



Conference Call Transcript

TSM - Q3 2006 TSMC Earnings Conference Call

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Operator

Good morning ladies and gentlemen. Welcome to TSMC's third quarter 2006 results 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 also being webcast live via the TSMC website at 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. Please also download the summary slides in relation to today's quarterly review presentation. Once again, the URL is www.tsmc.com.

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

Elizabeth Sun - TSMC - Head of Investor Relations

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Good morning and good evening to all participants. This is Elizabeth Sun, Head of Investor Relations for TSMC. Before we begin, I would like to state that the management's comments about TSMC's current expectations made during this conference call and 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 20, 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, CFO

Thank you, Elizabeth. Good morning and good evening to everyone. Welcome to our third quarter 2006 earnings conference call.

Operator

Please stand by. Your conference will resume momentarily. Ladies and gentlemen, thank you for standing by. Your conference will resume in just a moment.

Elizabeth, you may proceed.

Elizabeth Sun - TSMC - Head of Investor Relations

Alright. I apologize for a short pause because our line was temporarily disconnected. My apology to all of you. Now we will resume our call. Let's start with Ms. Lora Ho, our Chief Financial Officer and Vice-President.

Lora Ho - TSMC - VP, CFO

Thank you Elizabeth. And good evening to everyone. Welcome to our third quarter 2006 earnings conference call. I will start today's call with highlights from our third quarter results and then give you an overview of our expectations for the fourth quarter. As a remainder, we will discuss the third quarter results and provide fourth quarter guidance on a consolidated basis only. Please also refer to the quarterly financial summary slides on your website. All dollar figures are in NT dollars, unless otherwise stated.

With that, let me start with slide number five. Total revenue for the quarter was over NT\$82 billion, up 17% year-over-year and up 0.4% sequentially, roughly about the high end of our guidance, mainly driven by better than expected demand in computer-related applications. Revenue from consumer and communications both increased by 2% quarter-over-quarter, while revenue from computer applications declined by 6%.

In terms of revenue by technology, revenue from advanced technologies accounted for 49% of wafer revenues while revenue from 90nm alone accounted for 24% of total wafer sales. Both were flat from the previous quarter. Gross margin was at the high end of the guidance to reach 49.9% for the quarter, 1.9 percentage points lower than in the previous quarter, mainly due to low capacity utilization. Total operating expenses in the third quarter were slightly higher than the previous quarter, mostly due to increased R&D spending on 45nm and 65nm projects as well as opening expenses for phase II of Fab 14. As a result, our operating margin was 14.8% for the quarter, also at high end of our guidance.

Diluted EPS was NT\$1.26, up 32.5% year-over-year and down 4.4% quarter-over-quarter. I will leave most of the balance sheet and cash flow items for you to review. However, let me make a few comments. TSMC continued to generate strong cash from our operations. Cash flow from operations was 53 billion in the quarter. We spent 28 billion on Kpcs. In the third quarter, we also returned 62 billion in cash to our investors in the form of cash dividends as compared to 46 billion in the one year in 2005. As a result we ended the quarter with 164 billion in total cash and marketable securities, down 49 billion from quarter two.

On a quarter-over-quarter basis, our accounts receivable turnover days declined by one day. Our inventory turnover days increased by one day. Both were within our [noble] range. In terms of capacity, the total install capacity for the third quarter was 1.8 million 8" equivalent wafers in line with our previous expectations. We expect our fourth quarter capacity to be slightly above 1.9 million 8" equivalent wafers or a 6% sequential

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increase. We expect total capacity for 2006 to be slightly above seven million 8" equivalent wafers, unchanged from our previous guidance provided in July. The full year 2006 capacity was [indiscernible], an 18.6% increase over 2005. On a year-to-date basis, Kpcs totaled US\$1.9 billion. We now expect our full year Kpcs to be about US\$2.6 billion. This is the low end of the range we provided earlier.

Page 10 through page 13 of the slides break down our sales by technology application, geographic, and customer, which I will not go through in detail.

With that, let me turn to the outlook for the first quarter of 2006. Based on current business and foreign exchange rate expectations, we expect consolidated revenue to be between NT\$74 to NT\$76 billion. Our expectation for gross margin in the fourth quarter is between 45% and 47%. The operating profit margin is expected to be between 35% to 37%.

This concludes my remarks today. We will now open the conference call for Q&A.

QUESTION AND ANSWER

Operator

(OPERATOR INSTRUCTIONS) Mehdi Hosseini of Friedman, Billings, Ramsey.

Mehdi Hosseini - Friedman, Billings, Ramsey - Analyst

Yes, thank you. I do recognize that you don't really provide any commentary on shipment and pricing into Q4. But I would imagine that, given your customers' inventory adjustment, the wafer shipment decline should be at least in the high single digits with pricing pressure coming in. Am I in the right direction? Could you help me understand the trend?

Lora Ho - TSMC - VP, CFO

I think if you look at our guidance for the fourth quarter, we are guiding 74 to 76 billion, which represents roughly an 8% to 10% revenue drop for this combination of utilization product mix and ASP also. We don't break that down any more.

Mehdi Hosseini - Friedman, Billings, Ramsey - Analyst

Just one more question as a follow-up. Your competitor UMC was talking about at least \$1 billion spending for next year as they bring up 65nm capacity. How should we think about adjustments you are going to make to your capacity for next year. In terms of capital intensity, do you expect increased spending just to bring up the 65nm?

Rick Tsai - TSMC - President, CEO

Yes, we do plan to add capacity at 65nm next year, we will have some 90nm. But I think mainly there will be more for the 65nm. We did say in the afternoon that the capex for 2007, as far as we can tell now -- the number, of course, is still being worked out. We will give you a more definitive number by January timeframe. For now, what we're seeing now is a modest increase over that of 2006, which Lora just reported was about NT\$2.6 billion.

Mehdi Hosseini - Friedman, Billings, Ramsey - Analyst

Thank you.

Operator

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Bhavin Shah of JP Morgan.

Bhavin Shah - JP Morgan - Analyst

Can I ask for clarification. I think in the afternoon you discussed the integration possibilities of CPU and graphics and how that is going to expand the market, so expand available market for foundries and for you, I guess. Is the expansion of the market you believe is a possibility? Or you feel it is definitely happening?

Rick Tsai - TSMC - President, CEO

As I said also in the afternoon, I think -- well, we are still studying that ourselves here. What I understand is that can be for high-end application or for low-end application -- well, high performance or very low cost applications. So if you look at this, if people can work out a good solution for a very low cost PC, then we believe there is still a very large market out there in different countries that can use this kind of an ultra low-cost PC.

Bhavin Shah - JP Morgan - Analyst

A second question. Over the last two years, you have operated at average utilization of 100% and ROIC, or return on capital that is excluding cash, of 40% or somewhere in that ballpark. Also, your revenue growth has been a lot stronger than the longer-term semiconductor industry growth you talk about. So is it a fair statement to say that your ROE target of 20% and industry growth forecast of high single digits both seem to be too conservative, especially compared to what the semiconductor industry has done over the last four or five years and what you have done specifically over the last three years?

Rick Tsai - TSMC - President, CEO

Good question. We set our ROE target of better than 20%, for one, based on I think a global look of many, many different companies and among different industries. ROE of 20% seems to be a good benchmark, above which consistently by the way, over a long period of time, good, average better-than-20% ROE seems to be a good benchmark for a good company. Of course, that doesn't mean that we are going to be content with just 20% ROE. I agree with you, that the ROE or ROIC during the recent past has been quite good. You can be assured that the management team continues to do that. I think the other important thing, of course, is that as we move forward we need to continue to find growth opportunities. By that, we define the growth of EPS, not just revenue, but EPS growth. I think sometimes you need to have a balance between growth and profitability. We continue to weigh those things very carefully. We hope the ROE of 20% or better is really what we want to achieve as the minimum goal.

Bhavin Shah - JP Morgan - Analyst

Right. What about the growth part of my question.

Rick Tsai - TSMC - President, CEO

The growth part. I think if we look at semiconductor growth of high single digit to our growth in semiconductor industry, for a company like TSMC of our current size, of course, it's quite challenging. That is why we're looking at opportunities that we have not done for quite a few years before. I think we continue to -- in addition, where we have been very successful, we need to look at the semiconductor area, the obvious sectors that we are not present or we have low penetration as I've said that before. We have some success so far in, I think -- or it's just a start. I shouldn't say success. So we have a reasonably good start in the NOR flash. I think that will contribute to some of our growth. We continue to look at other segments where we have low penetration. We look at both from the organic and, to use Sunil's words, the inorganic manner.

Bhavin Shah - JP Morgan - Analyst

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Let me just ask my last question on the inorganic opportunities. I see growth coming up in two ways. One is because of private equity buyouts of some of the large IDMs, including one of your major investors. And second, relatively -- very low valuation at which some of the smaller analog-type foundries are currently trading at. How do you see that both areas evolving in terms of [indiscernible] consolidation and acquisition opportunities? How are you evaluating those opportunities?

Rick Tsai - TSMC - President, CEO

For IDM, we strongly believe the outsourcing trend continues. Actually I think -- I read something today, I believe ST had their earnings conference. They seem to also state that their outsourcing percentage will go up. We believe that this trend will continue because it is mutually beneficial for the foundry industry and the IDMs. I really cannot comment on how private equity impacts on that. I don't have enough exposure in that.

On the other opportunities you just mentioned, I think we have not really looked into that closely. We need to take a serious look and see how that can impact our growth.

Bhavin Shah - JP Morgan - Analyst

What I meant by private equity was that the private equity firms will be looking to dispose of -- do some sort of restructuring, spin-off of fabs and so on. In terms of who could be the potential acquirers counting of too many companies apart from someone like you. That is why I am asking that question.

Rick Tsai - TSMC - President, CEO

I think that we are -- I think we will basically be interested, if that should occur, we don't have any data to say today now. But of course, it will be a function of returns and all of that. I think we----

Elizabeth Sun - TSMC - Head of Investor Relations

Next question, please.

Operator

Randy Abrams of Credit Suisse.

Randy Abrams - Credit Suisse - Analyst

Good evening. I want to ask you on your cash balance with you building up about 5 billion in cash now. Could you talk about what level of cash you believe is reasonable. What would your thinking be behind a more intense share buyback or capital reduction?

Lora Ho - TSMC - VP, CFO

Cash, I think, comes with support operation, capex, we have some inorganic mergers & acquisition opportunities that will also consume some cash. Dividends we have said many times that we have committed to issue steadily increased dividends. We are also do not rule out the opportunity of buyback. It is indeed the cash that we currently have 5 billion. We have some excess cash. We have been doing the cash dividends in the past few years and we will continue to do so. As I said earlier we will consider buyback.

Randy Abrams - Credit Suisse - Analyst

This afternoon you mentioned that PCs are further along in their adjustments than communications. Could you give some color on what you are seeing in the consumer space heading into the fourth quarter.

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Rick Tsai - TSMC - President, CEO

Consumer I think mixed. We see a mixed picture. We see that the flat panel TV is doing quite well, very well. On the other hand, DVD players seems to be -- to have an inventory -- still being digested. It's not as clear as the, for instance, PC and handset. On the other hand, consumer electronics covers a lot of stuff to begin with. So not too surprise to us that it's a mixed picture.

Randy Abrams - Credit Suisse - Analyst

Just one final question. You mentioned that end demand from your perspective seems at least okay and it's largely inventory reductions taking place. Could you talk about the mentality of our customers, why you feel they are cutting inventory deeply if there product cycles going on and some looming in the next year with things like Vista.

Rick Tsai - TSMC - President, CEO

Actually, I think if you look at the data, the inventory level, I think -- at least at the end of the third quarter, it's at a level that I think they would do something to reduce. I am not getting a feeling that they want to cut back to the bone. I don't have that feeling. But I said in the afternoon, I see it in the PC area. Of course, not all components in PC, but in some PC areas, we see customers ordering what they believe they need just for the season. Handset, as I said also. started a bit late, so they are still really trying to digest.

Randy Abrams - Credit Suisse - Analyst

Great, thanks a lot.

Operator

William Dong of UBS.

William Dong - UBS - Analyst

Good evening. A quick question on the NOR flash line. I think in the afternoon session, you mentioned that 70% of the equipment are similar, between NOR production versus logic. I was wondering in terms of production planning, how do we optimize that production given this sort of a mix?

Rick Tsai - TSMC - President, CEO

I guess I need to go back to my operation days in order to answer your question. I think you can divide this into two kinds of situations. One being, we try to start producing the flash in existing wafer fabs with already large installed base of equipment. The other case being a relatively new fab. I think for the existing fab with installed base, it's something that we counted in our cost structure. From a planning point of view, let me see. I would say, for relatively new fabs, the way to do this, usually what you can do is actually you may want to ramp this product early during the ramp-up stage of the fab. So that can play some kind of role to help ramping the fab while we bringing the new customers to the logic application, then we add more equipment with more layer metals -- that sort of thing.

William Dong - UBS - Analyst

So when a new fab is ramping, is it correct to assume that there is more flexibility to actually run with NOR.

Rick Tsai - TSMC - President, CEO

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Yes. You can say that.

William Dong - UBS - Analyst

One last question from me. Can you provide a quick update in terms of what is happening in terms of the China operation as well as some of the development on the new fabless in China and how they are coming along.

Rick Tsai - TSMC - President, CEO

I think the fabless industry in China is growing quite fast, quite fast. I don't mean just the number of companies, but I think their output, their products, although it is starting from a relatively small base also. Our business in China also is growing very fast out of a small base too. But I feel pretty comfortable as to our operations in China, both from a business point of view and a production point of view. From a business point of view, as I said, we're growing leaps and bounds in China, although we are still somewhat handicapped because of the restriction that we have in terms of the 0.18um technology in our China fab, Shanghai fab. But I think we still manage to attract enough -- a lot of business from the Chinese fabless companies. I think we have -- they are moving to the more advanced node, 0.13um for sure. They start looking at 90nm also. They also used our embedded flash technology quite well.

William Dong - UBS - Analyst

So would you say they basically have reached the minimum economy of scale to really have an efficient supply chain in China now to make a difference?

Rick Tsai - TSMC - President, CEO

I think the infrastructure of the chain I think is getting better and better. probably still some way off compared to for instance what they are in Taiwan. But it's getting better. It's getting better.

William Dong - UBS - Analyst

Thank you very much.

Operator

Dan Hayler of Merrill Lynch.

Dan Hailer - Merrill Lynch - Analyst

Good evening. The question is on the flash business. You talked about the divestment and diversification strategy that you are pursuing. You want to really target areas where it would be long-term potential not just short-term opportunities. As you look at this business with AMD, I understand that they are in a transition phase and that this is largely, in their view, in intermediate strategy before ramping more capacity. I guess A whether or not you agree with that? And if that is the case, would you be looking to expand your flash customer base since you are making investments in this capability and typically you like to have a lot of customers at given capabilities anyway. Is this an area you think you'd diversify as well?

Rick Tsai - TSMC - President, CEO

- I am not sure -- you mean diversify into flash in what manner?

Dan Hailer - Merrill Lynch - Analyst

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More customers within the flash capabilities that you are currently offering. Predominantly right now, it's -- on the large scale basis, I believe it's just one customer. Since you are making a commitment, would you be looking for more partners in this area?

Rick Tsai - TSMC - President, CEO

I see. I think -- right now we don't have a plan. I do not rule out any opportunity for business. We do have another kind of a non-volatile memory business with another customer. But it is a quite different technology. I think going to other customers, that depends a lot on other customers', other companies' strategy -- their manufacturing strategy. Many of those products are run by memory IDMs. They still have a very strong hold in their fab. I hope I answered part of your question.

Dan Hailer - Merrill Lynch - Analyst

Are you considering this current partnership as a long-term partnership or as maybe a one-year opportunity?

Rick Tsai - TSMC - President, CEO

What we have now? Definitely long-term. We are talking not just manufacturing, but also technology collaboration for the generations ahead.

Dan Hailer - Merrill Lynch - Analyst

Okay, great. And the way you view that, I guess, as they build their new capacity, that TSMC can continue to generate value. That would incentivize them to not build more capacity, I imagine. Right?

Rick Tsai - TSMC - President, CEO

Yes. I think for a memory company, usually they need some of their own capacity. I think it is also wise for them to have a different source, both from a capacity and from technology point of view. You know how expensive nowadays, not to mention fab, but also development.

Dan Hailer - Merrill Lynch - Analyst

My second and last question is relating to mix. Your competitor has roughly a 7% to 9% revenue decline in the fourth quarter. That is predominantly on 300mm, which I think is where you are seeing the majority of your correction. That is resulting -- most of the revenue decline is an ASP decline of 5% to 6% in that case because of the steep 300mm decline. As I looked at your previous adjustments, you did tend to see the order of magnitude in terms of that decline mix-driven. So are we falling -- is it fair to say of your revenue decline of 8% to 10% that most of that was ASP, or mix? Or most of that is units?

Rick Tsai - TSMC - President, CEO

I think both.

Dan Hailer - Merrill Lynch - Analyst

Okay, great. Thanks a lot.

Operator

Mark Fitzgerald of Banc of America Securities.

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Mark Fitzgerald - Banc of America Securities - Analyst

Thank you. Given the inventory correction in the fourth quarter, would you expect typical seasonality into the first quarter. Are you going to shut down in the first quarter?

Rick Tsai - TSMC - President, CEO

I think first quarter our visibility is not yet good enough to -- and we don't really forecast first quarter. But the seasonality certainly will be there. I did comment on our review of the inventory among different segments. I think you probably can deduce some of your opinion.

To shut down, you mean the fab shutdown?

Mark Fitzgerald - Banc of America Securities - Analyst

Yes, for maintenance. You typically [inaudible]

Rick Tsai - TSMC - President, CEO

I think -- in light of -- we don't have a decision yet. I think it is likely that we will take the opportunity to do the things that we need to do before the business gets strong.

Mark Fitzgerald - Banc of America Securities - Analyst

One second question. Some of the Taiwanese memory manufacturers have talked about using their 200mm lines to go into the foundry business. Is that, from your vantage point, a competitive issue? Or do you not view these factories as not really ultimately competitive with your own 200mm lines?

Rick Tsai - TSMC - President, CEO

I do not know, of course, other people's plans with their fabs. I think certainly if you look at the history, the success of the DRAM fab converting into a foundry operation has been rare. We do know one reasonably good one. That is Vanguard but we work very closely with them. There are both financial constraints and the operation constraints, not to mention the customer orientation. Doing logic is usually many layers metal, so you need -- at the beginning you need to make some more investment in order to do at least logic type of a foundry. But again, we do not really know enough about other people's plans to give you any more insight.

Mark Fitzgerald - Banc of America Securities - Analyst

Thank you.

Operator

Ivan Goh of Dresdner Kleinwort.

Ivan Goh - Dresdner Kleinwort - Analyst

Good evening. Thank you. I have a number of questions. First of all, can you provide the percentage of your shipments in the third quarter that was sourced from external sources such as Vanguard and Power Chip.

Lora Ho - TSMC - VP, CFO

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The part of revenue from Vanguard is usually not very big. I don't know if I can tell you how much, but certainly it's not a significant number.

Ivan Goh - Dresdner Kleinwort - Analyst

If you can give it in a unit base, that would be more helpful. Thank you.

Lora Ho - TSMC - VP, CFO

Unit base? Vanguard has capacity that we can use. I think third quarter we did not use a whole lot of them.

Rick Tsai - TSMC - President, CEO

Ivan, I am sorry. If you need some better data. We need to find the data. We don't have them at [indiscernible] right now. I can say that from the other companies, minimum.

Ivan Goh - Dresdner Kleinwort - Analyst

OK. Let me move onto the next question. I think in the afternoon session you said that you foresee CapEx spending increasing, picking up starting from the second quarter of next year. Given that there is some time lag between when cash CapEx goes out and when the capacity comes on-stream, can you use that comment and convert it into a comment on when you think your capacity growth will pick up.

Lora Ho - TSMC - VP, CFO

Although, we do not have a firm number for 2007, usually first quarter capacity is probably flat to fourth quarter. The capacity growth will start from second quarter or so.

Ivan Goh - Dresdner Kleinwort - Analyst

My last question is, as I look at your Shanghai fab, it seems to have reached fairly good scale. I think by the fourth quarter about 30,000 wafers per month. What is your strategic direction following that? Are you thinking about establishing another Chinese production facility? Is that an option that you are thinking seriously about?

Rick Tsai - TSMC - President, CEO

We do have the space for further expansion there. We have not made any decision on our plan after the current scale because we still need to have a little better understanding as to what technology we can run there. We continue to work very hard hopefully to be able to run some higher-end technology in Shanghai before we can really say what we want to do longer term.

Ivan Goh - Dresdner Kleinwort - Analyst

So I take it to mean that if you cannot go below 0.18 micron, then you are not interested in establishing more capacity in China?

Rick Tsai - TSMC - President, CEO

I am not saying that. I think running 0.18 is quite important. Below 0.18 is not a must. It has a lot to do with how we can be more successful in growing our mature technology business.

Ivan Goh - Dresdner Kleinwort - Analyst

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Thank you very much.

Operator

Michael McConnell of Pacific Crest Securities.

Michael McConnell - Pacific Crest Securities - Analyst

Thank you. Rick, could you talk a little bit more in depth looking at the end markets. The comments here are that all the three major sectors will be down sequentially in Q4. Are there any outliers in terms of products within those three outside of flat panels, which you already commented on, that look like they are going to be growing in Q4?

Rick Tsai - TSMC - President, CEO

Kind of difficult -- I think fourth quarter our graphics should be in better shape. Also set-top box is another brighter spot, we of course, you know the story already. We are going to produce more flash.

Michael McConnell - Pacific Crest Securities - Analyst

Right, okay. So those four are the outliers that are going against the trend?

Rick Tsai - TSMC - President, CEO

Yes, but I also want to reiterate what I said earlier. The PC is doing -- is consuming the inventory. That is why you look at the third quarter, our PC shipment has a decline. I think fourth quarter it is picking up somewhat. Some of the business that they have a low in their inventory.

Michael McConnell - Pacific Crest Securities - Analyst

In today's view you've gone through several cycles. You had talked about how demand, while it is not above seasonal clearly, it's still ongoing. Based on going through past cycles, can you couch the probability -- at least from your vantage point, which is quite good -- that we can work through the inventory problems at various customers and get things back moving again in terms of your financial performance maybe reaccelerating maybe in Q2 next year.

Rick Tsai - TSMC - President, CEO

I think the inventory correction will go into first quarter, but the trend -- but definitely getting better. In the first quarter, of course, you have to couple the seasonality factor in too. But now we cannot really -- again, we do not have enough data and visibility to give you any comments further than that.

Michael McConnell - Pacific Crest Securities - Analyst

Okay, fair enough. In fact, that was helpful. And then, Lora, could you -- just a quick housekeeping. With respect to the environment and looking at your operating expenses, Q4 and Q1 we can back into it given your operating margin guidance. Should we weigh more of the growth on a sequential basis on the R&D line. And then considering where we are in the cycle, the SG&A should gradually start to pick up, if we believe that your financials start to pick up again or reaccelerate towards the second half of next year, etc?

Lora Ho - TSMC - VP, CFO

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I think in operating expenses you can see our track record, we have very tight control. But on the technology development, our R&D area, that area we would continue to invest, especially we'll accelerate 65nm and 45nm as well. I think it will be very close if you can assume that the R&D expenses will not go down, not go higher. SG&A probably more or less keep it flat.

Michael McConnell - Pacific Crest Securities - Analyst

Great. Thank you very much.

Operator

Mehdi Hosseini of FDR.

Mehdi Hosseini - Friedman, Billings, Ramsey - Analyst

Thank you. I want to go back to the comment that was made just seconds ago. Do you mean to imply that you think inventory correction may continue into Q1? Could you share with us what makes you think so.

And then, regarding the consumer end market, when do you think demand related to the game console would see a pickup?

Rick Tsai - TSMC - President, CEO

The reason for the Q1 comment that I made in the afternoon and earlier this evening that the handset inventory correction is starting -- has started, I should say. But timing-wise it's later compared to the PC. It seems to us that the handset inventory digestion will move into first quarter.

Game console, I think it is -- you have to excuse me for not commenting on that. That would basically give out customer information.

Mehdi Hosseini - Friedman, Billings, Ramsey - Analyst

But when you talk about consumer being more confusing ---

Rick Tsai - TSMC - President, CEO

Mix.

Mehdi Hosseini - Friedman, Billings, Ramsey - Analyst

Does game console have an impact there to make it more confusing?

Rick Tsai - TSMC - President, CEO

We didn't use confusing. It was a mixed picture. Of course, game console is part of that, yes.

Mehdi Hosseini - Friedman, Billings, Ramsey - Analyst

Thank you.

Operator

Satish Athavale of KSA Capital.

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Satish Athavale - KSA Capital - Analyst

Yes. I want to go back to your comments about the share buyback program. Can you provide more color. Is this supposed to offset the share dilution through the share dividend? Or are you proposing an even bigger share buyback program given that you have a lot of cash on the balance sheet and you are generating a lot of cash every year. Thank you.

Lora Ho - TSMC - VP, CFO

I think the thinking behind the possible share buyback is to use the cash as a way to return cash to the shareholder. The dilution coming from profit sharing in the past few years has been only 1.2 or 1.3 percentage level. I think the basic thinking is that it a way to return cash to the shareholder.

Satish Athavale - KSA Capital - Analyst

Right. So just to clarify then, you are thinking about a bigger share buyback program that will reduce the share count in a meaningful way?

Lora Ho - TSMC - VP, CFO

We have not decided how big the scale will be. But once we decide it, it is not going to be a very small and meaningless buyback.

Satish Athavale - KSA Capital - Analyst

Will that be in the local market or also for the ADR's? Can you clarify that?

Lora Ho - TSMC - VP, CFO

It will be done in the local market.

Satish Athavale - KSA Capital - Analyst

Okay. Thank you.

Operator

Titus Menzies of Jefferies & Co.

Titus Menzies - Jefferies & Co. - Analyst

Good evening. This is Titus on behalf of John Lau. Just a couple questions if I may. Firstly, we've been hearing a little bit from IDMs about plans for '07 to cut CapEx spending on equipment and look to use foundries more aggressively as they go forward. My question is, your guidance '07 of flattish CapEx spending, is that modest? Or is that sufficient to meet the requirements for your IDM partners?

Rick Tsai - TSMC - President, CEO

As we said, these numbers are still being worked on now. We said a modest increase over what we have in 2006. The guiding principle is to meet -- we will invest to meet our customers' demand. That of course, is also being worked out internally. We will not make the CapEx decision because of a quarter or two quarters inventory correction.

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Titus Menzies - Jefferies & Co. - Analyst

Okay. Thank you. In terms of your guidance, how much of your guidance is colored by already booked orders. How much of that is therefore left to raise in terms of business requirements?

Rick Tsai - TSMC - President, CEO

In our business, I think -- right now it's late October, almost November. I think the cycle time, if you consider the cycle time, you can figure out the opportunity for turn business is getting smaller and smaller as days go on. I think the visibility is reasonably good for fourth quarter.

Titus Menzies - Jefferies & Co. - Analyst

I guess the last question I will ask you, in terms of the overall utilization rate, do you expect for Q4 in general. Have you split that between advanced and trailing fabs? Could you give some color on that, please.

Rick Tsai - TSMC - President, CEO

We remarked that the 12" wafer fab decline is greater than the Company-wide average. The 8" is better than the Company average.

Titus Menzies - Jefferies & Co. - Analyst

Wonderful. Thank you very much.

Operator

Bhavin Shah, JP Morgan.

Bhavin Shah - JP Morgan - Analyst

Just one follow-up. When I look at the non-depreciation cost of goods sold as a percentage of sales, there is major improvement, some 500 basis points from -- I kind of used various points. I looked at 2004 versus 2006 because those two years had similar utilization levels to try to eliminate any other variables that affect this. So there seems to be something going on with respect to your cost reduction that I have not seen before. Is there anything that you could shed the light on? Or am I not -- is it not really a big issue?

Lora Ho - TSMC - VP, CFO

You are talking about the cost structure improvement over the past two years. I think we've seen the productivity improvement and continued cost reduction have been major factors. On that line, as you can see, the depreciation cost coming down. We have more 8" depreciation to cost of sales ratio is less than five years ago. Another reason is that we managed capacity better so that the ramp-up is very fast. We can drive the cost learning curve down very fast. So therefore the costs are seen in greater advantage.

Bhavin Shah - JP Morgan - Analyst

Right. The reason why this is particularly noticeable is that this is happening in spite of a fall in ASP. So as we go forward, can we assume that you have some more room for cost reduction? Because ASP falls don't seem to be stopping.

Rick Tsai - TSMC - President, CEO

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We are certainly target for it. Our operations have very a stringent target for cost reduction productivity improvement. Yes, I guess you probably exaggerated and maybe I should get a number from you.

Bhavin Shah - JP Morgan - Analyst

I am just looking at the data [indiscernible] in the statement. Thank you.

Elizabeth Sun - TSMC - Head of Investor Relations

Operator, in the interest of time, we will just allow for one last question.

Operator

Pranab Sarmah of Daiwa Institute of Research.

Pranab Sarmah - Daiwa Institute of Research - Analyst

Thank you. I have one question about the China operation. Recently we have seen the basically a lot of Chinese government are approaching foundries to put up probably a facility maybe coming from the local government. Are you being approached by those foundries to put up any mature technology fab. What is your stand? If your technology permits are there, will you be taking those type of opportunities in China?

Rick Tsai - TSMC - President, CEO

I think it's quite complicated. It's very complicated because of the situation that we have no control over. It makes it very difficult for us to engage in such kind of discussion. We do not have any. Let me be very clear. We do not have any.

Pranab Sarmah - Daiwa Institute of Research - Analyst

What about other countries. Any other country outside China, the government are approaching you?

Rick Tsai - TSMC - President, CEO

Oh, yes. That's for sure. For sure.

Pranab Sarmah - Daiwa Institute of Research - Analyst

Anything on that pipeline that we can expect in the next maybe one year timeframe, any [inaudible]---

Rick Tsai - TSMC - President, CEO

The thing I can say is we continue to look at different site in different areas. We need to ensure there is good cost structure and good human resources. I think we are making progress. We are making progress, but I really cannot comment specifically.

Elizabeth Sun - TSMC - Head of Investor Relations

Operator, I think we are done with the Q&A session.

Operator

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That concludes the Q&A session. I would like to turn the call over to management for closing comments.

Elizabeth Sun - TSMC - Head of Investor Relations

I would like to thank everybody for your participation. We are happy we can answer most of the questions. We are look forward to seeing you next quarter. Bye-bye.

Operator

Ladies and gentlemen, Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. Have a wonderful day.

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