



FSI INTERNATIONAL

ANNUAL REPORT

2006

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Financial Highlights:

FISCAL YEARS ENDED AUGUST (in thousands, except per share data, current ratio and number of employees)	2006 ⁽¹⁾	2005 ⁽²⁾	2004 ⁽³⁾	2003 ⁽⁴⁾	2002 ⁽⁵⁾
OPERATIONS					
Sales	\$ 113,241	\$ 86,370	\$ 114,404	\$ 88,826	\$ 143,374
Gross margin	52,850	39,994	59,020	14,508	44,375
Operating expenses	60,539	50,354	62,005	79,478	81,114
Operating loss	(7,689)	(10,360)	(2,985)	(64,970)	(36,739)
Net (loss) income	\$ (7,287)	\$ (3,302)	\$ 141	\$ (78,557)	\$ (34,663)
(Loss) earnings per share — diluted	\$ (0.24)	\$ (0.11)	\$ 0.00	\$ (2.66)	\$ (1.26)
Weighted average common shares used in per share calculations	30,042	29,928	30,315	29,546	27,450
BALANCE SHEET					
Cash, restricted cash, cash equivalents and marketable securities	\$ 26,916	\$ 31,879	\$ 42,208	\$ 43,759	\$ 63,868
Working capital	63,539	65,614	68,751	61,256	100,582
Total assets	123,737	121,939	139,797	133,386	211,770
Stockholders' equity	93,972	99,136	110,372	109,000	179,632
GENERAL DATA AND RATIO					
Capital expenditures	\$ 2,228	\$ 1,755	\$ 1,723	\$ 3,927	\$ 4,224
Depreciation and amortization	\$ 3,927	\$ 4,413	\$ 7,920	\$ 11,378	\$ 13,517
Current ratio	3.1	3.9	3.4	3.5	4.1
Number of employees	562	486	508	495	650
Backlog and deferred revenue	\$ 44,922	\$ 28,037	\$ 26,932	\$ 36,272	\$ 47,341
Book value per common share	\$ 3.10	\$ 3.32	\$ 3.69	\$ 3.68	\$ 6.10

NOTES:

- (1) Due to implementation of FAS 123R as of August 28, 2005, the Company recorded stock-based compensation expense of \$54,000 in cost of goods sold, \$743,000 in selling, general and administrative expenses and \$342,000 in research and development expenses. The Company also had sales of POLARIS® Systems and Services (PSS) product inventory with an original cost of \$2.1 million that previously had been written down to zero and an impairment charge of \$0.5 million related to an investment in a Malaysian foundry.
- (2) The Company recorded a \$7.0 million gain on the sale of the Allen, Texas facility and a gain of \$5.8 million on the Nortem (formerly Metron Technology, N.V.) (Metron) distributions. Also, the Company had sales of PSS product inventory with an original cost of \$0.5 million that previously had been written down to zero.
- (3) The Company recorded \$3.4 million of expense related to a patent litigation settlement and had sales of PSS product inventory with an original cost of \$3.2 million that previously had been written down to zero.
- (4) The Company entered into a transition agreement with Metron to terminate its distribution agreements and recorded a transition fee of \$2.75 million. In addition, the Company recorded an impairment charge of \$10.2 million in other expense related to the other than temporary impairment of its investment in Metron and the Company recorded a charge of \$19.0 million to cost of goods sold for inventory reserves related to the wind down of the Microlithography business and had sales of PSS product inventory with an original cost of \$3.0 million that previously had been written down to zero. The Company also recorded an impairment charge of \$7.0 million against the property, plant and equipment assets associated with the PSS business.
- (5) The Company recorded a charge of \$5.4 million related to impairment of goodwill and \$0.5 million in realignment charges.

Company Information:

FSI International, Inc. is a global supplier of surface conditioning equipment, technology and support services for microelectronics manufacturing. Using the Company's broad portfolio of cleaning products, which include batch and single-wafer platforms for immersion, spray, vapor and CryoKinetic technologies, customers are able to achieve their process performance, flexibility and

productivity goals. The Company's support services programs provide product and process enhancements to extend the life of installed FSI equipment, enabling worldwide customers to realize a higher return on their capital investment.

FSI maintains a web site at <http://www.fsi-intl.com>.

Letter to our shareholders

As a provider of process equipment that is used to manufacture microelectronic devices, FSI's primary customers are the leading global semiconductor manufacturers. The semiconductor industry has experienced growth for the past four consecutive years, driven principally by consumer spending on electronics, including cell phones, computers and other mobile and home entertainment products.

We supply surface conditioning equipment used to perform nearly 100 of the more than 500 total process steps required to manufacture a semiconductor device. The process steps that we address with our products include cleaning, etching and removing particles from the surface of silicon wafers.

After the technology bubble burst in 2001, we began restructuring the company with a goal of expanding into all segments of the surface conditioning market. Our strategy consisted of three major initiatives:

- convert from a third party to a direct distribution model in Europe and Asia while better aligning our product development and support initiatives with our customers' needs;
- make the investments required to expand our product portfolio so that we could participate in the larger segments of the surface conditioning market; and
- gain surface conditioning marketshare with the top 20 spenders in the semiconductor industry in an effort to leverage our technology and infrastructure investments and improve our financial performance.

As a result of our accomplishments the past few years, and more specifically in fiscal 2006, we are now a well established and globally recognized surface conditioning technology provider. Over the past year, we increased the frequency of technology roadmap exchanges with key customers, expanded the applications capability of our three flagship products and secured a "tool of record" status at several new customers. In addition, in the fourth quarter we shipped our first single wafer wet cleaning system as an entry into the fastest growing segment of the surface conditioning market. Finally, in fiscal 2006 we reported a sequential improvement in our quarterly financial performance and reported profitability in the fourth quarter.

Financial results

Sales increased 31 percent in fiscal 2006 to \$113 million as compared to \$86 million in the prior year. Our fiscal 2006 net loss was \$7.3 million, or \$.24 per share, as compared to a \$3.3 million, or \$.11 per share, loss in 2005. The fiscal 2005 net loss included a \$7.0 million gain on the sale of our Texas facility and a \$5.8 million gain on cash distributions associated with the Metron Technology N.V. sale to Applied Materials.

Orders increased 50 percent in fiscal 2006 to \$131 million as compared to \$87 million in the prior year. We experienced orders increase in all geographic regions, especially in the Asia region where year-over-year orders increased 138 percent. The resulting backlog and deferred revenue was \$45 million at the end of fiscal 2006, as compared to \$28 million at the end of 2005.

International customers accounted for 65 percent of all orders in fiscal 2006, as compared to 59 percent in the prior year. Led by stronger demand for our ZETA[®] spray processing system, orders from our customers in Asia represented 31 percent of total orders in 2006, as compared to 20 percent in the prior year.

We ended fiscal 2006 with \$27 million in cash, cash equivalents, restricted cash and marketable securities. Our year end working capital was \$64 million and our current ratio was 3.1 to 1.0. As of the end of the fiscal year, we had no debt and our book value was \$3.10 per share. We ended fiscal 2006 with 562 employees as compared to 486 employees at the end of the prior year. The increase in headcount occurred primarily in manufacturing and customer support functions as we experienced an increase in our quarterly unit shipment and installation levels during the fiscal year.

Industry

A leading industry research group is forecasting that demand for semiconductors will increase 11 percent to \$260 billion in calendar 2006 from \$235 billion in the prior year. The 2006 increase is being driven by increased demand for memory, optoelectronic and application specific standard products (or "ASSP") devices. They estimate that semiconductor device demand will increase more than 9 percent again in calendar 2007.*

The same industry research group is forecasting that total wafer fab equipment spending in 2006 will increase by more than 20 percent to over \$40 billion as compared to \$33 billion in calendar 2005. Leading industry analysts have a mixed view toward equipment spending in calendar 2007. Their forecasts range from a 10 percent decline to modest growth in calendar 2007, with an expected return to double digit growth in calendar 2008.

When comparing to prior industry cycles, device manufacturers are managing capacity increases carefully and are acting quickly to delay new equipment purchases in response to slowing demand to prevent an inventory build-up from occurring. Their quick response to changes in demand for their products should have a dampening effect on future industry cycles.*

Our available market

Our three current flagship products include our ZETA[®] Batch Spray Cleaning System, MAGELLAN[®] Batch Immersion Cleaning System and our ANTARES[®] Single Wafer CryoKinetic Cleaning System. These products are capable of performing a significant portion of semiconductor device manufacturers' surface conditioning process steps. The initial shipment of our single wafer wet cleaning system marks another milestone in the goals we established several years ago, and we now have products that address nearly all surface conditioning process steps required to manufacture an integrated circuit. Industry analysts are forecasting that the surface conditioning market will exceed \$2 billion in calendar 2006. We believe that demand for surface conditioning equipment will decline 5 to 10 percent in calendar 2007.*

A typical semiconductor device manufacturing process flow has more surface conditioning process steps than any other process. For example, a typical 90 nanometer (nm) logic device process flow can have in excess of 100 surface conditioning process steps. Many of these process steps require different technologies to achieve the desired result. Our customers select their surface conditioning process technology after balancing the importance of throughput, cost, cycle time and technical performance for each process step.

Surface conditioning process steps change as a silicon wafer progresses from transistor formation (front-end-of-line) to metal interconnect (back-end-of-line), and finally to the packaging operation within a device manufacturing fab. Process steps can be front- or back-side selective and in some cases are focused on cleaning the edge or bevel of the wafer. Other process flows may require the cleaning of either a hydrophobic or a hydrophilic wafer surface. Also, the removal of contaminants on the wafer surface can be dependent on the wafer topography and the variety of different materials used to form the device.

Positioning for the future

The immersion segment of the surface conditioning market addressed by our MAGELLAN system continues to represent more than 50 percent of the total market. From its introduction, our MAGELLAN system has demonstrated unparalleled process performance and configurability. Our proprietary STG[®] IPA dryer and MegaLens[™] Acoustic Diffuser technologies have contributed to the MAGELLAN's excellent particle removal and defectivity performance, and our novel chemical mixing capability has contributed to its etch uniformity and nitride etch selectivity performance.

As a result, during the year we added another leading semiconductor manufacturer to the MAGELLAN user base. This customer placed initial high volume manufacturing orders for shipment in fiscal 2007, and we anticipate adding additional customers during fiscal 2007.* From a development perspective, we will be enhancing the throughput capacities of this platform by more than 100 percent and expect to be capable of achieving a throughput level approaching 400 wafers per hour by mid-2007, depending upon the tool configuration.* This will position the MAGELLAN product for additional opportunities where wafer throughput is a key performance metric.*

Our ZETA[®] batch spray cleaning system has been a workhorse for customers since it was introduced. We now have over 100 systems in production at customers in all regions of the world. During the year, we increased our tool of record position with several customers and expanded the system's applications capability. For example, we introduced our patented new ViPR[™] technology on our ZETA[®] G3 platform. This application, as demonstrated in production, eliminates the need for ashing on most implanted photoresist strip steps. In addition, in 2006 we expanded the user base for salicide and contact cleaning applications on our ZETA system. We anticipate that a substantial portion of our expected revenue growth in fiscal 2007 will come from repeat and new customer orders for the ZETA system running the ViPR application.*

With the continuing trend to small feature sizes, a leading industry analyst is forecasting for calendar 2005 to 2011 a nearly 20 percent compounded annual growth for defect reduction cleaning technology. Our ANTARES[®] system addresses this segment of the market with more than 10 device manufacturers using this product in production. CryoKinetic cleaning technology is used extensively for both back-end-of-line copper cleaning applications and several front-end-of-line applications. The ANTARES system effectively removes fall-on type defects from airborne particles or from deposition, etch and chemical mechanical planarization processes. Our novel patented CryoKinetic aerosol technology cleans the wafer without inducing defects such as added particles, watermarks, streaks or surface charging that are common with alternative particle removal technologies. We are anticipating an increase in unit sales for this product in fiscal 2007 as device manufacturers ramp their 65nm production and continue qualification of products for 45nm.*

Finally, the single wafer wet technology segment represents nearly 30 percent of the total surface conditioning market and is the fastest growing segment. We shipped our first system, a product that has been under development the past two years, during the fourth quarter of fiscal 2006. This product is targeted for advanced single wafer wet applications in both the front-end and back-end-of-line manufacturing process flow. We do not expect any significant revenue from this product until next year as we focus on continuing to develop and demonstrate applications for use on this platform.*The introduction of this product does enables device manufacturers to come to FSI for nearly all their cleaning requirements.

Looking forward

Looking forward, we remain committed toward execution on our three strategic objectives, which include: meeting our commitments to our customers by providing best-of-breed product performance and world class global support; deploying a well-trained, productive workforce using efficient and lean processes; and delivering improved financial performance.

During 2007, we will measure our performance based upon winning additional tool of record status with the top spenders and by successfully deploying FSI's Best Known Methods for use on our installed base and newly delivered flagship products. Once again our performance is dependent on how well all of us at FSI execute each and every day.

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We are grateful for the confidence our customers have shown in 2006 and are pleased with our employees' commitment to their success. We thank our shareholders for their patience and loyalty through the year. We are optimistic that we can leverage our 2006 successes into improved performance in 2007.*

Sincerely,



Donald S. Mitchell
Chairman, President and
Chief Executive Officer

December 14, 2006

Certain statements contained in this shareholders' letter constitute forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and are subject to the safe harbor created by that statute. Such forward-looking statements are based upon current expectations and beliefs and involve numerous risks and uncertainties, both known and unknown, that could cause actual events or results to differ materially from these forward-looking statements. For a discussion of factors that could cause actual results to differ materially from those described in this shareholders' letter, see the discussion of risk factors set forth in Item 7 of the 10-K, included with this report. Typically we identify forward-looking statements by use of an asterisk "*". In some cases, you can identify forward-looking statements by terminology such as "expects," "anticipates," "intends," "may," "should," "plans," "believes," "seeks," "estimates," "could," "would" or the negative of such terms or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements are reasonable as of the date of this letter, we cannot guarantee future results, levels of activity, performance or achievements. We undertake no duty to update any of the forward-looking statements after the date of this shareholders letter.

Corporate Information:

Stock Listing:
NASDAQ Global MarketSM
Symbol: FSII

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Independent Auditors:
KPMG LLP
Minneapolis, Minnesota

Annual Meeting:
All stockholders and other
interested parties are invited
to attend the Company's
annual meeting scheduled for
January 17, 2007,
beginning at 3:30 p.m. at
FSI International,
3455 Lyman Boulevard,
Chaska, Minnesota.

Stockholder Inquiries:
Investors seeking financial
publications or wishing to be
placed on the Company's mailing list
of investors may call: 952.448.8922.

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