

## MANAGEMENT'S DISCUSSION AND ANALYSIS

Financial results in this MD&A refer to fiscal 2006, the year ended March 31, 2006. Percentage comparisons refer to year-on-year changes from fiscal 2005.

Effective from fiscal 2005, the Company made certain changes in accounting policies and segment classifications as discussed in the notes to consolidated financial statements.

- The policy for revenue recognition of semiconductor and FPD production equipment was changed from the time of shipment of products to, in principle, the time of confirmation of set-up and testing of products.
- The accounting treatment of after-sale repair expenses incurred during the warranty period for semiconductor and FPD production equipment was changed. In the past, the Company charged such expenses to income as incurred. Effective from the fiscal year ended March 31, 2005, the Company provides accrued warranty expenses for estimated expenses, calculated on the basis of after-sale repair expenses incurred in the past.
- In past fiscal years, Tokyo Electron's businesses were classified as a single segment. Effective from the fiscal year ended March 31, 2005, however, Tokyo Electron's businesses were reclassified into two segments, "Industrial Electronic Equipment" and "Electronic Components," based on the similarities between products and services as well as sales methods.

## Sales and Income

### Operating Environment

The overall global economic picture during the past fiscal year was favorable, led by brisk U.S. and Chinese economies, despite concerns about the economic impact from damage wreaked by major hurricanes in the U.S. and high crude oil prices. In Japan, there were continued signs of a steady recovery, including robust capital expenditure and an improvement in the employment situation bolstered by strong corporate performances.

With regard to the electronics industry, in which the Company participates, sales were strong of digital consumer electronics, such as portable music players, digital cameras, DVD recorders and flat panel TVs, expanding demand for semiconductors. PCs and mobile phones are starting to make rapid inroads into newly developed emerging markets, including the BRICs countries, which is also lifting semiconductor demand. In response to this favorable environment, semiconductor manufacturers and LCD panel manufacturers made substantial capital investments.

### Sales

Consolidated net sales increased 6.0% from the previous fiscal year to ¥673.7 billion.

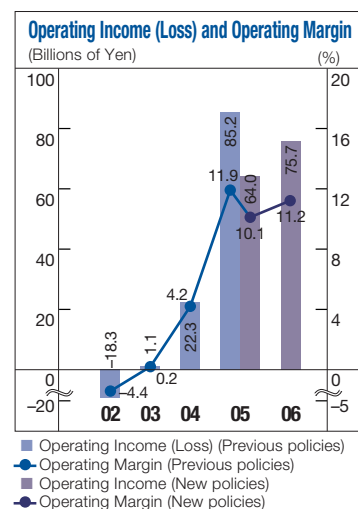
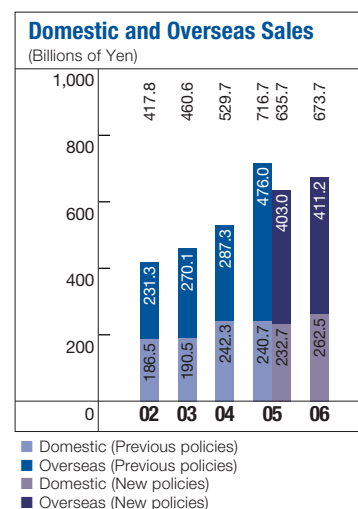
By region, sales of semiconductor production equipment in Japan and the United States exceeded the previous year by a wide margin and were also solid in South Korea and Taiwan. In addition, sales of FPD production equipment in Taiwan remained strong. As a result, net sales in Japan were up 12.8% over the previous fiscal year to ¥262.5 billion, and overseas net sales were up 2.0% to ¥411.2 billion. Overseas net sales accounted for 61.0% of consolidated net sales, down from the 63.4% recorded in the previous fiscal year.

Consolidated orders received during the fiscal year increased 7.0% over the previous fiscal year to ¥721.6 billion, and the consolidated order backlog at the end of the fiscal year increased 15.3% to ¥361.0 billion. Both figures were historical records.

### Gross Profit, SG&A Expenses and Operating Income

The cost of sales was ¥484.0 billion, an increase of 5.3% compared to the previous fiscal year, and gross profit was ¥189.7 billion, an increase of 7.9% over the previous fiscal year. As a result, the gross profit margin was 28.2%, an improvement of 0.5 percentage point, due mainly to higher sales of semiconductor production equipment.

Selling, general and administrative (SG&A) expenses were ¥114.0 billion, an increase of 1.9% from the previous fiscal year, and the ratio of SG&A expenses to net sales was 17.0%. R&D expenses included in general and administrative expenses increased 12.1% to ¥49.2 billion.



Despite this increase in R&D expenses, there was only a slight overall increase in total SG&A expenses due to lower depreciation and tighter control over variable expenses.

As a result of the above and other factors, operating income for fiscal 2006 was ¥75.7 billion, up 18.3% year on year. The operating margin was 11.2%, an increase of 1.1 percentage points.

### Research and Development

R&D expenses, as noted above, were ¥49.2 billion in fiscal 2006, up 12.1% from the previous fiscal year.

In semiconductor production equipment, in addition to design rule shrink, customers are demanding responses to new materials for realizing higher speeds and lower power consumption. In the past fiscal year, Tokyo Electron focused on the development of technologies and products that respond to these customer needs. As a result of ongoing R&D efforts, the Company was able to launch new products in five of six product categories. In FPD production equipment, the focus was on the development of equipment designed for large glass substrates. Tokyo Electron was successful in launching new models for handling eighth-generation glass substrates.

Another important R&D theme was lowering the environmental load of production equipment based on their individual environmental characteristics. A certain portion of the R&D budget is allocated for this purpose.

In addition to R&D spending to develop new technologies and products in existing areas of operation, the Company also invested in creating new businesses derived from its core technologies.

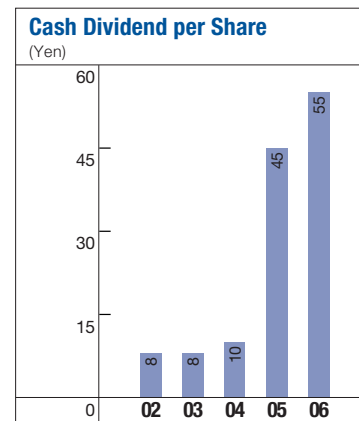
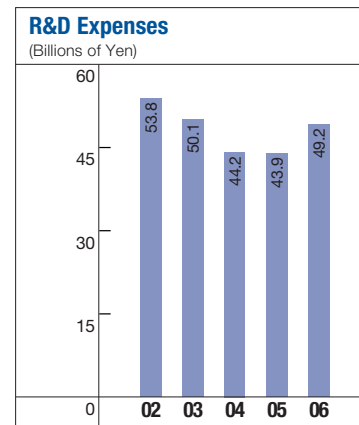
### Other Income (Expenses) and Net Income

Net non-operating expenses were ¥0.4 billion, since there were no significant extraordinary gains or losses during fiscal 2006 while the net non-operating expenses of the previous fiscal year were ¥8.2 billion due to ¥12.5 billion of provision for warranty expenses for the prior year. Income before income taxes was ¥75.3 billion, up 35.1%.

Net income was ¥48.0 billion, down 22.1%, mainly because of a one-time ¥27.9 billion reversal of valuation allowance on deferred tax assets that lifted net income in the previous fiscal year. Net income per share was ¥267.61 (net income per share was ¥343.63 in the previous fiscal year).

### Dividend Policy and Dividend

The fundamental policy regarding return of profit to shareholders is to pay dividends linked to business performance and backed by earnings. Effective from fiscal 2006, the Company adopted a new dividend policy that aims at a payout ratio of 20% of consolidated net income. In line with this policy, the Company declared a cash dividend per share of ¥55, up ¥10 from the previous fiscal year. This translates into a dividend payout ratio of 20.6% on a consolidated basis.



	2002	2003	2004	2005	2006
Net sales	¥417,825	¥460,580	¥529,654	¥635,710	<b>¥673,686</b>
Gross profit	115,555	134,040	140,155	175,913	<b>189,732</b>
Gross profit margin	27.7%	29.1%	26.5%	27.7%	<b>28.2%</b>
Selling, general and administrative expenses	133,865	132,921	117,875	111,930	<b>114,029</b>
Operating income (loss)	(18,310)	1,119	22,280	63,983	<b>75,703</b>
Operating margin	(4.4)%	0.2%	4.2%	10.1%	<b>11.2%</b>
Income (loss) before income taxes	(22,919)	(23,010)	14,936	55,775	<b>75,328</b>
Net income (loss)	(19,938)	(41,554)	8,297	61,601	<b>48,006</b>

Effective from fiscal 2005, the Company made certain changes in accounting policies as discussed in the notes to consolidated financial statements.

## Performance by Segment

### Industrial Electronic Equipment Segment

Due to continued strong net sales in the mainstay SPE Division, net sales (including inter-segment sales) during the past fiscal year were ¥587.8 billion, an increase of 6.8% over the previous fiscal year. Operating income rose 19.4% to ¥72.6 billion. The operating margin was 12.3%, up 1.3 percentage points.

#### ■ Semiconductor Production Equipment

Sales to external customers were ¥486.9 billion, a 6.5% year-on-year increase.

Despite some slightly pessimistic views at the beginning of the fiscal year, shipments of PCs and mobile phones remained strong, and portable music players and automotive electronic products have been experiencing rapid growth. As a result, there was strong demand for NAND flash memory, DRAM and other semiconductors used in these electronic devices. Reflecting this demand, semiconductor manufacturers invested heavily in increasing production capacity and developing cutting-edge semiconductors. In turn, this generated brisk inquiries for the Company's products.

By equipment type, backed by strong capital investment by semiconductor memory manufacturers, particularly in Asia, sales increased of etch systems, thermal processing systems, CVD systems, and surface preparation systems. Tokyo Electron saw sales growth of CLEAN TRACK™ LITHIUS™, a coater/developer compatible with next-generation design rule technologies; of EXPEDIUS, a new auto wet station; and of Telius™, a plasma etch system equipped with SCCM™-JI, the latest etch chamber.

In terms of wafer diameter, 85% of sales were for 300mm wafer plants and 15% of sales were for 200mm wafer plants.

Division orders declined 2.1% to ¥499.9 billion, and the order backlog at the end of fiscal 2006 was ¥249.2 billion, up 5.5% compared to the end of the previous fiscal year.

#### ■ FPD Production Equipment

Sales to external customers were ¥81.2 billion, an 8.2% year-on-year increase.

In conjunction with the shift to digital and high-definition broadcasting, large-screen flat panel TVs, including LCD TVs, are rapidly finding their way into homes. Given this, LCD panel manufacturers ramped up capital investment to develop cutting-edge display panels and boost production capacity. In this environment, sales rose of FPD production equipment, particularly in Taiwan. By generation, FPD production equipment for sixth-generation glass substrates contributed significantly to sales, while sales of FPD production equipment for seventh-generation glass substrates rose sharply.

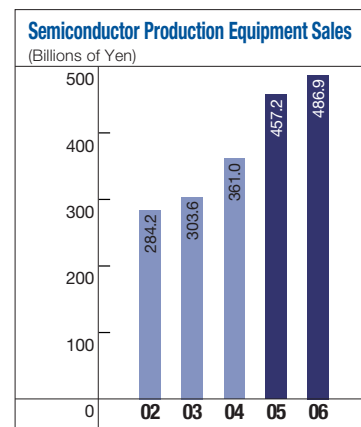
Division orders received increased 82.2% to ¥113.5 billion, and the order backlog at the end of fiscal 2006 was ¥99.1 billion, up 48.4% compared to the end of the previous fiscal year.

#### ■ Computer Network

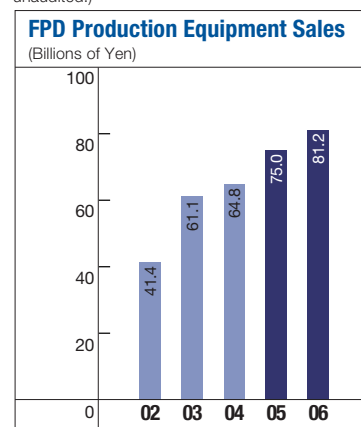
Sales to external customers were ¥17.5 billion, an increase of 9.6% compared to the previous fiscal year.

Among SAN (Storage Area Network)-related products, which account for 40% of net sales in this division, sales were strong of fibre channel fabric switches and fibre channel host bus adapters, which form the platform technologies for network construction. With respect to network-related products, the website construction business, centered on products that make possible the creation of highly secure websites, recorded solid sales, and sales related to support and maintenance increased.

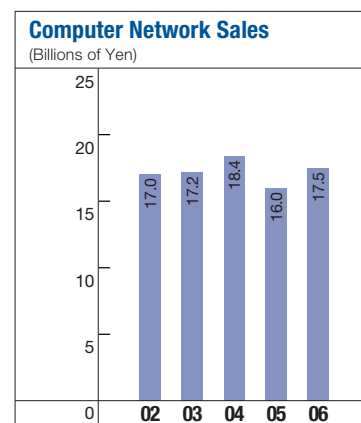
Division orders received increased 13.5% to ¥18.7 billion and the order backlog at the end of the fiscal year was ¥5.3 billion, up 28.7%.



Since fiscal 2005, sales of FPD production equipment have been shown separately from SPE Division sales, in which they were previously included. In the above graph, SPE sales for fiscal 2004 and prior years exclude FPD production equipment sales on a non-consolidated basis for the convenience of readers. (These figures are unaudited.)



Since fiscal 2005, sales of FPD production equipment have been shown separately from SPE Division sales, in which they were previously included. In the above graph, FPD production equipment sales for fiscal 2004 and prior years are on a non-consolidated basis, while those from fiscal 2005 are on a consolidated basis.



The Computer Network Division (excluding Aero Component Business) is scheduled to be transferred to Tokyo Electron Device Limited by simple separation through absorption in October 2006.

#### ■ Others

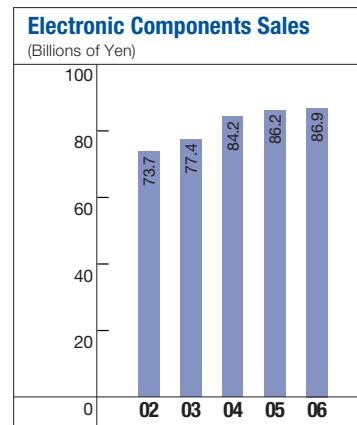
Other sales largely comprise in-house services, such as insurance and travel services. Sales for fiscal 2006 declined 1.4% year on year to ¥1.2 billion.

#### Electronic Components Segment (Tokyo Electron Device Limited)

Net sales in this segment, including intersegment sales, for fiscal 2006 rose 0.2% to ¥88.3 billion. Operating income was flat at ¥3.1 billion, and the operating margin was 3.5%. Sales to external customers were ¥86.9 billion, a 0.7% year-on-year increase.

Semiconductor products represented 88.6% of segment sales, board computer products 4.7%, software 3.6% and other electronic components 3.1%. In semiconductor products, sales of products for factory automation-related equipment and for cell phone base stations were firm on the back of higher capital investments. Furthermore, sales of products used in flat panel TVs and car navigation systems were solid as consumer spending grew.

This segment is working to expand its customer base by focusing on sales of high value-added products, such as custom ICs and general-purpose ICs (analog ICs), that require advanced technical support. At the same time, efforts are being made to expand contract design services, whereby Tokyo Electron Device Limited undertakes the design of semiconductors while raising the profile of its proprietary products under the *inrevium* brand.



The above graph shows the sales to external customers

#### Business segment information

2006	(Millions of Yen)				
	Industrial electronic equipment	Electronic components	Total	Eliminations and corporate	Consolidated
Net sales and operating income					
Net sales					
(1) Sales to external customers	¥586,805	¥86,881	¥673,686	¥ -	¥673,686
(2) Intersegment sales or transfers	1,004	1,409	2,413	(2,413)	-
Total	587,809	88,290	676,099	(2,413)	673,686
Operating expenses	515,241	85,190	600,431	(2,448)	597,683
Operating income	72,568	3,100	75,668	35	75,703
Assets, depreciation and amortization expenses and capital expenditure					
Assets	¥626,838	¥37,089	¥663,927	¥ (684)	¥663,243
Depreciation and amortization expenses	20,512	258	20,770	-	20,770
Loss on impairment of fixed assets	419	-	419	-	419
Capital expenditure, including intangible and other assets	16,223	144	16,367	-	16,367

## Financial Position and Cash Flows

### Assets, Liabilities and Shareholders' Equity

Total assets as of March 31, 2006 were ¥663.2 billion, ¥18.9 billion higher than as of March 31, 2005.

Current assets at the end of the fiscal year increased by ¥22.3 billion to ¥517.5 billion. Major changes included increases in cash and cash equivalents of ¥24.6 billion, decreased trade notes and accounts receivable of ¥3.5 billion, and increased inventories of ¥2.3 billion. As the Company focused on shortening the asset turnover period, the turnover period of trade notes and accounts receivable (excluding non-trade accounts receivable) shortened from 99 days to 92 days and inventory turnover improved from 93 days to 89 days.

Net property, plant and equipment decreased by ¥3.7 billion to ¥94.7 billion. The major reason for this was further equipment depreciation.

Investments and other assets increased by ¥0.3 billion to ¥51.0 billion, the net result of a ¥4.5 billion increase in investment securities due to a valuation gain as the stock market rallied and a decline in deferred income taxes and intangible assets.

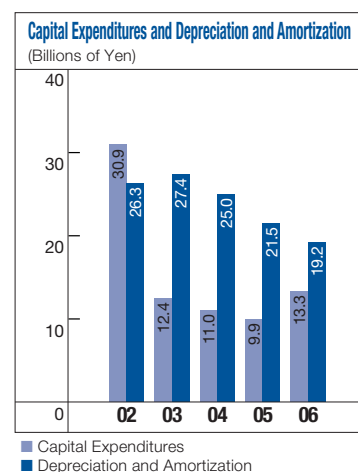
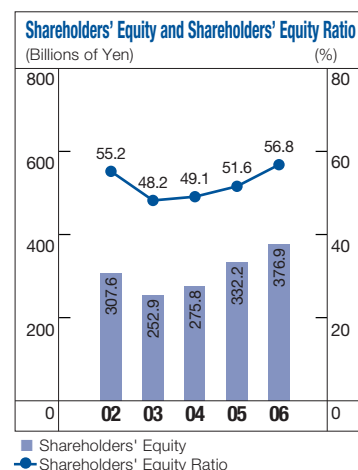
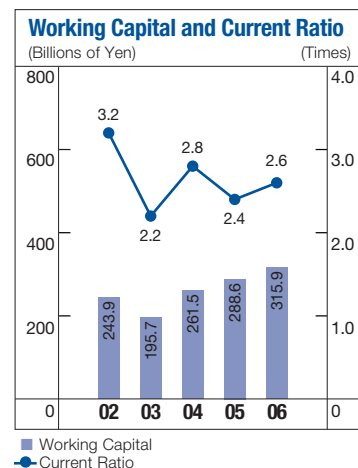
Total liabilities as of March 31, 2006 were ¥281.6 billion, ¥26.1 billion lower than as of March 31, 2005.

Continuing from the previous fiscal year, the Company concentrated on reducing interest-bearing debt. As a result, interest-bearing debt, including short-term borrowings, the current portion of corporate bonds, long-term debt and corporate bonds, declined ¥34.4 billion to ¥65.1 billion. This reflected a ¥30.0 billion drop in straight corporate bonds and a ¥4.3 billion decline in bank borrowings. The result was a marked improvement in the debt-to-equity ratio from 29.9% to 17.3%.

Shareholders' equity increased ¥44.7 billion to ¥376.9 billion, due mainly to favorable business results, which pushed up retained earnings by ¥37.8 billion. As a result, shareholders' equity, as a percentage of total assets, improved by 5.2 percentage points to 56.8%, but the return on average total shareholders' equity (ROE) declined 6.8 percentage points to 13.5%.

### Capital Expenditures and Depreciation

Capital expenditures were ¥13.3 billion, an increase of 35.0% compared to the previous fiscal year. The cost of evaluation equipment and measuring devices for semiconductor production equipment and FPD production equipment-related research and development, in addition to IT-related investments, were the most significant items of capital expenditures. Depreciation and amortization expenses declined 10.7% to ¥19.2 billion.



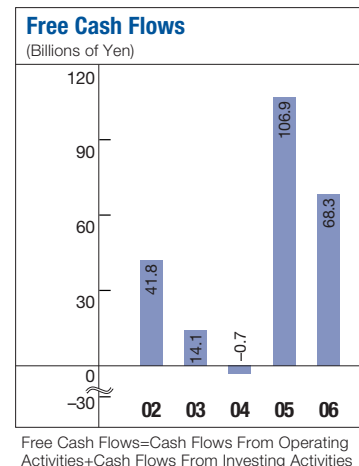
## Cash Flows

Net cash provided by operating activities was ¥78.9 billion, ¥35.5 billion lower compared to the previous fiscal year. The principal sources of cash from operating activities included income before income taxes of ¥75.3 billion, depreciation and amortization of ¥19.2 billion, a decrease in trade notes and accounts receivable of ¥5.1 billion, and an increase in trade notes and accounts payable of ¥6.7 billion. The principal uses of cash from operating activities included a decrease in customer advances of ¥9.5 billion and payment of income taxes of ¥19.5 billion.

Net cash used in investing activities was ¥10.5 billion, ¥3.1 billion more than in the previous fiscal year. The principal use of cash was ¥8.6 billion for the purchase of property, plant and equipment, mainly for the purchase of evaluation, measuring and other equipment for research and development.

Net cash used in financing activities was ¥43.4 billion, ¥9.1 billion more than in the previous fiscal year. The principal uses of cash were ¥30.0 billion for the redemption of the 9<sup>th</sup> series of unsecured straight bonds, ¥5.5 billion in repayment of long-term debt, and dividend payments of ¥9.8 billion.

As a result, cash and cash equivalents at March 31, 2006 were ¥140.0 billion, an increase of ¥24.6 billion from the end of the previous fiscal year.



## 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, whereby 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.