

## **FISCAL YEAR 2006 CHAIRMAN'S LETTER to STOCKHOLDERS**

As I write this letter, Frequency Electronics has been listed and begun trading on the NASDAQ Global Market. We were encouraged to make this move by suggestions from many of you that the NASDAQ is the appropriate platform for small, high technology companies like FEI, positioned for growth. I am pleased to report that our results for the past Fiscal Year measured up to our expectations of rising revenues and increased profitability in the second half of the year. The annualized revenue rate for the last two quarters exceeded \$60 million, up over 30% from the levels realized in the first half of the year. Satellite sales led these revenue increases, and proposal activity for space programs continues at very high levels. Total sales to the U.S. Government also rose, reaching 25% of revenues. As a result, our exposure to the impact of ups-and-downs in the wireless telecommunications infrastructure business has been materially reduced. There is little doubt that telecommunication service providers must make major investments in upgrades and the expansion of both wireless and wireline networks. We believe this will happen sooner rather than later, and FEI will be a major beneficiary. The technology we have developed in recent years is helping us capture larger shares in our satellite, DOD, and commercial telecommunications markets.

### **FINANCIAL REPORT**

Revenues for the year ended 30 April 2006 were \$52.8 million, compared to \$55.2 million for fiscal year 2005. Income from operations for Fiscal 2006 was \$1.7 million, compared to a \$1.3 million loss from operations in Fiscal 2005. Total income in both 2006 and 2005 included large gains in other income. Fiscal 2006 net income, \$4.8 million, or \$0.55 per diluted share, included \$3.2 million in pre-tax gains from real estate related investments. Fiscal 2005 net income was \$5.0 million, or \$0.58 per share, which included \$6.9 million in pre-tax gains also from real estate related investments. Stockholders were paid \$1.7 million in dividends, and stockholders' equity increased to \$70.6 million. The Company ended the year in a strong financial position, with no long term debt and \$24 million in cash, cash equivalents, and marketable securities.

### **THE YEAR IN REVIEW**

Gross margins and operating results, apart from investment gains, continued to improve for the third straight year. The rate of sales we experienced at the end of Fiscal 2005 persisted during the first half of Fiscal 2006, then rose sharply in the second half of the year. This rise was spurred principally by higher sales to the commercial satellite industry. Department of Defense sales increased from Fiscal 2005 as well. While sales to our large wireless infrastructure customers improved during the second half of the year, they have not yet recovered to the levels of early 2005.

Revenues for Gillam-FEI were lower year-to-year. A substantial portion of their activities involved development, in conjunction with FEI, of the new US5G and US5Ge wireline synchronization system units, for domestic and foreign markets, respectively. Gillam-FEI received the first order for the US5Ge in late Fiscal 2006. FEI-Zyfer, our high-precision GPS-aided instrument and systems subsidiary, recorded another year of revenue growth and increased profitability. FEI-Asia, our subsidiary in Tianjin, China, more than doubled in size and is providing high quality manufacturing support for FEI's products. Morion, our 36%-owned affiliate in St. Petersburg, Russia, enjoyed a banner year of growth.

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In recent years we have introduced advanced products based on our proprietary technology. As a result, in Fiscal 2006:

- Our commercial satellite business grew as large prime contractors began to outsource systems that we can build better, faster, and cheaper. We were awarded major contracts to provide our new signal generators and frequency synthesizers, in addition to the master reference oscillators, for large satellite payloads.
- Our new low-noise and low-G (gravity) sensitivity products generated very positive responses from the U.S. Government and the Department of Defense community. As a result, our products have been embedded in the development stages of fifteen critical military programs.
- Our new family of proprietary quartz products began to enter the wireless telecommunications infrastructure as a preferred timing system for the next generations of networks.

### LOOKING AHEAD TO NEXT YEAR

We expect Fiscal 2007 to be a very successful year for Frequency Electronics. Our products will make even more significant inroads in the markets that represent tomorrow's opportunities:

- For space applications, FEI's new products comprise a much larger portion of total satellite payloads than in the past. Historically FEI has provided only the master timing systems ("clocks"), which typically represent less than \$1 million per satellite. The addition of microwave frequency reference generators, synthesizers, and distribution systems increases FEI's total potential share of the payload by a factor of five to ten times, depending on the specific configuration of the satellite. We expect the outsourcing trend to continue and grow because the satellite integrators gain major benefits in cost effectiveness and cycle time from award to delivery. In Fiscal 2007 we will deliver the first payloads with our expanded product offering, totaling approximately \$15 million for two commercial satellites. We will also, for the first time, begin building a much larger portion of the payload for the next phase of a military satellite program. Previously, the Company had supplied only the master clocks for earlier phases of this same program.
- For the U.S. Government, new products are the major factor in the growth of our sales. FEI's unique low-noise and low-G sensitivity technology is a key ingredient to achieve the required functionality of many of the Department of Defense's most critical programs. These programs are now in development or early pre-production phases. The rate at which these programs advance depends on the rate of government funding and priorities reflecting the world situation. Over the long run, many of these programs will be strong sources of revenue for FEI.
- For commercial telecommunications, FEI has introduced state-of-the-art products for both wireless and wireline infrastructure. These proprietary products include new, unparalleled high performance, cost effective quartz oscillators. Wireless networks worldwide are migrating to quartz clocks to supplement and substitute for atomic timing and synchronization products. The Company's quartz products are key elements for future wireless/cellular communications.

For wireline synchronization equipment, the US5G and US5Ge offer lowest per-channel cost with remote system monitoring and management. Our new equipment addresses a large market for central office upgrades and expansion in the US and overseas. The first order was received in Fiscal 2006 for delivery in Fiscal 2007. These upgrades are necessary to replace out-of-date equipment and support the convergence with wireless and IP. Our equipment is undergoing tests by major service providers and we expect revenues to begin as service providers integrate these new equipments in their networks.

In Fiscal 2007 we will, as in past years, continue our major focus on research and development. R&D keeps FEI at the leading edge of technology in our fields of high precision time and frequency and RF microwave from one to 42 gigahertz and beyond. Some of our R&D is funded internally, and some is underwritten by our customers. We were previously funded to develop unique oscillators for the severe environments encountered in drilling for oil and gas. Based on favorable results from test wells, our customer is funding additional work to develop an enhanced unit to withstand even higher temperatures and deeper drilling. This advanced technology can have a major impact on oil and gas exploration and recovery in the future.

#### THE FUTURE

The total market for FEI's high precision time and frequency products is growing. I have described this market in previous correspondence, and more detail is included in the following pages of this Annual Report. FEI's products fill critical needs in this market. These needs stem from the increasing demand for services that require more efficient spectrum utilization and increased bandwidth, and for systems that perform with greater stability and dependability. Historically, this need represented a very small market. No longer. Today, precision time and frequency systems are critical components of U.S. Government and Department of Defense platforms for space, communications, weapons, navigation, and guidance. They are also critical components in commercial telecommunications systems. Moreover, the number of new platforms and systems is growing rapidly. FEI competes for this business with two significant advantages that have been established over many years: our unmatched legacy and the high technical barriers for competitors to enter these markets.

We continue to search for corporate partners to exploit the market opportunities before us. We identify potential candidates for merger, acquisition, or joint venture, whose resources could match our needs and support our goals. We have added to our corporate resources by acquisition in previous years. We will diligently evaluate and pursue those candidates that offer realistic prospects for future external growth.

As I have said before and it bears repeating, advanced technology represents the real shareholder value of Frequency Electronics. Thanks to the loyalty and skills of our senior staff and employees the Company continues to prosper, and is well-positioned to take advantage of its potential markets. On behalf of the Officers and Directors of Frequency Electronics, I also thank our shareholders for the confidence you have expressed in our fine Company.

JOSEPH P. FRANKLIN

Chairman of the Board