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

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# FORM 10-Q

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(Mark One)

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

**For the quarterly period ended September 30, 2006**

**or**

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

**Commission File Number: 0-26824**

# TEGAL CORPORATION

*(Exact Name of Registrant as Specified in Its Charter)*

| | |
|---|---|
| **Delaware** | **68-0370244** |
| ***(State or other jurisdiction of incorporation or organization)*** | ***(I.R.S. Employer Identification No.)*** |

**2201 South McDowell Blvd.**
**Petaluma, California 94954**
*(Address of Principal Executive Offices)*

**Telephone Number (707) 763-5600**
*(Registrant's Telephone Number, Including Area Code)*

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Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file reports) and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

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

As of November 13, 2006 there were 7,072,289 shares of our common stock outstanding. The number of shares outstanding reflects a 1 to 12 reverse stock split effected by the Registrant on July 25, 2006.

**TEGAL CORPORATION AND SUBSIDIARIES**

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**TEGAL CORPORATION AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED BALANCE SHEETS**
**(Unaudited)**
**(In thousands, except share data)**
**PART I — FINANCIAL INFORMATION**

**Item 1.** ***Condensed Consolidated Financial Statements***

| | September 30 2006 | March 31 2006 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 10,465 | $ 13,787 |
| Accounts receivable, net of allowances for sales returns and doubtful accounts of $506 and $205 at September 30, 2006, and March 31, 2006, respectively | 4,412 | 5,265 |
| Inventories, net | 7,780 | 7,700 |
| Prepaid expenses and other current assets | 1,643 | 1,270 |
| Total current assets | 24,300 | 28,022 |
| Property and equipment, net | 1,088 | 1,849 |
| Intangible assets, net | 1,317 | 1,474 |
| Other assets | 143 | 146 |
| Total assets | $ 26,848 | $ 31,491 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| Current liabilities: | | |
| Notes payable and bank lines of credit | $ 25 | $ 27 |
| Accounts payable | 2,263 | 2,458 |
| Accrued product warranty | 799 | 506 |
| Deferred revenue | 551 | 477 |
| Accrued expenses and other current liabilities | 1,987 | 1,975 |
| Total current liabilities | 5,625 | 5,443 |
| Long-term portion of capital lease obligations | — | 2 |
| Other long term obligations | 2 | 6 |
| Total long term liabilities | 2 | 8 |
| Total liabilities | 5,627 | 5,451 |
| | | |
| Stockholders' equity: | | |
| Preferred stock; $ 0.01 par value; 5,000,000 shares authorized; none issued and outstanding | — | — |
| Common stock; $ 0.01 par value; 200,000,000 shares authorized; 7,055,623 and 7,021,088 shares issued and outstanding at September 30, 2006 and March 31, 2006 respectively | 71 | 70 |
| Restricted Share Units | 422 | 810 |
| Additional paid-in capital | 120,822 | 119,782 |
| Accumulated other comprehensive income | 143 | 532 |
| Accumulated deficit | (100,237) | (95,154) |
| Total stockholders' equity | 21,221 | 26,040 |
| Total liabilities and stockholders' equity | $ 26,848 | $ 31,491 |

See accompanying notes.

**TEGAL CORPORATION AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**
**(Unaudited)**
**(In thousands, except per share data)**

| | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Six Months Ended September 30, 2006 | Six Months Ended September 30, 2005 |
|---|---|---|---|---|
| Revenue | $ 5,113 | $ 6,406 | $ 11,689 | $ 9,458 |
| Cost of revenue | 2,713 | 3,963 | 6,791 | 6,340 |
| Gross profit (loss) | 2,400 | 2,443 | 4,898 | 3,118 |
| Operating expenses: | | | | |
| Research and development | 1,066 | 1,211 | 2,062 | 2,387 |
| Sales and marketing | 964 | 757 | 2,008 | 1,401 |
| General and administrative | 3,485 | 3,398 | 5,787 | 4,638 |
| Total operating expenses | 5,515 | 5,366 | 9,857 | 8,426 |
| Operating loss | (3,115) | (2,923) | (4,959) | (5,308) |
| Other income (expense), net | (166) | 242 | (124) | 120 |
| Net loss | $ (3,281) | $ (2,681) | $ (5,083) | $ (5,188) |
| Net loss per share, basic and diluted | $ (0.47) | $ (0.51) | $ (0.72) | $ (1.13) |
| Shares used in per share computation: | | | | |
| Basic | 7,045 | 5,227 | 7,029 | 4,608 |
| Diluted | 7,045 | 5,227 | 7,029 | 4,608 |

Note: Shares used in per share computation for Basic and Diluted reflect a 1 to12 reverse stock split effected by the Company on July 25, 2006

See accompanying notes.

**TEGAL CORPORATION AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(Unaudited)**
**(In thousands)**

| | Six Months Ended September 30, 2006 | 2005 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net loss | $ (5,083) | $ (5,188) |
| Adjustments to reconcile net loss to cash used in operating activities: | | |
| Depreciation and amortization | 448 | 678 |
| Stock Compensation Expense | 463 | 1,004 |
| Fair value of warrants issued for services rendered | 48 | 792 |
| Provision for doubtful accounts and sales return allowances | 302 | (450) |
| Excess and obsolete inventory provision | (2,142) | -- |
| Non-cash valuation of marked to market investor warrants | -- | (326) |
| Changes in operating assets and liabilities: | | |
| Accounts receivables | 465 | (2,788) |
| Inventories | 1,738 | (769) |
| Prepaid expenses and other assets | (312) | (398) |
| Accounts payable | (203) | (489) |
| Accrued expenses and other liabilities | (7) | 277 |
| Accrued product warranty | 284 | 77 |
| Loss on disposal of property and equipment | 657 | -- |
| Deferred revenue | 74 | 312 |
| Net cash used in operating activities | (3,268) | (7,268) |
| Cash flows used in investing activities: | | |
| Purchases of property and equipment | (185) | (138) |
| Net cash used in investing activities: | (185) | (138) |
| Cash flows provided by financing activities: | | |
| Net proceeds from issuance of common stock | 143 | 18,657 |
| Borrowings under lines of credit | 2 | 44 |
| Repayment of borrowings under lines of credit | -- | (157) |
| Payments on capital lease financing | (2) | (6) |
| Net cash provided by financing activities | 143 | 18,538 |
| Effect of exchange rates on cash and cash equivalents | (12) | (24) |
| Net increase (decrease) in cash and cash equivalents | (3,322) | 11,108 |
| Cash and cash equivalents at beginning of period | 13,787 | 7,093 |
| Cash and cash equivalents at end of period | $ 10,465 | $ 18,201 |

See accompanying notes.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
**(Unaudited)**
**(All amounts in thousands, except share data)**

### 1. Basis of Presentation:

In the opinion of management, the unaudited condensed consolidated interim financial statements have been prepared on the same basis as the March 31, 2006 audited consolidated financial statements and include all adjustments, consisting only of normal recurring adjustments, necessary to fairly state the information set forth herein. The statements have been prepared in accordance with the regulations of the Securities and Exchange Commission (the "SEC"), but omit certain information and footnote disclosures necessary to present the statements in accordance with generally accepted accounting principles. These interim financial statements should be read in conjunction with the consolidated financial statements and footnotes included in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2006. The results of operations for the three and six months ended September 30, 2006 are not necessarily indicative of results to be expected for the entire year.

The consolidated financial statements contemplate the realization of assets and the satisfaction of liabilities in the normal course of business. The Company incurred net losses of $5,083 and $5,188 for the six months ended September 30, 2006 and 2005, respectively. The Company generated negative cash flows from operations of $3,268 and $7,268 for the period ended September 30, 2006 and 2005, respectively. During the fiscal 2006 the Company raised a net of $18,384 through a private investment placement of equity. Management believes that these proceeds, combined with projected sales, consolidation of certain operations and continued cost containment will be adequate to fund operations through fiscal 2007. However, projected sales may not materialize and unforeseen costs may be incurred**.** If the projected sales do not materialize, the Company's ability to achieve its intended business objectives may be adversely affected. The condensed consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded assets or the amount or classification of liabilities or any other adjustments that might be necessary should the Company be unable to continue as a going concern.

On July 21, 2006, Tegal Corporation filed with the Secretary of State of the State of Delaware a Certificate of Amendment to the Company's Certificate of Incorporation to affect a 1-for-12 reverse stock split of the Company's common. The condensed consolidated financial statements for current and prior periods have been adjusted to reflect the change in number of shares.

### Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of temporary cash investments and accounts receivable. Substantially all of the Company's temporary investments are invested in money market funds. The Company's accounts receivable are derived primarily from sales to customers located in the U.S., Europe and Asia. The Company performs ongoing credit evaluations of its customers and generally requires no collateral. The Company maintains reserves for potential credit losses. Write-offs during the periods presented have been insignificant. As of March 31, 2006 one customer accounted for approximately 63.4% of the accounts receivable balance.

During the three months ending September 30, 2006 three (3) customers accounted for 49% of total revenue. During the three months ending September 30, 2005 two (2) customers accounted for 78% of total revenue. During the six months ending September 30, 2006 and September 30, 2005, three (3) customers accounted for 53% and two (2) customers accounted for 69% of total revenue respectively.

As of September 30, 2006 four (4) customers accounted for 54% of outstanding accounts receivable balance. As of September 30, 2005 one (1) customer accounted for 69% of outstanding accounts receivable balance.

### Stock Based Compensation

### Adoption of SFAS 123R

The Company has adopted several stock plans that provide equity instruments to our employees and non-employee directors. Our plans include incentive and non-statutory stock options and restricted stock awards. Stock options generally vest ratably over a four-year period on the anniversary date of the grant, and expire ten years after the grant date. Restricted stock awards generally vest on the achievement of specific performance targets. The Company also has employee stock purchase plans that allow qualified employees to purchase Company shares at 85% of the fair market value on specified dates.

Prior to April 1, 2006 we accounted for these stock-based employee compensation plans under the measurement and recognition provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" or APB 25, and related Interpretations, as permitted by SFAS No. 123, "Accounting for Stock Based Compensation," or SFAS 123. With the exception of grants of restricted stock awards, we generally recorded no stock-based compensation expense during periods prior to April 1, 2006 as all stock-based grants had exercise prices equal to the fair market value of our common stock on the date of grant. We also recorded no compensation expense in connection with our employee stock purchase plans as they qualified as non-compensatory plans following the guidance provided by APB 25. In accordance with SFAS 123 and SFAS 148 "Accounting for Stock-Based Compensation-Transition and Disclosure," appearing later in this Note we disclose our net loss and net loss per share for the quarter and six (6) months ended September 30, 2005 as if we had applied the fair value-based method in measuring compensation expense for our stock-based compensation plans.

Effective April 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123R "Accounting for Stock Based Compensation", using the modified prospective transition method. Under that transition method, compensation expense that we recognized for the three and six months ended September 30, 2006 was $233 and $463 included: (a) compensation expense for all share-based payments granted prior to but not yet vested as of April 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation expense for all share-based payments granted or modified on or after April 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. Compensation expense is recognized only for those awards that are expected to vest, whereas prior to the adoption of SFAS 123R, we recognized forfeitures as they occurred. In addition, we elected the straight-line attribution method as our accounting policy for recognizing stock-based compensation expense for all awards that are granted on or after April 1, 2006. Results in prior periods have not been restated.

Total compensation expense for the period ended September 30, 2006 was $463, for the three months ended September 30, 2006, the compensation expense was $233. The total compensation expense related to non-vested awards not yet recognized is $1,010. The weighted average period for which it is expected to be recognized is 2 years.

Had the Company adopted SFAS No 123R during the fiscal year ended March 31, 2006, compensation expense of approximately $1,770 would have been recognized in the consolidated statements of operations for the year ended March 31, 2006.

The following assumptions are included in the estimated grant date fair value calculations for the Company's stock option awards and Employee Qualified Stock Purchase Plan ("ESPP"):

| | **September 30, 2006** | **September 30, 2005** |
|---|---|---|
| Expected life (years): | | |
| Stock options | 4.0 | 4.0 |
| ESPP | 0.5 | 0.5 |
| Volatility: | | |
| Stock options | 55% | 60% |
| ESPP | 55% | 60% |
| Risk-free interest rate | 4.85% | 3.52% |
| Dividend yield | 0.00% | 0% |

During the period ended September 30, 2006, there were 16,664 stock option grants.

The following table illustrates on a post reverse stock split basis, the effect on net income (loss) and net income (loss) per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation (in thousands, except per share data):

| | | Three Months September 30 2005 | | Six Months September 30 2005 |
|---|---|---|---|---|
| Net loss as reported | $ | (2,681) | $ | (5,188) |
| Add: Stock-based employee compensation expense included in Reported net loss | | 1,004 | | 1,004 |
| Deduct: Total stock-based employee compensation expense Determined under fair value method for all awards | | (1,533) | | (2,084) |
| Proforma net loss | $ | (3,210) | $ | (6,268) |
| Basic net loss per share: | | | | |
| As reported | $ | (0.51) | $ | (1.13) |
| Proforma | $ | (0.61) | $ | (1.36) |

The disclosure provisions of SFAS No. 123R and SFAS No. 148 require judgments by management as to the estimated lives of the outstanding options. Management has based the estimated life of the options on historical option exercise patterns. If the estimated life of the options increases, the valuation of the options will increase as well.

***Stock Options & Warrants***

A summary of stock option and warrant activity during the quarter ended September 30, 2006 is as follows:

| | Shares | | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (in Years) | | Aggregate Intrinsic Value |
|---|---|---|---|---|---|---|
| **BEGINNING OUTSTANDING** | 2,280,208 | $ | 13.54229 | | | |
| **GRANTED** | | | | | | |
| Price < Market Value | 0 | $ | 0.00000 | | | |
| Price = Market Value | 16,664 | $ | 4,68000 | | | |
| Price > Market Value | 0 | $ | 0.00000 | | | |
| Total | 16,664 | $ | 4,68000 | | | |
| **EXERCISED** | | $ | 0.00000 | | | |
| **CANCELLED** | | | | | | |
| Forfeited | (2,777) | $ | 8.28000 | | | |
| Expired | (21,464) | $ | 20.65380 | | | |
| Total | (24,241) | $ | 19.23628 | | | |
| **ENDING OUTSTANDING** | 2,272,631 | $ | 13.41657 | 4.88 | $ | 0.00 |
| **ENDING VESTED + EXPECTED TO VEST** | 2,260,911 | $ | 13.42443 | 0.09 | $ | 0.00 |
| **ENDING EXERCISABLE** | 2,092,357 | $ | 13.61673 | 4.69 | $ | 0.00 |

The aggregate intrinsic value of options and warrants outstanding at September 30, 2006 is calculated as the difference between the exercise price of the underlying options and the market price of our common stock as of September 30, 2006.

The following table summarizes information with respect to stock options and warrants outstanding as of September 30, 2006:

| Range of Exercise Prices | | Number Outstanding As of September 30, 2006 | Weighted Average Remaining Contractual Term (in years) | Weighted Average Exercise Price | Number Exercisable As of September 30, 2006 | Weighted Average Exercise Price As of September 30, 2006 |
|---|---|---|---|---|---|---|
| $4.20 | $7.08 | 228,412 | 5.34 | $6.05 | 176,192 | $5.95 |
| 7.20 | 9.60 | 147,632 | 8.38 | 8.31 | 101,107 | 8.32 |
| 12.00 | 12.00 | 1,284,990 | 3.93 | 12.00 | 1,284,990 | 12.00 |
| 12.36 | 12.96 | 242,335 | 7.26 | 12.43 | 196,783 | 12.43 |
| 13.20 | 25.68 | 236,044 | 6.84 | 16.74 | 200,067 | 16.17 |
| 27.00 | 82.56 | 124,476 | 1.41 | 37.38 | 124,476 | 37.38 |
| 92.26 | 92.26 | 416 | 3.44 | 92.25 | 416 | 92.26 |
| 92.52 | 92.52 | 4,165 | 3.38 | 92.52 | 4,165 | 92.52 |
| 99.00 | 99.00 | 2,498 | 3.49 | 99.00 | 2,498 | 99.00 |
| 105.00 | 105.00 | 1,663 | 2.23 | 105.00 | 1,663 | 105.00 |
| | | | | | | |
| $4.20 | $105.00 | 2,272,631 | 4.88 | $13.42 | 2,092,357 | $13.61673 |

**Restricted Stock Units**

The following table summarizes our restricted stock award activity for the period ended September 30, 2006:

| | Number of Shares | Weighted Avg. Grant Date Fair Value |
|---|---|---|
| Balance, June 30, 2006 | 62,500 | $ 9.82 |
| Granted | — | — |
| Vested | 16,666 | — |
| Forfeited | — | — |
| Released | (33,333) | $ 9.96 |
| Balance, September 30,2006 | 45,833 | $ 9.68 |

**Unvested restricted stock at September 30, 2006**

As of September 30, 2006, there was $51 of total unrecognized compensation cost related to restricted stock which is expected to be recognized during the current fiscal year. As of September 30, 2006, there were a total of 6,250 restricted shares subject to performance conditions that will result in forfeiture if the conditions are not realized.

**2. Inventories:**

Inventories are stated at the lower of cost or market, reduced by provisions for excess and obsolescence. Cost is computed using standard cost, which approximates actual cost on a first-in, first-out basis and includes material, direct labor and manufacturing overhead costs.

The estimate of the effect of excess and obsolescence on the carrying values of our inventories is based upon projected future demand and market conditions. A provision has been established for related inventories in excess of production demand. Should actual production demand differ from estimates, additional inventory write-downs may be required. The status of this reserve is reviewed on an on-going basis, any excess and obsolete provision is released only if and when the related inventory is sold or scrapped. During the six months ending September 30, 2006 the reserve was reduced by $2,594, the Company sold or scrapped previously reserved inventory of $2,255 and adjusted the reserve balance for a change in manufacturing overhead related to improved plant efficiencies by $339. The reserve balance at September 2006 is $4,542. At March of 2006 the reserve was at $7,136.

Inventories for the periods presented consisted of:

| | September 30 2006 | March 31 2006 |
|---|---|---|
| Raw materials | $ 704 | $ 1,692 |
| Work in progress | 5,324 | 4,173 |
| Finished goods and spares | 1,752 | 1,835 |
| | $ 7,780 | $ 7,700 |

We periodically analyze any systems that are in finished goods inventory to determine if they are suitable for current customer requirements. At the present time, our policy is that, if after approximately 18 months, we determine that a sale will not take place within the next 12 months and the system would be useable for customer demonstrations or training, it is transferred to fixed assets. Otherwise, it is expensed.

**3. Product Warranty:**

The Company provides warranty on all system sales based on the estimated cost of product warranties at the time revenue is recognized. The warranty obligation is affected by product failure rates, material usage rates, and the efficiency by which the product failure is corrected. Should actual product failure rates, material usage rates and labor efficiencies differ from estimates, revisions to the estimated warranty liability may be required.

Warranty activity for the three and six month periods ended September 30, 2006 and 2005 was:

| | Warranty Activity for the Three Months Ended September 30, | | Warranty Activity for the Six Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Balance at the beginning of the period | $ 668 | $ 238 | $ 723 | $ 252 |
| Additional warranty accruals for warranties issued during the period | 247 | 166 | 498 | 211 |
| Settlements made during the period | (116) | (89) | (422) | (148) |
| Balance at the end of the period | $ 799 | $ 315 | $ 799 | $ 315 |

Certain of the Company's sales contracts include provisions under which customers would be indemnified by the Company in the event of, among other things, a third-party claim against the customer for intellectual property rights infringement related to the Company's products. There are no limitations on the maximum potential future payments under these guarantees. The Company has accrued no amounts in relation to these provisions as no such claims have been made and the Company believes it has valid, enforceable rights to the intellectual property embedded in its products.

**4. Net Loss per Common Share:**

Basic net loss per common share is computed using the weighted-average number of shares of common stock outstanding. The following table represents the calculation of basic and diluted net loss per common share (in thousands, except per share data):

| | Three Months Ended September 30, 2006 | Six Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Six Months Ended September 30, 2005 |
|---|---|---|---|---|
| Net loss applicable to common stockholders | $ (3,281) | $ (5,083) | $ (2,681) | $ (5,188) |
| Basic and diluted: | | | | |
| Weighted-average common shares outstanding (adjusted to reflect 1 to 12 reverse stock split) | 7,045 | 7,029 | 5,227 | 4,608 |
| Weighted-average common shares used in computing basic and diluted net loss per common share | 7,045 | 7,029 | 5,227 | 4,608 |
| Basic and diluted net loss per common share | $ (0.47) | $ (0.72) | $ (0.51) | $ (1.13) |

Outstanding options, warrants and restricted stock equivalent of 2,318,464 and 2,410,092 shares of common stock at a weighted-average exercise price of $13.54 and $15.04 per share on September 30, 2006 and 2005 respectively, were not included in the computation of diluted net loss per common share for the periods presented as a result of their anti-dilutive effect. Such securities could potentially dilute earnings per share in future periods.

**5. Stock-Based Transactions:**

***Issuance of Warrants to Consultants***

The Company is party to a contract with certain consultants pursuant to which the Company will issue warrants on a monthly basis in lieu of cash payments through January 2008, depending upon the continuation of the contract and the achievement of certain performance goals. The maximum number of warrants to be issued under these agreements is 33,333 shares. During the three months ended September 30, 2006, and September 30, 2005, 4,165 and 7,083 warrants respectively, were granted to be purchased valued at $13 and $53 respectively. During the six months ended September 30, 2006 and September 30, 2005, 10,832 and 14,167 shares valued at $47 and $137 respectively. These values were calculated using the Black-Scholes model with an exercise price at the market value on the day of the grant. The life of the warrants is five and seven years with an interest rate of 4.51% and volatility of 118% and 115% respectively. None of these warrants have been exercised as of September 30, 2006.

**6. Lines of Credit:**

As of September 30, 2006, our Japanese subsidiary had $20 outstanding under its lines of credit which is collateralized by Japanese customer promissory notes held by such subsidiary in advance of payment on customers' accounts receivable. The credit line has a total borrowing capacity of 150 million yen (approximately $1,271 at exchange rates prevailing on September 30, 2006), which are secured by Japanese customer promissory notes held by such subsidiary in advance of payment on customers' accounts receivable. The Japanese bank line bears interest at Japanese prime (1.625% as of September 30, 2006) plus 0.875%.

Notes payable as of September 30, 2006 consisted of capital lease obligations on fixed assets totaling $7.

**7. Legal Proceedings**

Sputtered Films Inc. v. Advanced Modular Sputtering , et al., filed in Santa Barbara County Superior Court.

On December 22, 2003, Sputtered Films, Inc. ("SFI"), a wholly owned subsidiary of the Company, filed an action against two former employees, Sergey Mishin and Rose Stuart-Curran, and a company they formed after leaving their employment with SFI named Advanced Modular Sputtering, Inc. ("AMS"). Sergey Mishin and Rose Stuart-Curran had each signed confidentiality and non-disclosure agreements regarding information obtained while employed by SFI. The action contains causes of action for specific performance, breach of contract, breach of the covenant of good faith and fair dealing, misappropriation of trade secrets, unfair competition, unfair business practices, interference with prospective economic advantage, conversion, unjust enrichment, and declaratory relief. These claims arise out of information SFI received evidencing that AMS possessed and used SFI's confidential, proprietary and trade secret drawings, specifications and technology to manufacture the sputtering tool marketed by AMS.

During 2004 and 2005, this litigation was largely stalled while AMS and Agilent Technologies, Inc. contested SFI's right to conduct discovery. This dispute was resolved in late 2005 when the California Court of Appeal affirmed SFI's trade secrete identification as statutorily sufficient. On November 18, 2005, SFI requested leave to add Agilent Technologies, Inc. ("Agilent") as a defendant based on evidence that Agilent and AMS co-developed the machines which SFI contends were built using SFI proprietary information. The Court granted SFI's request and Agilent was served as a Doe defendant on December 12, 2005. In early December, SFI learned that Agilent transferred its Semiconductor Products Group to a number of Avago entities effective December 1, 2005, and accordingly SFI sought and received court approval to add Avago Technologies U.S., Inc. and Avago Technologies Wireless (U.S.A.) Manufacturing, Inc (collectively the "Avago Entities") as defendant in this action. On April 25, 2006, the Avago Entities filed a Cross-Complaint against SFI and Tegal Corporation alleging causes of action for breach of contract, trade secret misappropriation, unfair competition, conversion, unjust enrichment and declaratory relief. The Cross-Complaint alleges on information and belief that SFI misused information obtained from Hewlett-Packard in connection with Hewlett-Packard's request to purchase SFI machines or to upgrade SFI machines Hewlett-Packard already owned.

On November 13, 2006, following commencement of the trial, all the parties in the litigation agreed on terms of a settlement, which was filed with the court. The settlement terms provide for a payment to the Company of approximately $13 million, net of fees and certain expenses associated with the litigation. The settlement also calls for the transfer of assets related to PVD technology from AMS to SFI and the dissolution of AMS as of March 1, 2007. The Avago Cross-Complaint was also dismissed as part of the settlement.

**8. Geographical Information**

Tegal operates in one segment for the manufacture, marketing and servicing of integrated circuit fabrication equipment. In accordance with SFAS No. 131 (SFAS 131) “Disclosures about Segments of an Enterprise and Related Information,” Tegal’s chief operating decision-maker has been identified as the President and Chief Executive Officer, who reviews operating results to make decisions about allocating resources and assessing performance for the entire company. All material operating units qualify for aggregation under SFAS 131 due to their identical customer base and similarities in: economic characteristics; nature of products and services; and procurement, manufacturing and distribution processes. Since Tegal operates in one segment and in one group of similar products and services, all financial segment and product line information required by SFAS 131 can be found in the condensed consolidated financial statements.

For geographical reporting, revenues are attributed to the geographic location in which the customers’ facilities are located. Long-lived assets consist primarily of property, plant and equipment, and are attributed to the geographic location in which they are located. Net sales and long-lived assets by geographic region were as follows:

| | Revenue for the Three Months Ended September 30, | | Revenue for the Six Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Sales to customers located in: | | | | |
| United States | $ 1,414 | $ 1,416 | $ 3,762 | $ 1,743 |
| Asia, excluding Japan | 1,737 | 199 | 4,612 | 339 |
| Japan | 1,152 | 500 | 1,676 | 1,078 |
| Europe | 810 | 4,291 | 1,639 | 6,298 |
| Total sales | $ 5,113 | $ 6,406 | $ 11,689 | $ 9,458 |

| | Long-lived Assets as of September 30, | |
|---|---|---|
| | 2006 | 2005 |
| Long-lived assets at period-end: | | |
| United States | $ 2,461 | $ 4,573 |
| Europe | 13 | 12 |
| Japan | 9 | 9 |
| Asia, excluding Japan | 0 | 4 |
| Total long-lived assets | $ 2,483 | $ 4,598 |

**9. Comprehensive Income (Loss):**

The components of comprehensive loss for the three and six months ended September 30, 2006 and 2005 are as follows:

| | Three Months Ended September 30, | | Six Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Net loss | $ (2,901) | $ (2,681) | $ (4,703) | $ (5,188) |
| Foreign currency translation adjustment | (50) | 219 | (389) | 393 |
| Total comprehensive loss | $ (2,951) | $ (2,462) | $ (5,092) | $ (4,795) |

**10. Recent Accounting Pronouncements**

In February 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 155 *"Accounting for Certain Hybrid Financial Instruments"* ("SFAS 155"), an amendment of FASB Statements No. 133 and 140. SFAS 155 will be effective for the Company beginning in the first quarter of 2007. SFAS 155 permits interests in hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation, to be accounted for as a single financial instrument at fair value, with changes in fair value recognized in earnings. This election is permitted on an instrument-by-instrument basis for all hybrid financial instruments held, obtained, or issued as of the adoption date. The Company is assessing the impact of the adoption of SFAS 155.

In June 2006, the FASB ratified the consensus reached on Emerging Issues Task Force ("EITF") Issue No. 06-3, *"How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)"*. The scope of EITF Issue No. 06-3 includes any transaction-based tax assessed by a governmental authority that is imposed concurrent with or subsequent to a revenue-producing transaction between a seller and a customer. The scope does not include taxes that are based on gross receipts or total revenues imposed during the inventory procurement process. Gross versus net income statement classification of that tax is an accounting policy decision and a voluntary change would be considered a change in accounting policy requiring the application of SFAS No. 154, *"Accounting Changes and Error Corrections"*. The following disclosures will be required for taxes within the scope of this issue that are significant in amount: (1) the accounting policy elected for these taxes and (2) the amounts of the taxes reflected gross (as revenue) in the income statement on an interim and annual basis for all periods presented. The EITF Issue No. 06-3 ratified consensus is effective for interim and annual periods beginning after December 15, 2006. We do not expect the adoption of EITF Issue No. 06-3 to have a material impact on our Condensed Consolidated Financial Statements.

In June 2006, the FASB issued FASB Interpretation No. 48 *"Accounting For Uncertain Tax Positions".* An Interpretation of FASB Statement No. 109 ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109 *"Accounting for Income Taxes."* It prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of FIN 48 to its financial position and results of operations.

In September 2006, the FASB issued SFAS No. 157, *"Fair Value Measurements"* ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements; rather, it applies under other accounting pronouncements that require or permit fair value measurements. The provisions of SFAS 157 are to be applied prospectively as of the beginning of the fiscal year in which it is initially applied, with any transition adjustment recognized as a cumulative-effect adjustment to the opening balance of retained earnings. The provisions of SFAS 157 are effective for fiscal years beginning after November 15, 2007; therefore, the Company anticipates adopting SFAS 157 as of January 1, 2008. The Company is assessing the impact of the adoption of SFAS 157.

In September 2006, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 108 ("SAB 108"), *"Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements."* SAB 108 is effective for fiscal years ending on or after November 15, 2006 and addresses how financial statement errors should be considered from a materiality perspective and corrected. The literature provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. Historically, there have been two approaches commonly used to quantify such errors: (i) the "rollover" approach, which quantifies the error as the amount by which the current year income statement is misstated, and (ii) the "iron curtain" approach, which quantifies the error as the cumulative amount by which the current year balance sheet is misstated. The SEC Staff believes that companies should quantify errors using both approaches and evaluate whether either of these approaches results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. The Company is currently evaluating the impact, if any, of adopting the provisions of SAB 108 on our consolidated financial position, results of operations and liquidity.

**11. Subsequent Events**

On November 13, 2006, Sputtered Films, Inc. ("SFI"), a wholly owned subsidiary of the Company, agreed to the terms of a settlement of its trade secrets case against Sergey Mishin, Advanced Modular Sputtering (AMS), Agilent Technologies, Inc., Avago Technologies U.S., Inc., Avago Technologies Wireless (U.S.A) Manufacturing, Inc. and other defendants. All the parties in the litigation agreed on the terms of a settlement, which was filed with the Santa Barbara County Superior Court. The settlement terms provide for a payment to the Company of approximately $13 million, net of fees and certain expenses associated with the litigation. The settlement also calls for the transfer of assets related to PVD technology from AMS to SFI and the dissolution of AMS as of March 1, 2007. The Avago Cross-Complaint was also dismissed as part of the settlement.

**Item 2.** ***Management's Discussion and Analysis of Financial Condition and Results of Operations***

**Special Note Regarding Forward Looking Statements**

Information herein contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, which can be identified by the use of forward-looking terminology such as "may," "will," "expect," "anticipate," "estimate," or "continue" or the negative thereof or other variations thereon or comparable terminology or which constitute projected financial information. The forward-looking statements relate to the near-term semiconductor capital equipment industry outlook, demand for our products, our quarterly revenue and earnings prospects for the near-term future and other matters contained herein. Such statements are based on current expectations and beliefs and involve a number of uncertainties and risks that could cause the actual results to differ materially from those projected. Such uncertainties and risks include, but are not limited to, cyclicality of the semiconductor industry, impediments to customer acceptance of our products, fluctuations in quarterly operating results, competitive pricing pressures, the introduction of competitor products having technological and/or pricing advantages, product volume and mix and other risks detailed from time to time in our SEC reports, including in the section entitled "Risk Factors" elsewhere in this report. For further information, refer to the business description and risk factors described below. All forward-looking statements are expressly qualified in their entirety by the cautionary statements in this paragraph.

Tegal designs, manufactures, markets and services plasma etch and deposition systems that enable the production of integrated circuits ("ICs"), memory and related microelectronics devices used in personal computers, wireless voice and data telecommunications, contact-less transaction devices, radio frequency identification devices ("RFID's"), smart cards, data storage and micro-level actuators. Etching and deposition constitute two of the principal IC and related device production process steps and each must be performed numerous times in the production of such devices.

**Semiconductor Industry Background**

Over the past twenty years, the semiconductor industry has experienced significant growth. This growth has resulted from the increasing demand for ICs from traditional IC markets, such as personal computers, telecommunications, consumer electronics, automotive electronics and office equipment, as well as developing markets, such as wireless communications, multimedia and portable and network computing. As a result of this increased demand, semiconductor device manufacturers have periodically expended significant amounts of capital to build new semiconductor fabrication facilities ("fabs") and to expand existing fabs. More recently, growth has slowed, and there are signs that the industry is beginning to mature. While unit demand for semiconductor devices continue to rise, the average selling prices of chips continue to decline. There is growing pressure on semiconductor device manufacturers to reduce manufacturing costs while increasing the value of their products. The semiconductor industry has also been historically cyclical, with periods of rapid expansion followed by periods of over-capacity.

Growth in the semiconductor industry has been driven, in large part, by advances in semiconductor performance at a decreasing cost per function. Advanced semiconductor processing technologies increasingly allow semiconductor manufacturers to produce ICs with smaller features, thereby increasing processing speed and expanding device functionality and memory capacity. As ICs have become more complex, however, both the number and price of state of the art process tools required to manufacture ICs have increased significantly. As a result, the cost of semiconductor manufacturing equipment has become an increasingly large part of the total cost of producing advanced ICs.

To create an IC, semiconductor wafers are subjected to a large number of complex process steps. The three primary steps in manufacturing ICs are (1) deposition, in which a layer of insulating or conducting material is deposited on the wafer surface, (2) photolithography, in which the circuit pattern is projected onto a light sensitive material (the photoresist), and (3) etch, in which the unmasked parts of the deposited material on the wafer are selectively removed to form the IC circuit pattern.

Each step of the manufacturing process for ICs requires specialized manufacturing equipment. Today, plasma-based systems are used for the great majority of both deposition and etching processes. During physical vapor deposition (also known as "PVD"), the semiconductor wafer is exposed to a plasma environment that forms continuous thin films of electrically insulating or electrically conductive layers on the semiconductor wafer. During a plasma etch process (also known as "dry etch"), a semiconductor wafer is exposed to a plasma composed of a reactive gas, such as chlorine, which etches away selected portions of the layer underlying the patterned photoresist layer.

**Business Strategy**

Our business objective is to utilize the unique technologies that we have developed internally or acquired externally in order to increase our market share in process equipment for both semiconductor manufacturing and nanotechnology device fabrication. The following are key elements of our strategy:

*Maintain our Technology Leadership Position in New Materials Etch* - We have become a leading provider of etch process solutions for a set of new materials central to the production of an array of advanced semiconductor and nanotechnology devices in emerging markets. Incorporation of these new materials is essential to achieving the higher device densities, lower power consumption and novel functions exhibited by the newest generation of cell phones, computer memories, fiber optic switches and remote sensors. Currently, we are the leading supplier of etch solutions to makers of advanced "non-volatile" ferro-electric ("FeRAM"), magnetic ("MRAM") devices, and virtually all other types of non-volatile memories. FeRAM is just now entering commercial production with chips for the newest generation of cell phones, PDA's, smart cards and RFIDs, used for applications such as railway passes and ink jet cartridge tracking. Our new materials expertise also includes the etching of so-called "compound-semi" materials, such as GaAs, GaN and InP, widely used in telecom device production. In addition, we are known for our capability to etch certain noble metals, such as gold and platinum, as well as certain proprietary compound metals. This capability is increasingly important in advanced memory development and in the production of Micro-Electrical Mechanical Systems ("MEMS"), a type of commercially produced nanotechnology device, especially useful to the automotive industry.

*Strengthen our Position in Deposition Process Equipment for Advanced Packaging Applications* -- Since 2002, we have completed two acquisitions of deposition products incorporating the same unique "sputter-up" technology. This technology is directed principally at so-called "back-end" semiconductor manufacturing processes, including backside metallization and underbump metal processes, for both 200-mm and 300-mm wafer sizes. These processes are important to advanced, wafer-level packaging schemes, which are increasingly being used for high-pin-count logic and memory devices.

*Introduce a New Product into Established Equipment Market* -- The continued development of our recently acquired NLD technology represents our belief that we have a compelling solution to a critical process need in present-day and future semiconductor device fabrication. As device geometries continue to shrink, conventional chemical vapor deposition ("CVD") process equipment is increasingly incapable of depositing thin conformal films in high-aspect ratio trenches and vias. Atomic Level Deposition ("ALD") is one technology for satisfying this deposition requirement. However, ALD has several shortcomings, including low throughput and limitations on film type and quality, which we believe our NLD technology overcomes.

*Maintain our Service Leadership Position* -- Tegal has been consistently recognized by our customers for providing a high level of customer support, a fact that has been noted by our top rankings for several consecutive years in the annual survey conducted by VLSI Research, Inc. We expect to maintain and build on this reputation as we seek new customers in both emerging and established markets.

**Critical Accounting Policies**

Our discussion and analysis of the financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to inventory, warranty obligations, purchase order commitments, bad debts, income taxes, intangible assets, restructuring and contingencies and litigation. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our condensed consolidated financial statements:

**Accounting for Stock-Based Compensation**

Prior to April 1, 2006, we accounted for stock-based employee compensation plans under the measurement and recognition provisions of Accounting Principles Board Opinion No.25, "Accounting for Stock Issued to Employees," or APB25, and related Interpretations, as permitted by SFAS No.123, "Accounting for Stock-Based Compensation", or SFAS No.123. With the exception of certain warrants granted and grants of restricted stock awards, we generally, recorded no stock-based compensation expenses during periods prior to April 1, 2006 as all stock-based grants had exercise prices equal to the fair market value of our common stock on the date of grant. We also recorded no compensation expense in connection with our employee stock purchase plan as it qualified as a non-compensatory plan following the guidance provided by APB25. In accordance with SFAS123 and SFAS 148, "Accounting for Stock-Based Compensation - Transition and Disclosure", we disclosed our net loss per share as if we had applied the fair value based method in measuring compensation expense for our stock-based compensation programs. Under SFAS 123, we elected to calculate our compensation expense by applying the Black-Scholes valuation method,

Effective April 1, 2006, we adopted the fair value recognition provisions of SFAS No.123R "Accounting for Stock-Based Compensation", using the modified prospective transition method. Under that method, compensation expense that we recognized for the three months ended September 30, 2006 included: (a) compensation expense for all share-based payment granted prior to but not yet vested as of April 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation expense for all share-based payments granted on or modified after April 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS123R. Compensation expense is recognized only for those awards that are expected to vest, whereas prior to the adoption of SFAS123R, we recognized forfeitures as they occurred. In addition, we elected the straight-line attribution method as our accounting policy for recognizing stock-based compensation expense for all awards granted.

We estimate the fair value of options granted using the Black Scholes option valuation and the assumptions shown in Note.1 to our condensed consolidated financial statements. All options are amortized over the requisite service periods of the awards, which are generally the vesting periods.

**Revenue Recognition**

Each sale of our equipment is evaluated on an individual basis in regard to revenue recognition. We have integrated in our evaluation the related interpretative guidance included in Topic 13 of the codification of staff accounting bulletins, and recognize the role of the FASB's Emerging Issues Task Force ("EITF") consensus on Issue 00-21. We first refer to EITF 00-21 in order to determine if there is more than one unit of accounting and then we refer to SAB104 for revenue recognition topics for the unit of accounting. We recognize revenue when persuasive evidence of an arrangement exists, the seller's price is fixed or determinable and collectibility is reasonably assured.

For products produced according to our published specifications, where no installation is required or installation is deemed perfunctory and no substantive customer acceptance provisions exist, revenue is recognized when title passes to the customer, generally upon shipment. Installation is not deemed to be essential to the functionality of the equipment since installation does not involve significant changes to the features or capabilities of the equipment or building complex interfaces and connections. In addition, the equipment could be installed by the customer or other vendors and generally the cost of installation approximates only 1% of the sales value of the related equipment.

For products produced according to a particular customer's specifications, revenue is recognized when the product has been tested and it has been demonstrated that it meets the customer's specifications and title passes to the customer. The amount of revenue recorded is reduced by the amount (generally 10%), which is not payable by the customer until installation is completed and final customer acceptance is achieved.

For new products, new applications of existing products, or for products with substantive customer acceptance provisions where performance cannot be fully assessed prior to meeting customer specifications at the customer site, 100% of revenue is recognized upon completion of installation and receipt of final customer acceptance. Since title to goods generally passes to the customer upon shipment and 90% of the contract amount becomes payable at that time, inventory is relieved and accounts receivable is recorded for the entire contract amount. The revenue on these transactions is deferred and recorded as deferred revenue. We reserve for warranty costs at the time the related revenue is recognized.

Revenue related to sales of spare parts is recognized upon shipment. Revenue related to maintenance and service contracts is recognized ratably over the duration of the contracts. Unearned maintenance and service revenue is included in other accrued liabilities.

**Accounts Receivable - Allowance for Sales Returns and Doubtful Accounts**

We maintain an allowance for doubtful accounts receivable for estimated losses resulting from the inability of our customers to make required payments. If the financial conditions of our customers were to deteriorate, or even a single customer was otherwise unable to make payments, additional allowances may be required.

Our return policy is for spare parts and components only. Customers are allowed to return spare parts if they are defective upon receipt, in accordance with SFAS 48. The potential returns are offset against gross revenue on a monthly basis. Management reviews outstanding requests for returns on a quarterly basis to determine that the reserves are adequate.

**Inventories**

Inventories are stated at the lower of cost or market, reduced by provisions for excess and obsolescence. Cost is computed using standard cost, which approximates actual cost on a first-in, first-out basis and includes material, labor and manufacturing overhead costs. We estimate the effects of excess and obsolescence on the carrying values of our inventories based upon estimates of future demand and market condition. We establish provisions for related inventories in excess of production demand. Should actual production demand differ from our estimates, additional inventory write-downs may be required, as was the case in the current quarter and the fourth quarter of fiscal 2006. Any excess and obsolete provision is released only if and when the related inventories is sold or scrapped. The inventory provision balance at September 30, 2006 and March 31, 2006 was $4,542 and $7,136, respectively. The inventory provision expense for the period ended September 30, 2006 and March 31, 2006 was $(2,142) and $(1,146), respectively.

We periodically analyze any systems that are in finished goods inventory to determine if they are suitable for current customer requirements. At the present time, our policy is that if after approximately 18 months we determine that a sale will not take place within the next 12 months, and the system would be useable for customer demonstrations or training, it is transferred to fixed assets. Otherwise, it is expensed.

The carrying value of systems used for demonstrations or training is determined by assessing the cost of the components that are suitable for sale. Any parts that may be rendered not saleable as a result of such use are removed from the system and are not included in finished goods inventory. The remaining saleable parts are valued at the lower of cost or market, representing the system's net realizable value. The depreciation period for systems that are transferred to fixed assets is determined based on the age of the system and its remaining useful life (typically five to eight years).

**Impairment of Long-Lived Assets**

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If undiscounted expected future cash flows are less than the carrying value of the assets, an impairment loss is recognized based on the excess of the carrying amount over the fair value of the assets.

**Warranty Obligations**

We provide for the estimated cost of our product warranties at the time revenue is recognized. Our warranty obligation is affected by product failure rates, material usage rates and the efficiency by which the product failure is corrected. Should actual product failure rates, material usage rates and labor efficiencies differ from our estimates, revisions to the estimated warranty liability may be required.

**Deferred Taxes**

We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. Based on the uncertainty of future taxable income, we have fully reserved our deferred tax assets. In the event we were to determine that we would be able to realize our deferred tax assets in the future, an adjustment to the deferred tax asset would increase income in the period such determination was made.

**Results of Operations**

The following table sets forth certain financial items as a percentage of revenue for the three and six months ended September 30, 2006 and 2005:

| | Three Months Ended September 30, | | Six Months Ended September 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| Revenue | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of revenue | 53.1 | 61.9 | 58.1 | 67.0 |
| Gross profit | 46.9 | 38.1 | 41.9 | 33.0 |
| Operating expenses: | | | | |
| Research and development | 20.8 | 18.9 | 17.6 | 25.3 |
| Sales and marketing | 18.9 | 11.8 | 17.2 | 14.8 |
| General and administrative | 68.2 | 53.0 | 49.5 | 49.0 |
| Total operating expenses | 107.9 | 83.7 | 84.3 | 89.1 |
| Operating (Loss) | (61.0) | (45.6) | (42.4) | (56.1) |
| Other expense (Income) | (3.0) | (1.3) | (1.1) | (2.2) |
| Net loss | (64.0%) | (46.9%) | (43.5%) | (58.3%) |

The following table sets forth certain financial items for the three and six month periods ended September 30, 2006.

| | Three Months ended September 30, | | Six Months ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Revenue | $ 5,113 | $ 6,406 | $ 11,689 | $ 9,458 |
| Cost of revenue | 2,713 | 3,963 | 6,791 | 6,340 |
| Gross profit | 2,400 | 2,443 | 4,898 | 3,118 |
| Operating expenses: | | | | |
| Research and development | 1,066 | 1,211 | 2,062 | 2,387 |
| Sales and marketing | 964 | 757 | 2,008 | 1,401 |
| General and administrative | 3,485 | 3,398 | 5,787 | 4,638 |
| Total operating expenses | 5,515 | 5,366 | 9,857 | 8,426 |
| Operating Profit (loss) | (3,115) | (2,923) | (4,959) | (5,308) |
| Non-operating expenses | (166) | 242 | (124) | 120 |
| Net income (loss) | $ (3,281) | $ (2,681) | $ (5,083) | $ (5,188) |
| Earnings per share | (0.47) | (0.51) | (0.72) | (1.13) |
| Number of shares outstanding | | | | |
| Basic | 7,045 | 5,227 | 7,029 | 4,608 |
| Diluted | 7,045 | 5,227 | 7,029 | 4,608 |

***Revenue***

The changes in revenue for the three and six months ended September 30, 2006 was principally due to the product mix of systems sold during the period.

International sales as a percentage of the Company's revenue for the three and six months ended September 30, 2006 were 68% and 74%, respectively. We believe that international sales will continue to represent a significant portion of our revenue.

***Gross profit (loss)***

Gross profit as a percentage to revenue for the six months ended September 30, 2006 increased to 42% compared to 33% for the same period last year. During the three months ended September 30, 2006 gross profit as a percentage to revenue was 47% an increase from the 38% for the same period last year. The increase in gross profit as a percentage to revenue is due to the successful reductions in manufacturing overhead and favorable product mix.

***Research and Development***

Research and development expenses consist primarily of salaries, prototype material and other costs associated with our ongoing systems and process technology development, applications and field process support efforts. Spending has been consistent in total dollars, $1,066 for the three months and $2,062 for the six months ending September 30, 2006. Prior year spending was $1,211 and $2,387 respectively.

***Sales and Marketing***

Sales and marketing expenses consist primarily of salaries, commissions, trade show promotion and travel and living expenses associated with those functions. Sales and marketing spending for the three and six months ended September 30, 2006 was $964 and $2,008, respectively. This increase over the prior year periods of $757 and $1,401 respectively represents increased efforts that are being placed on increasing world wide sales.

***General and Administrative***

General and administrative expenses consist primarily of compensation for general management, accounting and finance, human resources, information systems and investor relations functions and for legal, consulting and accounting fees of the Company. The $87 increase over the prior year's three month period and the $1,149 over the prior year's six month period were primarily due to the legal fees relating directly to the litigation against AMS, Agilent, and Avago Technologies. Other factors to the increase relate to a one time lease termination expense of $500 for the reduction of space in the Petaluma facility and the costs associated with moving portions of the operations to San Jose.

***Other income (expense), net***

Other income (expense), net consists principally of, interest income, interest expense, other income, (expense), gains and losses on the disposal of fixed assets, and gains and losses on foreign exchange. We recorded net non-operating expense of $124 for the six months and $166 for the three months ending September 2006. The major component of these expenses was the loss on the disposal of fixed assets.

***Contractual obligation***

The following summarizes our contractual obligations at September 30, 2006, and the effect such obligations are expected to have on our liquidity and cash flows in future periods.

| Contractual obligations: | Total | Less than 1 Year | 1-3 Years | 3-5 Years | After 5 Years |
|---|---|---|---|---|---|
| Non-cancelable capital lease obligations | $ 7 | $ 7 | $ 0 | $ 0 | $ 0 |
| Non-cancelable operating lease obligations | 1,404 | 675 | 654 | 75 | 0 |
| Notes payable and bank lines of credit | 56 | 54 | 2 | 0 | 0 |
| Total contractual cash obligations | $ 1 ,467 | $ 736 | $ 656 | $ 75 | $ 0 |

Certain sales contracts of the Company include provisions under which customers would be indemnified by the Company in the event of, among other things, a third-party claim against the customer for intellectual property rights infringement related to the Company's products. There are no limitations on the maximum potential future payments under these indemnities. The Company has accrued no amounts in relation to these provisions as no such claims have been made and the Company believes it has valid, enforceable rights to the intellectual property embedded in its products.

**Liquidity and Capital Resources**

For the six month period ended September 30, 2006, we financed our operations through the use of outstanding cash balances, borrowings against our credit facilities in Japan and net proceeds from the 2005 PIPE.

As of September 30, 2006, our Japanese subsidiary had $20 outstanding under its lines of credit which is collateralized by Japanese customer promissory notes held by such subsidiary in advance of payment on customers' accounts receivable. The credit line has a total borrowing capacity of 150 million yen (approximately $1,271 at exchange rates prevailing on September 30, 2006), which are secured by Japanese customer promissory notes held by such subsidiary in advance of payment on customers' accounts receivable. The Japanese bank line bears interest at Japanese prime (1.625% as of September 30, 2006) plus 0.875%.

Notes payable as of September 30, 2006 consisted of capital lease obligations on fixed assets totaling $7.

The consolidated financial statements contemplate the realization of assets and the satisfaction of liabilities in the normal course of business. We incurred net losses of $3,281 and $5,083 and $2,681 and $5,188 for the three and six months ended September 30, 2006 and 2005, respectively. We generated negative cash flows from operations of $3,268 and $7,268 for the period ended September 30, 2006 and September 30, 2005, respectively. During the prior fiscal year 2006, we raised a net of $18,161 through the 2005 PIPE. Management believes that these proceeds, combined with projected sales, consolidation of certain operations and continued cost containment will be adequate to fund operations through fiscal 2007. However, projected sales may not materialize and unforeseen costs may be incurred**.** If the projected sales do not materialize, our ability to achieve our intended business objectives may be adversely affected. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded assets or the amount or classification of liabilities or any other adjustments that might be necessary should we be unable to continue as a going concern.

**Item 3.** ***Quantitative and Qualitative Disclosures about Market Risk***

Our cash equivalents are principally comprised of money market accounts. As of September 30, 2006, we had cash and cash equivalents of $10,465. These accounts are subject to interest rate risk and may fall in value if market interest rates increase. We attempt to limit this exposure by investing primarily in short-term securities having a maturity of three months or less. Due to the nature of our cash and cash equivalents, we have concluded that there is no material market risk exposure.

We have foreign subsidiaries that operate and sell our products in various global markets. As a result, our cash flow and earnings are exposed to fluctuations in interest and foreign currency exchange rates. We attempt to limit these exposures through the use of various hedge instruments, primarily forward exchange contracts and currency option contracts (with maturities of less than three months) to manage our exposure associated with firm commitments and net asset and liability positions denominated in non-functional currencies. There have been no material changes regarding market risk since the disclosures made in our Form 10-K for the fiscal year ended March 31, 2006.

At September 30, 2006, the Company had forward exchange contracts maturing at various dates to exchange 64,947 yen into $586.

**Item 4.** ***Controls and Procedures***

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and our management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

(a) *Evaluation of Disclosure Controls and Procedures.* Based on their evaluation as of a date at the end of the quarter covered by this quarterly report on Form 10-Q, the Company’s Chief Executive Officer and Chief Financial Officer have concluded that the Company’s disclosure controls and procedures (as defined in Rules 13a-14(c) under the Securities Exchange Act o f 1934) are effective at the reasonable assurance level.

(b) *Changes in Internal Controls*. There has been no change in the Company’s internal control over financial reporting during the fiscal quarter ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, the Company’s internal controls over financial reporting

## PART II — OTHER INFORMATION

**Item 1.** ***Legal Proceedings***

Sputtered Films, Inc. v. Advanced Modular Sputtering, et al., filed in Santa Barbara County Superior Court.

On December 22, 2003, Sputtered Films, Inc. ("SFI"), a wholly owned subsidiary of the Company, filed an action against two former employees, Sergey Mishin and Rose Stuart-Curran, and a company they formed after leaving their employment with SFI named Advanced Modular Sputtering, Inc. ("AMS"). Sergey Mishin and Rose Stuart-Curran had each signed confidentiality and non-disclosure agreements regarding information obtained while employed by SFI. The action contains causes of action for specific performance, breach of contract, breach of the covenant of good faith and fair dealing, misappropriation of trade secrets, unfair competition, unfair business practices, interference with prospective economic advantage, conversion, unjust enrichment, and declaratory relief. These claims arise out of information SFI received evidencing that AMS possessed and used SFI's confidential, proprietary and trade secret drawings, specifications and technology to manufacture the sputtering tool marketed by AMS.

During 2004 and 2005, this litigation was largely stalled while AMS and Agilent Technologies, Inc. contested SFI's right to conduct discovery. This dispute was resolved in late 2005 when the California Court of Appeal affirmed SFI's trade secrete identification as statutorily sufficient. On November 18, 2005, SFI requested leave to add Agilent Technologies, Inc. ("Agilent") as a defendant based on evidence that Agilent and AMS co-developed the machines which SFI contends were built using SFI proprietary information. The Court granted SFI's request and Agilent was served as a Doe defendant on December 12, 2005. In early December, SFI learned that Agilent transferred its Semiconductor Products Group to a number of Avago entities effective December 1, 2005, and accordingly SFI sought and received court approval to add Avago Technologies U.S., Inc. and Avago Technologies Wireless (U.S.A.) Manufacturing, Inc (collectively the "Avago Entities") as defendant in this action. On April 25, 2006, the Avago Entities filed a Cross-Complaint against SFI and Tegal Corporation alleging causes of action for breach of contract, trade secret misappropriation, unfair competition, conversion, unjust enrichment and declaratory relief. The Cross-Complaint alleges on information and belief that SFI misused information obtained from Hewlett-Packard in connection with Hewlett-Packard's request to purchase SFI machines or to upgrade SFI machines Hewlett-Packard already owned.

On November 13, 2006, following commencement of the trial, all the parties in the litigation agreed on terms of a settlement, which was filed with the court. The settlement terms provide for a payment to the Company of approximately $13 million, net of fees and certain expenses associated with the litigation. The settlement also calls for the transfer of assets related to PVD technology from AMS to SFI and the dissolution of AMS as of March 1, 2007. The Avago Cross-Complaint was also dismissed as part of the settlement.

**Item 1A.** ***Risk Factors***

*We wish to caution you that there are risks and uncertainties that could affect our business. These risks and uncertainties include, but are not limited to, the risks described below and elsewhere in this report, particularly in "Forward-Looking Statements." The following is not intended to be a complete discussion of all potential risks or uncertainties, as it is not possible to predict or identify all risk factors. The risk factors set forth below are also set forth in Part 1, Item 1A of our Annual Report on Form 10-K for the fiscal year ended March 31, 2006. Except for the deletion of the risk factor entitled "If we fail to meet the continued listing requirements of the NASDAQ Stock Market, our stock could be delisted," there have been no material changes made.*

**We have incurred operating losses and may not be profitable in the future; our plans to maintain and increase liquidity may not be successful.**

We incurred net losses of $8.9 million; $15.4 million and $12.6 million for the years ended March 31, 2006, 2005 and 2004, respectively, and generated negative cash flows from operations of $11.7 million, $7.5 million and $3.2 million in these respective years. . If the projected sales do not materialize, we will need to reduce expenses further and raise capital through the issuance of debt or equity securities. If additional funds are raised through the issuance of preferred stock or debt, these securities could have rights, privileges or preferences senior to those of our common stock, and debt covenants could impose restrictions on our operations. Moreover, such financing may not be available to us on acceptable terms, if at all. Failure to raise additional funds may adversely affect our ability to achieve our intended business objectives.

**The exercise of outstanding warrants, options and other rights to obtain additional shares will dilute the value of our shares of common stock and could cause the price of our shares of common stock to decline.**

As of September 30, 2006, there were 7,055,623 shares of our common stock issued and outstanding.

As of September 30, 2006, there were warrants, stock options and restricted stock awards outstanding for approximately 2,318,464 shares of our common stock and there were 1,918,221 shares of common stock reserved for issuance under our equity incentive and stock purchase plans.

The exercise of these warrants and options and the issuance of the common stock pursuant to our equity incentive plans will result in dilution in the value of the shares of our outstanding common stock and the voting power represented thereby. In addition, the exercise price of the warrants may be lowered under the price adjustment provisions in the event of a "dilutive issuance," that is, if we issue common stock at any time prior to their maturity at a per share price below such conversion or exercise price, either directly or in connection with the issuance of securities that are convertible into, or exercisable for, shares of our common stock. A reduction in the exercise price may result in the issuance of a significant number of additional shares upon the exercise of the warrants.

The warrants do not establish a "floor" that would limit reductions in such conversion price or exercise price. The downward adjustment of the exercise price of these warrants could result in further dilution in the value of the shares of our outstanding common stock and the voting power represented thereby.

No prediction can be made as to the effect, if any, that future sales of shares of our common stock, or the availability of shares for future sale, will have on the market price of our common stock prevailing from time to time. Sales of substantial amounts of shares of our common stock in the public market, or the perception that such sales could occur, may adversely affect the market price of our common stock and may make it more difficult for us to sell our equity securities in the future at a time and price which we deem appropriate.

To the extent our stockholders and the other holders of our warrants and options exercise such securities and then sell the shares of our common stock they receive upon exercise, our stock price may decrease due to the additional amount of shares available in the market. The subsequent sales of these shares could encourage short sales by our security holders and others, which could place further downward pressure on our stock price. Moreover, holders of these warrants and options may hedge their positions in our common stock by shorting our common stock, which could further adversely affect our stock price.

**The semiconductor industry is cyclical and may experience periodic downturns that may negatively affect customer demand for our products and result in losses such as those experienced in the past.**

Our business depends upon the capital expenditures of semiconductor manufacturers, which in turn depend on the current and anticipated market demand for integrated circuits. The semiconductor industry is highly cyclical and historically has experienced periodic downturns, which often have had a detrimental effect on the semiconductor industry's demand for semiconductor capital equipment, including etch and deposition systems manufactured by us. Despite a moderate recovery in the industry, we have continued to implement a cost containment program and have completed a corporate-wide restructuring to preserve our cash. However, the need for continued investment in research and development, possible capital equipment requirements and extensive ongoing customer service and support requirements worldwide will continue to limit our ability to reduce expenses in response to any future downturns. As a result, we may continue to experience operating losses such as those we have experienced in the past, which could materially adversely affect us.

**Our competitors have greater financial resources and greater name recognition than we do and therefore may compete more successfully in the semiconductor capital equipment industry than we can.**

We believe that to be competitive, we will require significant financial resources in order to offer a broad range of systems, to maintain customer service and support centers worldwide and to invest in research and development. Many of our existing and potential competitors, including, among others, Applied Materials, Inc., Lam Research Corporation, Novellus and Tokyo Electron Limited, have substantially greater financial resources, more extensive engineering, manufacturing, marketing and customer service and support capabilities, larger installed bases of current generation etch, deposition and other production equipment and broader process equipment offerings, as well as greater name recognition than we do. We cannot assure you that we will be able to compete successfully against these companies in the United States or worldwide.

**Our potential customers may not adopt our products because of their significant cost or because our potential customers are already using a competitor's tool.**

A substantial investment is required to install and integrate capital equipment into a semiconductor production line. Additionally, we believe that once a device manufacturer has selected a particular vendor's capital equipment, that manufacturer generally relies upon that vendor's equipment for that specific production line application and, to the extent possible, subsequent generations of that vendor's systems. Accordingly, it may be extremely difficult to achieve significant sales to a particular customer once that customer has selected another vendor's capital equipment unless there are compelling reasons to do so, such as significant performance or cost advantages. Any failure to gain access and achieve sales to new customers will adversely affect the successful commercial adoption of our products and could have a detrimental effect on us.

**We depend on sales of our advanced products to customers that may not fully adopt our product for production use.**

We have designed our advanced etch and deposition products for customer applications in emerging new films, polysilicon and metal which we believe to be the leading edge of critical applications for the production of advanced semiconductor and other microelectronic devices. Revenues from the sale of our advanced etch and deposition systems accounted for 69%, 30% and 40% of total revenues in fiscal 2006, 2005 and 2004, respectively. Our advanced systems are currently being used primarily for research and development activities or low volume production. For our advanced systems to achieve full market adoption, our customers must utilize these systems for volume production. We cannot assure you that the market for devices incorporating emerging films, polysilicon or metal will develop as quickly or to the degree we expect. If our advanced systems do not achieve significant sales or volume production due to a lack of customer adoption, our business, financial condition, results of operations and cash flows will be materially adversely affected.

**Our customers are concentrated and therefore the loss of a significant customer may harm our business.**

The composition of our top five customers has changed from year to year, but net system sales to our top five customers in each of fiscal 2006, 2005, and 2004 accounted for 68.9%, 80.0% and 84.8%, respectively, of our total net system sales. ST Microelectronics accounted for 54.3% of our total revenue in fiscal 2006. Fujitsu, Western Digital, and RF Micro Devices accounted for 38.2%, 12.8% and 10.1% respectively, of our net system sales in fiscal year 2005. Intel, Fuji Film, and Matsushita accounted for 31.4%, 22.9% and 12.6% respectively, of our net system sales in 2004. ST Microelectronics accounted for 47% of total revenue in the quarter ended September 30, 2006. Other than these customers, no single customer represented more than 10% of our total revenue in fiscal 2006, 2005, and 2004. Although the composition of the group comprising our largest customers may vary from year to year, the loss of a significant customer or any reduction in orders by any significant customer, including reductions due to market, economic or competitive conditions in the semiconductor and related device manufacturing industry, may have a material adverse effect on us.

**Our quarterly operating results may continue to fluctuate.**

Our revenue and operating results have fluctuated and are likely to continue to fluctuate significantly from quarter to quarter, and we cannot assure you that we will achieve profitability in the future.

Our 900 series etch systems typically sell for prices ranging between $250,000 and $600,000, while prices of our 6500 series critical etch systems and our Endeavor deposition systems typically range between $1,500,000 and $3,000,000. To the extent we are successful in selling our 6500 and Endeavor series systems, the sale of a small number of these systems will probably account for a substantial portion of revenue in future quarters, and a transaction for a single system could have a substantial impact on revenue and gross margin for a given quarter.

Other factors that could affect our quarterly operating results include:

· our timing of new systems and technology announcements and releases and ability to transition between product versions;

· seasonal fluctuations in sales;

· changes in the mix of our revenues represented by our various products and customers;

· adverse changes in the level of economic activity in the United States or other major economies in which we do business;

· foreign currency exchange rate fluctuations;

· expenses related to, and the financial impact of, possible acquisitions of other businesses; and

· changes in the timing of product orders due to unexpected delays in the introduction of our customers' products, due to lifecycles of our customers' products ending earlier than expected or due to market acceptance of our customers' products.

**Some of our sales cycles are lengthy, exposing us to the risks of inventory obsolescence and fluctuations in operating results.**

Sales of our systems depend, in significant part, upon the decision of a prospective customer to add new manufacturing capacity or to expand existing manufacturing capacity, both of which typically involve a significant capital commitment. We often experience delays in finalizing system sales following initial system qualification while the customer evaluates and receives approvals for the purchase of our systems and completes a new or expanded facility. Due to these and other factors, our systems typically have a lengthy sales cycle (often 12 to 18 months in the case of critical etch and deposition systems) during which we may expend substantial funds and management effort. Lengthy sales cycles subject us to a number of significant risks, including inventory obsolescence and fluctuations in operating results over which we have little or no control.

**Because technology changes rapidly, we may not be able to introduce our products in a timely manner.**

The semiconductor manufacturing industry is subject to rapid technological change and new system introductions and enhancements. We believe that our future success depends on our ability to continue to enhance our existing systems and their process capabilities, and to develop and manufacture in a timely manner new systems with improved process capabilities. We may incur substantial unanticipated costs to ensure product functionality and reliability early in our products' life cycles. We cannot assure you that we will be successful in the introduction and volume manufacture of new systems or that we will be able to develop and introduce, in a timely manner, new systems or enhancements to our existing systems and processes which satisfy customer needs or achieve market adoption.

**Our financial performance may adversely affect the morale and performance of our personnel and our ability to hire new personnel.**

Our common stock has declined in value below the exercise price of many options granted to employees pursuant to our stock option plans. Thus, the intended benefits of the stock options granted to our employees, the creation of performance and retention incentives, may not be realized. As a result, we may lose employees whom we would prefer to retain. As a result of these factors, our remaining personnel may seek employment with larger, more established companies or companies perceived as having less volatile stock prices.

**We may not be able to protect our intellectual property or obtain licenses for third parties' intellectual property and therefore we may be exposed to liability for infringement or the risk that our operations may be adversely affected.**

Although we attempt to protect our intellectual property rights through patents, copyrights, trade secrets and other measures, we may not be able to protect our technology adequately and competitors may be able to develop similar technology independently. Additionally, patent applications that we may file may not be issued and foreign intellectual property laws may not protect our intellectual property rights. There is also a risk that patents licensed by or issued to us will be challenged, invalidated or circumvented and that the rights granted there under will not provide competitive advantages to us. Furthermore, others may independently develop similar systems, duplicate our systems or design around the patents licensed by or issued to us.

Litigation could result in substantial cost and diversion of effort by us, which by itself could have a detrimental effect on our financial condition, operating results and cash flows. Further, adverse determinations in such litigation could result in our loss of proprietary rights, subject us to significant liabilities to third parties, and require us to seek licenses from third parties or prevent us from manufacturing or selling our systems. In addition, licenses under third parties' intellectual property rights may not be available on reasonable terms, if at all.

**We are exposed to additional risks associated with international sales and operations.**

International sales accounted for 76%, 70% and 67% of total revenue for fiscal 2006, 2005 and 2004, respectively. International sales are subject to certain risks, including the imposition of government controls, fluctuations in the U.S. dollar (which could increase the sales price in local currencies of our systems in foreign markets), changes in export license and other regulatory requirements, tariffs and other market barriers, political and economic instability, potential hostilities, restrictions on the export or import of technology, difficulties in accounts receivable collection, difficulties in managing representatives, difficulties in staffing and managing international operations and potentially adverse tax consequences. We cannot assure you that any of these factors will not have a detrimental effect on our operations, financial results and cash flows.

We generally attempt to offset a portion of our U.S. dollar denominated balance sheet exposures subject to foreign exchange rate re-measurement by purchasing forward currency contracts for future delivery. We cannot assure you that our future results of operations and cash flows will not be adversely affected by foreign currency fluctuations. In addition, the laws of certain countries in which our products are sold may not provide our products and intellectual property rights with the same degree of protection as the laws of the United States.

**Evolving regulation of corporate governance and public disclosure may result in additional expenses and continuing uncertainty.**

Changing laws, regulations and standard relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and Nasdaq Market rules are creating uncertainty for public companies. We continually evaluate and monitor developments with respect to new and proposed rules and cannot predict or estimate the amount of the additional costs we may incur or the timing of such costs. These new or changed laws, regulations and standards are subject to varying interpretations, in many cases due to their lack of specificity, and as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies. This could result in continuing uncertainty regarding compliance matters and higher costs necessitated by ongoing revisions to disclosure and governance practices. We are committed to maintaining high standards of corporate governance and public disclosure. As a result, we have invested resources to comply with evolving laws, regulations and standards, and this investment may result in increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities. If our efforts to comply with new or changed laws, regulations and standards differ from the activities intended by regulatory or governing bodies due to ambiguities related to practice, regulatory authorities may initiate legal proceedings against us and we may be harmed.

**Our stock price is volatile and could result in a material decline in the value of your investment in Tegal.**

We believe that factors such as announcements of developments related to our business, fluctuations in our operating results, sales of our common stock into the marketplace, failure to meet or changes in analysts' expectations, general conditions in the semiconductor industry or the worldwide economy, announcements of technological innovations or new products or enhancements by us or our competitors, developments in patents or other intellectual property rights, developments in our relationships with our customers and suppliers, natural disasters and outbreaks of hostilities could cause the price of our common stock to fluctuate substantially. In addition, in recent years the stock market in general, and the market for shares of small capitalization stocks in particular, have experienced extreme price fluctuations, which have often been unrelated to the operating performance of affected companies. We cannot assure you that the market price of our common stock will not experience significant fluctuations in the future, including fluctuations that are unrelated to our performance.

**Potential disruption of our supply of materials required to build our systems could have a negative effect on our operations and damage our customer relationships.**

Materials delays have not been significant in recent years. Nevertheless, we procure certain components and sub-assemblies included in our systems from a limited group of suppliers, and occasionally from a single source supplier. For example, we depend on MECS Corporation, a robotic equipment supplier, as the sole source for the robotic arm used in all of our 6500 series systems. We currently have no existing supply contract with MECS Corporation, and we currently purchase all robotic assemblies from MECS Corporation on a purchase order basis. Disruption or termination of certain of these sources, including our robotic sub-assembly source, could have an adverse effect on our operations and damage our relationship with our customers.

**Any failure by us to comply with environmental regulations imposed on us could subject us to future liabilities.**

We are subject to a variety of governmental regulations related to the use, storage, handling, discharge or disposal of toxic, volatile or otherwise hazardous chemicals used in our manufacturing process. We believe that we are currently in compliance in all material respects with these regulations and that we have obtained all necessary environmental permits generally relating to the discharge of hazardous wastes to conduct our business. Nevertheless, our failure to comply with present or future regulations could result in additional or corrective operating costs, suspension of production, and alteration of our manufacturing processes or cessation of our operations.

**Item 4.** ***Submission of Matters to a Vote of Security Holders***

On July 21, 2006, the Company held its annual meeting of the stockholders. There were present at the meeting, in person or by proxy, the holders of 78,027,980 shares of common stock of the Company, representing 92.61% of the total votes eligible to be cast, constituting a majority and more than a quorum of the outstanding shares entitled to vote. All shares are presented on a pre-reverse stock split basis.

The following individuals were re-elected to the board of directors:

| | Votes for | Votes Withheld |
|---|---|---|
| Edward A. Dohring | 74,169,000 | 3,858,980 |
| Jeffrey M. Krauss | 74,173,970 | 3,854,010 |
| Brad Mattson | 74,222,650 | 3,805,330 |
| H. Duane Wadsworth | 74,090,024 | 3,937,956 |
| Ralph S. Martin | 74,207,070 | 3,820,910 |

To approve a series of amendments to our Certificate of Incorporation to effect a reverse stock split of our common stock, whereby each outstanding 8 or 12 shares would be combined into one share and to grant authorization to the Board of Directors to determine, at its discretion, the timing and the actual ratio of the reverse stock split; was approved by the stockholders as follows:

| | |
|---|---|
| For | 74,226,512 |
| Against | 5,672,299 |
| Abstain | 133,662 |
| Broker Non Vote | 39,987,396 |

To approve our Eighth Amended and Restated 1998 Equity Participation Plan pursuant to which the plan will be amended to allow for the repricing of issued but unexercised stock options and awards held by employees and consultants; was approved by stockholders as follows:

| | |
|---|---|
| For | 32,234,623 |
| Against | 5,672,299 |
| Abstain | 133,662 |
| Broker Non Vote | 39,987,396 |

To ratify the appointment of Moss Adams LLP as our Independent Registered Public Accounting Firm for the fiscal year ending March 31, 2007; was approved by stockholders as follows:

| | |
|---|---|
| For | 75,808,068 |
| Against | 679,817 |
| Abstain | 1,540,095 |

To transact such other business as may properly come before the meeting or any adjournment or postponement of the meeting.

| | |
|---|---|
| For | 71,029,607 |
| Against | 5,010,227 |
| Abstain | 1,988,146 |

**Item 6.** ***Exhibits***

(a) *Exhibits*

31.1 Certifications of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certifications of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32 Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

TEGAL CORPORATION
(Registrant)

/s/ CHRISTINE HERGENROTHER

Christine Hergenrother
*Chief Financial Officer*

Dated: November 14 , 2006

**EXHIBIT 31.1**

**CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER**
**PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Thomas R. Mika, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Tegal Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-14(e)) for the registrant and we have:

   (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation;

   (c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):

   (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Date: November 14, 2006

/s/ Thomas R. Mika
Chief Executive Officer and President

**EXHIBIT 31.2**

**CERTIFICATION OF THE CHIEF FINANCIAL OFFICER**
**PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Christine Hergenrother, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Tegal Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-14(e)) for the registrant and we have:

   (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation;

   (c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):

   (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Date: November 14, 2006

/s/ Christine Hergenrother
Chief Financial Officer

**EXHIBIT 32**

**CERTIFICATION PURSUANT TO**
**SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**
**(18 U.S.C. SECTION 1350)**

In connection with the Quarterly Report of Tegal Corporation, a Delaware corporation (the “Company”), on Form 10-Q for the quarter ending June 30, 2005 as filed with the Securities and Exchange Commission (the “Report”), I, Thomas R. Mika, President and Chief Executive Officer of the Company, certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to my knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Thomas R. Mika

Chief Executive Officer and President
November 14, 2006

**CERTIFICATION PURSUANT TO**
**SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**
**(18 U.S.C. SECTION 1350)**

In connection with the Quarterly Report of Tegal Corporation, a Delaware corporation (the “Company”), on Form 10-Q for the quarter ending June 30, 2005 as filed with the Securities and Exchange Commission (the “Report”), I, Christine Hergenrother, Chief Financial Officer of the Company, certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to my knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Christine Hergenrother

Chief Financial Officer
November 14, 2006