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## Conference Call Transcript

**TSM - Q2 2006 TSMC Earnings Conference Call**

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Welcome to TSMC's second quarter 2006 results webcast conference call. Today's event is chaired by Ms. Lora Ho, Chief Financial Officer and Vice President, and Dr. Rick Tsai, Chief Executive Officer and President. This conference call is being webcast live via the TSMC website at [www.tsmc.com](http://www.tsmc.com) and only in audio mode. [OPERATOR INSTRUCTIONS] Please be advised, for those participants who do not yet have a copy of the press release, you may download it from TSMC's website at [www.tsmc.com](http://www.tsmc.com). Please also download the summary slides in relation to today's quarterly review presentation. One again, the URL is [www.tsmc.com](http://www.tsmc.com).

I would now like to turn the conference over to Dr. Elizabeth Sun, TSMC's Head of Investor Relations for the cautionary statement before the main presentation by Ms. Ho and Dr. Tsai. Please proceed.

**Dr. Elizabeth Sun - TSMC - Head of Investor Relations**

Good morning and good evening to all participants. This is Elizabeth Sun, Head of Investor Relations for TSMC. Welcome to join our second quarter conference call. Today's call will have three main parts. First, is our CFO Ms. Lora Ho's report on the second quarter results and third quarter guidance. Then it will be a presentation by Dr. Jack Sun, TSMC's Vice President of R&D, who will be talking about our recent progress in advanced technology. And finally we will have Dr. Rick Tsai chair the question-and-answer session.

Before we begin, I would like to state that management's comments about TSMC's current expectations made during this conference call are forward-looking statements subject to significant risks and uncertainties and that actual results may differ materially from those contained in the forward-looking statements. Information as to those factors that could cause actual results to differ materially from TSMC's forward-looking statements may be found in TSMC's annual report on Form 20-F filed with the United States Securities and Exchange Commission on April 20th, 2006, and such other documents as TSMC may file with or submit to the SEC from time to time. Except as required by law, we undertake no obligation to update any forward-looking statement, whether as a result of new information, future events or otherwise.

And now I would like to turn the conference call over to Ms. Lora Ho, our Chief Financial Officer and Vice President.

**Lora Ho - TSMC - VP and CFO**

Thank you, Elizabeth. Good morning and good evening to everyone. Welcome to the TSMC second quarter 2006 earnings conference call.

As mentioned during our first quarter earnings conference, TSMC will shift the basis for our financial reporting from unconsolidated basis to consolidated basis. For our first quarter earnings release we presented our financial results on an unconsolidated basis with a reconciliation of material differences between the two reporting bases provided in the management report. For the second quarter we will report the financial results of TSMC on the consolidated basis. A reconciliation of material differences between the two reporting bases will also be provided in the management report, as well as in my presentation. Starting from the third quarter of 2006, we will shift over to a consolidated report only.

Now I would like to walk you through our second quarter consolidated results, followed by a discussion of our second quarter unconsolidated results. I will then go over our guidance for the third quarter 2006. We have posted-- posted our quarterly financial summary slides on our website. Those slides are intended to assist you to follow the flow of our presentation. Slide numbers are posted on the bottom half of each slide and we may refer to certain slides throughout the presentation for your convenience. All dollar figures are in NT dollars unless otherwise stated.

With that, please flip to slide number five. Let me start with some of the highlights of the quarter. We had a good second quarter. Total revenue for the quarter was over NT\$82 billion, at the high end of our guidance, mainly driven by strong demand from our customers in consumer and communication segments. Earnings per share was NT\$1.32, up 85% year-over-year and up 4% quarter-over-quarter.

Now let's take a closer look at our income statement. During the second quarter of 2006, we delivered 37% year-over-year and over 5% quarter-over-quarter top-line growth.

We saw strength in consumer and communication segments with revenue from consumer and communication applications registering 21% and 19% sequential growth, respectively. On the other hand, revenue from computer applications declined by 16% quarter-over-quarter as a result of inventory corrections in the PC-related supply chain.

Gross margin improved by 3.3 percentage points Q-over-Q to reach 51.8%, largely due to a higher level of wafer outputs and productivity improvements. We grew operating income faster than revenue. Operating margin was 43% for the quarter, which was 1 percentage point higher than the high end of our expectations.

Finally, our net income increased by 85% year-over-year and 4% quarter-over-quarter with a one-time gain of NT\$1.6 billion included in the net income of the first quarter.

Now let me turn to the balance sheet. We ended the quarter with NT\$212 billion in cash and marketable securities, which is a NT\$19 billion increase from Q1. Our current liabilities increased by NT\$69 billion as a result of NT\$65 billion payable for cash dividend and employee bonus.

Our accounts receivable turnover days declined by two days Q-over-Q. In the meantime, our inventory turnover days increased by three days Q-over-Q, in part due to an increase in our turnkey business.

Now please turn to page eight for a brief summary of our cash flow statement. We generated over NT\$50 billion in cash from our operations, up 36% from the prior year. We spent over NT\$21 billion or US\$634 million on capital expenditures during the second quarter, which brings our first half capital spending to NT\$33 billion or a bit over US\$1 billion. We maintained our CapEx guidance for the whole year at between US\$2.6 to US\$2.8 billion. As a result, total cash increased by NT\$20 billion from the last quarter and now exceeds NT\$140 billion.

In terms of our capacity, total installed capacity for the second quarter was 1.7 8-inch equivalent wafers, in line with our previous expectations. We expect our third quarter capacity to reach close to 1.8 8-inch equivalent wafers or a 5.8% sequential growth.

Compared to the capacity guidance that we provided in April, we have slightly increased our 2006 total capacity by about 50,000 wafers. Most of the capacity increase is for the mature technology.

Page 11 through page 14 of the slides break down our sales by technology application, geography and customer, which I will not go through in detail. However, I would like to point out that our 90-nanometer revenue continues to increase and accounted for 24% of our total wafer sales in the second quarter, up from 20% in the first quarter.

Before I go over the next quarter guidance, I would like to quickly go through our unconsolidated results for the second quarter. Please turn to page 15.

For the second quarter of 2006 the consolidated net sales were higher than the unconsolidated net sales by about 1%. The consolidated gross margin was also higher than-- higher by about 1.4 percentage points, reflecting the true gross margin from the consolidating entities.

For TSMC the major income statement differences between the two reporting bases were operating expenses and non-operating items. Consolidated operating expenses were higher, mainly due to additional operating expenses from our overseas sales office, wafer [inaudible] and certain venture capital funds.

The difference in non-operating items was largely due to the consolidating-- consolidation of subsidiaries. Upon consolidation, the financial results of our consolidating subsidiaries are no longer included in our investment income. Instead, they are included in the appropriate categories of our income statement.

Now let me move to balance sheet. On the unconsolidated balance sheet, TSMC's share of its consolidated subsidiaries is included in the long-term investments on the balance sheet. Upon consolidation, the assets and liabilities of these subsidiaries are included in the appropriate category of the balance sheet. As a result, except for long-term investments, most of the asset and liability items are higher on the consolidated basis.

At the end of the second quarter among the balance sheet items which had the largest difference between the two reporting bases were cash and marketable securities and the fixed assets. On the liability side, total consolidated liability was about NT\$11 billion higher, largely due to borrowing by TSMC Shanghai.

Finally, the difference between the shareholders equity was due to minority interests.

Now a brief summary of our unconsolidated cash flow statement. When comparing the cash flow statements, we generated slightly more cash from our operations and spent a bit more cash for investment on a consolidated basis. As a result, net cash increase was NT\$2.5 billion more on the consolidated basis in the second quarter.

With that, I'll turn to our guidance for the third quarter of 2006. Since we are shifting to our consolidating reporting, we will provide guidance on consolidated basis only.

Based on current business and foreign exchange rate expectations, we expect consolidated revenue to be between NT\$79 to NT\$82 billion. Our expectation for gross margins in third quarter is between 48% to 50%. The operating profit margin is expected to be between 39% to 41%.

I have finished my presentation. Now I would like to turn the call over to Dr. Jack Sun, our Vice President of R&D, for an update of our advanced technology.

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**Dr. Jack Sun - TSMC - VP R&D**

Good morning and good evening. It's my pleasure to report some of TSMC's recent progress on advanced technology, for example, in the 80 nanometer, 65 nanometer and 45 nanometer, and here are the highlights.

We have brought 80 nanometer process into mass production to provide both cost and performance benefits. In addition, we have qualified 65 nanometer process for full production and we have started bringing three products with excellent yield ahead of the industry. As part of the technology package, we have established a design-for-manufacturing, DFM-- a DFM standard for 65 nanometer and beyond, which enables our customers time to market-- shorter time to market and time to volume.

At the same time, we continue to push Moore's Law and we are accelerating 45 nanometer technology for production by the end of next year and as part of this 45 nanometer thrust, we have demonstrated production capability for a new lithography capability, the immersion lithography with record low defect count.

I'll use a few slides to illustrate and highlight the immersion lithography progress and our innovation in DFM technology. First, let's look at immersion lithography.

Immersion lithography allows Moore's Law to continue beyond 65 nanometers and all the way to 22 nanometers. It is pioneered by TSMC's Dr. Burn Lin and got accepted by ATI, [inaudible] and the industry as the lithography standard.

How it works? By having water between the lens and the wafer we can improve the resolution and the depth of focus for better image quality. There are many challenges of immersion lithography and we have overcome almost all of them.

And one of the challenges is defects. Defects can come from particles, water marks, bubbles and so forth and we have perfected the art and demonstrated production capability.

And this slides shows the example that we have low single digit defects on a 12-inch wafer and we have even demonstrated zero defects while the others have double or triple digit type of defects.

And we have proven this production capability also in 65-nanometer using a 16 megabit [inaudible] vehicle.

Now let me turn into the yield and the DFM illustration. As you can see in this slide, from 0.18 micron to 0.13 micron to 90 nanometer to 65 nanometer, on the defect density running rate standpoint, we have generation-to-generation improvement. And these production data are based on actual customer products.

How can we do this? That is both in terms of solid technology and methodology. In addition, starting in 90-nanometer and 65-nanometer and beyond, yield is no longer purely limited by physical defects and we need and we have innovative design-for-manufacturing solutions to help our customers overcome residual process variances on wafers and achieve consistent success and fast time to money.

What is DFM and what is TSMC's innovation? I'll use a couple slides to show you. Variations naturally occur on silicon wafers. For example, lithography may not have a tool square pre-melt. You actually get a hole, a round hole. And when you try to [inaudible] the wafer, depending on density and environment, it may have different topography and thickness and these residual defects could cause serious problems for advanced technologies. And the old-fashioned DFM rules or guidelines can often-- are often hard to use or check, so designers often ignore them or they run into problems.

Our innovative DFM solution puts automated DFM capabilities at designer's fingertips so they can overcome such process variances-- variations and design sensitivity from the start in their design stage. They don't necessarily need to know the process and how to interpret all the subtleties in the design-for-manufacturing considerations.

Let me use an analogy. If a driver is driving to a new city or unfamiliar area, even if you have the map, traffic rules and some tips, you may still run into accidents or get tickets. And our DFM solution is like an enhanced GPS or auto-pilot kind of program, which can guide you all the way to your destination safely and quickly.

And the significance and value of TSMC's DFM solution is illustrated in the following slides. If you look at the bottom cartoon, in a now DFM design implementation or in the traditional way of doing it, you could easily run into serious yield or performance problems when you try to bring

up the yield and each screw-up may take months to fix and you know time is money. So you want to be able to tackle this from the beginning and our automated DFM solution is easy to use and we can shorten the yield rep cycle so that the customers can enjoy the early market benefit.

And let me also make a comment here. A poor DFM or a poor process may cost too much time in the design phase to implement DFM or it would increase the die size when you implement the DFM. So our differentiation is really in both process technology and also the DFM ease of use.

And we have established a de facto DFM standard and a DFM platform. Just like you need to define the DVD format when you try to create this market and make it easy to use for people to entertain themselves, we have defined a DFM format, a standardized format. With this TSMC can release our proprietary encrypted process DFM data kit to designers and IT providers and they can use in their own designs.

And we are also working with the EDA industry and IP library providers to have this DFM-compliant ecosystem, which also support our customers' product designs. In this way, designers can gain the full benefit of DFM without any pain or errors, even if they don't have the process technology expertise. And this ecosystem right now has close to 20 major EDA companies and 8 of them have been certified to date.

So let me summarize. We continue to lead in advanced technology and we have established, created a novel design-for-manufacturing standard and a solution that's a total integrated package to make advanced technology very easy to adopt and to have product success and quick ramps for the money and the market share.

And we have been accelerating 45-nanometer technology to extend our leadership and we have continued to invest in exploratory advanced research to continue to push more Moore's Law ahead to create value for our customers.

Thank you.

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**Dr. Elizabeth Sun - TSMC - Head of Investor Relations**

At this point, I think our CEO, Dr. Rick Tsai, will give a few remarks before we open the floor for questions.

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**Dr. Rick Tsai - TSMC - President and CEO**

Hello. Good morning and good evening. Since there are a few questions that are asked by many people, so what I would like to do is to give-- to give my comments and the answers to those questions at the beginning of the session.

The first one, obviously, is the question on the inventory or the correction by the inventory buildup in the industry and how that impacts the semiconductor in 2006 and 2007 and how TSMC manages this correction. My comments are as follows.

Obviously, from the guidance we just gave for the third quarter revenue you can see a slowdown in the growth of the business and this slowdown is mainly due to the inventory in the supply chain and the correction as a result by our customer base. You look at there-- there have been many data coming out from the second quarter earnings release. If you look through them carefully, you will find that basically the inventory level, either through the total value or DOI, is not coming down from the-- in the industry.

Although the two large CPU manufacturers represent a very large chunk of the inventory buildup, if you take the large CPU manufacturers, you will find the inventory level in terms of the value probably has gone up by a couple of points [inaudible]. Also if you use the DOI measures, their inventories stayed pretty much flat at the end of the second quarter compared to that of the end of the first quarter.

Which means our customer base has already started the correction in the second-- in the second quarter and going into the third quarter, however we believe this correction will probably go through the whole year of year 2006. And the-- as a result, the way we look at the semiconductor industry growth rate for the whole year 2006 has some change.

Three months ago we forecast 8% to 12% growth rate for the semiconductor industry as a whole for 2006. Now we are revising that growth rate to the low end of the range, that is, 8%, maybe to 9%.

As to year 2007, right now we do have a specific number for the-- for the whole industry, however we still hold a positive view of year 2007. I'd like to remind you that 8%-9% growth rate for the industry, in our view, represents a very good, healthy growth rate, which is also the growth rate we expect industry to perform over a long period of time going forward.

In year 2007 we expect the industry to perform at a similar rate to year 2006. We'll try to give you a more specific number once we have a little better feeling in the future.

Many people also ask whether it is very similar, I mean, this time the inventory correction in 2006 compared to the correction which happened in the year 2004. Our observations are, yes, there are similarities, but there are also differences.

Similarities being basically the correction is, indeed, produced by the buildup of the inventory. However, we also have seen our customers to respond quite fast to the inventory buildup and also they're responding in a pretty large, I would say large magnitude for this inventory buildup, with the result we do expect this inventory correction to be more moderate, to be milder, compared to that of the year 2004.

Now what will TSMC do? What is TSMC doing to manage this inventory correction? First-- first of all, since we believe this inventory correction is a mild-- is a mild and a shorter one, we do not plan to do things which are very drastic. The most important things for us to do, still, are the fundamentals.

We will not slow down any of our technology R&D. By this we mean both process technology and design technology. We will continue investing in the R&D. If anything, we will invest more and we'll try to accelerate our R&D so that we can have a better technology leadership going forward.

Of course, the same thing will apply to our manufacturing from cost-reduction point of view. We will continue to work very hard to accelerate the cost improvement.

Have said all that, we are doing something for the short term. Basically, we are managing our capital investments for the short-term purpose. We are reducing some of our capital investment for the short term, though by moderate one. We, of course, will also manage our operating expenses other than R&D so that we don't-- we can have a better profitability.

TSMC has gone through many cycles during the past five to seven years and you know our track record very well. I think we have-- what we have shown is our ability to manage the cycle better each time.

So with what we have been doing and what we have learned from both technology, manufacturing, CapEx management and demand generation, we have full confidence that we will do better this time compared to what we have done during the last correction.

And this is the comment for the first major, I would say, first set question. There are also quite a few people asking about our 65-nanometer status and the competitive landscape so I would like also to spend a few minutes on that subject.

Of course, Dr. Sun just now has made an excellent presentation on our technology status. What I will give you is probably more toward the business side.

65-nanometer I would-- I'm very pleased to say is really doing very well. Not only are we completing our qualification for both low-power and general versions of the technology, we have-- we have already started small but significant volume of production for customers.

In addition, we have quite a few customers now qualifying their products in our 65-nanometer process. We expect 65-nanometer production to have a significant ramp-up starting already last year and we also, according to our current forecast, we are expecting that we can-- the output of the 65-nanometer production will reach about 5% of the revenue by mid-199-- I'm sorry, 2007, give or take.

From a competitive landscape point of view, we do expect 65-nanometer competition to continue to be fierce, just as we have seen in the 90-nanometer node. However, I'd like to also show you the results that we have-- we have shown over the past several quarters of our 90-nanometer performance.

I think if you go and check the numbers you will find that TSMC has grabbed a very strong market share in the 90-nanometer technology node with the very fierce competition and I also am very happy to report that although the pricing pressure is very high, the gross margin pressure is

very high, the gross margin in the 90-nanometer technology node has done better than we expected and we continue to see the gradual improvement of the 90-nanometer technology gross margin.

You may ask why -- by the way we certainly expect we'll continue to perform equally well or better for the 65-nanometer technology. Why? I think because for the advanced technology, the more advanced it is, the more important to have a platform solution rather than just have a process.

What do we mean by platform solution? That is, in addition to the process technology you need, first and foremost, a design environment which provides all kinds of IP to our customers, the memory compiles, the DFM, design-for-manufacturing, that Dr. Sun just talked about, the back-end technology compatibility.

And why do we need all those things? Because as you also know, the most important thing for a new technology is to be able to ramp it up fast with very good yield learning curve. And nowadays, the yield, the limiting factors for the yield ramping lie not in the defects, the particles -- I'm not saying they're not important, what I'm saying they are not as critical as before because the yield limiting factors now lies a lot more in the interaction between the process technology and the product design.

The critical thing is to design the product with good yield so that our customers can ramp their products sooner with higher volume and they can get a better profit, they can make more money, and as a result, we can be more profitable.

So just to summarize, the 65-nanometer technology is doing very well. We will compete fiercely, again, in 65-nanometer as we have done in the 90-nanometer and we have all the confidence that we will again do well in the 65-nanometer technology.

Thank you. That's my comments. Elizabeth?

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**Dr. Elizabeth Sun - TSMC - Head of Investor Relations**

Operator, please open the floor to questions.

## QUESTION AND ANSWER

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**Operator**

[OPERATOR INSTRUCTIONS] Your first question comes from the line of Bhavin Shah with JPMorgan. Please proceed.

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**Bhavin Shah - JPMorgan Chase & Co. - Analyst**

Yes, thank you, and I apologize if there's any noise on the line. The question I wanted to ask you, Rick, was that when you speak to your customers and it looks like you feel that they are working on bringing down the inventory levels already, do you feel that they are-- they are factoring in a potential scenario of already weak U.S. economy? Or you feel that they are still believing in a normal demand environment but simply trying to be-- trying to bring inventories more in line? And I have another question, thank you.

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**Dr. Rick Tsai - TSMC - President and CEO**

Okay. I think it's more towards the latter of your two points, the second point. I think most customers feel fairly comfortable with the demand, I mean, for it. And, of course, PC, we all know, is not doing well. You've said that many times and the delay of the Vista may have contributed to that, at least part of that.

But other than that, I think consumer, communications, mind you that the handsets shipment this year is still very strong. Nokia has done quite well. I think that some people probably got over-excited in the early part of the year and built too much components.

So to answer your question, I think people are-- most people are still comfortable with the demand, but the inventory is not distributed evenly.

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**Bhavin Shah - JPMorgan Chase & Co. - Analyst**

Okay. I see. So if-- in the scenario where the U.S. economy actually does slow sharply, that will bring a new element of risk, I guess.

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**Dr. Rick Tsai - TSMC - President and CEO**

Certainly. Any time the U.S. economy--

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**Bhavin Shah - JPMorgan Chase & Co. - Analyst**

Fair enough. Okay. Second question I have was sort of-- I think clearly the discrete graphics you dominate the market and that's not going to change, but in the eventuality that CPU vendors start integrating graphics into the CPU, how do you see that developing? Is it like a three-year-out scenario that--? And also, do you feel that in that situation you may be able to participate in the CPU itself? Your thoughts on that, please? Thank you.

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**Dr. Rick Tsai - TSMC - President and CEO**

I think the-- that scenario is a fairly new scenario. I don't think there is a consensus in the industry, at least as far as we can tell yet. I do not mean-- I mean, obviously we need to pay a very large, tremendous amount of attention to that.

We view this, of course, as a potential opportunity for us, too. We-- I mean, graphics is a very large chip, very complicated chip, especially the higher performance ones. I think TSMC really has amassed expertise in building those products. I think we have a very good position in working with the potential customers in that arena, also. We will-- we definitely view that as an opportunity.

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**Bhavin Shah - JPMorgan Chase & Co. - Analyst**

Okay. Thank you.

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**Dr. Rick Tsai - TSMC - President and CEO**

Thank you.

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**Operator**

Your next question comes from the line of Johnny Chen with Deutsche Bank. Please proceed.

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**Johnny Chen - Deutsche Bank - Analyst**

Hi, Rick. I just have a question about the AMD's recent acquisition of ATI and with the acquisition you now have AMD, nVidia, Intel -- a lot of cooperation, a lot of competition in this thing at the same time. How do you think going forward the acquisition is going to affect TSMC's business on the PC side, both near term and long term. And I have another question.

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**Dr. Rick Tsai - TSMC - President and CEO**

Okay, I think the merger between AMD and ATI, short-term, should not have impact to our business. Mid-term to longer-term I expect to see opportunities. We-- as you know, we have-- we have had a very long and a very strong partnership relationship with ATI. We do have some relationship with AMD also. We certainly view these as opportunities for us to further strengthen the relationship and expand our future business in that area.

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**Johnny Chen - Deutsche Bank - Analyst**

When you mean your relationship with AMD, is that coming from expansion or is it coming from something else, AMD on its own.

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**Dr. Rick Tsai - TSMC - President and CEO**

We do have some-- some business with the, not big one.

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**Johnny Chen - Deutsche Bank - Analyst**

Okay. And my second question is on the 45-nanometer. I mean, obviously, the [inaudible] Jack Sun just talked about, the immersion lithography, and obviously TSMC's one of the leaders in there and just given TSMC's position there, do you think there is a sufficient entry barrier at 45 that TSMC may have an even better margin at 45-nanometer compared to 65 and 90-nanometer? Thanks.

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**Dr. Rick Tsai - TSMC - President and CEO**

Okay, Johnny, first-- first thing, I think each new technology presents a barrier. I understand some people view sometimes certain technologies, certain node is easier. What I can say is that going down to this very small dimension, any kind of a shrink, presents a lot of difficulties. However, going down to 45-nanometer is probably-- I think it is fair to say that the barrier is probably higher because of the need for this of the immersion lithography and also very likely another generation of the low-K dielectric material for the metallization plus even more tricks for the transistors to get the-- and the design techniques to reduce-- to lower the power consumption.

So, yes, I think the technology barrier is, indeed, higher for 45-nanometers. That's why TSMC is pouring so much-- so much resources into developing the technology and we're trying to pull up the schedule. We're working very closely with some of our largest customers to ensure we have an early capability for ramp.

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**Johnny Chen - Deutsche Bank - Analyst**

Yes--

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**Dr. Rick Tsai - TSMC - President and CEO**

Have said all those things, I still-- I do not want to say that we can just rest on that "barrier." We will do everything we can to compete in this technology, just as we have been doing before and now.

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**Johnny Chen - Deutsche Bank - Analyst**

If I can just quickly follow up, if you have compared 45-nanometer and 0.13, there is a similar stage of development. Which one do you think is technologically more challenging?

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**Dr. Rick Tsai - TSMC - President and CEO**

Good question. My feeling is the-- I think probably that the 45 may be a bit more challenging.

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**Johnny Chen - Deutsche Bank - Analyst**

Thank you.

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**Dr. Rick Tsai - TSMC - President and CEO**

Sure.

**Operator**

Your next question comes from the line of Mehdi Hosseini with FBR. Please proceed.

**Mehdi Hosseini - Friedman, Billings, Ramsey Group, Inc. - Analyst**

Yes. Thanks for taking my question. When you look at your overall capacity this year, up by 20%, how should I think about wafer shipments as you try to keep utilization rates where they are? Should I expect a downtick in utilization rate and if you could give me some color on it?

And also, on-- in terms of your customers, if you could, elaborate on the strength or weakness in the game-console-related orders? Thank you.

**Lora Ho - TSMC - VP and CFO**

You were talking about our capacity increase. Actually 2006 versus last year is 18.5% increase.

**Mehdi Hosseini - Friedman, Billings, Ramsey Group, Inc. - Analyst**

Yes, so 18.5% increase with a downtick in the wafer-- the wafer shipment in the second half, would overall wafer shipment still be more than 18.5% increase to keep the utilization rate from a significant dropoff?

**Lora Ho - TSMC - VP and CFO**

I think you're asking whether this year we'll have more than 18.5% increase in wafer shipment. Is that your question?

**Mehdi Hosseini - Friedman, Billings, Ramsey Group, Inc. - Analyst**

Yes. Yes.

**Lora Ho - TSMC - VP and CFO**

We will not talk about wafer shipment and if you look at our guidance on third quarter we are anticipating inventory corrections. That, of course, will affect some of the utilization, as well.

**Mehdi Hosseini - Friedman, Billings, Ramsey Group, Inc. - Analyst**

So would utilization rates go down in Q3?

**Lora Ho - TSMC - VP and CFO**

Yes, I believe so.

**Dr. Rick Tsai - TSMC - President and CEO**

Yes.

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**Mehdi Hosseini** - *Friedman, Billings, Ramsey Group, Inc. - Analyst*

Okay. But would it-- would it get utilization rates down to 90% or below 90%?

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**Lora Ho** - *TSMC - VP and CFO*

I will not quantify that. We have dropped guidance on utilization two quarters ago. But if you look at our guidance on revenue, you can see that we are guiding the revenue slightly down on third quarter, somewhat, so with that you can figure out--

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**Mehdi Hosseini** - *Friedman, Billings, Ramsey Group, Inc. - Analyst*

But-- we didn't have much color on the ASP, so maybe you can elaborate on the ASP trend, not specifically how it's changing, but is the dropoff in ASP more than the dropoff in wafer shipments?

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**Lora Ho** - *TSMC - VP and CFO*

We do not compare the ASP change versus wafer shipment change each year. Those two factors are the two factors that constitute total revenue, so we will talk about revenue only.

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**Mehdi Hosseini** - *Friedman, Billings, Ramsey Group, Inc. - Analyst*

Okay, that's fair.

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**Dr. Rick Tsai** - *TSMC - President and CEO*

I think-- I think that the-- you probably can-- I don't think the ASP decline rate will be abnormal, shall we say, and I don't believe-- we don't see the utilization rate to go down the number you mentioned.

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**Mehdi Hosseini** - *Friedman, Billings, Ramsey Group, Inc. - Analyst*

Okay, that's fair. And then regarding the game console market, [inaudible] had an interesting commentary regarding the cutback in wafer starts for one of their largest customers. If you could elaborate on that, how you see that specific segment tracking?

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**Dr. Rick Tsai** - *TSMC - President and CEO*

You're asking-- if the wafer starts is slowing down? Is that the question?

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**Mehdi Hosseini** - *Friedman, Billings, Ramsey Group, Inc. - Analyst*

No, actually, I'm talking about my second question and that has to do with the game console market.

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**Dr. Rick Tsai** - *TSMC - President and CEO*

Game consoles?

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**Mehdi Hosseini** - *Friedman, Billings, Ramsey Group, Inc. - Analyst*

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[inaudible] said last week that their wafer starts from their largest customer related to game console had dropped off significantly for Q3. Do you see the same trend or how would you characterize the demand from the game console segment?

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**Dr. Rick Tsai - TSMC - President and CEO**

Well, I'm sorry that the-- we cannot really comment on this question directly, because you know who the customer is and we cannot comment on specific customer questions. But we can comment on the segment application overall, in general.

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**Mehdi Hosseini - Friedman, Billings, Ramsey Group, Inc. - Analyst**

How would you characterize the consumer market, assuming that game console is included in there?

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**Lora Ho - TSMC - VP and CFO**

Consumer segment will be slightly up or flat in third quarter. That's overall picture of consumer.

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**Mehdi Hosseini - Friedman, Billings, Ramsey Group, Inc. - Analyst**

Thank you.

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**Operator**

Your next question comes from the line of Titus Menzies with Jefferies. Please proceed.

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**Titus Menzies - Jefferies & Co. - Analyst**

Good evening, gentlemen. Thank you for taking my call. Just a couple questions. Firstly, could you give me some color on-- on your migration to 45-- or your development of 45-nanometers? What type of [inaudible] aperture will you be using in terms of achieving the yield?

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**Dr. Jack Sun - TSMC - VP R&D**

Above 1. It's larger than 1.

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**Titus Menzies - Jefferies & Co. - Analyst**

Sure.

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**Dr. Rick Tsai - TSMC - President and CEO**

You're asking a very--

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**Dr. Jack Sun - TSMC - VP R&D**

Technical question.

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**Titus Menzies - Jefferies & Co. - Analyst**

Okay.

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**Dr. Rick Tsai - TSMC - President and CEO**

Not only technical, but also a very critical technical point of view.

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**Titus Menzies - Jefferies & Co. - Analyst**

That's fair enough. And maybe if I can ask, if we assume a slowdown in 2007 in terms of production from your end markets, would you CapEx going into the R&D remain unchanged or will that also be revised downwards too?

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**Lora Ho - TSMC - VP and CFO**

We will not revise down our R&D investment, including the CapEx for R&D and engineering wafer for R&D. We will only increase and accelerate our R&D activities.

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**Titus Menzies - Jefferies & Co. - Analyst**

Okay. And the last question is you spoke about increasing the power management or power consumption, having a license of SOI technology into your portfolio, are you seeing any sort of traction with any of your customers for development of SOI technology for production?

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**Dr. Rick Tsai - TSMC - President and CEO**

No. It's still too expensive and there are alternatives and the design barrier is quite high. As you know, SOI so far has been pretty in a niche market, meaning CPU with custom designs. And SOI introduces additional variance which everybody worry about and that requires a lot of effort in design and most of the applications and most of the market cannot take that risk or cannot afford that kind of investment.

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**Titus Menzies - Jefferies & Co. - Analyst**

Thank you very much for your time. I appreciate it.

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**Operator**

Your next question comes from the line of Ivan Goh with Dresdner Kleinwort. Please proceed.

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**Ivan Goh - Dresdner Kleinwort Wasserstein - Analyst**

Hi, good evening. I have two questions. The first one, is based on the comments made by many semiconductor companies it seems that if the order or forecast revisions for the third quarter happened quite late in the second quarter. Can you, first of all, say whether these revisions are continuing into the current time or have they kind of like finished?

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**Dr. Rick Tsai - TSMC - President and CEO**

I think that, as we said at the very beginning, there is an inventory correction going on and we-- we expect to see this impact throughout the year, for sure. What-- each customer is-- some customers start-- started the corrections sooner than the others, so I guess I would expect some more customers to continue the corrections for a while.

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**Ivan Goh - Dresdner Kleinwort Wasserstein - Analyst**

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Okay. And my second question is, at the start of the conference call you said that you expect the corrections to be carried through into the fourth quarter of this year or rather for the rest of 2006. What is your-- what is your assumption as to the level of correction in the third quarter and the fourth quarter? Mainly I want to know, do you think that most of the correction will take place in Q3 with corrections actually kind of like moderating in Q4? Or do you think that it's going to be one step at a time that the customers will take in regards to rationalizing their inventory?

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**Dr. Rick Tsai - TSMC - President and CEO**

I think it will be-- from that point of view, it will be more similar to the-- probably it will be more similar to that of the 2004.

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**Ivan Goh - Dresdner Kleinwort Wasserstein - Analyst**

Would you be more specific? Would it be one step at a time or would it be a big cut and then-- and a smaller one in Q4?

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**Dr. Rick Tsai - TSMC - President and CEO**

I--

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**Lora Ho - TSMC - VP and CFO**

Probably not a big cut in one shot. It's progressing gradually.

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**Dr. Rick Tsai - TSMC - President and CEO**

There's a spectrum of different customers corrections.

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**Lora Ho - TSMC - VP and CFO**

They behave differently.

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**Ivan Goh - Dresdner Kleinwort Wasserstein - Analyst**

Can you, perhaps, elaborate on the wireless area? And that's my last question.

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**Dr. Rick Tsai - TSMC - President and CEO**

In the wireless, the handset shows slightly down for the third quarter. For the third quarter?

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**Lora Ho - TSMC - VP and CFO**

Yes.

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**Ivan Goh - Dresdner Kleinwort Wasserstein - Analyst**

But would they be making most of the big cuts earlier and then-- or kind of like taking one step at a time?

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**Dr. Rick Tsai - TSMC - President and CEO**

That's difficult for us to say, but I think it's in a gradual manner.

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**Ivan Goh - Dresdner Kleinwort Wasserstein - Analyst**

Thank you very much.

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**Dr. Rick Tsai - TSMC - President and CEO**

All right.

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**Operator**

Your next question comes from the line of Timothy Arcuri with Citigroup. Please proceed.

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**Timothy Arcuri - Citigroup - Analyst**

Hi. A couple things. First of all, have your-- have your lead times-- when you go out and order a piece of equipment with your-- with your vendors, have the-- have the times-- have the lead times for that equipment, has that changed in the last couple months?

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**Dr. Rick Tsai - TSMC - President and CEO**

Not to a significant degree. I mean, I just read the news, I think, as you do. The semiconductor equipment industry's book-to-bill ratio seems to be doing well, at least reasonably well.

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**Timothy Arcuri - Citigroup - Analyst**

Okay. Okay. Second question, I know that you don't want to talk about capacity utilization, but is it kind of safe to assume you're guiding shipments down about 2% and capacity's growing-- or, sorry, you're guiding revenue down about 2% and capacity is growing about 6% sequentially. So if you use some kind of flattish ASPs, you're talking about a downtick in utilization maybe in the high single digits. And I'm just kind of wondering, as you compare this downturn relative to 2004 when you saw your capacity decline by about 25% in a six-month period, I'm wondering if there's reason to believe that the decline over a six-month period would be similar to what you saw back in 2004?

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**Dr. Rick Tsai - TSMC - President and CEO**

Well, I think, of course, we don't have-- we cannot guide fourth quarter right now, but the-- as a whole we do-- we do view this correction to be milder, more moderate than the one in 2004.

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**Timothy Arcuri - Citigroup - Analyst**

Okay. So you would think that if utilization's down the high single digits, you're guiding to capacity increasing another 6% sequentially in Q4, so if shipments are down again or if revenue's down again you're going to have another high-single-digit to maybe low-double-digit sequential decline in capacity utilization. That's almost as bad as it was in 2004, not that much better, but maybe that math is wrong.

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**Dr. Rick Tsai - TSMC - President and CEO**

I guess I stick to my answer just now.

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**Timothy Arcuri - Citigroup - Analyst**

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Okay. And then last thing, I understood that today on the-- on the other call, you talked about '07 CapEx trend being up. A) is that right? And B), how do you have the visibility on that given that you're-- you're actually cutting back on your 300-millimeter capacity right now? So I just wanted some color on that. Thanks.

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**Dr. Rick Tsai - TSMC - President and CEO**

I don't think we guided any specifics on 2007 CapEx. What I said earlier in the afternoon was since we view, in general, 2007 to be another positive year with a growth probably rather similar to that of 2006, we will continue investing in advanced technology to meet all our customers' needs and we also will look for cost-effective mature technology capacity, since we have been seeing a pretty strong demand for our mature technology capability.

But whether this will be larger or smaller compared to year 2006 we have not made that decision yet.

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**Timothy Arcuri - Citigroup - Analyst**

Great. Thanks a lot.

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**Operator**

Your next question comes from the line of Shailesh Jaitly with Nomura Securities. Please proceed.

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**Shailesh Jaitly - Nomura Securities - Analyst**

Yes, hi. Thanks. Last quarter I think you guided that your outsourcing relationship, the foundry relationship with the DRAM company and you characterized that roughly about 5% of the output was outsourced in the previous quarter from the DRAM company. How has that changed as you go into 3Q?

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**Lora Ho - TSMC - VP and CFO**

There's no change to the percentage, but I have to remind you that outsourcing does not only cover the DRAM company. It also covered our investment company Vanguard.

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**Shailesh Jaitly - Nomura Securities - Analyst**

Lora, in that case, how that has the outsourcing relationship with Vanguard changed as we go into 3Q?

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**Lora Ho - TSMC - VP and CFO**

It has not changed and we are increase our loading to Vanguard fabs, especially on 0.21 micron.

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**Shailesh Jaitly - Nomura Securities - Analyst**

Okay. In-- in terms of your guidance for 3Q, I just wanted to understand the linearity of this quarter. When you comprehended the month revenue run rate, is it fair to assume that July would be the peak revenue month in 3Q?

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**Lora Ho - TSMC - VP and CFO**

We do not comment monthly revenue. I think quarterly revenue should give you a good feeling of the trend.

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**Shailesh Jaitly** - *Nomura Securities - Analyst*

But as we go down the quarter, are you seeing the cuts being progressively increasing or what is your feel as of now?

**Dr. Rick Tsai** - *TSMC - President and CEO*

I think the three months will be fairly similar, but we cannot say which one will be higher than the other. But I don't-- what we can say is that there should not be a big gap between the-- between the months.

**Shailesh Jaitly** - *Nomura Securities - Analyst*

Thanks. One last thing I wanted to clarify. You mentioned earlier and I missed that for 3Q, if you look at various subsectors, you talked about PC wireless, consumer are you seeing an up-quarter in 3Q or that is also likely to come down sequentially?

**Lora Ho** - *TSMC - VP and CFO*

Consumer for the third quarter will be slightly up or flat, in general.

**Shailesh Jaitly** - *Nomura Securities - Analyst*

And which are the areas, which are the applications where you're seeing the growth?

**Lora Ho** - *TSMC - VP and CFO*

The application that has growth-- DVD players. Okay, DVD player and digital camera will decline and-- in second quarter and expected to improve slightly in third quarter.

**Shailesh Jaitly** - *Nomura Securities - Analyst*

Thanks.

**Operator**

Your next question comes from the line of [Donald Lu] with [inaudible]. Please proceed.

**Donald Lu** *Analyst*

Hi. Lora, can you give us the third quarter on an unconsolidated basis? That would simplify a lot of our work.

**Lora Ho** - *TSMC - VP and CFO*

Donald, so you like unconsolidated more?

**Donald Lu** *Analyst*

No, it just-- I believe not only me but some of us are going to still report with the unconsolidated reporting this quarter and so with that, it would just clarify a lot of uncertainties.

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**Lora Ho - TSMC - VP and CFO**

Okay. You know the unconsolidated revenue was slightly smaller than consolidated revenue. If I have to guide it on unconsolidated basis I would guide NT\$78 to NT\$81 in terms of trend lines.

**Donald Lu Analyst**

NT\$78 to NT\$81? How about margins, gross margin and operating margin?

**Lora Ho - TSMC - VP and CFO**

I give you one point less, 47% to 49%.

**Donald Lu Analyst**

Okay, great. Thank you so much. I have a followup question on-- on the CapEx. Apparently-- I mean, Rick has commented that you have pushed out some of the equipment delivery and for the second half, like if customers want to ramp up very quickly in the second quarter, can you-- how do you prepare for that?

**Dr. Rick Tsai - TSMC - President and CEO**

Well, Donald, I think we-- now it's July. For the second quarter next year what we have done and what we usually do is for the long-lead-time equipment such as scanners, we do not really slow down the purchasing. So what we usually slow down are the ones that we can get in a relatively short lead time, like three months. In that, I think we have a good buffer for the situation that you just mentioned.

**Donald Lu Analyst**

Okay. Great. Thank you very much.

**Dr. Rick Tsai - TSMC - President and CEO**

Sure.

**Operator**

Your next question comes from the line of Fayad Abbasi with Neuberger. Please proceed.

**Fayad Abbasi - Neuberger Berman - Analyst**

Rick, I had a question for you regarding the commentary about the 45-nanometer and it looks like with-- the amount of time before you move from 65 to 45 is a lot shorter than in prior process node trends. I was just curious. Is this-- how do you-- how would you characterize this change and are customers demanding it or is it you're bringing it to the market and waiting for the customers, then, to move to the node? And also, are you expecting these nodes, then, to see the same level of ramp-up that you have seen at prior nodes? Thanks.

**Dr. Rick Tsai - TSMC - President and CEO**

On the very first question, we have both. We have certain customers who are working closely with us who like to take the leading position in the process technology, of course, for their own benefit. But also I think TSMC [inaudible] over the years we have invested heavily -- I would also think very productively -- in our technology development and we were able to pull in, somewhat, the schedule.

I do not underestimate the level of the effort to get 45-nanometer technology into production into a large volume design. I think, as I said earlier in the session, the technology is just getting more and more difficult, both from a design point of view and a process point of view.

However, it is also obvious that the economics works very well for the technology moving forward. So you can view that, also, as a barrier. We are definitely working with customers who believe they can take the advantage of the 45-nanometer technology and get ahead against their competitors.

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**Fayad Abbasi - Neuberger Berman - Analyst**

I guess, if you've looked back in the past at the-- the amount of revenue contribution from a particular node before you see the crossover to the next node, is that percentage-- do you think that comes down then? In other words, 65-nanometers may be not contributing north of 20% or north of 30% before you start your initial contributions from 45?

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**Dr. Rick Tsai - TSMC - President and CEO**

Tell you the truth, I do not have that visibility right now. Don't get me wrong. I believe 65-nanometer will be a popular node, simply by the sheer number of customers who are now already designing in in that. What we're saying is we have-- on the other hand, there are customers who will jump ahead with 45, even though they are also using 65-nanometer, probably, for their mainstream volume products.

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**Fayad Abbasi - Neuberger Berman - Analyst**

And, Rick, maybe one last question on this topic, then. In terms of 45-nanometer, a lot of discussions about big materials changes and yet if you're pulling in the schedule for 45, have you made a decision, then, to push back on some of the big changes? I think the gate dielectric is one that usually comes up as the next big change in 45. Has that been-- has that decision been finalized then?

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**Dr. Rick Tsai - TSMC - President and CEO**

Yes. I mean, we do not plan to change the gate dielectrics at a 45-nanometer node. My feeling is that's a more industry trend. I do not know whether I can say consensus, but TSMC does not plan to use a different gate dielectric material. I mean, as of now, it's complicated enough.

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**Fayad Abbasi - Neuberger Berman - Analyst**

Right. I guess immersion, then, is going to be the big change as we go to 45?

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**Dr. Rick Tsai - TSMC - President and CEO**

Oh, absolutely. And, as I said, the lower-k dielectric for the metal addition is not a piece of cake, either.

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**Fayad Abbasi - Neuberger Berman - Analyst**

Sure. Thank you.

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**Dr. Rick Tsai - TSMC - President and CEO**

Thank you.

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**Operator**

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Ladies and gentlemen, in the interest of time, we only have time for two more participants. Your next question comes from the line of Michael McConnell with Pacific Crest Securities. Please proceed.

**Michael McConnell - Pacific Crest Securities - Analyst**

Thank you. Most of my questions have been answered. I just wanted a little bit more granularity on the end market outlook for Q3. I understand you've already talked about consumer and wireless, but if we could maybe talk a little bit about PCs and the wireline markets, as well, please?

**Lora Ho - TSMC - VP and CFO**

I think PC will continue the correction of inventory. We are anticipating a major segment decline among all segments.

**Michael McConnell - Pacific Crest Securities - Analyst**

Okay and wireline?

**Lora Ho - TSMC - VP and CFO**

Okay, on the wireline-- wireline has declined moderately in second quarter and will improve moderately in third quarter, basically.

**Michael McConnell - Pacific Crest Securities - Analyst**

Great. That's it. Thank you very much.

**Operator**

Your next question comes from the line of Mark Fitzgerald with Banc of America Securities. Please proceed.

**Mark Fitzgerald - Banc of America Securities - Analyst**

Thank you. Just a quick question on CapEx. You commented it's still NT\$2.6 to NT\$2.8 billion, but then you commented later in your call that you would be adjusting CapEx in the short term. How can we dovetail those two pieces of data?

**Lora Ho - TSMC - VP and CFO**

We have not changed our guidance of CapEx for the whole year. Actually, it actually-- when we first put out guidance, actually it was on the low end and a couple of months later it went up to the high end. We're now back to the low end again. So that small adjustment Rick just mentioned is-- for this year still doesn't affect too much our CapEx budget for the whole year.

**Mark Fitzgerald - Banc of America Securities - Analyst**

Okay. And then quickly on a bigger issue, design-for-manufacturability is something we constantly hear about in the industry. I'm curious if this is a really important trend and if it forces your customers to be tied more closely to your own process technology with they design a chip?

**Dr. Rick Tsai - TSMC - President and CEO**

Yes. We enable them to sort of have this kind of a close tie through two ways. One is our innovative design-for-manufacturing standard where we can pretty much provide them with ease of use, proprietary DFM data or process data at their fingertips. And second is for early adopters we have established a very good collaboration program with them. So they are involved, collaboratively, with us at the early stage of process

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development and we more or less are doing concurrent engineering with them. So they are very much in synch with our process capability and where they should watch out to avoid design processes [inaudible].

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**Dr. Jack Sun - TSMC - VP R&D**

Also, all our customers are very smart. I like to think they-- they understand the need to use DFM for-- for better yield early, to ramp early. It's a win-win type of relationship rather than the kind of, as you describe-- how do you say, try to lock them in. I don't think that-- I don't think-- I think the customers are too smart to do that for that reason.

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**Mark Fitzgerald - Banc of America Securities - Analyst**

Thank you.

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**Dr. Rick Tsai - TSMC - President and CEO**

Thank you.

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**Operator**

There are no further questions in queue. I would now like to turn the call over to management.

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**Dr. Elizabeth Sun - TSMC - Head of Investor Relations**

I'd like to thank you very much for your time and we'll look forward to seeing all our callers next quarter. 'Bye-bye.

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**Operator**

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect and have a great day.

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