TAIWAN SEMICONDUCTOR MANUFACTURING CO LTD
Form 20-F
April 20, 2007

Table of Contents

SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 20-F

o **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2006

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to __________

OR

o **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITEIS EXCHANGE ACT OF 1934**

Commission file number 1-14700

(Exact Name of Registrant as Specified in Its Charter)

Taiwan Semiconductor Manufacturing Company Limited (Translation of Registrant s Name Into English)	Republic of China (Jurisdiction of Incorporation or Organization)

No. 8, Li-Hsin Road 6
Hsinchu Science Park
Hsinchu, Taiwan
Republic of China
(Address of Principal Executive Offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Shares, par value NT$10.00 each	The New York Stock Exchange, Inc.*

Securities registered or to be registered pursuant to Section 12(g) of the Act:
None
(Title of Class)
Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:
None
(Title of Class)

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the annual report.

As of December 31, 2006, 25,829,687,846 Common Shares, par value NT$10 each were outstanding.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes þ No o

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or (15)(d) of the Securities Exchange Act of 1934. Yes o No þ

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

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

Large Accelerated Filer þ Accelerated Filer o Non-Accelerated Filer o

Indicate by check mark which financial statement item the registrant has elected to follow. Item 17 o Item 18 þ

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

* Not for trading, but only in connection with the listing on the New York Stock Exchange, Inc. of American Depositary Shares representing such Common Shares

TABLE OF CONTENTS
Taiwan Semiconductor Manufacturing Company Limited

TSMC and tsmc are our registered trademarks and NEXSYS, 1T RAM and Virtual fab are trademarks used by us.

Table of Contents

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

This annual report includes statements that are, or may be deemed to be, forward-looking statements within the meaning of U.S. securities laws. The terms anticipates, expects, may, will, should and other similar expressions identify forward-looking statements. These statements appear in a number of places throughout this annual report and include statements regarding our intentions, beliefs or current expectations concerning, among other things, our results of operations, financial condition, liquidity, prospects, growth, strategies and the industries in which we operate.

By their nature, forward-looking statements involve risks and uncertainties because they relate to events and depend on circumstances that may or may not occur in the future. Forward-looking statements are not guarantees of future performance and our actual results of operations, financial condition and liquidity, and the development of the industries in which we operate may differ materially from those made in or suggested by the forward-looking statements contained in this annual report. Important factors that could cause those differences include, but are not limited to:

- the volatility of the semiconductor and microelectronics industry;
- overcapacity in the semiconductor industry;
- the increased competition from other companies and our ability to retain and increase our market share;
- our ability to develop new technologies successfully and remain a technological leader;
- our ability to maintain control over expansion and facility modifications;
- our ability to generate growth or profitable growth;
- our ability to hire and maintain qualified personnel;
- our ability to acquire required equipment and supplies necessary to meet customer demand;
- our reliance on certain major customers;
- the political stability of our local region; and
- general local and global economic conditions.

Forward-looking statements include, but are not limited to, statements regarding our strategy and future plans, future business condition and financial results, our capital expenditure plans, our capacity expansion plans, our expansion plans in mainland China, expectations as to the commencement of commercial production using 65-nanometer and more advanced technologies, technological upgrades, investment in research and development, future market demand, future regulatory or other developments in our industry. Please see Item 3. Key Information Risk Factors for a further discussion of certain factors that may cause actual results to differ materially from those indicated by our forward-looking statements.

Table of Contents

PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

Selected Financial and Operating Data

The selected income statement data, cash flow data and other financial data for the years ended December 31, 2004, 2005 and 2006, and the selected balance sheet data as of December 31, 2005 and 2006, set forth below, are derived from our audited consolidated financial statements included herein, and should be read in conjunction with, and are qualified in their entirety by reference to, these consolidated financial statements, including the notes thereto. The selected income statement data, cash flow data and other financial data for the years ended December 31, 2002 and 2003 and the selected balance sheet data as of December 31, 2002, 2003 and 2004, set forth below, are derived from our audited consolidated financial statements not included herein. The consolidated financial statements have been prepared and presented in accordance with accounting principles generally accepted (GAAP or R.O.C. GAAP) in the Republic of China (R.O.C. or Taiwan), which differ in some material respects from accounting principles generally accepted in the United States of America (U.S. GAAP) as further explained under note 30 to our consolidated financial statements included herein.

	Year ended and as of December 31,					
	2002	2003	2004	2005	2006	2006
	NT$	NT$	NT$	NT$	NT$	US$
	(in millions, except for percentages, earnings per share and per ADS, and operating data)					
Income Statement Data:						
R.O.C. GAAP						
Net sales	162,301	202,997	257,213	266,565	317,407	9,739
Cost of sales	(109,988)	(128,113)	(141,394)	(148,362)	(161,597)	(4,958)
Gross profit	52,313	74,884	115,819	118,203	155,810	4,781
Operating expenses	(20,724)	(23,583)	(27,337)	(27,234)	(28,545)	(876)
Income from operations	31,589	51,301	88,482	90,969	127,265	3,905
Non-operating income and gains(1)	2,350	5,669	8,581	9,399	9,705	298
Non-operating expenses and losses(1)	(6,717)	(5,791)	(5,097)	(6,105)	(3,608)	(111)
Income before income tax and minority interest	27,222	51,179	91,966	94,263	133,362	4,092
Income tax benefit (expense)	(5,637)	(3,923)	363	(630)	(7,774)	(238)
Income before cumulative effect of changes in accounting principles	21,585	47,256	92,329	93,633	125,588	3,854
Cumulative effect of changes in accounting principles					1,607	49

Income before minority interest	21,585	47,256	92,329	93,633	127,195	3,903
Minority interest in loss (income) of subsidiaries	25	3	(13)	(58)	(185)	(6)
Net income attributable to shareholders of the parent	21,610	47,259	92,316	93,575	127,010	3,897
Basic earnings per share(2)	0.82	1.82	3.58	3.63	4.93	0.15
Diluted earnings per share(2)	0.82	1.82	3.58	3.63	4.92	0.15
Basic earnings per ADS equivalent(2)	4.09	9.09	17.89	18.16	24.63	0.76

	Year ended and as of December 31,					
	2002	**2003**	**2004**	**2005**	**2006**	**2006**
	NT$	**NT$**	**NT$**	**NT$**	**NT$**	**US$**
	(in millions, except for percentages, earnings per share and per ADS, and operating data)					
Diluted earnings per ADS equivalent(2)	4.09	9.09	17.88	18.15	24.60	0.75
Basic weighted average shares outstanding(2)	25,880	25,883	25,804	25,763	25,789	25,789
Diluted weighted average shares outstanding(2)	25,880	25,893	25,810	25,776	25,813	25,813
U.S. GAAP						
Net sales	162,990	203,600	260,035	267,028	317,979	9,757
Cost of sales	(115,374)	(133,493)	(154,785)	(161,808)	(179,175)	(5,498)
Operating expenses(3)	(21,154)	(27,369)	(32,191)	(32,764)	(37,050)	(1,137)
Income from operations	26,462	42,738	73,059	72,456	101,754	3,122
Income before income tax and minority interest	20,210	42,441	76,838	75,983	106,647	3,272
Income tax expense	(5,638)	(3,881)	(508)	(483)	(10,954)	(336)
Cumulative effect of changes in accounting principles					38	1
Net income	14,534	38,661	76,253	75,418	95,711	2,937
Cumulative preferred dividends	(455)	(184)				
Income attributable to common shareholders	14,079	38,477	76,253	75,418	95,711	2,937
Basic earnings per share(4)	0.57	1.55	3.04	2.98	3.73	0.11
Diluted earnings per share(4)	0.57	1.55	3.04	2.98	3.73	0.11
Basic earnings per ADS equivalent(4)	2.85	7.74	15.22	14.90	18.67	0.57
Diluted earnings per ADS equivalent(4)	2.85	7.74	15.22	14.89	18.66	0.57
Basic weighted average shares outstanding(4)	24,691	24,847	25,044	25,308	25,629	25,629
Diluted weighted average shares outstanding(4)	24,691	24,857	25,050	25,320	25,650	25,650
Balance Sheet Data:						
R.O.C. GAAP						
Working capital(1) (5)	62,705	136,121	120,574	177,179	213,457	6,550
Long-term investments(1)	10,635	10,748	38,058	42,383	53,895	1,654
Properties	246,498	211,854	258,911	244,823	254,094	7,797
Goodwill	10,159	8,721	7,116	6,011	5,985	184
Total assets	390,542	407,401	499,454	519,510	587,485	18,027
Long term bank borrowing	11,051	8,800	1,915	663	654	20
Long-term bonds payable	35,000	30,000	19,500	19,500	12,500	384
Guaranty deposit-in and other liabilities(5)(6)	8,710	8,876	15,079	17,986	18,333	563
Total liabilities	94,594	78,098	100,413	73,271	78,347	2,404
Capital stock	199,229	202,666	232,520	247,300	258,297	7,926
Cash dividend on common shares			12,160	46,504	61,825	1,897
Shareholders equity attributable to shareholders of the parent	295,853	329,214	398,965	445,631	507,981	15,587

Minority interest in subsidiaries	95	89	76	608	1,157	36
U.S. GAAP						
Goodwill	47,476	47,287	46,757	46,993	46,940	1,440
Total assets	420,528	439,853	536,286	558,919	626,108	19,212
Total liabilities	96,747	81,977	108,416	80,962	92,549	2,840
Capital Stock	186,229	202,666	232,520	247,300	258,297	7,926
Mandatory redeemable preferred stock	13,000					
Shareholders equity attributable to common shareholders of the parent	310,623	357,173	427,125	477,297	532,403	16,336
Minority interest in subsidiaries	158	703	745	660	1,156	36

-3-

Table of Contents

	Year ended and as of December 31,					
	2002	2003	2004	2005	2006	2006
	NT$	NT$	NT$	NT$	NT$	US$
	(in millions, except for percentages, earnings per share and per ADS, and operating data)					
Other Financial Data:						
R.O.C. GAAP						
Gross margin	32%	37%	45%	44%	49%	49%
Operating margin	19%	25%	34%	34%	40%	40%
Net margin	13%	23%	36%	35%	40%	40%
Capital expenditures	55,236	37,871	81,095	79,879	78,737	2,416
Depreciation and amortization	65,001	69,161	69,819	75,649	73,715	2,262
Cash provided by operating activities(1)	98,507	116,037	153,523	157,225	204,997	6,290
Cash used in investing activities(1)(7)	(62,190)	(53,702)	(148,359)	(77,652)	(119,724)	(3,674)
Cash used in financing activities(7)	(6,346)	(27,073)	(32,181)	(57,969)	(63,783)	(1,957)
Net cash inflow (outflow)	30,234	35,199	(28,687)	22,181	21,353	655
Operating Data:						
Wafer (200mm equivalent) shipment(8)	2,675	3,700	5,008	5,622	7,215	7,215
Billing Utilization Rate(9)	69%	92%	105%	94%	102%	102%

(1) As a result of the adoption of the newly released R.O.C. Statements of Financial Accounting Standards No. 34, Financial Instruments: Recognition and Measurement (R.O.C. SFAS No. 34), and R.O.C. Statements of Financial Accounting Standards No. 36, Financial Instruments: Disclosure and Presentation (R.O.C. SFAS No. 36), the balances in 2004 and 2005 were reclassified to be consistent with the classification used

in our consolidated financial statements for 2006 included herein. Amounts in 2004 reflect the reclassification of NT$2,565 million gains from non-operating expenses and losses to non-operating income and gains, NT$44 million from long-term investments to current investments in marketable financial instruments, and NT$372 million from cash used in investing activities to cash provided by operating activities. Amounts in 2005 reflect the reclassification of NT$2,331 million gains from non-operating expenses and losses to non-operating income and gains, NT$46 million from long-term investments to current investments in marketable financial instruments, and NT$212 million from cash used in investing activities to cash provided by operating activities. Balances in 2002 and 2003 were not reclassified accordingly. See note 4 to our consolidated financial statements for additional details about these new accounting standards.

(2) Retroactively adjusted for all subsequent stock dividends and employee stock bonuses.

(3) Amounts in 2006 include share-based compensation expenses as a result of the adoption of U.S. Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, effective January 1, 2006. See note 30.i. to our consolidated financial statements for additional details about this new accounting standard. Amounts in 2002, 2003, and 2005 reflect the reclassification of NT$390 million, NT$1,625 million, and NT$159 million, respectively, from

net non-operating expenses to operating expenses. Amounts in 2004 reflect the reclassification of NT$232 million from net non-operating income to operating expenses.

(4) Retroactively adjusted for all subsequent stock dividends.

(5) Amounts in 2003 reflect the reclassification of NT$727 million from current liabilities to long-term liabilities.

(6) Consists of other long term payables and total other liabilities.

(7) Amounts in 2003 reflect the reclassification of NT$300 million from cash used in investing activities to cash used in financing activities.

(8) In thousands.

(9) Billing Utilization Rate is equal to annual wafer shipment divided by annual capacity.

Exchange Rates

We publish our financial statements in New Taiwan dollars, the lawful currency of the R.O.C. In this annual report, $, US$ and U.S. dollars mean United States dollars, the lawful currency of the United States, and NT$ and dollars mean New Taiwan dollars. This annual report contains translations of certain NT dollar amounts into U.S. dollars at specified rates solely for the convenience of the reader. Unless otherwise noted, all translations from NT dollars to U.S. dollars and from U.S. dollars to NT dollars were made at the noon buying rate in The City of New York for cable transfers in NT dollars per U.S. dollar as certified for customs purposes by the Federal Reserve Bank of New York as of December 29, 2006, which was NT$32.59 to US$1.00 on that date. On April 16, 2007, the noon buying rate was NT$33.15 to US$1.00.

The following table sets forth, for the periods indicated, information concerning the number of NT dollars for which one U.S. dollar could be exchanged based on the noon buying rate for cable transfers in NT dollars as certified for customs purposes by the Federal Reserve Bank of New York.

		NT dollars per U.S. dollar		
	Average[(1)]	High	Low	Period-End
2002	34.53	35.16	32.85	34.70
2003	34.41	34.98	33.72	33.99
2004	33.37	34.16	31.74	31.74
2005	32.16	33.77	30.65	32.80
2006	32.51	33.31	31.28	32.59
October 2006	33.19	33.31	32.05	33.26
November 2006	32.81	33.16	32.35	32.35
December 2006	32.51	32.74	32.27	32.59
January 2007	32.77	32.99	32.38	32.95
February 2007	32.97	33.08	32.86	32.98
March 2007	33.01	33.13	32.84	33.01
April 2007 (through April 16, 2007)	33.10	33.15	33.05	33.15

(1) Annual averages calculated from month-end rates.

No representation is made that the NT dollar or U.S. dollar amounts referred to herein could have been or could be converted into U.S. dollars or NT dollars, as the case may be, at any particular rate or at all.

Capitalization and Indebtedness

Not applicable.

Reasons for the Offer and Use of Proceeds

Not applicable.

Risk Factors

We wish to caution readers that the following important factors, and those important factors described in other reports submitted to, or filed with, the Securities and Exchange Commission, among other factors, could affect our actual results and could cause our actual results to differ materially from those expressed in any forward-looking statements made by us or on our behalf and that such factors may adversely affect our business and financial status and therefore the value of your investment:

Risks Relating to Our Business

Since we are dependent on the highly cyclical semiconductor and microelectronics industries, which have experienced significant and sometimes prolonged periods of downturns and overcapacity, our revenues, earnings and margins may fluctuate significantly.

The semiconductor market and microelectronics industries have historically been cyclical and subject to significant and often rapid increases and decreases in product demand. Our semiconductor foundry business is affected by market conditions in such highly cyclical semiconductor and microelectronics industries. Most of our customers operate in these industries. Variations in order levels from our customers result in volatility in our revenues and earnings. From time to time, the semiconductor and microelectronics industries have experienced significant, and sometimes prolonged periods of downturns and overcapacity. Because our business is, and will continue to be, dependent on the requirements of semiconductor and microelectronics companies for our services, periods of downturns and overcapacity in the general semiconductor and microelectronics industries lead to reduced demand for overall semiconductor foundry services worldwide, including our services. If we cannot take appropriate actions such as reducing our costs to sufficiently offset declines in demand, our revenues, margin and earnings will suffer during downturns and periods of overcapacity.

Table of Contents

Decreases in demand and average selling prices for products that contain semiconductors may adversely affect demand for our products and may result in a decrease in our revenues and earnings.

A vast majority of our sales revenue is derived from customers who use our products in personal computers, communications devices and consumer electronics. Any significant decrease in the demand for these products may decrease the demand for overall global semiconductor foundry services, including our products and may adversely affect our revenues. In addition, the historical and current trend of declining average selling prices of end use applications places pressure on the prices of the components that go into these end use applications. If the average selling prices of end use applications continue to decrease, the pricing pressure on components produced by us may lead to a reduction of our revenue.

If we are unable to compete effectively in the highly competitive foundry segment of the semiconductor industry, we may lose customers and our profit margin and earnings may decrease.

The markets for our foundry services are highly competitive both in Taiwan and internationally. We compete with other dedicated foundry service providers, as well as integrated device manufacturers. Some of these companies may have access to more advanced technologies and greater financial and other resources than us. Our competition may, from time to time, also decide to undertake aggressive pricing initiatives in one or more technology nodes. Competitive activities may cause us to lose customers or to decrease our average selling prices.

If we are unable to remain a technological leader in the semiconductor industry, we may become less competitive.

The semiconductor industry and the technologies used in it are constantly changing. If we do not anticipate these changes in technologies and rapidly develop new and innovative technologies or our competitors unforeseeably gain sudden access to more advanced technologies, we may not be able to provide advanced foundry services on competitive terms. Although we have concentrated on maintaining a competitive edge in research and development, if we fail to achieve advances in technology or processes, or to obtain access to advanced technologies or processes developed by others, we may become less competitive.

If we are unable to manage our expansion and the modification of our production facilities effectively, our growth prospects may be limited.

We have been ramping up production at Fab 12 and Fab 14, our 300mm wafer fabs in the Hsinchu Science Park and in the Southern Taiwan Science Park, respectively, since 2004. In 2006, with the commencement of commercial production at Fab 14 (Phase II) and as a result of our ramping up efforts, the capacity of our 300mm wafer fabs increased from 68,000 wafer per month to 93,700 wafer per month at Fab 12 and Fab 14.

Although we have studied the potential effects of vibration from the high speed railway passing through the Southern Taiwan Science Park and believe that the vibrations are not affecting our yield rates for production in the Southern Taiwan Science Park, we can give no assurances that our yields will not be negatively affected by the continued operation of the high-speed railway.

Expansion and modification of our production facilities will, among other factors, increase our costs. For example, we will need to purchase additional equipment, train personnel to operate the new equipment or hire additional personnel. In addition, we may incur other expenditures resulting from any negative effects of the high-speed railway on our expansions in the Southern Taiwan Science Park. If we do not increase our net sales accordingly in order to offset these higher costs, our financial performance may be adversely affected.

We may not be able to implement our planned growth or development if we are unable to accurately forecast and sufficiently meet our future capital requirements.

Capital requirements are difficult to plan in the highly dynamic, cyclical and rapidly changing semiconductor industry. We will continue to need significant capital to fund our operations and growth. Although we currently have adequate financial resources and excellent relations with financial institutions who are willing to consider extending credit to us if needed on market terms, our continued ability to obtain sufficient external financing in the future is subject to a variety of uncertainties, including:

Table of Contents

- our future financial condition, results of operations and cash flow;
- general market conditions for financing activities by semiconductor companies; and
- economic, political and other conditions in Taiwan and elsewhere.

Sufficient external financing may not be available to us on a timely basis, on general market terms, or at all. As a result, we may be forced to curtail our expansion and modification plans or delay the deployment of new or expanded services until we obtain such financing.

We may not be able to implement our planned growth or maintain our leading position if we are unable to recruit and retain qualified management and skilled technical and service personnel.

We depend on the continued services and contributions of our executive officers and skilled technical and other personnel. Our business could suffer if we lose, for whatever reasons, the services and contributions of some of these personnel and we cannot adequately replace them. We may be required to increase the number of employees in connection with any business expansion, and since there is intense competition for the recruitment of these personnel, we cannot ensure that we will be able to fulfill our personnel requirements in a timely manner.

We may be unable to obtain in a timely manner and at a reasonable cost the equipment necessary for us to remain competitive.

Our operations and ongoing expansion plans depend on our ability to obtain a significant amount of equipment and related services from a limited number of suppliers in a market that is characterized, from time to time, by intense demand, limited supply and long delivery cycles. During such times, supplier-specific or industry-wide lead times for delivery can be as long as four to ten months or more. Supplier-specific or industry-wide shortages of equipment could result in an increase in equipment prices and longer delivery times. If we are unable to obtain equipment in a timely manner and at a reasonable cost, we may be unable to fulfill our customers orders, which could negatively impact our financial condition and results of operations.

Our revenue and profitability may decline if we are unable to obtain adequate supplies of raw materials in a timely manner and at reasonable prices.

Our production operations require that we obtain adequate supplies of raw materials, such as silicon wafers, gases, chemicals, and photoresist, on a timely basis. Shortages in the supply of some materials experienced by specific vendors or by the semiconductor industry generally have in the past resulted in occasional industry-wide price adjustments and delivery delays. Also, since we procure some of our raw materials from sole-source suppliers, there is a risk that our need for such raw materials may not be timely met. Our revenue and earnings could decline if we are unable to obtain adequate supplies of the necessary raw materials in a timely manner or if there are significant increases in the costs of raw materials that we cannot pass on to our customers.

If the Ministry of Economic Affairs uses a substantial portion of our production capacity, we will not be able to service our other customers.

According to our agreement with the Industrial Technology Research Institute of Taiwan, or ITRI, the Ministry of Economic Affairs of the R.O.C., or an entity designated by the Ministry of Economic Affairs, has an option to purchase up to 35% of certain of our capacity. Although the Ministry of Economic Affairs has never exercised this option, if this option is exercised to any significant degree during tight market conditions, we may not be able to provide services to all of our other customers unless we are able to increase our capacity accordingly or outsource such increased demand and in a timely manner.

Any inability to obtain, preserve and defend our technologies and intellectual property rights could harm our competitive position.

Our ability to compete successfully and to achieve future growth will depend in part on the continued strength of our intellectual property portfolio. There can be no assurance that, as our business or business models expand into new areas, we will be able to independently develop the technology, trade secrets, software or know-how necessary to conduct our business or that we can do so without infringing the intellectual property rights of others. We may have to rely increasingly on licensed technology from others. To the extent that we rely on licenses from others, there can be no assurance that we will be able to obtain all of the licenses we desire in the future on terms we consider reasonable or at all. The lack of necessary licenses could expose us to claims for damages and/or injunctions from third parties, as well as claims for indemnification by our customers in instances where we have contractually agreed to indemnify our customers against damages resulting from infringement claims. We have received, from time-to-time, communications from third parties asserting that our technologies, manufacturing processes, the design of the integrated circuits made by us or the use by our customers of semiconductors made by us may infringe their patents or other intellectual property rights. And, because of the nature of the industry, we may continue to receive such communications in the future. In some instances, these disputes have resulted in litigation. While we actively enforce and protect our intellectual property rights, there can be no assurance that our efforts will be adequate to prevent the misappropriation or improper use of the protected technology, trade secret, software or know-how.

If we fail to obtain or maintain certain government, technology or intellectual property licenses and, if litigation relating to alleged intellectual property matters occurs, it could prevent us from manufacturing or selling particular products or applying particular technologies, which could reduce our opportunities to generate revenues. See Item 8. Financial Information Legal Proceedings for a further discussion.

We are subject to the risk of loss due to explosion and fire because some of the materials we use in our manufacturing processes are highly combustible.

We and many of our suppliers use highly combustible and toxic materials in manufacturing processes and are therefore subject to the risk of loss arising from explosion, fire, or environmental excursions which cannot be completely eliminated. Although we maintain many overlapping risk prevention and protection systems, as well as comprehensive fire and casualty insurance, including insurance for loss of property and loss of profit resulting from business interruption, our risk management and insurance coverage may not be sufficient to cover all of our potential losses. If any of our fabs were to be damaged or cease operations as a result of an explosion, fire, or environmental excursions, it could reduce our manufacturing capacity and may cause us to lose important customers, thereby having a potentially material adverse impact on our financial performance.

Any impairment charges may have a material adverse effect on our net income.

Under R.O.C. GAAP and U.S. GAAP, we are required to evaluate our equipment and other long-lived assets for impairment whenever there is an indication of impairment. If certain criteria are met, we are required to record an impairment charge. We are also required under R.O.C. GAAP and U.S. GAAP to evaluate goodwill for impairment at least on an annual basis or whenever a triggering event or an indication of impairment occurs.

We currently are not able to estimate tign:left;">

Doug Scovanner - ***Target Corporation - EVP and CFO***

Yes, with respect to total receivables, some time in next several months next couple of months, we will cross over with receivables about equal to last year s levels, on a gross basis. Obviously, with our larger allowance this year, on a net basis, that s obviously different timing. By the time we get into the back half of the year, by the time we get to the end of the year, I continue to expect gross receivables to be down somewhere in the $0.5 billion to $1 billion range. There are obviously a lot of factors that will affect that outcome. Please don t be too harsh if we end up somewhat outside of either end of that range. There actually, could be some very favorable dynamics that would cause us to be outside of that range.

On your question about early stage delinquencies and how that flows through to write-offs. I think that in many cases, our portfolio over time is showing some signs that will end up flowing into many of the money center bank portfolios later. The issue that you re describing was a profoundly important issue for us three to six months ago. As our late stage delinquency and write-off experience was far worse relative to early stage delinquencies than it had been historically. I don t think you need to look any farther than the quarter

just ended, in which we correctly assessed the flow rates across these different levels of delinquencies and predicted, within a fraction of 1%, what our net write-offs for the quarter would be. And I feel quite good about making the same second quarter prediction about net write-offs that we made 90 days ago.

So, I think ultimately, you re seeing at minimum some stability in our portfolio. Perhaps some net improvement, as we get out later in the year this this net write-off statistic. Our enthusiasm is only tempered by a continued deterioration in some of the macroeconomic statistics that are tightly correlated with write-offs. If it weren t for expectations of further deterioration in unemployment rates, we d be little more bullish about our likely net write-off experience in the third and fourth quarters.

Wayne Hood ***- BMO Capital Markets - Analyst***

And my second question, Doug, relates to the prototype stores. Do you have any refinement in the capital costs around those remodels, both maybe from a capital standpoint and then just a pure labor expense standpoint? And as you think about that, does that you roll those out in 10, whatever number it may be, does it change the leverage point at which you think you can lever comps? And then, how when can we expect the inventory start to flowing through the P&L or through your bash balance sheet, as you begin to prepare for that?

Doug Scovanner - *Target Corporation - EVP and CFO*

Several points there. Generally, as we have incorporated all of our newest thinking into our new store prototypes, the increment of capital compared to our discount stores in the past, runs in the range of $1 million. As we think about how much capital we would invest per store to remodel existing discount stores, the number ranges beyond that figure, as we incorporate other elements of remodeling throughout the store. Because once we re into a store, it just makes a lot of sense to take care of some other unrelated things. While there s a wide range, I think that it s safe to say, give or take, $3 million is probably a good working figure, at this point, per copy.

Your leverage income is a fascinating one because on the one hand, certainly there s expense related to execution and there s some increment of ongoing expense. But of course, the denominator is changing as well. There s a lot of extra sales. After all, we wouldn t be doing this if it didn t drive meaningfully higher sales. Net-net, once we get a little deeper into this year, we ll pull together analytically all the pieces of that analysis and talk about it. And while it s margin, it s an interesting issue. Big picture, this is not some kind of fundamental driver of earnings in the short run that you should have any concern about.

On your inventory question, at the margin, of course, this is much faster turning product than the average product in our stores. And therefore, even though it adds a modest amount to inventories, it will add a commensurately modest amount to payables. And so, it really isn t the cash flow issue nor any kind of inventory that carries any form of fashion risk.

Wayne Hood - *BMO Capital Markets - Analyst*

Thank you, Doug.

Operator

Your next question comes from the line of Deborah Weinswig with Citi.

Deborah Weinswig - *Citigroup - Analyst*

Good morning and congratulations on the quarter. A few questions. One, I know you haven t broken it out historically, but how should we think about your comp on your grocery related merchandise? And also, with food becoming an increasingly important category, can you some shed light on what you re doing to drive your price message? And some of the food retailers are now offering free food or other significant discounts to drive traffic and share.

Doug Scovanner - *Target Corporation - EVP and CFO*

Food is still of course, only 15% of our overall sales. So, it s today, considerably smaller than home or apparel to pick a few nuts or random examples. Obviously, it s growing faster. And in our case, even against the backdrop of a negative 3.7% combined same store sales experience in Q1, across the board, we were quite positive in food categories. Quite positive in RX. Quite positive in OTC. So, these frequency building categories continue to drive very interesting and highly and perfectly acceptable same store sales performance.

Gregg Steinhafel - *Target Corporation - Chairman, President and CEO*

The promotional intensity and the frequency by which competitors use food to draw traffic, is really not that dissimilar to what we ve already been experiencing in other nonfood commodity categories, whether it s household chemicals or paper goods. So, there are a garden variety of ways to promote food and other frequency categories. I would tell you that first and foremost, we re committed to maintaining an every day competitive position in the marketplace. Just like we have for decades in our nonfood categories. And so, we re going to be focused in ensuring that, day in and day out, our food prices are equal to or better than our primary competitor, which is Wal-Mart. And then, we will deploy the same kinds of promotional tactics, as we have traditionally, as it relates to exposing and promoting food. So, we ll look at opportunities in print, with our circular, or direct mail pieces. When we have the right kind of critical mass in certain markets, we will develop broadcast campaigns to convey that or even receipt marketing campaigns. So, we ll use the entire Target tool box to promote food, as we increase its presence and density, as we roll out PFresh into more stores throughout this year. And then, into 2010 and beyond.

Deborah Weinswig - *Citigroup - Analyst*

And then, the home category has been quite strong at a lot of your competitors. Can you just talk about your trends in the category and what you expect to see going forward as well?

Gregg Steinhafel - *Target Corporation - Chairman, President and CEO*

Well, I m not sure what quite strong means. I think that what has been described as the deeply negative same store sales, have become less negative or perhaps in some time frames, they may even have become slightly positive. So, it s still really not a healthy industry, overall. And part of the same store sales increases or decreases depend upon the base period of analysis. And what we re seeing is, there is underlying stability and our business is less negative than it has been in the past. But as Kathy described, it s more about the replacement part of the business. So, we re selling more sheets and towels and pillows and pillow cases. And we re doing less redecorating of rooms or full lifestyle kinds of merchandising. So, it s still under pressure because it s such a highly discretionary category. But we have seen some signs of stability and some categories are actually performing better than they have in the past. So, it s getting better, it s still not where we would like it to be.

Deborah Weinswig - *Citigroup - Analyst*

Okay.

Kathy Tesija - *Target Corporation - EVP Merchandising*

One other thing that I d add to that, Deborah, is just some of the categories, with families eating out less and staying home more, we re seeing some of those categories pop in home. Cookware or pantryware, things of that nature that allow them to do more cooking at home or entertaining of their friends.

Gregg Steinhafel - *Target Corporation - Chairman, President and CEO*

Operator, we probably have time for one more question to hit our time slot.

Operator

Your final question comes from the line of Dan Binder with Jefferies.

Dan Binder - ***Jefferies & Co. - Analyst***

Hi, good morning and congratulations on a good quarter in a tough environment. My questions pertain to credit. I wanted to try and better understand what the likelihood, if any, is that we see the reserve for bad debts come in at a lower pace than write-offs going forward? Obviously, you ve reserved well in excess of write-offs and presumably at some point, that can reverse. I m just curious if you can give us a little bit of color on that? And then, secondly, as it pertains to the spreads over LIBOR that you achieved in Q1, well known at this point. I was wondering if you could share with us, your thoughts of what that might look like going forward and taking into consideration some of the policy changes recently?

Doug Scovanner - ***Target Corporation - EVP and CFO***

Well, those of course are related questions. To the extent that we expense less than we write-off, our spread to LIBOR will increase and our allowance would decrease. Back to some of my earlier remarks, today we have just a shade over $1 billion in our allowance. Clearly, if I looked solely at our internal metrics, I would be very encouraged about the likelihood of reserve reductions later in the year. As this early stage delinquency favorability that we re currently experiencing, to a fairly substantial extent, would flow through our thinking and our assessment of the future write-off potential of our portfolio at the end of Q2, at the end of Q3 and so forth.

I only temper that enthusiasm for fairly meaningful potential decreases in our allowance, by observing that it s a tough world out there and it s a tough world in a lot of respects. It is a tough world, especially, in employment and unemployment statistics, which have historically been very highly correlated with industry write-off metrics. Separately but in a highly related sense, currently, our net write-off experience is being

---

adversely affected buying by aggravated levels of personal bankruptcy. Much harder to predict the timing of how that flows through our portfolio, than the more scientific approach to figuring out the portion of gross write-offs due to aging.

But net-net, clearly, the reserve is not likely to increase. The question is; To what extent and over what time might it decrease? We ll stay on top of this and be as clear as we can moving forward. But certainly, there s some potential for some interesting developments in this portfolio. Favorable developments, from a profitability and a spread to LIBOR sense, to the extent that we feel comfortable that it s appropriate to reduce the reserve in light of improving risk metrics, if that were to occur in the back half of the year. And I think Gregg has a few concluding remarks and we ll let everyone get back to their day. Thank you.

Gregg Steinhafel - *Target Corporation - Chairman, President and CEO*

That concludes Target s first quarter 2009 earnings conference call. Thank you all for your participation and ongoing support for our strategy, management and Board.

Operator

This concludes today s conference call. You may now disconnect.