

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

FORM 10-Q

(Mark One)

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

QUARTERLY  
OF THE

For the quarterly period ended December 31, 2008

or

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

TRANSITION  
OF THE

Commission File Number: 0-26824

**TEGAL CORPORATION**

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

Delaware  
*(State or other jurisdiction of  
incorporation or organization)*

68-0370244  
*(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)*

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, a non-accelerated filer or a smaller reporting company. See definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer  (Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of February 12, 2009 there were 8,412,676 of the Registrant's 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

INDEX

**PART I. FINANCIAL INFORMATION**

**Page**

Item 1.	Condensed Consolidated Financial Statements (Unaudited)	
	Condensed Consolidated Balance Sheets as of December 31, 2008 and March 31, 2008	3
	Condensed Consolidated Statements of Operations for the three months and nine months ended December 31, 2008 and December 31, 2007	4
	Condensed Consolidated Statements of Cash Flows for the nine months ended December 31, 2008 and December 31, 2007	5
	Notes to Condensed Consolidated Financial Statements	6
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	11
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	14

**PART II. OTHER INFORMATION**

Item 1A.	Risk Factors	15
Item 6.	Exhibits	17
	Signatures	18

**PART I — FINANCIAL INFORMATION**

**Item 1. Condensed Consolidated Financial Statements**

**TEGAL CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(Unaudited)  
(In thousands, except per share data)

	<b>December 31, 2008</b>	<b>March 31, 2008</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 12,721	\$ 19,271
Accounts receivable, net of allowances for sales returns and doubtful accounts of \$204 and \$191 at December 31, 2008 and March 31, 2008, respectively	6,233	6,758
Inventories, net	14,061	11,056
Prepaid expenses and other current assets	579	788
Total current assets	<u>33,594</u>	<u>37,873</u>
Property and equipment, net	1,171	1,213
Intangible assets, net	3,670	903
Other assets	72	90
Total assets	<u>\$ 38,507</u>	<u>\$ 40,079</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Capital lease payable	\$ 1	\$ 14
Accounts payable	1,825	1,469
Accrued product warranty	837	1,770
Deferred revenue	254	252
Accrued expenses and other current liabilities	2,545	3,644
Total current liabilities	<u>5,462</u>	<u>7,149</u>
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Preferred stock; \$0.01 par value; 5,000,000 shares authorized; none issued and outstanding	-	-
Common stock; \$0.01 par value; 50,000,000 shares authorized; 8,412,676 and 7,242,736 shares issued and outstanding at December 31, 2008 and March 31, 2008, respectively	84	72
Additional paid-in capital	128,275	123,567
Accumulated other comprehensive loss	(396)	(446)
Accumulated deficit	(94,918)	(90,263)
Total stockholders' equity	<u>33,045</u>	<u>32,930</u>
Total liabilities and stockholders' equity	<u>\$ 38,507</u>	<u>\$ 40,079</u>

See accompanying notes to condensed consolidated financial statements.

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>December 31,</b>		<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Revenue	\$ 4,476	\$ 10,145	\$ 11,215	\$ 25,543
Cost of revenue	3,113	5,725	6,504	15,262
Gross profit	<u>1,363</u>	<u>4,420</u>	<u>4,711</u>	<u>10,281</u>
Operating expenses:				
Research and development expenses	1,142	810	3,423	2,645
Sales and marketing expenses	756	923	2,438	3,208
General and administrative expenses	880	938	3,681	3,589
Total operating expenses	<u>2,778</u>	<u>2,671</u>	<u>9,542</u>	<u>9,442</u>
Operating (loss) income	(1,415)	1,749	(4,831)	839
Other income (expense), net	50	1,085	176	2,049
(Loss) income before income tax expense (benefit)	<u>(1,365)</u>	<u>2,834</u>	<u>(4,655)</u>	<u>2,888</u>
Tax Expense	-	-	-	-
Net (loss) income	<u>\$ (1,365)</u>	<u>\$ 2,834</u>	<u>\$ (4,655)</u>	<u>\$ 2,888</u>
Net (loss) income per share:				
Basic	\$ (0.19)	\$ 0.40	\$ (0.61)	\$ 0.41
Diluted	\$ (0.19)	\$ 0.39	\$ (0.61)	\$ 0.40
Weighted average shares used in per share computation:				
Basic	7,368	7,148	7,569	7,120
Diluted	7,368	7,281	7,569	7,241

See accompanying notes to condensed consolidated financial statements.

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

	<b>Nine Months Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
Cash flows from operating activities:		
Net (Loss) Income	\$ (4,655)	\$ 2,888
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	688	566
Stock compensation expense	701	757
Stock issued under stock purchase plan	19	22
Provision for doubtful accounts and sales returns allowances	13	(255)
Loss on disposal of property and equipment	16	144
Fair value of warrants and options issued for services rendered	--	33
Changes in operating assets and liabilities:		
Accounts receivables	533	(3,297)
Inventories, net	(1,123)	(5,490)
Prepaid expenses and other assets	231	77
Accounts payable	365	(60)
Accrued expenses and other current liabilities	(1,114)	(144)
Accrued product warranty	(997)	896
Litigation suspense	--	(995)
Deferred revenue	2	38
Net cash used in operating activities	(5,321)	(4,820)
Cash flows used in investing activities:		
Purchases of property and equipment	(330)	(378)
Net cash used in AMMS asset acquisition	(1,000)	--
Net cash used in investing activities:	(1,330)	(378)
Cash flows used in financing activities:		
Payments on capital lease financing	(12)	(10)
Net cash used in financing activities	(12)	(10)
Effect of exchange rates on cash and cash equivalents	113	(772)
Net decrease in cash and cash equivalents	(6,550)	(5,980)
Cash and cash equivalents at beginning of period	19,271	25,776
Cash and cash equivalents at end of period	\$ 12,721	\$ 19,796
Supplemental disclosure of non-cash investing activities:		
Shares issued in AMMS asset acquisition	\$ 4,000	\$ -

See accompanying notes to condensed consolidated financial statements.

## TEGAL CORPORATION AND SUBSIDIARIES

### 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, 2008 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 ("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 audited consolidated financial statements and footnotes included in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2008. The results of operations for the three and nine months ended December 31, 2008 are not necessarily indicative of results to be expected for the entire year.

Our consolidated financial statements contemplate the realization of assets and the satisfaction of liabilities in the normal course of business. We had net (loss) income of (\$4,655) and \$2,888 for the nine month periods ended December 31, 2008 and 2007, respectively. We used cash flows from operations of (\$5,321) and (\$4,820) for the periods ended December 31, 2008 and 2007, respectively. In fiscal 2009, we financed our operations from existing cash on hand. In fiscal 2008, we financed our operations from existing cash on hand and from the release of \$14,705 from litigation suspense related to the settlement of the AMS litigation. We believe that these proceeds, combined with continued cost containment, will be adequate to fund operations through the next twelve months. However, projected sales may not materialize and unforeseen costs may be incurred. If the projected sales do not materialize, we will need to reduce expenses further and raise additional 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 common stock, and debt covenants could impose restrictions on our operations. The sale of equity or debt could result in additional dilution to current stockholders, and such financing may not be available to us on acceptable terms, if at all.

#### Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of cash investments and accounts receivable. Substantially all of the Company's liquid investments are invested in money market funds. The Company's accounts receivable are derived primarily from sales to customers located in the United States, 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 December 31, 2008, one customer accounted for approximately 36% of the accounts receivable balance. As of December 31, 2007 two customers accounted for approximately 81% of the accounts receivable balance.

During the quarter ended December 31, 2008, sales to suppliers of substrates and services in the integrated circuit and MEMS sensor markets and manufacturers of high brightness LEDs accounted for 67% of our total revenue. During the quarter ended December 31, 2007 ST Microelectronics and Analog Devices, Inc accounted for 82% of total revenues. During the nine months ended December 31, 2008, a leading supplier in the integrated circuit and MEMS sensor market, SVTC Tech. LLC and Diodes Fab Tech Inc, accounted for 47% of our total revenue. During the nine months ended December 31, 2007 ST Microelectronics accounted for 71% of total revenues.

#### Intangible Assets

Year to date acquisition-related intangibles include patents and trademarks that are amortized on a straight-line basis over periods ranging from 5 years to 15 years. The Company performs an ongoing review of its identified intangible assets to determine if facts and circumstances exist that indicate the useful life is shorter than originally estimated or the carrying amount may not be recoverable. If such facts and circumstances exist, the Company assesses the recoverability of identified intangible assets by comparing the projected undiscounted net cash flow associated with the related asset or group of assets over their remaining lives against their respective carrying amounts. Impairment, if any, is based on the excess of the carrying amount over the fair value of those assets.

#### Stock-Based Compensation

The Company has adopted several stock plans that provide for the issuance of equity instruments to the Company's employees and non-employee directors. The Company's plans include incentive and non-statutory stock options and restricted stock awards and restricted stock units ("RSUs"). Stock options and RSUs generally vest ratably over a four-year period on the anniversary date of the grant, and stock options expire ten years after the grant date. On occasion RSUs may vest on the achievement of specific performance targets. The Company also has an employee stock purchase plan (an "ESPP") that allows qualified employees to purchase Company shares at 85% of the lower of the common stock's market value on specified dates. The stock-based compensation for our ESPP was determined using the Black-Scholes option pricing model and the provisions of Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "*Share Based Payment*", ("SFAS 123R").

Effective April 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123R using the modified prospective transition method.

Total stock-based compensation expense related to stock options and RSUs for the nine months ended December 31, 2008 and 2007 was \$701 and \$757, respectively. Total stock-based compensation expense related to stock options and RSUs for the three months ended December 31, 2008 and 2007 was \$202 and \$66, respectively. The total compensation expense related to non-vested stock options and

RSUs not yet recognized is \$2,005.

The Company used the following valuation assumptions to estimate the fair value of options granted for the periods ended December 31, 2008 and 2007 respectively:

<b>STOCK OPTIONS:</b>	<u>2008</u>	<u>2007</u>
Expected life (years)	6.0	4.0
Volatility	68.3%	96.0%
Risk-free interest rate	2.49%	4.7%
Dividend yield	0%	0%

ESPP awards were valued using the Black-Scholes model with expected volatility calculated using a six-month historical volatility.

<b>ESPP:</b>	<u>2008</u>	<u>2007</u>
Expected life (years)	0.5	0.5
Volatility	117%	58.0%
Risk-free interest rate	0.94%	4.7%
Dividend yield	0%	0%

During the three months ended December 31, 2008, there were 378,847 stock option awards granted.



## Stock Options & Warrants

A summary of stock option and warrant activity during the quarter ended December 31, 2008 is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value
Beginning outstanding	2,266,912	\$ 10.55		
Granted				
Price = market value	378,847	2.33		
Total	378,847	2.33		
Exercised	--	0.00		
Cancelled				
Forfeited	(16,693)	4.36		
Expired	(13,712)	19.04		
Total	<u>(30,405)</u>	10.98		
Ending outstanding	<u>2,615,354</u>	<u>\$ 9.32</u>	<u>4.66</u>	<u>\$-</u>
Ending vested and expected to vest	<u>2,540,451</u>	<u>\$ 9.50</u>	<u>4.52</u>	<u>\$-</u>
Ending exercisable	<u>1,896,225</u>	<u>\$ 11.61</u>	<u>2.90</u>	<u>\$-</u>

The aggregate intrinsic value of stock options and warrants outstanding at December 31, 2008 is calculated as the difference, to the extent greater than zero, between the exercise price of the underlying options and the market price of our common stock as of December 31, 2008.

The following table summarizes information with respect to stock options and warrants outstanding as of December 31, 2008:

Range of Exercise Prices		Number Outstanding	Weighted Average Remaining	Weighted Average	Number Exercisable	Weighted Average Exercise Price
		As of December 31, 2008	Term (in years)	Exercise Price	As of December 31, 2008	As of December 31, 2008
\$ 2.20	\$ 2.20	20,000	9.87	\$ 2.20	--	\$ --
2.34	2.34	358,847	9.85	2.34	--	--
3.44	4.20	286,339	9.12	4.07	57,213	4.13
4.60	4.68	266,593	7.72	4.60	171,479	4.61
5.26	8.28	277,064	4.72	6.65	262,272	6.68
12.00	12.00	1,284,990	1.68	12.00	1,284,990	12.00
12.36	92.26	114,442	2.66	27.60	113,192	27.73
92.52	92.52	4,165	1.13	92.52	4,165	92.52
99.00	99.00	2,498	1.24	99.00	2,498	99.00
105.00	105.00	416	3.73	105.00	416	105.00
\$ 2.20	\$ 105.00	<u>2,615,354</u>	4.66	\$ 9.32	<u>1,896,225</u>	\$ 11.61

As of December 31, 2008, there was \$1,497 of total unrecognized compensation cost related to outstanding options and warrants which is expected to be recognized over a period of 3.24 years.

## Restricted Stock Units

The following table summarizes the Company's RSU activity for the three months ended December 31, 2008:

	Number of Shares	Weighted Average Grant Date Fair Value

Balance, September 30,2008	282,675	\$	3.22
Awarded	-	\$	-
Released	(173,494)	\$	1.67
Forfeited	(7,411)	\$	4.60
Balance December 31,2008	<u>101,770</u>	\$	1.10

**Unvested restricted stock at December 31, 2008**

As of December 31, 2008 there was \$508 of total unrecognized compensation cost related to unvested RSUs which is expected to be recognized over a period of 1.87 years.

## 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, 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 conditions. 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. Any excess and obsolete provision is released only if and when the related inventory is sold or scrapped. During the nine months ended December 31, 2008 and December 31, 2007, the Company sold or scrapped previously reserved inventory of \$154 and \$148, respectively. The inventory provision balance at December 31, 2008 and December 31, 2007 was \$3,541 and \$3,760, respectively.

Inventories for the periods presented consisted of:

	<b>December 31, 2008</b>	<b>March 31, 2008</b>
Raw materials	\$ 6,139	\$ 4,674
Work in progress	4,482	4,663
Finished goods and spares	3,440	1,719
	<u>\$ 14,061</u>	<u>\$ 11,056</u>

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. Warranty activity for the three and nine months ended December 31, 2008 and 2007 is as follows:

	<b>Warranty Activity for the Three Months Ended December 31,</b>		<b>Warranty Activity for the Nine Months Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Balance at the beginning of the period	\$ 947	\$ 1,435	\$ 1,770	\$ 1,101
Additional warranty accruals for warranties issued during the period	273	719	455	2,000
Warranty expense during the period	(383)	(201)	(1,388)	(1,148)
Balance at the end of the period	<u>\$ 837</u>	<u>\$ 1,953</u>	<u>\$ 837</u>	<u>\$ 1,953</u>

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) Income Per Common Share (EPS):

Basic EPS is computed by dividing net (loss) income available to common stockholders (numerator) by the weighted average number of common shares outstanding (denominator) for the period. For periods of net income, diluted EPS gives effect to all dilutive potential common shares outstanding during the period. The computation of diluted EPS uses the average market price of the common stock during the period.

The following table represents the calculation of basic and diluted net loss per common share (in thousands, except per share data):

	<b>Three Months Ended December 31,</b>		<b>Nine Months Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Net (loss) income applicable to common stockholders	\$ (1,365)	\$ 2,834	\$ (4,655)	\$ 2,888
Basic and diluted:				
Weighted-average common shares outstanding	7,368	7,148	7,569	7,120
Plus diluted - common stock equivalents	--	133	--	121

Weighted-average common shares used in diluted net (loss) income per common share	7,368	7,281	7,569	7,241
Basic net (loss) income per common share	\$ (0.19)	\$ 0.40	\$ (0.61)	\$ 0.41
Diluted net (loss) income per common share	\$ (0.19)	\$ 0.39	\$ (0.61)	\$ 0.40

Outstanding options, warrants and RSUs of 2,717,124 and 2,587,953 shares of common stock at a weighted-average exercise price per share of \$9.01 and \$9.74 on December 31, 2008 and 2007 respectively, were not included in the computation of diluted net (loss) income 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 issued no warrants to any party for the nine months ended December 31, 2008. During the nine months ended December 31, 2007 the Company issued 7,500 warrants valued at \$33 using the Black-Scholes model with an exercise price at the market value on the day of the grant and an average interest rate of 4.51%, a volatility rate of 115% and a 5 year life. These warrants remain outstanding.

## 6. Financial Instruments:

We adopted the provisions of Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, (“SFAS 157”) on April 1, 2008. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability (“exit price”) in an orderly transaction between market participants at the measurement date.

In determining fair value, we use various approaches, including market, income and/or cost approaches, and each of these approaches requires certain inputs. SFAS No. 157 establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of us. Unobservable inputs are inputs that reflect our assumptions as compared to the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

Level 1: Quoted market prices in active markets for identical assets or liabilities.

Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data.

Level 3: Unobservable inputs that are not corroborated by market data.

Level 1 primarily consists of financial instruments whose value is based on quoted market prices in active markets for identical assets or liabilities we have the ability to access. This category also includes financial instruments that are valued using alternative approaches but for which the Company typically receives independent external valuation information including U.S. Treasuries, other U.S. Government and agency securities and certain cash instruments such as money market funds and certificates of deposit.

Level 2 includes financial instruments that are valued based on quoted prices of similar investments in active markets or similar or identical investments in markets that are not active or model based valuations for which all significant inputs and value drivers are observable directly or indirectly. Financial instruments in this category include sovereign debt, certain corporate equities, corporate debt, certain U.S. agency and non-agency mortgage-backed securities and non-exchange-traded derivatives such as interest rate swaps.

Level 3 is comprised of financial instruments whose fair value is based on inputs that are unobservable and significant to the overall fair value measurement.

Fair value is a market-based measure considered from the perspective of a market participant who holds the asset or owes the liability rather than an entity-specific measure. Therefore, even when market assumptions are not readily available, our own assumptions are set to reflect those that market participants would use in pricing the asset or liability at the measurement date.

Financial instruments owned and financial instruments sold, but not yet purchased, including contractual commitments arising pursuant to futures, forward and option contracts, interest rate swaps and other derivative contracts, are recorded on a trade-date basis at fair value. Fair value is generally based on quoted market prices. If quoted market prices are not available, fair value is determined based on other relevant factors, including dealer price quotations, price activity for equivalent instruments and valuation pricing models. Valuation pricing models consider time value, yield curve and volatility factors, prepayment speeds, default rates, loss severity, current market and contractual prices for the underlying financial instruments, as well as other measurements.

On September 24, 2008, the Company entered into a foreign exchange contract to sell Euros, which was used to hedge a sales transaction in which costs are denominated in U.S. dollars and the related revenues are generated in Euros. The contract was valued using Level 1 inputs as defined by SFAS No. 157. As of December 31, 2008 the Company concluded the foreign exchange contract for a net gain of \$8.

## 7. AMMS Asset Acquisition

On September 16, 2008, the Company acquired certain assets from Alcatel Micro Machining Systems (“AMMS”) and Alcatel Lucent (“Alcatel”, and together with AMMS, the “Sellers”), pursuant to an Asset Purchase Agreement dated September 2, 2008 between the Company and the Sellers. In connection with the Acquisition, the Company also entered into an Intellectual Property Agreement dated September 16, 2008 between the Company, Alcatel and an affiliate of Alcatel. The Asset Purchase Agreement and the Intellectual Property Agreement were acquired for an aggregate consideration of \$5,000,000 comprised of \$1,000,000 in cash and \$4,000,000 in shares of the Company’s common stock. The 1,044,386 shares of common stock issued to the Seller was calculated by obtaining the quotient of (a) \$4,000,000 divided by (b) the average of the closing sales prices of the Company’s common stock as reported on the Nasdaq Capital Market on the five (5) consecutive trading days immediately preceding the closing date.

In connection with this acquisition, the Company obtained limited rights to use the AMMS trademark pursuant to a trademark license agreement and agreed to purchase certain equipment from an affiliate of the Sellers pursuant to a preferred supplier agreement.

The purchase price was allocated as follows:

Assets acquired:

Trademarks	\$	428
Patents		<u>2,648</u>
Total Intangible Assets		3,076
Fixed Assets		24
Inventory		<u>1,900</u>
Total Tangible Assets		1,924
Total Acquired Assets	\$	<u><u>5,000</u></u>

## 8. Geographical Information

The Company operates in one segment for the manufacture, marketing and servicing of integrated circuit fabrication equipment. In accordance with SFAS No. 131, “Disclosures About Segments of an Enterprise and Related Information,” (“SFAS 131”) the Company’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.

For geographical reporting, revenues are attributed to the geographic location in which the customers’ facilities are located. Long-lived assets consist 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 December 31,		Revenue for the Nine Months Ended December 31,	
	2008	2007	2008	2007
	Sales to customers located in:			
United States	\$ 2,789	\$ 3,315	\$ 7,663	\$ 4,431
Asia	245	6,003	962	9,397
Germany	576	733	751	2,116
Europe, excluding Germany	866	94	1,839	9,599
Total sales	\$ 4,476	\$ 10,145	\$ 11,215	\$ 25,543

	Long-lived Assets as of:	
	December 31, 2008	March 31, 2008
	Long-lived assets at period-end:	
United States	\$ 1,160	\$ 1,195
Europe	11	18
Total long-lived assets	\$ 1,171	\$ 1,213

## 9. Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board, (“FASB”) issued Statement of Financial Standards 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. The Company began complying with SFAS 157 as of April 1, 2008 as follows: Before September 26, 2008, the Company held no derivatives, commodity instruments or other financial instruments for trading purposes. The only assets and liabilities valued using a fair value methodology were related to stock based compensation. The Company has been using this valuation method since April 1, 2006 when it adopted the fair value recognition provisions of SFAS 123R. On September 26, 2008, the Company became a party to a foreign exchange contract to sell Euros. See Note 6 Financial Instruments.

In February 2007, FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Liabilities” (“SFAS 159”). SFAS 159 provides entities with the option to report selected financial assets and liabilities at fair value. Business entities adopting SFAS 159 will report unrealized gains and losses in earnings at each subsequent reporting date on items for which fair value option has been elected. SFAS 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 requires additional information that will help investors and other financial statement users to understand the effect of an entity’s choice to use fair value on its earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. The Company adopted SFAS 159 on April 1, 2008 and chose not to elect the fair value option for its financial assets and liabilities that had not previously been carried at fair value.

In December 2007, FASB issued SFAS No. 141 (revised 2007), “Business Combinations”, (“SFAS 141R”) which replaces SFAS No 141. SFAS 141R retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. SFAS No. 141R is effective for the Company beginning April 1, 2009 and will apply prospectively to business combinations completed on or after that date. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS 162 on its consolidated financial statements.

In December 2007, FASB issued SFAS No. 160, “Noncontrolling Interests in Consolidated Financial Statement, - an amendment of

ARB No. 51", ("SFAS 160") which changes the accounting and reporting for minority interests. Minority interests will be recharacterized as noncontrolling interests and will be reported as a component of equity separate from the parent's equity, and purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement and, upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in earnings. SFAS No. 160 is effective for the Company beginning April 1, 2009 and will apply prospectively, except for the presentation and disclosure requirements, which will apply retrospectively. The Company does not anticipate a material effect to the consolidated financial statements.

In March 2008, FASB issued SFAS No. 161, "*Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*" ("SFAS 161"), which requires enhanced disclosures about an entity's derivative and hedging activities and thereby improves the transparency of financial reporting. The statement requires disclosure about (a) why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133, "*Accounting for Derivative Instruments and Hedging Activities*" and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. SFAS 161 is effective for fiscal years beginning after November 15, 2008. The Company does not anticipate a material effect to the consolidated financial statements.

In May 2008, FASB issued SFAS No. 162 "*The Hierarchy of Generally Accepted Accounting Principles*" ("SFAS 162"). SFAS 162 identifies the sources of generally accepted accounting principles in the United States. SFAS 162 is effective sixty days following the SEC's approval of PCAOB amendments to AU Section 411, "*The Meaning of 'Present fairly in conformity with generally accepted accounting principles'*". The Company is currently evaluating the potential impact, if any, of the adoption of SFAS 162 on its consolidated financial statements.

In May 2008, FASB issued SFAS No. 163, "*Accounting for Financial Guarantee Insurance Contracts*" ("SFAS 163"). The new standard clarifies how SFAS 60, "*Accounting and Reporting by Insurance Enterprises*", applies to financial guarantee insurance contracts issued by insurance enterprises, including the recognition and measurement of premium revenue and claim liabilities. It also requires expanded disclosures about financial guarantee insurance contracts. SFAS 163 is effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the impacts and disclosures of this standard, but does not expect SFAS 163 to have a material effect on the Company's consolidated financial statements.

In June 2007, FASB's Emerging Issues Task Force ("EITF") reached a consensus on EITF Issue No. 07-3, "*Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities*" ("EITF Issue No. 07-3") that would require nonrefundable advance payments made by the Company for future research and development activities to be capitalized and recognized as an expense as the goods or services are received by the Company. EITF Issue No. 07-3 is effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the impacts and disclosures of this standard, but does not expect EITF Issue No. 07-3 to have a material impact on the Company's consolidated financial statements.

In December 2007, FASB ratified the EITF consensus on EITF Issue No. 07-1, "*Accounting for Collaborative Arrangements*" ("EITF Issue 07-01") that discusses how parties to a collaborative arrangement (which does not establish a legal entity within such arrangement) should account for various activities. The consensus indicates that costs incurred and revenues generated from transactions with third parties (i.e., parties outside of the collaborative arrangement) should be reported by the collaborators on the respective line items in their income statements pursuant to EITF Issue No. 99-19, "*Reporting Revenue Gross as a Principal Versus Net as an Agent.*" Additionally, the consensus provides that income statement characterization of payments between the participants in a collaborative arrangement should be based upon existing authoritative pronouncements, analogy to such pronouncements if not within their scope, or a reasonable, rational, and consistently applied accounting policy election. EITF Issue No. 07-1 is effective for fiscal years beginning after December 15, 2008 and is to be applied retrospectively to all periods presented for collaborative arrangements existing as of the date of adoption. The Company is currently evaluating the impacts and disclosures of this standard, but does not expect EITF Issue No. 07-1 to have a material impact on the Company's consolidated financial statements in the current fiscal year.

In April 2008, the FASB issued FASB Staff Position Statement of Financial Accounting Standards 142-3, "*Determination of the Useful Life of Intangible Assets*" ("FSP SFAS 142-3"). FSP SFAS 142-3 provides guidance with respect to estimating the useful lives of recognized intangible assets acquired on or after the effective date and requires additional disclosure related to the renewal or extension of the terms of recognized intangible assets. FSP SFAS 142-3 is effective for fiscal years and interim periods beginning after December 15, 2008. The Company is currently evaluating the impacts and disclosures of this standard, but does not expect FSP SFAS 142-3 to have a material impact on the Company's consolidated financial statements.



## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations – (Amounts in thousands)**

### **Special Note Regarding Forward Looking Statements**

*Information contained or incorporated by reference in this report contains forward-looking statements. These forward-looking statements are based on current expectations and beliefs and involve numerous risks and uncertainties that could cause actual results to differ materially from expectations. These forward-looking statements should not be relied upon as predictions of future events as we cannot assure you that the events or circumstances reflected in these statements will be achieved or will occur. You can identify forward-looking statements 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 which constitutes projected financial information. These forward-looking statements are subject to risks, uncertainties and assumptions about Tegal Corporation including, but not limited to, industry conditions, economic conditions, acceptance of new technologies and market acceptance of Tegal Corporation's products and service. For a discussion of the factors that could cause actual results to differ materially from the forward-looking statements, see the "Part Item 1A—Risk Factors" and the "Liquidity and Capital Resources" section set forth in this section and such other risks and uncertainties as set forth below in this report or detailed in our other SEC reports and filings. We assume no obligation to update forward-looking statements.*

Tegal Corporation, a Delaware corporation ("Tegal" or the "Company"), 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 portable computers, cell phones, PDAs and RFID applications; megapixel imaging chips used in digital and cell phone cameras; power amplifiers for portable handsets and wireless networking gear; and micro-electrical mechanical systems ("MEMS") devices including accelerometers for automotive airbags, microfluidic control devices for ink-jet printers; and laboratory-on-a-chip medical test kits. 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 the industry is maturing as the cost of building new wafer fabs has increased dramatically. Similarly, the rate of semiconductor sales growth has slowed as the industry feels the effects of the current economic environment and average selling prices of chips continue to decline. The industry faces a period of uncertainty with a steep decline in consumer confidence and caution in the enterprise segment. 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. Currently, the industry is experiencing a down-turn, heightened by tighter credit markets and the negative economic environment. These circumstances have caused customers to delay or reconsider expenditures on capital equipment.

Historically, 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 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 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 (i.e., devices smaller than about 100 nanometers). In the recent past, we have focused on competing with more established competitors by being "designed-in" to the advanced device fabrication plans of our customers. We have done so primarily by engaging in research and development activities on behalf of our customers that our more established competitors were unwilling or unable to perform. Many of these advanced devices promise substantial returns as consumer demand for certain functions grows and new markets are created. However, the timing of the emergence of such demand is highly uncertain. In addition, the successful integration by our customers of all the various technical processes required to manufacture a device at an acceptable cost is also highly uncertain. We cannot accurately predict the timing of the stable emergence of these markets. Due to the cyclical nature of our industry, we expect that net orders will continue to fluctuate. In the meantime, our costs for maintaining our research and development efforts and our service and manufacturing infrastructure have remained constant or in some cases increased.

At the present time, we are continuing our transition of the Company's dependence on these highly unpredictable markets to more

established equipment markets, where our success is dependent more on our ability to apply successfully our engineering capabilities to solving existing manufacturing problems. We aim to carefully manage this transition by limiting our research and development efforts to the most promising near-term sales opportunities, while at the same time redirecting all our available resources toward new products aimed at established equipment markets. Because of our relatively small size, our ability to meet the needs of individual customers is far more important to our success than either macroeconomic factors or industry-wide factors such as cyclicalities, although both of these factors affect our performance as well. As a result, our methods of evaluating our progress will continue to be highly customer-focused.

In order to achieve our business strategy, we are focused on the following key elements:

*Maintaining our Technology Leadership Position in New Materials Etch* – We are 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 a leading supplier of etch solutions to makers of various advanced “non-volatile” memories, as well as to device makers incorporating compound metals and certain high-K dielectric materials into their devices. Our new materials expertise also includes the etching of so-called “compound-semi” materials, such as gallium arsenide, gallium nitride and indium phosphide, widely used in telecom device production, as well as expanding use in growth markets such as mobile terminals, digital home appliances as well as enterprise applications, such as wireless local area networks. The advantages of compound semiconductor devices over traditional silicon devices include higher operating speeds, lower power consumption, reduced noise and distortion, higher operable temperature, light emitting and detecting properties, higher light emission efficiency and longer product life. 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”). We intend to maintain our leadership position in new materials etch through our own internal development efforts and through various joint development programs and production efforts with leading device manufacturers.

*Strengthening our Position in Deposition Process Equipment* – Since 2002, we have completed two acquisitions of deposition products incorporating the same unique “sputter-up” technology. In December 2006, as a result of the settlement of our litigation with Advanced Modular Systems (“AMS”) and others, we also acquired the assets and know-how of a similar deposition system. These deposition tools enable the production of highly-oriented, thin piezoelectric films composed of aluminum nitride. Such films are incorporated into high frequency filters called Bulk Acoustic Wave (“BAW”) and Film Bulk Acoustic Resonators (“FBARs”) used in cellular telephone and wireless communications. In addition our PVD products are well-suited for applications within so-called “back-end” semiconductor manufacturing processes, including backside metallization of ultra-thin wafers and underbump metal processes. These processes are important to power devices, as well as certain advanced, wafer-level packaging schemes, which are increasingly being used for high-pin-count logic and memory devices.

*Introducing a New Product into Established Equipment Market* - The continued development of our Nano Layer Deposition (“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. In addition, there appear to be significant applications of our NLD technology in barrier films and high-K materials deposition. 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.

*Maintaining 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 ranking for eight of the last ten 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 and Estimates**

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting 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 ongoing basis, we evaluate our estimates, including those related to revenue recognition, bad debts, sales returns allowance, inventory, intangible and long lived assets, warranty obligations, restructure expenses, deferred taxes and freight charged to customers. 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 are the most significant to the presentation of our consolidated financial statements:

### **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 consensus on Emerging Issues Task Force Issue No. 00-21, “*Accounting for Revenue Arrangements with Multiple Deliverables*” (“EITF Issue 00-21”). We first refer to EITF Issue 00-21 in order to determine if there is more than one unit of accounting and then we refer to Staff Accounting Bulletin (“SAB”) 104 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 collectability 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 deferred revenue.

#### **Accounting for Stock-Based Compensation**

We have adopted several stock plans that provide for issuance of equity instruments to our employees and non-employee directors. Our plans include incentive and non-statutory stock options and restricted stock awards and RSUs. These equity awards generally vest ratably over a four-year period on the anniversary date of the grant, and stock options expire ten years after the grant date. Certain restricted stock awards may vest on the achievement of specific performance targets. We also have an ESPP that allows qualified employees to purchase Tegal shares at 85% of the fair market value on specified dates.

Effective April 1, 2006, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), "*Share Based Payment*" ("SFAS 123R") using the modified prospective transition method.

## Accounts Receivable – Allowance for Sales Returns and Doubtful Accounts

The Company maintains an allowance for doubtful accounts receivable for estimated losses resulting from the inability of the Company's customers to make required payments. If the financial condition of the Company's customers were to deteriorate, or even a single customer was otherwise unable to make payments, additional allowances may be required. As of December 31, 2008 one customer accounted for approximately 36% of the accounts receivable balance. As of December 31, 2007 two customers accounted for approximately 81% of the accounts receivable balance.

The Company's return policy is for spare parts and components only. A right of return does not exist for systems. Customers are allowed to return spare parts if they are defective upon receipt. 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 conditions. 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. Any excess and obsolete provision is released only if and when the related inventories is sold or scrapped. The inventory provision balance at December 31, 2008 and March 31, 2008 was \$3,541 and \$3,760, respectively. During the nine months ended December 31, 2008, and December 31, 2007, the reserve was reduced by \$154 and \$148, respectively when the Company sold or scrapped previously reserved inventory.

The Company periodically analyzes any systems that are in finished goods inventory to determine if they are suitable for current customer requirements. At the present time, the company's policy is that, if after approximately 18 months, it determines 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 unsellable 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. No impairment charge has been recorded for the years ended 2008 and 2007.

## 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. The warranty reserve is based on historical cost data related to warranty. Should actual product failure rates, material usage rates and labor efficiencies differ from our estimates, revisions to the estimated warranty liability may be required. Actual warranty expense is typically low in the period immediately following installation.

## 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 nine months ended December 31, 2008 and 2007:

	Three Months Ended		Nine Months Ended	
	December 31,		December 31,	
	2008	2007	2008	2007
Revenue	100.0%	100.0%	100.0%	100.0%
Cost of revenue	69.6%	56.4%	58.0%	59.8%
Gross profit	30.4%	43.6%	42.0%	40.2%
Operating expenses:				
Research and development	25.5%	8.0%	30.5%	10.4%

Sales and marketing	16.9%	9.1%	21.7%	12.6%
General and administrative	19.7%	9.2%	32.8%	14.1%
Total operating expenses	62.1%	26.3%	85.0%	37.1%
Operating income (loss)	(31.7%)	17.3%	(43.0%)	3.1%
Other income (expense), net	1.1%	10.7%	1.6%	7.9%
Income (loss) before income tax expense (benefit)	(30.6%)	28.0%	(41.4%)	11.0%
Net income (loss)	(30.6%)	28.0%	(41.4%)	11.0%

The following table sets forth certain financial items for the three and nine months ended December 31, 2008 and 2007:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>December 31,</b>		<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Revenue	\$ 4,476	\$ 10,145	\$ 11,215	\$ 25,543
Cost of revenue	3,113	5,725	6,504	15,262
Gross profit	1,363	4,420	4,711	10,281
Operating expenses:				
Research and development expenses	1,142	810	3,423	2,645
Sales and marketing expenses	756	923	2,438	3,208
General and administrative expenses	880	938	3,681	3,589
Total operating expenses	2,778	2,671	9,542	9,442
Operating (loss) income	(1,415)	1,749	(4,831)	839
Other income (expense), net	50	1,085	176	2,049
(Loss) income before income tax expense (benefit)	(1,365)	2,834	(4,655)	2,888
Tax Expense	-	-	-	-
Net (loss) income	\$ (1,365)	\$ 2,834	\$ (4,655)	\$ 2,888
Net (loss) income per share:				
Basic	\$ (0.19)	\$ 0.40	\$ (0.61)	\$ 0.41
Diluted	\$ (0.19)	\$ 0.39	\$ (0.61)	\$ 0.40
Weighted average shares used in per share computation:				
Basic	7,368	7,148	7,569	7,120
Diluted	7,368	7,281	7,569	7,241

### **Revenue**

Revenue of \$4,476 for the three months ended December 31, 2008 decreased by \$5,669 from revenue of \$10,145 for the three months ended December 31, 2007. Revenue for the three months ended December 31, 2008 was mainly from the sale of one new DRIE (Deep Reactive Ion Etch) system, one new 900 series system, and one used DRIE system. Revenue for the three months ended December 31, 2007 resulted principally from the sale of two new advanced series systems, two new 900 series systems and one new Endeavor system ..

Revenue of \$11,215 for the nine months ended December 31, 2008 decreased by \$14,328 from revenue of \$25,543 for the nine months ended December 31, 2007. Revenue for the nine months ended December 31, 2008 resulted from the sale of two new systems (one DRIE and one 900 series) and three used systems (one Advanced Etch, one Endeavor, one DRIE). Revenue for the nine months ended December 31, 2007 resulted principally from the sale of six new advanced series systems and three new 900 series systems, as well as one new Endeavor system and one used Endeavor system.

International sales as a percentage of total revenue for the three and nine months ended December 31, 2008 was approximately 38% and 32% respectively. International sales as a percentage of revenue for the three and nine months ended December 31, 2007 was approximately 67% and 83%, respectively. The decrease in international sales as a percentage of revenue can be attributed to fewer systems sold. The Company typically sells more systems in international markets. Despite this decrease we believe that international sales will continue to represent a significant portion of our revenue.

### **Gross profit**

Gross profit of \$1,363 for the three months ended December 31, 2008 decreased by \$3,057 from gross profit of \$4,420 for the three months ended December 31, 2007, representing a 69% decrease. The decrease in gross profit was attributable to fewer systems sold. Our gross profit margin for the three months ended December 31, 2008 was 30% compared to 44% for the same period last year. The principle reason for the decreased margin was increased costs associated with the introduction and integration of the new DRIE systems acquired from AMMS into our manufacturing structure.

Gross profit of \$4,711 for the nine months ended December 31, 2008 decreased by \$5,570 from the gross profit of \$10,281 for the nine months ended December 31, 2007, representing a 54% decrease. The decrease in gross profit was attributable to fewer systems sold. While our gross profit declined, our gross profit margin for the nine months ended December 31, 2008 was 42% compared to 40% for the same period last year. The principle reason for the increased margin was the specific mix of sales from different products.

Future gross profit and gross margin are highly dependent on the level and product mix included in net revenues. This includes the mix of sales between lower and higher margin products. Accordingly, we are not able to predict future gross profit levels or gross margins with certainty.

### **Research and Development**

Research and development (R&D) 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. The spending increase of \$332 for the three months ended December 31, 2008 compared to the three months ended December 31, 2007 resulted primarily from an increase of R&D project material costs. The spending increase of \$778 for the nine months ended December 31, 2008 compared to the nine months ended

December 31, 2007 resulted primarily from increase of legal cost for patent maintenance and reimbursement for non-recurring engineering work during the first quarter of fiscal 2008. There have not been any engineering reimbursements in fiscal 2009.

### ***Sales and Marketing***

Sales and marketing expenses consist primarily of salaries, commissions, trade show promotion and travel and living expenses associated with those functions. The decrease of \$167 and \$770 in sales and marketing spending for the three and nine months ended December 31, 2008, respectively, as compared to the same periods in 2007 was primarily due to the decrease of sales commission for systems over the same period last year combined with decreased spending on travel expenses and payroll costs.

### ***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 decrease of \$58 in spending for the three months ended December 31, 2008 as compared to the three months ended December 31, 2007 was primarily due to decreases in consulting/outside service fees offset by an increase in legal expenses. The increase of \$92 in spending for the nine months ended December 31, 2008 as compared to the nine months ended December 31, 2007 was primarily due to increases in legal fees related to the purchase of the AMMS assets.

### ***Other income, net***

Other income, net consists of interest income, other income, gains and losses on foreign exchange and gain and losses on the disposal of fixed assets. For the three months ended December 31, 2008 over the three months ended December 31, 2007, other income (expense), net decreased by \$1,035 primarily due to decreased interest income and the closing of the Japanese subsidiary. Other income (expense), net decreased by \$1,873 in the nine months ended December 31, 2008 compared to the nine months ended December 31, 2007. The decrease is primarily related to the change in other income, resulting from recording \$682 from the recognition of foreign exchange differences between current and historical valuations of investment as a result of the dissolution of our Japan subsidiary and a \$278 gain related to the AMS settlement in the prior year period. In the same nine months ended December 31, 2008, interest income decreased by of \$504 compared to the same period in the prior year due to lower cash balances held at lower interest rates. The change in the value of the Euro compared to the U.S. dollar also contributed to the decrease.

### **Contractual Obligation**

The following summarizes our contractual obligations at December 31, 2008, and the effect such obligations are expected to have on our liquidity and cash flows in future periods (in thousands).

Contractual obligations:

	<u>Total</u>	<u>Less than 1 Year</u>	<u>1-3 Years</u>	<u>3-5 Years</u>	<u>After 5 Years</u>
Non-cancelable capital lease obligations	\$ 1	\$ 1	\$ -	\$ -	\$ -
Non-cancelable operating lease obligations	1,012	613	362	37	-
<b>Total contractual cash obligations</b>	<u>\$ 1,013</u>	<u>\$ 614</u>	<u>\$ 362</u>	<u>\$ 37</u>	<u>\$ -</u>

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

### **Liquidity and Capital Resources**

For the nine months ended December 31, 2008, we financed our operations from existing cash on hand. In fiscal 2008 we financed our operations from existing cash on hand and from the release of the net \$14,705 from litigation suspense related to the settlement of the AMS litigation. We received \$19,500 representing the gross cash proceeds from the settlement of the AMS litigation.

The consolidated financial statements contemplate the realization of assets and the satisfaction of liabilities in the normal course of business. We had net (loss) income of (\$4,655) and \$2,888 for the nine months ended December 31, 2008 and 2007, respectively. We had net (loss) income of (\$1,365) and \$2,834 for the three months ended December 31, 2008 and 2007, respectively. We used cash from operations of (\$5,321) and (\$4,820) for the nine months ended December 31, 2008 and 2007, respectively. We believe that the outstanding cash balances, combined with projected sales and continued cost containment will be adequate to fund operations through the next twelve months. However, projected sales may not materialize and unforeseen costs may be incurred. If the projected sales do not materialize, we will need to reduce expenses further and raise additional 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 common stock, and debt covenants could impose restrictions on our operations. The sale of equity or debt could result in additional dilution to current stockholders, and such financing may not be available to us on acceptable terms, if at all.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Our cash equivalents are principally comprised of money market accounts. As of December 31, 2008, we had cash and cash equivalents of \$12,721. Our exposure to foreign currency fluctuations is primarily related to inventories held in Europe, which are denominated in the Euro. Changes in the exchange rate between the Euro and the U.S. dollar could adversely affect our operating results. Exposure to foreign currency exchange rate risk may increase over time as our business evolves and our products continue to be sold into international markets. We concluded a forward foreign exchange contract to manage possible short-term exposures to changing foreign exchange rates on December 30, 2008. For the quarter ended December 31, 2008, fluctuations of the U.S. dollar in relation to the Euro were immaterial to our financial statements. These fluctuations primarily affect cost of goods sold as it relates to varying levels of inventory held in Europe and denominated in the Euro.

#### *Interest Rate Risk*

We are only marginally exposed to interest rate risk through interest earned on money market accounts. Interest rates that may affect these items in the future will depend on market conditions and may differ from the rates we have experienced in the past. We do not hold or issue derivatives, commodity instruments or other financial instruments for trading purposes.

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

#### *Evaluation of disclosure controls and procedures.*

As of the period covered by this quarterly report, management performed, with the participation of our Chief Executive Officer and Chief Financial Officer, an evaluation of the effectiveness of our disclosure controls and procedures as defined in Rule 13a-15(e) and 15d-15(e) of the Exchange Act. Our disclosure controls and procedures are designed to ensure that information required to be disclosed in the report we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures. Based on the evaluation, our Chief Executive Officer and Chief Financial Officer concluded that as of December 31, 2008, such disclosure controls and procedures were effective.

#### *Changes in Internal Control Over Financial Reporting*

There were no changes in our internal control over financial reporting during the quarter ended December 31, 2008 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



***Disclosure Controls and Internal Controls for Financial Reporting***

Disclosure controls are procedures that are designed with the objective of ensuring that information required to be disclosed in our reports filed under the Exchange Act such as this Quarterly Report on Form 10-Q, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls are also designed with the objective of ensuring that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Internal controls for financial reporting are procedures which are designed with the objective of providing reasonable assurance that our transactions are properly authorized, our assets are safeguarded against unauthorized or improper use and our transactions are properly recorded and reported, all to permit the preparation of our financial statements in conformity with U.S. GAAP.

## PART II — OTHER INFORMATION

### 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.*

**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 had net income (loss) of \$18,104, (\$13,213) and (\$8,880) for the years ended March 31, 2008, 2007 and 2006, respectively. We generated (used) cash flows from operations of (\$5,057), \$12,772, and (\$11,576) in these respective years. For the three and nine months ended December 31, 2008, we had a net loss of (\$1,365) and (\$4,655), respectively. We believe that our outstanding balances, combined with continued cost containment will be adequate to fund operations through fiscal year 2009. Our business is dependent upon the sales of our capital equipment, and projected sales may not materialize and unforeseen costs may be incurred. If the projected sales do not materialize, we will need to reduce expenses further and/or raise additional capital which may include capital raises 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 any needed funds would materially adversely affect us.

**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 ICs. The semiconductor industry is highly cyclical and historically has experienced periodic downturns, including the downturn we are currently experiencing, 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. In response to the current prolonged industry slowdown, we have initiated a substantial cost containment program and 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 the current and 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.

**We are exposed to risks associated with the ongoing financial crisis and weakening global economy.**

The recent severe tightening of the credit markets, turmoil in the financial markets and weakening global economy are contributing to slowdowns in the industries in which we operate, which slowdowns are expected to worsen if these economic conditions are prolonged or deteriorate further. The markets for ICs depend largely on consumer spending. Economic uncertainty exacerbates negative trends in consumer spending and may cause our customers to push out, cancel or refrain from placing equipment or service orders, which may reduce our revenue. Difficulties in obtaining capital and deteriorating market conditions may also lead to the inability of some customers to obtain affordable financing, resulting in lower Tegal sales. These conditions may also similarly affect key suppliers, which could affect their ability to deliver parts and result in delays for our products. Further, these conditions and the uncertainty about future economic conditions make it challenging for us to forecast operating results, make business decisions and identify the risks that may affect our business, financial condition and results of operations. If we are not able to timely and appropriately adapt to changes resulting from the difficult economic environment, our business, financial condition or results of operations may be materially and 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 changes from year to year, but net system sales to our top five customers in fiscal 2008 and 2007 accounted for 87.2% and 77.8% respectively, of our total net system sales. ST Microelectronics accounted for 57.8% of our total revenue in fiscal 2008. ST Microelectronics and International Rectifier accounted for 43.1% and 13.4%, respectively, of our total revenue in fiscal 2007. During the nine months ended December 31, 2008, suppliers and or manufacturers in the integrated circuit, MEMS sensor and high brightness LED markets, SVTC Tech, LLC and Diodes Fab Tech, Inc. accounted for 18%, 17% and 12% respectively, of our total revenue. During the nine months ended December 31, 2007, ST Microelectronics accounted for 71% of total revenues. Other than these customers, no single customer represented more than 10% of our total revenue in fiscal 2008 or the three or nine months ended December 31, 2008. Although the composition of the group comprising our largest customers may vary from year to year, and quarter to quarter, 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, would have a material adverse effect on 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 Aviza Technology, Inc., OC Oerlikon Corporation AG, Ulvac Japan, Ltd., Canon Anelva Technix Corporation, 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 material adverse 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. Revenue from the sale of our advanced etch and deposition systems accounted for 61% and 57% of total revenue in fiscal 2008 and 2007, 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 full customer adoption, we will be materially adversely affected.

**We face risks associated with acquisitions, divestitures and other transactions.**

We face risks associated with acquisitions, divestitures and other transactions. We have made, and may in the future make, acquisitions of or significant investments in businesses with complementary products, services and/or technologies. Acquisitions, including the recently completed acquisition of DRIE (Deep Reactive Ion Etch) and PECVD (Plasma-Enhanced Chemical Vapor Deposition) products and related intellectual property from AMMS, involve numerous risks, including, but not limited to:

- Difficulties in integrating the operations, technologies, products and personnel of acquired companies;
- Lack of synergies or the inability to realize expected synergies and cost savings;
- Revenue and expense levels of acquired entities differing from those anticipated at the time of the acquisitions;
- Difficulties in managing geographically dispersed operations;
- The potential loss of key employees, customers and strategic partners of acquired companies;
- Claims by terminated employees, shareholders of acquired companies or other third parties related to the transaction;
- The issuance of dilutive securities, assumption or incurrence of additional debt obligations or expenses, or use of substantial portions of our cash;
- Diversion of management's attention from normal daily operations of the business; and
- The impairment of acquired intangible assets as a result of technological advancements, or worse-than-expected performance of acquired companies.

When we make a decision to sell assets or a business, we may encounter difficulty completing the transaction as a result of a range of possible factors such as new or changed demands from the buyer. These circumstances may cause us to incur additional time or expense or to accept less favorable terms, which may adversely affect the overall benefits of the transaction. Acquisitions, divestitures, and other transactions are inherently risky, and we cannot provide any assurance that our previous or future transactions will be successful. The inability to effectively manage the risks associated with these transactions could materially and adversely affect our business, financial condition or results of operations.

### **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 system typically range between \$1.8 million and \$3.0 million. 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;
- 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 enough fashion.**

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 and may have difficulty in hiring new employees to replace them. 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. The loss of any significant employee or a large number of employees over a short period of time could have a material adverse effect on us.

### **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 thereunder 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 to protect our intellectual property could result in substantial cost and diversion of effort by us, which by itself could have a material adverse 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, 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 72%, and 67% of total revenue for fiscal 2008 and 2007, respectively. For the three and nine months

ended December 31, 2008, international sales accounted for 38% and 32% of total revenue, 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 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 standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new Securities and Exchange Commission (“SEC”) regulations and Nasdaq 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 materially adversely affected.

**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.

**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 December 31, 2008, there were 8,412,676 shares of our common stock issued and outstanding, 3,323,908 shares of our common stock reserved for issuance of shares issuable upon exercise of outstanding warrants, and shares underlying equity awards created or available for grant under our equity incentive plans, and shares available under our stock purchase plan.

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 outstanding 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.

**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 subassemblies included in our systems from a limited group of suppliers, and occasionally from a single source supplier. Such components and subassemblies include robots, electrostatic chucks, power supplies and flow control devices. Disruption or termination of certain of these sources 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, alteration of our manufacturing processes or cessation of our operations.

**Item 6. Exhibits**

<u>Number</u>	<u>Description</u>
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*

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Date: February 13, 2009

**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 am 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) 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; and
  - (d) 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 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: February 13, 2009

/s/ Thomas R. Mika

Chief Executive Officer and President



**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 am 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) 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; and

(d) 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 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: February 13, 2009  
/s/ Christine Hergenrother  
Chief Financial Officer

**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 ended December 31, 2008 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  
February 13, 2009

**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 ended December 31, 2008 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  
February 13, 2009