

Management's Discussion and Analysis of Operations

1. Overall Results

In fiscal 2000, for Advantest and other companies in the electronics industry, the advancing digital society has required aggressive infrastructure investment in the areas of cellular telephones, next generation high-speed data communication, and information technology, and has made some semiconductors and electronic components obsolete. But conditions have reversed since the start of the year for the semiconductor and electronic component markets due to falling demand.

In order to adapt to these increasingly severe market conditions and respond to 2nd generation IT (broadband) product needs, Advantest has worked to quickly introduce new products and further increase customer satisfaction. As a result, we have achieved our best record for consolidated net sales of ¥276,512 million in fiscal year 2000, a 74.4% increase over the previous fiscal year. Net income was ¥53,121 million (a 154.1% increase).

2. Results of Operations Overview

(1) Sales

Advantest's net sales increased by ¥117,934 million, or 74.4%, compared with fiscal 1999 to ¥276,512 million in fiscal 2000.

(2) Operating Expenses

Advantest's operating expenses increased by ¥67,831 million, or 54.8% compared to fiscal 1999 to total ¥191,607 million in fiscal 2000. This increase principally reflects increases in cost of sales in an amount proportional to the increase in net sales and increased research and development expenses.

(Costs of sales)

Cost of sales increased ¥51,381 million, or 69.8%, compared to fiscal 1999 to ¥125,028 million in fiscal 2000. This increase consists of an increase of ¥46,904 million, or 78.7%, for the automated test equipment segment and an increase of ¥4,477 million, or 32.0%, for the measuring instruments segment.

Cost of sales as a percentage of net sales of automated test equipment was 44.1% in fiscal 2000 and remained relatively flat compared to fiscal 1999. The largest portion of Advantest's cost of sales for its automated test equipment consists of costs of parts and components. Advantest's fixed costs, consisting primarily of depreciation and amortization and compensation to full-time employees, as a percentage of net sales decreased as capacity utilization of Advantest's manufacturing facilities and personnel increased. Advantest has made efforts over time to reduce fixed costs by increasing outsourcing of production, the use of temporary workers and the use of automation and information technology in its manufacturing processes. This decrease in the cost of sales as a percentage of net sales was offset by an increase in outsourcing costs, costs related to temporary employees and inventory write downs. Advantest's inventory write downs increased by ¥5,718 million, or 314.7% compared to fiscal 1999 to ¥7,535 million in fiscal 2000. This increase is primarily attributable to higher amounts of slow moving raw materials due to current adverse trends in demand for Advantest's products, particularly semiconductor test systems, the discontinuation of semiconductor test system product lines, consisting mainly of product lines replaced by new product lines, and valuation reserves taken for used equipment.

Cost of sales as a percentage of net sales of measuring instruments decreased from 61.3% in fiscal 1999 to 52.8% in fiscal 2000. This decrease was primarily due to increased efficiency in

Advantest's use of manufacturing facilities and personnel.

(Research & Development Expenses)

Research and development expenses increased by ¥5,060 million, or 21.5% compared to fiscal 1999 to ¥28,541 million in fiscal 2000. This reflects increased investments in the development of new products, in particular SoC semiconductor test systems, and enhancements to existing product lines.

(Selling, General and Administrative Expenses)

Selling, general and administrative expenses increased by ¥11,390 million, or 42.7%, compared to fiscal 1999 to ¥38,038 million in fiscal 2000. This increase includes a ¥3,650 million, or 90.0% increase in product warranty expenses compared to fiscal 1999 to ¥7,753 million in fiscal 2000. The increase in product warranty costs is primarily a result of increased sales of semiconductor test system units. The increase in other selling, general and administrative expenses is primarily attributable to increased costs related to overseas sales and selling expenses of overseas subsidiaries for sales of automated test equipment, increased amortization expense relating to Advantest's new information management system installed in May 2000 and smaller increases in rent expense.

(3) Operating Income

Operating income increased by ¥50,103 million, or 144.0%, compared to fiscal 1999 to total ¥84,905 million in fiscal 2000. Operating income of the automated test equipment segment increased by ¥45,690 million, or 112.2%, compared to fiscal 1999 to ¥86,413 million in fiscal 2000. Operating margins increased from 30.0% in fiscal 1999 to 35.8% in fiscal 2000 primarily as a result of improvements in the ratio of selling, general and administrative expenses to net sales. Operating income of measuring instruments segment increased by ¥6,740 million compared to fiscal 1999 to a profit of ¥6,672 million in fiscal 2000. This increase in operating income is primarily the result of increased efficiency in the use of Advantest's manufacturing capacity.

(4) Other Income and Expenses

Interest income increased by ¥294 million, or 52.1%, compared to fiscal 1999 to ¥858 million in fiscal 2000. This increase was primarily due to an increase in the proportion of funds held in foreign currency accounts where interest rates are higher than rates in Japan. Interest expense decreased by ¥129 million, or 16.9%, compared to fiscal 1999 to ¥635 million in fiscal 2000. This decrease was primarily due to lower average balance of long-term debt outstanding during fiscal 2000 compared to fiscal 1999. Other income increased by ¥2,296 million from a loss of ¥1,079 million in fiscal 1999 to income of ¥1,217 million in fiscal 2000. This increase in other income resulted primarily from foreign exchange gains in the amount of ¥1,127 million in fiscal 2000 compared to foreign exchange losses of ¥1,582 million in fiscal 1999. In fiscal 2000, foreign exchange gain was favorably impacted compared to the previous year primarily as a result of the trend of the weakening of the yen, particularly against the U.S. dollar, during the second half of the fiscal year.

(5) Net Income

Advantest's effective tax rate was 37.6% in fiscal 1999 compared to 38.5% in fiscal 2000. Advantest's normal tax rate was 41.6% for both fiscal 1999 and fiscal 2000. The difference between the normal tax rate and the effective tax rate was

primarily due to lower tax rates imposed at foreign subsidiaries and tax credits received and utilized, offset by non-deductible expenses for income tax purposes.

Advantest's net income increased by ¥32,216 million, or 154.1%, compared to fiscal 1999 to total ¥53,121 million in fiscal 2000.

3. Segment Information

Segment Information by Business

Net sales for both automated test equipment and measuring instruments increased considerably in fiscal 2000.

(Automated Test Equipment)

In fiscal 2000, net sales from Advantest's automated test equipment segment accounted for 87.3% of total net sales. Net sales from the automated test equipment segment increased by ¥105,771 million or 77.9%, compared to fiscal 1999 to total ¥241,499 million in fiscal 2000.

Net sales of memory semiconductor test system increased ¥84,350 million, or 150.3%, compared to fiscal 1999 to ¥140,486 million in fiscal 2000. This increase was generally attributable to volume increases in product sold, and in particular the sales volume of new semiconductor test systems introduced in the second half of fiscal 1999 and during fiscal 2000. The success of Advantest's new memory semiconductor test systems resulted in Advantest significantly increasing its market share in memory semiconductor test systems during a period when total market sales increased by over 60%.

Net sales of test handlers increased by ¥19,927 million or 62.7% compared to fiscal 1999 to ¥51,710 million in fiscal 2000, reflecting the increase in number of semiconductor test system units sold.

Net sales for non-memory semiconductor test systems increased by ¥2,132 million, or 5.5% compared to fiscal 1999 to ¥41,191 million in fiscal 2000. This increase was generally attributable to a full year of sales of the T6672 as compared to a half year in fiscal 1999, and the release of the T6500 series during the second half of fiscal 2000, partially offset by lower sales of other non-memory semiconductor test systems.

These increases were offset by a ¥638 million, or 7.3%, decrease in net sales of Advantest's other products in the automated test equipment segment compared to fiscal 1999 to ¥8,112 million in fiscal 2000.

(Measuring Instruments Segment)

Advantest's measuring instruments segment had a record level of net sales in fiscal 2000. Net sales from this segment increased by ¥12,163 million, or 53.2% compared to fiscal 1999 to ¥35,013 million in fiscal 2000.

Net sales of fiber optic communications measuring instruments increased by ¥7,562 million, or 106.6%, compared to fiscal 1999 to ¥14,655 million in fiscal 2000. This increase was primarily attributable to continued growth in investment levels in fiber optic communications networks in Japan and, to a lesser extent, the United States.

Net sales for measuring instruments for the wireless communications industry (including RF component measuring

instruments) increased by ¥2,489 million, or 26.6%, compared to fiscal 1999 to total ¥11,853 million in fiscal 2000. This increase was primarily attributable to increased sales to Japanese communications equipment and component manufacturers for networks based on current, as well as third-generation, technologies.

Net sales from the sale of Rohde & Schwarz measuring instruments also increased by ¥2,166 million, or 74.6% compared to fiscal 1999 to total ¥5,069 million. This increase was primarily attributable to a general increase in the number of units sold.

These increases were partially offset by a ¥54 million, or 1.5%, decline in net sales of Advantest's general measuring instruments compared to fiscal 1999 to ¥3,436 million in fiscal 2000. This decrease was primarily attributable to the effect of a general decrease in global consumer spending levels during the year on electronic consumer products.

Segment Information by Region

Advantest achieved increases in net sales in every geographic region, with sales in Asia (excluding Japan) experiencing the largest increase.

(Asian Region Excluding Japan)

Net sales in Asia increased by ¥78,676 million, or 128.4% compared to fiscal 1999 to ¥139,936 million in fiscal 2000. This increase was primarily attributable to increased sales of Advantest's automated test equipment in Singapore, South Korea, and Taiwan. Net sales in Singapore and South Korea are highly concentrated.

(Japan)

Net sales in Japan increased by ¥12,521 million, or 18.9% compared to fiscal 1999 to ¥78,649 million in fiscal 2000. This increase was primarily attributable to increased sales of measuring instruments to the fiber optic and wireless communication industry in Japan, and to a lesser extent, increased sales of automated test equipment. Net sales in Japan fell as a percentage of total net sales from 41.7% in fiscal 1999 to 28.4% in fiscal 2000. The slower growth rate in net sales in Japan compared to the rest of Asia and other regions resulted from a fall in Japanese semiconductor production as a percentage of worldwide semiconductor production in fiscal 2000. Recently, Japanese semiconductor manufacturers have started to shift their manufacturing to production facilities and foundries in other parts of Asia.

(North America)

Net sales in North America increased by ¥17,883 million, or 78.4% compared to fiscal 1999 to total ¥40,700 million in fiscal 2000. This increase was primarily attributable to increased sales of automated test equipment to semiconductor manufacturers in the United States and, to a significantly lesser extent, increased sales of measuring instruments to the fiber optic communications industry.

(Europe)

Net sales in Europe increased by ¥8,854 million, or 105.7% compared to fiscal 1999 to total ¥17,227 million in fiscal 2000. This increase was primarily attributable to increased sales of automated test equipment to Advantest's largest European customer.

4. Financial Condition

The total assets of the company at the end of fiscal 2000 were greater by ¥86.5 billion yen over the previous year, to ¥ 407.4 billion.

This increase was primarily attributable to the increase in current assets such as accounts receivable and inventory. Inventory increased by ¥25.7 billion, to ¥82.2 billion, due to a decrease in new orders for semiconductor test equipment that started in January 2001, and the cancellation of orders and delivery postponements.

Total liabilities at the end of fiscal 2000 were greater by ¥33.2 billion over the previous year, to ¥139.4 billion. This increase was primarily attributable to the increase in current liabilities along with the increase in tax liabilities and the allowance for product warranties. Stockholders' equity at the end of fiscal 2000 were increased by ¥53.3 billion compared to the previous year, to ¥267.9 billion.

ROE improved to 10.17% compared to the previous year's ROE of 22.02%.

5. Capital Expenditure

Total capital expenditures increased by ¥5,811 million, or 89.8% compared to fiscal 1999, to total ¥12,280 million in fiscal 2000. Advantest expects capital expenditures to increase to approximately ¥19.6 billion in fiscal 2001. Advantest's largest capital expenditures during fiscal 2000 consisted of investments in facilities and equipment for its research and development and manufacturing activities.

Expected capital expenditures in fiscal 2001 include:

- ¥5.1 billion on equipment for research and development and manufacturing;
- ¥5.1 billion allocated to equipment used in the test equipment leasing program;
- ¥2.9 billion on research and development facilities; and
- ¥2.1 billion for expansion of the Gunma measuring instruments plant.

In light of the significant decrease in demand for products during 2001, Advantest may elect to postpone a portion of its planned capital expenditures until a later date.

6. Cash Flows

Advantest's cash and cash equivalents balance increased by ¥5,089 million in fiscal 2000, to total ¥123,542 million as of March 31, 2001.

Net cash provided by operating activities was ¥29,597 million in fiscal 2000, compared to ¥21,707 million in fiscal 1999. The increase was primarily attributable to the increase in net income, income taxes payable and accrued expenses, offset to some extent by an increase in outstanding amounts of accounts receivable and inventories.

Net cash used for investing activities was ¥16,130 million in fiscal 2000, compared to ¥9,080 million in fiscal 1999. This increase was mainly due to increased expenditures for property, plant and equipment such as construction of the Gunma R & D Center II (¥2.1 billion).

Net cash used in financing activities was ¥10,266 million in fiscal 2000, compared to ¥1,775 million in fiscal 1999. The

increase was primarily attributable to the outlay of funds from the redemption of our 1st unsecured corporate bond (¥10 billion) and dividend payments (¥4.4 billion), but partially offset by proceeds from the issuance of our 3rd unsecured warrant bond (¥4.5 billion).

7. Corporate Governance

We are advocating continuous management innovation and are making aggressive efforts to achieve positive results. In fiscal 2000, we established a system to objectively analyze company management, by setting a specific management AVA (Advantest Value Added) target and by establishing a new cost control method, ABCM, as well as enhancing development, productivity and sales systems together with the restructured basic information system. We are also implementing an incentive system based on the company's results as well as the individual's contribution. The merit based bonus system is designed to encourage employees to pay attention to the company's financial status while motivating them to improve productivity.

With these reforms, we are continuing our efforts to enhance our corporate value as well as realize a greater degree of management transparency.

AVA (Advantest Value Added)

AVA stands for Advantest Value Added, the Advantest version of the widely used economic value added (EVA) model. Introduced in April 2000, it is used to establish management targets, and to determine the business efficiency of our investments. This index gives us the ability to determine the contribution to corporate value of an investment. It is only after we realize a positive AVA that we can say that an investment is truly profitable.

AVA is calculated as follows:

$$AVA = \text{operating profit after tax} - \text{capital cost}$$

We are improving our fiscal structure by introducing an independent division system with distinct profit centers and by promoting a results-oriented cash flow with the goal that all business activities of the Advantest Group increase corporate value. We will work to offer the most appropriate values for all stakeholders — shareholders, customers, and employees — by promoting the use of AVA as a management tool.

8. Outlook

Advantest has built a flexible organization able to quickly respond to changes in the market. Possessing strong financial fundamentals, the company has made an all-out effort to maintain stable personnel and research and development activities, increase investment, and maintain competitiveness even during down periods in the semiconductor market. We will accomplish this by outsourcing to reduce fixed expenses while investing in R & D and our core competencies.

Advantest's core business objectives are:

- Strengthen our position at the top of the memory and semiconductor automated test equipment market.
- Expand our share of the SoC automated test equipment market.
- Focus on developing measuring instruments that respond to the needs of high growth industries.
- Raise profitability by improving business efficiency and

performance.

To achieve these objectives, Advantest has 6 specific plans:

(1) Take the lead in responding to industry trends, ascertaining customer needs, and bringing products to market.

Advantest cooperates closely with major semiconductor manufacturers starting from the design stage for next-generation products, and understands customer needs concerning future technologies. Based on our knowledge and strong technical expertise, we work to develop high-performance automated test equipment ahead of the competition. The following strategies are examples of our efforts in the area of automated test equipment:

- Coordinate innovations in semiconductor technology achieved in memory, SoC, and other areas, and develop automated test equipment with greater testing speed and throughput performance.
- Design semiconductor test equipment for next-generation 300 mm wafers and achieve higher throughput by increasing the number of dies that can be simultaneously measured.
- Take the lead in developing products for the shift of the semiconductor industry toward a focus on die preprocessing testing.
- Use strengths in developing products and software to develop semiconductor equipment optimized to measure and evaluate flash memory, while maintaining high throughput.

(2) Strengthen the SoC automated test equipment business

Advantest believes that the SoC market has greater long-term growth prospects than other areas in the semiconductor market. Based on this belief, we have developed a full line-up of logic and semiconductor test systems that meet a wide array of SoC test needs for a large number of manufacturers. We have developed the following strategies for our SoC and other logic automated test systems business:

- Increase technical personnel by up to 1000 by 2004 for SoC automated test equipment support and work with customers to improve existing products and develop new products.
- Use a single platform for SoC test equipment to reduce research and development costs and shorten the time needed for bringing new products to market.
- Develop automated test equipment that works seamlessly with circuitry using built-in self-test technology, and work to reduce overall test costs.

(3) Always maintain our commitment to continuously developing new products.

Advantest believes that this factor is essential for the success of research and product development. We plan to continuously invest in research and development that focuses on developing fundamental technology and improving products. Our target is to reinvest at least 10% of net sales toward R&D for new products and new technologies. Over the last 5 years, we have appropriated a total of approximately ¥110 million toward research and development and we plan to continue this level of research and product development investment. It is also a possibility that Advantest will acquire other companies for the purpose of enhancing the company's research and development capability and basic technology.

(4) Focus our sales activities on our most important automated test equipment customers around the world.

The semiconductor industry is extremely concentrated. The great majority of sales for the entire semiconductor test equipment industry come from just a few major semiconductor manufacturers and businesses retained for testing. Advantest has major customers all over the world. We intend to further expand our sales to these major customers and work to develop new potential customers. To achieve this goal, we are carrying out the following specific measures:

- Open new sales offices and support centers overseas.
- Hire additional engineers in important regions outside of Japan.
- Carry out joint development activities with major semiconductor manufacturers to design and bring to market new automated test equipment.

(5) Focus our measurement instruments business on high-growth opportunities.

Advantest's Measurement Instruments Division is focusing on the performance needs of industries in the areas of optical and wireless communications and electronic components. In 1999 we released an optical spectrum analyzer, which measures wavelength dispersion and amplitude of signals transmitted through long distance subsea fiber optic lines. In June 2000 we released irregularity analyzing options to be used for the spectrum analyzer aimed at capturing market share for third-generation wireless communications protocols such as W-CDMA. NTT DoCoMo launched its third generation wireless network service using W-CDMA in Japan in the fall of 2001 and wireless service providers in other countries in Europe and Korea are expected to follow in the next several years.

(6) Strengthen cost management

To raise Advantest's corporate value, we introduced a new cost management system, ABCM (Activity Based Costing Management) that maintains a yield of at least 8% on our business investments. Under this system, employees are required to fill out daily detailed activity reports, and management uses this information to calculate the cost of each business activity and channel resources to corporate activities that achieve the requisite level of return. Activities that fail to achieve the requisite levels within a defined period of time will be reevaluated.

This system also motivates employees to contribute to the company's success by basing bonuses on business performance. Advantest links employee salaries to business performance and individual achievement to raise both employee awareness of Advantest's financial state of affairs and employee productivity. In all respects, we believe that our employees are our greatest asset and rewarding their efforts is intimately linked to raising corporate value.