

MANAGEMENT'S DISCUSSION AND ANALYSIS

Unless otherwise indicated, financial results referred to in this MD&A refer to fiscal 2005, the year ended March 31, 2005. Percentage comparisons, unless otherwise indicated, refer to year-on-year changes from fiscal 2004.

Sales and Income

Operating Environment

During fiscal 2005, there were concerns that the world economy would slow due to a rise in the prices of raw materials resulting from soaring crude oil prices and other factors. Nevertheless, the U.S. economy showed steady growth, backed by pump-priming measures leading up to the presidential election. In Asia, the Chinese economy continued to grow rapidly, while the South Korean and Taiwanese economies also recorded healthy growth. Meanwhile, the Japanese economy continued to perform strongly as a whole, due chiefly to growth in consumer spending and corporate capital expenditure.

In the electronics industry, the digital consumer electronics market, which includes DVD recorders and flat-panel TVs, remained buoyant, partly as an effect of the Summer Olympic Games in Athens, Greece. In addition, the market was driven by demand for PCs to replace older models, as well as by demand from consumers upgrading their mobile phones to third-generation models. The market for semiconductors, FPD, and other electronic components used in these products also grew steadily as a result. These trends, together with the silicon cycle reaching a peak and other factors, combined to create a favorable business environment for Tokyo Electron.

Changes in Accounting Policies

Effective from fiscal 2005, the Company changed the method for revenue recognition from semiconductor and FPD production equipment from the time of shipment to, in principle, the time of confirmation of set-up and testing of products. This change is intended to more appropriately reflect actual revenue of the Company. There are two reasons for this change. First, lead times from the shipment of products to the confirmation of set-up and testing are becoming markedly longer. Second, revisions to post-shipment business processes have made it possible to provide a complete set of data upon the confirmation of set-up and testing of products.

Also beginning in fiscal 2005, the Company changed how it recognizes after-sale repair expenses incurred during the warranty period for semiconductor and FPD production equipment. In past fiscal years, these expenses were charged to income as incurred. However, effective from the fiscal year ended March 31, 2005, Tokyo Electron provides accrued warranty expenses for estimated expenses calculated on the basis of after-sale repair expenses incurred in the past. This change is intended to make income statements more appropriate by matching after-sales repair expenses with revenues when products are sold. The change was made because a complete set of historical data on these expenses and remaining warranty periods has been compiled and because the after-sale business has gained importance from a customer satisfaction perspective.

Comparison of Consolidated Results Under the New Accounting Policies With Previous Accounting Policies

	Fiscal 2004 Previous Policies	Fiscal 2005 Previous Policies (A)	YoY Change	Fiscal 2005 New Policies (B)	Difference (B-A)
Net sales	¥529,654	¥716,666	35.3%	¥635,710	¥-80,956
Industrial electronic equipment	445,425	630,417	41.5%	549,461	-80,956
Semiconductor/FPD production equipment	425,747	613,185	44.0%	532,229	-80,956
Semiconductor production equipment (SPE)	-	516,318	-	457,191	-59,127
FPD production equipment	-	96,867	-	75,038	-21,829
Computer network	18,448	15,966	-13.5%	15,966	0
Other	1,230	1,266	3.0%	1,266	0
Electronic components	84,229	86,249	2.4%	86,249	0
Gross profit	140,155	197,167	40.7%	175,913	-21,254
Selling, general and administrative expenses	117,875	112,007	-5.0%	111,930	-77
Operating income	22,280	85,160	282.2%	63,983	-21,177
Other income (expenses)	-7,344	4,284	-158.3%	-8,208	-12,492
Income before income taxes	14,936	89,444	498.9%	55,775	-33,669

Note: Sales were not disclosed separately for SPE and FPD production equipment until fiscal 2004.

There was no effect on Computer network division and Electronic components segment of changes in accounting policies.

(Millions of Yen)

Change to the Classification of Business Segments

Tokyo Electron is engaged in the manufacture and sale of industrial electronic products. Until previous fiscal years, Tokyo Electron's businesses were classified as a single segment based on the sales formation. Effective from the fiscal year ended March 31, 2005, however, Tokyo Electron's businesses have been reclassified into two segments, "Industrial Electronic Equipment" and "Electronic Components," based on the similarities between products and services as well as sales methods.

This change was made to present more appropriately the actual state of Tokyo Electron's businesses following the change in the method of revenue recognition in the "Industrial Electronic Equipment" segment from the time of shipment to the time of the confirmation of set-up and testing of products.

Sales

Consolidated net sales for fiscal 2005 were ¥635.7 billion. Under the previous accounting policies, net sales rose 35.3% to ¥716.7 billion.

Sales of Tokyo Electron's core SPE Division for fiscal 2005 were ¥457.2 billion. Under the previous accounting policies, division sales were ¥516.3 billion. The sales in this division reflected a large volume of orders from semiconductor manufacturers in Japan, South Korea, Taiwan and elsewhere in Asia. This was the result of growth in demand for DRAMs, flash memories and system LSIs for PCs, mobile phones, digital consumer electronics and other access devices in line with the development of communications infrastructure.

Sales of FPD production equipment for fiscal 2005 were ¥75.0 billion. Under the previous accounting policies, sales were ¥96.9

billion. Results reflect strategic actions taken by LCD panel manufacturers to increase their supply capacity to popularize and grow sales of flat-panel TVs through price reductions and mass production.

Sales in the Computer Network Division for fiscal 2005 fell 13.5% to ¥16.0 billion, while sales in the Electronic Components Division rose 2.4% to ¥86.2 billion.

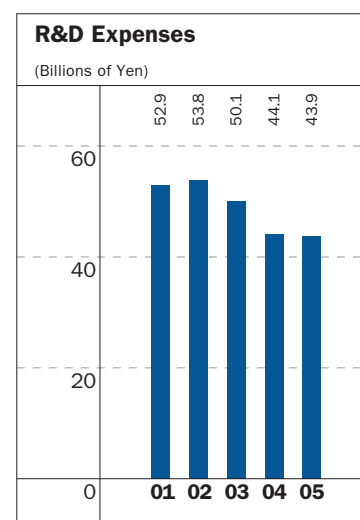
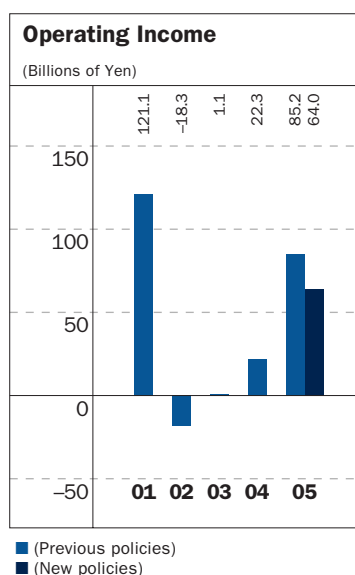
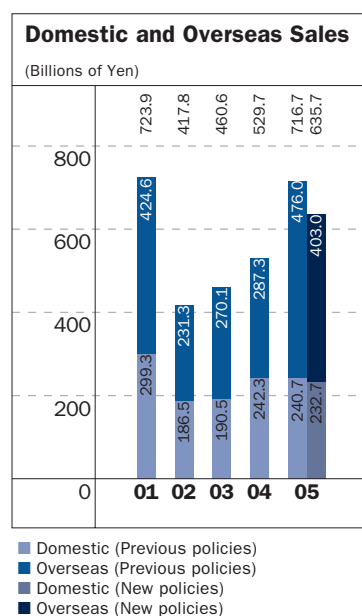
By region, net sales for fiscal 2005 in Japan were ¥232.7 billion. Under the previous accounting policies, sales fell 0.7% to ¥240.7 billion. Overseas sales for fiscal 2005 were ¥403.0 billion and, under the previous accounting policies, rose 65.7% to ¥476.0 billion. Overseas sales for fiscal 2005 accounted for 63.4% of consolidated net sales, up from 54.2% in the previous fiscal year.

Consolidated orders received for fiscal 2005 increased by 3.1% to ¥674.2 billion. Order backlogs as of March 31, 2005 were ¥313.1 billion. Under the previous accounting policies, order backlogs were ¥232.2 billion, down 15.5% year on year.

Cost of Sales, Selling, General and Administrative ("SG&A") Expenses and Operating Income

Cost of sales for fiscal 2005 rose 18.0% to ¥459.8 billion. Gross profit was ¥175.9 billion, representing a gross profit ratio to net sales of 27.7%. Under the previous accounting policies, cost of sales rose 33.4% to ¥519.5 billion, and gross profit increased by 40.7% to ¥197.2 billion. The gross profit ratio was 27.5%. The higher gross profit mainly reflects an increase in net sales and an improved gross profit margin in the SPE Division.

SG&A expenses for fiscal 2005 decreased by 5.0% to ¥111.9 billion, and SG&A expenses to net sales were 17.6%. Under the



previous accounting policies, SG&A expenses decreased 5.0% to ¥112.0 billion, and represented 15.6% of net sales. The main reasons for the decrease in SG&A expenses were a reduction of ¥2.2 billion in personnel expenses as a result of a headcount reduction carried out as part of structural reforms in fiscal 2004, and a ¥2.4 billion decrease in depreciation and amortization due to curbs on capital expenditures. R&D expenses for fiscal 2005 included in general and administrative expenses declined 0.6% to ¥43.9 billion, and represented 6.9% of net sales.

As a result of the above and other factors, operating income for fiscal 2005 was ¥64.0 billion. Under the previous accounting policies, operating income increased by ¥62.9 billion from ¥22.3 billion to ¥85.2 billion.

Other Income and Expenses and Net Income

Net non-operating expenses were ¥8.2 billion, despite Tokyo Electron booking a gain of ¥7.1 billion on return of substitutional portion of employees' pension fund. This mainly reflected losses on business reorganization of ¥2.8 billion, and ¥12.5 billion for accrued warranty expenses for previous fiscal years. As a result, income before income taxes was ¥55.8 billion. Under the previous accounting policies, income before income taxes rose ¥74.5 billion, from ¥14.9 billion to ¥89.4 billion.

Net income for fiscal 2005 dramatically increased to ¥61.6 billion, increasing by ¥53.3 billion from fiscal 2004, reflecting in part a contribution from reversal of valuation allowance on deferred tax assets that amounted to ¥22.0 billion. Net income per share was ¥343.63, compared with ¥46.37 a year earlier. Tokyo Electron increased cash dividends by ¥35.0 per share to ¥45.0 per share; the payout ratio was 13.1% on a consolidated basis and 23.9% on a non-consolidated basis.

Performance by Segment

Industrial Electronic Equipment Segment

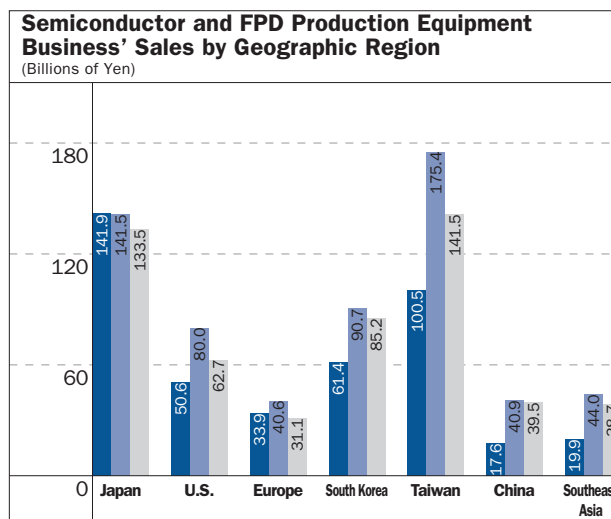
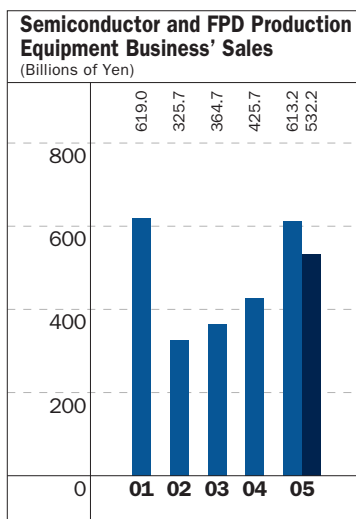
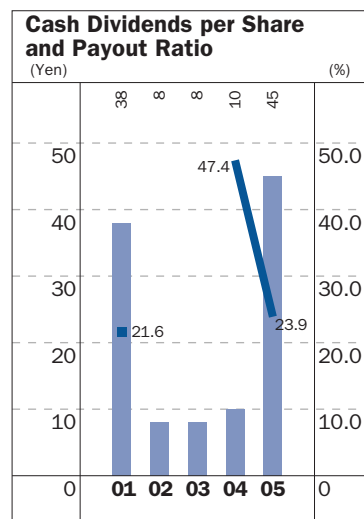
Net sales, including the inter segment sales, for fiscal 2005 were ¥550.5 billion due to strong sales in the mainstay SPE Division. Under the new accounting policies, the gross profit ratio to the segment sales for fiscal 2005 was 29.9%, operating income was ¥60.8 billion and the operating income ratio was 11.0%.

Semiconductor and FPD Production Equipment

Semiconductor Production Equipment

Division sales for fiscal 2005 were ¥457.2 billion. Under the previous accounting policies, division sales were ¥516.3 billion. During the year ended March 31, 2005, Tokyo Electron received a steady stream of orders from Japanese semiconductor manufacturers, who specialize in system LSIs. These products are embedded in digital consumer electronics, one of the driving forces of the current economic recovery. A large number of orders were also received from South Korean and Taiwanese semiconductor manufacturers, who are actively making investments, backed by strong demand for DRAM and flash memory.

In terms of trends by equipment type, sales of all product categories, including coaters/developers, etch systems, thermal processing systems, CVD systems, wafer probers and surface preparation systems, increased as the market for semiconductor production equipment expanded. Tokyo Electron expanded sales of new products, in particular, such as the TELFORMULA™, a thermal processing system, the CLEAN TRACK™ LITHIUS™, a coater/developer compatible with next-generation semiconductor production technology, and the EXPEDIUS, a surface preparation system.



Note: The payout ratio of FY2002 and FY2003 are not indicated due to net loss on a non-consolidated basis.

In terms of wafer diameter, Tokyo Electron focused on 300mm wafers as many semiconductor manufacturers moved to invest in 300mm wafer plants. As a result, sales of these products accounted for around 70% of total sales of semiconductor production equipment.

Orders received in this division for fiscal 2005 were ¥510.5 billion and order backlogs as of March 31, 2005 were ¥236.2 billion. From fiscal 2005, orders received and order backlogs for this business are disclosed on a consolidated basis.

FPD Production Equipment

Sales in this division for fiscal 2005 were ¥75.0 billion. During fiscal 2005, orders were brisk for Tokyo Electron's dry process and photo process systems as LCD panel manufacturers took strategic actions to increase production capacity to popularize flat-panel TVs and expand the market.

Orders received for fiscal 2005 were ¥62.3 billion and order backlogs as of March 31, 2005 were ¥66.8 billion. From fiscal 2005, orders received and order backlogs for this business are disclosed on a consolidated basis.

Computer Network

Division sales for fiscal 2005 declined 13.5% from fiscal 2004 to ¥16.0 billion, despite Tokyo Electron's efforts to increase sales of storage area network ("SAN": high-speed networks that connect external storage systems or storage systems with computers) solutions, network solutions and broadband solutions.

In SAN-related products, which account for 71% of division sales, fibre channel fabric switches and fibre channel host bus adapters, both of which are technological platforms for network

construction, recorded firm growth in sales. During the year, Tokyo Electron bolstered its backup solutions, such as by securing the right to sell ADIC's products and introducing high-compression backup disks and other products. Tokyo Electron also began sales of storage data encryption products in Japan. These moves were made against a backdrop of demand for better data protection. Network security countermeasures are attracting the attention of businesses from the standpoint of preventing the unauthorized disclosure of personal and corporate information.

In network-related products, the website construction business turned in a solid performance, particularly in F5 Networks, Inc's products that facilitate the construction of highly secure websites. The network construction business also made a solid start. This business facilitates secure access through the provision of secure sockets layer-virtual private network products. At the same time, Tokyo Electron made inroads in business to corporations by adding to its lineup CipherTrust, Inc's new products, which block spam and fraudulent e-mail.

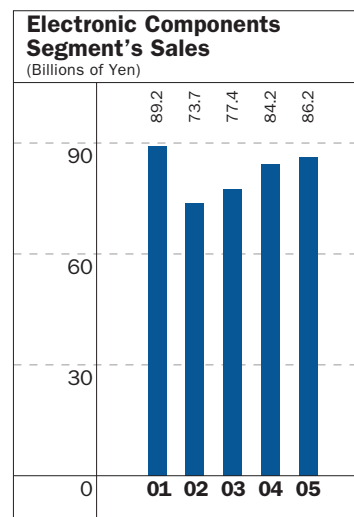
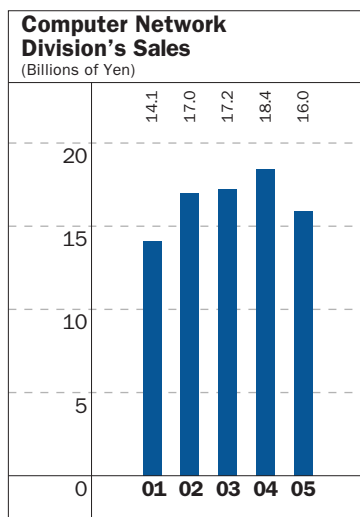
Orders received for fiscal 2005 were ¥16.5 billion, on a par with the previous fiscal year, and order backlogs were ¥4.1 billion, up 13.6% from fiscal 2004.

Others

Sales for fiscal 2005 rose 3.0% to ¥1.3 billion. Orders received for fiscal 2005 were flat at ¥1.3 billion.

Electronic Components Segment

This segment is the responsibility of Tokyo Electron Device Limited, a consolidated subsidiary.



In fiscal 2005, the business concentrated on sales activities that closely targeted customer needs through 16 sales offices nationwide, including three newly established bases in the cities of Kyoto, Hamamatsu and Mishima. Furthermore, Tokyo Electron worked to raise the profile of its proprietary products under the *inrevium* brand by developing ICs, boards, software and other products that reflect market needs. At the same time, efforts were made to expand design services, whereby Tokyo Electron undertakes the design of customized ICs and other products on a contract basis. As a result, net sales in this segment including the inter segment sales for fiscal 2005, which handles semiconductor products, board computer products, software and general electronic components, rose 2.7% to ¥88.1 billion. The gross profit ratio to the segment sales for fiscal 2005 edged down from 13.3% to 13.2%, while operating income was flat at ¥3.1 billion and the operating margin declined from 3.7% to 3.5%.

Segment orders received for fiscal 2005 fell 3.0% from fiscal 2004 to ¥83.6 billion. Order backlogs as of March 31, 2005 were ¥6.1 billion, 30.3% less than the amount as of March 31, 2004.

Sales of semiconductor products for fiscal 2005, which account for 88% of segment sales, rose 2.9% from fiscal 2004. This result reflects firm overall sales of products for digital consumer electronics. Sales of ASICs and other customized ICs for fiscal 2005, which require advanced technological capabilities, grew for use in flat-panel PDP and LCD TVs. Furthermore, sales of dedicated ICs for mobile phones also grew.

Sales of board computer products for fiscal 2005 rose 11.0% from fiscal 2004 on the back of healthy sales of PC motherboards for FA-related equipment and voice processing boards for

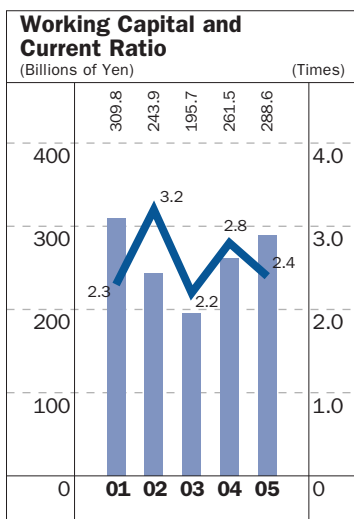
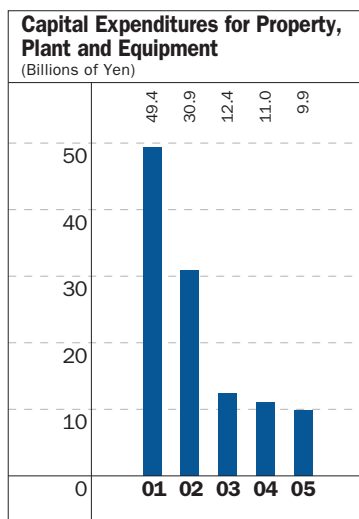
communications equipment. Software sales from fiscal 2004 declined 9.1% from fiscal 2004, despite efforts to expand sales of operating systems and tools for embedded system equipment, particularly POS terminals. Sales of other electronic components declined by 1.6% even as Tokyo Electron worked to expand sales, particularly of switching power supplies, LCDs and panel PCs.

Looking ahead, Tokyo Electron continues to aim to become the leading technology trading company, trusted by customers and suppliers alike. Tokyo Electron's approach, as it strives to achieve this goal, will be to focus on providing thorough technical support for value-added products such as custom ICs and to beef up development of own-brand *inrevium* products and contract design services. In addition, actions will be taken to expand business in the rest of Asia and the Pacific region. One recent development was the start of operations in April 2005 at a subsidiary established in Hong Kong in fiscal 2005.

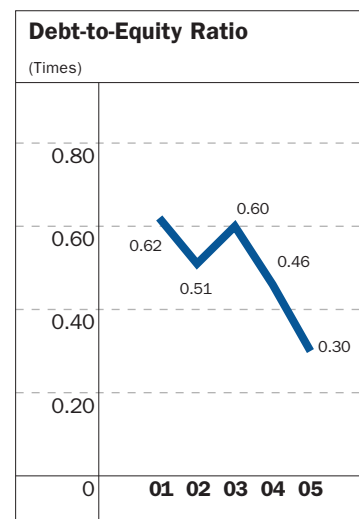
Financial Position and Cash Flows

Financial Position

Current assets as of March 31, 2005 were ¥495.2 billion, ¥92.2 billion higher than the amount as of March 31, 2004. In terms of the major changes, cash and cash equivalents increased ¥72.8 billion due in part to the early collection of trade notes and accounts receivable. Trade notes and accounts receivable improved ¥58.6 billion from March 31, 2004 despite the upward trend in sales. This reflected efforts to collect trade notes and accounts receivable as well as the change in revenue recognition



■ Working Capital
■ Current Ratio



Debt-to-Equity Ratio = Interest-bearing Debt / Shareholders' Equity as of Fiscal Year-end

policies from the time of shipment to the time of confirmation of set-up and testing of products. Furthermore, inventories increased ¥56.3 billion due to the change in revenue recognition policies, although Tokyo Electron saw benefits from measures taken to reduce inventories. Deferred tax assets for fiscal 2005 increased ¥15.3 billion due to the reversal of valuation allowance on deferred tax assets.

Excluding non-trade accounts receivable, trade notes and accounts receivable turnover based on figures at the end of the fiscal year improved from 159 days to 114 days due to the early collection of trade notes and accounts receivable as part of structural reforms and the shortening of the number of days that are required to obtain confirmation of set-up and testing of products at customers fabs. Inventory turnover improved from 72 days to 56 days. Both the trade notes and accounts receivable and inventory turnovers are computed based on net sales at year-end under the previous accounting policies.

Property, plant and equipment as of March 31, 2005 decreased by ¥10.4 billion to ¥98.4 billion, the result mainly of the depreciation of equipment. During fiscal 2005, the Company made an investment of ¥9.9 billion in property, plant and equipment, primarily for the purchase of evaluation equipment.

As a result of the above and other changes, total assets as of March 31, 2005 increased by ¥82.7 billion to ¥644.3 billion.

Current liabilities as of March 31, 2005 rose ¥65.1 billion to ¥206.6 billion. This mainly reflected an increase of ¥30.8 billion in customer advances, mostly due to a change in the accounting policy for revenues recognition, and increases of ¥10.1 billion and ¥10.0 billion in income taxes payable and straight bonds due within one year, respectively. In addition, accrued warranty expenses of

¥13.1 billion were recorded following the change in the accounting policy for after-sale repair.

Non-current liabilities as of March 31, 2005 decreased by ¥39.3 billion to ¥101.1 billion, reflecting factors such as the 9th series of unsecured straight bonds of ¥30.0 billion becoming due within one year.

Shareholders' equity increased ¥56.4 billion to ¥332.2 billion. As a percentage of total assets, shareholders' equity rose 2.5 percentage points from 49.1% to 51.6%. Return on average total shareholders' equity ("ROE") increased by 17.2 percentage points from 3.1% to 20.3%.

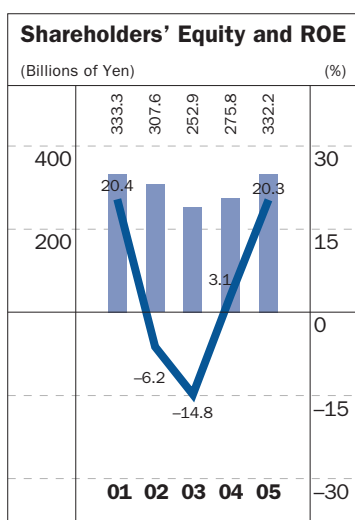
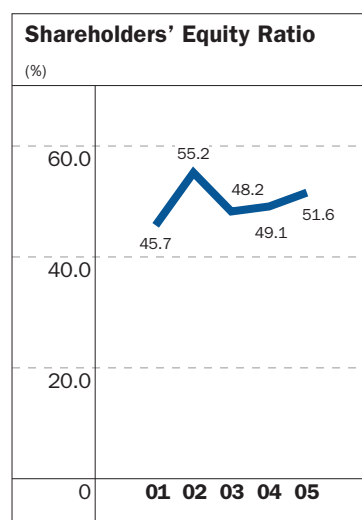
Cash Flows

Net cash provided by operating activities for fiscal 2005 increased sharply from ¥7.9 billion to ¥114.4 billion. This mainly reflected income before income taxes of ¥55.8 billion, depreciation and amortization of ¥21.5 billion and an increase in customer advances of ¥30.8 billion, as well as the benefits of efforts to achieve the early collection of trade notes and accounts receivable and other factors.

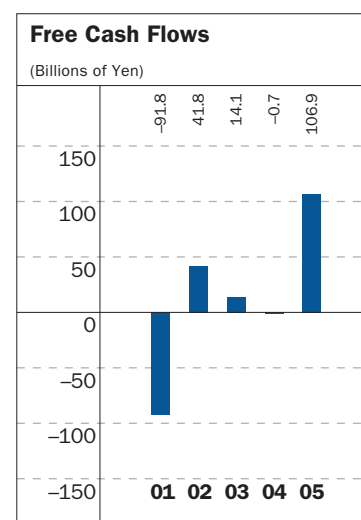
Investing activities used net cash of ¥7.5 billion in fiscal 2005, compared with ¥8.5 billion in fiscal 2004. The main component was outflows of ¥8.7 billion for the acquisition of evaluation equipment.

Financing activities used net cash of ¥34.3 billion in fiscal 2005, compared with ¥10.3 billion in fiscal 2004. This increase mainly reflected the redemption of the 7th series of unsecured corporate bonds of ¥20.0 billion and debt repayments as Tokyo Electron continued to reduce debt, as well as dividends paid.

As a result, cash and cash equivalents as of March 31, 2005 were ¥115.4 billion, ¥72.8 billion higher than the ¥42.7 billion as of March 31, 2004.



■ Shareholders' Equity
■ ROE



Free Cash Flows = Cash Flows From Operating Activities + Cash Flows From Investing Activities

Business-related and Other Risks

The following are possible risks that may have an impact on Tokyo Electron's business performance, stock price, or financial position.

(1) Impact of Fluctuating Foreign Exchange Rates

Success in the development of overseas operations has increased the share of sales generated overseas. As a rule, Tokyo Electron conducts export transactions on a yen basis to avert exposure to foreign currency risks. However, some exports are denominated in foreign currencies. In these cases, Tokyo Electron hedges foreign currency risk by using a forward foreign exchange contract when an order is received or by other means. However, foreign exchange rate risks can arise from fluctuations in prices due to sudden foreign exchange movements, which could have an indirect adverse effect on Tokyo Electron's business performance.

(2) Impact From Research and Development

Through ongoing and proactive R&D investment and activities in cutting-edge technologies—miniaturization, vacuum, plasma, thermal-processing, coating/developing, cleaning, wafer-transfer and clean technologies—Tokyo Electron has created advanced technologies. At the same time, by quickly bringing to market new products incorporating these technologies, Tokyo Electron has successfully captured a high market share in each of the product fields it has entered and generated a high profit margin. However, delays in the launch of new products and other factors could adversely affect Tokyo Electron's business performance.

(3) Impact From Changes in the Semiconductor Market

Tokyo Electron has achieved a high profit margin by concentrating resources in high-tech fields, including semiconductor production equipment, where technological innovation is rapid but Tokyo Electron can effectively use its strengths. Although technological change is responsible for the semiconductor market's rapid growth, Tokyo Electron has actively undertaken structural reforms to be able to generate profits under any circumstances, such as when the market contracts temporarily due to imbalance of supply and demand. However, order cancellations, excess capacity and personnel and increased inventories resulting from an unexpectedly large market contraction could adversely affect Tokyo Electron's business performance.

(4) Impact From Concentration of Transactions on Particular Customers

Tokyo Electron has been successful at increasing transactions with the leading semiconductor manufacturers worldwide, including those in Japan, through the provision of products featuring outstanding, cutting-edge technology and of services offering a high level of customer satisfaction. However, Tokyo Electron's sales may from time to time be temporarily concentrated on particular customers due to the timing of large capital investments of major semiconductor manufacturers. The resulting escalation in sales competition could adversely affect Tokyo Electron's business performance.

(5) Safety-related Impacts

Tokyo Electron's basic philosophy is to always bear in mind safety and health in the execution of business activities, including

development, manufacturing, sales, services and management. In accordance with this philosophy, Tokyo Electron works actively and continuously to improve the safety of its products and to eliminate any harmful impact on health. However, harm to customers, order cancellations or other circumstances resulting from safety problems or other problems related to Tokyo Electron's products could adversely affect Tokyo Electron's business performance.

(6) Impact From Quality Issues

Tokyo Electron actively develops outstanding, cutting-edge technologies for incorporation in new products that are brought quickly to market. At the same time, Tokyo Electron works to establish a quality assurance system, efforts that include obtaining ISO 9001 certification, as well as to establish a world-class service system. These actions have resulted in a large number of customers adopting Tokyo Electron's products. However, because Tokyo Electron's products are based on cutting-edge technologies, and due to other factors, many of the technologies developed are in unfamiliar fields. The occurrence of unforeseen defects or other issues could adversely affect Tokyo Electron's business performance.

(7) Impact of Intellectual Property Rights

In order to distinguish its products and make them more competitive, Tokyo Electron has promoted its R&D strategy for the early development of cutting-edge technologies together with its business and intellectual property strategies. This approach has enabled Tokyo Electron to obtain sole possession of many proprietary technologies that have been instrumental to Tokyo Electron's ability to capture a high market share and generate high profit margins in each of its product fields. However, Tokyo Electron's products incorporate and optimize many of these proprietary cutting-edge technologies. There may be cases, therefore, where by avoiding the use of third-party technologies and intellectual property rights, Tokyo Electron's business performance could be adversely affected.

(8) Other Risks

Tokyo Electron is actively involved in reforming the corporate structure so that it can generate profits even when markets contract. These reforms have entailed creating new high-growth, high-return businesses and pursuing higher earnings from existing businesses. At the same time, Tokyo Electron has promoted activities to preserve the environment and worked to restructure its compliance and risk management systems. However, as long as it conducts business activities, as with peer companies or companies in different industries, Tokyo Electron is subject to the effect of many other factors. These include the world and regional economic environments, natural disasters, war, terrorism, unavoidable occurrences (such as infectious diseases), financial or stock markets, government or other regulations, supply systems of suppliers, market conditions for products and real estate, the ability to recruit personnel in Japan and overseas, competition over standardization, and loss of key personnel. Any of these factors could adversely affect Tokyo Electron's business performance.