

APPLIED MATERIALS INC /DE

Form 10-Q

February 28, 2007

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**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 January 28, 2007**
- or
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the transition period from        to**

**Commission File Number 000-06920**

**Applied Materials, Inc.**

*(Exact name of registrant as specified in its charter)*

**Delaware**

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

**3050 Bowers Avenue, P.O. Box 58039**

**Santa Clara, California**

*(Address of principal executive offices)*

**94-165526**

*(I.R.S. Employer  
Identification No.)*

**95052-8039**

*(Zip Code)*

**(408) 727-5555**

*(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 such 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.

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

Number of shares outstanding of the issuer's common stock as of January 28, 2007: 1,396,873,999

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|                                         | <b>Three Months Ended</b>                           |                             |
|-----------------------------------------|-----------------------------------------------------|-----------------------------|
|                                         | <b>January 29,<br/>2006</b>                         | <b>January 28,<br/>2007</b> |
|                                         | <b>(Unaudited)</b>                                  |                             |
|                                         | <b>(In thousands, except<br/>per share amounts)</b> |                             |
| Net sales                               | \$ 1,857,592                                        | \$ 2,277,267                |
| Cost of products sold                   | 1,019,893                                           | 1,214,729                   |
| Gross margin                            | 837,699                                             | 1,062,538                   |
| Operating expenses:                     |                                                     |                             |
| Research, development and engineering   | 272,877                                             | 287,567                     |
| Marketing and selling                   | 100,773                                             | 106,912                     |
| General and administrative              | 105,263                                             | 121,811                     |
| Restructuring and asset impairments     | 214,847                                             | (3,278)                     |
| Income from operations                  | 143,939                                             | 549,526                     |
| Pretax loss of equity-method investment |                                                     | 3,937                       |
| Interest expense                        | 8,705                                               | 10,468                      |
| Interest income                         | 48,691                                              | 30,103                      |
| Income before income taxes              | 183,925                                             | 565,224                     |
| Provision for income taxes              | 41,145                                              | 161,748                     |
| Net income                              | \$ 142,780                                          | \$ 403,476                  |
| Earnings per share:                     |                                                     |                             |
| Basic                                   | \$ 0.09                                             | \$ 0.29                     |
| Diluted                                 | \$ 0.09                                             | \$ 0.29                     |
| Weighted average number of shares:      |                                                     |                             |
| Basic                                   | 1,598,260                                           | 1,394,710                   |
| Diluted                                 | 1,608,165                                           | 1,409,014                   |

See accompanying notes to Consolidated Condensed Financial Statements.

**Table of Contents****APPLIED MATERIALS, INC.****CONSOLIDATED CONDENSED BALANCE SHEETS\***

|                                                       | <b>October 29,<br/>2006</b> | <b>January 28,<br/>2007</b> |
|-------------------------------------------------------|-----------------------------|-----------------------------|
|                                                       | <b>(In thousands)</b>       |                             |
| <b>ASSETS</b>                                         |                             |                             |
| Current assets:                                       |                             |                             |
| Cash and cash equivalents                             | \$ 861,463                  | \$ 1,068,615                |
| Short-term investments                                | 1,035,875                   | 1,014,205                   |
| Accounts receivable, net                              | 2,026,199                   | 2,051,606                   |
| Inventories                                           | 1,406,777                   | 1,518,882                   |
| Deferred income taxes                                 | 455,473                     | 461,142                     |
| Assets held for sale                                  | 37,211                      | 31,005                      |
| Other current assets                                  | 258,021                     | 260,130                     |
| <br>Total current assets                              | <br>6,081,019               | <br>6,405,585               |
| Long-term investments                                 | 1,314,861                   | 1,327,945                   |
| Property, plant and equipment                         | 2,753,883                   | 2,741,074                   |
| Less: accumulated depreciation and amortization       | (1,729,589)                 | (1,712,136)                 |
| <br>Net property, plant and equipment                 | <br>1,024,294               | <br>1,028,938               |
| Goodwill, net                                         | 572,558                     | 572,558                     |
| Purchased technology and other intangible assets, net | 201,066                     | 191,646                     |
| Equity-method investment                              | 144,431                     | 140,494                     |
| Deferred income taxes and other assets                | 142,608                     | 140,837                     |
| <br>Total assets                                      | <br>\$ 9,480,837            | <br>\$ 9,808,003            |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>            |                             |                             |
| Current liabilities:                                  |                             |                             |
| Current portion of long-term debt                     | \$ 202,535                  | \$ 202,521                  |
| Accounts payable and accrued expenses                 | 2,023,651                   | 1,910,718                   |
| Income taxes payable                                  | 209,859                     | 330,957                     |
| <br>Total current liabilities                         | <br>2,436,045               | <br>2,444,196               |
| Long-term debt                                        | 204,708                     | 204,692                     |
| Other liabilities                                     | 188,684                     | 192,404                     |
| <br>Total liabilities                                 | <br>2,829,437               | <br>2,841,292               |
| <br>Stockholders' equity:                             |                             |                             |
| Common stock                                          | 13,917                      | 13,969                      |
| Additional paid-in capital                            | 3,678,202                   | 3,785,066                   |
| Retained earnings                                     | 9,472,303                   | 9,805,927                   |

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|                                            |              |              |
|--------------------------------------------|--------------|--------------|
| Treasury stock                             | (6,494,012)  | (6,622,955)  |
| Accumulated other comprehensive loss       | (19,010)     | (15,296)     |
| Total stockholders' equity                 | 6,651,400    | 6,966,711    |
| Total liabilities and stockholders' equity | \$ 9,480,837 | \$ 9,808,003 |

\* Amounts as of January 28, 2007 are unaudited. Amounts as of October 29, 2006 are derived from the October 29, 2006 audited consolidated financial statements. See accompanying notes to Consolidated Condensed Financial Statements.

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|                                                                                        | <b>Three Months Ended</b>   |                             |
|----------------------------------------------------------------------------------------|-----------------------------|-----------------------------|
|                                                                                        | <b>January 29,<br/>2006</b> | <b>January 28,<br/>2007</b> |
|                                                                                        | <b>(Unaudited)</b>          |                             |
|                                                                                        | <b>(In thousands)</b>       |                             |
| Cash flows from operating activities:                                                  |                             |                             |
| Net income                                                                             | \$ 142,780                  | \$ 403,476                  |
| Adjustments required to reconcile net income to cash provided by operating activities: |                             |                             |
| Depreciation and amortization                                                          | 69,676                      | 60,904                      |
| Loss on fixed asset retirements                                                        | 2,538                       | 3,122                       |
| Non-cash portion of restructuring and asset impairments                                | 214,847                     | (3,278)                     |
| Excess tax benefits from equity-based compensation plans                               | (9,187)                     |                             |
| Net recognized loss on investments                                                     | 7,108                       | 1,767                       |
| Pretax loss of equity-method investment                                                |                             | 3,937                       |
| Deferred income taxes                                                                  | (92,717)                    | (2,457)                     |
| Equity-based compensation                                                              | 51,952                      | 34,901                      |
| Changes in operating assets and liabilities, net of amounts acquired:                  |                             |                             |
| Accounts receivable, net                                                               | (136,895)                   | (24,350)                    |
| Inventories                                                                            | 10,918                      | (110,695)                   |
| Other current assets                                                                   | 42,102                      | (31)                        |
| Other assets                                                                           | (20,292)                    | (3,078)                     |
| Accounts payable and accrued expenses                                                  | (11,679)                    | (107,823)                   |
| Income taxes payable                                                                   | 141,323                     | 121,082                     |
| Other liabilities                                                                      | 6,706                       | 3,720                       |
| Cash provided by operating activities                                                  | 419,180                     | 381,197                     |
| Cash flows from investing activities:                                                  |                             |                             |
| Capital expenditures                                                                   | (48,821)                    | (58,901)                    |
| Cash paid for acquisition, net of cash acquired                                        | (18,257)                    |                             |
| Proceeds from disposition of assets held for sale                                      |                             | 9,484                       |
| Proceeds from sales and maturities of investments                                      | 1,315,678                   | 730,009                     |
| Purchases of investments                                                               | (1,072,826)                 | (728,520)                   |
| Cash provided by (used for) investing activities                                       | 175,774                     | (47,928)                    |
| Cash flows from financing activities:                                                  |                             |                             |
| Short-term debt repayments                                                             | (5,007)                     |                             |
| Proceeds from common stock issuances                                                   | 88,324                      | 75,094                      |
| Common stock repurchases                                                               | (522,269)                   | (132,017)                   |
| Excess tax benefits from equity-based compensation plans                               | 9,187                       |                             |
| Payment of dividends to stockholders                                                   | (48,236)                    | (69,614)                    |



|                                               |              |              |
|-----------------------------------------------|--------------|--------------|
| Cash used for financing activities            | (478,001)    | (126,537)    |
| Effect of exchange rate changes on cash       | 4            | 420          |
| Increase in cash and cash equivalents         | 116,957      | 207,152      |
| Cash and cash equivalents beginning of period | 990,342      | 861,463      |
| Cash and cash equivalents end of period       | \$ 1,107,299 | \$ 1,068,615 |
| Supplemental cash flow information:           |              |              |
| Cash payments for/(refunds of) income taxes   | \$ (6,456)   | \$ 40,428    |
| Cash payments for interest                    | \$ 152       | \$ 57        |

See accompanying notes to Consolidated Condensed Financial Statements.

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**APPLIED MATERIALS, INC.**

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS  
(Unaudited)**

**Note 1 Basis of Presentation and Equity-Based Compensation**

***Basis of Presentation***

In the opinion of management, the unaudited interim consolidated condensed financial statements of Applied Materials, Inc. and its subsidiaries (Applied or the Company) included herein have been prepared on a basis consistent with the October 29, 2006 audited consolidated financial statements and include all material adjustments, consisting of normal recurring adjustments, necessary to fairly present the information set forth therein. These unaudited interim consolidated condensed financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in Applied's Form 10-K for the fiscal year ended October 29, 2006 (2006 Form 10-K). Applied's results of operations for the three months ended January 28, 2007 are not necessarily indicative of future operating results.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (United States) requires management to make judgments, estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ materially from those estimates.

***Reclassifications***

The accompanying consolidated condensed financial statements for fiscal 2006 contain certain reclassifications to conform to the fiscal 2007 presentation.

***Equity-Based Compensation***

Applied has adopted stock plans that provide for grants to employees of equity-based awards, including stock options, restricted stock, and restricted stock units (also referred to as performance shares under the Applied Materials, Inc. Employee Stock Incentive Plan). In addition, certain of these plans provide for the automatic grant of stock options to non-employee directors and permit the grant of equity-based awards to consultants. Applied also has two Employee Stock Purchase Plans (ESPP) for United States and international employees, respectively, which enable employees to purchase Applied common stock.

Applied's Board of Directors has approved certain changes to the Applied Materials, Inc. Employee Stock Incentive Plan and the ESPP which, along with other proposals, are subject to approval by the stockholders at the 2007 Annual Meeting of Stockholders to be held on March 14, 2007. The changes provide, among other things, for the automatic grant to non-employee directors of restricted stock units in lieu of the currently authorized stock options.

During the three months ended January 29, 2006 and January 28, 2007, Applied recognized equity-based compensation expense related to stock options, ESPP, restricted stock units and restricted stock of \$52 million and \$35 million, respectively. Applied recognized an income tax benefit related to equity-based compensation during the three months ended January 29, 2006 and January 28, 2007 of \$13 million and \$10 million, respectively. The estimated fair value of the Company's equity-based awards, less expected forfeitures, is amortized over the awards service period. The equity-based compensation expense for the three months ended January 29, 2006 and January 28,

2007 included \$4 million and \$20 million, respectively, related to restricted stock units and restricted stock.

*Stock Options*

The exercise price of each stock option equals the market price of Applied common stock on the date of grant. Most options are scheduled to vest over four years and expire no later than seven years from the grant date. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. This

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model was developed for use in estimating the value of publicly traded options that have no vesting restrictions and are fully transferable. Applied's employee stock options have characteristics significantly different from those of publicly traded options. The weighted average assumptions used in the model are outlined in the following table:

|                          | <b>Three Months<br/>Ended<br/>January 29,<br/>2006</b> | <b>Three Months<br/>Ended<br/>January 28,<br/>2007</b> |
|--------------------------|--------------------------------------------------------|--------------------------------------------------------|
| <i>Stock Options:</i>    |                                                        |                                                        |
| Dividend yield           | 0.65%                                                  | 1.12%                                                  |
| Expected volatility      | 37%                                                    | 32%                                                    |
| Risk-free interest rate  | 4.40%                                                  | 4.70%                                                  |
| Expected life (in years) | 3.8                                                    | 3.9                                                    |

The computation of the expected volatility assumption used in the Black-Scholes calculations for new grants is based on a combination of historical and implied volatilities. When establishing the expected life assumption, Applied annually reviews historical employee exercise behavior with respect to option grants with similar vesting periods. The weighted average grant date fair value of options granted during the quarters ended January 29, 2006 and January 28, 2007 was \$6.01 and \$5.12, respectively.

*Employee Stock Purchase Plans*

Under the ESPP, substantially all employees may purchase Applied common stock through payroll deductions at a price equal to 85 percent of the lower of the fair market value of Applied stock at the beginning of the applicable offering period or at the end of each applicable purchase period. No shares were issued under the ESPP during the quarters ended January 29, 2006 and January 28, 2007. Compensation expense is calculated using the fair value of the employees' purchase rights under the Black-Scholes model.

*Restricted Stock Units and Restricted Stock*

Restricted stock units (also referred to as performance shares) are converted into shares of Applied common stock upon vesting on a one-for-one basis. Typically, vesting of restricted stock units is subject to the employee's continued service with Applied. The compensation expense related to these awards is determined using the fair value of Applied common stock on the date of the grant, and compensation is recognized over the service period. Restricted stock units vest over a minimum of three years and typically over four years.

On January 25, 2007, the Human Resources and Compensation Committee (the Committee) of the Board of Directors approved new awards of 1,950,000 performance-based restricted stock units for Applied's named executive officers and other key employees. The Committee also approved the issuance of 150,000 shares of restricted stock to Applied's President and Chief Executive Officer at \$0.01 per share. These awards will vest only if specific performance goals set by the Committee are achieved. The goals require the achievement of specified levels of Applied's annual operating profit and also that the officer remain an employee of Applied through the vesting date. The fair value of the

performance-based restricted stock awards and restricted stock was estimated using the fair value of Applied common stock on the date of the grant and assumes that performance goals will be achieved. If such goals are not met, no compensation cost will be recognized and any recognized compensation cost will be reversed. The expected cost of the grant is being reflected over the service period, and is reduced for estimated forfeitures.

**Note 2 Earnings Per Share**

Basic earnings per share is determined using the weighted average number of common shares outstanding during the period. Diluted earnings per share is determined using the weighted average number of common shares and potential common shares (representing the dilutive effect of stock options, restricted stock units, ESPP shares

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and amounts due under the agreements associated with the accelerated stock buyback program) outstanding during the period. Applied's net income has not been adjusted for any period presented for purposes of computing basic or diluted earnings per share.

For purposes of computing diluted earnings per share, weighted average common share equivalents do not include stock options with an exercise price that exceeded the average fair market value of Applied common stock for the period, as the effect would be anti-dilutive. Options to purchase 138,178,000 and 90,744,000 shares of common stock for the three months ended January 29, 2006 and January 28, 2007, respectively, were excluded from the computation.

**Note 3 Accounts Receivable, Net**

Applied has agreements with various financial institutions to sell accounts receivable from selected customers. Applied also discounts letters of credit through various financial institutions. Under these agreements, Applied sold accounts receivable and discounted letters of credit in the amounts of \$51 million and \$237 million for the three months ended January 29, 2006 and January 28, 2007, respectively. Financing charges on the sale of receivables are included in general and administrative expense in the accompanying Consolidated Condensed Statements of Operations and were not material for all periods presented. As of January 28, 2007, \$3 million of sold accounts receivable remained outstanding under these agreements. A portion of these sold accounts receivable is subject to certain recourse provisions. As of January 28, 2007, Applied has not experienced any losses under these recourse provisions.

**Note 4 Inventories**

Inventories are stated at the lower of cost or market, with cost determined on a first-in, first-out (FIFO) basis. Components of inventories were as follows:

|                         | <b>October 29,<br/>2006</b> | <b>January 28,<br/>2007</b> |
|-------------------------|-----------------------------|-----------------------------|
|                         | <b>(In thousands)</b>       |                             |
| Customer service spares | \$ 466,414                  | \$ 491,843                  |
| Raw materials           | 236,913                     | 287,863                     |
| Work-in-process         | 272,654                     | 318,456                     |
| Finished goods          | 430,796                     | 420,720                     |
|                         | <b>\$ 1,406,777</b>         | <b>\$ 1,518,882</b>         |

Included in finished goods inventory is \$174 million at October 29, 2006 and \$202 million at January 28, 2007 of newly-introduced systems at customer locations where the sales transaction did not meet Applied's revenue recognition criteria, as set forth in Note 1 of the Notes to the Consolidated Financial Statements in the 2006 Form 10-K.







and \$9 million for the three months ended January 28, 2007. As of January 28, 2007, future estimated amortization expense is expected to be \$24 million for the remainder of fiscal 2007, \$29 million for fiscal 2008, \$27 million for fiscal 2009, \$24 million for fiscal 2010, \$20 million for fiscal 2011, and \$50 million thereafter. As of January 28, 2007, amortized intangible assets by reportable segment were: Silicon, \$22 million; Display, \$55 million; Fab Solutions, \$17 million; and Adjacent Technologies, \$80 million.

**Table of Contents****APPLIED MATERIALS, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)****Note 6 Accounts Payable, Accrued Expenses, Guarantees and Contingencies*****Accounts Payable and Accrued Expenses***

Components of accounts payable and accrued expenses were as follows:

|                                    | <b>October 29,<br/>2006</b> | <b>January 28,<br/>2007</b> |
|------------------------------------|-----------------------------|-----------------------------|
|                                    | <b>(In thousands)</b>       |                             |
| Accounts payable                   | \$ 475,479                  | \$ 486,586                  |
| Deferred revenue                   | 369,875                     | 332,915                     |
| Compensation and employee benefits | 439,333                     | 324,623                     |
| Installation and warranty          | 215,578                     | 221,575                     |
| Customer deposits                  | 97,495                      | 134,228                     |
| Dividends payable                  | 69,600                      | 69,844                      |
| Other accrued taxes                | 84,957                      | 69,133                      |
| Restructuring reserve              | 24,731                      | 21,699                      |
| Other                              | 246,603                     | 250,115                     |
|                                    | <b>\$ 2,023,651</b>         | <b>\$ 1,910,718</b>         |

Changes in the warranty reserves during the first quarters of fiscal 2006 and 2007 were as follows:

|                         | <b>Three Months Ended</b>   |                             |
|-------------------------|-----------------------------|-----------------------------|
|                         | <b>January 29,<br/>2006</b> | <b>January 28,<br/>2007</b> |
|                         | <b>(In thousands)</b>       |                             |
| Beginning balance       | \$ 136,613                  | \$ 174,605                  |
| Provisions for warranty | 51,843                      | 46,801                      |
| Consumption of reserves | (47,670)                    | (44,013)                    |
| Ending balance          | <b>\$ 140,786</b>           | <b>\$ 177,393</b>           |

Applied products are generally sold with a 12-month warranty period following installation. The provision for the estimated cost of warranty is recorded when revenue is recognized. Parts and labor are covered under the terms of the warranty agreement. The warranty provision is based on historical experience by product, configuration and geographic region. Quarterly warranty consumption is generally associated with sales that occurred during the

preceding four quarters, and quarterly warranty provisions are generally related to the current quarter's sales.

***Guarantees***

During the ordinary course of business, Applied provides standby letters of credit or other guarantee instruments to certain parties as required for certain transactions initiated by either Applied or its subsidiaries. As of January 28, 2007, the maximum potential amount of future payments that Applied could be required to make under these guarantee arrangements was approximately \$100 million. Applied has not recorded any liability in connection with these guarantee arrangements beyond that required to appropriately account for the underlying transaction being guaranteed. Applied does not believe, based on historical experience and information currently available, that it is probable that any amounts will be required to be paid under these guarantee arrangements.

Applied also has agreements with various global banks to facilitate subsidiary banking operations world-wide, including overdraft arrangements, bank guarantees and letters of credit. As of January 28, 2007, Applied Materials, Inc. has provided parent guarantees to banks for approximately \$85 million to cover these arrangements.

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**APPLIED MATERIALS, INC.**

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

*Legal matters*

*David Scharf*

On July 31, 2001, David Scharf, an individual, filed a lawsuit against Applied in the United States District Court for the Central District of California, captioned David Scharf v. Applied Materials, Inc. The lawsuit alleges that Applied has infringed, has induced others to infringe, and has contributed to others' infringement of, a patent concerning color synthesizing scanning electron microscope technology. Mr. Scharf seeks preliminary and permanent injunctions, a finding of willful infringement, damages (including treble damages), and costs. Applied has answered the complaint and counterclaimed for declaratory judgment of non-infringement and invalidity. On May 10, 2002, Mr. Scharf filed a request for re-examination of his patent with the Patent and Trademark Office (PTO). On June 26, 2002, the case was removed from the Court's active docket after the parties stipulated to stay the case pending the results of that re-examination. On July 11, 2002, Applied filed its own request for re-examination of Mr. Scharf's patent with the PTO. Applied's request for re-examination was granted on September 19, 2002. On April 23, 2004, the PTO notified Applied that it intended to issue a re-examination certificate. On June 14, 2004, Applied filed a second request for re-examination of Mr. Scharf's patent with the PTO. The second request was denied on September 1, 2004. On October 1, 2004, Applied filed a petition for reconsideration of that denial, which subsequently was denied. The lawsuit was returned to the active docket of the District Court for the Central District of California in January 2006. The parties have completed fact discovery and on February 22, 2007, the Court held a claim construction hearing. The Court has vacated all scheduled dates, including an April 3, 2007 trial date, which will be re-set following the Court's order on claim construction. Applied believes it has meritorious defenses and counterclaims and intends to pursue them vigorously.

*Linear Technology*

On March 12, 2002, Linear Technology Corp. (LTC) filed a complaint against Applied in the Superior Court for the County of Santa Clara, captioned Linear Technology Corp. v. Applied Materials, Inc., Novellus Systems, Inc. and Tokyo Electron Ltd., alleging claims for breach of contract, fraud and deceit, negligent misrepresentation, suppression of fact, unfair competition, breach of warranty, express contractual indemnity, implied equitable indemnity and declaratory relief. The complaint alleged, among other things, that Applied is obligated to indemnify and defend LTC for certain claims in an underlying patent infringement lawsuit brought by Texas Instruments, Inc. (TI) against LTC. On November 12, 2002, LTC filed an amended complaint asserting essentially the same claims as in the original complaint, but adding an additional assertion that LTC and TI have settled their litigation. Applied's motion to dismiss the amended complaint was granted in part. LTC filed Second and Third Amended Complaints, each of which was dismissed upon Applied's motion. On February 13, 2004, LTC filed a Fourth Amended Complaint, which Applied moved to dismiss. LTC then filed a motion to amend its Fourth Amended Complaint, which the Court granted. On July 7, 2004, LTC filed a Fifth Amended Complaint. On October 5, 2004, Applied's motion to dismiss LTC's Fifth Amended Complaint was granted with prejudice. On January 11, 2005, LTC filed a notice of appeal of the dismissal of its complaint. Applied believes it has meritorious defenses and intends to pursue them vigorously.

*Jusung*

On December 24, 2003, Applied filed a lawsuit against Jusung Engineering Co., Ltd. (Jusung Engineering) and Jusung Pacific Co., Ltd. (Jusung Pacific, referred to together with Jusung Engineering as Jusung) in Tao-Yuan District

Court in Taiwan, captioned Applied Materials, Inc. v. Jusung Engineering Co., Ltd. The lawsuit alleges that Jusung is infringing a patent related to chemical vapor deposition owned by Applied. In the lawsuit, Applied seeks a provisional injunction prohibiting Jusung from importing, using, manufacturing, servicing or selling in Taiwan certain flat panel display manufacturing equipment. On December 25, 2003, the Tao-Yuan District Court ruled in favor of Applied's request for a provisional injunction, and on January 14, 2004, the Court issued a provisional injunction order against Jusung Pacific. Jusung Pacific appealed those decisions, and the decisions were affirmed on appeal. On January 30, 2004, Jusung Pacific requested permission to post a counterbond to have the Jusung Pacific

**Table of Contents****APPLIED MATERIALS, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

injunction lifted. Jusung Pacific's counterbond request was granted, and on March 30, 2004, the provisional injunction order was lifted. At Applied's request, on December 11, 2004, the District Court issued a provisional injunction order against Jusung Engineering. Jusung Engineering appealed that order, and the order was affirmed on appeal. Jusung Engineering also requested permission to post a counterbond to have the Jusung Engineering injunction lifted. Jusung Engineering's counterbond request was granted, and on April 25, 2005, the provisional injunction order against Jusung Engineering was lifted. Applied has appealed both counterbond decisions. On June 30, 2004, Applied filed a main action patent infringement complaint against Jusung in the Hsinchu District Court in Taiwan, captioned Applied Materials, Inc. v. Jusung Engineering Co., Ltd. In the lawsuit, Applied seeks damages and a permanent injunction for infringement of the same patent. The decisions regarding the provisional injunction and counterbond have no effect on the separate patent infringement lawsuit filed by Applied against Jusung in the Hsinchu Court. In August 2006, the Court set the litigation fee and the litigation security payment, and the main action is now proceeding on its merits. The Court held a second hearing in the main action on October 30, 2006. This same patent is the subject of an invalidity proceeding filed in the Taiwanese Patent and Trademark Office by Jusung Pacific in June 2004. Applied believes it has meritorious claims and intends to pursue them vigorously. On January 31, 2007, Applied received notice that Jusung filed a complaint of private prosecution in the Taipei District Court of Taiwan dated November 10, 2006, entitled Jusung Engineering Co., Ltd. v. M. Splinter, Y. Lin, C. Lai and J. Lin. The complaint alleges that Applied's outside counsel received from the Court and used a copy of an expert report that Jusung had filed in the ongoing patent infringement lawsuits and that Jusung had intended to remain confidential. Jusung named as defendants Applied's Taiwan attorneys, as well as Michael R. Splinter, Applied's President and Chief Executive Officer, as the statutory representative of Applied. Applied believes that this action is without merit.

On June 13, 2006, Applied filed an action in the Taiwanese Patent and Trademark Office challenging the validity of a patent owned by Jusung Engineering related to the severability of the transfer chamber. On June 20, 2006, Jusung Engineering filed a lawsuit against Applied and Applied's subsidiary, AKT, in Hsinchu District Court in Taiwan, captioned Jusung Engineering, Co. Ltd. v. AKT America, Inc. and Applied Materials, Inc., alleging infringement of this patent. Jusung Engineering's lawsuit seeks damages, costs and attorneys' fees, but does not seek injunctive relief. A hearing before the Court was conducted on December 28, 2006. Applied believes that it has meritorious defenses that it intends to pursue vigorously.

*Taiwan Fair Trade Commission*

On April 10, 2004, the Taiwan Fair Trade Commission (TFTC) notified Applied's subsidiary, AKT, in Taiwan that, pursuant to a complaint filed by Jusung, the TFTC had begun an investigation into whether AKT had violated the Taiwan Fair Trade Act. The investigation focused on whether AKT violated the Taiwan Guidelines for the Review of Cases Involving Enterprises Issuing Warning Letters for Infringement on Copyright, Trademark and Patent Rights by allegedly notifying customers about AKT's patent rights and the infringement of those rights by Jusung. On June 15, 2004, the TFTC notified Applied that Applied also was the subject of the investigation. By letter dated April 15, 2005, the TFTC notified Applied and AKT that there was insufficient evidence to support a claim against either company. Jusung appealed the TFTC's decision, and the appeals court affirmed the decision of the TFTC in favor of Applied on February 7, 2006. Jusung appealed the appeals court's affirmation of the decision of the TFTC, in January 2007 the Taipei High Administrative Court dismissed Jusung's appeal, and in February 2007, Jusung appealed the dismissal to the Supreme Administrative Court.

*Silicon Services Consortium*

On January 19, 2006, five companies that sell refurbished Applied tools (Silicon Services Consortium Inc., Semiconductor Support Services Co., OEM Surplus, Inc., Precision Technician Inc., and Semiconductor Equipment Specialist, Inc.) filed a lawsuit against Applied in the United States District Court for the Western District of Texas, captioned Silicon Services Consortium, Inc., et al. v. Applied Materials, Inc. The plaintiffs claim that a policy that Applied announced in January 2005 limiting the sale of certain parts to them constituted an unlawful

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**APPLIED MATERIALS, INC.**

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

attempt to monopolize the refurbishment business, an interference with existing contracts, and an interference with prospective business relationships. The suit seeks injunctive relief, damages, costs and attorneys' fees. After Applied filed a motion to dismiss the original complaint, the plaintiffs filed an amended complaint alleging similar conduct. Applied filed a motion to dismiss the amended complaint on April 7, 2006, which the Court denied on February 16, 2007. Applied believes it has meritorious defenses and intends to pursue them vigorously. On January 17, 2007, Applied filed a counterclaim in this matter, asserting claims for patent infringement, trademark infringement, trademark dilution, unfair competition, and misuse and misappropriation of trade secrets against each of the five plaintiffs/counterdefendants. Applied seeks damages for the harm it has suffered, as well as an injunction prohibiting any further violation of Applied's intellectual property rights. Applied believes that it has meritorious claims and intends to pursue them vigorously.

Applied does not believe that the outcome of any of the above matters will have a material adverse effect on its financial position or results of operations.

Applied is subject to various legal proceedings and claims, either asserted or unasserted, that arise in the ordinary course of business. Applied from time to time is, and in the future may be, involved in legal proceedings or claims regarding patent infringement, intellectual property rights, antitrust, environmental regulations, securities, contracts, product performance, product liability, unfair competition, employment and other matters. In addition, Applied on occasion receives notification from customers who believe that Applied owes them indemnification or other obligations related to infringement claims made against the customers by third parties. Applied evaluates, among other factors, the degree of probability of an unfavorable outcome and reasonably estimates the amount of the loss. Significant judgment is required both in the determination of the probability and as to whether an exposure can be reasonably estimated. When Applied determines that a loss is probable and the amount of the loss is reasonably estimable, the effect is recorded in the consolidated financial statements. Significant changes in legal proceedings and claims or the factors considered in the evaluation of those matters could have a material adverse effect on Applied's business, financial condition and results of operations.

**Note 7 Restructuring and Asset Impairments**

During the first quarter of fiscal 2006, Applied's Board of Directors approved a plan to disinvest a portion of Applied's real estate and facilities portfolio (the Disinvestment Plan). Properties with an estimated fair value of \$56 million were reported as assets held-for-sale and reclassified from property, plant and equipment on the consolidated condensed balance sheet. Applied recorded an asset impairment charge of \$124 million during the first quarter of fiscal 2006 to write down the following properties to estimated fair value: facilities in Narita, Japan; Chunan, Korea; Hillsboro, Oregon; and Danvers, Massachusetts; and 26 acres of unimproved land in Hillsboro, Oregon. During fiscal 2006, Applied sold the Danvers, Massachusetts facility for net proceeds of \$16 million and recognized a gain of \$4 million; recorded additional impairment charges on the Narita and Chunan facilities of \$6 million; and recorded a restructuring charge of \$4 million related to environmental contamination of the Narita site. During the first quarter of fiscal 2007, Applied sold the Hillsboro, Oregon facility for net proceeds of \$9 million and recognized a gain of \$3 million. Applied has entered into a contract to sell the Chunan facility and continues to actively market the remaining properties.

As part of the Disinvestment Plan, Applied also recorded a charge in the amount of \$91 million for future lease obligations that were scheduled to continue through fiscal 2014 related to the closure of its leased Hayward, California



facility. During fiscal 2006, Applied consumed \$9 million in restructuring reserves for rental and operating costs associated with this facility. In the fourth quarter of fiscal 2006, Applied paid \$81 million to terminate the Hayward lease.

Restructuring actions were taken in fiscal 2003 and 2004 to align Applied's cost structure with prevailing market conditions due to an industry downturn. These actions, which were necessary as a result of reduced business volume, decreased Applied's global workforce and consolidated Applied's global facilities. As of January 28, 2007, the majority of the fiscal 2003 and 2004 restructuring activities were completed, and restructuring reserve balances

**Table of Contents****APPLIED MATERIALS, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

consisted principally of remaining lease commitments associated with the facilities that continue through fiscal 2009.

Changes in restructuring reserves for facilities for the three months ended January 28, 2007 were as follows:

|                           | <b>(In thousands)</b> |
|---------------------------|-----------------------|
| Balance, October 29, 2006 | \$ 24,731             |
| Consumption of reserves   | (3,032)               |
| Balance, January 28, 2007 | \$ 21,699             |

**Note 8 Derivative Financial Instruments**

Applied's derivative financial instruments, consisting of currency forward exchange and option contracts, are recorded at fair value on the consolidated condensed balance sheet, either in other current assets or accounts payable and accrued expenses. Changes in the fair value of derivatives that do not qualify for hedge accounting treatment, as well as the ineffective portion of any hedges, are recognized in the consolidated results of operations. The effective portion of the gain/(loss) is reported as a component of accumulated other comprehensive income in stockholders' equity, and is reclassified into results of operations when the hedged transaction affects income/(loss). All amounts included in accumulated other comprehensive income as of January 28, 2007 will generally be reclassified into earnings within 12 months. Changes in the fair value of currency forward exchange and option contracts due to changes in time value are excluded from the assessment of effectiveness, and are recognized in cost of products sold or expensed. The change in option and forward time value was not material for all periods presented. If the transaction being hedged fails to occur, or if a portion of any derivative is deemed to be ineffective, Applied promptly recognizes the gain/(loss) on the associated financial instrument in general and administrative expenses. The amounts recognized due to the anticipated transactions failing to occur or ineffective hedges were not material for all periods presented.

Accumulated other comprehensive income related to derivative activities for the three months ended January 28, 2007 increased by \$1 million due to a net increase in the intrinsic value of derivatives.

**Note 9 Stockholders' Equity*****Comprehensive Income***

Components of comprehensive income, on an after-tax basis where applicable, were as follows:

| <b>Three Months Ended</b>   |                             |
|-----------------------------|-----------------------------|
| <b>January 29,<br/>2006</b> | <b>January 28,<br/>2007</b> |
| <b>(In thousands)</b>       |                             |

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|                                                                                                  |            |            |
|--------------------------------------------------------------------------------------------------|------------|------------|
| Net income                                                                                       | \$ 142,780 | \$ 403,476 |
| Change in unrealized net gain/(loss) on investments                                              | 4,967      | (3,385)    |
| Change in unrealized net gain/(loss) on derivative instruments qualifying as cash<br>flow hedges | (4,546)    | 1,204      |
| Foreign currency translation adjustments                                                         | 812        | 5,895      |
| Change in minimum pension liability                                                              | (7,069)    |            |
| Comprehensive income                                                                             | \$ 136,944 | \$ 407,190 |

**Table of Contents****APPLIED MATERIALS, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

Components of accumulated other comprehensive loss, on an after-tax basis where applicable, were as follows:

|                                                                          | <b>October 29,<br/>2006</b> | <b>January 28,<br/>2007</b> |
|--------------------------------------------------------------------------|-----------------------------|-----------------------------|
|                                                                          | <b>(In thousands)</b>       |                             |
| Unrealized loss on investments                                           | \$ (5,132)                  | \$ (8,517)                  |
| Unrealized gain on derivative instruments qualifying as cash flow hedges | 4,319                       | 5,523                       |
| Minimum pension liability                                                | (17,985)                    | (17,985)                    |
| Cumulative translation adjustments                                       | (212)                       | 5,683                       |
|                                                                          | <b>\$ (19,010)</b>          | <b>\$ (15,296)</b>          |

***Stock Repurchase Program***

Since March 1996, Applied has systematically repurchased shares of its common stock in the open market. In March 2006, the Board of Directors approved a stock repurchase program for up to \$5.0 billion in repurchases over the next three years ending in March 2009. Pursuant to this authorization, on September 18, 2006, Applied entered into accelerated stock buyback agreements with Goldman, Sachs & Co. (Goldman Sachs), under which Applied agreed to purchase from Goldman Sachs outstanding shares of Applied common stock for an initial purchase price of \$2.5 billion. Under the agreements, Applied purchased 145 million shares of Applied common stock on September 18, 2006 at a price per share of \$17.20, and Goldman Sachs agreed to purchase an equivalent number of shares in the open market over the following four months. At the end of the four month period, Applied was entitled to or subject to a price adjustment based upon the volume weighted average price of Applied common stock during the purchase period that could be settled, at Applied's option, in cash or shares of its common stock. On January 24, 2007, Applied settled the price adjustment of \$132 million by payment in cash to Goldman Sachs, resulting in an adjusted price per share of \$18.08. The repurchase was funded with Applied's existing cash and investments and reported as treasury stock.

On September 15, 2006, the Board of Directors approved a new stock repurchase program for up to \$5.0 billion in repurchases over the next three years, ending in September 2009, of which \$5.0 billion remained as of January 28, 2007. Under this authorization, Applied is continuing a systematic stock repurchase program and may also make additional stock repurchases from time to time, depending on market conditions, stock price and other factors.

During the three months ended January 28, 2007, Applied did not repurchase any shares of its common stock. During the three months ended January 29, 2006, Applied repurchased 26,531,000 shares of its common stock at an average price of \$18.84 for a cash outlay of \$500 million.

***Dividends***

On September 13, 2006, Applied's Board of Directors declared a quarterly cash dividend in the amount of \$0.05 per share, which was paid on December 7, 2006 to stockholders of record as of November 16, 2006, for a total of

\$70 million. On December 13, 2006, Applied's Board of Directors declared a quarterly cash dividend in the amount of \$0.05 per share, payable on March 8, 2007 to stockholders of record as of February 15, 2007, for a total of \$70 million. The declaration of any future cash dividend is at the discretion of the Board of Directors and will depend on the Company's financial condition, results of operations, capital requirements, business conditions and other factors.

Table of Contents**APPLIED MATERIALS, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)****Note 10 Employee Benefit Plans**

Applied sponsors a number of employee benefit plans, including defined benefit plans of certain foreign subsidiaries. The components of the net periodic pension costs of these defined benefit plans for the three months ended January 29, 2006 and January 28, 2007 were as follows:

|                                       | <b>Three Months Ended</b>   |                             |
|---------------------------------------|-----------------------------|-----------------------------|
|                                       | <b>January 29,<br/>2006</b> | <b>January 28,<br/>2007</b> |
|                                       | <b>(In thousands)</b>       |                             |
| Service cost                          | \$ 3,599                    | \$ 3,851                    |
| Interest cost                         | 2,045                       | 2,602                       |
| Expected return on plan assets        | (1,058)                     | (1,425)                     |
| Amortization of transition obligation | 16                          | 16                          |
| Amortization of prior service costs   | 34                          | (30)                        |
| Amortization of net loss              | 620                         | 503                         |
| Net periodic pension cost             | \$ 5,256                    | \$ 5,517                    |

**Note 11 Borrowing Facilities**

Applied has credit facilities for unsecured borrowings in various currencies of up to approximately \$1.2 billion, of which \$1 billion is comprised of a 5-year revolving credit agreement with a group of banks that expires in January 2012. This agreement provides for borrowings at interest rates keyed to one of the two rates selected by Applied for each advance, and includes financial and other covenants with which Applied was in compliance at January 28, 2007. No amounts were outstanding under this agreement at January 28, 2007. This credit facility replaced a \$100 million 364-day unsecured credit agreement entered into during the fourth quarter of fiscal 2006, which was terminated. The remaining credit facilities of approximately \$157 million are with Japanese banks at rates indexed to their prime reference rate and are denominated in Japanese yen. No amounts were outstanding under these Japanese credit facilities at January 28, 2007.

**Note 12 Business Combinations and Equity-Method Investment**

On August 14, 2006, Applied's wholly-owned subsidiary, Metron Technology, Inc. (Metron), purchased certain assets of UMS Solutions Pte. Ltd.'s (UMS Solutions) parts cleaning and recycling business in Singapore for \$10 million. The acquisition enhanced Metron's capabilities in Southeast Asia with advanced, high-quality parts cleaning services to support its customers' semiconductor manufacturing requirements. In connection with this acquisition, Applied recorded goodwill of \$7 million and other intangible assets of \$1 million.

On July 20, 2006, Applied and Dainippon Screen Mfg. Co., Ltd. (Screen) completed the formation of Sokudo Co., Ltd., a Japanese joint venture company (Sokudo), to deliver advanced track solutions for customers' critical semiconductor manufacturing requirements. Screen owns 52 percent and holds the controlling interest in Sokudo, and Applied owns 48 percent. Screen transferred into Sokudo its existing track business and related intellectual property, including employees, products and its installed base of systems. Applied paid \$147 million for its investment in Sokudo. Additionally, Applied contributed to Sokudo certain technology and related intellectual property and provided key development employees. Screen performs manufacturing for Sokudo under an outsourcing agreement. Applied accounts for its interest in Sokudo under the equity method of accounting. Under this accounting method, Applied's exposure to loss from ongoing operations is limited to \$140 million as of January 28, 2007, which represents Applied's carrying value of its investment in Sokudo. Applied's investment in Sokudo is classified as an equity-method investment on the consolidated condensed balance sheet. Applied's investment in Sokudo includes the unamortized excess of Applied's investment over its equity in the joint venture's net assets. This excess of \$41 million is being amortized on a straight-line basis over its estimated economic useful life of 7 years.

**Table of Contents****APPLIED MATERIALS, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

On July 7, 2006, Applied completed its acquisition of Applied Films Corporation, a Colorado corporation (Applied Films) and leading supplier of thin film deposition equipment used in manufacturing flat panel displays (FPDs), solar cells, flexible electronics and energy-efficient glass. Applied paid \$28.50 per share in cash for each outstanding share of Applied Films. The total purchase price was approximately \$484 million, or \$328 million net of Applied Films existing cash and marketable securities. As part of the acquisition, Applied assumed Applied Films' outstanding stock options and restricted stock awards that, at the acquisition date, had a total fair value of \$26 million, of which \$18 million was allocated to the purchase price and the remainder to unearned compensation. Upon the acquisition and subject to vesting, Applied Films stock options became exercisable for shares of Applied common stock and Applied Films restricted stock awards became payable in shares of Applied common stock totaling, in the aggregate, three million shares of Applied common stock. The fair value of the assumed Applied Films stock options was determined using a Black-Scholes model. The use of the Black-Scholes model and method of determining the variables is consistent with Applied's valuation of equity-based compensation. Applied recorded an in-process research and development expense of \$14 million, reported as research, development and engineering expense; goodwill of \$226 million; and other intangible assets of \$140 million. The acquired in-process research and development expense was determined by identifying research projects for which technological feasibility had not been established and no alternative future use existed. The value of the projects identified as in-process was determined by estimating the future cash flows from the projects once commercially feasible, discounting the net cash flows back to their present value at a rate commensurate with the level of risk and maturity of the projects, and then applying a percentage of completion to the calculated value.

On December 23, 2005, Applied acquired all of the outstanding shares of ChemTrace Corporation and ChemTrace Precision Cleaning, Inc. (collectively, ChemTrace) for approximately \$22 million in cash, net of cash acquired, of which \$18 million was paid upon closing. ChemTrace provides customers with precision parts cleaning and materials testing solutions. In connection with this acquisition, Applied recorded goodwill of \$12 million and other intangible assets of \$8 million.

For all of the purchase business combinations discussed above, the results of operations prior to the acquisition dates were not material in relation to those of Applied for any of the periods presented herein. Goodwill is not amortized but is reviewed periodically for impairment and purchased technology is amortized over its useful life of 2 to 15 years.

**Note 13 Pending Business Combination**

On November 6, 2006, Applied announced that it had entered into an agreement to purchase the assets of Brooks Software, a division of Brooks Automation, Inc., for \$125 million in cash. Brooks Software is a leading provider of factory management and control software to the semiconductor and flat panel display industries. Brooks Software's products complement Applied's existing software applications and are expected to enable Applied to offer customers a comprehensive computer integrated manufacturing (CIM) solution for optimizing fab operations. After the closing of this transaction, the Brooks Software business and employees will be integrated within the Applied Global Services organization and reported under the Fab Solutions segment. Completion of this acquisition is subject to receipt of regulatory approvals and certain other closing conditions, and is expected to be completed in the second quarter of fiscal 2007.

**Note 14 Income Taxes**



The effective tax rate for the first quarter of fiscal 2007 was 28.6 percent and included benefits of \$30 million due to a favorable resolution of audits of prior years' income tax filings and to the retroactive reinstatement to January 1, 2006 of the research and development tax credit pursuant to the Tax Relief and Health Care Act of 2006. Applied's effective tax rate was 22.4 percent for the comparable quarter of fiscal 2006. The first quarter fiscal 2006 effective tax rate includes the tax impact of the restructuring and asset impairment charge related to the Disinvestment Plan (see Note 7). The effective tax rate is highly dependent on the geographic composition of

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**APPLIED MATERIALS, INC.**

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

worldwide earnings, tax regulations for each region, non-tax deductible expenses incurred in connection with acquisitions, and availability of tax credits. Management carefully monitors these factors and timely adjusts the effective tax rate accordingly.

**Note 15 Industry Segment Operations**

Applied made certain changes to its internal financial reporting structure during the fourth quarter of fiscal 2006 and, as a result, reports four segments: Silicon, Fab Solutions, Display, and Adjacent Technologies. Applied's chief operating decision-maker has been identified as the President and CEO, who reviews operating results to make decisions about allocating resources and assessing performance for the entire Company. Segment information is presented based upon Applied's management organization structure as of January 28, 2007 and the distinctive nature of each segment. Prior periods have been reclassified to conform to the current presentation. Future changes to this internal financial structure may result in changes to the reportable segments disclosed. Prior to the fourth quarter of fiscal 2006, Applied operated in one reportable segment.

Each reportable segment is separately managed and has separate financial results that are reviewed by Applied's chief operating decision-maker. Each reportable segment contains closely related products that are unique to the particular segment. Segment operating income is determined based upon internal performance measures used by the President and CEO.

Applied derives the segment results from its internal management reporting system. The accounting policies Applied uses to derive reportable segment results are substantially the same as those used for external reporting purposes. Management measures the performance of each reportable segment based upon several metrics including orders, net sales and operating income. Management uses these results to evaluate the performance of, and to assign resources to, each of the reportable segments. Applied does not allocate to its reportable segments certain operating expenses, which it manages separately at the corporate level. These unallocated costs include charges for equity-based compensation, corporate marketing and sales, corporate functions (certain management, finance, legal, human resources and RD&E) and unabsorbed information technology and occupancy. In addition, Applied does not allocate to its reportable segments restructuring and asset impairment charges and any associated adjustments related to restructuring actions. Segment operating income excludes interest income, interest expense and other financial charges and income taxes. Management does not use the unallocated costs to measure the performance of the reportable segments.

The Silicon segment is comprised of a wide range of semiconductor manufacturing equipment that customers use to perform most of the steps in the chip fabrication process, including atomic layer deposition, chemical vapor deposition, physical vapor deposition, electrochemical plating, etch, ion implantation, rapid thermal processing, chemical mechanical planarization, wafer wet cleaning, and wafer metrology and inspection.

The Fab Solutions segment is comprised of a broad range of products and services designed to improve the performance and productivity of semiconductor manufacturers' fab operations.

Applied reports under the Display segment the manufacture, sale and servicing of equipment used to fabricate and test flat panel displays (FPD) for televisions, computer displays and other applications. With the acquisition of Applied Films, the Display segment was expanded to include equipment to manufacture color filters for flat panel displays.

The Adjacent Technologies segment manufactures, sells and services equipment used to fabricate solar photovoltaic cells, flexible electronics and energy-efficient glass.

**Table of Contents****APPLIED MATERIALS, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

Information for each reportable segment for the three months ended January 29, 2006 and January 28, 2007 is as follows:

|                       | <b>Net Sales</b>      | <b>Operating<br/>Income (Loss)</b> |
|-----------------------|-----------------------|------------------------------------|
|                       | <b>(In thousands)</b> |                                    |
| 2006:                 |                       |                                    |
| Silicon               | \$ 1,221,105          | \$ 333,413                         |
| Fab Solutions         | 470,735               | 119,115                            |
| Display               | 165,752               | 47,420                             |
| Adjacent Technologies |                       |                                    |
| Total Segment         | \$ 1,857,592          | \$ 499,948                         |
| 2007:                 |                       |                                    |
| Silicon               | \$ 1,490,262          | \$ 520,153                         |
| Fab Solutions         | 524,691               | 145,935                            |
| Display               | 230,491               | 63,564                             |
| Adjacent Technologies | 31,823                | (14,694)                           |
| Total Segment         | \$ 2,277,267          | \$ 714,958                         |

Reconciliations of segment operating results to Applied consolidated totals for the three months ended January 29, 2006 and January 28, 2007 are as follows:

|                                            | <b>2006</b>           | <b>2007</b> |
|--------------------------------------------|-----------------------|-------------|
|                                            | <b>(In thousands)</b> |             |
| Total segment operating income             | \$ 499,948            | \$ 714,958  |
| Corporate and unallocated costs            | (141,162)             | (168,710)   |
| Restructuring and asset impairment charges | (214,847)             | 3,278       |
| Income from operations                     | \$ 143,939            | \$ 549,526  |

**Note 16 Recent Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement No. 158, Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87,

88, 106, and 132R (SFAS 158). SFAS 158 requires an entity to recognize in its statement of financial condition the funded status of its defined benefit post-retirement plans, measured as the difference between the fair value of the plan assets and the benefit obligation. SFAS 158 also requires an entity to recognize changes in the funded status of a defined benefit post-retirement plan directly to accumulated other comprehensive income, net of tax, to the extent such changes are not recognized in earnings as components of periodic net benefit cost. SFAS 158 is effective for Applied in the fourth quarter of fiscal 2007. Applied does not expect the implementation of this standard to have a material effect on Applied's financial position or results of operations.

In September 2006, the FASB issued Statement No. 157, Fair Value (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 becomes effective for Applied in fiscal 2009. Applied is evaluating the potential impact of the implementation of SFAS 157 on its financial position and results of operations.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial

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**APPLIED MATERIALS, INC.**

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

Statements (SAB 108), which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current misstatement. SAB 108 is effective for Applied in the fourth quarter of fiscal 2007. Applied does not expect the implementation of this staff accounting bulletin to have a material effect on Applied's financial position or results of operations.

In July 2006, the FASB issued FASB Interpretation 48, Accounting for Income Tax Uncertainties (FIN 48). FIN 48 defines the threshold for recognizing the benefits of tax return positions in the financial statements as more-likely-than-not to be sustained by the taxing authority. The recently-issued literature also provides guidance on the derecognition, measurement and classification of income tax uncertainties, along with any related interest and penalties. FIN 48 also includes guidance concerning accounting for income tax uncertainties in interim periods and increases the level of disclosures associated with any recorded income tax uncertainties. FIN 48 will become effective for Applied beginning in fiscal 2008. Any differences between the amounts recognized in the statements of financial position prior to the adoption of FIN 48 and the amounts reported after adoption will be accounted for as a cumulative-effect adjustment recorded to the beginning balance of retained earnings. Applied is evaluating the potential impact of the implementation of FIN 48 on its financial position and results of operations.

**Note 17 Subsequent Event**

On February 9, 2007, the Board of Directors of Applied approved a plan (the Plan) to cease future development of beamline implant products for semiconductor manufacturing and close the operations of its Applied Implant Technologies (Implant) group based in Horsham, England. Under the Plan, the Company expects to wind down its research and development and manufacturing operations in Horsham to closure by the end of December 2007. The total cost of implementing the Plan is expected to be in the range of \$90 to \$130 million, which will be reported in the Company's consolidated statements of operations under cost of products sold and operating expenses (including asset impairment and restructuring charges). Costs are anticipated to be incurred over multiple quarters beginning in the second quarter of fiscal 2007 and concluding in the first quarter of fiscal 2008.

As part of the total cost of the Plan indicated above, Applied anticipates that it will record pre-tax restructuring and asset impairment charges in the range of \$45 to \$53 million over multiple fiscal quarters, consisting principally of lease termination/facilities-related charges and employee termination charges. Included in the restructuring charges are anticipated cash expenditures in the range of \$38 to \$43 million. Applied estimates that costs other than restructuring and asset impairment charges associated with the Plan will range between \$45 and \$77 million, consisting primarily of inventory-related and employee-related charges. The Implant group operates in the Silicon segment and the results of its operations are not material to the consolidated or the segment financial position or results of operations.

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

Certain information contained in this Quarterly Report on Form 10-Q is forward-looking in nature. All statements in this Quarterly Report, including those made by the management of Applied, other than statements of historical fact, are forward-looking statements. Examples of forward-looking statements include statements regarding Applied's future financial results, operating results, cash flows and cash deployment strategies, business strategies, projected costs, products, competitive positions, management's plans and objectives for future operations, acquisitions and joint ventures, growth opportunities, and legal proceedings, as well as semiconductor and semiconductor-related industry trends. These forward-looking statements are based on management's estimates, projections and assumptions as of the date hereof and include the assumptions that underlie such statements. Forward-looking statements may contain words such as may, will, should, could, would, expect, plan, anticipate, believe, estimate, predict, or other comparable terminology, or other comparable terminology. Any expectations based on these forward-looking statements are subject to risks and uncertainties and other important factors, including those discussed below and in Part II, Item 1A, Risk Factors. Other risks and uncertainties may be disclosed from time to time in Applied's other Securities and Exchange Commission (SEC) filings. These and many other factors could affect Applied's future financial condition and operating results and could cause actual results to differ materially from expectations based on forward-looking statements made in this document or elsewhere by Applied or on its behalf. Applied undertakes no obligation to revise or update any forward-looking statements.

**Overview**

Applied develops, manufactures, markets and services semiconductor and semiconductor-related fabrication equipment, providing nanomanufacturing technology™ solutions to the global semiconductor, flat panel display, solar and other industries. Product development and manufacturing activities occur in North America, Europe and Israel. Applied's broad range of equipment and service products are highly technical and are sold through a direct sales force. Customer demand for spare parts and services is fulfilled through a global spare parts distribution system and trained service engineers located around the world in close proximity to customer sites.

As a supplier to the semiconductor and semiconductor-related industries, Applied's results are primarily driven by worldwide demand for integrated circuits, which in turn depends on end-user demand for electronic products. The industries in which Applied operates are volatile, and Applied's operating results have reflected this volatility.

The following table presents certain significant measurements for the three months ended January 29, 2006 and January 28, 2007:

|                      | <b>Three Months Ended</b>                                      |                    |               |
|----------------------|----------------------------------------------------------------|--------------------|---------------|
|                      | <b>January 29,</b>                                             | <b>January 28,</b> | <b>%</b>      |
|                      | <b>2006</b>                                                    | <b>2007</b>        | <b>Change</b> |
|                      | <b>(In millions, except per share amounts and percentages)</b> |                    |               |
| New orders           | \$ 2,041                                                       | \$ 2,538           | 24%           |
| Net sales            | \$ 1,858                                                       | \$ 2,277           | 23%           |
| Gross margin         | \$ 838                                                         | \$ 1,063           | 27%           |
| Gross margin percent | 45.1%                                                          | 46.7%              | 4%            |
| Net income           | \$ 143                                                         | \$ 403             | 183%          |

|                    |    |      |    |      |      |
|--------------------|----|------|----|------|------|
| Earnings per share | \$ | 0.09 | \$ | 0.29 | 223% |
|--------------------|----|------|----|------|------|

Customer demand increased in fiscal 2006, resulting in higher orders and revenue. Fiscal 2006 results reflected a recovery in the semiconductor and semiconductor-related industries and the global economy as end-user demand for electronic products and flat panel displays drove increased customer requirements for advanced silicon and display products. During this period, Applied's semiconductor customers increased both high-volume production and leading-edge 65nm and 45nm chip development. Results for this period also reflected Applied's continued focus on cost controls. Improvements in operating performance were offset in part by restructuring and asset impairment charges associated with real estate and facilities disinvestment that commenced during the first fiscal



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quarter, equity-based compensation expenses and an in-process research and development expense associated with the acquisition of Applied Films Corporation (Applied Films).

In the first quarter of fiscal 2007, Display customers delayed their capacity expansion plans, resulting in a significant decrease in orders. This decline was partially offset by record Fab Solutions orders and increased Silicon orders. During the quarter, growth also slowed in semiconductor demand and chip manufacturers reduced production and delayed capacity additions. The operating results in the first quarter of fiscal 2007 were achieved through continued focus on cost controls, despite a slight decline in orders and net sales.

Applied's long-term opportunities depend in part on successful execution of its growth strategy, including increasing market share in existing markets, expanding into related markets, and cultivating new markets and new business models. These opportunities are also subject to many factors, including: (1) global economic conditions; (2) advanced technology and/or capacity requirements of semiconductor manufacturers and their capital investment trends; (3) the profitability of chip and display manufacturers; (4) supply and demand for chips, flat panel displays, solar panels, and related products and services; (5) realization of the anticipated benefits of business combinations; (6) continued investment in research, development and engineering (RD&E); and (7) the relative competitiveness of Applied's equipment and service products. For these and other reasons set forth in Part II, Item 1A, Risk Factors, Applied's historical consolidated results of operations may not necessarily be indicative of future operating results.

**Results of Operations**

Applied received new orders of \$2.5 billion for the first quarter of fiscal 2007, compared to \$2.7 billion for the fourth quarter of fiscal 2006 and \$2.0 billion for the first quarter of fiscal 2006. New orders for the first quarter of fiscal 2007 decreased by 6 percent from the preceding quarter and increased by 24 percent from the first quarter of fiscal 2006. The decrease in new orders for the first quarter of fiscal 2007 from the previous quarter was primarily attributable to lower demand for flat panel display equipment, partially offset by annual service and parts contract renewals and investment in next-generation semiconductor manufacturing equipment.

New orders by region for the past two consecutive quarters were as follows:

|                          | <b>Three Months Ended</b>    |            |                             |            |
|--------------------------|------------------------------|------------|-----------------------------|------------|
|                          | <b>October 29,<br/>2006</b>  |            | <b>January 28,<br/>2007</b> |            |
|                          | <b>(\$)</b>                  | <b>(%)</b> | <b>(\$)</b>                 | <b>(%)</b> |
|                          | <b>(Dollars in millions)</b> |            |                             |            |
| Taiwan                   | 563                          | 21         | 605                         | 24         |
| North America*           | 521                          | 19         | 550                         | 22         |
| Korea                    | 413                          | 15         | 492                         | 19         |
| Europe                   | 254                          | 10         | 323                         | 13         |
| Japan                    | 589                          | 22         | 300                         | 12         |
| Southeast Asia and China | 348                          | 13         | 268                         | 10         |
| Total                    | 2,688                        | 100        | 2,538                       | 100        |

\* Primarily the United States.

Applied's backlog for the most recent three fiscal quarters was as follows: \$3.6 billion at January 28, 2007, \$3.4 billion at October 29, 2006 and \$3.3 billion at July 30, 2006. Backlog consists only of orders for which written authorizations have been accepted, shipment dates within 12 months have been assigned and revenue has not been recognized. Due to the potential for customer changes in delivery schedules or cancellation of orders, Applied's backlog at any particular time is not necessarily indicative of actual sales for any future periods.

Applied's business is subject to cyclical industry conditions and, as a result of these conditions, there were fluctuations in Applied's net sales during fiscal year 2006. Demand for manufacturing equipment has historically been volatile as a result of sudden changes in chip and flat panel supply and demand and other factors, including rapid technological advances in fabrication processes. During fiscal 2006, net sales increased from \$1.9 billion in the first fiscal quarter to \$2.2 billion in the second fiscal quarter, increased again to \$2.5 billion in the third fiscal

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quarter, and then remained flat at \$2.5 billion for the fourth fiscal quarter. Net sales in the first quarter of fiscal 2007 decreased to \$2.3 billion due to declining fab utilization and customers pushing out shipments due to delayed capacity needs.

Net sales by region for the first quarters of fiscal 2006 and 2007 were as follows:

|                          | <b>Three Months Ended</b>    |            |                             |            |
|--------------------------|------------------------------|------------|-----------------------------|------------|
|                          | <b>January 29,<br/>2006</b>  |            | <b>January 28,<br/>2007</b> |            |
|                          | (\$)                         | (%)        | (\$)                        | (%)        |
|                          | <b>(Dollars in millions)</b> |            |                             |            |
| Taiwan                   | 405                          | 22         | 583                         | 26         |
| Korea                    | 399                          | 22         | 475                         | 21         |
| North America*           | 391                          | 21         | 467                         | 21         |
| Japan                    | 300                          | 16         | 261                         | 11         |
| Europe                   | 228                          | 12         | 254                         | 11         |
| Southeast Asia and China | 135                          | 7          | 237                         | 10         |
| <b>Total</b>             | <b>1,858</b>                 | <b>100</b> | <b>2,277</b>                | <b>100</b> |

\* Primarily the United States.

Gross margin percentage was 46.7 percent for the first quarter of fiscal 2007, compared to 47.1 percent for the fourth quarter of fiscal 2006 and 45.1 percent for the first quarter of fiscal 2006. Gross margin during the first quarter of fiscal 2006 and 2007 included \$9 million and \$6 million, respectively, of equity-based compensation expense. The decrease in the gross margin percentage for the first quarter of fiscal 2007 from that of the previous quarter was principally attributable to the combination of reduced revenue levels, product mix, and lower manufacturing volume, partially offset by lower material costs. The increase in the gross margin percentage for the first quarter of fiscal 2007 from that of the prior year was principally attributable to the combination of higher revenue levels and product mix, and by lower material costs.

Operating expenses included expenses related to RD&E, marketing and selling (M&S), and general and administrative (G&A). Expenses related to RD&E, M&S and G&A were \$516 million for the first quarter of fiscal 2007, compared to \$550 million for the fourth quarter of fiscal 2006 and \$479 million for the first quarter of fiscal 2006. Lower total operating expenses during the first quarter of fiscal 2007 were principally attributable to savings resulting from Applied's December shutdown and continued focus on controlling its overall cost structure and decreases in equity-based and variable compensation expenses.

During the first quarter of fiscal 2006, the Board of Directors approved a real estate and facilities disinvestment plan under which the Company recorded asset impairment charges and restructuring charges totaling \$215 million. The impairment and restructuring charges related to the write down of the Company's Danvers, Massachusetts; Hillsboro, Oregon; Narita, Japan; and Chunan, Korea facilities and unimproved land in Hillsboro, Oregon, and future lease obligations related to the closure of its Hayward, California facility. During the first quarter of fiscal 2007, Applied sold the Hillsboro, Oregon facility for net proceeds of \$9 million and recognized a gain of \$3 million. (See Note 7 of Notes to Consolidated Condensed Financial Statements).

Net interest income was \$20 million and \$40 million for the three months ended January 28, 2007 and January 29, 2006, respectively. Lower net interest income during the first quarter of fiscal 2007 was primarily due to the partial liquidation of the investment portfolio during the fourth quarter of fiscal 2006, when Applied repurchased 145 million shares of its outstanding common stock for an aggregate purchase price of \$2.6 billion under an accelerated buyback program. The repurchase was funded with Applied's existing cash and investments, resulting in lower interest income.

The effective income tax rate for the first quarter of fiscal 2007 was 28.6 percent and included benefits of \$30 million due primarily to a favorable resolution of audits of prior years' income tax filings and to the retroactive reinstatement to January 1, 2006 of the research and development tax credit pursuant to the Tax Relief and Health Care Act of 2006. Applied's effective income tax rate was 22.4 percent for the comparable quarter of fiscal 2006,

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which included the tax impact of the restructuring and asset impairment charge. Applied's future effective income tax rate depends on various factors, such as tax legislation, the geographic composition of Applied's pre-tax income, and non-tax deductible expenses incurred in connection with acquisitions. Management carefully monitors these factors and timely adjusts the effective income tax rate accordingly.

On February 9, 2007, the Board of Directors of Applied approved a plan (the Plan) to cease future development of beamline implant products for semiconductor manufacturing and close the operations of its Applied Implant Technologies (Implant) group based in Horsham, England. Under the Plan, the Company expects to wind down its research and development and manufacturing operations in Horsham to closure by the end of December 2007. The total cost of implementing the Plan is expected to be in the range of \$90 to \$130 million, which will be reported in the Company's consolidated statements of operations under cost of products sold and operating expenses (including asset impairment and restructuring charges). Costs are anticipated to be incurred over multiple quarters beginning in the second quarter of fiscal 2007 and concluding in the first quarter of fiscal 2008.

As part of the total cost of the Plan indicated above, Applied anticipates that it will record pre-tax restructuring and asset impairment charges in the range of \$45 to \$53 million over multiple fiscal quarters, consisting principally of lease termination/facilities-related charges and employee termination charges. Included in the restructuring charges are anticipated cash expenditures in the range of \$38 to \$43 million. Applied estimates that costs other than restructuring and asset impairment charges associated with the Plan will range between \$45 and \$77 million, consisting primarily of inventory-related and employee-related charges. The Implant group operates in the Silicon segment and the results of its operations are not material to the consolidated or the segment financial position or results of operations.

**Segment Information**

After the acquisition of Applied Films, Applied made certain changes to its internal financial reporting structure during the fourth quarter of fiscal 2006 and, as a result, reports four segments: Silicon, Fab Solutions, Display, and Adjacent Technologies. A description of the products and services, as well as financial data, for each reportable segment can be found in Note 15 of Notes to Consolidated Condensed Financial Statements. Future changes to Applied's internal financial reporting structure may result in changes to the reportable segments disclosed. Applied does not allocate to its reportable segments certain operating expenses which are reported separately at the corporate level. These unallocated costs include charges for equity-based compensation, corporate marketing and sales, corporate functions (certain management, finance, legal, human resources and RD&E) and unabsorbed information technology and occupancy. Prior to the fourth quarter of fiscal 2006, Applied operated in one reportable segment. Accordingly, prior period amounts have been reclassified to conform to the current presentation. Discussions below include the results of each reportable segment for the quarters ended January 29, 2006, October 29, 2006 and January 28, 2007.

***Silicon Segment***

|                  | <b>Three Months Ended</b>   |                             |                             |
|------------------|-----------------------------|-----------------------------|-----------------------------|
|                  | <b>January 29,<br/>2006</b> | <b>October 29,<br/>2006</b> | <b>January 28,<br/>2007</b> |
|                  | <b>(In millions)</b>        |                             |                             |
| New orders       | \$ 1,154                    | \$ 1,671                    | \$ 1,755                    |
| Net sales        | \$ 1,221                    | \$ 1,612                    | \$ 1,490                    |
| Operating income | \$ 333                      | \$ 572                      | \$ 520                      |

Silicon received new orders of \$1.8 billion for the first quarter of fiscal 2007, compared to \$1.7 billion for the fourth quarter of fiscal 2006 and \$1.2 billion for the first quarter of fiscal 2006. New orders for the first quarter of fiscal 2007 increased by 5 percent from the preceding quarter and increased 52 percent from the first quarter of fiscal 2006, and the majority of new orders were from memory customers. New orders increased from the previous quarter as semiconductor customers invested in newly-released products including Applied Opus<sup>™</sup> AdvantEdge<sup>™</sup> Metal Etch for sub-70nm aluminum interconnects in leading-edge Flash and DRAM memory devices and the Applied Producer<sup>®</sup> GT<sup>™</sup> platform. New orders increased over the first quarter of fiscal 2006 reflecting the semiconductor industry's growth during the year, driven by demand for cell phones, digital TVs, game consoles, MP3 players and other chip-powered products.

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Net sales decreased to \$1.5 billion for the first quarter of fiscal 2007 from \$1.6 billion for the fourth quarter of fiscal 2006 and increased from \$1.2 billion for the first quarter of fiscal 2006. Net sales for the first quarter of fiscal 2007 decreased by 8 percent from the preceding quarter and increased 22 percent from the first quarter of fiscal 2006. Net sales decreased from the previous quarter as semiconductor customers experienced an increase in inventories and delayed equipment spending. Net sales increased from the first quarter of fiscal 2006 as demand increased in many areas including etch, inspection and thin films products.

Operating income of \$520 million for the first quarter of fiscal 2007 decreased by 9 percent from the preceding quarter and increased 56 percent from the first quarter of fiscal 2006. The decrease in operating income from the preceding fiscal quarter was due to lower revenue levels and change in product mix, partially offset by savings from the December shutdown, continued focus on controlling the overall cost structure and reduced variable compensation costs. The increase in operating income from the first fiscal quarter of 2006 was due to higher revenue levels, partially offset by increased variable compensation costs.

***Fab Solutions Segment***

|                  | <b>Three Months Ended</b>   |                             |                             |
|------------------|-----------------------------|-----------------------------|-----------------------------|
|                  | <b>January 29,<br/>2006</b> | <b>October 29,<br/>2006</b> | <b>January 28,<br/>2007</b> |
|                  | <b>(In millions)</b>        |                             |                             |
| New orders       | \$ 607                      | \$ 625                      | \$ 686                      |
| Net sales        | \$ 471                      | \$ 590                      | \$ 525                      |
| Operating income | \$ 119                      | \$ 169                      | \$ 146                      |

New orders were \$686 million for the first quarter of fiscal 2007, compared to \$625 million for the fourth quarter of fiscal 2006 and \$607 million for the first quarter of fiscal 2006. New orders for the first quarter of fiscal 2007 increased by 10 percent from the preceding quarter and 13 percent from the first quarter of fiscal 2006. The increase in new orders from the previous quarter reflected annual renewals of service and parts contracts.

Net sales decreased to \$525 million for the first quarter of fiscal 2007 from \$590 million for the fourth quarter of fiscal 2006 and increased from \$471 million for the first quarter of fiscal 2006. Net sales for the first quarter of fiscal 2007 decreased by 11 percent from the preceding quarter and increased 12 percent from the first quarter of fiscal 2006. The decrease in net sales from the previous quarter reflected a decrease in spare parts shipments as a result of lower wafer starts and lower shipments of remanufactured equipment. The increase in net sales from the first quarter of fiscal 2006 reflected higher shipments of remanufactured equipment and higher spares and service contract revenues.

Operating income decreased to \$146 million for the first quarter of fiscal 2007 from \$169 million from the fourth quarter of fiscal 2006 and increased from \$119 million for the first quarter of fiscal 2006. Operating income for the first quarter of fiscal 2007 decreased by 14 percent from the preceding quarter and increased 23 percent from the first quarter of fiscal 2006. The decrease in operating income from the previous quarter primarily reflects the impact of lower revenue and lower mix of remanufactured equipment.

***Display Segment***

|                  | <b>Three Months Ended</b>   |                             |                             |
|------------------|-----------------------------|-----------------------------|-----------------------------|
|                  | <b>January 29,<br/>2006</b> | <b>October 29,<br/>2006</b> | <b>January 28,<br/>2007</b> |
|                  | <b>(In millions)</b>        |                             |                             |
| New orders       | \$ 280                      | \$ 355                      | \$ 67                       |
| Net sales        | \$ 166                      | \$ 296                      | \$ 230                      |
| Operating income | \$ 47                       | \$ 94                       | \$ 64                       |

New orders were \$67 million for the first quarter of fiscal 2007, compared to \$355 million for the fourth quarter of fiscal 2006 and \$280 million for the first quarter of fiscal 2006. New orders for the first quarter of fiscal 2007 decreased by 81 percent from the preceding quarter and decreased 76 percent from the first quarter of fiscal 2006. Display orders declined from the previous quarter and the first quarter of 2006 as several LCD panel makers reduced their capacity build plans.



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Net sales decreased to \$230 million for the first quarter of fiscal 2007 from \$296 million for the fourth quarter of fiscal 2006 and increased from \$166 million for the first quarter of fiscal 2006. Net sales for the first quarter of fiscal 2007 decreased by 22 percent from the preceding quarter as customers pushed out shipments due to reduced capacity needs. Net sales for the first quarter of fiscal 2007 increased 39 percent from the first quarter of fiscal 2006 reflecting the timing of revenue recognition of shipments in the later half of 2006 for Gen-7, Gen-7.5, Gen-5 and Gen-5.5 equipment as display manufacturers aggressively invested as the consumer electronics market grew.

Operating income decreased to \$64 million for the first quarter of fiscal 2007 from \$94 million for the fourth quarter of fiscal 2006 and increased from \$47 million for the first quarter of fiscal 2006. Operating income for the first quarter of fiscal 2007 decreased by 32 percent from the preceding quarter and increased 36 percent from the first quarter of fiscal 2006. The decrease in operating income from the preceding fiscal quarter was due to lower revenue levels offset by savings from the December shut down, continued focus on controlling the overall cost structure and reduced variable compensation costs. The increase in operating income from the first fiscal quarter of 2006 was due to higher revenue levels, partially offset by increased variable compensation costs.

**Adjacent Technologies Segment**

| <b>Fiscal Year</b> | <b>Three Months Ended</b>   |                             |                             |
|--------------------|-----------------------------|-----------------------------|-----------------------------|
|                    | <b>January 29,<br/>2006</b> | <b>October 29,<br/>2006</b> | <b>January 28,<br/>2007</b> |
|                    | <b>(In millions)</b>        |                             |                             |
| New orders         | \$                          | \$ 37                       | \$ 31                       |
| Net sales          | \$                          | \$ 20                       | \$ 32                       |
| Operating loss     | \$                          | \$                          | \$ 15                       |

New orders were \$31 million for the first quarter of fiscal 2007, compared to \$37 million for the fourth quarter of fiscal 2006. New orders for the first quarter of fiscal 2007 decreased by 16 percent from the preceding quarter.

Net sales increased to \$32 million for the first quarter of fiscal 2007 from \$20 million from the fourth quarter of fiscal 2006. Net sales for the first quarter of fiscal 2007 increased by 60 percent from the preceding quarter. Net sales recognized in the first quarter of fiscal 2007 and the fourth quarter of fiscal 2006 are a result of the timing of customer acceptance of previously shipped systems.

Operating loss increased to \$15 million for the first quarter of fiscal 2007 from breakeven for the fourth quarter of fiscal 2006. The increase in operating loss from the previous quarter was due to additional expenditures in solar energy product development, partially offset by increased revenue from glass and web products.

**Financial Condition, Liquidity and Capital Resources**

During the first quarter of fiscal 2007, cash, cash equivalents and investments increased by \$199 million, from \$3.2 billion as of October 29, 2006 to \$3.4 billion as of January 28, 2007.

Cash, cash equivalents and investments consist of the following:

**October 29,      January 28,**

|                                              | <b>2006</b>          | <b>2007</b> |
|----------------------------------------------|----------------------|-------------|
|                                              | <b>(In millions)</b> |             |
| Cash and cash equivalents                    | \$ 861               | \$ 1,069    |
| Short-term investments                       | 1,036                | 1,014       |
| Long-term investments                        | 1,315                | 1,328       |
| Total cash, cash-equivalents and investments | \$ 3,212             | \$ 3,411    |

Applied generated \$381 million of cash from operating activities for the three months ended January 28, 2007. The primary sources of operating cash flow for the three months ended January 28, 2007 were net income, adjusted to exclude the effect of non-cash charges including depreciation, amortization, equity-based compensation, asset impairments and restructuring and an increase in income taxes payable, which were partially offset by increases in accounts receivable, inventories and other assets and decreases in accounts payable and accrued expenses. Applied

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sold certain accounts receivable and discounted certain letters of credit totaling \$237 million for the three months ended January 28, 2007. The sales of accounts receivable increase cash and reduce accounts receivable and days sales outstanding. Days sales outstanding for the first quarter of fiscal 2007 increased to 82 days, primarily due to lower revenue levels. Availability and usage of these accounts receivable sale programs depend on many factors, including the willingness of financial institutions to purchase accounts receivable and the cost of such arrangements. For further details regarding accounts receivable sales, see Note 3 of Notes to Consolidated Condensed Financial Statements.

Applied used \$48 million of cash from investing activities during the three months ended January 28, 2007. Capital expenditures totaled \$59 million. Proceeds from sales and maturities of investments, net of purchases of investments, totaled \$1 million.

Applied used \$127 million of cash for financing activities during the three months ended January 28, 2007, consisting of \$132 million for the settlement of the price adjustment with Goldman Sachs related to the accelerated stock buyback initiated in the fourth quarter of fiscal 2006 and \$70 million for cash dividends, partially offset by \$75 million from the issuance of common stock under equity plans. There were no common stock repurchases during the first quarter of fiscal 2007 as compared to \$2.6 billion in repurchases of common stock during the fourth quarter of fiscal 2006.

On December 13, 2006, Applied's Board of Directors declared a cash dividend in the amount of \$0.05 per share, payable on March 8, 2007 to stockholders of record as of February 15, 2007, for a total of \$70 million. The declaration of any future cash dividend is at the discretion of the Board of Directors and will depend on Applied's financial condition, results of operations, capital requirements, business conditions and other factors.

Applied has credit facilities for unsecured borrowings in various currencies of up to approximately \$1.2 billion, of which \$1 billion is comprised of a 5-year revolving credit agreement with a group of banks that expires in January 2012. The agreement provides for borrowings at interest rates keyed to one of the two rates selected by Applied for each advance, and includes financial and other covenants with which Applied was in compliance at January 28, 2007. No amounts were outstanding under this agreement at January 28, 2007.

In the ordinary course of business, Applied provides standby letters of credit or other guarantee instruments to certain parties as required for certain transactions initiated by either Applied or its subsidiaries. As of January 28, 2007, the maximum potential amount of future payments that Applied could be required to make under these guarantee arrangements was approximately \$100 million. Applied has not recorded any liability in connection with these guarantee arrangements beyond that required to appropriately account for the underlying transaction being guaranteed. Applied does not believe, based on historical experience and information currently available, that it is probable that any amounts will be required to be paid under these guarantee arrangements.

Although cash requirements will fluctuate based on the timing and extent of many factors such as those discussed above and in Risk Factors below, Applied's management believes that cash generated from operations, together with the liquidity provided by existing cash balances and borrowing capability, will be sufficient to satisfy Applied's liquidity requirements for the next 12 months. For further details regarding Applied's operating, investing and financing activities, see the Consolidated Condensed Statements of Cash Flows.

## **Critical Accounting Policies**

The preparation of consolidated financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make judgments, assumptions and estimates that affect the amounts reported. Certain of these significant accounting policies are considered to be critical accounting policies, as defined below.

A critical accounting policy is defined as one that is both material to the presentation of Applied's consolidated financial statements and requires management to make difficult, subjective or complex judgments that could have a material effect on Applied's financial condition or results of operations. Specifically, these policies have the following attributes: (1) Applied is required to make assumptions about matters that are highly uncertain at the time of the estimate; and (2) different estimates Applied could reasonably have used, or changes in the estimate that are reasonably likely to occur, would have a material effect on Applied's financial condition or results of operations.

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Estimates and assumptions about future events and their effects cannot be determined with certainty. Applied bases its estimates on historical experience and on various other assumptions believed to be applicable and reasonable under the circumstances. These estimates may change as new events occur, as additional information is obtained and as Applied's operating environment changes. These changes have historically been minor and have been included in the consolidated financial statements as soon as they became known. In addition, management is periodically faced with uncertainties, the outcomes of which are not within its control and will not be known for prolonged periods of time. These uncertainties are discussed in the section below entitled "Risk Factors." Based on a critical assessment of its accounting policies and the underlying judgments and uncertainties affecting the application of those policies, management believes that Applied's consolidated financial statements are fairly stated in accordance with accounting principles generally accepted in the United States of America, and provide a meaningful presentation of Applied's financial condition and results of operations.

For further information about Applied's critical accounting policies, see the discussion of critical accounting policies in Applied's 2006 Form 10-K for the fiscal year ended October 29, 2006.

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

Applied's investment portfolio includes fixed-income securities with a fair value of approximately \$2.4 billion at January 28, 2007. These securities are subject to interest rate risk and will decline in value if interest rates increase. Based on Applied's investment portfolio at January 28, 2007, an immediate 100 basis point increase in interest rates would result in a decrease in the fair value of the portfolio of approximately \$28 million. While an increase in interest rates reduces the fair value of the investment portfolio, Applied will not realize the losses in the consolidated condensed statement of operations unless the individual fixed-income securities are sold prior to recovery or the loss is determined to be other-than-temporarily impaired.

Certain operations of Applied are conducted in foreign currencies. Applied enters into currency forward exchange and option contracts to hedge a portion of, but not all, existing and anticipated foreign currency denominated transactions expected to occur within 12 months. Gains and losses on these contracts are generally recognized in income at the time that the related transactions being hedged are recognized. Because the effect of movements in currency exchange rates on currency forward exchange and option contracts generally offsets the related effect on the underlying items being hedged, these financial instruments are not expected to subject Applied to risks that would otherwise result from changes in currency exchange rates. Applied does not use derivative financial instruments for trading or speculative purposes. Net foreign currency gains and losses were not material for the three months ended January 29, 2006 and January 28, 2007.

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

As required by Rule 13a-15(b) under the Securities Exchange Act of 1934 (Exchange Act), Applied management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation as of the end of the period covered by this report, of the effectiveness of Applied's disclosure controls and procedures as defined in Exchange Act Rule 13a-15(e). Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that Applied's disclosure controls and procedures were effective as of the end of the period covered by this report in ensuring that information required to be disclosed was recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and to provide reasonable assurance that information required to be disclosed by Applied in such reports is accumulated and communicated to Applied's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

As required by Rule 13a-15(d), Applied management, including the Chief Executive Officer and Chief Financial Officer, also conducted an evaluation of Applied's internal control over financial reporting to determine whether any changes occurred during the fiscal quarter that have materially affected, or are reasonably likely to materially affect, Applied's internal control over financial reporting. Based on that evaluation, there has been no such change during the fiscal quarter.

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It should be noted that any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system will be met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events.

**PART II. OTHER INFORMATION**

**Item 1. *Legal Proceedings***

**David Scharf**

On July 31, 2001, David Scharf, an individual, filed a lawsuit against Applied in the United States District Court for the Central District of California, captioned David Scharf v. Applied Materials, Inc. (case no. 01-06580 AHM). The lawsuit alleges that Applied has infringed, has induced others to infringe, and has contributed to others' infringement of, a patent concerning color synthesizing scanning electron microscope technology. Mr. Scharf seeks preliminary and permanent injunctions, a finding of willful infringement, damages (including treble damages), and costs. Applied has answered the complaint and counterclaimed for declaratory judgment of non-infringement and invalidity. On May 10, 2002, Mr. Scharf filed a request for re-examination of his patent with the Patent and Trademark Office (PTO). On June 26, 2002, the case was removed from the Court's active docket after the parties stipulated to stay the case pending the results of that re-examination. On July 11, 2002, Applied filed its own request for re-examination of Mr. Scharf's patent with the PTO. Applied's request for re-examination was granted on September 19, 2002. On April 23, 2004, the PTO notified Applied that it intended to issue a re-examination certificate. On June 14, 2004, Applied filed a second request for re-examination of Mr. Scharf's patent with the PTO. The second request was denied on September 1, 2004. On October 1, 2004, Applied filed a petition for reconsideration of that denial, which subsequently was denied. The lawsuit was returned to the active docket of the District Court for the Central District of California in January 2006. The parties have completed fact discovery and on February 22, 2007, the Court held a claim construction hearing. The Court has vacated all scheduled dates, including an April 3, 2007 trial date, which will be re-set following the Court's order on claim construction. Applied believes it has meritorious defenses and counterclaims and intends to pursue them vigorously.

**Linear Technology**

On March 12, 2002, Linear Technology Corp. (LTC) filed a complaint against Applied in the Superior Court for the County of Santa Clara, captioned Linear Technology Corp. v. Applied Materials, Inc., Novellus Systems, Inc. and Tokyo Electron Ltd. (case no. CV806004), alleging claims for breach of contract, fraud and deceit, negligent misrepresentation, suppression of fact, unfair competition, breach of warranty, express contractual indemnity, implied equitable indemnity and declaratory relief. The complaint alleged, among other things, that Applied is obligated to indemnify and defend LTC for certain claims in an underlying patent infringement lawsuit brought by Texas Instruments, Inc. (TI) against LTC. On November 12, 2002, LTC filed an amended complaint asserting essentially the same claims as in the original complaint, but adding an additional assertion that LTC and TI have settled their litigation. Applied's motion to dismiss the amended complaint was granted in part. LTC filed Second and Third Amended Complaints, each of which was dismissed upon Applied's motion. On February 13, 2004, LTC filed a Fourth Amended Complaint, which Applied moved to dismiss. LTC then filed a motion to amend its Fourth Amended Complaint, which the Court granted. On July 7, 2004, LTC filed a Fifth Amended Complaint. On October 5, 2004, Applied's motion to dismiss LTC's Fifth Amended Complaint was granted with prejudice. On January 11, 2005, LTC filed a notice of appeal of the dismissal of its complaint. Applied believes it has meritorious defenses and intends to pursue them vigorously.

**Jusung**

On December 24, 2003, Applied filed a lawsuit against Jusung Engineering Co., Ltd. (Jusung Engineering) and Jusung Pacific Co., Ltd. (Jusung Pacific, referred to together with Jusung Engineering as Jusung) in Tao-Yuan District Court in Taiwan, captioned Applied Materials, Inc. v. Jusung Engineering Co., Ltd. The lawsuit alleges that Jusung is infringing a patent related to chemical vapor deposition owned by Applied. In the lawsuit, Applied seeks a provisional injunction prohibiting Jusung from importing, using, manufacturing, servicing or selling in Taiwan



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certain flat panel display manufacturing equipment. On December 25, 2003, the Tao-Yuan District Court ruled in favor of Applied's request for a provisional injunction and, on January 14, 2004, the Court issued a provisional injunction order against Jusung Pacific. Jusung Pacific appealed those decisions, and the decisions were affirmed on appeal. On January 30, 2004, Jusung Pacific requested permission to post a counterbond to have the Jusung Pacific injunction lifted. Jusung Pacific's counterbond request was granted and, on March 30, 2004, the provisional injunction order was lifted. At Applied's request, on December 11, 2004, the District Court issued a provisional injunction order against Jusung Engineering. Jusung Engineering appealed that order, and the order was affirmed on appeal. Jusung Engineering also requested permission to post a counterbond to have the Jusung Engineering injunction lifted. Jusung Engineering's counterbond request was granted and on April 25, 2005, the provisional injunction order against Jusung Engineering was lifted. Applied has appealed both counterbond decisions. On June 30, 2004, Applied filed a main action patent infringement complaint against Jusung in the Hsinchu District Court in Taiwan, captioned Applied Materials, Inc. v. Jusung Engineering Co., Ltd. (case no. 93 Zhong Zhi No. 3). In the lawsuit, Applied seeks damages and a permanent injunction for infringement of the same patent. The decisions regarding the provisional injunction and counterbond have no effect on the separate patent infringement lawsuit filed by Applied against Jusung in the Hsinchu Court. In August 2006, the Court set the litigation fee and the litigation security payment, and the main action is now proceeding on its merits. The Court held a second hearing in the main action on October 30, 2006. This same patent is the subject of an invalidity proceeding filed in the Taiwanese Patent and Trademark Office by Jusung Pacific in June 2004. Applied believes it has meritorious claims and intends to pursue them vigorously. On January 31, 2007, Applied received notice that Jusung filed a complaint of private prosecution in the Taipei District Court of Taiwan dated November 10, 2006, entitled Jusung Engineering Co., Ltd. v. M. Splinter, Y. Lin, C. Lai and J. Lin, which is related to the ongoing patent infringement lawsuits between Applied and Jusung. The complaint alleges that Applied's outside counsel received from the court and used a copy of an expert report that Jusung had filed in the lawsuits and that Jusung had intended to remain confidential. Jusung named as defendants Applied's Taiwan attorneys, as well as Michael R. Splinter, Applied's President and Chief Executive Officer, as the statutory representative of Applied. Applied believes that this action is without merit.

On June 13, 2006, Applied filed an action in the Taiwanese Patent and Trademark Office challenging the validity of a patent owned by Jusung Engineering (Taiwanese Patent No. 249186) related to the severability of the transfer chamber. On June 20, 2006, Jusung Engineering filed a lawsuit against Applied and Applied's subsidiary, AKT, in Hsinchu District Court in Taiwan, captioned Jusung Engineering, Co. Ltd. v. AKT America, Inc. and Applied Materials, Inc., alleging infringement of this patent. Jusung Engineering's lawsuit seeks damages, costs and attorneys fees, but does not seek injunctive relief. A hearing before the Court was conducted on December 28, 2006. Applied believes that it has meritorious defenses that it intends to pursue vigorously.

**Taiwan Fair Trade Commission**

On April 10, 2004, the Taiwan Fair Trade Commission (TFTC) notified Applied's subsidiary, AKT, in Taiwan that, pursuant to a complaint filed by Jusung, the TFTC had begun an investigation into whether AKT had violated the Taiwan Fair Trade Act. The investigation focused on whether AKT violated the Taiwan Guidelines for the Review of Cases Involving Enterprises Issuing Warning Letters for Infringement on Copyright, Trademark and Patent Rights by allegedly notifying customers about AKT's patent rights and the infringement of those rights by Jusung. On June 15, 2004, the TFTC notified Applied that Applied also was the subject of the investigation. By letter dated April 15, 2005, the TFTC notified Applied and AKT that there was insufficient evidence to support a claim against either company. Jusung appealed the TFTC's decision, and the appeals court affirmed the decision of the TFTC in favor of Applied on February 7, 2006. Jusung appealed the appeals court's affirmation of the decision of the TFTC, in January 2007 the Taipei High Administrative Court dismissed Jusung's appeal, and in February 2007, Jusung appealed the dismissal to the Supreme Administrative Court.

**Silicon Services Consortium**

On January 19, 2006, five companies that sell refurbished Applied tools (Silicon Services Consortium Inc., Semiconductor Support Services Co., OEM Surplus, Inc., Precision Technician Inc., and Semiconductor Equipment Specialist, Inc.) filed a lawsuit against Applied in the United States District Court for the Western District of

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Texas, captioned Silicon Services Consortium, Inc., et al. v. Applied Materials, Inc. (case no. A06CA051 LY). The plaintiffs claim that a policy that Applied announced in January 2005 limiting the sale of certain parts to them constituted an unlawful attempt to monopolize the refurbishment business, an interference with existing contracts, and an interference with prospective business relationships. The suit seeks injunctive relief, damages, costs and attorneys fees. After Applied filed a motion to dismiss the original complaint, the plaintiffs filed an amended complaint alleging similar conduct. Applied filed a motion to dismiss the amended complaint on April 7, 2006, which the Court denied on February 16, 2007. Applied believes it has meritorious defenses and intends to pursue them vigorously. On January 17, 2007, Applied filed a counterclaim in this matter, asserting claims for patent infringement, trademark infringement, trademark dilution, unfair competition, and misuse and misappropriation of trade secrets against each of the five plaintiffs/counterdefendants. Applied seeks damages for the harm it has suffered as well as an injunction prohibiting any further violation of Applied's intellectual property rights. Applied believes that it has meritorious claims and intends to pursue them vigorously.

Applied does not believe that the outcome of any of the above matters will have a material adverse effect on its financial position or results of operations.

## **Other Legal Matters**

From time to time, Applied receives notification from third parties, including customers and suppliers, seeking indemnification, litigation support, payment of money or other actions by Applied in connection with claims made against them by third parties. In addition, from time to time, Applied receives notification from third parties claiming that Applied may be or is infringing their intellectual property or other rights. Applied also is subject to various other legal proceedings and claims, both asserted and unasserted, that arise in the ordinary course of business. Although the outcome of these claims and proceedings cannot be predicted with certainty, Applied does not believe that any of these other existing proceedings or claims will have a material adverse effect on its consolidated financial condition or results of operations.

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

The risk factors set forth below include any material changes to, and supersede the description of, the risk factors disclosed in Item 1A of the 2006 Form 10-K.

### ***The industries that Applied serves are volatile and unpredictable.***

As a supplier to the global semiconductor and semiconductor-related industries, Applied is subject to business cycles, the timing, length and volatility of which can be difficult to predict. The industries have historically been cyclical due to sudden changes in demand and manufacturing capacity, including capacity using the latest technology. The effect on Applied of these changes in demand, including end-customer demand, is occurring more rapidly. These changes have affected the timing and amounts of customers' purchases and investments in technology, and continue to affect Applied's orders, net sales, gross margin, contributed profit and results of operations.

Applied must effectively manage its resources and production capacity to meet changing demand. During periods of increasing demand for semiconductor and semiconductor-related manufacturing equipment, Applied must have sufficient manufacturing capacity and inventory to meet customer demand and must be able to attract, retain and motivate a sufficient number of qualified individuals and effectively manage its supply chain. During periods of decreasing demand, Applied must be able to appropriately align its cost structure with prevailing market conditions, effectively motivate and retain key employees, and effectively manage its supply chain. If Applied is not able to timely and appropriately align its cost structure with business conditions and/or effectively manage its resources and production capacity, including its supply chain, during changes in demand, Applied's business, financial condition or

results of operations may be materially and adversely affected.

**Table of Contents*****Applied is exposed to risks as a result of ongoing changes in the semiconductor and semiconductor-related industries.***

The global industries in which Applied operates are characterized by ongoing changes, including: (1) changes in customers' capacity requirements, capacity utilization and capital spending, which depend in part on the demand for customers' products and their inventory levels relative to demand; (2) the importance of reducing the cost of system ownership, due in part to the increasing significance of consumer electronics as a driver for semiconductor and display demand and the related focus on lower prices; (3) varying levels of business information technology spending; (4) increasingly complex technology requirements, including a significant rise in the number and importance of new materials and the importance of expertise in chemical processes and device structure; (5) the growing types and varieties of semiconductors and expanding number of applications across multiple substrate sizes, resulting in customers' divergent technical demands and different rates of spending on capital equipment; (6) customers' varying adoption rates of new technology; (7) a rising percentage of business from customers in Asia and the emergence of customers, competitors and suppliers in new geographical regions; (8) demand for shorter cycle times for the development, manufacture and installation of manufacturing equipment; (9) the heightened importance to customers of system reliability and productivity, and the effect on demand for systems as a result of their increasing productivity, device yield and reliability; (10) differing rates of market growth for, and capital investments by, various semiconductor device makers, such as memory (including NAND flash and DRAM), logic, foundry, display and solar; (11) customers' increasing use of partnerships, alliances, joint ventures and industry consortia, which has increased the influence of key integrated circuit manufacturers in technology decisions made by their global partners; (12) higher capital requirements for building and operating new semiconductor fabrication plants; (13) the increasing difficulty for customers to move from product design to volume manufacturing; (14) the challenge to semiconductor manufacturers of moving volume manufacturing from one technology node to the next smaller technology node and the resulting impact on the technology transition rate; (15) the increasing cost and reduced affordability of research and development due to many factors, including decreasing linewidths and the increasing number of materials, applications and process steps; (16) the industry growth rate; (17) the increasing importance of the availability of spare parts to assure maximum system uptime; (18) concern among United States governmental agencies regarding possible national commercial and/or security issues posed by the growing manufacturing business in Asia; and (19) the increasing importance of operating flexibility to enable different responses to different markets, customers and applications. The emerging solar market, which Applied recently entered, is also characterized by ongoing changes in demand for photovoltaic (PV) products arising from, among other things, fluctuations in the cost of fossil fuels and electric power, availability of government subsidies, the performance and reliability of PV technology, and the success of other renewable energy sources. If Applied does not successfully manage the risks resulting from the ongoing changes occurring in the semiconductor and semiconductor-related industries, its business, financial condition and results of operations could be materially and adversely affected.

***Applied must adapt its business and product offerings to respond to competition and rapid technological changes.***

As Applied operates in a highly competitive environment, its future success depends on many factors, including the effective development, commercialization and customer acceptance of its nanomanufacturing technology equipment, service and related products. In addition, Applied must successfully execute its growth strategy, including enhancing market share in existing markets, expanding into related markets, and cultivating new markets and new business models, while constantly improving its operational performance. The development, introduction and support of a broadening set of products in more varied competitive environments have grown increasingly complex and expensive over time. Applied's success is subject to many risks, including but not limited to its ability to timely, cost-effectively and successfully: (1) improve and develop new applications for existing products and increase market share in its existing markets; (2) develop, appropriately price, and achieve market acceptance of new products; (3) expand into or develop related and new markets for its nanomanufacturing technology; (4) anticipate and capitalize on opportunities

in new markets, such as solar, and with new technologies; (5) supply a range of Applied and non-Applied equipment as part of its solar offerings; (6) appropriately allocate resources, including RD&E funding, among Applied's products and between the development of new products and the improvement of existing products; (7) accurately forecast demand and meet production schedules for its

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products; (8) achieve cost efficiencies across product offerings; (9) adapt to technology changes in related markets, such as lithography; (10) develop, market and price similar products for use by customers in different applications and/or markets that may have varying technical requirements; (11) adapt to changes in value offered by companies in different parts of the supply chain; (12) qualify products for volume manufacturing with its customers; (13) implement changes in its design engineering methodology, including those that enable significant decreases in material costs and cycle time, greater commonality of platforms and types of parts used in different systems, and effective product life cycle management; (14) improve its manufacturing processes; and (15) deploy initiatives to transform Applied's information technology systems and enhance business processes, including transitioning to a single-vendor enterprise resource planning (ERP) software system. Furthermore, new or improved products may involve higher costs and reduced efficiencies compared to Applied's more established products and could adversely affect Applied's gross margins. Also, entry into new markets entails additional challenges, including those arising from changes in Applied's customer and/or supplier base. In addition, Applied must regularly reassess the size, capability and location of its global infrastructure and timely make appropriate changes in its real estate and facilities portfolio. If Applied does not successfully manage these challenges, its business, financial condition and results of operations could be materially and adversely affected.

***Applied is exposed to the risks of operating a global business.***

In the first quarter of fiscal 2007, approximately 80 percent of Applied's net sales were to customers in regions outside the United States. Certain of Applied's RD&E and manufacturing facilities, as well as suppliers to Applied, are also located outside the United States. Managing Applied's global operations presents challenges, including but not limited to those arising from: (1) varying regional and geopolitical business conditions and demands; (2) global trade issues; (3) variations in protection of intellectual property and other legal rights in different countries; (4) fluctuating raw material and energy costs; (5) variations in the ability to develop relationships with suppliers and other local businesses; (6) changes in laws and regulations of the United States (including export restrictions) and other countries, as well as their interpretation and application; (7) fluctuations in interest rates and currency exchange rates; (8) the need to provide sufficient levels of technical support in different locations; (9) political instability, natural disasters (such as earthquakes, floods or storms), pandemics, terrorism or acts of war where Applied has operations, suppliers or sales; (10) cultural differences; (11) special customer- or government-supported efforts to promote the development and growth of local competitors; and (12) shipping costs and/or delays. Many of these challenges are present in China, which is experiencing significant growth of both suppliers and prospective competitors to Applied, and which Applied believes presents a large potential market for its products and opportunity for growth over the long term. These challenges, as well as global uncertainties with respect to economic growth rates in various countries, consumer confidence, the sustainability, timing, rate and amount of demand for electronics products and integrated circuits, capital and operational spending by semiconductor and display manufacturers, and price trends for certain semiconductor devices and flat panel displays, may materially and adversely affect Applied's business, financial condition and results of operations.

***Applied is exposed to risks associated with a highly concentrated customer base.***

Applied's customer base is and has historically been highly concentrated. Orders from a relatively limited number of manufacturers have accounted for, and are expected to continue to account for, a substantial portion of Applied's net sales. In addition, the mix and type of customers, and sales to any single customer, may vary significantly from quarter to quarter and from year to year. Moreover, certain customers, particularly in emerging areas such as solar, may have capital resource constraints and/or a limited operating history. If customers do not place orders, or they delay or cancel orders, Applied may not be able to replace the business. As Applied's products are configured to customer specifications, changing, rescheduling or canceling orders may result in significant non-recoverable costs. Major customers may also seek, and on occasion receive, pricing, payment, intellectual property-related or other commercial terms that are less favorable to Applied. In addition, certain customers have undergone significant

ownership changes and/or formed strategic alliances or collaborative efforts, which may result in additional complexities in managing customer relationships and transactions. These factors could have a material adverse effect on Applied's business, financial condition and results of operations.



**Table of Contents*****Manufacturing interruptions or delays could affect Applied's ability to meet customer demand, while the failure to estimate customer demand accurately could result in excess or obsolete inventory.***

Applied's business depends on its ability to supply equipment, services and related products that meet the rapidly changing requirements of its customers, which depends in part on the timely delivery of parts, components and subassemblies (collectively, parts) from suppliers. Some key parts may be subject to long lead-times and/or obtainable only from a single supplier or limited group of suppliers, and some sourcing or subassembly is provided by suppliers in developing regions, including China. In addition, Applied has implemented several key operational initiatives intended to improve manufacturing efficiency, including integrate-to-order, module-final-test and merge-in-transit programs. Applied has also begun a multi-year, company-wide program to transform certain business processes that includes transitioning to a single-vendor enterprise resource planning (ERP) software system to perform various functions, such as order management and manufacturing control. Significant interruptions of manufacturing operations or the delivery of services as a result of: (1) the failure or inability of suppliers to timely deliver quality parts; (2) volatility in the availability and cost of materials; (3) difficulties or delays in obtaining required export approvals; (4) information technology or infrastructure failures; (5) difficulties and costs related to planning or effecting business process changes and implementing a new ERP system; (6) natural disasters (such as earthquakes, floods or storms); or (7) other causes (such as regional economic downturns, pandemics, political instability, terrorism or acts of war), could result in delayed deliveries, manufacturing inefficiencies, increased costs or order cancellations. Moreover, if actual demand for Applied's products is different than expected, Applied may purchase more/fewer parts than necessary or incur costs for canceling, postponing or expediting delivery of parts. Any or all of these factors could materially and adversely affect Applied's business, financial condition and results of operations.

***The failure to successfully implement and conduct offshoring and outsourcing activities could adversely affect results of operations.***

To better align costs with market conditions, increase its presence in growing markets, improve its tax structure, and enhance productivity and operational efficiency, Applied conducts engineering, software development and other operations in regions outside the United States, particularly India and China, and outsources certain functions to third parties, including companies in the United States, India, China and other countries. Outsourced functions include engineering, manufacturing, customer support, software development and administrative activities. The expanding role of third party providers has required changes to Applied's existing operations and the adoption of new procedures and processes for retaining and managing these providers in order to protect its intellectual property. If Applied does not effectively develop and implement its offshoring and outsourcing strategies, if required export and other governmental approvals are not timely obtained, or if Applied's third party providers do not perform as anticipated, Applied may not realize productivity improvements or cost efficiencies and may experience operational difficulties, increased costs, manufacturing interruptions or delays, loss of its intellectual property rights, quality issues, increased product time-to-market and/or inefficient allocation of human resources, any or all of which could materially and adversely affect Applied's business, financial condition and results of operations.

***Applied is exposed to risks associated with acquisitions and strategic investments.***

Applied has made, and in the future intends to make, acquisitions of, or investments in, companies, technologies or products in existing, related or new markets for Applied. Acquisitions involve numerous risks, including but not limited to: (1) diversion of management's attention from other operational matters; (2) inability to complete acquisitions as anticipated or at all; (3) inability to realize anticipated benefits; (4) failure to commercialize purchased technologies; (5) inability to capitalize on characteristics of new markets that may be significantly different from Applied's existing markets; (6) inability to obtain and protect intellectual property rights in key technologies; (7) ineffectiveness of an acquired company's internal controls; (8) impairment of acquired intangible assets as a result

of technological advancements or worse-than-expected performance of the acquired company or its product offerings; (9) unknown, underestimated and/or undisclosed commitments or liabilities; (10) excess or underutilized facilities; and (11) ineffective integration of operations, technologies, products or employees of the acquired companies. Applied also makes strategic investments in other companies, including companies formed as

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joint ventures, which may decline in value and/or not meet desired objectives. The success of these investments depends on various factors over which Applied may have limited or no control and, particularly with respect to joint ventures, requires ongoing and effective cooperation with strategic partners. Mergers and acquisitions and strategic investments are inherently subject to significant risks, and the inability to effectively manage these risks could materially and adversely affect Applied's business, financial condition and results of operations.

### ***The ability to attract, retain and motivate key employees is vital to Applied's success.***

Applied's success and competitiveness depend in large part on its ability to attract, retain and motivate key employees. Achieving this objective may be difficult due to many factors, including fluctuations in global economic and industry conditions, changes in Applied's management or leadership, competitors' hiring practices, and the effectiveness of Applied's compensation programs, including its equity-based programs. Applied regularly evaluates its overall compensation program and makes adjustments, as appropriate, to enhance its competitiveness, such as instituting broad-based grants of restricted stock units. If Applied does not successfully attract, retain and motivate key employees, Applied's ability to capitalize on its opportunities and its operating results may be materially and adversely affected.

### ***Changes in tax rates or tax liabilities could affect results.***

As a global company, Applied is subject to taxation in the United States and various other countries. Significant judgment is required to determine and estimate worldwide tax liabilities. Applied's future annual and quarterly tax rates could be affected by numerous factors, including changes in the (1) applicable tax laws; (2) composition of earnings in countries with differing tax rates; or (3) valuation of Applied's deferred tax assets and liabilities. In addition, Applied is subject to regular examination of its income tax returns by the Internal Revenue Service and other tax authorities. Applied regularly assesses the likelihood of favorable or unfavorable outcomes resulting from these examinations to determine the adequacy of its provision for income taxes. Although Applied believes its tax estimates are reasonable, there can be no assurance that any final determination will not be materially different from the treatment reflected in Applied's historical income tax provisions and accruals, which could materially and adversely affect Applied's results of operations.

### ***Applied is exposed to various risks related to legal proceedings or claims and protection of intellectual property rights.***

Applied from time to time is, and in the future may be, involved in legal proceedings or claims regarding patent infringement, intellectual property rights, antitrust, environmental regulations, securities, contracts, product performance, product liability, unfair competition, employment and other matters. In addition, Applied on occasion receives notification from customers who believe that Applied owes them indemnification or other obligations related to claims made against customers by third parties. These legal proceedings and claims, whether with or without merit, may be time-consuming and expensive to prosecute or defend and also divert management's attention and resources. There can be no assurance regarding the outcome of current or future legal proceedings or claims. Applied previously entered into a mutual covenant-not-to-sue arrangement with one of its competitors to decrease the risk of patent infringement lawsuits in the future. There can be no assurance that the intended results of this arrangement will be achieved or that Applied will be able to adequately protect its intellectual property rights with the restrictions associated with such a covenant. In addition, Applied's success depends in significant part on the protection of its intellectual property and other rights. Infringement of Applied's rights by a third party, such as the unauthorized manufacture or sale of equipment or spare parts, could result in uncompensated lost market and revenue opportunities for Applied. Applied's intellectual property rights may not provide significant competitive advantages if they are circumvented, invalidated, rendered obsolete by the rapid pace of technological change, or if Applied does not adequately assert these rights. Furthermore, the laws and practices of other countries, including China, Taiwan and

Korea, permit the protection and enforcement of Applied's rights to varying extents, which may not be sufficient to protect Applied's rights. If Applied is not able to obtain or enforce intellectual property rights, resolve or settle claims, obtain necessary licenses on commercially reasonable terms, and/or successfully prosecute or defend its position, Applied's business, financial condition and results of operations could be materially and adversely affected.

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***Applied is subject to risks of non-compliance with environmental and safety regulations.***

Applied is subject to environmental and safety regulations in connection with its global business operations, including but not limited to regulations related to the development, manufacture and use of its products; recycling and disposal of materials used in its products; the operation of its facilities; and the use of its real property. Failure or inability to comply with existing or future environmental and safety regulations could result in significant remediation liabilities, the imposition of fines and/or the suspension or termination of development, manufacture, sale or use of certain of its products, and/or may affect the operation of its facilities, use or value of its real property, each of which could have a material adverse effect on Applied's business, financial condition and results of operations.

***Applied is exposed to various risks related to the regulatory environment.***

Applied is subject to various risks related to: (1) new, different, inconsistent or even conflicting laws, rules and regulations that may be enacted by legislative bodies and/or regulatory agencies in the countries in which Applied operates; (2) disagreements or disputes between national or regional regulatory agencies related to international trade; and (3) the interpretation and application of laws, rules and regulations. If Applied is found by a court or regulatory agency not to be in compliance with applicable laws, rules or regulations, Applied's business, financial condition and results of operations could be materially and adversely affected.

***Applied is subject to internal control evaluations and attestation requirements of Section 404 of the Sarbanes-Oxley Act.***

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, Applied must include in its annual report on Form 10-K a report of management on the effectiveness of Applied's internal control over financial reporting and an attestation by Applied's independent registered public accounting firm to the adequacy of management's assessment of Applied's internal control. Ongoing compliance with these requirements is complex, costly and time-consuming. If (1) Applied fails to maintain effective internal control over financial reporting; (2) Applied's management does not timely assess the adequacy of such internal control; or (3) Applied's independent registered public accounting firm does not timely attest to the evaluation, Applied could be subject to regulatory sanctions and the public's perception of Applied may decline.

***Item 2. Unregistered Sales of Equity Securities and Use of Proceeds***

Applied did not repurchase any shares of its common stock during the first quarter of fiscal 2007. On January 24, 2007, Applied settled a price adjustment of \$132 million in connection with the accelerated stock buyback agreements with Goldman, Sachs & Co. entered into in the fourth quarter of fiscal 2007. On September 15, 2006, the Board of Directors approved a new stock repurchase program for up to \$5.0 billion in repurchases over the next three years, ending September 2009.

***Item 3. Defaults Upon Senior Securities***

None.

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

None.

***Item 5. Other Information***

None.

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**Item 6. Exhibits**

*Exhibits are numbered in accordance with the Exhibit Table of Item 601 of Regulation S-K:*

| <b>Exhibit<br/>No</b> | <b>Description</b>                                                                                                                                                                                                                                                             |
|-----------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.43                 | Separation Agreement and Release between Applied Materials, Inc. and Nancy H. Handel dated December 15, 2006.                                                                                                                                                                  |
| 10.44                 | \$1,000,000,000 Credit Agreement dated as of January 26, 2007 among Applied Materials, Inc., as borrower, several lenders named therein and Citicorp USA, Inc., as agent for the lenders. (Confidential treatment has been requested for redacted portions of the agreement.)* |
| 31.1                  | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002                                                                                                                                                                         |
| 31.2                  | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002                                                                                                                                                                         |
| 32.1                  | Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                                                                                                                           |
| 32.2                  | Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                                                                                                                           |
| 99.1                  | Ratio of Earnings to Fixed Charges                                                                                                                                                                                                                                             |

\* Certain schedules and exhibits to this agreement, as set forth in the Table of Contents of the agreement, have been omitted. Applied Materials, Inc. hereby undertakes to furnish supplementally copies of any of the omitted schedules and exhibits upon request by the Securities and Exchange Commission.

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**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.

APPLIED MATERIALS, INC.

By: /s/ GEORGE S. DAVIS  
George S. Davis  
*Senior Vice President,  
Chief Financial Officer  
(Principal Financial Officer)*

February 28, 2007

By: /s/ YVONNE WEATHERFORD  
Yvonne Weatherford  
*Corporate Vice President,  
Corporate Controller  
(Principal Accounting Officer)*

February 28, 2007