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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2007

☐ 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
(State or other jurisdiction of
incorporation or organization)

68-0370244
(I.R.S. Employer Identification No.)

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

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

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

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

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☒

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

As of August 9, 2007 there were 7,113,372 shares of our common stock outstanding. The number of shares outstanding reflects a 1 to 12 reverse stock split effected by the Registrant on July 25, 2006.

TEGAL CORPORATION AND SUBSIDIARIES

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PART I — FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

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

	June 30 2007	March 31 2007
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 23,349	\$ 25,776
Accounts receivable, net of allowances for sales returns and doubtful accounts of \$318 and \$413 at June 30, 2007 and March 31, 2007, respectively	6,883	6,634
Inventories, net	8,640	5,567
Prepaid expenses and other current assets	1,350	991
Total current assets	40,222	38,968
Property and equipment, net	1,312	1,351
Intangible assets, net	1,087	1,161
Other assets	108	176
Total assets	\$ 42,729	\$ 41,656
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Notes payable and bank lines of credit	\$ —	\$ 10
Accounts payable	3,705	1,974
Accrued product warranty	1,191	1,101
Deferred revenue	968	1,064
Litigation suspense	19,500	19,500
Accrued expenses and other current liabilities	3,244	3,590
Total current liabilities	28,608	27,239
Total long term liabilities	—	—
Total liabilities	28,608	27,239
Commitments and contingencies (Note 7)		
Stockholders' equity:		
Preferred stock; \$0.01 par value; 5,000,000 shares authorized; none issued and outstanding	—	—
Common stock; \$0.01 par value; 200,000,000 shares authorized; 7,113,372 and 7,106,867 shares issued and outstanding at June 30, 2007 and March 31, 2007, respectively	71	71
Additional paid-in capital	122,871	122,473
Accumulated other comprehensive income	184	240
Accumulated deficit	(109,005)	(108,367)
Total stockholders' equity	14,121	14,417
Total liabilities and stockholders' equity	\$ 42,729	\$ 41,656

See accompanying notes.

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

	Three Months Ended	
	June 30,	
	2007	2006
Revenue	\$ 4,598	\$ 6,576
Cost of sales	2,977	4,078
Gross profit	1,621	2,498
Operating expenses:		
Research and development expenses	778	996
Sales and marketing expenses	1,006	1,044
General and administrative expenses	1,203	2,302
Total operating expenses	2,987	4,342
Operating loss	(1,366)	(1,844)
Other income (expense), net	728	42
Net loss	\$ (638)	\$ (1,802)
Net loss per share, basic and diluted	\$ (0.09)	\$ (0.26)
Shares used in per share computation:		
Basic and diluted	7,110	7,023

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

See accompanying notes.

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

	Three Months Ended	
	June 30,	
	2007	2006
Cash flows from operating activities:		
Net loss	\$ (638)	\$ (1,802)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	215	232
Stock compensation expense	380	230
Stock issued under stock purchase plan	8	—
Provision for recovery of doubtful accounts and sales return allowances	(95)	152
Loss on disposal of property and equipment	—	23
Fair value of warrants and options issued for services rendered	9	26
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivables	(159)	(1,017)
Inventories	(3,137)	235
Prepaid expenses and other assets	(302)	(13)
Accounts payable	1,736	211
Accrued expenses and other current liabilities	(360)	225
Accrued product warranty	114	112
Deferred revenue	(96)	87
Net cash provided by (used in) operating activities	<u>\$ (2,325)</u>	<u>\$ (1,299)</u>
Cash flows used in investing activities:		
Purchases of property and equipment	(102)	(20)
Net cash used in investing activities:	<u>(102)</u>	<u>(20)</u>
Cash flows provided by financing activities:		
Net proceeds from issuance of common stock	—	4
Borrowings under notes payable and bank lines of credit	(10)	94
Payments on capital lease financing	—	(2)
Net cash (used in) provided by financing activities	<u>(10)</u>	<u>96</u>
Effect of exchange rates on cash and cash equivalents	10	76
Net increase (decrease) in cash and cash equivalents	<u>(2,427)</u>	<u>(1,147)</u>
Cash and cash equivalents at beginning of period	25,776	13,787
Cash and cash equivalents at end of period	<u>\$ 23,349</u>	<u>\$ 12,640</u>

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, 2007 audited consolidated financial statements and include all adjustments, consisting only of normal recurring adjustments, necessary to fairly state the information set forth herein. The statements have been prepared in accordance with the regulations of the Securities and Exchange Commission ("SEC"), but omit certain information and footnote disclosures necessary to present the statements in accordance with generally accepted accounting principles. These interim financial statements should be read in conjunction with the audited consolidated financial statements and footnotes included in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2007. The results of operations for the three months ended June 30, 2007 are not necessarily indicative of results to be expected for the entire year.

Our consolidated financial statements contemplate the realization of assets and the satisfaction of liabilities in the normal course of business. We incurred net losses of \$638 and \$1,802 for the periods ended June 30, 2007 and 2006, respectively. We generated (used) cash flows from operations of (\$2,325) and (\$1,299) for the period ended June 30, 2007 and 2006, respectively. During the fiscal year 2006 we raised approximately \$18,410 in net proceeds from the sale of our common stock and warrants to institutional investors. We believe that these proceeds, combined with the effects of the consolidation of operations and continued cost containment, will be adequate to fund operations through fiscal year 2008. However, projected sales may not materialize and unforeseen costs may be incurred. If the projected sales do not materialize, we will need to reduce expenses further and raise additional capital through the issuance of debt or equity securities. If additional funds are raised through the issuance of preferred stock or debt, these securities could have rights, privileges or preferences senior to those of common stock, and debt covenants could impose restrictions on our operations. The sale of equity or debt could result in additional dilution to current stockholders, and such financing may not be available to us on acceptable terms, if at all.

On July 25, 2006, Tegal Corporation effected a 1-for-12 reverse stock split of the Company's common stock. The consolidated financial statements for current and prior periods have been adjusted to reflect the change in number of shares.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of temporary cash investments and accounts receivable. Substantially all of the Company's temporary investments are invested in money market funds. The Company's accounts receivable are derived primarily from sales to customers located in the United States, Europe and Asia. The Company performs ongoing credit evaluations of its customers and generally requires no collateral. The Company maintains reserves for potential credit losses. Write-offs during the periods presented have been insignificant. As of March 31, 2007 three customers accounted for approximately 86% of the accounts receivable balance.

During the quarter ended June 30, 2007 one customer (ST Microelectronics) accounted for 68% of total revenues. During the quarter ended June 30, 2006, three customers (ST Microelectronics, FlipChip, and RF Micro Devices) accounted for 83% of total revenues.

As of June 30, 2007 two customers accounted for approximately 71% and as of June 30, 2006 three customers accounted for approximately 80% of the accounts receivable balance

Stock Based Compensation

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

Effective April 1, 2006, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share Based Payment" (SFAS 123R) using the modified prospective transition method. Under that transition method, compensation expense that we recognized for the three months ended June 30, 2006 included: (a) compensation expense for all share-based payments granted prior to but not yet vested as of April 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation expense for all share-based payments granted or modified on or after April 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. Compensation expense is recognized only for those awards that are expected to vest, whereas prior to the adoption of SFAS 123R, we recognized forfeitures as they occurred. In addition, we elected the straight-line attribution method as our accounting policy for recognizing stock-based compensation expense for all awards that are granted on or after April 1, 2006. Results in prior periods have not been restated.

Total compensation expense for the period ended June 30, 2007 and 2006 was \$388 and \$230, respectively. The total compensation expense related to nonvested awards not yet recognized is \$3,916. The weighted average period for which it is expected to be recognized is 2 years.

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

	Three Months Ended June 30,	
	2007	2006
Expected life (years):		
Stock options	3.22	4.0
ESPP	0.5	0.5
Volatility:		
Stock options	82.40%	82.40%
ESPP	82.40%	82.40%
Risk-free interest rate	5.25%	5.25%
Dividend yield	0.00%	0.00%

During the three months ended June 30, 2007, there were no stock option grants.

Stock Options & Warrants

A summary of stock option and warrant activity during the quarter ended June 30, 2007 is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value
Beginning outstanding	2,051,746	\$ 11.36		
Granted				
Price = market value	—	\$ 0.00		
Total	—	\$ 0.00		
Exercised	—	\$ 0.00		
Cancelled				
Forfeited	(793)	\$ 12.36		
Expired	(14,457)	\$ 8.53		
Total	(15,250)	\$ 8.73		
Ending outstanding	2,036,496	\$ 11.39	4.48	\$698
Ending vested and expected to vest	1,967,897	\$ 11.61	4.31	\$584
Ending exercisable	1,744,802	\$ 12.48	3.69	\$207

The aggregate intrinsic value of options and warrants outstanding at June 30, 2007 is calculated as the difference between the exercise price of the underlying options and the market price of our common stock as of June 30, 2007.

The following table summarizes information with respect to stock options and warrants outstanding as of June 30, 2007:

Range of Exercise Prices		Number Outstanding As of June 30, 2007	Weighted Average Remaining Contractual Term (in years)	Weighted Average Exercise Price	Number Exercisable As of June 30, 2007	Weighted Average Exercise Price As of June 30, 2007
\$ 4.20	\$ 4.20	16,344	1.19	\$ 4.20	16,344	\$ 4.20
4.60	4.60	304,653	9.18	4.60	50,000	4.60
4.68	7.08	222,902	5.27	6.16	188,108	6.14
7.20	8.28	62,079	7.60	8.18	62,079	8.18
12.00	12.00	1,284,990	3.18	12.00	1,284,990	12.00
12.36	73.50	136,869	3.90	26.19	134,622	26.38
92.26	92.26	416	2.69	92.26	416	92.26
92.52	92.52	4,165	2.63	92.52	4,165	92.52
99.00	99.00	2,498	2.74	99.00	2,498	99.00
105.00	105.00	1,580	1.55	105.00	1,580	105.00
\$ 4.20	\$ 105.00	2,036,496	4.47	\$ 11.39	1,744,802	\$ 12.48

Restricted Stock Units

The following table summarizes our restricted stock award activity for the three months ended June 30, 2007

	Number of Shares	Weighted Average Grant Date Fair Value
Balance, March 31, 2007	485,683	\$ 4.73
Granted	—	—
Vested	—	—
Forfeited	—	—
Distributed	(5,000)	4.75
Balance, June 30, 2007	480,683	\$ 6.45

Unvested restricted stock at June 30, 2007

As of June 30, 2007 there was \$3,100 of total unrecognized compensation cost related to restricted stock which is expected to be recognized over a weighted average period of 2.44 years.

2. Inventories:

Inventories are stated at the lower of cost or market, reduced by provisions for excess and obsolescence. Cost is computed using standard cost, which approximates actual cost on a first-in, first-out basis and includes material, labor and manufacturing overhead costs. We estimate the effects of excess and obsolescence on the carrying values of our inventories based upon estimates of future demand and market conditions. We establish provisions for related inventories in excess of production demand. Should actual production demand differ from our estimates, additional inventory write-downs may be required. Any excess and obsolete provision is released only if and when the related inventory is sold or scrapped. During the three months ended June 30, 2007 and June 30, 2006, the Company sold or scrapped previously reserved inventory of \$137 and \$2,088 respectively. The inventory provision balance at June 30, 2007 and June 30, 2006 was \$3,771 and \$5,047, respectively

Inventories for the periods presented consisted of:

	June 30 2007	March 31 2007
Raw materials	\$ 3,932	\$ 1,315
Work in progress	3,427	2,928
Finished goods and spares	1,281	1,324
	<u>\$ 8,640</u>	<u>\$ 5,567</u>

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

3. Product Warranty:

The Company provides warranty on all system sales based on the estimated cost of product warranties at the time revenue is recognized. The warranty obligation is affected by product failure rates, material usage rates, and the efficiency by which the product failure is corrected. Warranty activity for the three-months ended June 30, 2007 and 2006 is as follows:

	Warranty Activity for the Three Months Ended June 30,	
	2007	2006
Balance at the beginning of the period	\$ 1,101	\$ 506
Additional warranty accruals for warranties issued during the period	247	322
Less settlements made during the period	(157)	(160)
Balance at the end of the period	<u>\$ 1,191</u>	<u>\$ 668</u>

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

4. Net Loss Per Common Share:

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

	Three Months Ended June 30,	
	2007	2006
Net loss applicable to common stockholders	\$ (638)	\$ (1,802)
Basic and diluted:		
Weighted-average common shares outstanding	7,110	7,023
Less weighted-average common shares subject to repurchase.....	—	—
Weighted-average common shares used in computing basic and diluted net loss per common share	<u>7,110</u>	<u>7,023</u>
Basic and diluted net loss per common share	<u>\$ (0.09)</u>	<u>\$ (0.26)</u>

Outstanding options, warrants and restricted stock equivalent of 2,517,179 and 2,342,817 shares of common stock at a weighted-average exercise price of \$12.48 and \$13.54 per share on June 30, 2007 and 2006 respectively, were not included in the computation of diluted net loss per common share for the periods presented as a result of their anti-dilutive effect. Such securities could potentially dilute earnings per share in future periods.

5. Stock-Based Transactions:

Issuance of Warrants to Consultants

The Company is party to a contract with certain consultants pursuant to which the Company will issue warrants on a monthly basis in lieu of cash payments through December 2007. The maximum number of warrants to be issued under these agreements is 5,000 shares. During the three months ended June 30, 2007 the Company issued 2,500 warrants valued at \$9 using the Black-Scholes model with an exercise price at the market value on the day of the grant and an average interest rate of 4.51% and a 5 year life. None of these warrants have been exercised as of June 30, 2007.

6. Lines of Credit:

As of June 30, 2007, our Japanese subsidiary had no amounts outstanding under its lines of credit. The two credit lines have a total borrowing capacity of 150 Million Yen (approximately \$1,219 at exchange rates prevailing on June 30, 2007). These credit lines will be terminated during September 2007 when the company will complete its liquidation of Tegal Japan, Inc.

7. Legal Proceedings

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

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

On November 13, 2006, following commencement of the trial, all the parties in the litigation agreed on terms of a settlement, which was filed with the court. Among other things, the settlement called for the transfer of assets related to PVD technology from AMS to SFI, the dissolution of AMS as of March 1, 2007 and the assumption by Tegal of certain warranty obligations of AMS. The Avago Cross-Complaint was also dismissed as part of the settlement. A final confidential settlement and release of claims was executed among the parties on December 21, 2006.

The two law firms representing SFI in this matter claim they are entitled, as a result of the settlement, to receive contingent fees from us and SFI. Keeker & Van Nest LLP ("KVN") claims fees in the amount of \$6,717; Gonzalez & Leigh LLP ("G&L") claims fees in the amount of \$2,249. We have initiated proceedings with the Bar Association of San Francisco ("BASF"), pursuant to California statutes, to dispute the claims of both firms. KVN has filed suit against us and SFI in San Francisco Superior Court, the action is stayed pending completion of the BASF proceedings. G&L has not filed suit. We have identified legal and factual defenses to substantial elements of both claims and are vigorously contesting the claims.

As a result of the dispute described above, as of March 31, 2007, we had placed \$19,500, representing the gross cash proceeds from the recent settlement of this litigation into suspense. Since the amount in dispute cannot be determined with reasonable certainty until the dispute is resolved, we have elected to suspend the entire amount, in accordance with Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies."

8. Geographical Information

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

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

	Revenue for the Three Months Ended June 30,	
	2007	2006
Sales to customers located in:		
United States	\$ 729	\$ 2,544
Asia, excluding Japan	353	2,679
Japan	5	524
Germany	574	707
Italy	—	54
Europe, excluding Germany and Italy	2,937	68
Total sales	<u>\$ 4,598</u>	<u>\$ 6,576</u>

	Long-lived Assets as of June 30,	
	2007	2006
Long-lived assets at period-end:		
United States	\$ 2,388	\$ 4,336
Europe	11	14
Japan	—	10
Asia, excluding Japan	—	2
Total long-lived assets	<u>\$ 2,399</u>	<u>\$ 4,362</u>

9. Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) ratified the consensus reached by the Emerging Issues Task Force ("EITF") regarding EITF Issue No. 06-03, "*How Taxes Collected from Customers and Remitted to Government Authorities Should be Presented in the Income Statement (That Is, Gross versus Net Presentation)*". This guidance requires that companies disclose this accounting policy related to sales tax and other similar taxes, effective for interim and annual reporting periods beginning after December 15, 2006. We report these taxes on a net basis, excluding them from revenue.

In July 2006, FASB issued FASB Interpretation No. 48, "Accounting for Uncertainties in Income Taxes — An Interpretation of FASB Statement No. 109" (FIN 48), effective for fiscal periods beginning after December 15, 2006. FIN 48 requires recognition on the financial statements the effects of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (SFAS 157), which established a common definition for fair value to be applied to U.S. GAAP guidance requiring use of fair value. Also, SFAS 157 establishes a framework for measuring fair value, and expands disclosure about such fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of SFAS 157 on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of SFAS 115" (SFAS 159). The new statement allows entities to choose, at specified election dates, to measure eligible financial instruments and certain other items at fair value that are not otherwise required to be so measured. If a company elects the fair value option for an eligible item, changes in that item's fair value in subsequent reporting periods must be recognized in current earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the potential impact of SFAS 159 on its consolidated financial statements.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations—(Amounts in 000's)

Special Note Regarding Forward Looking Statements

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

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

Semiconductor Industry Background

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

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

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

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

Business Strategy

Our business objective is to utilize the technologies that we have developed internally or acquired externally in order to increase our market share in process equipment for both semiconductor manufacturing and nanotechnology device fabrication. In the recent past, we have attempted to “leap frog” more established competitors by being “designed-in” to the advanced device fabrication plans of our customers. We have done so primarily by engaging in research and development activities on behalf of our customers that our more established competitors were unwilling or unable to perform. Many of these advanced devices promise substantial returns as consumer demand for certain functions grows and new markets are created. However, the timing of the emergence of such demand, such as broadband wireless communications and RFID tags is highly uncertain. In addition, the successful integration by our customers of all the various technical processes required to manufacture a device at an acceptable cost is also highly uncertain. As a result of our inability to accurately predict the timing of the emergence of these markets, our sales have declined over the past few years, while our costs for maintaining our research and development efforts and our service and manufacturing infrastructure have remained constant or in some cases increased.

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

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

Maintaining our Technology Leadership Position in New Materials Etch— We have become a leading provider of etch process solutions for a set of new materials central to the production of an array of advanced semiconductor and nanotechnology devices in emerging markets. Incorporation of these new materials is essential to achieving the higher device densities, lower power consumption and novel functions exhibited by the newest generation of cell phones, computer memories, fiber optic switches and remote sensors. Currently, we are a leading supplier of etch solutions to makers of various advanced “non-volatile” memories, as well as to device makers incorporating compound metals and certain high-K dielectric materials into their devices. Our new materials expertise also includes the etching of so-called “compound-semi” materials, such as gallium arsenide, gallium nitride and indium phosphide, widely used in telecom device production. In addition, we are known for our capability to etch certain noble metals, such as gold and platinum, as well as certain proprietary compound metals. This capability is increasingly important in advanced memory development and in the production of Micro-Electrical Mechanical Systems (“MEMS”), a type of commercially produced nanotechnology device, especially useful to the automotive industry.

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

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

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

Critical Accounting Policies

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

We believe the following critical accounting policies are the most significant to the presentation of our consolidated financial statements:

Accounting for Stock-Based Compensation

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

Prior to April 1, 2006 we accounted for these stock-based employee compensation plans under the measurement and recognition provisions of Accounting Principles Board Opinion No.25, "Accounting for Stock Issued to Employees," or APB 25, and related interpretations, as permitted by SFAS No.123, "Accounting for Stock Based Compensation" (SFAS 123). With the exception of grants of restricted stock awards, we generally, recorded no stock-based compensation expense during periods prior to April 1, 2006 as all stock-based grants had exercise prices equal to the fair market value of our common stock on the date of grant. We also recorded no compensation expense in connection with our employee stock purchase plan as they qualified as a non-compensatory plan following the guidance provided by APB 25.

Effective April 1, 2006, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share Based Payment" (SFAS 123R) using the modified prospective transition method. Under that transition method, we recognized compensation expense of \$1,664 for the fiscal year 2007, which included: (a) compensation expense for all share-based payments granted prior to but not yet vested as of April 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation expense for all share-based payments granted or modified on or after April 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. Compensation expense is recognized only for those awards that are expected to vest, whereas prior to the adoption of SFAS 123R, we recognized forfeitures as they occurred. In addition, we elected the straight-line attribution method as our accounting policy for recognizing stock-based compensation expense for all awards that are granted on or after April 1, 2006. Results in prior periods have not been restated.

Revenue Recognition

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

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

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

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

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

Accounts Receivable – Allowance for Sales Returns and Doubtful Accounts

We maintain an allowance for doubtful accounts receivable for estimated losses resulting from the inability of our customers to make required payments. We consider the aging of individual customer accounts and determine, according to corporate policy, which accounts should be included in the reserve for doubtful accounts. If the financial conditions of our customers were to deteriorate, or even a single customer was otherwise unable to make payments, additional allowances may be required and may materially affect our consolidated financial position.

Our return policy is for spare parts and components only. A right of return does not exist for systems. Customers are allowed to return spare parts if they are defective upon receipt. The potential returns are offset against gross revenue on a monthly basis. Management reviews outstanding requests for returns on a quarterly basis to determine that the reserves are adequate.

Inventories

Inventories are stated at the lower of cost or market, reduced by provisions for excess and obsolescence. Cost is computed using standard cost, which approximates actual cost on a first-in, first-out basis and includes material, labor and manufacturing overhead costs. We estimate the effects of excess and obsolescence on the carrying values of our inventories based upon estimates of future demand and market conditions. We establish provisions for related inventories in excess of production demand. Should actual production demand differ from our estimates, additional inventory write-downs may be required. Any excess and obsolete provision is released only if and when the related inventories is sold or scrapped. The inventory provision balance at June 30, 2007 and March 31, 2007 was \$3,771 and \$3,908, respectively. The recovery of previously reserved inventory upon sale of such inventory for the three months ended June 30, 2007 and June 30, 2006 was \$137 and \$2,088, respectively.

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

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

Impairment of Long-Lived Assets

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

Warranty Obligations

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

Deferred Taxes

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

Results of Operations

The following table sets forth certain financial items as a percentage of revenue for the three months ended June 30, 2007 and 2006:

	Three Months Ended June 30,	
	2007	2006
Revenue	100.0%	100.0%
Cost of sales	64.7%	62.0%
Gross profit	35.3%	38.0%
Operating expenses:		
Research and development	16.9%	15.1%
Sales and marketing	21.9%	15.9%
General and administrative	26.2%	35.0%
Total operating expenses	65.0%	66.0%
Other income	15.8%	0.6%
Net loss	(13.9)%	(27.4)%

The following table sets forth certain financial items for the three months ended June 30, 2007 and 2006:

	Three Months Ended June 30	
	2007	2006
Revenue	\$ 4,598	\$ 6,576
Cost of sales	2,977	4,078
Gross profit	1,621	2,498
Operating expenses:		
Research and development	778	996
Sales and marketing	1,006	1,044
General and administrative	1,203	2,302
Total operating expenses	2,987	4,342
Other income	728	42
Net loss	\$ (638)	\$ (1,802)

Revenue

Revenue for the three months ended June 30, 2007 was due principally to the sale of one advanced series system. Revenue for the three months ended June 30, 2006 was principally due to the sale of two advanced series systems over the same period of the previous year.

International sales as a percentage of the Company's revenue for the three months ended June 30, 2007 were approximately 84.1%, and for the three months ended June 30, 2006 were approximately 61.3%. We believe that international sales will continue to represent a significant portion of our revenue.

Gross profit

Gross profit to revenue for the three months ended June 30, 2007 decreased \$877 to \$1,621. This was a 35.1% decrease from the three months ended June 30, 2006. The decrease in gross profit as a percentage to revenue, was principally attributable to a decrease in system sales. Cost containment and some operations consolidation, however, held the gross margin at 35.3% for the current first quarter fiscal year compared to 38.0% for the same period last year.

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. The decrease of \$218 in research and development spending for the three months ended June 30, 2007 resulted from reimbursement for prototype costs during the current quarter.

Sales and Marketing

Sales and marketing expenses consist primarily of salaries, commissions, trade show promotion and travel and living expenses associated with those functions. The decrease of \$38 in sales and marketing spending for the three months ended June 30, 2007 was primarily due to lower inhouse commissions offset by higher agent commissions over the same period last year combined with decreased spending on trade shows.

General and Administrative

General and administrative expenses consist primarily of compensation for general management, accounting and finance, human resources, information systems and investor relations functions and for legal, consulting and accounting fees of the Company. The decrease of \$1,044 in spending for the three months ended June 30, 2007 was primarily due to decreases in legal fees, accounting fees, moving costs, rent and other facility costs, employee costs, and offset by SFAS No.123R costs. The decrease in legal fees is primarily due to the termination of the litigation against AMS, Agilent, and Avago Technologies which was settled December 2006.

Other income

Other income (expense) consists principally of interest income (expense) net, other income (expense) net, gains and losses on the disposal of fixed assets, and gains and losses on foreign exchange. Other income (expense) net had a \$686 gain in the three months ended June 30, 2007 over the three months ended June 30, 2006. The majority of the increase related to net interest income of \$297, and net other income of \$278 from the AMS settlement. Net interest income is higher due to higher cash balances earning higher interest.

Contractual Obligation

The following summarizes our contractual obligations at June 30, 2007, and the effect such obligations are expected to have on our liquidity and cash flows in future periods.

	Total	Less than 1 Year	1-3 Years	3-5 Years	After 5 Years
Contractual obligations:					
Non-cancelable operating lease obligations	1,111	636	430	45	—
Total contractual cash obligations	\$ 1,111	\$ 636	\$ 430	\$ 45	\$ —

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

Liquidity and Capital Resources

For the three-month period ended June 30, 2007, we financed our operations through the use of outstanding cash balances.

As of June 30, 2007, our Japanese subsidiary had no amounts outstanding under its lines of credit. The two credit lines have a total borrowing capacity of 150 Million Yen (approximately \$1,219 at exchange rates prevailing on June 30, 2007). These credit lines will be terminated during September 2007 when the company will complete its liquidation of Tegal Japan, Inc.

The consolidated financial statements contemplate the realization of assets and the satisfaction of liabilities in the normal course of business. We incurred net losses of \$638 and \$1,802 for the three months ended June 30, 2007 and 2006, respectively. We generated negative cash flows from operations of \$2,325 and \$1,299 for the period ended June 30, 2007 and June 30, 2006, respectively. During the prior fiscal year 2007, we reached the lawsuit settlement of \$19,500, which is currently in litigation suspense, and in the fiscal year 2006, we raised a net of \$18,161 through the 2005 PIPE. Management believes that these proceeds, combined with projected sales, consolidation of certain operations and continued cost containment will be adequate to fund operations through fiscal 2008. However, projected sales may not materialize and unforeseen costs may be incurred. Moreover, the amount we ultimately receive from the AMS lawsuit settlement is uncertain as we continue to dispute the claims by the two law firms who represented us in that matter. If the amount we ultimately receive under the lawsuit settlement is materially less, or if the projected sales do not materialize, our ability to achieve our intended business objectives may be adversely affected. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded assets or the amount or classification of liabilities or any other adjustments that might be necessary should we be unable to continue as a going concern.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our cash equivalents are principally comprised of money market accounts. As of June 30, 2007, we had cash and cash equivalents of \$23,349. 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 which operate and sell our products in various global markets. As a result, we are exposed to changes in foreign currency exchange rates. We do not hold derivative financial instruments for speculative purposes. 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, 2007.

Item 4. Controls and Procedures

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

- (a) **Evaluation of Disclosure Controls and Procedures.** - Under the supervision and with the participation of our management, our Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that the our disclosure controls and procedures were effective as of the end of the period covered by this report.
- (b) **Changes in Internal Controls over financial reporting.** - As required by Rule 13a-15(d), our management, including our Chief Executive Officer and Chief Financial Officer, also conducted an evaluation of our internal control over financial reporting to determine whether any changes occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based on that evaluation, there has been no such change during the period covered by this report.
- (c) **Limitations of the effectiveness of internal control.** - A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the internal control system are met. Because of the inherent limitations of any internal control system, no evaluation of controls can provide absolute assurance that all control issues, if any, within a company have been detected. Notwithstanding these limitations, our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives. Our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are, in fact, effective at the "reasonable assurance" level.

PART II — OTHER INFORMATION

Item 1.A. Risk Factors

We wish to caution you that there are risks and uncertainties that could affect our business. These risks and uncertainties include, but are not limited to, the risks described below and elsewhere in this report, particularly in "Forward-Looking Statements." The following is not intended to be a complete discussion of all potential risks or uncertainties, as it is not possible to predict or identify all risk factors.

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

Our business depends upon the capital expenditures of semiconductor manufacturers, which in turn depend on the current and anticipated market demand for ICs. The semiconductor industry is highly cyclical and historically has experienced periodic downturns, 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 have completed a corporate-wide restructuring to preserve our cash. However, the need for continued investment in research and development, possible capital equipment requirements and extensive ongoing customer service and support requirements worldwide will continue to limit our ability to reduce expenses in response to current and any future downturns. As a result, we may continue to experience operating losses such as those we have experienced in the past, which could materially adversely affect us.

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, Applied Materials, Inc., Lam Research Corporation, Novellus and Tokyo Electron Limited, have substantially greater financial resources, more extensive engineering, manufacturing, marketing and customer service and support capabilities, larger installed bases of current generation etch, deposition and other production equipment and broader process equipment offerings, as well as greater name recognition than we do. We cannot assure you that we will be able to compete successfully against these companies in the United States or worldwide.

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

The composition of our top five customers has changed from year to year, but net system sales to our top five customers in each of fiscal 2007, 2006, and 2005 accounted for 77.8%, 68.9%, and 80.0% respectively, of our total net system sales. ST Microelectronics and International Rectifier accounted for 43.1% and 13.4%, respectively, of our total revenue in fiscal 2007. ST Microelectronics accounted for 54.3% of our total revenue in fiscal 2006. Fujitsu, Western Digital, and RF Micro Devices accounted for 38.2%, 12.8% and 10.1% respectively, of our net system sales in fiscal year 2005. ST Microelectronics and International Rectifier accounted for 45.1% and 25.8%, respectively, of total revenue in the quarter ended June 30, 2007. ST Microelectronics accounted for 47% of total revenue in the quarter ended June 30, 2006. Other than these customers, no single customer represented more than 10% of our total revenue in fiscal 2007, 2006, and 2005. Although the composition of the group comprising our largest customers may vary from year to year, the loss of a significant customer or any reduction in orders by any significant customer, including reductions due to market, economic or competitive conditions in the semiconductor and related device manufacturing industry, would have a material adverse effect on us.

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

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

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

We have designed our advanced etch and deposition products for customer applications in emerging new films, polysilicon and metal which we believe to be the leading edge of critical applications for the production of advanced semiconductor and other microelectronic devices. Revenues from the sale of our advanced etch and deposition systems accounted for 69%, 69%, and 30% of total revenue in fiscal 2007, 2006, and 2005, respectively. Our advanced systems are currently being used primarily for research and development activities or low volume production. For our advanced systems to achieve full market adoption, our customers must utilize these systems for volume production. We cannot assure you that the market for devices incorporating emerging films, polysilicon or metal will develop as quickly or to the degree we expect. If our advanced systems do not achieve significant sales or volume production due to a lack of customer adoption, we will be materially adversely affected.

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

We incurred net losses of \$13.2 million, \$8.9 million, and \$15.4 million for the years ended March 31, 2007, 2006, and 2005, respectively, and generated (used) cash flows from operations of \$12.8 million, (\$11.6) million, and (\$7.5) million in these respective years. We have raised approximately \$18.4 million from the sale of stock and warrants to institutional investors in fiscal 2006. While we believe that these proceeds, combined with a projected increase in sales, consolidation of certain operations and continued cost containment will be adequate to fund operations through fiscal year 2008, 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. For quarter ended June 30, 2007, we incurred a net loss of \$0.7 million. If additional funds are raised through the issuance of preferred stock or debt, these securities could have rights, privileges or preferences senior to those of our common stock, and debt covenants could impose restrictions on our operations. Moreover, such financing may not be available to us on acceptable terms, if at all. Failure to raise any needed funds would materially adversely affect us.

Our quarterly operating results may continue to fluctuate.

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

Our 900 series etch systems typically sell for prices ranging between \$250,000 and \$600,000, while prices of our 6500 series critical etch systems and our Endeavor deposition system typically range between \$1.8 million and \$3.0 million. To the extent we are successful in selling our 6500 and Endeavor series systems, the sale of a small number of these systems will probably account for a substantial portion of revenue in future quarters, and a transaction for a single system could have a substantial impact on revenue and gross margin for a given quarter.

Other factors that could affect our quarterly operating results include:

- our timing of new systems and technology announcements and releases and ability to transition between product versions;
- seasonal fluctuations in sales;
- changes in the mix of our revenues represented by our various products and customers;
- adverse changes in the level of economic activity in the United States or other major economies in which we do business;
- foreign currency exchange rate fluctuations;
- expenses related to, and the financial impact of, possible acquisitions of other businesses; and
- changes in the timing of product orders due to unexpected delays in the introduction of our customers' products, due to lifecycles of our customers' products ending earlier than expected or due to market acceptance of our customers' products.

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

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

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

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

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

Our common stock has declined in value below the exercise price of many options granted to employees pursuant to our stock option plans. Thus, the intended benefits of the stock options granted to our employees, the creation of performance and retention incentives, may not be realized. As a result, we may lose employees whom we would prefer to retain and may have difficulty in hiring new employees to replace them. As a result of these factors, our remaining personnel may seek employment with larger, more established companies or companies perceived as having less volatile stock prices. The loss of any significant employee or a large number of employees over a short period of time could have a material adverse effect on us.

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

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

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

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

International sales accounted for 67%, 76%, and 70% of total revenue for fiscal 2007, 2006, and 2005, respectively. As of the first quarter for fiscal 2008, international sales accounted for approximately 84% of total revenue. International sales are subject to certain risks, including the imposition of government controls, fluctuations in the U.S. dollar (which could increase the sales price in local currencies of our systems in foreign markets), changes in export license and other regulatory requirements, tariffs and other market barriers, political and economic instability, potential hostilities, restrictions on the export or import of technology, difficulties in accounts receivable collection, difficulties in managing representatives, difficulties in staffing and managing international operations and potentially adverse tax consequences. We cannot assure you that any of these factors will not have a detrimental effect on our operations, financial results and cash flows.

We cannot assure you that our future results of operations and cash flows will not be adversely affected by foreign currency fluctuations. In addition, the laws of certain countries in which our products are sold may not provide our products and intellectual property rights with the same degree of protection as the laws of the United States.

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

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

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

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

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

As of June 30, 2007, there were 7,113,372 shares of our common stock issued and outstanding and there were 1,863,707 shares of common stock reserved for issuance under our equity incentive and stock purchase plans and there were warrants outstanding for approximately 1,706,185 shares of our common stock.

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

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

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

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

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

Materials delays have not been significant in recent years. Nevertheless, we procure certain components and 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

- 31.1 Certifications of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certifications of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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

TEGAL CORPORATION
(Registrant)

/s/ CHRISTINE HERGENROTHER

Christine Hergenrother
Chief Financial Officer

Dated: August 14 , 2007

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

I, Thomas R. Mika, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Tegal Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-14(e)) for the registrant and we have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation;
 - (c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

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

Date: August 14, 2007

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

I, Christine Hergenrother, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Tegal Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-14(e)) for the registrant and we have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation;
 - (c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

/s/ Christine Hergenrother
Chief Financial Officer

Date: August 14, 2007

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

In connection with the Quarterly Report of Tegal Corporation, a Delaware corporation (the "Company"), on Form 10-Q for the quarter ended June 30, 2007 as filed with the Securities and Exchange Commission (the "Report"), I, Thomas R. Mika, President and Chief Executive Officer of the Company, certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Thomas R. Mika
Chief Executive Officer and President
August 14, 2007

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

In connection with the Quarterly Report of Tegal Corporation, a Delaware corporation (the "Company"), on Form 10-Q for the quarter ended June 30, 2007 as filed with the Securities and Exchange Commission (the "Report"), I, Christine Hergenrother, Chief Financial Officer of the Company, certify, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Christine Hergenrother
Chief Financial Officer
August 14, 2007

