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

FORM 10-Q

(Mark One)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2003

OR

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

COMMISSION FILE NUMBER: 0-26824

TEGAL CORPORATION
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	68-0370244
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NO.)

2201 SOUTH MCDOWELL BLVD.
PETALUMA, CALIFORNIA 94954
(Address of Principal Executive Offices)

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

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 [X] No [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange List. Yes [ ] No [X]

As of February 10, 2004, there were 36,226,589 shares of our common stock outstanding.

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TEGAL CORPORATION AND SUBSIDIARIES

INDEX

<TABLE>
<CAPTION>

PAGE

<S> <C>

PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Condensed Consolidated Balance Sheets as of December 31, 2003 and March 31, 2003 3

Condensed Consolidated Statements of Operations -- for the three and nine months ended December 31, 2003 and 2002 4

Condensed Consolidated Statements of Cash Flows -- for the nine months ended December 31, 2003 and 2002 5

Notes to Condensed Consolidated Financial Statements 6

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS 13

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK 17

ITEM 4. CONTROLS AND PROCEDURES 17

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS 18

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS 18

ITEM 5. OTHER INFORMATION 19

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K 28

SIGNATURES 43

</TABLE>

PART I -- FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

TEGAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(IN THOUSANDS)

<TABLE>
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ASSETS	DECEMBER 31, 2003	MARCH 31, 2003
Current assets:		
Cash and cash equivalents	$ 5,089	$ 912
Trade receivables, net	2,985	2,681
Inventories	4,914	7,032
Prepaid expenses and other current assets	2,983	465
Total current assets	15,971	11,090
Property and equipment, net	4,093	4,916
Intangible assets, net	1,251	959
Other assets	267	244
Total assets	$ 21,582	$ 17,209

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Notes payable	$ 166	$ 389
2% convertible debentures, net	72	--
Accounts payable	1,494	1,923
Accrued product warranty	286	734
Customer deposits	1,142	--
Accrued expenses and other current liabilities	2,997	2,679
Deferred revenue	331	324
Total current liabilities	6,488	6,049
Other long-term obligations	111	--
Long-term portion of capital lease obligation	54	37
Total liabilities	6,653	6,086
Stockholders' equity:		
Common stock	300	161
Additional paid-in capital	82,268	68,806
Accumulated other comprehensive income	254	465
Accumulated deficit	(67,893)	(58,309)
Total stockholders' equity	14,929	11,123
	$ 21,582	$ 17,209

</TABLE>

See accompanying notes.

ITEM 2. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

TEGAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE DATA)

<TABLE>
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	THREE MONTHS ENDED DECEMBER 31,		NINE MONTHS ENDED DECEMBER 31,	
	2003	2002	2003	2002
<S>	<C>	<C>	<C>	<C>
Revenue	$ 3,276	$ 3,701	$ 10,371	$ 10,098
Cost of revenue	3,331	3,613	8,397	11,439
Gross profit (loss)	(55)	88	1,974	(1,341)
Operating expenses:				
Research and development	951	1,102	2,490	3,397
Sales and marketing	592	855	1,760	2,260
General and administrative	812	1,452	2,764	3,776
In-process research and development	2,202	--	2,202	--
Total operating expenses	4,557	3,409	9,216	9,433
Operating loss	(4,612)	(3,321)	(7,242)	(10,774)
Other income (expense), net				
Interest expense, net	(2,055)	(54)	(2,408)	(360)
Other income (expense)	6	113	66	204
Total other income (expense), net	(2,049)	59	(2,342)	(156)
Net loss	$ (6,661)	$ (3,262)	$ (9,584)	$(10,930)
Net loss per share, basic and diluted	$ (0.29)	$ (0.20)	$ (0.52)	$ (0.73)
Shares used in per share computation:				

Basic	23,234	16,002	18,588	15,048
Diluted	23,234	16,002	18,588	15,048

</TABLE>

See accompanying notes.

TEGAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(IN THOUSANDS)

<TABLE>
<CAPTION>

	NINE MONTHS ENDED DECEMBER 31, 2003	2002
<S>	<C>	<C>
Cash flows from operating activities:		
Net loss	$ (9,584)	$(10,930)
Adjustments to reconcile net loss to cash used in operating activities:		
Non cash in-process research & development charge	2,202	--
Depreciation and amortization	987	743
Non cash interest expense - accretion of debt discount and amortization of debt issuance costs	2,346	--
Fair value of warrants issued for services rendered	159	121
Provision for doubtful accounts and sales return allowances .	90	(116)
Excess and obsolete inventory provision	967	1,922
Changes in operating assets and liabilities:		
Receivables	(444)	1,822
Inventories	1,114	2,538
Prepaid expenses and other assets	(487)	753
Accounts payable	(474)	465
Accrued expenses and other liabilities	88	(653)
Accrued product warranty	(540)	(166)
Customer deposits	1,142	574
Deferred revenue	6	(864)
Net cash used in operating activities	(2,428)	(3,791)
Cash flows used in investing activities:		
Purchases of property and equipment	(19)	(323)
Cash flows from financing activities:		
Gross proceeds from the issuance of convertible debentures	7,165	--
Convertible debentures issuance costs	(982)	--
Net proceeds from issuance of common stock	609	27
Borrowings under lines of credit	183	5,467
Repayment of borrowings under lines of credit	(416)	(6,209)
Proceeds from and (payments on) capital lease financing ..	28	(5)
Net cash provided by (used in) financing activities	6,587	(720)
Effect of exchange rates on cash and cash equivalents	37	98
Net increase (decrease) in cash and cash equivalents	4,177	(4,736)
Cash and cash equivalents at beginning of period	912	8,100
Cash and cash equivalents at end of period	$ 5,089	$ 3,364

</TABLE>

See accompanying notes.

SUPPLEMENTAL SCHEDULE OF NON CASH INVESTING ACTIVITIES (IN THOUSANDS):

On November 11, 2003, the Company purchased certain assets and assumed certain liabilities of Simplus Systems. Consideration totaled $2,522 and consisted of 1,500,000 shares of the Company's common stock valued at $2,310, fully vested Tegal employee stock options to purchase 58,863 shares of the Company's common stock at an exercise price of $3.09 per share, valued at $32 and transaction costs of $180. The purchase price was allocated as follows:

Assets acquired:	
Fixed assets	48
Identifiable intangible assets	389
In-process research and development	2,202
Total assets	2,639
Liabilities assumed:	
Current liabilities	(117)
Net assets acquired	$ 2,522

See accompanying notes.

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, 2003 audited consolidated financial statements and include all adjustments, consisting only of normal recurring adjustments, necessary to fairly state the information set forth herein. The statements have been prepared in accordance with the regulations of the Securities and Exchange Commission (the "SEC"), but omit certain information and footnote disclosures necessary to present the statements in accordance with generally accepted accounting principles. These interim financial statements should be read in conjunction with the consolidated financial statements and footnotes included in the Annual Report on Form 10-K of Tegal Corporation (the "Company") for the fiscal year ended March 31, 2003. The results of operations for the three and nine months ended December 31, 2003 are not necessarily indicative of results to be expected for the entire year.

The consolidated financial statements contemplate the realization of assets and the satisfaction of liabilities in the normal course of business. The Company incurred net losses of $9,584 and $10,930 for the nine months ended December 31, 2003 and 2002, respectively. The Company generated negative cash flows from operations of $2,428 and $3,791 for the periods ended December 31, 2003 and 2002, respectively. To finance its operations, the Company raised approximately $6,626 in net proceeds from the sale of convertible debentures and the issuance of common stock as a result of the exercise of warrants during the nine-month period ended December 31, 2003 (see Note 9). Management believes that these proceeds, combined with the effects of its cost compression program, will be adequate to fund operations through fiscal year 2005. However, projected sales may not materialize and unforeseen costs may be incurred. Additionally, the convertible debentures agreement includes a material adverse change clause which allows the debenture holders to demand the immediate payment of all outstanding balances upon the debenture holders' determination of the occurrence of deemed material adverse changes to the Company's financial condition, business or operations as determined by the debenture holders based on required financial reporting and other criteria. These issues raise substantial doubt about the Company's ability to continue as a going concern. Our auditors have included a going concern uncertainty explanatory paragraph in their latest auditors' report dated June 10, 2003 which is included in our 10K for the year ended March 31, 2003.

CONCENTRATION OF CREDIT RISK

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of cash and cash equivalents and accounts receivable. Substantially all of the Company's cash equivalents are invested in highly liquid money market accounts. The Company's accounts receivables are derived from sales to customers located in the U.S., Europe, and Asia. The Company performs ongoing credit evaluations of its customers and generally requires no collateral. The Company maintains allowances for potential credit losses. Write-offs during the periods presented have been insignificant. As of December 31, 2003 and March 31, 2003, three customers accounted for approximately 57% and one customer accounted for approximately 38% respectively, of the accounts receivable balance.

During the three months ended December 31, 2003, two customers accounted for 38% of total revenues. During the nine months ended December 31, 2003 and December 31, 2002, two customers accounted for 29% and one customer accounted for 14% of total revenues, respectively.

2. STOCK-BASED COMPENSATION:

The Company accounts for stock-based employee compensation under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB No. 25) and related interpretations. Under APB No. 25, compensation cost is equal to the difference, if any, on the date of grant between the fair value of the Company's stock and the amount an employee must pay to acquire the stock. SFAS No. 123, Accounting for Stock-based Compensation, established accounting and disclosure requirements using a fair value based method of accounting for stock-based employee compensation plans. As allowed by SFAS No. 123, the Company has elected to continue to apply the intrinsic value based method of accounting described above, and has adopted the disclosure requirements of SFAS No. 123 and related SFAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure.

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

<TABLE>
<CAPTION>

	THREE MONTHS ENDED DECEMBER 31,		NINE MONTHS ENDED DECEMBER 31,	
	2003	2002	2003	2002
<S>	<C>	<C>	<C>	<C>
Net loss as reported	$ (6,661)	$ (3,262)	$ (9,584)	$(10,930)
Add: Stock-based employee compensation expense included in Reported net loss				
Deduct: Total stock-based employee compensation expense Determined under fair value method for all awards	(32)	(91)	(121)	(357)
Proforma net loss	$ (6,693)	$ (3,353)	$ (9,705)	$(11,287)
Basic net loss per share:				
As reported	$ (.29)	$ (.21)	$ (.52)	$ (.75)
Proforma	$ (.29)	$ (.21)	$ (.52)	$ (.75)

</TABLE>

The Company accounts for stock-based employee compensation arrangements in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB No. 25) and related interpretations, and complies with the disclosure provisions of SFAS No. 123, Accounting for Stock-based Compensation and SFAS No. 148 Accounting for Stock-Based Compensation - Transition and Disclosure. The disclosure provisions of SFAS No. 123 and SFAS No. 148 require judgments by management as to the estimated lives of the outstanding options. Management has based the estimated life of the options on historical option exercise patterns. If the estimated life of the options

increases, the valuation of the options will increase as well.

On October 28, 2003, the Board of Directors granted options to purchase 3,410,000 shares of the Company's common stock at an exercise price of $1.03 per share, which was the closing price of the Company's common stock on October 28, 2003, to certain employees and directors of the Company. On December 18, 2003, the Company granted options to purchase 500,000 shares of the Company's common stock at an exercise price of $2.14 per share to certain employees, which was the closing price of the Company's common stock on December 18, 2003.

3. INVENTORIES:

	DECEMBER 31, 2003	MARCH 31, 2003
Raw materials	$1,777	$3,218
Work in progress	1,887	1,937
Finished goods and spares	1,250	1,877
	$4,914	$7,032

The Company recorded a $967 provision for excess and obsolete raw materials and spare parts inventory during the quarter ended December 31, 2003 as a result of reduced revenue projections which reflect the continued slow-down of the semiconductor sector. Additionally, the spares requested by customers do not necessarily match those parts that are in inventory, which has created an excess of spare parts.

4. PRODUCT WARRANTY:

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

Warranty activity for the three-month and nine-month periods ended December 31, 2003 and 2002 was:

<TABLE>
<CAPTION>

	WARRANTY ACTIVITY FOR THE THREE MONTHS ENDED DECEMBER 31,		WARRANTY ACTIVITY FOR THE NINE MONTHS ENDED DECEMBER 31,	
	2003	2002	2003	2002
<S>	<C>	<C>	<C>	<C>
Balance at the beginning of the period	$ 386	$ 1,064	$ 734	$ 1,205
Additional warranty accruals for warranties issued during the period	43	92	188	303
Accruals related to pre-existing warranties	--	--	(227)	--
Less settlements made during the period ...	(143)	(117)	(409)	(469)
Balance at the end of the period	$ 286	$ 1,039	$ 286	$ 1,039

</TABLE>

Certain sales contracts of the Company include provisions under which customers would be indemnified by the Company in the event of, among other

things, a third-party claim against the customer for intellectual property rights infringement related to the Company's products. There are no limitations on the maximum potential future payments under these 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.

5. NET LOSS PER COMMON SHARE:

Basic Net Loss Per Share ("EPS") is calculated by dividing net profit (loss) for the period by the weighted average common shares outstanding for that period. Diluted EPS takes into account the number of additional common shares that would have been outstanding if the dilutive potential common shares ("common stock equivalents") had been issued.

Common stock equivalents for the three months ended December 31, 2003 and December 31, 2002, and the nine months ended December 31, 2003 and December 31, 2002 were 19,477,218 and 220,513, and 18,766,218 and 408,873, respectively, and have been excluded from shares used in calculating diluted loss per share because their effect would be antidilutive. The antidilutive securities excluded from shares used in calculating diluted loss per share are as follows (in thousands):

<TABLE>
<CAPTION>

<S>	THREE MONTHS ENDED DECEMBER 31, 2003 <C>	THREE MONTHS ENDED DECEMBER 31, 2002 <C>	NINE MONTHS ENDED DECEMBER 31, 2003 <C>	NINE MONTHS ENDED DECEMBER 31, 2002 <C>
Antidilutive common equivalent shares:				
Options and warrants	9,916	220	9,205	408
Shares issuable upon conversion of convertible debentures	9,560	--	9,560	--
Total antidilutive shares	19,476	220	18,765	408

</TABLE>

6. LINES OF CREDIT:

On June 30, 2003, the Company entered into an Amended Letter Agreement and Subordination Agreement with Silicon Valley Bank, which subordinated the bank's interest in Tegal's intellectual property to the investors in the Convertible Debt Financing (See Note 9). The Company agreed not to request, until such time as the investors' security interest in the intellectual property was terminated, any loan, letter of credit, foreign exchange forward contract, cash management service or credit accommodation under the Company's current line of credit with Silicon Valley Bank. As of December 31, 2003, the Company had no amounts outstanding under this domestic line of credit, which had been collateralized by substantially all of the Company's domestic assets and which was further limited by the amounts of accounts receivable and inventories on the Company's balance sheet. The facility had a maximum borrowing capacity of $10.0 million, and bore interest at prime plus 1.0 %, or 5.25 % as of December 31, 2003. On January 19, 2004, the Company entered into a new line of credit with Silicon Valley Bank that will be available until January 19, 2005. The new line of credit has a maximum borrowing capacity of $3.5 million, bears interest of prime plus 1.0% and is collateralized by substantially all of the Company's domestic and Japanese assets.

As of December 31, 2003, the Company's Japanese subsidiary had $6 outstanding under its bank line of credit which is collateralized by Japanese customer promissory notes held by such subsidiary in advance of payment on customers' accounts receivable. The Japanese bank line bears interest at Japanese prime (1.375 % as of December 31, 2003) plus 1.0%, and has a total capacity of 150 million yen (approximately $1,401 at exchange rates prevailing on December 31, 2003). As of March 31, 2003, the Company's Japanese subsidiary had approximately $70 outstanding under its bank line of credit which was collateralized by Japanese customer promissory notes held by such subsidiary in advance of payment on customers' accounts receivable.

Notes payable as of December 31, 2003 consisted primarily of one outstanding note, to the California Trade and Commerce Agency for $139. The unsecured note from the California Trade and Commerce Agency carries an annual interest rate of 5.75% with monthly interest only payments of approximately $4.2 per month. Although the payment deadlines are being met, the note is currently in technical default due to the merger of Sputtered Films and Tegal Corporation.

The Company also entered into a convertible debenture financing, which is described in Note 9 to the financial statements.

7. COMPREHENSIVE LOSS:

The components of comprehensive loss for the three and nine-month periods ended December 31, 2003 and 2002 are as follows:

<TABLE>
<CAPTION>

	THREE MONTHS ENDED DECEMBER 31,		NINE MONTHS ENDED DECEMBER 31,	
	2003	2002	2003	2002
<S>	<C>	<C>	<C>	<C>
Net loss	(6,661)	$ (3,262)	$ (9,584)	$(10,930)
Foreign currency translation adjustment	111	(33)	211	(27)
	$ (6,550)	$ (3,295)	$ (9,373)	$(10,957)

</TABLE>

8. ACQUISITIONS:

Simplus Systems Corporation:

On November 11, 2003, the Company acquired substantially all of the assets and certain liabilities of Simplus Systems Corporation, ("Simplus"), a development stage company, pursuant to an asset purchase agreement. Simplus had developed a deposition cluster tool and certain processes for barrier, copper seed and high-K dielectric applications. The purchase consideration of $2,522 includes 1,500,000 shares of the Company's common stock valued at $2,310; 58,863 fully vested employee stock options to purchase Tegal common stock at an exercise price of $3.09 per share valued at $32, and acquisition costs of $180.

During the three months ended December 31, 2003, the Company completed the preliminary allocation of the purchase price of Simplus. The following table represents the preliminary allocation of the purchase price for Simplus. In estimating the fair value of the assets acquired and liabilities assumed, management considered various factors, including an independent appraisal.

Fair value fixed assets acquired ..	$ 48
Work Force	50
Patents	339
In-process research and development	2,202
Assumed liabilities	(117)
	$ 2,522

The assets will be amortized over a period of years shown on the following table:

Fixed assets acquired	1 year
Work Force	2 years
Patents	5 years

The fair value underlying the $2.2 million assigned to acquired in-process research and development ("IPR&D") in the Simplus acquisition was charged to the Company's results of operations during the quarter ended December 31, 2003 and was determined by identifying research projects in areas for which technological feasibility had not been established and there was no alternative future use. Projects in the IPR&D category are certain design change improvements on the existing 150mm and 200mm systems and the development of a 300mm system. The design change improvements on the existing systems is estimated to cost approximately $500,000 to $1 million, is approximately 90% complete and will be completed by December 31, 2004. The development of a 300mm system is estimated to be approximately 10% complete, and to cost between $2 and $4 million over the next two to four years, as market demand materializes.

The IPR&D value of $2.2 million was determined by an income approach where fair value is the present value of projected free cash flows that will be generated by the products incorporating the acquired technologies under development, assuming they are successfully completed. The estimated net free cash flows generated by the products over a seven-year period were discounted at a rate of 32% in relation to the stage of completion and the technical risks associated with achieving technological feasibility. The net cash flows for such projects were based on management's estimates of revenue, expenses and asset requirements. Any delays or failures in the completion of these projects could impact expected return on investment and future results of operations. In addition, the Company's financial condition would be adversely affected if the value of other intangible assets acquired became impaired.

All of these projects have completion risks related to functionality, architecture performance, process technology availability, continued availability of key technical personnel, product reliability and availability of software support. To the extent that estimated completion dates are not met, the risk of competitors' product introductions is greater and revenue opportunity may be permanently lost.

Sputtered Films, Inc:

On August 30, 2002, the Company acquired Sputtered Films, Inc., a California corporation ("Sputtered Films") pursuant to an Agreement and Plan of Merger Agreement dated August 13, 2002. The following unaudited proforma financial results of Tegal Corporation and Sputtered Films for the three and nine months ended December 31, 2002 give effect to the acquisition of Sputtered Films as if the acquisition had occurred on April 1, 2002 and includes adjustments such as amortization of intangible assets directly attributable to the acquisition, and expected to have a continuing impact on the combined Company.

These unaudited proforma financial results are provided for comparative purposes only and are not necessarily indicative of what the Company's actual results would have been had the forgoing transaction been consummated on April 1, 2002, nor does it give effect to the synergies, cost savings and other charges expected to result from the acquisition. Accordingly, the proforma financial results do not purport to be indicative of the Company's results of operations as of the date hereof or for any period ended on the date hereof or for any other future date or period.

Unaudited actual and proforma financial Information (in thousands, except share and per share amounts):

<TABLE>
<CAPTION>

	THREE MONTHS ENDED DECEMBER 31,		NINE MONTHS ENDED DECEMBER 31,	
	2003	2002	2003	2002
<S>	<C>	<C>	<C>	<C>
Revenue	$ 3,276	$ 3,701	$ 10,371	$ 11,763
Net loss	$ (6,661)	$ (3,262)	$ (9,584)	$(11,473)
Net loss per share, basic and diluted	$ (0.29)	$ (0.20)	$ (0.52)	$ (0.72)

Shares used in per share computations:				
Basic	23,233	16,002	18,588	15,881
Diluted	23,233	16,002	18,588	15,881

</TABLE>

9. CONVERTIBLE DEBENTURE FINANCING:

On June 30, 2003, the Company signed definitive agreements with investors to raise up to $7.2 million in a private placement of convertible debt financing to be completed in two tranches. The first tranche, which closed on June 30, 2003, involved the sale of debentures in the principal amount of $929. The Company received $424 in cash on June 30, 2003 and the remaining balance of $505 on July 1, 2003, which was recorded as an other receivable as of June 30, 2003. The closing of the second tranche, which occurred on September 9, 2003 following shareholder approval on September 8, 2003, resulted in the receipt of approximately $6,236 in cash on September 10, 2003.

The debentures agreement includes a Material Adverse Change ("MAC") clause which allows the debenture holders to demand the immediate payment of all outstanding balances upon the debenture holders' determination of the occurrence of deemed material adverse changes to the Company's financial condition, business or operations as determined by the debenture holders. Potential material adverse changes that may cause the Company to default on the debentures include any significant adverse effect on the Company's financial condition arising from an event not previously disclosed in the Company's filings with the Securities and Exchange Commission ("SEC"), such as a significant litigation judgment against the Company, bankruptcy, or termination of the majority of the Company's customer relationships. The MAC clause is effective until the conversion of all outstanding debentures. As a result of the MAC clause, the debentures are classified as current liabilities.

The Company was required to pay a cash fee of up to 6.65% of the gross proceeds of the debentures to certain financial advisors upon the closing of the second tranche. A fee of $448 has been recorded as a debt issuance cost and was paid in September 2003. The financial advisors also were granted warrants to purchase 1,756,127 shares of the Company's common stock at an exercise price of $0.35 per share. These warrants were valued at $1,387 using the Black-Scholes option pricing model with the following variables: stock fair value of $0.93, term of five years, volatility of 95% and risk-free interest rate of 2.5%. During the three-month period ended December 31, 2003, the financial advisors exercised warrants for 763,563 shares, leaving advisor warrants for 992,257 shares unexercised at the end of the quarter.

The debentures accrue interest at the rate of 2% per annum. Both the principal of, and the interest on, the debentures are convertible at the rate of $0.35 per share. The principal of the debentures is convertible into 20,471,428 shares of the Company's common stock. The closing prices of the Company's common stock on June 30, 2003 and September 9, 2003, the closing dates for the first and second tranches, respectively, were $0.55 and $1.49. Therefore, a beneficial conversion feature exists which needs to be accounted for under the provisions of EITF 00-27, Application of Issue 98-5 to Certain Convertible Instruments. A beneficial feature also exists in connection with the conversion of the interest on the debentures into shares of common stock.

As of December 31, 2003, several debenture holders converted debentures in the principal amount of $3,774 into 10,745,054 shares of the Company's common stock. In addition, 41,681 shares were issued which represented interest payable to the debenture holders at the time of the conversions. As of December 31, 2003, there remained convertible debentures in the principal amount of $3,391 convertible into 9,689,319 shares of the Company's common stock.

In addition, the debenture holders were granted warrants to purchase 4,094,215 shares of the Company's common stock at an exercise price of $0.50. The warrants expire after eight years. The warrants were valued using the Black-Scholes model with the following variables: fair value of common stock of $0.35 for the first tranche debentures and $0.93 for the second tranche debentures, volatility of 37% and risk-free interest rate of 2.5%. As of December 31, 2003, the debenture holders had exercised warrants to purchase 437,139 shares of the Company's common stock. As of December 31, 2003, there remained unexercised warrants held by the debenture holders for 3,657,076 of the Company's common stock.

The relative fair value of the warrants of $1,572 has been classified as equity because it meets all the equity classification criteria of EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock.

The following table presents the amounts originally allocated to the beneficial conversion feature and warrants and the outstanding balance of debt at December 31, 2003 after accounting for these two equity instruments and conversions (in thousands):

	FIRST TRANCHE	SECOND TRANCHE	TOTAL
Debentures - principal amount	$ 929	$ 6,236	$ 7,165
Beneficial conversion feature (included in equity)	(653)	(6,236)	(6,889)
Warrants (included in equity)	(61)	--	(61)
Conversions to common stock	(174)	--	(174)
Accretion of debt discount	8	23	31
Net amount of 2% convertible debentures	$ 49	$ 23	$ 72

The beneficial conversion feature was recorded as a credit to equity with the offsetting debit as a debt discount, which significantly reduced the debt balance. The debt balance is gradually increased to the face value of the debt over the eight-year term of the debt. The effect of an early conversion is to stop accretion to such pay out amount for the converted debentures. Additionally, any associated accretion and debt balance originally not offset by the debt discount relating to the converted debentures is reclassified to equity at the time of conversion.

The issuance costs associated with the debentures amounted to $3,940 and are comprised of $982 in cash issuance costs, $1,387 associated with warrants issued to financial advisors and $1,572 associated with warrants issued to the second tranche debenture holders. These costs have been recorded as a short-term asset to be amortized over the life of the debt. Amortization of debt issuance costs for the quarter ended December 31, 2003 amounted to $1,926.

The value of the beneficial conversion feature, warrants and debt issuance costs are being amortized as interest expense over the life of the debt using the effective interest method. Interest expense for the quarter ended December 31, 2003 amounted to $2,044. This amount is comprised of $26 in nominal interest, $92 in amortization of beneficial conversion feature and $1,926 in amortization of debt issuance costs. Interest expense for the nine months ended December 31, 2003 amounted to $2,347. This amount is comprised of $37 in nominal interest, $343 in amortization of beneficial conversion feature and $1,967 in amortization of debt issuance costs.

Amortization will accelerate if the Company repays the debt early, upon conversion, if the material adverse change clause is invoked, or if it is deemed that such invocation is probable given the presence of negative factors or if the debt is converted into common stock. The Company will assess the probability of the occurrence of the material adverse change clause on a quarterly basis.

10. SUBSEQUENT EVENT:

On February 11, 2004, the Company signed a $25 million equity facility with Kinsbridge Capital, a firm that specializes in the financing of small to medium sized technology-based companies. The arrangement will allow the Company to sell shares of its common stock to Kingsbridge at its sole discretion over a 24-month

period on a "when and if needed" basis. Kingsbridge Capital is required under the terms of the arrangement to purchase Tegal's stock, following the effectiveness of a registration statement. The price of the common shares issued under the agreement is based on a discount to the volume-weighted average market price during a specified drawdown period. The Company has no obligation to draw down all or any portion of the commitment.

In connection with the agreement, the Company issued fully vested warrants to Kingsbridge Capital to purchase 300,000 shares of the Company's common stock at an exercise price of $4.11 per share.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Information herein contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, which can be identified by the use of forward-looking terminology such as "may," "will," "expect," "anticipate," "estimate," or "continue" or the negative thereof or other variations thereon or comparable terminology or which constitute projected financial information. The forward-looking statements relate to the near-term semiconductor capital equipment industry outlook, demand for our products, our quarterly revenue and earnings prospects for the near-term future and other matters contained herein. Such statements are based on current expectations and beliefs and involve a number of uncertainties and risks that could cause the actual results to differ materially from those projected. Such uncertainties and risks include, but are not limited to, the cyclicality of the semiconductor industry, impediments to customer acceptance, fluctuations in quarterly operating results, competitive pricing pressures, the introduction of competitor products having technological and/or pricing advantages, product volume and mix and other risks detailed from time to time in our SEC reports. For further information, refer to the business description and risk factors sections included in our Form 10-K for the year ended March 31, 2003 and the risk factors section included in this Form 10-Q (Part II, Item 5) as filed with the SEC.

RESULTS OF OPERATIONS

Tegal designs, manufactures, markets and services plasma etch systems used in the fabrication of integrated circuits, memory devices, read-write heads for the disk drive industry, printer heads, telecommunications equipment, small flat panel displays, device-level packaging, mask/reticle formation and MEMS. With the acquisition of Sputtered Films on August 30, 2002, and the acquisition of Simplus on November 11, 2003, the Company now also provides deposition capabilities. The acquisition of Sputtered Films and Simplus secured a source for a complementary deposition technology for our new materials strategy. The continuation of Moore's Law is dependent on the adoption of a variety of new materials that, because of their composition, are extremely difficult to deposit an etch uniformly. Since the mid-1990's Tegal has focused on developing and implementing process solutions for the new materials being adopted by the makers of advanced semiconductor and nanotechnology devices.

The following table sets forth certain financial items as a percentage of revenue for the three and nine-month periods ended December 31, 2003 and 2002:

<TABLE>
<CAPTION>

	THREE MONTHS ENDED DECEMBER 31,		NINE MONTHS ENDED DECEMBER 31,	
	2003	2002	2003	2002
<S>	<C>	<C>	<C>	<C>
Revenue	100.0%	100.0%	100.0%	100.0%
Cost of sales	101.7	97.6	81.0	113.4
	------	------	------	------
Gross profit (loss)	(1.7)	2.4	19.0	(13.4)
Operating expenses:				
Research and development	29.0	29.8	24.0	33.6
Sales and marketing	18.1	23.1	17.0	22.4
General and administrative	24.8	39.2	26.6	37.4

In-process research and development	67.2	--	21.2	--
Total operating expenses	139.1	92.1	88.9	93.4
Operating loss	(140.8)	(89.7)	(69.8)	(106.8)
Other income, net				
Interest expense, net	(62.7)	(1.5)	(23.2)	(3.6)
Other income (expense), net	0.2	3.1	0.6	2.1
Other income (expense), net	(62.5)	1.6	(22.6)	(1.5)
Net loss	(203.3%)	(88.1%)	(92.4%)	(108.3%)

</TABLE>

Revenue. System revenue for the three and nine months ended December 31, 2003 was $3,276 and $10,371 respectively, a decrease for the three months and an increase for the nine months of $425 and $273, respectively, over the comparable periods in 2002. The decrease for the three months ended December 31, 2003 was principally due to the sale of a 6500 series system upgrade as compared to the sale of one full 6500 series systems for the same period in the prior year. The increase for the nine months ended December 31, 2003 was principally due to the systems sales product mix as compared to the same period in the prior year. As of December 31, 2003 and 2002, our backlog was $5,189 and $2,774, respectively.

Revenue from spare parts and service sales for the three months ended December 31, 2003 and December 31, 2002 were $1,930 and $1,860, respectively. The increase of spare parts and service revenue during the three months ended December 31, 2003 was primarily due to increased sales of spare parts as compared to the same period in the prior year. For the nine months ended December 31, 2003, service and spare parts revenue was $5,701, down from $5,809 for the nine-month period ended December 31, 2002. The decrease of spare parts and service revenue in the nine months ended December 31, 2003 was as a result of slow service and spare parts sales at the beginning of the current fiscal year, that is partially offset by an increase in the three months ended December 31, 2003, which the Company believes is due to increased usage of systems in the customers' facilities during the last three-month period.

International sales as a percentage of the Company's revenue for the three and nine months ended December 31, 2003 were approximately 79.1% and 81.0%, respectively, and for the three and nine months ended December 31, 2002 were 83.2% and 77.2%, respectively. We believe that international sales will continue to represent a significant portion of our revenue.

Gross profit (loss). Gross profit (loss) as a percentage of revenue (gross margin) was (1.7)% and 2.4% for the three months ended December 31, 2003 and 2002, respectively, and 19.0% and (13.4)% for the nine months ended December 31, 2003 and 2002, respectively. The decrease in gross margin for the three months ended December 31, 2003 compared to the same period in the prior year was principally attributable to a $967 excess and obsolete inventory provision based on reduced revenue projections and recent changes in product mix of spare parts creating an excess of the spare parts currently in inventory. The increase in gross margin for the nine months ended December 31, 2003 compared to the same period in the prior year was principally attributable to a $1,922 excess and obsolete inventory provision based on reduced revenue projections during the prior year, which reflected the slow-down of the semiconductor sector.

Research and development. Research and development expenses consist primarily of salaries, prototype material and other costs associated with our ongoing systems and process technology development, applications and field process support efforts. Research and development expenses were $951 and $1,102 for the three months and $2,694 and $3,397 for the nine months ended December 31, 2003 and 2002, respectively, representing 29.0% and 29.8% of revenue for the three months and 24.0% and 33.6% of revenue for the nine months ended December 31, 2003 and 2002, respectively. The decrease in research and development spending is primarily due to the completion and implementation of specific projects and the Company's continued cost reduction efforts.

Sales and marketing. Sales and marketing expenses consist primarily of

salaries, commissions, trade show promotion and travel and living expenses associated with those functions. Sales and marketing expenses were $592 and $855 for the three months and $1,760 and $2,260 for the nine months ended December 31, 2003 and 2002, respectively, representing 18.1% and 23.1% of revenue for the three months and 17.0% and 22.4% of revenue for the nine months ended December 31, 2003 and 2002, respectively. The decrease in sales and marketing spending is due to the Company's continued cost reduction efforts.

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. General and administrative expenses were $812 and $1,452 for the three months and $2,764 and $3,776 for the nine months ended December 31, 2003 and 2002, respectively, representing 24.8% and 39.2% of revenue for the three months and 26.7% and 37.4% of revenue for the nine months ended December 31, 2003 and 2002, respectively. The decrease in general and administrative spending for the three-month period ended December 31, 2003, compared to the same periods in the prior year, was primarily attributable to the operating expenses that are incurred by Sputtered Films in the prior year. The decrease in general and administrative spending for the nine month period ended December 31, 2003, compared to the same periods in the prior year, was primarily attributable to Company's continued cost reduction efforts.

In-process research & development. In-process research & development ("IPR&D") consists of those products obtained through acquisition that are not yet proven to be technologically feasible but have been developed to a point where there is value associated with them in relation to potential future revenue. Because technological feasibility was not yet proven and no alternative future uses are believed to exist for the in-process technologies, the assigned value of $2,202 was expensed immediately upon the date of the acquisition.

The fair value underlying the $2.2 million assigned to IPR&D in the Simplus acquisition was determined by identifying research projects in areas for which technological feasibility had not been established and there was no alternative future use. Projects in the IPR&D category are certain design change improvements on the existing 150mm and 200mm systems and the development of a 300mm system. The design change improvements on the existing systems is estimated to cost approximately $500,000 to $1 million, is approximately 90% complete and will be completed by December 31, 2004. The development of a 300mm system is estimated to be approximately 10% complete, and to cost between $2 and $4 million over the next two to four years, as market demand materializes.

The IPR&D value of $2.2 million was determined by an income approach where fair value is the present value of projected free cash flows that will be generated by the products incorporating the acquired technologies under development, assuming they are successfully completed. The estimated net free cash flows generated by the products over a seven-year period were discounted at a rate of 32% percent in relation to the stage of completion and the technical risks associated with achieving technological feasibility. The net cash flows for such projects were based on management's estimates of revenue, expenses and asset requirements. Any delays or failures in the completion of these projects could impact expected return on investment and future results of operations. In addition, the Company's financial condition would be adversely affected if the value of other intangible assets acquired became impaired.

All of these projects have completion risks related to functionality, architecture performance, process technology availability, continued availability of key technical personnel, product reliability and availability of software support. To the extent that estimated completion dates are not met, the risk of competitors' product introductions is greater and revenue opportunity may be permanently lost.

Interest expense, net. Interest expense consists primarily of interest expense on the debenture financing and the domestic line of credit offset in part by interest income on outstanding cash balances.

Other income (expense), net. Other income (expense), net consists primarily of gains and losses on foreign exchange.

LIQUIDITY AND CAPITAL RESOURCES

For the nine-month period ended December 31, 2003, we financed our operations through the use of outstanding cash balances, the sale of convertible debentures, and borrowings against our promissory note borrowing facilities in Japan, as well as our domestic line of credit.

Net cash used in operations was $2,428 during the nine months ended December 31, 2003, due principally to a net loss of $9,584 offset by non cash expense from depreciation and amortization, warrants issued for services rendered, and non cash amortization of debt discount, and a non cash charge for acquired IPR&D related to the Simplus acquisition. Additionally, the net loss is offset by a net decrease in inventory and an increase in accounts receivable offset by a net decrease in accounts payable and accrued liabilities, offset by an increase in prepaid expenses and other assets. We expect to incur additional costs in connection with the completion of certain projects as a result of the acquisition of Simplus. Net cash used in operations was $3,791 during the nine months ended December 31, 2002, due principally to a net loss of $10,930 offset by non cash expense for depreciation and amortization, a non cash related provision for inventory and warrants issued for services rendered. Additionally, the net loss was offset by a decrease in accounts receivable and inventory offset, in part, by a decrease in deferred revenue and increase in prepaid expenses and other assets, and a decrease in accounts payable and other accrued liabilities.

There were minimal capital expenditures for the nine months ended December 31, 2003. Capital expenditures totaled approximately $19 and $323 for the nine months ended December 31, 2003 and December 31, 2002, respectively. Capital expenditures in 2002 were incurred principally for leasehold improvements and to acquire design tools, analytical equipment and computers.

Cash proceeds from financing activities totaled $6,587 for the nine months ended December 31, 2003 and were primarily from the sale of debentures and the subsequent exercise of common stock warrants by service providers and debenture holders, partially offset by the repayment of the Japanese line of credit. Net cash used in financing activities totaled $720 for the nine months ended December 31, 2002 primarily related to the repayment of the domestic and Japanese lines of credit.

On June 30, 2003, the Company entered into an Amended Letter Agreement and Subordination Agreement with Silicon Valley Bank, which subordinated the bank's interest in Tegal's intellectual property to the investors in the Convertible Debt Financing (See Note 9). The Company agreed not to request, until such time as the investors' security interest in the intellectual property was terminated, any loan, letter of credit, foreign exchange forward contract, cash management service or credit accommodation under the Company's current line of credit with Silicon Valley Bank. As of December 31, 2003, the Company had no amounts outstanding under this domestic line of credit, which had been collateralized by substantially all of the Company's domestic assets and which was further limited by the amounts of accounts receivable and inventories on the Company's balance sheet. The facility had a maximum borrowing capacity of $10.0 million, and bore interest at prime plus 1.0 %, or 5.25 % as of December 31, 2003. On January 19, 2004, the Company entered into a new line of credit with Silicon Valley Bank that will be available until January 19, 2005. The new line of credit has a maximum borrowing capacity of $3.5 million, bears interest of prime plus 1.0% and is collateralized by substantially all of the Company's domestic and Japanese assets.

As of December 31, 2003, the Company's Japanese subsidiary had $6 outstanding under its bank line of credit which is collateralized by Japanese customer promissory notes held by such subsidiary in advance of payment on customers' accounts receivable. The Japanese bank line bears interest at Japanese prime (1.375% as of December 31, 2003) plus 1.0%, and has a total capacity of 150 million yen (approximately $1,401 at exchange rates prevailing on December 31, 2003).

Notes payable as of December 31, 2003 consisted primarily of one outstanding note to the California Trade and Commerce Agency for $139. The unsecured note from the California Trade and Commerce Agency carries an annual interest rate of 5.75% with monthly interest only payments of approximately $4.2 per month. Although the payment deadlines are being met, the note is currently

in technical default due to the merger of Sputtered Films and Tegal Corporation.

The Company also entered into a convertible debenture financing, which is described in Note 9 to the financial statements.

The consolidated financial statements contemplate the realization of assets and the satisfaction of liabilities in the normal course of business. The Company incurred net losses of $9,584 and $10,930 for the nine months ended December 31, 2003 and 2002, respectively. The Company generated negative cash flows from operations of $2,428 and $3,791 for the periods ended December 31, 2003 and 2002, respectively. To finance its operations, the Company raised approximately $6,626 in net proceeds from the sale of convertible debentures and exercise of warrants during the nine-month period ended December 31, 2003 (see Note 9). Management believes that these proceeds, combined with the effects of its cost compression program, will be adequate to fund operations through fiscal year 2005. However, projected sales may not materialize and unforeseen costs may be incurred. Additionally, the convertible debentures agreement includes a material adverse change clause which allows the debenture holders to demand the immediate payment of all outstanding balances upon the debenture holders' determination of the occurrence of deemed material adverse changes to the Company's financial condition, business or operations as determined by the debenture holders based on required financial reporting and other criteria. These issues raise substantial doubt about the Company's ability to continue as a going concern.

For more information on our capital resources, see "Risk Factors" in Part II, Item 5.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our cash equivalents are principally comprised of money market accounts. As of December 31, 2003, we had cash equivalents of $5,089. These accounts are subject to interest rate risk and may fall in value if market interest rates increase. We attempt to limit this exposure by investing primarily in short-term securities having a maturity of three months or less. Due to the nature of our cash and cash equivalents, we have concluded that there is no material market risk exposure.

We have foreign subsidiaries that operate and sell our products in various global markets. As a result, our cash flow and earnings are exposed to fluctuations in interest and foreign currency exchange rates. We attempt to limit these exposures through the use of various hedge instruments, primarily forward exchange contracts and currency option contracts (with maturities of less than three months) to manage our exposure associated with firm commitments and net asset and liability positions denominated in non-functional currencies. While the Japanese Yen has appreciated significantly against the US Dollar in the last few months, it has not resulted in a significant impact on our operations due to the use of forward contracts to hedge against such fluctuations. There have been no material changes regarding market risk since the disclosures made in our Form 10-K for the fiscal year ended March 31, 2003.

ITEM 4. CONTROLS AND PROCEDURES

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

As required by SEC Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of the Company's management,

including the Company's Chief Executive Officer and the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the quarter covered by this report. Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level.

There has been no change in the Company's internal controls over financial reporting during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

PART II -- OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On March 17, 1998, Tegal filed suit in the United States District Court in the Eastern District of Virginia against Tokyo Electron America, Inc. and several of its affiliated companies (the "TEA case") alleging that TEL's 65DI and 85DI IEM etch equipment infringe certain of Tegal's patents. The TEA case was tried in the District Court in May 1999, and on August 31, 1999, the Court found both patents-in-suit valid, and found that TEA had willfully infringed our `223 dual-frequency triode etcher patent. The District Court enjoined TEA from further sales or service of its IEM etchers. In addition, the District Court ordered TEA to pay attorney's fees and court costs to Tegal. On appeal, the Federal Circuit affirmed the District Court's findings of infringement and the interpretations of the `223 patent on which those findings were made, but reversed the contempt finding, the willfulness finding, and the award of attorneys fees, and remanded for further consideration of TEA's defense of anticipation. As a result, the Federal Circuit vacated the judgment and the injunction and remanded the case for further consideration of the anticipation defense. In a separate but related action against Tokyo Electron Limited (the "TEL case") concerning a later generation of etchers known as the Advanced IEM or AIEM, the United States District Court for the Eastern District of Virginia granted summary judgment of non-infringement for TEL on August 7, 2000 and entered judgment for TEL on September 11, 2000. On February 1, 2002, the Federal Circuit affirmed the District Court's decision on summary judgment that the AIEM does not infringe the `223. The Federal Circuit's decision in the TEL case is now final. Subsequent to the Federal Circuit's decision in the TEL case, Tegal entered into a non-exclusive license agreement with TEA. Accordingly, on October 27, 2003 the District Court vacated its stay order and dismissed the case. The outcome of the litigation is now final.

On September 1, 1999, Tegal filed a patent infringement action against Lam Research Corporation (the "Lam case"), asserting infringement of two of Tegal's patents directed to dual frequency plasma processing technologies (the "618 and the `223 patents"). Tegal sought injunctive relief barring Lam from manufacturing, selling and supporting products that incorporate its patented technology. The Company further sought enhanced damages for willful infringement of its patents. The suit was initially filed in United States District Court for the Eastern District of Virginia, but was transferred by that court to the United States District Court of the Northern District of California. Following an adverse decision from the United States Court of Appeals for the Federal Circuit in a prior case against Tokyo Electron Limited, Tegal voluntarily dismissed the '223 patent from the Lam case. A Markman hearing was held on the '618 patent in July 2002, and in September 2002 the Court issued a claim interpretation ruling in which it determined that the claim term "low frequency" means "less than approximately 1Mhz." In October 2002, Lam filed a motion for summary judgment of non-infringement of the '618 patent. On January 14, 2003, after modifying its original Markman ruling and further interpreting "low frequency" to have an upper limit of 1.4 Mhz, the Court granted Lam's motion for summary judgment of noninfringement of the '618 patent. Thereafter, Lam sought to pursue a counterclaim alleging that the case ought to be deemed "exceptional" under 28 U.S.C. ss. 285, thus justifying an award of attorney's fees in its favor. On June 13, 2003, the Court issued an order finding that the case is not "exceptional" and declining to award Lam its attorney's fees. Neither party has appealed any of the rulings made by the District Court and the time to file appeals has expired. Thus, the outcome of the litigation is now final.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

In June 2003, the Company issued stock options to purchase 300,000 shares of the Company's common stock to the landlord of its Petaluma facility, as part of a new lease agreement, and options to purchase 60,000 shares of the Company's common stock to a service provider for services rendered. The options to the landlord were valued at $107,000 (included in other assets as of June 30, 2003) using the Black-Scholes model and the value of the option was expensed immediately. The deferred charge associated with the landlord's options is being amortized to operating expense over the life of the new lease of seven years. Expenses related to both of these transactions for the quarter ended June 30, 2003 amounted to $32 in the June quarter. The amortization of these charges amounted to $16 in the quarter ended December 31, 2003.

In August 2003, the Company issued fully vested stock options to purchase 10,000 shares of the Company's common stock to a service provider for services rendered. These options were valued at $5,917 using the Black-Scholes model and the value of the option was expensed immediately. In September 2003, the Company issued 158,311 restricted shares of the Company's common stock to a service provider for services rendered. The fair value of these securities amounted to $111 and was expensed in the quarter ended December 31, 2003.

On September 8, 2003, the Company closed the second tranche of a private placement in which it sold to accredited investors $6,236 principal amount of its 2.0% Convertible Secured Debentures Due 2011 and warrants initially exercisable for 3,563,122 shares of common stock. The Debentures and accrued interest thereon are convertible into shares of the Company's common stock at a price of $0.35 per share. The warrants have an exercise price of $0.50 per share and expire September 8, 2011. The sale and issuance of these securities was exempt from registration under the Securities Act pursuant to Section 4(2) thereof, on the basis that the transaction did not involve a public offering. The Company intends to use the net proceeds from these securities for general corporate purposes.

During the nine-month period ended December 31, 2003, several debenture holders converted debentures in the principal amount of $3,774 into 10,745,054 shares of the Company's common stock. In addition, 41,681 shares were issued which represented interest payable to the debenture holders at the time of the conversions. As of December 31, 2003, there remained convertible debentures in the principal amount of $3,391 convertible into 9,689,319 shares of the Company's common stock.

During the nine-month period ended December 31, 2003, the debenture holders had exercised warrants to purchase 437,139 shares of the Company's common stock. As of December 31, 2003, there remained unexercised warrants held by the debenture holders for 3,657,076 of the Company's common stock. During the nine-month period ended December 31, 2003, the financial advisors exercised warrants for 763,563 shares, leaving advisor warrants for 992,257 shares unexercised at the end of the quarter.

On November 11, 2003, the Company acquired substantially all of the assets and certain liabilities of Simplus Systems Corporation, ("Simplus"), a development stage company, pursuant to an asset purchase agreement. Simplus had developed a deposition cluster tool and certain processes for barrier, copper seed and high-K dielectric applications. The purchase consideration of $2,522 includes 1,500,000 shares of the Company's common stock valued at $2,310, 58,863 fully vested stock options valued at $32, and acquisition costs of $180.

ITEM 5. OTHER INFORMATION

In accordance with Section 10A(i)(2) of the Securities Exchange Act of 1934, as added by Section 202 of the Sarbanes-Oxley Act of 2002 (the "Act"), we are required to disclose the non-audit services approved by our Audit Committee to be performed by PricewaterhouseCoopers LLP, our external auditor. Non-audit services are defined in the Act as services other than those provided in connection with an audit or a review of the financial statements of a company. The Audit Committee has approved the engagement of PricewaterhouseCoopers LLP

for the following non-audit services: the preparation of federal and state income tax returns.

Our stock is currently listed on The Nasdaq SmallCap Market. The Nasdaq Stock Market's Marketplace Rules impose certain minimum financial requirements on us for the continued listing of our stock. One such requirement is the minimum bid price on our stock of $1.00 per share. Beginning in 2002, there have been periods of time during which we have been out of compliance with the $1.00 minimum bid requirements of the Nasdaq SmallCap Market.

On September 6, 2002, we received notification from Nasdaq that for the 30 days prior to the notice, the price of our common stock had closed below the minimum $1.00 per share bid price requirement for continued inclusion under Marketplace Rule 4450(a)(5) (the "Rule"), and were provided 90 calendar days, or until December 5, 2002, to regain compliance. Our bid price did not close above the minimum during that period. On December 6, 2002, we received notification from Nasdaq that our securities would be delisted from The Nasdaq National Market, the exchange on which our stock was listed prior to May 6, 2003, on December 16, 2002 unless we either (i) applied to transfer our securities to The Nasdaq SmallCap Market, in which case we would be afforded additional time to come into compliance with the minimum $1.00 bid price requirement; or (ii) appealed the Nasdaq staff's determination to the Nasdaq's Listing Qualifications Panel (the "Panel"). On December 12, 2002 we requested an oral hearing before the Panel and such hearing took place on January 16, 2003 in Washington, D.C. Our appeal was based, among other things, on our intention to seek stockholder approval for a reverse split of our outstanding common stock. On April 28, 2003 at a special meeting of our stockholders, our board of directors was granted the authority to effect a reverse split of our common stock within a range of two-for-one to fifteen-for-one. This authority was reaffirmed by our stockholders at the Annual Meeting on September 8, 2003. The timing and ratio of a reverse split, if any, is at the sole discretion of our board of directors, but it must be completed on or before December 2, 2003. On May 6, 2003, we transferred the listing of our common stock to The Nasdaq SmallCap Market. In connection with this transfer, and by additional notice, Nasdaq granted us an extension until December 31, 2003, to regain compliance with the Rule's minimum $1.00 per share bid price requirement for continued inclusion on The Nasdaq SmallCap Market. On September 16, 2003, the bid price for our stock had closed at $1.00 or above for ten consecutive days. On September 17, 2003, we received a letter from Nasdaq confirming that Tegal had regained compliance with the minimum bid price requirement and that the question of its continued listing on the SmallCap Market was now closed.

If we are out of compliance in the future with Nasdaq listing requirements, we may take actions in order to achieve compliance, which actions may include a reverse split of our common stock. If an initial delisting decision is made by the Nasdaq's staff, we may appeal the decision as permitted by Nasdaq rules. If we are delisted and cannot obtain listing on another major market or exchange, our stock's liquidity would suffer, and we would likely experience reduced investor interest. Such factors may result in a decrease in our stock's trading price. Delisting also may restrict us from issuing additional securities or securing additional financing.

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; OUR AUDITORS' REPORT INCLUDES A GOING CONCERN UNCERTAINTY EXPLANATORY PARAGRAPH; THE ACCOUNTING FOR THE DEBENTURES WILL RESULT IN SIGNIFICANT EXPENSE AMOUNTS.

We incurred net losses of $12,625 and $8,730 for the years ended March 31, 2003 and 2002, respectively, and generated negative cash flows from operations of $5,984 and $3,603 in these respective years. We also incurred a net loss of $9,584 and generated negative cash flows from operations of $2,428 during the nine months ended December 31, 2003. These factors raise substantial doubt as to our ability to continue as a going concern, and our auditors have included a

going concern uncertainty explanatory paragraph in their latest auditors' report dated June 10, 2003 which is included in our 10-K for the year ended March 31, 2003. Our plans to maintain and increase liquidity include the restructuring executed during fiscal 2002 and 2003, which reduced headcount from 155 employees to 81 employees and has reduced our cost structure entering fiscal 2004. We believe the cost reduction and a projected increase in sales during fiscal 2005 will generate sufficient cash flows to fund our operations through the end of fiscal 2005. However, these projected sales are to a limited number of new and existing customers and are based, for the most part, on internal and customer provided estimates of future demand, not firm customer orders. 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 our 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. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded assets or the amount or classification of liabilities or any other adjustments that might be necessary should we be unable to continue as a going concern.

Our debentures issued in June and September are convertible at a conversion rate of $0.35 per share, which was lower than the common stock's prices at June 30, 2003, the commitment date for the first tranche and September 8, 2003, the stockholder approval date for the second tranche. Additionally, we granted a 20% warrant coverage to our debenture holders. The value of both the beneficial conversion feature and warrants resulted in a significant debt discount which will be accreted as interest expense over the eight-year life of the debentures. This will result in substantial interest expense during fiscal 2004 and through fiscal 2011 or until the debentures are converted.

OUR DEBENTURES INCLUDE A MATERIAL ADVERSE CHANGE CLAUSE.

As disclosed in our Current Report on Form 8-K filed with the SEC on June 2, 2003, our 2% Convertible Secured Debentures Due 2011 that we sold on June 30, 2003 and September 9, 2003 include a material adverse change clause. This material adverse change clause allows the debenture holders to demand the immediate payment of all outstanding balances upon the debenture holders' determination of the occurrence of deemed material adverse changes to our financial condition, business or operations as determined by the debenture holders based on required financial reporting and other criteria. Potential material adverse changes causing us to default on the debentures may include any significant adverse effect on our financial condition arising from an event not previously disclosed in our SEC filings such as a significant litigation judgment against Tegal, bankruptcy or termination of the majority of our customer relationships. As of December 31, 2003, $3,346 principal amount of our 2% Convertible Secured Debentures Due 2011 plus accrued interest payable in kind by issuance of additional debentures convertible into common stock in the amount of such interest could be demanded for immediate payment by the debenture holders upon such an event of default. In the event of such a demand, Tegal would need to pursue additional funding for repayment of such amount, or risk insolvency.

THE CONVERSION OF OUR CONVERTIBLE SECURITIES, THE EXERCISE OF OUTSTANDING WARRANTS, OPTIONS AND OTHER RIGHTS TO OBTAIN ADDITIONAL SHARES WILL DILUTE THE VALUE OF THE SHARES.

On June 30, 2003, we entered into agreements with investors to raise up to $7.2 million in a private placement of convertible debt financing to be completed in two tranches, the first of which was completed on June 30, 2003 for $0.9 million and the second of which was completed on September 9, 2003 for $6.2 million following stockholder approval on September 8, 2003. As of September 10, 2003, there were debentures convertible into 20,471,428 shares of our common stock (2,655,554 from the first tranche and 17,815,874 from the second tranche, all of which are based on a conversion price of $0.35 per share and a cash payment in lieu of any fractional share), warrants exercisable for approximately 4,094,212 shares of our common stock (531,103 from the first tranche and

3,563,109 from the second tranche), advisor warrants convertible into 1,756,127 shares, 3,542,436 shares issuable as interest payment in lieu of cash and options exercisable for approximately 1,474,725 shares of our common stock. In addition, we have warrants outstanding from previous offerings for approximately 1,705,964 shares of our common stock.

The conversion of these convertible securities and the exercise of these warrants will result in dilution in the value of the shares of our outstanding common stock and the voting power represented thereby. In addition, the conversion price of the Debentures or 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.

Neither the debentures nor the warrants establish a "floor" that would limit reductions in such conversion price or exercise price. The downward adjustment of the conversion price of these debentures and 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.

On October 14, 2003, we registered 3,542,436 shares which can be issued as interest payments to the debenture holders in lieu of cash. The number of shares issuable as interest payments is calculated by dividing total interest due over the life of the debentures at 2% per annum by a price per share of $0.35. If we elect to use such shares to pay interest, such issuance will result in dilution to our stockholders.

As of December 31, 2003, a total of 10,058,547 shares were issued in connection with the conversion of outstanding debentures, including 39,395 shares representing interest, and 1,621,289 shares were issued in connection with the exercise of warrants by debenture holders and financial advisors.

SALES OF SUBSTANTIAL AMOUNTS OF OUR SHARES OF COMMON STOCK COULD CAUSE THE PRICE OF OUR COMMON STOCK TO GO DOWN.

To the extent the holders of our convertible securities and warrants convert or exercise such securities and then sell the shares of our common stock they receive upon conversion or 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 stockholders and others which could place further downward pressure on our stock price. Moreover, holders of these convertible securities and warrants may hedge their positions in our common stock by shorting our common stock, which could further adversely affect our stock price. The effect of these activities on our stock price could increase the number of shares issuable upon future conversions of our convertible securities or exercises of our warrants.

We received stockholder approval to increase the number of authorized shares of common stock to 100,000,000 shares and to effect a reverse stock split. We may also issue additional capital stock, convertible securities and/or warrants to raise capital in the future. In addition, we may elect to pay any accrued interest on the outstanding $7.2 million principal amount of debentures with shares of our common stock. Interest on the debentures is compounded quarter-annually, based on 2% per annum on the principal amount outstanding. In addition, to attract and retain key personnel, we may issue additional securities, including stock options. All of the above could result in additional dilution of the value of our 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. Public or private sales of substantial amounts of shares of our common stock by persons or entities that have exercised options and/or warrants could adversely affect the prevailing market price of the shares of our common stock.

THE SEMICONDUCTOR INDUSTRY IS CYCLICAL AND MAY EXPERIENCE PERIODIC DOWNTURNS THAT MAY NEGATIVELY AFFECT CUSTOMER DEMAND FOR OUR PRODUCTS AND RESULT IN LOSSES SUCH AS THOSE EXPERIENCED IN THE PAST.

Our business depends upon the capital expenditures of semiconductor manufacturers, which in turn depend on the current and anticipated market demand for integrated circuits. The semiconductor industry is highly cyclical and historically has experienced periodic downturns, which often have had a detrimental effect on the semiconductor industry's demand for semiconductor capital equipment, including etch and deposition systems manufactured by us. In response to the current prolonged industry slow-down, we have initiated a substantial cost containment program and 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 downturn.

OUR COMPETITORS HAVE GREATER FINANCIAL RESOURCES AND GREATER NAME RECOGNITION THAN WE DO AND THEREFORE MAY COMPETE MORE SUCCESSFULLY IN THE SEMICONDUCTOR CAPITAL EQUIPMENT INDUSTRY THAN WE CAN.

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

IF WE FAIL TO MEET THE CONTINUED LISTING REQUIREMENTS OF THE NASDAQ STOCK MARKET, OUR STOCK COULD BE DELISTED.

Our stock is currently listed on The Nasdaq SmallCap Market. The Nasdaq Stock Market's Marketplace Rules impose certain minimum financial requirements on us for the continued listing of our stock. One such requirement is the minimum bid price on our stock of $1.00 per share. Beginning in 2002, there have been periods of time during which we have been out of compliance with the $1.00 minimum bid requirements of The Nasdaq SmallCap Market.

On September 6, 2002, we received notification from Nasdaq that for the 30 days prior to the notice, the price of our common stock had closed below the minimum $1.00 per share bid price requirement for continued inclusion under Marketplace Rule 4450(a)(5) (the "Rule"), and were provided 90 calendar days, or until December 5, 2002, to regain compliance. Our bid price did not close above the minimum during that period. On December 6, 2002, we received notification from Nasdaq that our securities would be delisted from The Nasdaq National Market, the exchange on which our stock was listed prior to May 6, 2003, on December 16, 2002 unless we either (i) applied to transfer our securities to The Nasdaq SmallCap Market, in which case we would be afforded additional time to come into compliance with the minimum $1.00 bid price requirement; or (ii) appealed the Nasdaq staff's determination to the Nasdaq's Listing Qualifications Panel (the "Panel"). On December 12, 2002 we requested an oral hearing before the Panel and such hearing took place on January 16, 2003 in Washington, D.C. Our appeal was based, among other things, on our intention to seek stockholder approval for a reverse split of our outstanding common stock. On April 28, 2003 at a special meeting of our stockholders, our board of directors was granted the authority to effect a reverse split of our common stock within a range of two-for-one to fifteen-for-one. This authority was reaffirmed by our stockholders at the Annual Meeting on September 8, 2003. The timing and ratio of a reverse split, if any, is at the sole discretion of our board of directors, but it must be completed on or before December 2, 2003. On May 6, 2003, we transferred the listing of our common stock to The Nasdaq SmallCap Market. In connection with this transfer, and by additional notice, Nasdaq granted us an extension until December 31, 2003, to regain compliance with the Rule's minimum $1.00 per share bid price requirement for continued inclusion on The Nasdaq SmallCap Market. On September 16, 2003, the bid price for our stock had closed

at $1.00 or above for ten consecutive days. On September 17, 2003, we received a letter from Nasdaq confirming that Tegal had regained compliance with the minimum bid price requirement and that the question of its continued listing on The SmallCap Market was now closed.

If we are out of compliance in the future with Nasdaq listing requirements, we may take actions in order to achieve compliance, which actions may include a reverse split of our common stock. If an initial delisting decision is made by the Nasdaq's staff, we may appeal the decision as permitted by Nasdaq rules. If we are delisted and cannot obtain listing on another major market or exchange, our stock's liquidity would suffer, and we would likely experience reduced investor interest. Such factors may result in a decrease in our stock's trading price. Delisting also may restrict us from issuing additional securities or securing additional financing.

We have designed our advanced etch and deposition products for customer applications in emerging new films, polysilicon and metal which we believe to be the leading edge of critical applications for the production of advanced semiconductor and other microelectronic devices. Revenues from the sale of our advanced etch and deposition systems accounted for 25% and 36% of total revenues in fiscal 2003 and 2002, 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. There can be no assurance 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, our business, financial condition, results of operations and cash flows will be materially adversely affected.

OUR POTENTIAL CUSTOMERS MAY NOT ADOPT OUR PRODUCTS BECAUSE OF THEIR SIGNIFICANT COST OR BECAUSE OUR POTENTIAL CUSTOMERS ARE ALREADY USING A COMPETITOR'S TOOL.

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

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 there can be no assurance as to future profitability.

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;

- seasonal fluctuations in sales;

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

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

- foreign currency exchange rate fluctuations;

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

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

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. There can be no assurance 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.

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.

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 could result in substantial cost and diversion of effort by us, which by itself could have a detrimental effect on our financial condition, operating results and cash flows. Further, adverse determinations in such litigation could result in our loss of proprietary rights, subject us to significant liabilities to third parties, 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.

OUR CUSTOMERS ARE CONCENTRATED AND THEREFORE THE LOSS OF A SIGNIFICANT CUSTOMER MAY HARM OUR BUSINESS.

Our top five customers accounted for 88.2%, 54.4% and 42.0% of our systems revenues in fiscal 2003, 2002 and 2001, respectively. Four customers each accounted for more than 10% of net systems sales in fiscal 2003. Although the composition of the group comprising our largest customers may vary from year to year, the loss of a significant customer or any reduction in orders by any significant customer, including reductions due to market, economic or competitive conditions in the semiconductor manufacturing industry, may have a detrimental effect on our business, financial condition, results of operations and cash flows. Our ability to increase our sales in the future will depend, in part, upon our ability to obtain orders from new customers, as well as the financial condition and success of our existing customers and the general economy, which is largely beyond our ability to control.

WE ARE EXPOSED TO ADDITIONAL RISKS ASSOCIATED WITH INTERNATIONAL SALES AND OPERATIONS.

International sales accounted for 66%, 67% and 61% of total revenue for fiscal 2003, 2002 and 2001, 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. There can be no assurance that any of these factors will not have a detrimental effect on our operations, financial results and cash flows.

We generally attempt to offset a portion of our U.S. dollar denominated balance sheet exposures subject to foreign exchange rate remeasurement by purchasing forward currency contracts for future delivery. There can be no assurance 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.

WE MUST INTEGRATE OUR ACQUISITIONS OF SPUTTERED FILMS AND SIMPLUS SYSTEMS CORPORATION AND WE MAY NEED TO MAKE ADDITIONAL FUTURE ACQUISITIONS TO REMAIN COMPETITIVE. THE PROCESS OF IDENTIFYING, ACQUIRING AND INTEGRATING FUTURE ACQUISITIONS MAY CONSTRAIN VALUABLE MANAGEMENT RESOURCES, AND OUR FAILURE TO EFFECTIVELY INTEGRATE FUTURE ACQUISITIONS MAY RESULT IN THE LOSS OF KEY EMPLOYEES AND THE DILUTION OF STOCKHOLDER VALUE AND HAVE AN ADVERSE EFFECT ON OUR OPERATING RESULTS.

We acquired Sputtered Films, Inc. in August 2002. On November 11, 2003, we acquired substantially all of the assets of Simplus Systems Corporation. We may in the future seek to acquire or invest in additional businesses, products or technologies that we believe could complement or expand our business, augment our market coverage, enhance our technical capabilities or that may otherwise offer growth opportunities. We may encounter problems with the assimilation of Sputtered Films and Simplus or businesses, products or technologies acquired in the future including:

- difficulties in assimilation of acquired personnel, operations, technologies or products;

- unanticipated costs associated with acquisitions;

- diversion of management's attention from other business concerns and potential disruption of our ongoing business;

- adverse effects on our existing business relationships with our customers;

- potential patent or trademark infringement from acquired technologies;

- adverse effects on our current employees and the inability to retain employees of acquired companies;

- use of substantial portions of our available cash as all or a portion of the purchase price;

- dilution of our current stockholders due to the issuance of additional securities as consideration for acquisitions; and

- inability to complete acquired research and development projects.

If we are unable to successfully integrate our acquired companies or to create new or enhanced products and services, we may not achieve the anticipated benefits from our acquisitions. If we fail to achieve the anticipated benefits from the acquisitions, we may incur increased expenses and experience a shortfall in our anticipated revenues and we may not obtain a satisfactory return on our investment. In addition, if a significant number of employees of acquired companies fail to remain employed with us, we may experience difficulties in achieving the expected benefits of the acquisitions.

Completing any potential future acquisitions could cause significant diversions of management time and resources. Financing for future acquisitions may not be available on favorable terms, or at all. If we identify an appropriate acquisition candidate for any of our businesses, we may not be able to negotiate the terms of the acquisition successfully, finance the acquisition or integrate the acquired business, products, technologies or employees into our existing business and operations. Future acquisitions may not be well-received by the investment community, which may cause our stock price to fall. We have not entered into any agreements or understanding regarding any future acquisitions and cannot ensure that we will be able to identify or complete any acquisition in the future.

If we acquire businesses, new products or technologies in the future, we may be required to amortize significant amounts of identifiable intangible assets and we may record significant amounts of goodwill that will be subject to annual testing for impairment. If we consummate one or more significant future acquisitions in which the consideration consists of stock or other securities, our existing stockholders' ownership could be significantly diluted. If we were to proceed with one or more significant future acquisitions in which the consideration included cash, we could be required to use a substantial portion of our available cash.

OUR WORKFORCE REDUCTIONS AND FINANCIAL PERFORMANCE MAY ADVERSELY AFFECT THE MORALE AND PERFORMANCE OF OUR PERSONNEL AND OUR ABILITY TO HIRE NEW PERSONNEL.

We have made reductions in our workforce in order to reduce costs and bring staffing in line with our anticipated requirements. There were costs associated with the workforce reductions related to severance and other employee-related costs, and our restructuring may yield unanticipated costs and consequences, such as attrition beyond our planned reduction in staff. In addition, 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. In addition, workforce reductions and management changes create anxiety and uncertainty and may adversely affect employee morale. As a result, we may lose employees whom we would prefer to retain. As a result of these factors, our remaining personnel may seek employment with larger, more established companies or companies perceived as having less volatile stock prices.

PROVISIONS IN OUR AGREEMENTS, CHARTER DOCUMENTS, STOCKHOLDER RIGHTS PLAN AND DELAWARE LAW MAY DETER TAKEOVER ATTEMPTS, WHICH COULD DECREASE THE VALUE OF YOUR SHARES.

Our certificate of incorporation and bylaws and Delaware law contain provisions that could make it more difficult for a third party to acquire us without the consent of our board of directors. Our board of directors has the right to issue preferred stock without stockholder approval, which could be used to dilute the stock ownership of a potential hostile acquirer. Delaware law imposes some restrictions on mergers and other business combinations between us and any holder of 15% or more of our outstanding common stock. In addition, we have adopted a stockholder rights plan that makes it more difficult for a third party to acquire us without the approval of our board of directors. These provisions apply even if the offer may be considered beneficial by some stockholders.

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. There can be no assurance that the market price of our common stock will not experience significant fluctuations in the future, including fluctuations that are unrelated to our performance.

POTENTIAL DISRUPTION OF OUR SUPPLY OF MATERIALS REQUIRED TO BUILD OUR SYSTEMS COULD HAVE A NEGATIVE EFFECT ON OUR OPERATIONS AND DAMAGE OUR CUSTOMER RELATIONSHIPS.

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

ANY FAILURE BY US TO COMPLY WITH ENVIRONMENTAL REGULATIONS IMPOSED ON US COULD SUBJECT US TO FUTURE LIABILITIES.

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

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

2.1 Asset Acquisition Agreement by and between Tegal Corporation and Simplus Systems Corporation, dated November 10, 2003, filed as Exhibit 2.1 to Tegal's current report on Form 8-K (SEC File No. 000-26824), filed on December 9, 2003, and incorporated herein by reference.

4.1 Registration Rights Agreement by and among Tegal Corporation, Simplus System Corporation and Kiet Nguyen, as representative of the stockholders of Simplus Systems Corporation, dated December 5, 2003, filed as Exhibit 4.1 to Tegal's current report on Form 8-K (SEC File No. 000-26824), filed on December 9, 2003, and incorporated herein by reference.

10.1 Accounts Receivable Financing Agreement by and between Tegal Corporation and Silicon Valley Bank, dated January 16, 2003.

31 Certifications of the Chief Executive Officer and 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.

(b) Reports on Form 8-K

Current Report on Form 8-K filed December 9, 2003, under item 5 and item 7 thereof.

EXHIBIT 10.1

[LOGO]
SILICON VALLEY BANK
SPECIALTY FINANCE DIVISION

ACCOUNTS RECEIVABLE FINANCING AGREEMENT

This ACCOUNTS RECEIVABLE FINANCING AGREEMENT (the "Agreement"), dated as of the Effective Date, is among Silicon Valley Bank, Specialty Finance Division ("Bank") on the one hand, and Tegal Corporation, a Delaware corporation, and Tegal Japan, Inc., a corporation organized under the laws of Japan (collectively, joint and severally "Borrower") on the other hand, whose address is 2201 S. McDowell Blvd, Petaluma, CA 94954 and with a FAX number of (707) 765 - - 9311.

1. DEFINITIONS. In this Agreement:

"ACCOUNTS" are all existing and later arising accounts, contract rights, and other obligations owed Borrower in connection with its sale or lease of goods (including licensing software and other technology) or provision of services, all credit insurance, guaranties, other security and all merchandise returned or reclaimed by Borrower and Borrower's Books relating to any of the foregoing.

"ACCOUNT DEBTOR" is defined in the California Uniform Commercial Code and shall include any person liable on any Financed Receivable or Exim Financed Receivable, such as a guarantor of the Financed Receivable or Exim Financed Receivable and any issuer of a letter of credit or banker's acceptance.

"ADJUSTMENTS" are all discounts, allowances, returns, disputes, counterclaims, offsets, defenses, rights of recoupment, rights of return, warranty claims, or short payments, asserted by or on behalf of any Account Debtor for any Financed Receivable or Exim Financed Receivable.

"ADVANCE" is defined in Section 2.2.

"ADVANCE RATE" is 80%, net of deferred revenue and offsets related to each specific Account Debtor, or another percentage as Bank establishes under Section 2.2.

"APPLICABLE RATE" is a rate per annum equal to the "Prime Rate" plus 1.00 percentage point.

"BORROWER AGREEMENT" is the Export-Import Bank of the United States Working Capital Guarantee Program Borrower Agreement between Borrower and Bank.

"BORROWING BASE" has the meaning set forth in the Borrower Agreement.

"BORROWER'S BOOKS" are all Borrower's books and records including ledgers, records regarding Borrower's assets or liabilities, the Collateral, business operations or financial condition and all computer programs or discs or any equipment containing the information.

"CODE" is the California Uniform Commercial Code as in effect from time to time.

"COLLATERAL" is attached as Exhibit "A".

"COLLATERAL HANDLING FEE" is defined in Section 4.5.

"COLLECTIONS" are all funds received by Bank from or on behalf of an Account Debtor for Financed Receivables or Exim Financed Receivables.

"COMPLIANCE CERTIFICATE" is attached as Exhibit "B".

"EARLY TERMINATION FEE" is defined in Section 4.6.

"EFFECTIVE DATE" is the date in which Bank executes this Agreement.

"EVENT OF DEFAULT" is defined in Section 10.

"EXIM ADVANCE" is defined in Section 3.1.

"EXIM ADVANCE RATE" is 90%, net of deferred revenue and offsets related to each specific Account Debtor, or another percentage as Bank establishes under Section 3.1.

"EXIM BANK" is the Export-Import Bank of the United States.

"EXIM BANK EXPENSES" are all audit fees and expenses, reasonable costs or expenses (including reasonable attorneys' fees and expenses) for preparing, negotiating, administering, defending and enforcing the Exim Loan Documents (including appeals or Insolvency Proceedings) and the fees that the Bank pays to the Exim Bank in consideration of the issuance of the Exim Guarantee.

"EXIM ELIGIBLE FOREIGN ACCOUNTS" are Accounts payable in United States Dollars that arise in the ordinary course of Borrower's business from Borrower's sale of Exim Eligible Foreign Inventory (i) that the Account Debtor does not have its principal place of business in the United States and (ii) that have been assigned and comply with all of Borrower's representations and warranties in this Agreement; but Bank, in its good faith business judgment, may change eligibility standards by giving Borrower notice. Unless Bank agrees otherwise in writing, Exim Eligible Foreign Accounts will not include:

(a) Accounts with terms of sales greater than 90 days;

(b) Accounts which are more than 60 calendar days past the original due date, unless it is insured through Exim Bank export credit insurance for comprehensive commercial and political risk, or through Exim Bank approved private insurers for a comparable coverage, in which case 90 calendar days shall apply;

(c) Credit balances over 60 days from due date of the relevant invoice;

(d) Accounts evidenced by a letter of credit until the date of shipment of the items covered by the subject letter of credit;

(e) Accounts for which the Account Debtor is a military or defense entity;

(f) Accounts for which Borrower owes the Account Debtor, but only up to the amount owed (sometimes called "contra" accounts, accounts payable, customer deposits or credit accounts);

(g) Accounts for demonstration or promotional equipment, or in which goods are consigned, sales guaranteed, sale or return, sale on approval, bill and hold, or other terms if Account Debtor's payment may be conditional;

(h) Accounts for which the Account Debtor is Borrower's Affiliate, officer, employee, or agent;

(i) Accounts in which the Account Debtor disputes liability or makes any claim and Bank believes there may be a basis for dispute (but only up to the disputed or claimed amount), or if the Account Debtor is subject to an Insolvency Proceeding, or becomes insolvent, or goes out of business;

(j) Accounts generated by the sale of products purchased for military purposes;

(k) Accounts generated by the sales of Inventory which constitute defense articles or defense services;

(l) Accounts excluded from the Borrowing Base under the Borrower Agreement;

(m) Accounts that arise from the sales of items not in the ordinary

course of Borrower's business;

(n) Accounts not owned by Borrower or that are subject to any right, claim or interest of another person other than the lien in favor of Bank;

(o) Accounts with respect to which an invoice has not been sent;

(p) Accounts billed and payable outside the United Stated unless approved in writing by Exim Bank; and such Accounts are subject to the following:

1. Each subsidiary or affiliate is a party to the Loan Agreement;

2. All proceeds are remitted to the United States on a monthly basis (excluding the retention of proceeds for the purpose of funding local expenses);

3. Accounts are derived from eligible exports originating from the United States;

4. Bank obtains a valid first priority security interest (or equivalent) in the jurisdiction where the Accounts are located; and

5. Bank obtains a legal opinion from local counsel with regard to the enforceability of such security interest.

(s) Accounts billed in currencies other than U.S. Dollars, unless approved in writing by Exim Bank;

(t) Accounts from foreign buyers in countries where Exim Bank is legally prohibited from doing business or in which Exim Bank coverage is not available (as designated in the Country Limitation Schedule);

(u) Accounts backed by letters of credit unacceptable to Bank in its reasonable and good faith credit judgment;

(v) Accounts for which Bank or Exim Bank determines collection to be doubtful, with Bank's determination of same to be reasonable;

(w) Accounts for which the items giving rise to such Account have not been shipped and delivered to and accepted by the Buyer or the services giving rise to such Account have not been performed by Borrower and accepted by the Buyer or the Account does not represent a final sale;

(x) Accounts for which Borrower has made any agreement with the Buyer for any deduction therefrom, except for discounts or allowances made in the ordinary course of business for prompt payment, all of which discounts or allowances are reflected in the calculation of the face value of each respective invoice related thereto; and

(y) Accounts for which any of the items giving rise to such Account have been returned, rejected or repossessed.

"EXIM FINANCED RECEIVABLES" are all those accounts, receivables, chattel paper, instruments, contract rights, documents, general intangibles, letters of credit, drafts, bankers acceptances, and rights to payment, and all proceeds, including their proceeds (collectively "receivables"), which Bank finances and makes an Exim Advance. An Exim Financed Receivable stops being an Exim Financed Receivable (but remains Collateral) when the Exim Advance made for the Exim Financed Receivable has been finally paid.

"EXIM GUARANTEE" is that certain Master Guarantee Agreement or other agreement, as amended from time to time, the terms of which are incorporated into this Agreement.

"EXIM LOAN DOCUMENTS" means this Agreement, any note or notes executed by Borrower or any other agreement entered into in connection with this Agreement, pursuant to which Exim Bank guarantees Borrower's obligations under this Agreement.

"EXISTING FACILITY" means that certain LOAN AND SECURITY AGREEMENT BETWEEN BANK AND TEGAL CORPORATION AND ________________________ DATED AS OF JUNE 26, 2002 AND ANY NOTE OR NOTES EXECUTED BY TEGAL CORPORATION OR ANY OTHER AGREEMENT ENTERED INTO IN CONNECTION WITH SUCH LOAN AND SECURITY AGREEMENT.

"EXPORT ORDER" is a written export order or contract for the purchase by the buyer from the Borrower of any finished goods or services which are intended for export.

"FACILITY" is an extension of credit by Bank to Borrower in order to finance receivables with an aggregate Account Balance not exceeding the Facility Amount.

"FACILITY AMOUNT" is $3,500,000 gross.

"FACILITY PERIOD" is the period beginning on this date and continuing until January 16,2005 unless the period is terminated sooner by Bank with notice to Borrower or by Borrower under Section 4.6.

"FINANCE CHARGES" is defined in Section 4.2.

"FINANCED RECEIVABLES" are all those accounts, receivables, chattel paper, instruments, contract rights, documents, general intangibles, letters of credit, drafts, bankers acceptances, and rights to payment, and all proceeds, including their proceeds (collectively "receivables"), which Bank finances and make an Advance. A Financed Receivable stops being a Financed Receivable (but remains Collateral) when the Advance made for the Financed Receivable has been finally paid.

"FINANCED RECEIVABLE BALANCE" is the total outstanding amount, at any time, of all Financed Receivables and Exim Financed Receivables.

"GAAP" means United States generally accepted accounting principals.

"GOOD FAITH DEPOSIT" is defined in Section 4.9.

"GUARANTOR" means any guarantor of the Obligations.

"INELIGIBLE RECEIVABLE" is any accounts receivable:

(A) that is unpaid (90) calendar days after the invoice date; or

(B) that is owed by an Account Debtor that has filed, or has had filed against it, any bankruptcy case, assignment for the benefit of creditors, receivership, or Insolvency Proceeding or who has become insolvent (as defined in the United States Bankruptcy Code) or who is generally not paying its debts as they become due; or

(C) for which there has been any breach of warranty or representation in Section 7 or any breach of any covenant in this Agreement; or

(D) for which the Account Debtor asserts any discount, allowance, return, dispute, counterclaim, offset, defense, right of recoupment, right of return, warranty claim, or short payment; or

(E) is not an Exim Eligible Foreign Account.

"INSOLVENCY PROCEEDING" are proceedings by or against any person under the United States Bankruptcy Code, or any other bankruptcy or insolvency law, including assignments for the benefit of creditors, compositions, extensions generally with its creditors, or proceedings seeking reorganization, arrangement, or other relief.

"INVOICE TRANSMITTAL" shows accounts receivable which Bank may finance and, for each receivable, includes the Account Debtor's, name, address, invoice amount, invoice date and invoice number and is signed by Borrower's authorized representative.

"LOCKBOX" is described in Section 7.2.

"OBLIGATIONS" are all advances, liabilities, obligations, covenants and

duties owing, arising, due or payable by Borrower to Bank now or later under this Agreement or any other document, instrument or agreement, account (including those acquired by assignment) primary or secondary, such as all Advances, Exim Advances, Finance Charges, Collateral Handling Fees, interest, fees, expenses, professional fees and attorneys' fees or other.

"PRIME RATE" is Bank's most recently announced "prime rate," even if it is not Bank's lowest rate. Notwithstanding the foregoing, for purposes of this Agreement, the Prime Rate shall not be less than 4.25%.

"RECONCILIATION DAY" is the last calendar day of each month.

"RECONCILIATION PERIOD" is each calendar month.

"TANGIBLE NET WORTH" shall mean the excess of total assets over total liabilities, determined in accordance with GAAP, with the following adjustments:

(A) there shall be excluded from assets: (i) notes, accounts receivable and other obligations owing to Borrower from its officers or other Affiliates, and (ii) all assets which would be classified as intangible assets under GAAP, including without limitation goodwill, licenses, patents, trademarks, trade names, copyrights, capitalized software and organizational costs, licenses and franchises; and

(B) there shall be excluded from liabilities all 50% of all consideration received after the effective date of this Agreement for equity securities and indebtedness which is subordinated to the Obligations under a subordination agreement in form specified by Bank or by language in the instrument evidencing the indebtedness which Bank agrees in writing is acceptable to Bank in its good faith business judgment.

2. FINANCING OF ACCOUNTS RECEIVABLE.

2.1. REQUEST FOR ADVANCES. During the Facility Period, Borrower may offer accounts receivable to Bank if there is not an Event of Default. Borrower will deliver an Invoice Transmittal (in the form of Exhibit C) for each accounts receivable it offers. Bank may rely on information in or with the Invoice Transmittal. The Bank shall not make any Advances prior to Borrower transferring all of its cash in its primary operating account at California Bank & Trust ("CBT") from CBT to Bank.

2.2. ACCEPTANCE OF ACCOUNTS RECEIVABLE. Bank is not obligated to finance any accounts receivable. Bank may approve any Account Debtor's credit before financing any receivable. When Bank accepts a receivable, it will pay Borrower the Advance Rate times the face amount of the receivable (the "Advance"). Bank may, in its discretion, change the percentage of the Advance Rate. When Bank makes an Advance, the receivable becomes a "Financed Receivable." All representations and warranties in Section 7 must be true as of the date of the Invoice Transmittal and of the Advance and no Event of Default exists would occur as a result of the Advance. There shall be Advances for no more than 12 invoices at any one time outstanding. At no time shall the sum of all outstanding Advances plus Exim Advances exceed the Facility Amount.

3. EXIM ADVANCES; OVERADVANCES.

3.1 EXIM ADVANCES SUBLIMIT.

(a) During the Facility Period, Borrower may offer Exim Eligible Foreign Accounts to Bank if there is not an Event of Default. Borrower will deliver an Invoice Transmittal for each Exim Eligible Foreign Account it offers. Bank may rely on information in or with the Invoice Transmittal. The Bank shall not make any Exim Advances prior to Borrower transferring all of its cash in its primary operating account at CBT from CBT to Bank.

(b) Bank is not obligated to finance any Exim Eligible Foreign Accounts. Bank may approve any Account Debtor's credit before financing any receivable. When Bank accepts a receivable in connection with an Exim Advance, the Bank will pay Borrower the Exim Advance Rate times the face amount of the receivable (the "Exim Advance"). Bank may, in its discretion, change the percentage of the Exim Advance Rate. When Bank makes an Exim Advance, the receivable becomes a "Exim Financed Receivable." All representations and warranties in Section 7 must be true as of the date of the Invoice Transmittal and of the Advance and no Event of Default exists would occur as a result of the Advance. There shall be Exim Advances for no more than 12 invoices at any one time outstanding. The total amount of Exim Advances outstanding at any one time may not exceed $2,800,000. The aggregate amount of outstanding Exim Advances shall reduce the amount otherwise available to be borrowed under the Facility Amount.

(c) To obtain an Exim Advance, Borrower must notify Bank (which notice is irrevocable) by facsimile no later than 3:00 p.m. Pacific time 1 Business Day before the day on which the Exim Advance is to be made. The notice must be in the form of Exhibit C and shall be accompanied by any Export Orders. The notice must be signed by a Responsible Officer or designee. In addition, the Exim Guarantee must be in full force and effect.

3.2 OVERADVANCES.

If Borrower's Obligations under Section 2.1 and 3.1 exceed the Facility Amount, Borrower must immediately pay Bank the excess.

4. COLLECTIONS, FINANCE CHARGES, REMITTANCES AND FEES. The Obligations shall be subject to the following fees and Finance Charges. Fees and Finance Charges may, in Bank's discretion, be charged as an Advance or Exim Advance, and shall thereafter accrue fees and Finance Charges as described below. Bank may, in its discretion, charge fee and Finance Charges to Borrower's deposit account maintained with Bank.

4.1. COLLECTIONS. Collections will be credited to the Financed Receivables Balance, but if there is an Event of Default, Bank may apply Collections to the Obligations in any order it chooses. If Bank receives a payment for both a Financed Receivable or an Exim Financed Receivable and a non-Financed receivable or a non-Exim Financed Receivable, the funds will first be applied to the Financed Receivable or the Exim Financed Receivable, as the case may be, and if there is not an Event of Default, the excess will be remitted to the Borrower, subject to Section 4.10. Bank, in its sole and exclusive discretion, may apply Collections towards the repayment of a Financed Receivable or an Exim Financed Receivable in any order and in any manner as it sees fit.

4.2. FINANCE CHARGES. In computing Finance Charges on the Advances and Exim Advances, all Collections received by Bank shall be deemed applied by Bank on account of the Advances and Exim Advances 3 Business Days after receipt of the Collections. Borrower will pay a finance charge (the "Finance Charge"), which is equal to the Applicable Rate times the number of days in the Reconciliation Period times the outstanding average daily Financed Receivable Balance for that Reconciliation Period. After an Event of Default, Advances and Exim Advances accrue interest at 5 percent above the Applicable Rate effective immediately before the Event of Default.

4.3. [THIS SECTION INTENTIONALLY LEFT BLANK.]

4.4. [THIS SECTION INTENTIONALLY LEFT BLANK.]

4.5. COLLATERAL HANDLING FEE. On each Reconciliation Day, Borrower will pay to Bank a collateral handling fee, equal to 0.50% per month of the average daily Financed Receivable Balance outstanding during the applicable Reconciliation Period. After an Event of Default, the Collateral Handling Fee will increase an additional 0.50% effective immediately before the Event of Default.

4.6. EARLY TERMINATION FEE. A fully earned, non-refundable early termination fee equal to one percent (1%) of the Financed Receivable Balance (such amount to be calculated on the date such early termination fee is earned) on the date such early termination fee is due upon voluntary or involuntary full payment of the Obligations and termination of this Facility prior to twelve (12) months from the date of this Agreement, unless the Obligations are paid in full from an initial advance from a loan agreement with Bank.

4.7. ACCOUNTING. After each Reconciliation Period, Bank will provide an accounting of the transactions for that Reconciliation Period, including the amount of all Financed Receivables, Exim Financed Receivables, all Collections, Adjustments, Finance Charges and the Collateral Handling Fee. If Borrower does not object to the accounting in writing within 30 days it is considered correct. All Finance Charges and other interest and fees calculated on the basis of a 360-day year and actual days elapsed.

4.8. DEDUCTIONS. Bank may deduct fees, finance charges and other amounts due from any Advances made or Collections received by Bank.

4.9. GOOD FAITH DEPOSIT. Borrower has paid to Bank a Good Faith Deposit of $20,000 to initiate Bank's due diligence review process.

4.10. ACCOUNT COLLECTION SERVICES. All Borrowers' receivables are to be paid to the same address/or party and Borrower and Bank must agree on such address. If Bank collects all receivables and there is not an Event of Default or an event that with notice or lapse of time will be an Event of Default, within FIVE (5) days of receipt of those collections, Bank will give Borrower, the receivables collections it receives for receivables other than Financed Receivables or Exim Financed Receivables and/or amount in excess of the amount for which Bank has made an Advance or an Exim Advance to Borrower, less any amount due to Bank, such as the Finance Charge, Collateral Handling Fee and expenses or otherwise. This section does not impose any affirmative duty on Bank to do any act other than to turn over amounts. All receivables and collections are Collateral and if an Event of Default occurs, Bank need not remit collections of Collateral and may apply them to the Obligations.

4.11 EXIM BANK EXPENSES. On the date this Agreement is executed and delivered, Borrower will pay all Exim Bank Expenses incurred through the date hereof.

5. REPAYMENT OF CERTAIN OBLIGATIONS.

5.1. REPAYMENT ON MATURITY. Borrower will repay each Advance and Exim Advance on the earliest of: (a) payment of the Financed Receivable or Exim Financed Receivable in respect which the Advance or Exim Advance was made, (b) the Financed Receivable or Exim Financed Receivable becomes an Ineligible Receivable, (c) when any Adjustment is made to the Financed Receivable or Exim Financed Receivable (but only to the extent of the Adjustment if the Financed Receivable or Exim Financed Receivable is not otherwise an Ineligible Receivable, or (d) the last day of the Facility Period (including any early termination). Each payment will also include all accrued Finance Charges on the Advance or Exim Advance and all other amounts due hereunder.

5.2. REPAYMENT ON EVENT OF DEFAULT. When there is an Event of Default, Borrower will, if Bank demands (or, in an Event of Default under Section 10(B), immediately without notice or demand from Bank) repay all of the Obligations. The demand may, at Bank's option, include the Advance or Exim Advance, as the case may be, for each Financed Receivable or Exim Financed Receivable then outstanding and all accrued Finance Charges, Collateral Handling Fees, attorneys and professional fees, court costs and expenses, and any other Obligations.

6. POWER OF ATTORNEY. Borrower irrevocably appoints Bank and its successors and assigns it attorney-in-fact and authorizes Bank, regardless of whether there has been an Event of Default, to:

(A) sell, assign, transfer, pledge, compromise, or discharge all or any

part of the Financed Receivables or Exim Financed Receivables:

(B) demand, collect, sue, and give releases to any Account Debtor for monies due and compromise, prosecute, or defend any action, claim, case or proceeding about the Financed Receivables or Exim Financed Receivables, including filing a claim or voting a claim in any bankruptcy case in Bank's or Borrower's name, as Bank chooses;

(C) prepare, file and sign Borrower's name on any notice, claim, assignment, demand, draft, or notice of or satisfaction of lien or mechanics' lien or similar document;

(D) notify all Account Debtors to pay Bank directly;

(E) receive, open, and dispose of mail addressed to Borrower;

(F) endorse Borrower's name on check or other instruments;

(G) execute on Borrower's behalf any instruments, documents, financing statements to perfect Bank's interests in the Financed Receivables and Collateral; and

(H) do all acts and things necessary or expedient.

7. REPRESENTATIONS, WARRANTIES AND COVENANTS.

7.1. REPRESENTATIONS AND WARRANTIES. Borrower represents and warrants for each Financed Receivable and each Exim Financed Receivable:

(A) It is the owner with legal right to sell, transfer and assign it;

(B) The correct amount is on the Invoice Transmittal and is not disputed;

(C) Payment is not contingent on any obligation or contract and it has fulfilled all its obligations as of the Invoice Transmittal date;

(D) It is based on an actual sale and delivery of goods and/or services rendered, due to Borrower, it is not past due or in default, has not been previously sold, assigned, transferred, or pledged and is free of any liens, security interests and encumbrances;

(E) There are no defenses, offsets, counterclaims or agreements for which the Account Debtor may claim any deduction or discount;

(F) It reasonably believes no Account Debtor is insolvent or subject to any Insolvency Proceedings;

(G) It has not filed or had filed against it Insolvency Proceedings and does not anticipate any filing;

(H) Bank has the right to endorse and/ or require Borrower to endorse all payments received on Financed Receivables and Exim Financed Receivables and all proceeds of Collateral; and

(I) No representation, warranty or other statement of Borrower in any certificate or written statement given to Bank contains any untrue statement of a material fact or omits to state a material fact necessary to make the statement contained in the certificates or statement not misleading.

7.1.1 ADDITIONAL REPRESENTATIONS AND WARRANTIES. Borrower represents and warrants as follows:

(A) Borrower is duly existing and in good standing in its state of formation and qualified and licensed to do business in, and in good standing in, any state in which the conduct of its business or its ownership of property requires that it be qualified. The execution, delivery and performance of this Agreement has been duly authorized, and does not conflict with Borrower's organizational documents, nor

constitute an Event of Default under any material agreement by which Borrower is bound. Borrower is not in default under any agreement to which or by which it is bound.

(B) Borrower has good title to the Collateral, free and clear of all liens. The Accounts in any report submitted to Bank, are bona fide, existing obligations and the service or property has been performed or delivered to the Account Debtor or its agent (subject only to installation and warranty obligations arising in the ordinary course of Borrower's business), for immediate shipment to and unconditional acceptance by the Account Debtor. Borrower has no notice of any actual or imminent Insolvency Proceeding of any Account Debtor.

(C) All inventory is in all material respects of good and marketable quality and free from material defects.

(D) Borrower is not an "investment company" or a company "controlled" by an "investment company" under the Investment Company Act. Borrower is not engaged as one of its important activities in extending credit for margin stock (under Regulations G, T and U of the Federal Reserve Board of Governors). Borrower has complied with the Federal Fair Labor Standards Act. Borrower has not violated any laws, ordinances or rules. None of Borrower's properties or assets has been used by Borrower, to the best of Borrower's knowledge, by previous persons, in disposing, producing, storing, treating, or transporting any hazardous substance other than legally. Borrower has timely filed all required tax returns and paid, or made adequate provision to pay, all taxes. Borrower has obtained all consents, approvals and authorizations of, made all declarations or filings with, and given all notices to, all government authorities that are necessary to continue its business as currently conducted.

(E) Borrower will use the proceeds of the Exim Advances only for the purposes specified in the Borrower Agreement. Borrower will not use the proceeds of the Exim Advances for any purpose prohibited by the Borrower Agreement.

7.2. AFFIRMATIVE COVENANTS. Borrower will do all of the following:

(A) Maintain its corporate existence and good standing in its jurisdictions of incorporation and maintain its qualification in each jurisdiction necessary to Borrower's business or operations.

(B) Give Bank at least 10 days prior written notice of changes to its name, organization, chief executive office or location of records.

(C) Pay all its taxes including gross payroll, withholding and sales taxes when due and will deliver satisfactory evidence of payment if requested.

(D) Provide a written report within 10 days, if payment of any Financed Receivable or Exim Financed Receivable does not occur by its due date and include the reasons for the delay.

(E) Give Bank copies of all Forms 10-K, 10-Q and 8-K (or equivalents) within 5 days of filing with the Securities and Exchange Commission, while any Financed Receivable or Exim Financed Receivable is outstanding.

(F) Execute any further instruments and take further action as Bank requests to perfect or continue Bank's security interest in the Collateral or to effect the purposes of this Agreement.

(G) Provide Bank with a Compliance Certificate no later than 30 days following each month end when there is a positive Financed Receivable Balance or as requested by Bank.

(H) When there is a positive Financed Receivable Balance, provide Bank with, as soon as available, but no later than 30 days following each Reconciliation Period, a company prepared balance sheet and income

statement, prepared under GAAP, consistently applied, covering Borrower's operations during the period together with an aged listing of accounts receivable and accounts payable along with a deferred revenue report; provided, however, that such deferred revenue report shall be provided to Bank upon each Advance or Exim Advance if such Advances or Exim Advances occur more than once per month or if more than one Advance or Exim Advance is made per month.

(I) Immediately notify, transfer and deliver to Bank all collections Borrower receives for Financed Receivables or Exim Financed Receivables.

(J) Borrower will remit all payment's for Accounts to the Bank by the close of business on each Friday along with a detailed cash receipts journal and shall immediately notify and direct all of the Borrower's Account Debtor's to make all payment's for Borrower's Accounts to a lockbox account established with a third party acceptable to Bank ("Lockbox") or to wire transfer payments to a cash collateral account that Bank controls. It will be considered an immediate Event of Default if the Lockbox is not set-up and operational within 45 days from the date of this Agreement.

(K) Borrower will allow Bank to audit Borrower's Collateral, including but not limited to Borrower's Accounts, at Borrowers expense, no later than 90 days of the execution of this Agreement and every six months thereafter. Provided, however, if an Event of Default has occurred, Bank may audit Borrower's Collateral, including but not limited to Borrower's Accounts at Bank's sole discretion and without notification and authorization from Borrower.

(L) Provide Bank with, as soon as available, but no later than 120 days after the last day of Borrower's fiscal year, either (i) audited consolidated financial statements prepared under GAAP, consistently applied, together with an unqualified opinion on the financial statements from an independent certified public accounting firm reasonably acceptable to Bank or (ii) a copy of the Borrower's most recently filed United States income tax return.

(M) Provide Bank with inventory reports reasonably requested by Bank. Each Exim Advance shall be supported by Export Orders in connection with such advance.

(N) Borrower shall deliver all reports, certificates and other documents to Bank as provided in the Borrower Agreement, including, without limitation, copies of Export Orders and any other information that Bank and Exim Bank may reasonably request.

(O) Borrower will keep all inventory in good and marketable condition, free from material defects except for inventory for which adequate reserves have been made in accordance with GAAP, which reserves have been, and at all times will be with respect to Exim Eligible Inventory. Returns and allowances between Borrower and its Account Debtors will follow Borrower's customary practices as they exist at execution of this Agreement. Borrower must promptly notify Bank of all returns, recoveries, disputes and claims, that involve more than $100,000.00.

(P) If required by Bank, Borrower will obtain, with respect to Accounts that are otherwise ineligible under Exim borrowing criteria and where Borrower has requested or obtained an Advance, and pay when due all premiums with respect to, and maintain uninterrupted foreign credit insurance. In addition, Borrower will execute in favor of Bank an assignment of proceeds of any insurance policy obtained by Borrower and issued by Exim Bank insuring against comprehensive commercial and political risk (the "EXIM Bank Policy"). The insurance proceeds from the EXIM Bank Policy assigned or paid to Bank will be applied to the balance outstanding under this Agreement. Borrower will immediately notify Bank and Exim Bank in writing upon submission of any claim under the Exim Bank Policy. Then Bank will not be obligated to make any further Credit

Extensions to Borrower based on Exim Eligible Foreign Accounts without prior approval from Exim Bank.

(Q) Borrower will comply with all terms of the Borrower Agreement. If any provision of the Borrower Agreement conflicts with any provision contained in this Agreement, the more strict provision, with respect to the Borrower, will control; provided, however, any action or event that is permitted hereunder shall be deemed to satisfy any requirement for consent of Bank under the Borrower Agreement.

(R) Borrower will, if required by Exim Bank or Bank, cause all sales of products on which the Exim Advances are based to satisfy at least one of the following: (i) be supported by one or more irrevocable letters of credit in an amount and of matter, naming a beneficiary and issued by a financial institution acceptable to Bank and negotiated by Bank, (ii) be for any Account which satisfies all of the requirements to constitute an Exim Eligible Foreign Account, or (iii) where the Accounts from the Buyer exceed twenty-five percent (25%) of all Exim Eligible Foreign Accounts, to be preapproved in writing, by Bank or Exim Bank.

(S) Borrower shall maintain a minimum Tangible Net Worth as follows:

(i) During the period commencing on April 1, 2003 and continuing through June 30, 2003, $8,800,000;

(ii) During the period commencing on July 1, 2003 and continuing through September 31, 2003, $8,000,000;

(iii) During the period commencing on October 1, 2003 and continuing through December 31, 2003, $7,000,000; and

(iv) Commencing on January 1, 2004 and at all times thereafter, $6,500,000.

Increases in this minimum Tangible Net Worth covenant based on consideration received for equity securities and subordinated debt of the Borrower shall be effective as of the end of the month in which such consideration is received, and shall continue effective thereafter. Increases in this minimum Tangible Net Worth Covenant based on net income shall be effective on the last day of the fiscal quarter in which said net income is realized, and shall continue effective thereafter. In no event shall this minimum Tangible Net Worth covenant be decreased.

7.3. NEGATIVE COVENANTS. Borrower will not do any of the following without Bank's prior written consent:

(A) Assign, transfer, sell or grant, or permit any lien or security interest in the Collateral except to Orin Hirschman ("Hirschman") with respect to Borrower's intellectual property.

(B) Convey, sell, lease, transfer or otherwise dispose of the Collateral.

(C) Create, incur, assume, or be liable for any indebtedness.

(D) Become an "investment company" or a company controlled by an "investment company," under the Investment Company Act of 1940 or undertake as one of its important activities extending credit to purchase or carry margin stock, or use the proceeds of any Advance for that purpose; fail to meet the minimum funding requirements of ERISA, permit a Reportable Event or Prohibited Transaction, as defined in ERISA, to occur; fail to comply with the Federal Fair Labor Standards Act or violate any other law or regulation, or permit any of its subsidiaries to do so.

(E) Violate or fail to comply with any provision of the Borrower Agreement or take an action, or permit any action to be taken, that causes, or could be expected to cause, the Exim Guarantee to not be

in full force and effect. Notwithstanding the introductory sentence to this Section 7, at no time will Bank give or be required to give its consent to the actions set forth in this Section 7.3.

8. ADJUSTMENTS. If any Account Debtor asserts a discount, allowance, return, offset, defense, warranty claim, or the like (an "Adjustment") or if Borrower breaches any of the representations, warranties or covenants set forth in Section 7, Borrower will promptly advise Bank. Borrower will resell any rejected, returned, returned, or recovered personal property for Bank, at Borrower's expense, and pay proceeds to Bank. While Borrower has returned goods that are Borrower property, Borrower will segregate and mark them "property of Silicon Valley Bank." Bank owns the Financed Receivables and Exim Financed Receivables and until receipt of payment, has the right to take possession of any rejected, returned, or recovered personal property.

9. SECURITY INTEREST. Borrower grants to Bank a continuing security interest in all presently and later acquired Collateral to secure all Obligations and the performance of each of Borrower's duties hereunder. Any security interest will be a first priority security interest in the Collateral; provided, however that Bank's security interest in Borrower's intellectual property shall be a second priority security interest solely behind Hirschman. Notwithstanding the foregoing, when the debt owed by Borrower to Hirschman is converted to equity, Bank's interest in Borrower's intellectual property will become a first priority security interest.

10. EVENTS OF DEFAULT. Any one or more of the following is an Event of Default.

(A) Borrower fails to pay any amount owed to Bank when due;

(B) Borrower files or has filed against it any Insolvency Proceedings or any assignment for the benefit of creditors, or appointment of a receiver or custodian for any of its assets;

(C) Borrower becomes insolvent or is generally not paying its debts as they become due or is left with unreasonably small capital;

(D) Any involuntary lien, garnishment, attachment attaches to the Financed Receivables, Exim Financed Receivables or any Collateral;

(E) Borrower breaches any covenant, agreement, warranty, or representation is an immediate Event of Default;

(F) Borrower is in default under any document, instrument or agreement evidencing any debt, obligation or liability in favor of Bank its affiliates or vendors regardless of whether the debt, obligation or liability is direct or indirect, primary or secondary, or fixed or contingent;

(G) An event of default occurs under any guaranty of the Obligations or any material provision of any Guaranty is not valid or enforceable or a guaranty is repudiated or terminated;

(H) A material default or Event of Default occurs under any agreement between Borrower and any creditor of Borrower that signed a subordination agreement with Bank;

(I) Any creditor that has signed a subordination agreement with Bank breaches any terms of the subordination agreement; or

(J) (i) A material impairment in the perfection or priority of the Bank's security interest in the Collateral; (ii) a material adverse change in the business, operations, or conditions (financial or otherwise) of the Borrower occurs; or (iii) a material impairment of the prospect of repayment of any portion of the Advances occurs; or

(K) If the Exim Guarantee ceases for any reason to be in full force and effect, or if the Exim Bank declares the Exim Guarantee void or revokes any obligations under the Exim Guarantee.

11. REMEDIES.

11.1. REMEDIES UPON DEFAULT. When an Event of Default occurs, (1) Bank may stop financing receivables or extending credit to Borrower; (2) at Bank's option and on demand, all or a portion of the Obligations or, for to an Event of Default described in Section 10(B), automatically and without demand, are due and payable in full; (3) apply to the Obligations any (i) balances and deposits of Borrower it holds, or (ii) any amount held by Bank owing to or for the credit or the account of Borrower; and (4) Bank may exercise all rights and remedies under this Agreement and the law, including those of a secured party under the Code, power of attorney rights in Section 6 for the Collateral, and the right to collect, dispose of, sell, lease, use, and realize upon all Financed Receivables, Exim Financed Receivables and Collateral in any commercial manner. Borrower agrees that any notice of sale required to be given to Borrower is deemed given if at least five days before the sale may be held.

11.2. DEMAND WAIVER. Borrower waives demand, notice of default or dishonor, notice of payment and nonpayment, notice of any default, nonpayment at maturity, release, compromise, settlement, extension, or renewal of accounts, documents, instruments, chattel paper, and guaranties held by Bank on which Borrower is liable.

11.3. DEFAULT RATE. If any amount is not paid when due, the amount bears interest at the Applicable Rate plus five percent until the earlier of (a) payment in good funds or (b) entry of a final judgment when the principal amount of any money judgment will accrue interest at the highest rate allowed by law.

11.4 EXIM DIRECTION; NOTIFICATION. Upon the occurrence and during the continuance of an Event of Default, Exim Bank shall have right to (i) direct Bank to exercise the remedies specified in Section 9.1 and (ii) request that Bank accelerate the maturity of any other loans to Borrower. Bank has the right to immediately notify Exim Bank in writing if it has knowledge of any of the following events: (1) any failure to pay any amount due under this Agreement; (2) the Borrowing Base is less than the sum of the outstanding Credit Extensions; (3) any failure to pay when due any amount payable to Bank under any loan owing by Borrower to Bank; (4) the filing of an action for debtor's relief by, against or on behalf of Borrower; (5) any threatened or pending material litigation against Borrower, or any dispute involving Borrower. If Bank sends a notice to Exim Bank, Bank has the right to send Exim Bank a written report on the status of events covered by the notice every 30 days after the date of the original notification, until Bank files a claim with Exim Bank or the defaults have been cured (but no Advances may be required during the cure period unless Exim Bank gives its written approval). If directed by Exim Bank, Bank will have the right to exercise any rights it may have against the Borrower to demand the immediate repayment of all amount outstandings under the Exim Loan Documents.

12. FEES, COSTS AND EXPENSES. The Borrower will pay on demand all fees, costs and expenses (including attorneys' and professionals fees with costs and expenses) that Bank incurs from: (a) preparing, negotiating, administering, and enforcing this Agreement or related agreement, including any amendments, waivers or consents, (b) any litigation or dispute relating to the Financed Receivables, the Exim Financed Receivables, the Collateral, this Agreement or any other agreement, (c) enforcing any rights against Borrower or any guarantor, or any Account Debtor, (d) protecting or enforcing its interest in the Financed Receivables, Exim Financed Receivables or other Collateral, (e) collecting the Financed Receivables, Exim Financed Receivables and the Obligations, and (f) any bankruptcy case or insolvency proceeding involving Borrower, any Financed Receivable, any Exim Financed Receivable, the Collateral, any Account Debtor, or any Guarantor.

13. CHOICE OF LAW, VENUE AND JURY TRIAL WAIVER. California law governs this Agreement. Borrower and Bank each submit to the exclusive jurisdiction of the State and Federal courts in Santa Clara County, California.

BORROWER AND BANK EACH WAIVE THEIR RIGHT TO A JURY TRIAL OF ANY CLAIM OR CAUSE OF ACTION ARISING OUT OF OR BASED UPON THIS AGREEMENT OR ANY CONTEMPLATED

TRANSACTION, INCLUDING CONTRACT, TORT, BREACH OF DUTY AND ALL OTHER CLAIMS. THIS WAIVER IS A MATERIAL INDUCEMENT FOR BOTH PARTIES TO ENTER INTO THIS AGREEMENT. EACH PARTY HAS REVIEWED THIS WAIVER WITH ITS COUNSEL.

14. NOTICES. Notices or demands by either party about this Agreement must be in writing and personally delivered or sent by an overnight delivery service, by certified mail postage prepaid return receipt requested, or by FAX to the addresses listed at the beginning of this Agreement. A party may change notice address by written notice to the other party.

15. GENERAL PROVISIONS.

15.1. SUCCESSORS AND ASSIGNS. This Agreement binds and is for the benefit of successors and permitted assigns of each party. Borrower may not assign this Agreement or any rights under it without Bank's prior written consent which may be granted or withheld in Bank's discretion. Bank may, without the consent of or notice to Borrower, sell, transfer, or grant participation in any part of Bank's obligations, rights or benefits under this Agreement.

15.2. INDEMNIFICATION. Borrower will indemnify, defend and hold harmless Bank and its officers, employees, and agents against: (a) obligations, demands, claims, and liabilities asserted by any other party in connection with the transactions contemplated by this Agreement; and (b) losses or expenses incurred, or paid by Bank from or consequential to transactions between Bank and Borrower (including reasonable attorneys fees and expenses), except for losses caused by Bank's gross negligence or willful misconduct.

15.3. TIME OF ESSENCE. Time is of the essence for performance of all obligations in this Agreement.

15.4. SEVERABILITY OF PROVISION. Each provision of this Agreement is severable from every other provision in determining the enforceability of any provision.

15.5. AMENDMENTS IN WRITING, INTEGRATION. All amendments to this Agreement must be in writing. This Agreement is the entire agreement about this subject matter and supersedes prior negotiations or agreements.

15.6. COUNTERPARTS. This Agreement may be executed in any number of counterparts and by different parties on separate counterparts and when executed and delivered are one Agreement.

15.7. SURVIVAL. All covenants, representations and warranties made in this Agreement continue in force while any Financed Receivable amount remains outstanding. Borrower's indemnification obligations survive until all statutes of limitations for actions that may be brought against Bank have run.

15.8. CONFIDENTIALITY. Bank will use the same degree of care handling Borrower's confidential information that it uses for its own confidential information, but may disclose information; (i) to its subsidiaries or affiliates in connection with their business with Borrower, (ii) to prospective transferees or purchasers of any interest in the Agreement, (iii) as required by law, regulation, subpoena, or other order, (iv) as required in connection with an examination or audit and (v) as it considers appropriate exercising the remedies under this Agreement. Confidential information does not include information that is either: (a) in the public domain or in Bank's possession when disclosed, or becomes part of the public domain after disclosure to Bank; or (b) disclosed to Bank by a third party, if Bank does not know that the third party is prohibited from disclosing the information.

15.9. OTHER AGREEMENTS. This Agreement may not adversely affect Banks rights under any other document or agreement. If there is a conflict between this Agreement and any agreement between Borrower and Bank, Bank may determine in its sole discretion which provision applies. Borrower acknowledges that any security agreements, liens and/or security interests securing payment of Borrower's Obligations also secure Borrower's Obligations under this Agreement and are not adversely affected by this Agreement. Additionally, (a) any Collateral under other agreements or documents between Borrower and Bank secures Borrowers Obligations under

this Agreement and (b) a default by Borrower under this Agreement is a default under agreements between Borrower and Bank.

15.10. EXISTING CREDIT LINE. The Borrower agrees that it shall not be able to borrow any amounts under its Existing Facility with Bank as of the Effective Date of this Agreement. Borrower also agrees that all outstanding obligations under the Existing Facility shall be paid in full in cash on or prior to the date this Agreement becomes effective.

BORROWER: TEGAL CORPORATION

By /s/ Thomas R. Mika

Title Executive Vice President & CFO

BORROWER: TEGAL JAPAN, INC.

By /s/ James McKibben

Title President - Tegal Japan Inc.

BANK: SILICON VALLEY BANK

By /s/ R. Michael White

Title Market Manager

Effective Date: January 16, 2003

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/ THOMAS R. MIKA

Thomas R. Mika
Chief Financial Officer

Dated: February 12, 2004

EXHIBIT 31

CERTIFICATIONS

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; and

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

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

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

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

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

5. The registrant's other certifying officer 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 functions):

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 control over financial reporting.

Date: February 12, 2004 /s/ THOMAS R. MIKA

Thomas R. Mika
Chief Financial Officer

I, Michael L. Parodi, certify that:

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

2. Based on my knowledge, this quarterly 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; and

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

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

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

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

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

5. The registrant's other certifying officer 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 functions):

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 control over financial reporting.

Date: February 12, 2004 /s/ MICHAEL L. PARODI

Michael L. Parodi
Chief Executive Officer

EXHIBIT 32

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

Pursuant to 18 U.S.C. ss. 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned officer of Tegal Corporation (the "Company") hereby certifies, to such officer's knowledge, that:

(i) the accompanying Quarterly Report on Form 10-Q of the Company for the quarterly period ended June 30, 2003 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and

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

Date: February 12, 2004 /s/ MICHAEL L. PARODI

Michael L. Parodi
Chief Executive Officer

CERTIFICATION OF CHIEF FINANCIAL OFFICER

Pursuant to 18 U.S.C. ss. 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned officer of Tegal Corporation (the "Company") hereby certifies, to such officer's knowledge, that:

(i) the accompanying Quarterly Report on Form 10-Q of the Company for the quarterly period ended June 30, 2003 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and

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

Date: February 12, 2004 /s/ THOMAS R. MIKA

Thomas R. Mika
Chief Financial Officer