other factors which may have an influence on the Company's results of operations in a particular quarter include the volume, mix and timing of the receipt of orders from major customers, competitive pricing pressures, costs of components and subsystems, the Company's ability to design, manufacture and introduce new products on a cost effective and timely basis, the delay between incurrence of expenses to further develop marketing and service capabilities and realization of benefits from such improved capabilities, fluctuations in foreign exchange rates, the timing of recognition of revenue under development contracts, the introduction and announcement of new products by the Company's competitors and changing conditions in the FPD ("Flat Panel Display")market worldwide. In particular, due to substantial differences in gross margin for the Company's products, changes in the mix of products sold could result in substantial fluctuations in the Company's gross margin. Accordingly, the Company's results of operations are subject to significant variability from quarter to quarter.

DEPENDENCE ON RECENTLY INTRODUCED AND NEW PRODUCTS

The markets for the Company's products are characterized by rapidly changing technologies, extensive research and new product introductions. The Company believes that its future success will depend in part upon its ability to continue to enhance its existing products and to develop and manufacture new products. As a result, the Company expects to continue to make a significant investment in engineering, research and development. There can be no assurance that the Company will be successful in the introduction, marketing and cost effective

manufacture of any of its new or recently introduced products or that the Company will be able to develop and introduce new products or enhancements to its existing products and processes in a timely manner which satisfy customer needs, achieve market acceptance or address technological changes in the FPD industry. In order to develop new products successfully, the Company is

dependent upon close relationships with its customers and the willingness of those customers to share information with the Company. The failure to develop products and introduce them successfully and in a timely manner could adversely affect the Company's competitive position and results of operations. The Company's future results of operations are highly dependent on the continuing market introduction, marketing and cost-effective manufacture of its In-Process Test Mass Production System (IPT-MPS), which first shipped in September 1995. The Company continues to perform research and development work with respect to the IPT-MPS system to attain additional throughput levels requested by the Company's customers and other performance parameters sought by manufacturers of active matrix liquid crystal displays ("AMLCDs") for their volume production environments. The Company has experienced delays in implementing the software necessary to achieve throughput rates. No assurance can be given that development efforts related to other performance parameters will be successful. The Company believes that future orders of IPT-MPS systems will be dependent on its ability to attain requested throughput levels and other performance parameters. The Company has experienced delays in obtaining final acceptance and final payment on some products. If products have performance, reliability or quality problems or shortcomings, then the Company may experience reduced orders, higher manufacturing costs, continued delays in collecting accounts receivable and additional warranty and service expenses which may have an adverse effect on the Company's results of operations. In addition, future growth in sales of the Company's products will depend upon the acceptance of the Company's IPT or FIS technologies by a broader group of customers, including additional international customers and FPD manufacturers who currently do not perform the type of FPD test or inspection offered by the Company's products or utilize alternative technologies for, or methods of, inspection, such as "open/short" testing and human visual inspection. Because of the large capital commitment involved in the construction and operation of an FPD manufacturing facility, the decision by an FPD manufacturer to purchase the Company's IPT or FIS systems involves a significant technological and financial commitment as compared to current alternatives such as human inspection and open/short testers. While the Company is actively promoting the acceptance of these technologies, there can be no assurance that the Company will be successful in obtaining broader acceptance of its IPT or FIS technologies. Failure to achieve broader acceptance would have an adverse effect on the Company's results of operations.

DEPENDENCE ON PRINCIPAL CUSTOMERS

The FPD industry is extremely concentrated, with virtually all major FPD manufacturers and many of the Company's principal customers located in Asia. Although the composition of the Company's largest customers has changed from year to year, direct sales to the Company's top six in fiscal 1996 and top four in fiscal 1995 end user customers accounted for approximately 78% and 71%, respectively, of the Company's total revenue. The Company currently has no long-term purchase commitments with any of its customers and sales are generally made pursuant to purchase orders. All orders are subject to delay or cancellation with limited or no penalty. A reduction, delay, or cancellation of orders from one or more of its significant customers, or the loss of one or more of such customers, could have a material adverse effect on the Company's results of operations.

DEPENDENCE ON SINGLE OR LIMITED SUPPLIERS

Certain of the components and subassemblies included in the Company's systems are obtained from a single source or a limited group of suppliers. For example, the Company has obtained all of the high speed image processing systems, materials handling platforms and ultra-high resolution cameras used in its products from single source suppliers, including Kodak Corporation and Anorad Corporation. The Company has not entered into any formal agreements with such suppliers, other than long term purchase orders and, in some cases, volume pricing agreements. The partial or complete loss of such suppliers could increase the Company's manufacturing costs or delay product shipments while the Company qualifies a new supplier, could require redesigning the

Company's products and could therefore have an adverse effect on the Company's results of operations and damage customer relationships. Further, a significant increase in the price of one or more of the components supplied by such suppliers could adversely affect the Company's results of operations.

RELATIONSHIP WITH IHI

The Company has granted certain exclusive manufacturing and sales rights to Ishikawajima-Harima Heavy Industries Co., Ltd. ("IHI") with respect to its IPT systems, including the IPT-MPS, for Japan, Korea, a number of other Asian countries, Saudi Arabia, Australia, New Zealand, India and Sri Lanka. Under the terms of this relationship the Company reserves the rights to manufacture certain critical components and to sell the components to IHI for inclusion in IPT systems to be sold by IHI in its territory. The agreements between IHI and the Company further provide for the Company to assist IHI in its sales efforts in these countries in exchange for a commission. This relationship continues on an exclusive basis for the IHI territory until June 1997, and, if such exclusivity is not renewed, IHI will have non-exclusive manufacturing and sales rights in its territory in periods thereafter. In exchange for these rights, IHI has provided and continues to provide significant funding for development of the IPT systems, which funding substantially enhanced the Company's ability to complete development of these systems in a timely fashion. To date, IHI has allowed Photon to manufacture all IPT systems sold by IHI in the IHI territory, and the Company expects that many, if not all, of the IPT systems that will be sold in IHI's territory will be manufactured by the Company. At present, IHI and Photon share sales responsibility for Photon manufactured IPT systems in Japan, and IHI has agreed to allow Photon to sell directly all IPT systems outside Japan through December 31, 1996. IHI performs all support and service for system units in Japan, while Photon provides support and service in the balance of the IHI territory. To the extent IHI determines in the future to exercise fully its contractual rights to manufacture and sell these systems in the IHI territory, such action would reduce revenue of the Company attributable to these IHI manufactured IPT systems and may have a material adverse effect on the Company's results of operations. Given the concentration of FPD manufacturers in the IHI territory, the Company is highly dependent on IHI and the success of the Company's relationship with IHI to market and sell the IPT systems, including the IPT-MPS, in these critical markets. In the event IHI should determine to reduce its internal budgets, staffing levels, research and development funding or

other allocations of its resources for the development, manufacture, sale and support of IPT systems in its territory, such action by IHI could have a material adverse effect on the Company's ability to compete in these markets and on the Company's results of operations. While the Company believes that both it and IHI have obtained significant mutual benefit from their continuing relationship, no assurance can be given that the IHI relationship will continue to provide such benefits to the Company or that the Company's results of operations will not be adversely impacted in the future based on its dependency on IHI for the manufacture, sales and support of IPT systems in Japan and other important Asian markets in the IHI territory.

INTERNATIONAL OPERATIONS

Approximately 88% of the Company's total revenue for fiscal 1996 was attributable to sales outside the U.S. The Company expects that international sales will continue to represent a significant portion of its total sales. Sales to customers outside the U.S. are subject to risks, including the imposition of governmental controls, the need to comply with a wide variety of foreign and U.S. export laws, political and economic instability, trade restrictions, changes in tariffs and taxes, longer payment cycles typically associated with international sales, and the greater difficulty of administering business overseas as well as general economic conditions. Although substantially all of the Company's direct international sales are denominated in U.S. dollars, both direct sales by the Company and sales through IHI may be affected by changes in demand resulting from fluctuations in interest and currency exchange rates. To the extent the Company's sales are denominated in foreign currency, the Company's revenue and results of operations may also be directly affected by fluctuations in foreign currency exchange rates. Furthermore, although the Company endeavors to meet technical standards established by foreign regulatory bodies, there can be no assurance that the Company will be able to comply with changes in foreign standards in the future. The inability of the Company to design products to comply with foreign standards could have a material adverse effect on the Company. In addition, the laws of certain foreign countries may not protect the Company's intellectual property to the same extent as do the laws of the U.S.

DEPENDENCE ON JAPANESE MARKET

The future performance of the Company will be dependent, in part, upon its ability to continue to compete successfully in the Japanese market, one of the largest markets for FPD test, inspection and repair equipment. The Company's ability to compete in this market in the future is dependent upon continuing free trade between Japan and the U.S., the continuing ability of the Company to develop products in a timely manner that meet the technical requirements of its Japanese customers and the continuing ability of the Company to maintain satisfactory relationships with leading companies in the Japanese FPD industry. The Company believes that the Japanese companies with which it competes may have a competitive advantage in Japan because of the preference of some Japanese customers for Japanese equipment suppliers because such customers may have longer standing or closer business relationships with such competitors. The Company's sales to Japan and results of operations will also

be affected by the overall health of the Japanese economy, including the effects of currency exchange rate fluctuations on the global competitiveness of Japanese FPD manufacturers.

RAPID AND FUNDAMENTAL TECHNOLOGICAL CHANGE

The FPD industry is an evolving industry characterized by extensive research and development which has and is expected to continue to lead to rapid technological change. The development by others of new or improved products or technologies may make the Company's current or proposed products obsolete or less competitive. Although the Company devotes significant efforts and financial resources to further develop and enhance its existing products, there can be no assurance that advances in other or alternative technologies will not make the Company's products obsolete or less competitive. Currently, the predominant technology used in the FPD industry is liquid crystal display ("LCD") technology. Although the Company has installed its products or has entered into discussions with manufacturers utilizing virtually all of the alternative FPD technologies which the Company believes are commercially viable FPD technologies, its revenue is derived primarily from sales of products related to a variant of LCD technology used in a substantial portion of all FPDs, AMLCD technology. An industry shift away from AMLCD technology or the emergence of new competing technologies could have a material adverse effect on the Company's business and results of operations.

COMPETITION

The FPD equipment industry is highly competitive. The Company faces the prospect of substantial future competition from established companies, some of which are expected to be larger companies, or parts thereof, some of which are expected to have greater financial, engineering and manufacturing resources than the Company and some of which are expected to have larger sales and service organizations and long-standing customer relationships with major FPD manufacturers. In the event that the Company's agreements with IHI are not extended in 1997, IHI may compete with the Company in selling the Company's IPT systems in Japan, Korea and the rest of the IHI territory. The Company also expects it may face additional competition from new entrants into the FPD equipment industry and from competitors utilizing new technologies. The Company's competitors can be expected to continue to improve the design and performance of their products and to introduce new products with competitive price/performance characteristics. In addition, the Company's customers may choose to develop proprietary technology and FPD equipment which may obviate or lessen their need to purchase the Company's products. The Company's customers may also use multiple technologies and solutions, including competitors' products, to provide the functionality of the Company's systems. Competitive pressures may necessitate price reductions which could adversely affect the Company's results of operations. Although the Company believes that it has certain technological and other advantages over its competitors, realizing and maintaining such advantages will require a continued high level of investment by the Company in engineering, research and development, marketing and customer service and support. There can be no assurance that the Company will have sufficient resources to continue to make such investments or that the Company will be able to make the technological advances necessary to maintain such competitive advantages.

FLAT PANEL DISPLAY INDUSTRY DOWNTURNS OR SLOWDOWNS

The Company's business depends in large part upon the capital equipment expenditures of FPD manufacturers, which in turn depend on the current and anticipated market demand for FPDs and products utilizing FPDs. For example, the Company believes that historical shortages of supplies of semiconductor components may have in the past temporarily limited the quantities of laptop computers that were manufactured, which in turn may have reduced demand from laptop computer manufacturers for certain FPDs. Should these conditions have continued for an extended period, the resulting reduced long-term demand for FPDs suitable for laptop computers could adversely affect the level of capital expenditure by FPD manufacturers. Although to date the FPD industry has had a relatively steady growth rate, the FPD industry may, like the semiconductor industry, become highly cyclical and experience periodic downturns or slowdowns in growth, which may have a material adverse effect on capital equipment expenditures by FPD manufacturers and in turn adversely affect the Company's results of operations. No assurance can be given that the Company's results of operations would not be adversely affected if such downturns or slowdowns in the FPD industry were to occur in the future. In addition, the need for continued investment in engineering, research and development and marketing required to penetrate targeted foreign markets and maintenance of extensive worldwide customer service and support capabilities will limit the Company's ability to reduce expenses during downturns or slowdowns in growth in the FPD industry.

PATENTS AND PROPRIETARY RIGHTS

The Company's future success and competitive position are dependent in part upon its proprietary technology, and the Company relies on patent, trade secret, trademark and copyright law to protect its intellectual property. There can be no assurance that any patent owned or licensed by the Company will not be invalidated, circumvented, challenged or licensed to others, that the rights granted thereunder will provide competitive advantages to the Company or that any of the Company's pending or future patent applications will be issued with the scope of the claims sought by the Company, if at all. Furthermore, there can be no assurance that others will not develop technologies that are similar or superior to the Company's technology, duplicate the Company's technology or design around the patents owned by the Company. In addition, effective copyright and trade secret protection may be unavailable or limited in certain foreign countries. There can be no assurance that the steps taken by the Company will prevent misappropriation of its technology. In addition, litigation may be necessary in the future to enforce the Company's patents and other intellectual property rights, to protect the Company's trade secrets, to determine the validity and scope of the proprietary rights of others or to defend against claims of infringement or invalidity. Such litigation could result in substantial costs and diversion of resources and could have a material adverse effect on the Company's results of operations.

Competitors in both the U.S. and foreign countries, many of which have

substantially greater resources and have made substantial investments in competing technologies, may have applied for or obtained, or may in the future apply for and obtain, patents that will prevent, limit or interfere with the Company's ability to manufacture and sell its products. The Company has not conducted an independent review of patents issued to third parties. Although the Company believes that its products do not infringe the patents or other proprietary rights of third parties, there can be no assurance that other third parties will not assert infringement claims against the Company or that such claims will not be successful. Even successful defense of patent suits are both costly and time-consuming. An adverse outcome in the defense of a patent suit could subject the Company to significant liabilities to third parties, require disputed rights to be licensed from third parties or require the Company to cease selling its products.

MANAGEMENT OF GROWTH

The Company has recently experienced and may continue to experience growth in the number of its employees and the scope of its operations, resulting in increased responsibilities for management personnel. To manage recent and potential future growth effectively, the Company will need to continue to implement and improve its operational, financial and management information systems and to hire, train, motivate and manage

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a growing number of employees. The future success of the Company also will depend on its ability to attract and retain qualified technical, marketing and management personnel, particularly highly skilled software engineers, for whom competition is intense. In particular, the current availability of qualified engineers is limited, and competition among companies for skilled and experienced engineering personnel is very strong. The Company is currently attempting to hire a number of engineering personnel and has experienced delays in filling such positions. The Company expects to experience continued difficulty in filling its needs for qualified engineers and other personnel. There can be no assurance that the Company will be able to achieve or manage effectively any such growth, and failure to do so could delay product development cycles or otherwise have a material adverse effect on the Company's results of operations.

DEPENDENCE ON KEY EMPLOYEES

The future success of the Company is dependent, in part, on its ability to retain certain key personnel. The Company also needs to attract additional skilled personnel in all areas of its business to continue to grow. While many of the Company's current employees have many years of service with the Company, there can be no assurance that the Company will be able to retain its existing personnel or attract additional qualified employees in the future.

POSSIBLE VOLATILITY OF COMMON STOCK PRICE

Many factors such as, but not limited to, announcements of technological innovations or new products by the Company, its competitors or third parties, as well as quarterly variations in the Company's actual or anticipated results

of operations, may cause the market price of the Company's Common Stock to fluctuate significantly. Furthermore, the stock market has experienced extreme price and volume fluctuations, which have particularly affected the market prices of many high technology companies and which have often been unrelated to the operating performance of such companies. These broad market fluctuations may adversely affect the market price of the Company's Common Stock.

ITEM 2: DESCRIPTION OF PROPERTY.

The Company's main headquarters, located in San Jose, California consists of a 50,000 square foot facility. The current monthly base rental under the lease for the facility is approximately \$49,000. The lease expires in 2001. The Company also leases office space for its sales and service operations in Seoul, Korea and Tokyo, Japan.

ITEM 3: LEGAL PROCEEDINGS.

The Company is not a party to any material litigation.

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

No matters were submitted to a vote of security holders during the fourth quarter ended September 30, 1996.

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PART II

ITEM 5: MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.

The information required by this Item is incorporated by reference from page 24 of the Company's 1996 Annual Report to Stockholders.

ITEM 6: MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION.

The information required by this Item is incorporated by reference from pages 6-10 of the Company's 1996 Annual Report to Stockholders.

ITEM 7: FINANCIAL STATEMENTS.

The information required by this Item is incorporated by reference from pages 11-22 of the Company's 1996 Annual Report to Stockholders.

ITEM 8: CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

Not applicable

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PART III

Certain information required by Part III is omitted from this Report in that the Registrant will file a definitive proxy statement within 120 days after the end of its fiscal year pursuant to Regulation 14A (the "Proxy Statement") for its 1997 Annual Meeting of Stockholders to be held February 12, 1997 and the information included therein is incorporated herein by reference.

ITEM 9: DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS;
COMPLIANCE WITH SECTION 16(A) OF THE EXCHANGE ACT.

The information required by this Item is incorporated by reference from the Company's Proxy Statement for the 1997 Annual Meeting of Stockholders under the Heading "Management

ITEM 10: EXECUTIVE COMPENSATION.

The information required by this Item is incorporated by reference from the Company's Proxy Statement for the 1997 Annual Meeting of Stockholders under the Heading "Management

ITEM 11: SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.

The information required by this Item is incorporated by reference from the Company's Proxy Statement for the 1997 Annual Meeting of Stockholders under the Heading "Security Ownership Of Certain Beneficial Owners And Management"

ITEM 12: CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

The information required by this Item is incorporated by reference from the Company's Proxy Statement for the 1997 Annual Meeting of Stockholders under the Heading "Certain Relationships And Related Transactions"

ITEM 13: EXHIBITS AND REPORTS ON FORM 8-K.

(a) The following documents are filed as part of this Form 10-KSB Report:

(1) Financial Statements

(2) Exhibits: See index to Exhibits. The Exhibits listed in the accompanying Index to Exhibits are filed as incorporated by references as part of this report.

(b) Reports on Form 8-K. No reports on Form 8-K were filed during the fourth quarter of 1996.

SIGNATURES

In accordance with Section 13 or 15(d) of the Securities and Exchange Act of 1932 as amended (the "Exchange Act"), the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: December 30, 1996

/s/ Vincent Sollitto

 Vincent Sollitto
 Chief Executive Officer and Director
 (Principal Executive Officer)

KNOW ALL PERSONS BY THESE PRESENTS, THAT EACH PERSON WHOSE SIGNATURE APPEARS BELOW CONSTITUTES AND APPOINTS VINCENT F. SOLLITTO JR. AND HOWARD M. BAILEY, AND EACH OF THEM, ACTING INDIVIDUALLY, AS HIS OR HER ATTORNEY-IN-FACT, EACH WITH FULL POWER OF SUBSTITUTION AND RESUBSTITUTION, FOR HIM AND IN HIS NAME, PLACE AND STEAD, IN ANY AND ALL CAPACITIES, TO SIGN ANY AND ALL AMENDMENTS TO THIS ANNUAL REPORT ON FORM 10-KSB, AND TO FILE THE SAME, WITH ALL EXHIBITS THERETO, AND OTHER DOCUMENTS IN CONNECTION THEREWITH, WITH THE SECURITIES AND EXCHANGE COMMISSION, GRANTING UNTO SAID ATTORNEYS-IN-FACT AND AGENTS, AND EACH OF THEM, FULL POWER AND AUTHORITY TO DO AND PERFORM EACH AND EVERY ACT AND THING REQUISITE AND NECESSARY TO BE DONE IN CONNECTION THEREWITH AND ABOUT THE PREMISES, AS FULLY TO ALL INTENTS AND PURPOSES AS HE MIGHT OR COULD DO IN PERSON, HEREBY RATIFYING AND CONFIRMING ALL THAT SAID ATTORNEYS-IN-FACT AND AGENTS, OR ANY OF THEM, OR THEIR OR HIS SUBSTITUTE OR SUBSTITUTES, MAY LAWFULLY DO OR CAUSE TO BE DONE BY VIRTUE HEREOF.

PURSUANT TO THE REQUIREMENTS OF THE SECURITIES ACT OF 1932, THIS ANNUAL REPORT ON FORM 10-KSB HAS BEEN SIGNED BY THE FOLLOWING PERSONS IN THE CAPACITIES AND ON THE DATES INDICATED:

<TABLE>

<S> December 30, 1996	<C> Chief Executive Officer and Director (Principal Executive Officer)	<C> /s/ Vincent Sollitto <hr/> Vincent Sollitto
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</TABLE>

<TABLE>

<S> December 30, 1996	<C> Chief Financial Officer and Secretary (Principal Financial and Accounting Officer)	<C> /s/ Howard Bailey <hr/> Howard Bailey
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</TABLE>

<TABLE>

<S> December 30, 1996	<C> Chief Technical Officer, Director	<C> /s/ Francois Henley <hr/> Francois Henley
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</TABLE>

<TABLE>		
<S>	<C>	<C>
December 30, 1996	Chairman of the Board	/s/ E. Floyd Kvamme

		E. Floyd Kvamme
</TABLE>		

<TABLE>		
<S>	<C>	<C>
December 30, 1996	Director	/s/ Barry Cox

		Barry Cox
</TABLE>		

<TABLE>		
<S>	<C>	<C>
December 30, 1996	Director	/s/ Michael Kim

		Michael Kim
</TABLE>		

<TABLE>		
<S>	<C>	<C>
December 30, 1996	Director	/s/ Dr. Malcolm J. Thompson

		Dr. Malcolm J. Thompson
</TABLE>		

<TABLE>		
<S>	<C>	<C>
December 30, 1996	Director	/s/ Steve Krausz

		Steve Krausz
</TABLE>		

INDEX TO EXHIBITS

<TABLE>		
<CAPTION>		
NUMBER	EXHIBIT	REFERENCE
-----	-----	-----
<C>	<S>	<C>
3.1	Form of Amended and Restated Articles of Incorporation of	A

	the Registrant.	
3.2	Bylaws of the Registrant and amendments thereto.	A
4.1	Reference is made to Exhibits 3.1 and 3.2.	A
10.1	First Amended and Restated Investor Rights Agreement between Registrant and the shareholders set forth therein dated May 11, 1994.	A
10.2	Fourth Amended Shareholders Agreement for Photon Dynamics, Inc. between the Registrant and the shareholders set forth therein dated May 11, 1994.	A
10.3	Form of Indemnification Agreement between the Registrant and each of its executive officers and directors.	A
10.4	1987 Stock Option Plan and Form of Stock Option Agreement.	A,B
10.5	1995 Stock Option Plan and Forms of Stock Option Agreements.	A,B
10.6	1995 Employee Stock Purchase Plan.	A,B
10.7	Lease agreement between Berg & Berg Developers and Photon Dynamics, Inc. Dated August 6, 1996.	
10.8	Sales Agent Agreement between the Registrant, K.K. Photon Dynamics and Ishikawajima-Harima Heavy Industries Co., Ltd. dated June 1, 1992, the amendment thereto dated November 17, 1993 and the modification agreement related thereto dated January 1, 1995.	A
10.9	License Agreement between the Registrant and Ishikawajima-Harima Heavy Industries Co., Ltd. dated June 1, 1992 and the addendum thereto dated November 11, 1993.	A
10.10	Commercialization Agreement between the Registrant and Ishikawaima-Harima Heavy Industries Co., Ltd. dated June 1, 1992 and the amendment thereto dated November 17, 1993.	A
10.11	Form of Agreements Regarding Change of Control between the Registrant and each of Francois J. Henley, Howard M. Bailey, Jeffrey Hawthome and Alan Nolet.	A,B
10.12	Agreement Regarding Change of Control between the Registrant Donald Jerome dated July 1, 1996.	
10.13	Form of Amendment to First Amended and Restated Investor Rights Agreement.	A
10.14	Agreement Regarding Change of Control between the Registrant and Vincent Sollitto dated July 1, 1996.	
11.1	Statement re: computation of earnings per share.	
13.1	Registrants Annual Report to Stockholders for the year ended September 30, 1996 (only such portions as necessary to satisfy Form 10-KSB requirements).	
21.1	Subsidiaries of the Registrant.	
23.1	Consent of Ernst & Young LLP, Independent Auditors	
27.1	Financial Data Schedules	
Key to Exhibits:		
(A)	Incorporated by reference to Registrants' Registration Statement on Form SB-2 filed with the Securities and Exchange Commission on November 15, 1995	
(B)	Management contract or compensatory plan or arrangements required to filed as an exhibit to this report on Form 10-KSB pursuant to Item 13(a) of this report.	

</TABLE>

STANDARD FORM LEASE

PARTIES: This Lease, executed in duplicate at Cupertino, California, on August _____, 1996, by and between Berg & Berg Developers, a California General Partnership, and Photon Dynamics, Inc., a California Corporation, hereinafter called respectively Lessor and Lessee, without regard to number or gender.

USE: Witnesseth: That Lessor hereby leases to Lessee, and Lessee hires from -----

Lessor, for the purpose of conducting therein office, research and development, light manufacturing, and warehouse activities, and any other legal activity; and for no other purpose without obtaining the prior written consent of Lessor.

PREMISES: The real property with appurtenances as shown on Exhibit A. 1, composed of 4 buildings, (the "Premises") situated in the City of San Jose, County of Santa Clara, State of California, and more particularly described as follows:

Lessee's portion of the building is 52,000 square feet including all improvements thereto as outlined in red (tile "Building") as shown on Exhibit A.2 including the right to use up to 182 unreserved parking spaces at the Premises. The address for the leased portion of file Premises is 6325 San Ignacio, San Jose, California. Lessee's pro-rata share of the building is 51%.

TERM: The term shall be for sixty (60) months unless extended pursuant to Section 35 of this Lease (the "Lease Term"), commencing on the Commencement Date as defined in Section 1), and ending on the day sixty (60) months thereafter.

RENT: Base rent shall be payable in monthly installments as follows:

	Base rent	Estimated CAC	Total
	-----	-----	-----
Months 1 through 12	\$46,540	\$8,320*	\$54,860

Monthly base rent shall increase by 3% on the annual anniversary of the Commencement Date each year during the Lease Term over the prior year's rent.

* CAC charges to be adjusted per Common Area Charges Section below.

Base rent as scheduled above shall be payable in advance on or before the first day of each calendar month during the Lease Term. The term "Rent," as used herein, shall be deemed to be and to mean the base monthly rent and all other sums required to be paid by Lessee pursuant to the terms of this Lease. Rent shall be paid in lawful money of the United States of America, without offset or deduction, and shall be paid to Lessor at such place or places as may be designated from time to time by Lessor. Rent for any period less than a calendar

month shall be a pro rata portion of the monthly installment. Upon execution of this Lease, Lessee shall deposit with Lessor the first month's rent.

SECURITY DEPOSIT: Lessee shall deposit with Lessor in trust the sum of Fifty-Four Thousand Eight Hundred Sixty Dollars (\$54,860) (the "Security Deposit"). The Security Deposit shall be held by Lessor as security for the faithful performance by Lessee of all of the terms, covenants, and conditions of this Lease applicable to Lessee. If Lessee commits a default as provided for herein, including but not limited to a default with respect to the provisions contained herein relating to the condition of the Premises, Lessor may (but shall not be required to) use, apply or retain all or any part of the Security Deposit for the payment of any amount which Lessor may spend by reason of default by Lessee. If any portion of the Security Deposit is so used or applied, Lessee shall, within ten days after

written demand therefor, deposit cash with Lessor in an amount sufficient to restore the Security Deposit to its original amount. Lessee's failure to do so shall be a default by Lessee. Any attempt by Lessee to transfer or encumber its interest in the Security Deposit shall be null and void. Upon execution of this Lease, Lessee shall deposit with Lessor the Security Deposit.

LATE CHARGES: Lessee hereby acknowledges that a late payment made by Lessee to Lessor of Rent and other sums due hereunder will cause Lessor to incur costs not contemplated by this Lease, the exact amount of which will be extremely difficult to ascertain. Such costs include, but are not limited to, processing and accounting charges, and late charges, which may be imposed on Lessor according to the terms of any mortgage or trust deed covering the Premises. Accordingly, if any installment of Rent or any other sum due from Lessee is not received by Lessor or Lessor's designee within ten (10) days after such amount is due, Lessee shall pay to Lessor a late charge equal to five (5%) percent of such overdue amount. The parties hereby agree that such late charge represents a fair and reasonable estimate of the costs Lessor will incur by reason of late payments made by Lessee. Acceptance of such late charges by Lessor shall in no event constitute a waiver of Lessee's default with respect to such overdue amount, nor shall it prevent Lessor from exercising any of the other rights and remedies granted hereunder. Notwithstanding the above, Lessee shall not be required to pay a late charge if it is the result of a non-recurring unusual event such as a accounting error.

QUIET ENJOYMENT: Lessor covenants and agrees with Lessee that upon Lessee paying Rent and performing its covenants and conditions under this Lease, Lessee shall and may peaceably and quietly have, hold and enjoy the Premises for the Lease Term, subject, however, to the rights reserved by Lessor hereunder.

COMMON AREA CHARGES: Lessee shall pay to Lessor, as additional Rent, an amount equal to Lessee's pro-rata share of the total common area charges of the Premises and the total common area charges for the Building as defined below (the common area charges for the Premises and the common area charges for the Building collectively referred to herein as ("CAC")). Lessee shall pay to Lessor as Rent, on or before the first day of each calendar month during the Lease

Term, subject to adjustment and reconciliation as provided hereinbelow, the sum of Eight Thousand Three Hundred Twenty Dollars (\$8,320), said sum representing Lessee's estimated monthly payment of Lessee's percentage share of CAC. It is understood and agreed that Lessee's obligation under this paragraph shall be prorated to reflect the Commencement Date and the end of the Lease Term.

Lessee's estimated monthly payment of CAC payable by Lessee during the calendar year in which the Lease commences is set forth above. At or prior to the commencement of each succeeding calendar year term (or as soon as practical thereafter), Lessor shall provide Lessee with Lessee's estimated monthly payment for CAC which Lessee shall pay to Lessor as Rent. Within 120 days of the end of the calendar year and the end of the Lease Term, Lessor shall provide Lessee a statement of actual CAC incurred including capital reserves for the preceding year or other applicable period in the case of a termination year. If such statement shows that Lessee has paid less than its actual percentage, then Lessee shall on demand pay to Lessor the amount of such deficiency. If such statement shows that Lessee has paid more than its actual percentage, then Lessor shall, at its option, promptly refund such excess to Lessee or credit the amount thereof to the Rent next becoming due from Lessee. Lessor reserves the right to revise any estimate of CAC if the actual or projected CAC show an increase or decrease in excess of 10% from an earlier estimate for the same period. In such event, Lessor shall provide a revised estimate to Lessee, together with an explanation of the reasons therefor, and Lessee shall revise its monthly payments accordingly. Lessor's and Lessee's obligation with respect to adjustments at the end of the Lease Term or earlier expiration of this Lease shall survive the Lease Term or earlier expiration.

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As used in this Lease, CAC shall include, but are not limited to (i) items specified as CAC items in Paragraphs 5(b), 6, 16 and 31; (ii) utility costs related to the common areas of the Premises as shown on Exhibit A.1 (iii) all costs and expenses including but not limited to supplies, materials, equipment and tools used or required in connection with the operation and maintenance of the Premises; (iv) licenses, permits and inspection fees; (v) all other costs incurred by Lessor in maintaining and operating the Premises; (vi) all reserves for capital replacements; and (vii) an amount equal to five percent (5%) of the aggregate of all CAC, as compensation for Lessor's accounting and processing services. Lessee shall have the right to review the CAC applicable to this Lease annually.

COMMENCEMENT DATE MEMORANDUM: When the actual Commencement Date is determined, the parties shall execute a Commencement Date Memorandum setting forth the Commencement Date, the expiration date of the Lease Term and any required adjustments to base rent as provided in this Lease, but failure to do so shall not affect the continuing validity and enforceability of this Lease, which shall remain in full force and effect.

IT IS FURTHER MUTUALLY AGREED BETWEEN THE PARTIES AS FOLLOWS:

1. POSSESSION: Possession shall be deemed tendered and the term shall commence upon the first to occur of the following (the "Commencement Date"): (i) the Lessee Interior Improvements are Substantially Complete or (ii) Lessee occupies the Building and commences to conduct business operations or (iii) if Lessor is prevented from or delayed in completing its work under Section 2 of this Lease due to Lessee Delays, such work will be deemed Substantially Complete as of the date on which it would have been Substantially Complete had it not been for such Lessee Delays. It is the intention of Lessee and Lessor that November 1, 1996 shall be the Commencement Date.

"Substantially Complete" shall mean that: (i) Lessor has tendered possession of Building to Lessee, (ii) Lessor has met all legal requirements for occupancy, (iii) The Lessee Interior improvements are materially complete per the approved plans, exclusive of telephone or other communication systems, punchlist items and there remains no incomplete or defective items of work which would materially adversely affect Lessee's intended use of the Premises and (iv) said interior of the building is in a "broom clean" condition.

2. LESSEE'S IMPROVEMENTS: The "Lessee Interior Improvements" shall be defined as all items as shown on attached Exhibit B and shall be constructed by independent contractors to be employed by and under the supervision of Lessor, in accordance with complete plans and specifications prepared by Lessor and approved by Lessee ("Lessee Improvement Plans"), to be attached hereto as Exhibit B.1. Lessee and its designated representatives, shall at all times during the construction of the Lessee Interior Improvements have access to the Building to monitor the progress of construction and Lessor's compliance with its obligation hereunder; provided however, that such access shall not unreasonably interfere with the activities of Lessor or its contractors. If Lessor notifies Lessee that any fittings, finishes or other materials included in the specifications for the Lessee Interior Improvements cannot be obtained within fifteen (15) days after placing an order therefor for fittings, finishes, or other materials specified by Lessee, Lessee shall be responsible for selecting alternative fittings, finishes or other materials which can be obtained within said fifteen (15) day period, or, if Lessee does not specify any alternative, Lessee shall be responsible for any delay beyond said fifteen (15) day period including Rent for each day of delay.

Lessor shall be responsible for ensuring that the Lessee Interior Improvements conform to the approved plans and all applicable statutes, rules, regulations, ordinances, and San Jose Building Department interpretations necessary for occupancy.

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For any contract to be entered into between Lessor and any contractor furnishing labor or materials in connection with the construction of the Lessee Interior Improvements where the payment due under such contract is estimated by Lessor to be in excess of One Hundred Thousand Dollars \$100,000, Lessor shall request bids from at least three (3) qualified contractors selected by Lessor for bidding. Lessor will accept the lowest qualified bid. Lessee shall have the opportunity

to review the qualified bidders list and may select a bidder of their choice for any bid provided the bidder meets Lessor's reasonable requirements.

Lessor shall be responsible for and shall pay the cost of the Lessee Interior Improvements up to the amount of Six Hundred Ninety Thousand Dollars (\$690,000) (the "TI Allowance"). In the event the cost of the Lessee Interior Improvements is less than the TI Allowance, the monthly base rent under the Lease shall be reduced by \$15.83 per month for every \$1,000 dollars the costs are less than the TI Allowance. Costs in excess of the TI Allowance, if any, and the cost of clean room estimated at \$280,000 will not be incurred without advance approval of Lessee. Any approved cost over the TI Allowance shall be paid for by Lessee in cash within fifteen (15) days after Lessor has provided Lessee with evidence that the work approved is complete.

Lessor shall be entitled to a construction management fee covering its overhead and profit on the TI work of six percent (6%). All costs for Lessee Interior Improvements shall be documented and subject to verification by Lessee.

Notwithstanding Lessor's responsibility for the TI Allowance, if at any time after the execution of the Lease and upon the first occurrence only, Lessee's cash position falls below One Million Five Hundred Thousand Dollars (\$1,500,000), Lessee shall immediately reduce the principal amount of the TI Allowance by paying to Lessor cash, the amount of which shall be determined with reference to the following months of the Lease Term:

Months 1 through 12	\$300,000
Months 13 through 24	250,000
Months 25 through 36	200,000
Months 37 through 48	100,000

After receipt of any required payments from Lessee to reduce the principal amount of the TI Allowance, Lessor shall provide Lessee with a recalculation of rent for the balance of the Lease Term.

Lessor shall use its best efforts to cause the Commencement Date of the initial term to occur not later than November 1, 1996. If the Commencement Date has not occurred by December 1, 1996, Lessee shall receive one day of base rent abatement for each day after December 1, 1996 until the Commencement Date. Lessor and Lessee agree that having a Commencement Date after December 1, 1996 will cause Lessee and Lessor to incur costs not contemplated by this Lease, the exact amount of which will be extremely difficult to ascertain. Accordingly, the parties hereby agree that Lessee's right to the abatement of base rent specified herein represents a fair and reasonable settlement for both parties and neither party shall have further liability to the other for any damages. If the Commencement Date has not occurred by December 1, 1996, Lessee may at its sole option, by written notice to Lessor, have the right to terminate this Lease at any time after December 1, 1996 until the Commencement Date. Notwithstanding anything to the contrary herein, all dates stated herein shall be extended for the number of days Lessor is unable to Substantially Complete the Building as a result of delays (i) due to governmental actions (other than governmental action of refusing to approve work which fails to comply with the law or the building

permit) which occurs after receipt of normal building permits, (ii) due to acts of God, (iii) due to circumstances beyond Lessor's control, (iv) after thirty (30) days that the City of San Jose requires to issue a building permit after plan submittal by Lessor, and (v) due to Lessee Delays. "Lessee Delays" means a delay in Substantial Completion

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resulting from (a) Lessee's failure to meet Lessee's deadlines for approval as shown on Exhibit E, (b) delays due to change orders, (c) delays due to Lessee's failure to meet the deadlines for approving any plans or change orders, and (d) delays because of the inability to obtain any product, materials, design, color, fitting, or finish pursuant to this Section 2. Lessee shall have a minimum of 3 business days to approve or disapprove any preliminary plans or change orders and a minimum of 10 business days to approve or disapprove any final plans. If Lessee does not disapprove any plans or change orders within the time period set forth herein in writing, Lessor may proceed on the basis that the plans or change orders are approved by Lessee. If plans or change orders are disapproved, Lessee shall state the reason for disapproval and Lessor and Lessee shall act in good faith to resolve any issues. Lessor shall charge Lessee \$250 per change order after the fifth (5th) change order for processing.

2.1 ACCEPTANCE OF PREMISES AND COVENANTS TO SURRENDER: Lessor represents that the Premises shall be in good order and repair, and shall comply with all requirements for occupancy as of the Commencement Date. Lessee agrees on the last day of the Lease Term, or on the sooner termination of this Lease, to surrender the Building to Lessor in Good Condition and Repair. Good Condition and Repair ("Good Condition and Repair") shall not mean original condition, but shall mean that the Building are in a commercially acceptable condition suitable for occupancy by a reasonable lessee. The interior walls of all office and warehouse areas, the floors of all office and warehouse areas, all suspended ceilings and any carpeting are to be cleaned and in Good Condition and Repair. Lessee also agrees to surrender unto Lessor all alterations, additions, and improvements which may have been made in, to, or on the Building by Lessee, except that Lessee shall ascertain from Lessor, within (30) days before the end of the Lease Term or earlier termination of this Lease, whether Lessor desires to have the Building or any part or parts thereof restored to their condition as of the Commencement Date of this Lease; if Lessor shall so desire, then Lessee shall restore said Building or such part or parts thereof before the end of the Lease Term or earlier termination of this Lease at Lessee's sole cost and expense. Lessee, on or before the end of the Lease Term or sooner termination of this Lease, shall remove all its personal property and trade fixtures from the Building, and all such property not so removed shall be deemed to be abandoned by Lessee. Lessee shall reimburse Lessor for all disposition costs incurred by Lessor relative to Lessee's abandoned property. If the Building are not surrendered at the end of the Lease Term or earlier termination of this Lease, Lessee shall indemnify Lessor against loss or liability resulting from any delay caused by Lessee in surrendering the Building including, without limitation, any claims made by any succeeding Lessee founded on such delay.

3. USES PROHIBITED: Lessee shall not commit, or suffer to be committed, any waste upon the Premises, or any nuisance, or other act or thing which may disturb the quiet enjoyment of any other tenant in or around the buildings in which the subject Premises are located or allow any sale by auction upon the Premises, or allow the Premises to be used for any improper, immoral, unlawful or objectionable purpose, or place any loads upon the floor, walls, or ceiling which may endanger the structure, or use any machinery or apparatus which will in any manner vibrate or shake the Building, or place any harmful liquids in the drainage system of the building. No waste materials or refuse shall be dumped upon or permitted to remain upon any part of the Premises outside of the building proper. No materials, supplies, equipment, finished products or semi-finished products, raw materials or articles of any nature shall be stored upon or permitted to remain on any portion of the Premises outside of the building structure, unless approved by the local, state federal or other applicable governing authority. Lessor consents to Lessee's use of materials which are incidental to the normal, day-to-day operations of any office user, such as copier fluids, cleaning materials, etc., but this does not relieve Lessee of any of its obligations not to contaminate the Premises or related real property or violated any Hazardous Materials Laws.

4. ALTERATIONS AND ADDITIONS: Lessee shall not make, or suffer to be made, any alteration or addition to the Building, or any part thereof, without the express, advance written consent of Lessor; any addition or alteration to

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said Building, except movable furniture and trade fixtures, shall become at once a part of the realty and belong to Lessor at the end of the Lease Term or earlier termination of this Lease. Alterations and additions which are not deemed as trade fixtures shall include HVAC systems, lighting systems, electrical systems, partitioning, carpeting, or any other installation which has become an integral part of the Building. Lessee agrees that it will not proceed to make such alterations or additions until all required government permits have been obtained and after having obtained consent from Lessor to do so, until five (5) days from the receipt of such consent, so that Lessor may post appropriate notices to avoid any liability to contractors or material suppliers for payment for Lessee's improvements. Lessee shall at all times permit such notices to be posted and to remain posted until the completion of work. At the end of the Lease Term or earlier termination of this Lease, Lessee shall remove and shall be required to remove its special tenant improvements and all related equipment installed by Lessee at or during the Lease Term and Lessee shall return the Building to the condition that existed before the installation of the special tenant improvements. Notwithstanding the above, Lessor agrees to allow any reasonable alterations and improvements and will use its best efforts to notify Lessee at the time of approval if such improvements or alterations are to be removed at the end of the Lease Term or earlier termination of this Lease.

5. MAINTENANCE OF PREMISES:

(a) Lessee shall at its sole cost and expense keep and maintain the interior of the Building, including, but not limited to, all lighting systems, temperature control systems, clean room systems other than base HVAC units and plumbing systems, in Good Condition and Repair, including any required replacements. Lessee shall maintain all wall surfaces and floor coverings in Good Condition and Repair, free of holes, gouges, or defacements.

(b) Lessor shall keep and maintain in Good Condition and Repair including replacements, at Lessee's expense, based on a pro-rata share of cost based on square footage or costs directly related to Lessee's use of the Premises the following, which shall be included in the monthly CAC:

1. The exterior of the building, any appurtenances and every part thereof, including but not limited to, glazing, sidewalks, parking areas, electrical systems, HVAC systems, roof membrane, and painting of exterior walls.

2. The HVAC by a service contract with a licensed air conditioning and heating contractor which contract shall provide for a minimum of quarterly maintenance of all air conditioning and heating equipment at the Building including HVAC repairs or replacements which are either excluded from such service contract or any existing equipment warranties.

3. The landscaping by a landscape contractor to water, maintain, trim and replace, when necessary, any shrubbery and landscaping at the Premises.

4. The roof membrane by a service contract with a licensed reputable roofing contractor which contract shall provide for a minimum of semi-annual maintenance, cleaning of storm gutters, drains, removing of debris and trimming overhanging trees, repair of the roof and application of a finish coat every five years at the Building.

5. Extermination services.

6. Fire monitoring services.

(c) Lessee hereby waives any and all rights to make repairs at the expense of Lessor as provided in Section 1942 of the Civil Code of the State of California, and all rights provided for by Section 1941 of said Civil Code.

(d) Lessor shall be responsible for the repair of any structural defects in the Building including the roof structure (not membrane), exterior walls and foundation during the Lease Term.

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6. HAZARD INSURANCE: Lessee shall not use, or permit said Premises, or any part thereof, to be used, for any purpose other than that for which said Premises are hereby leased; and no use shall be made or permitted to be made of the Premises, nor acts done, which may cause a cancellation of any insurance policy covering said building, or any part thereof, nor shall Lessee sell or permit to be kept,

used or sold, in or about said Premises, any article which may be prohibited by a standard form fire insurance policy. Lessee shall, at its sole cost and expense, comply with any and all requirements, pertaining to said Premises, of any insurance organization or company, necessary for the maintenance of reasonable fire and general liability insurance, covering said building and appurtenances. Lessor agrees to purchase and keep in force fire and extended coverage insurance covering loss or damage to the Premises in amounts not to exceed the full replacement cost of said Premises as determined by Lessor, with proceeds payable to Lessor. Lessee acknowledges that the insurance referenced above does not include coverage for Lessee's personal property. In the event of a loss per the insurance provisions of this paragraph, Lessee shall be responsible for deductibles up to a maximum of \$5,000 per occurrence. Lessee agrees to pay to the Lessor as additional Rent, on demand, the full cost of said insurance as evidenced by insurance billings to the Lessor which shall be included in Lessee's monthly CAC. If said insurance billings cover the Premises, and Lessee does not occupy the entire Premises, the insurance premiums and deductibles shall be allocated to the portion of the Premises occupied by Lessee on a pro-rata square footage or other equitable basis, as determined by Lessor. It is understood and agreed that Lessee's obligation under this paragraph will be prorated to reflect the Commencement Date and the end of the Lease Term.

Lessor and Lessee hereby waive any rights each may have against the other related to any loss or damage caused to Lessor or Lessee as the case may be, or to the Premises, the Building, or its contents, and which may arise from any risk generally covered by fire and extended coverage insurance. The parties shall provide that their respective insurance policies insuring the property or the personal property include a waiver of any right of subrogation which said insurance company may have against Lessor or Lessee, as the case may be. Lessor shall maintain in full force and effect, a policy of rental loss insurance, in an amount equal to the amount of Rent payable by Lessee commencing on the date of loss during the next ensuing one (1) year, as reasonably determined by Lessor with proceeds payable to Lessor ("Loss of Rents Insurance"). Lessee shall reimburse Lessor for the full cost of said rental loss insurance coverage.

7. ABANDONMENT: Lessee shall not vacate or abandon the Building at any time during the Lease Term; and if Lessee shall abandon, vacate or surrender the Building, or be dispossessed by process of law, or otherwise, any personal property belonging to Lessee and left on the Building shall be deemed to be abandoned, at the option of Lessor. Notwithstanding the above, the Building shall not be considered vacated or abandoned if Lessee maintains the Building in Good Condition and Repair, provides security and is not in default.

8. FREE FROM LIENS: Lessee shall keep the subject Premises and the property in which the subject Premises are situated, free from any and all liens including but not limited to liens arising out of any work performed, materials furnished, or obligations incurred by Lessee. However, the Lessor shall allow Lessee to contest a lien claim, so long as the claim is discharged prior to any foreclosure proceeding being initiated against the property and provided Lessee provides Lessor a bond if the lien exceeds \$5,000.

9. COMPLIANCE WITH GOVERNMENTAL REGULATIONS: Lessee shall, at its sole cost and expense, comply with all of the requirements of all local, municipal, state and federal authorities now in force, or which may hereafter be in force, pertaining to Lessee's use and occupancy of the said Premises, and shall faithfully observe in the use of the Premises all local and municipal ordinances and state and federal statutes now in force or which may hereafter be in force.

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10. LESSEE'S INSURANCE: Lessee, as a material part of the consideration to be rendered to Lessor, hereby waives all claims against Lessor and Lessor's Agents for damages to goods, wares and merchandise, and all other personal property in, upon or about said Premises, and for injuries to persons in, upon or about said Premises, from any cause arising at any time, and Lessee will hold Lessor and Lessor's Agents exempt and harmless from any damage or injury to any person, or to the goods, wares and merchandise and all other personal property of any person, arising from the use or occupancy of the Premises by Lessee, or from the failure of Lessee to keep the Building in good condition and repair, as herein provided. Lessee shall secure and keep in force a standard policy of commercial general liability insurance and property damage policy covering the Premises, including parking areas, insuring the Lessee. A certificate of said policy naming Lessor as an additional insured shall be delivered to Lessor and will have a combined single limit for both bodily injury, death and property damage in an amount not less than five million dollars (\$5,000,000.00). The limits of said insurance shall not, however, limit the liability of Lessee hereunder. Lessee shall obtain a written obligation on the part of the insurer to notify Lessor 30 days in advance in writing before any cancellation thereof Lessee shall obtain, at Lessee's sole cost and expense, a policy of fire and extended coverage insurance including coverage for direct physical loss special form, and a sprinkler leakage endorsement insuring the personal property of Lessee. The proceeds from any personal property damage policy shall be payable to Lessee. Lessee shall, at its sole cost and expense, comply with all of the insurance requirements of all local, municipal, state and federal authorities now in force, or which may hereafter be in force, pertaining to Lessee's use and occupancy of the said Premises.

11. ADVERTISEMENTS AND SIGNS: Lessee shall not place or permit to be placed, in, upon or about the Premises any unusual or extraordinary signs, or any signs not approved by the city, local, state, federal or other applicable governing authority. Lessee shall not place, or permit to be placed upon the Premises, any signs, advertisements or notices without the written consent of the Lessor, and such consent shall not be unreasonably withheld. A sign so placed on the Premises shall be so placed upon the understanding and agreement that Lessee will remove same at the end of the Lease Term or earlier termination of this Lease and repair any damage or injury to the Premises caused thereby, and if not so removed by Lessee, then Lessor may have the same removed at Lessee's expense.

12. UTILITIES: Lessee shall pay for all water , gas , heat, light, power, telephone and other utilities supplied to the Building. Any charges for sewer

usage or related fees shall be the obligation of Lessee and paid for by Lessee. If any such services are not separately metered to Lessee, Lessee shall pay a reasonable proportion of all charges which are jointly metered, the determination to be made by Lessor acting reasonably and on any equitable basis. Lessor shall not be liable to Lessee for any disruption in any of the utility services to the Building or Premises.

13. ATTORNEY'S FEES: In case suit should be brought for the possession of the Building or Premises, for the recovery of any sum due hereunder, or because of the breach of any other covenant herein, the losing party shall pay to the prevailing party reasonable attorney's fee which shall be deemed to have accrued on the commencement of such action and shall be enforceable whether or not such action is prosecuted to judgment.

14.1 DEFAULT: The occurrence of any of the following shall constitute a default and breach of this Lease by Lessee: a) Any failure by Lessee to pay Rent or to make any other payment required to be made by Lessee hereunder when due if not cured within ten (10) days after written notice thereof by Lessor to Lessee; b) The abandonment or vacation of the Premises by Lessee except as provided in Section 7; c) A failure by Lessee to observe and perform any other provision of this Lease to be observed or performed by Lessee, where such failure continues for thirty days after written notice thereof by Lessor to Lessee; provided, however, that if the nature of such default is such that the same cannot be reasonably cured within such thirty (30) day period, Lessee shall not be deemed to be in

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default if Lessee shall, within such period, commence such cure and thereafter diligently prosecute the same to completion; d) The making by Lessee of any general assignment for the benefit of creditors; the filing by or against Lessee of a petition to have Lessee adjudged a bankrupt or of a petition for reorganization or arrangement under any law relating to bankruptcy; e) the appointment of a trustee or receiver to take possession of substantially all of Lessee's assets or Lessee's interest in this Lease, or the attachment, execution or other judicial seizure of substantially all of Lessee's assets located at the Premises or of Lessee's interest in this Lease.

14.2 SURRENDER OF LEASE: In the event of any such default by Lessee, then in addition to any other remedies available to Lessor at law or in equity, Lessor shall have the immediate option to terminate this Lease before the end of the Lease Term and all rights of Lessee hereunder, by giving written notice of such intention to terminate. In the event that Lessor terminates this Lease due to a default of Lessee, then Lessor may recover from Lessee: a) the worth at the time of award of any unpaid Rent which had been earned at the time of such termination; plus b) the worth at the time of award of unpaid Rent which would have been earned after termination until the time of award exceeding the amount of such rental loss that the Lessee proves could have been reasonably avoided; plus c) the worth at the time of award of the amount by which the unpaid Rent for the balance of the Lease Term after the time of award exceeds

the amount of such rental loss that the Lessee proves could have been reasonably avoided; plus d) any other amount necessary to compensate Lessor for all the detriment proximately caused by Lessee's failure to perform his obligations under this Lease or which in the ordinary course of things would be likely to result therefrom; and e) at Lessor's election, such other amounts in addition to or in lieu of the foregoing as may be permitted from time to time by applicable California law. As used in (a) and (b) above, the "worth at the time of award" is computed by allowing interest at the rate of Wells Fargo's prime rate plus two percent (2%) per annum. As used in (c) above, the "worth at the time of award" is computed by discounting such amount at the discount rate of the Federal Reserve Bank of San Francisco at the time of award plus one percent (1%).

14.3 RIGHT OF ENTRY AND REMOVAL: In the event of any such default by Lessee, Lessor shall also have the right, with or without terminating this Lease, to re-enter the Building and remove all persons and property from the Building; such property may be removed and stored in a public warehouse or elsewhere at the cost of and for the account of Lessee.

14.4 ABANDONMENT: In the event of the vacation or abandonment, except as provided in Section 7, of the Building by Lessee or in the event that Lessor shall elect to re-enter as provided in paragraph 14.3 above or shall take possession of the Premises pursuant to legal proceeding or pursuant to any notice provided by law, and Lessor does not elect to terminate this Lease as provided in paragraph 14.2 above, then Lessor may from time to time, without terminating this Lease, either recover all Rent as it becomes due or relet the Building or any part thereof for such term or terms and at such rental rates and upon such other terms and conditions as Lessor, in its sole discretion, may deem advisable with the right to make alterations and repairs to the Building. In the event that Lessor elects to relet the Building, then Rent received by Lessor from such reletting shall be applied; first, to the payment of any indebtedness other than Rent due hereunder from Lessee to Lessor; second, to the payment of any cost of such reletting; third, to the payment of the cost of any alterations and repairs to the Building; fourth, to the payment of Rent due and unpaid hereunder; and the residue, if any, shall be held by Lessor and applied to the payment of future Rent as the same may become due and payable hereunder. Should that portion of such Rent received from such reletting during any month, which is applied by the payment of Rent hereunder according to the application procedure outlined above, be less than the Rent payable during that month by Lessee hereunder, then Lessee shall pay such deficiency to Lessor immediately upon demand therefor by Lessor. Such deficiency shall be calculated and paid monthly. Lessee shall also pay to Lessor, as soon as ascertained, any costs and expenses incurred by

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Lessor in such reletting or in making such alterations and repairs not covered by the rentals received from such reletting.

14.5 NO IMPLIED TERMINATION: No re-entry or taking possession of the Building by

Lessor pursuant to 14.3 or 14.4 of this Article 14 shall be construed as an election to terminate this Lease unless a written notice of such intention is given to Lessee or unless the termination thereof is decreed by a court of competent jurisdiction. Notwithstanding any reletting without termination by Lessor because of any default by Lessee, Lessor may at any time after such reletting elect to terminate this Lease for any such default.

15. SURRENDER OF LEASE: The voluntary or other surrender of this Lease by Lessee, or a mutual cancellation thereof, shall not work a merger, and shall, at the option of Lessor, terminate all or any existing subleases or sub tenancies, or may, at the option of Lessor, operate as an assignment to him of any or all such subleases or sub tenancies.

16. TAXES: Lessee shall pay and discharge punctually and when the same shall become due and payable without penalty, all real estate taxes, personal property taxes, taxes based on vehicles utilizing parking areas in the Premises, taxes computed or based on rental income (other than federal, state and municipal net income taxes), Environmental Surcharges, privilege taxes, excise taxes, business and occupation taxes, school fees or surcharges, gross receipts taxes, sales and/or use taxes, employee taxes, occupational license taxes, water and sewer taxes, assessments (including, but not limited to, assessments for public improvements or benefit), assessments for local improvement and maintenance districts, and all other governmental impositions and charges of every kind and nature whatsoever, regardless of whether now customary or within the contemplation of the parties hereto and regardless of whether resulting from increased rate and/or valuation, or whether extraordinary or ordinary, general or special, unforeseen or foreseen, or similar or dissimilar to any of the foregoing (all of the foregoing being hereinafter collectively called "Tax" or "Taxes") which, at any time during the Lease Term, shall be applicable or against the Premises, or shall become due and payable and a lien or charge upon the Premises under or by virtue of any present or future laws, statutes, ordinances, regulations, or other requirements of any governmental authority whatsoever. The term "Environmental Surcharge" shall include any and all expenses, taxes, charges or penalties imposed by the Federal Department of Energy, Federal Environmental Protection Agency, the Federal Clean Air Act, or any regulations promulgated thereunder, or any other local, state or federal governmental agency or entity now or hereafter vested with the power to impose taxes, assessments or other types of surcharges as a means of controlling or abating environmental pollution or the use of energy (i) generally imposed on similar properties in a wide geographic area without regard to whether the properties are subject to the tax are contaminated by Hazardous Materials and which is part of a comprehensive plan imposed by a governmental unit or (ii) imposed with respect to the Premises as the result of presence of Hazardous Materials for which Lessee is required to indemnify Lessor under Section 33. The term "Tax" shall include, without limitation, all taxes, assessments, levies, fees, impositions or charges levied, imposed, assessed, measured, or based in any manner whatsoever (i) in whole or in part on the Rent payable by Lessee under this Lease, (ii) upon or with respect to the use, possession, occupancy, leasing, operation or management of the Premises, (iii) upon this transaction or any document to which Lessee is a party creating or transferring an interest or an estate in

the Premises, (iv) upon Lessee's business operations conducted at the Premises, (v) upon, measured by or reasonably attributable to the cost or value of Lessee's equipment, furniture, fixtures and other personal property located on the Premises or the cost or value of any leasehold improvements made in or to the Premises by or for Lessee, regardless of whether title to such improvements shall be in Lessor or Lessee, or (vi) in lieu of or equivalent to any Tax set forth in this Section 16. In the event any such Taxes are payable by Lessor and it shall not be lawful for Lessee to reimburse Lessor for such Taxes, then the Rent payable thereunder shall be increased to net Lessor the same net rent after imposition of any such Tax upon Lessor as would have been payable to Lessor prior to the imposition of any

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such Tax. It is the intention of the parties that Lessor shall be free from all such Taxes and all other governmental impositions and charges of every kind and nature whatsoever. However, nothing contained in this Section 16 shall require Lessee to pay any Federal or State income, franchise, estate, inheritance, succession, transfer or excess profits tax imposed upon Lessor. If any general or special assessment is levied and assessed against the Premises, Lessor agrees to use its best reasonable efforts to cause the assessment to become a lien on the Premises securing repayment of a bond sold to finance the improvements to which the assessment relates which is payable in installments of principal and interest over the maximum term allowed by law. It is understood and agreed that Lessee's obligation under this paragraph will be prorated to reflect the Commencement Date and the end of the Lease Term. It is further understood that if Taxes cover the Premises and Lessee does not occupy the entire Premises, the Taxes will be allocated to the portion of the Premises occupied by Lessee based on a pro-rata square footage or other equitable basis. Taxes billed by Lessor to Lessee shall be included in the monthly CAC.

Subject to any limitations or restrictions imposed by any deeds of trust or mortgages now or hereafter covering or affecting the Premises, Lessee shall have the right to contest or review the amount or validity of any Tax by appropriate legal proceedings but which is not to be deemed or construed in any way as relieving, modifying or extending Lessee's covenant to pay such Tax at the time and in the manner as provided in this Section 16. However, as a condition of Lessee's right to contest, if such contested Tax is not paid before such contest and if the legal proceedings shall not operate to prevent or stay the collection of the Tax so contested, Lessee shall, before instituting any such proceeding, protect the Premises and the interest of Lessor and of the beneficiary of a deed of trust or the mortgagee of a mortgage affecting the Premises against any lien upon the Premises by a surety bond, issued by an insurance company acceptable to Lessor and in an amount equal to one and one-half (1 1/2) times the amount contested or, at Lessor's option, the amount of the contested Tax and the interest and penalties in connection therewith. Any contest as to the validity or amount of any Tax, whether before or after payment, shall be made by Lessee in Lessee's own name, or if required by law, in the name of Lessor or both Lessor and Lessee. Lessee shall defend, indemnify and hold harmless Lessor from

and against any and all costs or expenses, including attorneys' fees, in connection with any such proceedings brought by Lessee, whether in its own name or not. Lessee shall be entitled to retain any refund of any such contested Tax and penalties or interest thereon which have been paid by Lessee. Nothing contained herein shall be construed as affecting or limiting Lessor's right to contest any Tax at Lessor's expense.

17. NOTICES: Unless otherwise provided for in this Lease, any and all written notices or other communication (the "Communication") to be given in connection with this Lease shall be given in writing and shall be given by personal delivery, facsimile transmission or by mailing by registered or certified mail with postage thereon or recognized overnight courier, fully prepaid, in a sealed envelope addressed to the intended recipient as follows:

(a) to the Lessor at: 10050 Bandley Drive
Cupertino, California 95014
Attention: Carl E. Berg
Fax No: (408) 725-1 626

(b) to the Lessee at: 6325 San Ignacio
San Jose, California
Attention: CFO
Fax No:

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or such other addresses, facsimile number or individual as may be designated by a Communication given by a party to the other parties as aforesaid. Any Communication given by personal delivery shall be conclusively deemed to have been given and received on a date it is so delivered at such address provided that such date is a business day, otherwise on the first business day following its receipt, and if given by registered or certified mail, on the day on which delivery is made or refused or if given by recognized overnight courier, on the first business day following deposit with such overnight courier and if given by facsimile transmission, on the day on which it was transmitted provided such day is a business day, failing which, on the next business day thereafter.

18. ENTRY BY LESSOR: Lessee shall permit Lessor and its agents to enter into the Building at all reasonable times using the minimum amount of interference and inconvenience to Lessee and Lessee's business, subject to any security regulations of Lessee, for the purpose of inspecting the same or for the purpose of maintaining the Building, or for the purpose of making repairs, alterations or additions to any other portion of said Building, including the erection and maintenance of such scaffolding, canopies, fences and props as may be required, without any rebate of Rent and without any liability to Lessee for any loss of occupation or quiet enjoyment of the Premises; and shall permit Lessor and his agents, at any time within ninety (90) days prior to the end of the Lease Term, to place upon said Premises any usual or ordinary "For Sale" or "For Lease" signs and exhibit the Premises and the Building to prospective tenants at reasonable hours.

19. DESTRUCTION OF PREMISES: In the event of a partial destruction of the said Premises during the Lease Term from any cause which is covered by Lessor's property insurance, Lessor shall forthwith repair the same, provided such repairs can be made within ninety (90) days under the laws and regulations of State, Federal, County, or Municipal authorities, but such partial destruction shall in no way annul or void this Lease, except that Lessee shall be entitled to a proportionate reduction of Rent while such repairs are being made to the extent of payments received by Lessor under its Loss of Rents Insurance coverage. With respect to any partial destruction which Lessor is obligated to repair or may elect to repair under the terms of this paragraph, the provision of Section 1932, Subdivision 2, and of Section 1933, Subdivision 4, of the Civil Code of the State of California are waived by Lessee. In the event that the Building is destroyed to all extent greater than thirty-three and one-third (33 1/3%) of the replacement cost thereof, Lessor may, at its sole option, elect to terminate this Lease, whether the subject Premises is insured or not. A total destruction of the Building shall terminate this Lease. Notwithstanding the above, Lessor is only obligated to repair or rebuild to the extent of available insurance proceeds including any deductible amount. Should Lessor determine that insufficient or no insurance proceeds are available for repair or reconstruction of Premises, Lessor, at its sole option, may terminate the Lease. Lessee shall have the option of continuing this Lease by agreeing to pay all repair costs to the subject Premises.

20. ASSIGNMENT AND SUBLETTING: Lessee shall not assign this Lease, or any interest therein, and shall not sublet the said Building or any part thereof, or any right or privilege appurtenant thereto, or cause any other person or entity (a bona fide subsidiary or affiliate of Lessee excepted) to occupy or use the Building, or any portion thereof, without the advance written consent of Lessor. Any such assignment or subletting without such consent shall be void, and shall, at the option of the Lessor, terminate this Lease. This Lease shall not, or shall not be an) interest therein, be assignable, as to the interest of Lessee, by operation of law, without the written consent of Lessor. Notwithstanding Lessor's obligation to provide reasonable approval, Lessor reserves the right to withhold its consent for any proposed sublessee or assignee of Lessee if the proposed sublessee or assignee is a user or generator of Hazardous Materials. If Lessee desires to assign its rights under this Lease or to sublet, all or a portion of the subject Building to a party other than a bona fide subsidiary or affiliate of Lessee, Lessee shall first notify Lessor of the proposed terms and conditions of such assignment or subletting. Lessor shall have the right of first refusal to enter into a direct Lessor-Lessee relationship with such party under such proposed terms and conditions, in which

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event Lessee shall be relieved of its obligations hereunder to the extent of the Lessor-lessee relationship entered into between Lessor and such third party. Notwithstanding the foregoing, Lessee may assign this Lease to a successor in interest, whether by merger or acquisition, provided there is no substantial reduction in the net worth of the resulting entity and the

resulting entity is not a user or generator of Hazardous Materials. Whether or not Lessor's consent to a sublease or assignment is required, in the event of any sublease or assignment, Lessee shall be and shall remain primarily liable for the performance of all conditions, covenants, and obligations of Lessee hereunder and, in the event of a default by an assignee or sublessee, Lessor may proceed directly against the original Lessee hereunder and/or any other predecessor of such assignee or sublessee without the necessity of exhausting remedies against said assignee or sublessee.

21. CONDEMNATION: If any part of the Building shall be taken for any public or quasi-public use, under any statute or by right of eminent domain or private purchase in lieu thereof, and a part thereof remains which is susceptible of occupation hereunder, this Lease shall as to the part so taken, terminate as of the date title vests in the condemnor or purchaser, and the Rent payable hereunder shall be adjusted so that the Lessee shall be required to pay for the remainder of tile Lease Term only that portion of Rent as the value of the part remaining. The rental adjustment resulting will be computed at the same Rental rate for the remaining part not taken; however, Lessor shall have the option to terminate this Lease as of the date when title to the part so taken vests in the condemnor or purchaser. If all of the Building, or such part thereof be taken so that there does not remain a portion susceptible for occupation hereunder, this Lease shall thereupon terminate. If a part or all of the Building be taken, all compensation awarded upon such taking shall be payable to the Lessor. Lessee may file a separate claim and be entitled to any award granted to Lessee.

22. EFFECTS OF CONVEYANCE: The term "Lessor" as used in this Lease, means only the owner for the time being of the land and building constituting the Premises, so that, in the event of any sale of said land or building, or in the event of a Lease of said building, Lessor shall be and hereby is entirely freed and relieved of all covenants and obligations of Lessor hereunder, and it shall be deemed and construed, without further agreement between the parties and the purchaser of any such sale, or the Lessor of the building, that the purchaser or lessor of the building has assumed and agreed to carry out any and all covenants and obligations of the Lessor hereunder. If any security is given by Lessee to secure the faithful performance of all or any of the covenants of this Lease on the part of Lessee, Lessor may transfer and deliver the security, as such, to the purchaser at any such sale of the building, and thereupon the Lessor shall be discharged from any further liability.

23. SUBORDINATION: This Lease, in the event Lessor notifies Lessee in writing, shall be subordinate to any ground lease, deed of trust, or other hypothecation for security now or hereafter placed upon the real property at which the Premises are a part and to any and all advances made on the security thereof and to renewals, modifications, replacements and extensions thereof. Lessee agrees to promptly execute any documents which may be required to effectuate such subordination. Notwithstanding such subordination, if Lessee is not in default and so long as Lessee shall pay the Rent and observe and perform all of the provisions and covenants required under this Lease, Lessee's right to quiet possession of the Premises shall not be disturbed or effected by any subordination.

24. WAIVER: The waiver by Lessor of any breach of any term, covenant or condition, herein contained shall not be construed to be a waiver of such term, covenant or condition or any subsequent breach of the same or any other term, covenant or condition therein contained. The subsequent acceptance of Rent hereunder by Lessor shall not be deemed to be a waiver of Lessee's breach of any term, covenant, or condition of the Lease.

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25. HOLDING OVER: Any holding over after the end of the Lease Term requires Lessor's written approval prior to the end of the Lease Term, which, notwithstanding any other provisions of this Lease, Lessor may withhold and shall be construed to be a tenancy at sufferance from month to month. Lessee shall pay to Lessor monthly base rent equal to one and one-half (1.5) times the monthly base rent installment due in the last month of the Lease Term and all other additional rent and all other terms and conditions of the Lease shall apply, so far as applicable. Holding over by Lessee without written approval of Lessor shall subject Lessee to the liabilities and obligations provided for in this Lease and by law, including, but not limited to those in Section 2.1 of this Lease. Lessee shall indemnify and hold Lessor harmless against any loss or liability resulting from any delay caused by Lessee in surrendering the Building, including without limitation, any claims made or penalties incurred by any succeeding lessee or by Lessor. No holding over shall be deemed or construed to exercise any option to extend or renew this Lease in lieu of full and timely exercise of any such option as required hereunder.

26. SUCCESSORS AND ASSIGNS: The covenants and conditions herein contained shall, subject to the provisions as to assignment, apply to and bind the heirs, successors, executors, administrators and assigns of all of the parties hereto; and all of the parties hereto shall be jointly and severally liable hereunder.

27. ESTOPPEL CERTIFICATES: Lessee shall at any time during the Lease Term, upon not less than ten (10) days prior written notice from Lessor, execute and deliver to Lessor a statement in writing certifying that, this Lease is unmodified and in full force and effect (or, if modified, stating the nature of such modification) and the dates to which the Rent and other charges have been paid in advance, if any, and acknowledging that there are not, to Lessee's knowledge, any uncured defaults on the part of Lessor hereunder or specifying such defaults if they are claimed. Any such statement may be conclusively relied upon by any prospective purchaser or encumbrancer of the Premises. Lessee's failure to deliver such a statement within such time shall be conclusive upon the Lessee that (a) this Lease is in full force and effect, without modification except as may be represented by Lessor, (b) there are 110 uncured defaults in Lessor's performance.

28. TIME: Time is of the essence of the Lease.

29. CAPTIONS: The headings on titles to the paragraphs of this Lease are not a

part of this Lease and shall have no effect upon the construction or interpretation of any part thereof. This instrument contains all of the agreements and conditions made between the parties hereto and may not be modified orally or in any other manner than by an agreement in writing signed by all of the parties hereto or their respective successors in interest.

30. PARTY NAMES: Landlord and Tenant may be used in various places in this Lease as a substitute for Lessor and Lessee respectively.

31. EARTHQUAKE INSURANCE: As a condition of Lessor agreeing to waive the requirement for earthquake insurance, Lessee agrees that it will pay, as additional Rent, which shall be included in the monthly CAC, an amount not to exceed twenty thousand eight hundred dollars (\$20,800) per year for earthquake insurance if Lessor desires to obtain some form of earthquake insurance in the future, if and when available, on terms acceptable to Lessor.

32. HABITUAL DEFAULT: Notwithstanding anything to the contrary contained in Section 14 herein, Lessor and Lessee agree that if Lessee shall have defaulted in the payment of Rent for three or more times during any twelve month period during the Lease Term, then such conduct shall, at the option of the Lessor, represent a separate event of default which cannot be cured by Lessee. Lessee acknowledges that the purpose of this provision is to prevent

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repetitive defaults by the Lessee under the Lease, which constitute a hardship to the Lessor and deprive the Lessor of the timely performance by the Lessee hereunder.

33. HAZARDOUS MATERIALS

33.1 DEFINITIONS: As used in this Lease, the following terms shall have the following meaning:

a. The term "Hazardous Materials" shall mean (i) polychlorinated biphenyls; (ii) radioactive materials and (iii) any chemical, material or substance now or hereafter defined as or included in the definitions of "hazardous substance" "hazardous water", "hazardous material", "extremely hazardous waste", "restricted hazardous waste" under Section 25115, 25117 or 15122.7, or listed pursuant to Section 25140 of the California Health and Safety Code, Division 20, Chapter 6.5 (Hazardous Waste Control Law), (ii) defined as "hazardous substance" under Section 25316 of the California Health and Safety Code, Division 20, Chapter 6.8 (Carpenter-Presley-Tanner Hazardous Substances Account Act), (iii) defined as "hazardous material", "hazardous substance", or "hazardous waste" under Section 25501 of the California Health and Safety Code, Division 20, Chapter 6.95 (Hazardous Materials Release, Response, Plans and Inventory), (iv) defined as a "hazardous substance" under Section 25181 of the California Health and Safety Code, Division 201, Chapter 6.7 (Underground Storage of Hazardous Substances), (v) petroleum, (vi) asbestos, (vii) listed under Article 9 or

defined as "hazardous" or "extremely hazardous" pursuant to Article II of Title 22 of the California Administrative Code, Division 4, Chapter 20, (viii) defined as "hazardous substance" pursuant to Section 311 of the Federal Water Pollution Control Act, 33 U.S.C. 1251 et seq. or listed pursuant to Section 1004 of the Federal Water Pollution Control Act (33 U.S.C. 1317), (ix) defined as a "hazardous waste", pursuant to Section 1004 of the Federal Resource Conservation and Recovery Act, 42 U.S.C. 6901 et seq., (x) defined as "hazardous substance" pursuant to Section 101 of the Comprehensive Environmental Responsibility Compensations, and Liability Act, 42 U.S.C. 9601 et seq., or (xi) regulated under the Toxic Substances Control Act, 156 U.S.C. 2601 et seq.

b. The term "Hazardous Materials Laws" shall mean any local, state and federal laws, rules, regulations, or ordinances relating to the use, generation, transportation, analysis, manufacture, installation, release, discharge, storage or disposal of Hazardous Material.

c. The term "Lessor's Agents" as used herein shall mean Lessor's agents, representatives, employees, contractors, subcontractors, directors, officers and partners.

d. The term "Lessee's Agents" as used herein shall mean Lessee's agents, representatives, employees, contractors, subcontractors, directors, officers, partners, invitees or any other person in or about the Premises.

33.2 LESSEE'S RIGHT TO INVESTIGATE: Lessee shall be entitled to cause such inspection, soils and ground water tests, and other evaluations to be made of the Premises as Lessee deems necessary regarding (i) the presence and use of Hazardous Materials in or about the Premises, and (ii) the potential for exposure to Lessee's employees and other persons to any Hazardous Materials used and stored by previous occupants in or about the Premises. Lessee shall provide Lessor with copies of all inspections, tests and evaluations. Lessee shall indemnify, defend and hold Lessor harmless from any cost, claim or expense arising from such entry by Lessee or from the performance of any such investigation by such Lessee.

33.3 LESSOR'S REPRESENTATIONS: Lessor hereby represents and warrants to the best of Lessor's knowledge that the Premises are, as of the date of this Lease, in compliance with all Hazardous Material Laws.

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33.4 LESSEE'S OBLIGATION TO INDEMNIFY: Lessee, at its sole cost and expense, shall indemnify, defend, protect and hold Lessor and Lessor's Agents harmless from and against any and all cost or expenses, including those described under subparagraphs i, ii and iii herein below set forth, arising from or caused in whole or in part, directly or indirectly by:

a. Lessee's or Lessee's Agents' use, analysis, storage, transportation, disposal, release, threatened release, discharge or generation of Hazardous

Material to, in, on, under, about or from the Premises; or

b. Lessee's or Lessee's Agents failure to comply with Hazardous Material laws; or

c. Any release of Hazardous Material to, in, on, under, about, from or onto the Premises caused by Lessee or Lessee's Agents, except ground water contamination from other parcels where the source is from off the Premises not arising from or caused by Lessee or Lessee's Agents.

The cost and expenses indemnified against include, but are not limited to the following:

i. Any and all claims, actions, suits, proceedings, losses, damages, liabilities, deficiencies, forfeitures, penalties, fines, punitive damages, cost or expenses;

ii. Any claim, action, suit or proceeding for personal injury (including sickness, disease, or death), tangible or intangible property damage, compensation for lost wages, business income, profits or other economic loss, damage to the natural resources of the environment, nuisance, pollution, contamination, leaks, spills, release or other adverse effects on the environment;

iii. The cost of any repair, clean-up, treatment or detoxification of the Premises necessary to bring the Premises into compliance with all Hazardous Material Laws, including the preparation and implementation of any closure, disposal, remedial action, or other actions with regard to the Premises, and expenses (including, without limitation, reasonable attorney's fees and consultants fees, investigation and laboratory fees, court cost and litigation expenses).

33.5 LESSEE'S OBLIGATION TO REMEDIATE CONTAMINATION: Lessee shall, at its sole cost and expense, promptly take any and all action necessary to remediate contamination of the Premises by Hazardous Materials arising or occurring as a result of acts or omissions of Lessee or Lessee's Agents during the Lease Term.

33.6 OBLIGATION TO NOTIFY: Lessor and Lessee shall each give written notice to the other as soon as reasonably practical of (i) any communication received from any governmental authority concerning Hazardous Material which related to the Premises and (ii) any contamination of the Premises by Hazardous Materials which constitutes a violation of any Hazardous Material Laws.

33.7 SURVIVAL: The obligations of Lessee under this Section 33 shall survive the Lease Term or earlier termination of this Lease.

33.8 CERTIFICATION AND CLOSURE: On or before the end of the Lease Term or earlier termination of this Lease, Lessee shall deliver to Lessor a certification executed by Lessee stating that, to the best of Lessee's knowledge, there exists no violation of Hazardous Material Laws resulting from Lessee's obligation in Paragraph 33. If pursuant to local ordinance, state or

federal law, Lessee is required, at the expiration of the Lease Term, to submit a closure plan for the Premises to a local, state or federal agency, then Lessee shall furnish to Lessor a copy of such plan.

33.9 PRIOR HAZARDOUS MATERIALS: Notwithstanding anything contained to the contrary herein, Lessee shall have no obligation to clean up or to hold Lessor harmless or make any payment with respect to, any Hazardous Material or wastes discovered on the Premises which were not introduced into, in, on, about, from or under the Premises

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during the Lease Term or ground water contamination from other parcels where the source is from off the Premises not arising from or caused by Lessee or Lessee's Agents.

34. BROKERS: Lessor and Lessee represent that they have not utilized or contacted a real estate broker or finder with respect to this Lease other than Cornish & Carey ("C&C") and Lessee agrees to indemnify and hold Lessor harmless against any claim, cost, liability or cause of action asserted by any broker or finder claiming through Lessee other than C&C. Lessor shall at its sole cost and expense pay the brokerage commission per Lessor's standard commission schedule to C&C in connection with this transaction. Lessor represents and warrants that it has not utilized or contacted a real estate broker or finder with respect to this Lease other than C&C and Lessor agrees to indemnify and hold Lessee harmless against any claim, cost, liability or cause of action asserted by any broker or finder claiming through Lessor.

35. OPTION TO EXTEND

A. Option: Lessor hereby grants to Lessee one (1) option to extend the Lease

Term, with the extended term to be for a period of five (5) years, on the following terms and conditions:

(i) Lessee shall give Lessor written notice of its exercise of its option to extend no earlier than twenty-four (24) calendar months, nor later than six (6) calendar months before the Lease Term would end but for said exercise. Time is of the essence.

(ii) Lessee may not extend the Lease Term pursuant to any option granted by this section 35 if Lessee is in default as of the date of the exercise of its option. If Lessee has committed a default by Lessee as defined in Section 14 or 32 that has not been cured or waived by Lessor in writing by the date that any extended term is to commence, then Lessor may elect not to allow the Lease Term' to be extended, notwithstanding any notice given by Lessee of an exercise of this option to extend.

(iii) All terms and conditions of this Lease shall apply during the extended term, except that the base rent and rental increases for each

extended term shall be determined as provided in Section 35 (B) below

(iv) Once Lessee delivers a notice of exercise of its options to extend the Lease Term, Lessee may not withdraw such exercise and subject to the provisions of this Section 35, such notice shall operate to extend the Lease Term. Upon any extension of the Lease Term pursuant to this Section 35, the term "Lease Term" as used in this Lease shall thereafter include the then extended term.

(v) The option rights of Photon Dynamics, Inc. granted under this Section 35 are granted for Photon Dynamics, Inc.'s personal benefit and may not be assigned or transferred by Photon Dynamics, Inc. or exercised if Photon Dynamics, Inc. is not occupying the Building at the time of exercise.

B. Extended Term Rent - Option Period: The monthly Rent for the Building

during the extended term shall equal to ninety-five percent (95%) of the fair market monthly Rent for the Building as of the commencement date of the extended term, but in no case, less than the Rent during the last month of the prior Lease term. Promptly upon Lessee's exercise of the option to extend, Lessee and Lessor shall meet and attempt to agree on the fair market monthly Rent for the Building as of the commencement date of the extended term. In the event the parties fail to agree upon the amount of the monthly Rent for the extended term prior to commencement thereof, the monthly Rent for the extended term shall be determined by appraisal in the manner hereafter set forth; provided, however, that in no event shall the monthly Rent for the extended term be less than in the immediate preceding period.

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Annual base rent increases during the extended term shall be three percent (3%) per year. In the event it becomes necessary under this paragraph to determine the fair market monthly Rent of the Building by appraisal, Lessor and Lessee each shall appoint a real estate appraiser who shall be a member of the American Institute of Real Estate Appraiser ("AIREA") and such appraisers shall each determine the fair market monthly Rent for the Building taking into account the value of the Premises and the amenities provided by the outside areas, the common areas, and the Building, and prevailing comparable Rentals in the area. Such appraisers shall, within twenty (20) business days after their appointment, complete their appraisals and submit their appraisal reports to Lessor and Lessee. If the fair market monthly Rent of the Building established in the two (2) appraisals varies by five percent (5%) or less of the higher Rent, the average of the two shall be controlling. If said fair market monthly Rent varies by more than five percent (5%) of the higher Rental, said appraisers, within ten (10) days after submission of the last appraisal, shall appoint a third appraiser who shall be a member of the AIREA and who shall also be experienced in the appraisal of Rent values and adjustment practices for commercial properties in the vicinity of the Building. Such third appraiser shall, within twenty (20) business days after his appointment, determine by appraisal the fair market monthly Rent of the

Building taking into account the same factors referred to above, and submit his appraisal report to Lessor and Lessee. The fair market monthly Rent determined by the third appraiser for the Building shall be controlling, unless it is less than that set forth in the lower appraisal previously obtained, in which case the value set forth in said lower appraisal shall be controlling, or unless it is greater than that set forth in the higher appraisal previously obtained in which case the Rent set for in said higher appraisal shall be controlling. If either Lessor or Lessee fails to appoint an appraiser, or if an appraiser appointed by either of them fails, after his appointment to submit his appraisal within the required period in accordance with the foregoing, the appraisal submitted by the appraiser properly appointed and timely submitting his appraisal shall be controlling. If the two appraisers appointed by Lessor and Lessee are unable to agree upon a third appraiser within the required period in accordance with the foregoing, application shall be made within twenty (20) days thereafter by either Lessor or Lessee to AIREA, which shall appoint a member of said institute willing to serve as appraiser. The cost of all appraisals under this subparagraph shall be borne equally by Lessor and Lessee.

36. APPROVALS: Whenever in this Lease the Lessor's or Lessee's consent is required, such consent shall not be unreasonably or arbitrarily withheld or delayed. In the event that the Lessor or Lessee does not respond to a request for any consents which may be required of it in this Lease within ten business days of the request of such consent in writing by the Lessee or Lessor, such consent shall be deemed to have been given by the Lessor or Lessee.

37. AUTHORITY: Each party executing this Lease represents and warrants that he or she is duly authorized to execute and deliver the Lease. If executed on behalf of a corporation, that the Lease is executed in accordance with the by-laws of said corporation (or a partnership that the Lease is executed in accordance with the partnership agreement of such partnership), that no other party's approval or consent to such execution and delivery is required, and that the Lease is binding upon said individual, corporation (or partnership) as the case may be in accordance with its terms.

38. (a) INDEMNIFICATION OF LESSEE: Lessor shall indemnify and hold Lessee harmless for the negligent acts amid willful misconduct of Lessor and Lessor's Agents in not performing Lessor's obligations under the Lease provided Lessee has given Lessor written notice with adequate time to cure of any obligations which it believes Lessor has not performed per the terms of the Lease. Notwithstanding this indemnification, Lessor shall have no liability nor obligation for consequential damages, including but not limited to, damages for loss of use or profits.

(b) INDEMNIFICATION OF LESSOR: Except to the extent caused by the sole negligence or willful misconduct of Lessor or Lessor's Agents, Lessee shall defend, indemnify and hold Lessor harmless from and against any amid all obligations, losses, costs, expenses, claims, demands, attorney's fees , investigation costs or liabilities on account

of, or arising out of the use, condition or occupancy of the Premises or any act or omission to act of Lessee or Lessee's Agents or any occurrence in, upon, about or at the Premises, including, without limitation, any of the foregoing provisions arising out of the use, generation, manufacture, installation, release, discharge, storage, or disposal of Hazardous Materials by Lessee or Lessee's Agents. It is understood that Lessee is and shall be in control and possession of the Premises and that Lessor shall in no event be responsible or liable for any injury or damage or injury to any person whatsoever, happening on, in, about, or in connection with the Premises, or for any injury or damage to the Premises or any part thereof This Lease is entered into on the express condition that Lessor shall not be liable for, or suffer loss by reason of injury to person or property, from whatever cause, which in any way may be connected with the use, condition or occupancy of the Premises or personal property located herein. The provisions of this Lease permitting Lessor to enter and inspect the Premises are for the purpose of enabling Lessor to become informed as to whether Lessee is complying with the terms of this Lease and Lessor shall be under no duty to enter, inspect or to perform any of Lessee's covenants set forth in this Lease. Lessee shall further indemnify, defend and hold harmless Lessor from and against any and all claims arising from any breach or default in the performance of any obligation to Lessee's part to be performed under the terms of this Lease. The provisions of Section 38 shall survive the Lease Term or earlier termination of this Lease with respect to any damage, injury or death occurring during the Lease Term.

39. LESSOR'S LIABILITY: If Lessee should recover a money judgment against Lessor arising in connection with this Lease, the judgment shall be satisfied only out of the Lessor's interest in the Building and neither Lessor or any of its partners shall be liable personally for any deficiency.

40. MISCELLANEOUS PROVISIONS: All rights and remedies hereunder are cumulative and not alternative to the extent permitted by law and are in addition to all other rights or remedies in law and in equity.

41. CHOICE OF LAW: This lease shall be construed and enforced in accordance with the substantive laws of the State of California. The language of all parts of this lease shall in all cases be construed as a whole according to its fair meaning and not strictly for or against either Lessor or Lessee.

42. ENTIRE AGREEMENT: This Lease is the entire agreement between the parties, and there are no agreements or representations between the parties except as expressed herein. Except as otherwise provided for herein, no subsequent change or addition to this Lease shall be binding unless in writing and signed by the parties hereto.

IN WITNESS WHEREOF, Lessor and Lessee have executed these presents, the day and year first above written.

LESSOR
BERG & BERG DEVELOPERS

LESSEE
PHOTON DYNAMICS, INC.

By: _____
signature of authorized representative

By: _____
signature of authorized representative

printed name

printed name

title

title

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date

date

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Exhibit E
Lessee Approval Deadlines

Lease signed 08/05/96

Approval of preliminary floor plan, single line 08110196

Final selection of all material and interior finishes
for construction such as carpet, ceramic tile, paint
and any other lessee selected materials & finishes 08/15/96

Lessee shall not unreasonably withhold approval of final shell or interior plans if they conform in general to the preliminary site plan, preliminary elevation, and floor plans.

The Commencement Date shall be extended one day for each day Lessee does not meet each deadline set forth on this Exhibit E.

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[MAP APPEARS HERE]

[MAP APPEARS HERE]

[CHART APPEARS HERE]

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AGREEMENT REGARDING CHANGE OF CONTROL

This Agreement is entered into as of this 1st day of July 1996 by and between Photon Dynamics, Inc., a California corporation (the "Company"), and Donald Jerome ("Executive").

RECITALS

Executive is employed by the Company and is a valued officer of the Company. As an inducement to Executive to remain in the employ of the Company, the Company wishes to provide for certain rights in favor of Executive to severance payments and other benefits in the event of a Change of Control (as defined below) of the Company upon the terms herein provided.

NOW THEREFORE, in consideration of the foregoing and the mutual promises herein contained, the parties agree as follows:

AGREEMENT

Section 1. Definitions

For purposes of this Agreement, the following definitions shall apply:

"Alternative Employment" shall mean any employment, consulting or other relationship pursuant to which Executive provides in excess of 20 hours of service per week for compensation following any Protection Termination of his employment with the Company.

"Change of Control" shall mean the occurrence of one or more of the following with respect to the Company: (i) the sale or exchange of more than 50% of the outstanding shares of Common Stock (treating any Preferred Stock on a fully converted basis) in a single transaction or series of related transactions; (ii) a merger or consolidation in which the Company is not the surviving entity, except for a transaction the principal purpose of which is to change the state of the Company's incorporation; or (iii) any reverse merger in which the Company is the surviving entity but in which securities representing more than fifty percent (50%) of the total combined voting power of the Company's outstanding securities are transferred to holder different from those who held such securities immediately prior to such merger.

"Closing Date" shall mean the date of the first closing of the transactions

constituting a Change of Control.

"Common Stock" shall mean no par value, Common Stock of the Company.

"Constructive Termination" shall mean any of the following actions taken by the Company with respect to the position or compensation or other material terms and conditions of Executive's employment with the Company: (A) unless approved in writing in advance by Executive, the assignment to Executive of any duties materially inconsistent with his position,

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duties, responsibilities, authority and status, or the removal of any material duties, responsibilities or authority from such position, except to the extent necessary in connection with a disability that would qualify under the Company's existing disability plan, if any, but for any requirement in such plan that the disability continue for any period of time, for the period of such disability; (B) a reduction in Executive's annual base salary in effect at the time any determination thereof is to be made; or (C) unless approved in writing in advance by Executive, the Company's requiring the Executive to work, apart from reasonable business trips, more than 100 miles from the location at which Executive was working on the Closing Date.

"Executive's Stock Options" shall mean those options to purchase Common Stock held by Executive that have been issued to Executive prior to the date hereof pursuant to the Photon Dynamics, Inc. 1987 and 1995 Stock Option Plan and that are set forth in Exhibit A attached hereto.

"Protected Termination" shall mean any termination of Executive's employment with the Company (including, without limitation, a Constructive Termination as provided in Section 2.5 below) other than: (i) a voluntary termination of such employment by Executive other than as a result of a Constructive Termination; or (ii) a termination by the Company of such employment for cause, which shall mean, for purposes of this Section 1, a termination of Executive's employment by the Company as a result of the occurrence of one or more of the following with respect to Executive: (w) chronic alcoholism or drug addiction, to the extent discharge therefor is permitted by applicable law; (x) misappropriation of any money or other assets or properties of the Company or any subsidiary of the Company; (y) the conviction of Executive of any felony, or of any lesser crime or offense materially and adversely affecting the property, reputation or goodwill of the Company or any of its subsidiaries; or (z) willful or gross neglect by Executive of his duties, or willful misconduct by Executive in connection with the performance of his duties, which neglect or misconduct shall have an adverse effect on the Company or one of its subsidiaries and which shall remain unremedied for thirty (30) days after written notice (indicating with reasonable specificity the events of neglect and/or misconduct) given to Executive by the Company through its Board of Directors.

"Severance Payments and Benefits" shall mean Executive's base salary and

non-discretionary bonuses (as measured at the then effective rates), plus medical, health and other insurance benefits that are in effect as of the Closing Date.

Section 2. Severance Payments

2.1 In the event of and following a Change of Control and in the further event that Executive is an employee of the Company as of the Closing Date of such Change of Control, the Company agrees that Executive shall be entitled to the Severance Payments and Benefits and other consideration in accordance with this Section 2 in the event Executive's employment with the Company terminates as a result of a Protected Termination (or is deemed to terminate as a result of a Constructive Termination as provided in Section 2.5 below) within the nine (9) month period following the Closing Date.

2.2 Subject to Section 2.1 above and in the event that Executive's employment with the Company is to be terminated as of the Closing Date as a result of a Protected Termination (or

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is deemed to terminate as a result of a Constructive Termination as provided in Section 2.5 below), Executive shall be paid or otherwise provided by the Company Severance Payments and Benefits for a period of six (6) months following the Closing Date; provided that if Executive has not obtained Alternative Employment upon the expiration of said six (6) month period, Executive's right pursuant to this Section 2.2 to receive Severance Payments and Benefits shall be extended for an additional three (3) months. To the extent that Executive shall obtain Alternative Employment at a compensation rate or for benefits that are less in any material respect than the Severance Payments and Benefits that Executive would otherwise be entitled to receive pursuant to this Section 2.2, said three (3) month extension shall apply, and Executive be entitled to continue to receive the Severance Payments and Benefits for the Company until expiration of said three (3) month period, less those credits against such obligation which the Company is allowed pursuant to Section 3.1 below.

2.3 Subject to Section 2.1 above and in the event that Executive remains an employee of the Company at any time following the Closing Date and his employment is terminated as a result of a Protected Termination (or is deemed to terminate as a result of a Constructive Termination pursuant to Section 2.5 below) within nine (9) months following the Closing, Executive shall be paid or otherwise provided by the Company Severance Payments and Benefits from the date of such termination of employment until six (6) months from such termination date.

2.4 Subject to Section 2.1 above, the Company agrees that the right of Executive to exercise the Executive's Stock Options shall be accelerated as of the Closing Date of a Change of Control as follows: (i) if Executive's employment with the Company is to be terminated as of the Closing Date in the

manner described in Section 2.2 above, Executive's Stock Options shall become fully exercisable as of the Closing Date as to all shares of the Company's Common Stock subject thereto; and (ii) if Executive is to remain an employee of the Company at any time following the Closing Date as described in Section 2.3 above, Executive's Stock Options shall become exercisable as to that number of shares of Common Stock (in addition to that number of shares of Common Stock for which the Executive's Stock Option is then otherwise exercisable) for which the Executive's Stock Options would be exercisable upon the expiration of two (2) years following the Closing Date (assuming that Executive was then employed by the Company). As a condition to an acceleration of the Executive's Stock Options as provided in this Section 2.4, Executive agrees that the Executive's Stock Options shall terminate as of the Closing Date to the extent unexercised as of such Closing Date if the terms and conditions of such Change of Control require that all employee stock options terminate as of such Closing Date. In no event shall this Section 2.4 be interpreted to cause the Executive's Stock Options to be exercisable for a greater number of shares of Common Stock than were subject to the Executive's Stock Options immediately prior to the Closing Date.

2.5 In the event of a Constructive Termination, Executive shall have the option to give notice to the Company within ten (10) business days of the effective date of such Constructive Termination that Executive elects to terminate his employment with the Company, in which case Executive's employment with the Company shall be deemed to have been terminated as a result of a Protected Termination, and Executive shall be entitled to the appropriate Severance Payments and Benefits as provided in Section 2.2 or 2.3 above. In the event Executive does not elect to resign his employment with the Company in accordance with the preceding sentence

following a Constructive Termination and notwithstanding any proposed term of employment related to such Constructive Termination, Executive shall remain entitled to the same level of base salary compensation and non-discretionary bonuses (which are then in effect) and medical, health and other insurance benefits that were in effect as of the Closing Date until the first to occur of: (i) the expiration of fifteen (15) months following the Closing Date, or (ii) the termination of Executive's employment with the Company (in which case Executive shall retain those rights described in Section 2 hereof as to such termination).

Section 3. Alternative Employment: Payment of Severance Payments and Benefits

3.1 In the event Executive shall obtain Alternative Employment during any period in which Executive is entitled to Severance Payments and Benefits pursuant to Section 2.2 or 2.3 above (other than the initial six (6) month period described in Section 2.2 or 2.3), Executive shall promptly give notice to the Company of such Alternative Employment, which notice shall describe the following with respect to such Alternative Employment: (i) the salary, commission, bonus and other monetary compensation payable to Executive; (ii) the

medical, health and other insurance benefits to be provided to Executive and (iii) any other consideration payable to or otherwise be provided to Executive. The Company shall be credited for any compensation payable or benefits provided with respect to such Alternative Employment against the Company's obligation to pay and or provide Severance Payments and Benefits for any period (other than the Initial six (6) month period described in Section 2.2 or 2.3) pursuant to Section 2 hereof so that: (A) the monetary portion of the Severance Payments and Benefits shall be reduced for any cash compensation payable to Executive for such period with respect to such Alternative Employment; and (B) the Company shall cease to be obligated to provide any medical, health or other insurance benefit to the extent an equivalent benefit is provided to Executive in connection with such Alternative Employment. Following a Protected Termination of Executive's employment with the Company, Executive shall use reasonable efforts to obtain Alternative Employment, provided, that nothing contained herein shall be deemed to obligate Executive to accept Alternative Employment that: (1) involves duties, responsibility, authority and status that are less in any material respect that applied to Executive's position with the Company as of the Closing Date; (2) involves a reduction in Executive's annual base salary that Executive was receiving as of the Closing Date; or (iii) requires Executive to work more than 100 miles from the location at which Executive was working on the Closing Date.

3.2 During any period in which Executive is entitled to Severance Payments and Benefits, the Company shall (i) pay the salary and bonus component thereof in accordance with the Company's then effective payroll payment policies; and (ii) provide Executive with the same or equivalent medical, health and other insurance policies or, at the Company's option, reimburse Executive for premiums payable with respect to equivalent policies to be obtained directly by Executive.

Section 4. No Employment Agreement Employment at Will

Except as previously herein provided, Executive and the Company each acknowledge and agree that: (i) this Agreement does not provide for the terms and conditions of Executive's employment with the Company and does not require or obligate Executive to provide services to the Company or the Company to continue to employ Executive; and (ii) Executive's employment with the Company remains an employment relationship terminable at will by either Executive or the Company.

Section 5. Release of the Company and Its Affiliates

5.1 Upon a termination of Executive's employment with the Company following a Change of Control for which Executive is entitled to payments or other benefits pursuant to Section 2 above and subject to full performance by the Company of its obligations hereunder, Executive hereby forever and

completely releases and discharges the following (and each of them); (i) the Company; (ii) any entity which is controlled by, or under common control with, the Company (including, without limitation, any entity or entities or persons acquiring control of the Company through the Change of Control); and (iii) any past, present or future agents, attorneys, directors, officers, shareholders, employees, affiliates, predecessors and successors of any of the foregoing individuals or entities under clauses (i) and (ii) above, of and from any and all claims and demands of every kind and nature, in law, equity or otherwise, known or unknown, suspected or unsuspected, disclosed or undisclosed, including but not limited to all claims and demands of every kind and nature, known or unknown, suspected or unsuspected, disclosed or undisclosed, for damages actual, consequential or exemplary, past, present and future, arising out of or in any way related to Executive's employment with the Company.

5.2 Notwithstanding anything to the contrary set forth in Section 5.1 above, the releases set forth in said Section 5.1 shall not apply to any claims or demands that: (i) do not arise in connection with Executive's employment with the Company or a termination thereof; or (ii) are for salary or other benefits for periods prior to such termination that have not been paid or otherwise provided by the Company prior to the date of such termination.

Section 6. Notices

All notices or other communications required or permitted hereunder shall be made in writing and shall be deemed to have been duly given if delivered by hand or mailed, postage prepaid, by certified or registered mail, return receipt requested, and addressed to the Company at:

Photon Dynamics, Inc.
1504 McCarthy Blvd.
Milpitas, CA 95035
Attention: Chairman

or to the Executive at:

Notice of change of address shall be effective only when done in accordance with this Section.

Section 7. Successors

This Agreement shall be binding upon and shall inure to the benefit of the parties hereto and their respective heirs, executors, administrators, successors and assigns.

Section 8. California Law

The interpretation, performance and enforcement of this Agreement shall be governed by the laws of the State of California.

IN WITNESS WHEREOF, the parties hereto have duly executed this Agreement as of the date first above written.

PHOTON DYNAMICS, INC.,
a California corporation

EXECUTIVE:

By: /s/ E. Floyd Kvamme

/s/ Donald Jerome

E. Floyd Kvamme

Donald Jerome

Title: Chairman

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EXHIBIT A

Executive's Stock Options

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AGREEMENT REGARDING CHANGE OF CONTROL

This Agreement is entered into as of this 1st day of July 1996 by and between Photon Dynamics, Inc., a California corporation (the "Company"), and Vincent F. Sollitto, Jr. ("Executive").

RECITALS

Executive is employed by the Company and is a valued officer of the Company. As an inducement to Executive to remain in the employ of the Company, the Company wishes to provide for certain rights in favor of Executive to severance payments and other benefits in the event of a Change of Control (as defined below) of the Company upon the terms herein provided.

NOW THEREFORE, in consideration of the foregoing and the mutual promises herein contained, the parties agree as follows:

AGREEMENT

Section 1. Definitions

For purposes of this Agreement, the following definitions shall apply:

"Alternative Employment" shall mean any employment, consulting or other relationship pursuant to which Executive provides in excess of 20 hours of service per week for compensation following any Protection Termination of his employment with the Company.

"Change of Control" shall mean the occurrence of one or more of the following with respect to the Company: (i) the sale or exchange of more than 50% of the outstanding shares of Common Stock (treating any Preferred Stock on a fully converted basis) in a single transaction or series of related transactions; (ii) a merger or consolidation in which the Company is not the surviving entity, except for a transaction the principal purpose of which is to change the state of the Company's incorporation; or (iii) any reverse merger in which the Company is the surviving entity but in which securities representing more than fifty percent (50%) of the total combined voting power of the Company's outstanding securities are transferred to holder different from those who held such securities immediately prior to such merger.

"Closing Date" shall mean the date of the first closing of the transactions

constituting a Change of Control.

"Common Stock" shall mean no par value, Common Stock of the Company.

"Constructive Termination" shall mean any of the following actions taken by the Company with respect to the position or compensation or other material terms and conditions of Executive's employment with the Company: (A) unless approved in writing in advance by

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Executive, the assignment to Executive of any duties materially inconsistent with his position, duties, responsibilities, authority and status, or the removal of any material duties, responsibilities or authority from such position, except to the extent necessary in connection with a disability that would qualify under the Company's existing disability plan, if any, but for any requirement in such plan that the disability continue for any period of time, for the period of such disability; (B) a reduction in Executive's annual base salary in effect at the time any determination thereof is to be made; or (C) unless approved in writing in advance by Executive, the Company's requiring the Executive to work, apart from reasonable business trips, more than 100 miles from the location at which Executive was working on the Closing Date.

"Executive's Stock Options" shall mean those options to purchase Common Stock held by Executive that have been issued to Executive prior to the date hereof pursuant to the Photon Dynamics, Inc. 1995 Stock Option Plan and that are set forth in Exhibit A attached hereto.

"Protected Termination" shall mean any termination of Executive's employment with the Company (including, without limitation, a Constructive Termination as provided in Section 2.5 below) other than: (i) a voluntary termination of such employment by Executive other than as a result of a Constructive Termination; or (ii) a termination by the Company of such employment for cause, which shall mean, for purposes of this Section 1, a termination of Executive's employment by the Company as a result of the occurrence of one or more of the following with respect to Executive: (w) chronic alcoholism or drug addiction, to the extent discharge therefor is permitted by applicable law; (x) misappropriation of any money or other assets or properties of the Company or any subsidiary of the Company; (y) the conviction of Executive of any felony, or of any lesser crime or offense materially and adversely affecting the property, reputation or goodwill of the Company or any of its subsidiaries; or (z) willful or gross neglect by Executive of his duties, or willful misconduct by Executive in connection with the performance of his duties, which neglect or misconduct shall have an adverse effect on the Company or one of its subsidiaries and which shall remain unremedied for thirty (30) days after written notice (indicating with reasonable specificity the events of neglect and/or misconduct) given to Executive by the Company through its Board of Directors.

"Severance Payments and Benefits" shall mean Executive's base salary and non-discretionary bonuses (as measured at the then effective rates), plus medical, health and other insurance benefits that are in effect as of the Closing Date.

Section 2. Severance Payments

2.1 In the event of and following a Change of Control and in the further event that Executive is an employee of the Company as of the Closing Date of such Change of Control, the Company agrees that Executive shall be entitled to the Severance Payments and Benefits and other consideration in accordance with this Section 2 in the event Executive's employment with the Company terminates as a result of a Protected Termination (or is deemed to terminate as a result of a Constructive Termination as provided in Section 2.5 below) within the fifteen (15) month period following the Closing Date.

2.2 Subject to Section 2.1 above and in the event that Executive's employment with the Company is to be terminated as of the Closing Date as a result of a Protected Termination (or

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is deemed to terminate as a result of a Constructive Termination as provided in Section 2.5 below), Executive shall be paid or otherwise provided by the Company Severance Payments and Benefits for a period of six (6) months following the Closing Date; provided that Executive's right pursuant to this Section 2.2 to receive Severance Payments and Benefits shall be extended for up to three (3) additional three (3) month periods as provided in this Section 2.2. In the event that Executive shall not have obtained Alternative Employment by the expiration of the initial six (6) month period, Executive's right to Severance Benefits and Payments shall be extended for one (1) three (3) month extension period. In the further event that Executive shall not have obtained Alternative Employment by the expiration of such initial three (3) month extension period, Executive's right to receive Severance Benefits and Payments shall be continued for one (1) additional three month extension period following expiration of such initial extension period, and if Executive shall not have obtained Alternative Employment by the expiration of the second three (3) month extension period, Executive's right to receive Severance Benefits and Payments shall be continued for one (1) additional three month extension period following expiration of such second extension period. Any right of Executive to Severance Payments and Benefits pursuant to this Section 2.2 shall cease and terminate fifteen (15) months from the Closing Date. To the extent Executive shall obtain Alternative Employment at a compensation rate or for benefits that are less in any material respect than the Severance Payments and Benefits that Executive would otherwise be entitled to receive pursuant to this Section 2.2, Executive's right to receive Severance Payments and Benefits from the Company shall continue to be extended as provided above in this Section 2.2, provided that the Company shall be allowed a credit as provided in Section 3.1 below on the basis of such Alternative Employment with

respect to its obligation to pay and provide such extended Severance Payments and Benefits.

2.3 Subject to Section 2.1 above and in the event that Executive remains an employee of the Company at any time following the Closing Date and his employment is terminated as a result of a Protected Termination (or is deemed to terminate as a result of a Constructive Termination pursuant to Section 2.5 below) within fifteen (15) months following the Closing, Executive shall be paid or otherwise provided by the Company Severance Payments and Benefits from the date of such termination of employment until six (6) months from the date of such termination.

2.4 Subject to Section 2.1 above, the Company agrees that the right of Executive to exercise the Executive's Stock Options shall be accelerated as of the Closing Date of a Change of Control as follows: (i) if Executive's employment with the Company is to be terminated as of the Closing Date in the manner described in Section 2.2 above, Executive's Stock Options shall become fully exercisable as of the Closing Date as to all shares of the Company's Common Stock subject thereto; and (ii) if Executive is to remain an employee of the Company at any time following the Closing Date as described in Section 2.3 above, Executive's Stock Options shall become exercisable as to that number of shares of Common Stock (in addition to that number of shares of Common Stock for which the Executive's Stock Option is then otherwise exercisable) for which the Executive's Stock Options would be exercisable upon the expiration of two (2) years following the Closing Date (assuming that Executive was then employed by the Company). As a condition to an acceleration of the Executive's Stock Options as provided in this Section 2.4, Executive agrees that the Executive's Stock Options shall terminate as of the Closing Date to the extent unexercised as of such Closing Date if the terms and conditions of such Change of Control require that all employee stock options terminate as of such Closing Date. In

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no event shall this Section 2.4 be interpreted to cause the Executive's Stock Options to be exercisable for a greater number of shares of Common Stock than were subject to the Executive's Stock Options immediately prior to the Closing Date.

2.5 In the event of a Constructive Termination, Executive shall have the option to give notice to the Company within ten (10) business days of the effective date of such Constructive Termination that Executive elects to terminate his employment with the Company, in which case Executive's employment with the Company shall be deemed to have been terminated as a result of a Protected Termination, and Executive shall be entitled to the appropriate Severance Payments and Benefits as provided in Section 2.2 or 2.3 above. In the event Executive does not elect to resign his employment with the Company in accordance with the preceding sentence following a Constructive Termination and notwithstanding any proposed term of employment related to such Constructive Termination, Executive shall remain entitled to the same level of base salary compensation and non-discretionary bonuses (which are then in effect) and

medical, health and other insurance benefits that were in effect as of the Closing Date until the first to occur of: (i) the expiration of fifteen (15) months following the Closing Date, or (ii) the termination of Executive's employment with the Company (in which case Executive shall retain those rights described in Section 2 hereof as to such termination).

Section 3. Alternative Employment: Payment of Severance Payments and Benefits

3.1 In the event Executive shall obtain Alternative Employment during any period in which Executive is entitled to Severance Payments and Benefits pursuant to Section 2.2 or 2.3 above (other than the initial six (6) month period described in Section 2.2 or 2.3), Executive shall promptly give notice to the Company of such Alternative Employment, which notice shall describe the following with respect to such Alternative Employment: (i) the salary, commission, bonus and other monetary compensation payable to Executive; (ii) the medical, health and other insurance benefits to be provided to Executive and (iii) any other consideration payable to or otherwise be provided to Executive. The Company shall be credited for any compensation payable or benefits provided with respect to such Alternative Employment against the Company's obligation to pay and or provide Severance Payments and Benefits for any period (other than the initial six (6) month period provided in Section 2.2 or 2.3) pursuant to Section 2 hereof so that: (A) the monetary portion of the Severance Payments and Benefits shall be reduced for any cash compensation payable to Executive for such period with respect to such Alternative Employment; and (B) the Company shall cease to be obligated to provide any medical, health or other insurance benefit to the extent an equivalent benefit is provided to Executive in connection with such Alternative Employment. Following a Protected Termination of Executive's employment with the Company, Executive shall use reasonable efforts to obtain Alternative Employment provided that nothing contained herein shall be deemed to obligate Executive to accept Alternative Employment that: (1) involves duties, responsibility, authority and status that are less in any material respect that applied to Executive's position with the Company as of the Closing Date; (2) involves a reduction in Executive's annual base salary that Executive was receiving as of the Closing Date; or (iii) requires Executive to work more than 100 miles from the location at which Executive was working on the Closing Date.

3.2 During any period in which Executive is entitled to Severance Payments and Benefits, the Company shall (i) pay the salary and bonus component thereof in accordance with

the Company's then effective payroll payment policies; and (ii) provide Executive with the same or equivalent medical, health and other insurance policies or, at the Company's option, reimburse Executive for premiums payable with respect to equivalent policies to be obtained directly by Executive.

Section 4. No Employment Agreement, Employment at Will

Except as previously herein provided, Executive and the Company each acknowledge and agree that: (i) this Agreement does not provide for the terms and conditions of Executive's employment with the Company and does not require or obligate Executive to provide services to the Company or the Company to continue to employ Executive; and (ii) Executive's employment with the Company remains an employment relationship terminable at will by either Executive or the Company.

Section 5. Release of the Company and Its Affiliates

5.1 Upon a termination of Executive's employment with the Company following a Change of Control for which Executive is entitled to payments or other benefits pursuant to Section 2 above and subject to full performance by the Company of its obligations hereunder, Executive hereby forever and completely releases and discharges the following (and each of them); (i) the Company; (ii) any entity which is controlled by, or under common control with, the Company (including, without limitation, any entity or entities or persons acquiring control of the Company through the Change of Control); and (iii) any past, present or future agents, attorneys, directors, officers, shareholders, employees, affiliates, predecessors and successors of any of the foregoing individuals or entities under clauses (i) and (ii) above, of and from any and all claims and demands of every kind and nature, in law, equity or otherwise, known or unknown, suspected or unsuspected, disclosed or undisclosed, including but not limited to all claims and demands of every kind and nature, known or unknown, suspected or unsuspected, disclosed or undisclosed, for damages actual, consequential or exemplary, past, present and future, arising out of or in any way related to Executive's employment with the Company.

5.2 Notwithstanding anything to the contrary set forth in Section 5.1 above, the releases set forth in said Section 5.1 shall not apply to any claims or demands that: (i) do not arise in connection with Executive's employment with the Company or a termination thereof; or (ii) are for salary or other benefits for periods prior to such termination that have not been paid or otherwise provided by the Company prior to the date of such termination.

Section 6. Notices

All notices or other communications required or permitted hereunder shall be made in writing and shall be deemed to have been duly given if delivered by hand or mailed, postage prepaid, by certified or registered mail, return receipt requested, and addressed to the Company at:

Milpitas, CA 95035
Attention: Chairman

or to the Executive at:

Notice of change of address shall be effective only when done in accordance with this Section.

Section 7. Successors

This Agreement shall be binding upon and shall inure to the benefit of the parties hereto and their respective heirs, executors, administrators, successors and assigns.

Section 8. California Law

The interpretation, performance and enforcement of this Agreement shall be governed by the laws of the State of California.

IN WITNESS WHEREOF, the parties hereto have duly executed this Agreement as of the date first above written.

PHOTON DYNAMICS, INC.,
a California corporation

EXECUTIVE:

By: /s/ E. Floyd Kvamme

/s/ Vincent F. Sollitto, Jr.

E. Floyd Kvamme

Vincent F. Sollitto, Jr.

Title: Chairman

EXHIBIT A

Executive's Stock Options

PHOTON DYNAMICS, INC.

STATEMENT RE COMPUTATION OF EARNINGS PER SHARE

(In thousands, except per share data)

Primary and Fully Diluted Earnings Per Share

<TABLE>

<CAPTION>

	YEAR ENDED SEPTEMBER 30,	
	1996	1995
<S>	<C>	<C>
Net income.....	\$ 854	\$ 377
Reduction of interest expense related to modified treasury stock method.....	--	26
Adjusted net income.....	\$ 854	\$ 403
Computation of weighted average common and common equivalent shares outstanding:		
Common stock.....	7,387	963
Convertible preferred shares.....	--	3,482
Options and warrants.....	--	518
Shares related to SAB No. 55, 64, and 83.....	--	462
Total weighted average common and common equivalent shares outstanding.....	7,387	5,425
Net income per share.....	\$0.12	\$0.07

</TABLE>

COMPANY PROFILE

The flat panel display (FPD) industry has grown significantly in recent years due to expanding applications made possible by improvements in size, resolution, and power utilization. Flat panel display manufacturing is a complex, materials intensive process. Fast, accurate testing of FPDs is a critical step in successful manufacturing. Early defect detection can eliminate the investment of further materials and labor, and allows for repair prior to final assembly, providing a substantial savings in manufacturing costs.

Photon Dynamics is a leading worldwide supplier of test, inspection and repair systems for the flat panel display industry. Photon Dynamics' products incorporate technologies that are designed to provide FPD manufacturers with the ability to obtain information critical to yield improvement and manufacturing processes insights. Our systems are used to control, monitor and refine the manufacturing process in order to increase yields, reduce materials loss, transition new designs from R & D to commercial production, and to assist in the rapid start-up of new manufacturing facilities.

Photon Dynamics offers a suite of products to inspect virtually all types of FPDs and to address the key areas of active matrix liquid crystal display (AMLCD) test, inspection and repair, from research and development through commercial production. Photon Dynamics' In Process Test Systems (IPT) locate, count and characterize electrical defects, contamination and other defects at the active array stage. Flat Panel Inspection Systems (FIS) perform cell and module inspection to detect and locate optical defects. Review stations with Integrated Laser Cut and Weld (ILW) repair defects based on precise location information generated by the IPT and the FIS. Patented technologies, such as Voltage Imaging and N-Aliasing, work in conjunction with proprietary software programs to permit low cost, non-contact, full characterization and image evaluation.

Photon Dynamics has been issued over 21 U.S. patents for flat panel display test, inspection and repair technologies, and has other U.S. and foreign applications pending. As the only company with systems addressing all key areas of AMLCD test, inspection and repair, Photon Dynamics is positioned to provide an integrated yield and cost management solution for FPD manufacturing.

Customer Commitment

Photon Dynamics' expertise in flat panel test, inspection, and repair comes from many years of production experience with the worlds leading FPD manufacturers. Our philosophy is to develop our technologies through close interaction with our customers in order to provide the most efficient, cost-effective solutions throughout the world. We are dedicated to maximizing value to our customers, and cooperating with them to achieve lower costs, higher quality products, and increased production levels.

Worldwide Presence

Photon Dynamics' main headquarters, located in San Jose, California, is home to our manufacturing and research and development facilities. In order to meet our customer' needs throughout the world, Photon Dynamics also maintains offices in Japan and Korea, and is represented in Taiwan. With systems installed throughout the world, we are committed to serving our customer base with the highest level of support possible. Our customer support network

allows us to meet our customer satisfaction goals, and helps us to stay in close contact with the issues that impact their success.

Training and Service

The relationships we have with our customers continue long after our systems are installed at their facilities. Our trained technical support and service staff is available to maintain the high standard of performance that our customers expect from our systems. In addition, Photon Dynamics offers a full range of customer training courses for all of our products, covering maintenance, basic operation, test design and applications. These courses provide our customers with the latest theory of operation, methodology, and technological enhancements. Our service and training teams are dedicated to providing customized solutions for the specific needs of each of our customers.

SHAREHOLDERS' LETTER

Fiscal 1996 marked an important year of growth for the flat panel display industry and Photon Dynamics. In the first quarter, we became a publicly traded

company, and reported record revenue and earnings, which earned us a spot as one of Silicon Valley's 50 fastest growing companies. We have developed new versions of our test, inspection, and repair systems, added key management and engineering people, and recently moved into a new 50,000 sq. ft. corporate office and manufacturing facility in San Jose, Ca. In addition, we have added several new customers throughout the world, and have seen repeat business from some of the worlds' largest flat panel display manufacturers that make up our existing customer base.

Flat panel displays are one of the fastest growing segments of the electronics industry, with excellent potential for growth throughout the next decade. We are very excited about the opportunities for flat panel displays, led by the growth of the notebook computer market. Today, flat panel displays are also being used for other markets which are potentially much larger than notebook computers. We are beginning to see flat panel displays replacing the cathode ray tube (CRT) in the desktop monitor market, and the technology for a flat television screen that hangs on the wall is now a reality. Other emerging flat panel display applications include on-board vehicle navigation, personal information devices, and projection systems. These visual delivery technologies are key components of today's multi-media information age.

To be a leader in these industries, companies must be proficient in two key technologies for the 21st Century: machine vision and image processing. These technologies are Photon Dynamics' core competency, and represent the future of our Company's technological development.

The thrust of our business is to offer integrated, software driven, capital equipment solutions that apply machine vision technology to flat panel display manufacturing.

In the future, we plan to broaden our machine vision and image processing technology to include new applications and new product opportunities. 1997 will present challenges as well as opportunities for Photon Dynamics.

In order to reduce deadline pressures and to help smooth out periods of fluctuating revenue, as seen in the fourth quarter of fiscal year 1996, we are committed to building up our backlog to a significant level. As the flat panel industry matures and expands, so does the sophistication of the manufacturing process, which has been gradually gearing up towards mass production to meet increasing demand. Our challenge is to continue to move the

use of machine vision systems from a research and development stage to the mass production lines of all of our strategic customers. To achieve this, we must improve our throughput to match the high level of performance our systems offer. We must also continue to raise our level of worldwide service and applications to meet our customers' requirements, while continuing to develop new technologies that lead the industry.

We believe that fiscal 1997 will bring more industry growth, more product development, and more technology advances for Photon Dynamics than any other period of time in our Company's history. We are focused on the challenges that face us, and look forward to the tremendous opportunities that lie ahead.

Vincent F. Sollitto Jr.
Chief Executive Officer

SELECTED FINANCIAL DATA

<TABLE>
<CAPTION>
Consolidated Statements of Operations
In thousands except per share data
For the Years Ended September 30,

	1996	1995	1994	1993	1992
<S>	<C>	<C>	<C>	<C>	<C>
Revenue	\$24,763	\$18,447	\$10,587	\$10,312	\$ 5,721
Gross margin	11,507	6,756	3,902	3,066	756
Operating income (loss)	563	710	(2,048)	(3,109)	(4,802)
Net income (loss)	\$ 854	\$ 377	\$(2,105)	\$(3,070)	\$(4,607)
Net income per share (pro forma for 1995)	\$0.12	\$0.07			
Shares used in computing net income per share	7,387	5,425			

</TABLE>

<TABLE>
<CAPTION>
Consolidated Balance Sheet Data
In thousands September 30,

	1996	1995	1994	1993	1992
<S>	<C>	<C>	<C>	<C>	<C>
Working capital (deficit)	\$17,290	\$ 709	\$ 408	\$ (857)	\$ 2,064

Total assets	24,958	10,519	6,567	4,948	5,006
Total shareholders' equity	19,770	1,857	1,435	132	3,204

<TABLE>
<CAPTION>
Unaudited Quarterly Consolidated Financial Data
In thousands

Fiscal Quarters Ended	December 31, 1995	March 31, 1996	June 30, 1996	September 30, 1996
<S>	<C>	<C>	<C>	<C>
Revenue	\$ 6,205	\$ 6,308	\$ 7,709	\$ 4,541
Gross margin	2,804	2,975	3,599	2,129
Net income (loss) ¹	563	751	825	(1,285)

Fiscal Quarters Ended	December 31, 1994	March 31, 1995	June 30, 1995	September 30, 1995
1995	<C>	<C>	<C>	<C>
Revenue	\$ 2,963	\$ 4,448	\$ 4,857	\$ 6,179
Gross margin	1,192	1,453	1,778	2,333
Net income	25	32	110	210

1. Net loss for the fourth quarter of fiscal 1996 includes a \$844,000 charge for the write down of assets related to a product line disposal, see Note 3 to the consolidated financial statements.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

The following table sets forth certain operating data as a percentage of total revenue:

Years Ended September 30,	1996	1995
<S>	<C>	<C>
Revenue:		
Product sales	94.4%	75.4%
Development contracts	5.6	24.6
	100.0	100.0
Cost of revenue:		
Product sales	49.6	38.6
Development contracts	3.9	24.8
	53.5	63.4
Gross margin	46.5	36.6
Operating expenses:		
Research and development	16.1	9.1
Selling, general and administrative	24.7	23.7
Asset write-off related to product line disposal	3.4	-
Total operating expenses	44.2	32.8
Operating income	2.3	3.8
Other income (expense), net	1.3	(1.7)
Income before provision for income taxes	3.6	2.1
Provision for income taxes	0.2	0.1
Net income	3.4%	2.0%

To the extent that this annual report discusses financial projections, information or expectations about products or markets of Photon Dynamics Inc. (the Company), all such forward looking statements are based on information available to the Company on the date hereof, and the Company assumes no obligation to update any such forward looking statements. It is important to note that the Company's actual results could differ materially from those in such forward looking statements. The Company's results will be affected, particularly when measured on a quarterly basis, by the volume, composition and timing of orders for capital equipment by Flat Panel Display (FPD) manufacturers.

Other uncertainties include, acceptance of new products, timing of orders received, costs associated with new product introductions and managing growth. For a further discussion of the Company's business, please refer to the Company's 1996 Annual Report on Form 10-KSB.

Overview

Photon Dynamics develops, manufactures and markets on a worldwide basis a suite of products to inspect virtually all types of FPDs and to address all key areas

of AMLCD test, inspection and repair throughout all major stages of the manufacturing life cycle, from research and development to commercial production. The Company's revenue is derived primarily from the sale of products and, to a lesser extent, from revenue under development contracts. In fiscal 1996 and 1995, revenue under development contracts accounted for 6% and 25% of total revenue, respectively.

The Company expects revenue under development contracts to decline on an absolute dollar basis in 1997. The Company does not expect that service revenue for continuing maintenance of its products will be a significant part of its revenue in the near term.

Results of Operations

Revenue

Revenue increased 34% from \$18.4 million in fiscal 1995 to \$24.8 million in fiscal 1996. Revenue from product sales increased 68% from \$13.9 million to \$23.4 million over the same period. The increase in product sales was primarily attributable to the introduction of the In-Process Test Mass Production System (IPT-MPS) in late fiscal 1995, which sold into both new and existing customer plants, and the continued penetration of the Japanese and Korean markets. International sales accounted for \$21.6 million and \$11.6 million of revenue in fiscal 1996 and 1995, respectively. Sales to Japan increased to \$9.3 million in fiscal 1996 from \$5.2 million in fiscal 1995, and sales to Korea increased to \$10.6 million in fiscal 1996 from \$4.5 million in fiscal 1995.

Gross Margin

Gross margin as a percent of revenue increased to 46.5% in fiscal 1996 from 36.6% in 1995. This increase in gross margins was due to the relative decrease in development contract revenue, with associated lower gross margins, as a percentage of total revenue. The gross margin for product sales decreased to 47.4% in fiscal 1996 from 48.8% in fiscal 1995. The decrease was the result of lower foreign exchange rates on Yen denominated sales and a less favorable product mix year to year. Overall product gross margins will fluctuate on a quarterly basis as the Company's product mix fluctuates. The Company expects to add to its infrastructure by hiring additional personnel and increasing its

capital expenditures for new facilities and equipment which is expected to modestly reduce gross margins at the start of 1997.

The increase in gross margin attributable to development contracts was primarily due to the ending of two lower margin contracts with government agencies.

Research and Development

The Company increased its research and development expenses on an absolute dollar basis to \$4.0 million in fiscal 1996, or 16% of revenue, from \$1.7 million in fiscal 1995, or 9% of revenue. In addition to these research and development expenses incurred for product development, the Company spent \$1.0 million in fiscal 1996 and \$4.6 million in fiscal 1995 in performance of its obligations under third party development contracts. The combination of research and development expenses and costs incurred on development contracts was \$4.9 million, or 20% of revenue, in fiscal 1996 and \$6.3 million, or 34% of revenue, in fiscal 1995. The Company expects that these combined product development expenses will increase in absolute dollar amounts in fiscal 1997 with continued emphasis on Company spending and lower spending under third party development contracts.

Selling, General and Administrative

Selling, general and administrative expenses increased to \$6.1 million, or 25% of revenue, in fiscal 1996 from \$4.4 million, or 24% of revenue, in fiscal 1995. The increase reflects an overall increase in revenue and the associated incremental selling costs as well as the administration costs associated with being a public company. Selling, general and administrative expenses may increase in absolute dollar amounts in fiscal 1997 and in future periods depending on factors including the level of the Company's revenue and other operations. Selling expenses may also fluctuate based on the Company's product and territory sales mix, which have different sales channels and associated cost structures.

In September, 1996, the Company ceased operations of its Defect Monitoring Tool (DMT) product line. The DMT product group had been working exclusively on a single customer project not in the flat panel display market. As a result of the cancellation of this project, the associated inventory and assets of this product line which can not be transferred to other products will be disposed of. The Company recorded a \$844,000 charge to write down the inventory and assets associated with the product line.

Interest income/expense

Interest income in fiscal 1996 increased to \$646,000 from the fiscal 1995 level of \$16,000 as a result of interest received on the proceeds from the Company's Initial Public Offering (IPO) in November 1995. Interest expense was \$263,000 and \$194,000 in fiscal 1996 and 1995 respectively, because of increases in borrowings under the Company's revolving bank lines of credit which were repaid in the first quarter of fiscal 1996, as well as borrowing under a term loan which was repaid in late fiscal 1996.

Provision for Income Taxes

Provisions for income taxes in fiscal 1995 and 1996 were minimal due to utilization of loss carryforwards. As of September 30, 1996 the Company had available federal and state net operating loss carryforwards of approximately \$12.5 million and \$3.0 million, respectively. The Company also had federal and state research and development tax credit carryforwards of approximately \$698,000 and \$341,000, respectively. The net operating loss and credit carryforwards will expire at various times beginning in 1998 through 2011 if not utilized. As of September 30, 1996, the Company had deferred tax assets of approximately \$7.8 million, for which no benefit has been recorded on the Company's financial statements, and which consist primarily of net operating loss carryforwards. This deferred tax asset will be recognized in future periods as taxable income is realized and consistent profits are reported.

Under certain provisions of the Internal Revenue Code of 1986, as amended, the availability of the Company's operating loss and credit carryforwards may be subjected to limitation if it should be determined that there has been a change of ownership of more than 50% of the value of the Company's stock within any three year period. See Note 7 to Consolidated Financial Statements.

Liquidity and Capital Resources

Working capital increased from \$709,000 as of September 30, 1995 to \$17.3 million at September 30, 1996, of which \$5.1 million was cash or cash equivalents. In November 1995, the Company completed its IPO of 2,932,500 shares of Common Stock, of which 2,127,661 shares were issued and sold by the Company and 804,839 shares were sold by stockholders. The IPO raised approximately \$17.8 million before deducting offering expenses.

Cash used by operating activities was \$3.8 million for the year. Working capital items that significantly impacted cash balances were accounts receivable and inventory. The Company's accounts receivable balance increased \$3.4 million to \$8.7 million. The factors affecting the accounts receivable balance include, the Company's credit terms to customers which typically have a small portion of the payment extended for a period of months after shipment resulting in a larger accounts receivable balance, especially when combined with the growth in product sales in fiscal 1996 compared fiscal 1995 as well as the near quarter end timing of such product shipments. Inventory levels increased \$1.1 million reflecting the increased production levels in fiscal 1996.

Capital expenditures in fiscal 1996 and fiscal 1995 were \$1.2 million and \$1.0 million, respectively. The increase is the result of the capitalization of engineering and demonstration equipment related to the Company's latest products. In the first quarter of fiscal 1997 the Company relocated to a new facility and expects to spend approximately \$700,000 in leasehold improvements and related costs.

The Company believes that cash and cash equivalents, income from operations and the proceeds from the Offering will be sufficient to satisfy working capital requirements and capital equipment needs for the next 12 months. As of September 30, 1996, the Company had no material outstanding commitments to purchase or lease capital equipment.

The Company believes that success in its industry requires substantial capital in order to maintain the flexibility to take advantage of opportunities as they may arise. The Company may, from time to time, invest in or acquire complementary businesses, products or technologies. The Company may effect additional equity or debt financing to fund such activities. The sale of additional equity or convertible debt could result in additional dilution to the Company's shareholders.

Other Factors Affecting Company Results

The Company has experienced, (see unaudited quarterly consolidated financial data, page 5), and expects to continue to experience significant fluctuations

in its quarterly results of operations. The Company derives substantially all of its revenue from the sale of a relatively small number of systems, which typically range in price from \$400,000 to \$1,500,000. As a result, the timing of

the sale of a single system could have a significant impact on the Company's quarterly revenue and results of operations. The failure to receive anticipated orders or delays in shipments in a particular quarter, due, for example, to unanticipated shipment reschedulings or cancellations by customers or unexpected manufacturing difficulties, may cause revenue for that quarter to fall significantly below the Company's expectations, which would have a material adverse effect on the Company's results of operations for such quarter.

The Company's backlog at the beginning of each quarter is not necessarily indicative of actual sales for any succeeding period. All orders are subject to delay or cancellation with limited or no penalty. The Company's sales will often reflect orders shipped in the same quarter that they are received.

Other factors which may have an influence on the Company's results of operations in a particular quarter include the volume, mix and timing of the receipt of orders from major customers, competitive pricing pressures, costs of components and subsystems, the Company's ability to design, manufacture and introduce new products on a cost effective and timely basis, the delay between incurrence of expenses to further develop marketing and service capabilities and realization of benefits from such improved capabilities, fluctuations in foreign exchange rates, the timing of recognition of revenue under development contracts, the introduction and announcement of new products by the Company's competitors and changing conditions in the FPD market worldwide. In particular, due to substantial differences in gross margin for the Company's products, changes in the mix of products sold could result in substantial fluctuations in the Company's gross margin. Accordingly, the Company's results of operations are subject to significant variability from quarter to quarter.

<TABLE>
<CAPTION>
CONSOLIDATED BALANCE SHEETS

In thousands, except share amounts	1996	1995
Years Ended September 30,	<C>	<C>
<S>		
Assets		
Current assets:		
Cash and cash equivalents	\$ 5,108	\$ 298
Short term investments	4,066	-
Accounts receivable, net of allowance for doubtful accounts of \$629 (\$224 in 1995); including \$1,220 receivable from related parties (\$1,907 in 1995)	8,652	5,280
Inventories	4,125	2,986
Prepaid expenses and other current assets	518	219
Total current assets	22,469	8,783
Property, equipment, and leasehold improvements, net	1,849	1,418

<S>	<C>	<C>
Other assets	640	318
Total assets	\$ 24,958	\$10,519
Liabilities and shareholders' equity		
Current liabilities:		
Accounts payable	\$ 2,743	\$ 1,684
Accrued expenses and other liabilities	2,067	2,368
Customer deposits and deferred revenue	353	1,251
Line of credit and other short-term debt	-	2,407
Current portion of long-term debt	16	364
Total current liabilities	5,179	8,074
Noncurrent portion of long-term debt	9	588
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, no par value, issuable in series: 13,000,000 authorized, convertible shares issued and outstanding - 9,822,826 in 1995	-	17,935
Preferred Stock, no par value, 5,000,000 authorized, none issued and outstanding	-	-
Common stock, no par value, 20,000,000 authorized, shares issued and outstanding - 6,888,032 and 1,155,782 in 1996 and 1995	38,064	3,008
Accumulated deficit	(18,201)	(19,055)
Foreign currency translation adjustment and other	(7)	104
Notes receivable from shareholders	(86)	(135)
Total shareholders' equity	19,770	1,857
Total liabilities and shareholders' equity	\$ 24,958	\$ 10,519

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF OPERATIONS

<TABLE>		
<CAPTION>		
In thousands, except share amounts		
Years Ended September 30,	1996	1995
<S>	<C>	<C>
Revenue		
Product sales	\$ 23,381	\$ 13,906
Development contracts	1,382	4,541
	24,763	18,447
Cost of revenue:		
Product sales	12,294	7,114
Development contracts	962	4,577
	13,256	11,691
Gross margin	11,507	6,756
Operating expenses		
Research and development	3,982	1,676
Selling, general, and administrative	6,118	4,370
Asset write-off related to product line disposal	844	-
Total operating expenses	10,944	6,046
Operating income	563	710
Interest income	646	16
Interest expense	(263)	(194)
Foreign exchange loss	(53)	(142)
Income before provision for income taxes	893	390
Provision for income taxes	39	13
Net income	\$ 854	\$ 377
Net income per share (pro forma for 1995)	\$ 0.12	\$ 0.07
Shares used in computing net income per share	7,387	5,425

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

<TABLE>		
<CAPTION>		
In thousands		
Years Ended September 30,	1996	1995
<S>	<C>	<C>
Operating activities		
Net income	\$ 854	\$ 377
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	723	451

<TABLE>		
<S>		
Changes in operating assets and liabilities:		
	<C>	<C>
Accounts receivable	(3,372)	(2,615)
Inventories	(1,139)	(1,433)
Prepaid expenses and other current assets	(299)	(167)
Other assets	(418)	(173)
Accounts payable	1,044	(109)
Accrued expenses and other liabilities	(301)	117
Customer deposits and deferred revenue	(898)	293
Net cash used in operating activities	(3,806)	(3,259)
Investing activities		
Acquisition of property and equipment	(1,154)	(975)
Acquisition of short term investments	(10,554)	-
Maturities of short term investments	6,488	-
Net cash used in investing activities	(5,220)	(975)
Financing activities		
Borrowings under lines of credit	-	2,325
Proceeds from issuance of note payable	-	1,000
Proceeds from issuance of short term debt	-	41
Repayment of lines of credit	(2,325)	-

Principal payments under capital leases	(30)	(50)
Issuance of common stock	226	83
Proceeds from initial public offering, net	16,895	-
Repayment of notes receivable from shareholders	49	-
Payment of notes payable	(979)	(103)
Net cash provided by financing activities	13,836	3,296
Net increase (decrease) in cash and cash equivalents	4,810	(938)
Cash and cash equivalents at beginning of period	298	1,236
Cash and cash equivalents at end of period	\$ 5,108	\$ 298

</TABLE>

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

<TABLE>

<CAPTION>

	Convertible Preferred Stock		Common Stock	
	Shares	Amount	Shares	Amount
In thousands				
<S>	<C>	<C>	<C>	<C>
Balance at September 30, 1994	9,823	\$ 17,935	860	\$ 2,790
Issuance of common stock	-	-	98	83
Issuance of common stock for notes receivable	-	-	198	135
Foreign currency translation adjustment	-	-	-	-
Net Income	-	-	-	-
Balance at September 30, 1995	9,823	\$ 17,935	1,156	\$ 3,008
Issuance of common stock	-	-	122	226
Conversion of preferred stock to common stock	(9,823)	(17,935)	3,482	17,935
Initial public offering, net of offering costs	-	-	2,128	16,895
Foreign currency translation adjustment	-	-	-	-
Repayment of notes receivable	-	-	-	-
Net Income	-	-	-	-
Balance at September 30, 1996	-	-	6,888	\$38,064

<CAPTION>

	Accumulated Deficit	Foreign Currency Translation Adjustment and other	Notes Receivable From Shareholders'	Total Shareholders' Equity
In thousands				
<S>	<C>	<C>	<C>	<C>
Balance at September 30, 1994	\$ (19,432)	\$ 142	\$ -	\$ 1,435
Issuance of common stock	-	-	-	83
Issuance of common stock for notes receivable	-	-	(135)	-
Foreign currency translation adjustment	-	(38)	-	(38)
Net Income	377	-	-	377
Balance at September 30, 1995	\$ (19,055)	\$ 104	(135)	\$ 1,857
Issuance of common stock	-	-	-	226
Conversion of preferred stock to common stock	-	-	-	-
Initial public offering, net of offering costs	-	-	-	16,895
Foreign currency translation adjustment	-	(111)	-	(111)
Repayment of notes receivable	-	-	49	49
Net Income	854	-	-	854
Balance at September 30, 1996	\$ (18,201)	\$ (7)	\$ (86)	\$19,770

</TABLE>

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE I Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries after elimination of all material intercompany balances and transactions. Photon Dynamics, Inc. is a manufacturer of test inspection and repair systems for the flat panel display industry.

Use of Estimates

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

Initial Public Offering

In November 1995, the Company completed an initial public offering (IPO) of 2,932,500 share of Common Stock, of which 2,127,661 shares were issued and sold by the Company and 804,439 shares were sold by stockholders. The IPO raised approximately \$17.8 million before deducting offering expenses.

Reverse Stock Split

In November 1995, the Company effected a one-for-three reverse stock split of the Company's common stock. All references in the accompanying financial 1 statements to numbers of common shares and per share amounts have been retroactively restated to reflect the reverse stock split.

Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with a maturity of three months or less on the date of purchase to be cash equivalents.

Short Term Investments

Effective October 1, 1994, the Company adopted Statement of Financial Accounting Standards No. 115 Accounting for Investments in Certain Debt and Equity securities (FAS 115), which requires investment securities to be classified as either held to maturity, trading or available for sale.

The Company has classified its investment portfolio as available for sale. Under FAS 115, investments classified as available for sale are required to be recorded at fair value and any temporary difference between an investment's cost and its fair value is recorded as a separate component o= f shareholders' equity.

At September 30, 1996, short term investments consisted of commercial paper and fixed rate notes. The cost of these securities approximated the fair value and the amount of unrealized gains or losses was not significant. These securities mature through May 1997.

Inventories

Inventories are stated at the lower of cost or market, with cost being determined on a first-in, first-out basis.

<TABLE>

<CAPTION>

September 30,	1996	1995
Inventories comprise (in thousands):		
<S>	<C>	<C>
Raw materials	\$1,970	\$1,322
Work-in-progress	1,247	461
Finished goods	908	1,203
	\$4,125	\$2,986

</TABLE>

Property, Equipment and Leasehold Improvements

Property and equipment are recorded at cost. Depreciation is computed using the straight-line method based upon the estimated useful lives of the assets, generally three to five years.

Equipment recorded under capital leases is amortized using the straight-line method over the lesser of the lease terms or the lives of the related assets.

<TABLE>

<CAPTION>

September 30,	1996	1995
<S>	<C>	<C>
Property and equipment comprise		

(in thousands):

Equipment	\$ 3,553	\$ 2,390
Office furniture and fixtures	265	268
Leasehold improvements	459	458
	4,277	3,116
Less accumulated depreciation and amortization	(2,428)	(1,698)
	\$ 1,849	\$ 1,418

</TABLE>

Foreign Currency Translation

Assets and liabilities of the Company's foreign subsidiary are translated into U.S. dollars at year-end exchange rates and revenues and expenses are translated at average rates prevailing during the year. Translation adjustments are included in a separate component of shareholders' equity.

Foreign currency transaction gains and losses are included in results of operations.

Revenue Recognition

The Company generally recognizes revenue from product sales at the time of shipment. The Company also sells one-year service contracts, for which revenue is recognized ratably over the contract period. Revenue under cost reimbursement type development contracts is recorded as costs are incurred.

Applicable estimated profits are included in revenue in the same proportion that incurred costs bear to total estimated costs. Certain fixed-price contracts that require substantial performance over a long period of time before deliveries begin are accounted for under the percentage-of-completion method. Under all other contracts, sales are recorded at delivery or on completion of specified tasks, as applicable, and estimated contract profits are taken into earnings in proportion to recorded sales.

Concentrations of Credit Risk

The Company markets its products primarily to a limited number of customers in the Far East. The Company has development contracts primarily with the U.S. government and companies in the Far East.

The Company is subject to economic conditions affecting its customers and the countries in which it operates. The Company believes its credit evaluation and

monitoring process mitigates this credit risk. In 1996, sales to two unaffiliated and one affiliated customer accounted for 30%, 14% and 19% respectively. In 1995, sales to two unaffiliated and one affiliated customer represented 25%, 24%, and 24% of total revenue. International sales accounted for 88% and 63% of total revenue in 1996 and 1995, respectively.

Warranty and Installation

The Company generally warrants its systems for a period of 12 months from installation for material and labor to repair and service the system. A provision for the estimated cost of installation and warranty is recorded upon shipment.

Net Income Per Share

Except as noted below, net income per share is computed using the weighted average number of shares of common stock and dilutive common stock equivalents from stock options and warrants (using the treasury stock method). Pursuant to Securities and Exchange Commission Staff Accounting Bulletins, common and common stock equivalent shares issued by the Company at prices below the initial offering price during the 12-month period prior to the offering in 1995 have been included in the calculation as if they were outstanding for all periods presented regardless of whether they are dilutive (using the treasury stock method and the initial public offering price).

The net income per share for the year ended September 30, 1995 is pro forma and is computed using the same method described above and also gives effect to common equivalent shares from convertible preferred stock using the if-converted method.

Impact of Recently Issued Accounting Standards

In March 1995, the FASB issued Statement of Financial Accounting Standards No. 121, Accounting for the Impairment of Long-Lived Assets and for Long Lived Assets to be Disposed Of (FAS 121), effective for fiscal years beginning after December 15, 1995. The Company will adopt FAS 121 in the first quarter of fiscal 1997 and, based on current circumstances, does not believe the effect of

adoption will be material. In October 1995, the FASB issued Statement of Financial Accounting Standards No. 123, Accounting for Stock Based compensation (FAS 123), effective for fiscal years beginning after December 15, 1995. The Company will adopt the FAS 123 disclosure method of reporting in its fiscal 1997 financial statements.

NOTE 2 =F1 Related Parties

During 1996 and 1995 the Company sold approximately \$4,651,000 and \$4,482,000 of its systems to LG. Electronics, Inc. LG. Electronics owns approximately 8% of the Company's common stock, and warrants to purchase 28,333 shares of Common Stock at an exercise price of \$0.60 per share. The Company believes its sales to LG. Electronics were made on terms no less favorable than would have been obtained from unaffiliated parties.

NOTE 3 =F1 Asset Write-off Related to Product line Disposal

In September, 1996, the Company ceased operations of its Defect Monitoring Tool (DMT) product line. The DMT product group had been working exclusively on a single customer project not in the flat panel display market. As a result of the cancellation of this project, the associated inventory and assets of this

product line which can not be transferred to other products will be disposed of. The Company recorded a \$844,000 charge to write down the inventory and assets associated with the product line.

NOTE 4 =F1 Lease Obligations and Commitments

The Company leases certain equipment under capital leases. Total capitalized costs and related accumulated amortization for equipment under capital leases was \$215,000 and \$175,000, respectively, as of September 30, 1996 and \$215,000 and \$150,000, respectively, as of September 30, 1995.

The Company leases its main facility under a noncancelable operating lease agreement that expires in fiscal 1997. In late fiscal 1996 the Company entered into a new noncancelable operating lease on a facility which commences in November 1996 and expires in fiscal 2002.

Total future minimum lease obligations are as follows:

<TABLE>	
<CAPTION>	
In thousands	Operating Leases
<S>	<C>
1997	\$512
1998	574
1999	591
2000	609
2001	627
2002	52

Rental expense for the years ended September 30, 1996 and 1995 was \$352,000 and \$404,000, respectively.

NOTE 5 =F1 Shareholders' Equity Preferred Stock

At September 30, 1995 the Company had 9,822,826 shares of Convertible Preferred Stock outstanding which automatically converted into Common Stock upon the closing of the Company's initial public offering in November 1995=
=2E

Additionally, in November 1995, the Board of Directors approved an amendment of the Company's Articles of Incorporation to authorize 5,000,000 shares of preferred stock, no par value, none of which are outstanding.

In 1995, the Company issued two sets of warrants to purchase 177,777 shares of Series E preferred stock, which are currently exercisable in exchange for 59,259 shares of common stock at \$5.50 per share. The warrants expire from 2000 to 2002.

Warrants to Purchase Common Stock

In connection with bridge financing in 1994, the Company issued warrants to purchase a total of 160,856 shares of common stock at \$0.60 per share. These warrants expire in 1999.

Stock Reserved for Future Issuance

As of September 30, 1996, the Company has reserved 1,732,506 shares of common stock for future issuance.

Stock Option and Purchase Plans

Under the Company's stock option plans, the Board of Directors may, at its discretion, grant incentive or nonqualified stock options to employees and directors. Options may be granted for a period not to exceed ten years from the date of grant, at prices at least equal to the fair market value of common

stock at the grant date, and become exercisable generally over a period of four years.

The following table summarizes activity under the Plans:

<TABLE>
<CAPTION>

<S>	Shares Under Option <C>	Exercise Price <C>
Balance at Sept. 30, 1994	615,956	
Granted	616,678	\$0.60 - \$ 7.20
Exercised	(293,383)	\$0.60 - \$ 7.20
Canceled	(119,671)	\$0.60 - \$ 1.20
Balance at Sept. 30, 1995	819,580	
Granted	591,900	\$6.75 - \$11.00
Exercised	(91,905)	\$0.60 - \$ 7.20
Canceled	(217,056)	\$0.60 - \$11.00
Balance at Sept. 30, 1996	1,102,519	

</TABLE>

Options to purchase 409,872 shares of common stock are available for grant as of September 30, 1996. Options to purchase 67,328 shares of common stock have been granted subject to shareholder approval by the Board of Directors. Compensation related to such options will not be measured until approved. Options for 354,119 shares are currently exercisable (options for 223,872 shares at September 30, 1995).

The Company has reserved 100,000 shares of common stock to be issued under the 1995 Employee Stock Purchase Plan. The plan permits eligible employees to purchase common stock, through payroll deductions, at 85% of the lower of the fair market value of the common stock on the date at the beginning of the two-year offering period or the last day of the purchase period.

Substantially all employees are eligible to participate in the plan. At September 30, 1996 81,884 shares were available for issuance under the plan.

NOTE 6 =F1 Notes Receivable From Shareholders

The notes receivable from shareholders arose from certain employees exercising their stock options. The notes bear interest at 6.83% per annum, and are secured by the shares of common stock.

NOTE 7 =F1 Income Taxes

The provision for income taxes for the year ended September 30, 1996 consists of the following:

<TABLE>
<CAPTION>

In thousands	1996	1995
<S>	<C>	<C>
Year Ended September 30,		
Federal - current	\$ 29	\$ 10
State - current	10	3
Total	\$ 39	\$ 13

</TABLE>

The provisions for taxes on income differed from the provisions calculated by applying the federal statutory rate to income before taxes as follows:

<TABLE>
<CAPTION>

In thousands	1996	1995
<S>	<C>	<C>
Years ended September 30,		
Expected provision (benefit) at statutory rate	\$ 313	\$ 137
Alternative minimum taxes	39	13
Benefit of operating loss carryforwards	(313)	(137)
	\$ 39	\$ 13

</TABLE>

As of September 30, 1996, the Company has federal and state net operating loss carryforwards of approximately \$12,500,000 and \$3,000,000, respectively. The Company also has federal and state research and development tax credit carryforwards of approximately \$698,000 and \$341,000, respectively. The net operating loss and credit carryforwards will expire at various times beginning in 1998 through 2011, if not utilized.

Under certain provisions of the Internal Revenue Code of 1986, as amended, the availability of the Company's net operating loss and tax credit carryforwards may be subject to limitation if it should be determined that there has been a change in ownership of more than 50% of the value of the Company's stock. Such determination could limit the utilization of net operating loss and tax credit carryforwards. Deferred tax assets 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, net operating loss and credit carryforwards.

Significant components of the Company's deferred tax assets are as follows:

<TABLE>		
<CAPTION>		
In thousands		
Years Ended September 30,	1996	1995
<S>	<C>	<C>
Deferred tax assets:		
Net operating loss carryforwards	\$ 4,712	\$ 4,955
Research credit carryforwards	920	794
Capitalized research costs	335	338
Inventory valuation	771	584
Deferred revenue	103	534
Other individually immaterial items	960	755
Total deferred tax assets	7,801	7,960
Valuation allowance	(7,801)	(7,960)1
Net deferred tax assets	\$ -	\$ -

1The valuation allowance increased by \$201,000 in 1995.

NOTE 8 - Statements of Cash Flows Data

<TABLE>		
<CAPTION>		
In thousands		
Supplemental disclosure of cash flow information	1996	1995
<S>	<C>	<C>
Interest paid	\$ 272	\$ 124
Income taxes paid	\$ 110	\$ 13

Supplemental disclosure of noncash investing and financing activities

<TABLE>		
<S>		
	<C>	<C>
Equipment purchased under capital leases	\$ -	\$ 16
Common stock issued for notes	\$ -	\$ 135
Conversion of Preferred Stock to Common Stock	\$17,935	\$ -

REPORT OF INDEPENDENT AUDITORS

The Board of Directors
Photon Dynamics, Inc.

We have audited the accompanying consolidated balance sheets of Photon Dynamics, Inc. as of September 30, 1996 and 1995, and the related consolidated statements of operations, shareholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 Photon

Dynamics, Inc. as of September 30, 1996 and 1995, and the consolidated results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

San Jose California
October 25, 1996

CORPORATE OFFICERS AND DIRECTORS

Directors

E. Floyd Kvamme - Chairman
Partner
Kleiner Perkins Caufield & Byers

Barry Cox
Private Investor

Michael Kim
Executive Director - New Business Development
LG Electronics, Inc.

Dr. Malcolm J. Thompson
Chief Executive Officer dpiX

Francois Henley
Chief Technical Officer
Photon Dynamics, Inc.

Steve Krausz
General Partner
U.S. Venture Partners

Vincent F. Sollitto Jr.
Chief Executive Officer
Photon Dynamics, Inc.

Officers

Vincent F. Sollitto Jr.
Chief Executive Officer

Francois Henley
Chief Technical Officer

Howard Bailey
Chief Financial Officer

Jeff Hawthorne
Vice President - Development

Alan Nolet
Senior Vice President - Sales

Donald Jerome
Vice President - Operations

C.J. Meurell
Vice President - Marketing and Technology

Dr. William Pratt
Chief Technical Officer - Software

CORPORATE INFORMATION

Independent Auditors
Ernst and Young LLP
San Jose, CA
Legal Counsel
Morrison and Foerster LLP
San Francisco, CA
Registrar and Transfer Agent
Bank of Boston
Boston, MA

Investor Information

Additional Copies of this report, as well as copies of SEC Form 10-KSB, for the year ended September 30, 1996, may be obtained from the Company without charge by contacting Investor Relations at Photon Dynamics Corporate Office.

The Company's common stock is traded on the Nasdaq National Market under the symbol PHTN.

<TABLE>
<CAPTION>
FISCAL 1996

	High	Low
<S>		<C>
1st Quarter	12 1/4	6 7/8
2nd Quarter	10 1/2	6 3/4
3rd Quarter	13 1/2	7
4th Quarter	10 1/4	5

The preceding table sets forth the high and low sales prices as reported on the Nasdaq National Market since the IPO in November 1995.

Corporate Office
Photon Dynamics, Inc.
6325 San Ignacio Avenue
San Jose, CA 95119-1202 telephone: (408) 226-9900 facsimile: (408) 226-9910

Subsidiaries
K.K. Photon Dynamics
No. 2 SVAX Hamamatsucho Building
Minato-ku, Tokyo 105
Japan telephone: (03) 5472-6147 facsimile: (03) 5472-6138

Photon Dynamics, Korea
7th Floor Taejin Building
14-2 Yangjae-Dong
Soecho-Ku, Seoul, Korea telephone: (02) 575-3443 facsimile: (02) 575-3446

PHOTON DYNAMICS, INC.

The Company has two subsidiaries, K.K. Photon Dynamics, which is incorporated in Japan and Photon Dynamics, Korea which is incorporated in Korea.

CONSENT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

We consent to the incorporation by reference in the Registration Statements (Form S-8 Nos. 33-98232-LA and 333-05283) pertaining to the 1995 Employee Stock Purchase Plan, the 1987 Stock Option Plan and the 1995 Stock Option Plan of Photon Dynamics, Inc. of our report dated October 25, 1996, with respect to the consolidated financial statements of Photon Dynamics, Inc. incorporated by reference in the Annual Report (Form 10-KSB) for the year ended September 30, 1996.

Ernst & Young LLP

San Jose, California
December 23, 1996

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<CGS>	(12,294)	(7,114)
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