Q113 Earnings Conference Call Remarks (3pm CET)

Tuesday, April 23, 2013
Carlo Bozotti, President and Chief Executive Officer

Thank you for joining us.

On our call today I would like to focus my comments in four principal areas: our first quarter review and product highlights, progress towards our first quarter 2014 net operating expense goal and the ST-Ericsson exit, our cash flow and net financial position and our outlook. Let me begin with a brief summary.

First, our net revenues and gross margin were well aligned with the outlook we shared with you last quarter and were at the mid-point of our guidance range. Excluding Wireless, our revenues experienced better than normal seasonal performance in the fourth quarter and again in the first quarter.

Second, we have put in place a new product segment organization beginning with the 2013 first quarter, aligned to our new strategy, sharpening our focus around five main growth drivers within two product segments: Sense & Power and Automotive, representing about 56% of net revenues and, Embedded Processing Solutions, representing about 44% of net revenues.

Third, in March we signed an agreement with Ericsson to split-up the ST-Ericsson joint venture. Subject to regulatory approvals, we expect the closing to occur during the third quarter as already anticipated.

Now while the closing is in the third quarter we have each begun to fund our respective parts as of March 2nd, and jointly fund the wind-down activities. So this entails Ericsson assuming the funding of the LTE Modem development activity, while ST is assuming the funding of the existing products and related business, as well as certain assembly and test facilities. And together we are jointly and equally funding the wind-down related activities.

This was an important decision and a key part of our cost reductions; now we can intensify our efforts and focus on the other parts of our new strategic plan.

In the first quarter, we repaid our maturing debt, and also entered into a new credit facility with the European Investment Bank which was undrawn at quarter end, further strengthening the Company's financial flexibility.

Finally, touching briefly on our outlook, we continue to see some positive signals in the market place and anticipate sequential growth and gross margin improvement. More importantly, with our key product growth drivers, we see ST gaining share in 2013 in our target growth areas independent of the market environment.

Turning now to the first quarter, our revenue results came in at $2.01 billion. Excluding ST's Wireless product line, our product portfolio saw a year-over-year increase of 1.3% and on a sequential basis, we saw better than normal seasonality as we had anticipated, with a decrease of 3.4%.

Looking first at Sense & Power and Automotive Products, net revenues decreased 4.8% sequentially. We did see growth in Automotive and Industrial & Power Discrete products. And as expected, there were lower MEMS product sales. With respect to Automotive, the market is still soft in certain regions, but this is a market where we are very well positioned, from a leadership view in the largest markets, from a product portfolio offering, and from a content perspective, where we are adding more content per car. Importantly, we have also expanded our presence among top automotive OEMs as we have discussed including with Audi and with Hyundai.

Our operating margin in the quarter for Sense & Power and Automotive Products was 5.1%. The decrease compared to the 2012 fourth quarter reflected a number of factors, including price pressure on MEMS and Automotive, expected lower sales volumes and additional R&D resources for the Analog and MEMS businesses. However we expect double-digit margins of the product segment during the second half of 2013, driven by growth in Analog, MEMS and Power products and improved manufacturing performance.

Turning to Embedded Processing Solutions, we saw sequential growth in Microcontrollers, a key growth driver for us. And we saw a sequential improvement in Digital Convergence products. Imaging decreased sequentially mainly due to seasonality, but here I see a positive growth trajectory during the year as momentum will return to this area which had been weak for some quarters. Wireless saw a significant decrease due to ST-Ericsson and this will continue.

Embedded Processing Solutions operating margin was negative 24.2% in the first quarter of 2013, mainly due to ST-Ericsson. We expect to see substantial improvement in operating results over the next several quarters driven by the ST-Ericsson exit already underway, our savings plan announced in October of last year as well as significant continued growth in Microcontrollers and a recovery in sales for Imaging.

Moving to our gross margin, our results came in at 31.3%. On a sequential basis, we saw a reduction due to no revenues from licensing and the usual price pressure we experience at the beginning of the year, offset in part by lower unsaturation charges. Specifically, utilization improved from 67% in Q4 to about 72% on average for the first quarter, with even further progress at the end of March. We saw improvement in both front end and back end manufacturing and we expect to return to optimal loading during the second half of 2013.

As we move through the year we expect to see a progressive improvement in gross margin due to lower unsaturation costs and improved manufacturing efficiencies, in Q2 as our outlook indicates, and based upon our visibility on the second half of 2013.

Our inventory level is quite well aligned with where we want to be. As you recall, we took very aggressive actions in the second half of 2012 to bring down our inventory levels and, as a consequence, we increased our turns and reduced inventory days. Inventory came down further in Q1 by about $47 million. In the first quarter we were at 4.2 turns or 86 days, somewhat steady with the improvements reached exiting Q4 2012 and a solid improvement compared to last year at this time of 3.8 turns or 95 days.

Turning to capital expenditures, we expect to invest around $600 million during 2013; this takes into account an improved environment in the second half.

Now, let me turn to our product highlights. Looking at our Sense & Power and Automotive businesses:

For **MEMS AND SENSORS,** during Q1 we started production of a 6-axis MEMS device for the flagship model of an Asian Smartphone manufacturer. In the Automotive space, we are making a strong push into automotive sensors--of an accelerometer for an airbag. We also began production of our active noise-cancelation chip for an important Asian gaming manufacturer.

In **POWER AND SMARTPOWER,** we earned sockets for our high-voltage products in several large and small appliances with major European manufacturers and in Asia. Intelligent power modules scored several design wins from home-appliance leaders in the US and Europe. We also began ramping production for a new LED lighting platform for a major US LED manufacturer and the newest AMOLED driver for a market-leading Korean manufacturer.

In **AUTOMOTIVE,** we further strengthened our position in braking applications with two important wins with two global Tier 1s. We also earned an award for a full chipset for a gasoline direct-injection engine controller with an important Chinese OEM and landed a win--the first resulting from a collaboration with a strategic Asian customer--for an injector driver for a gasoline direct-injection engine controller. In Navigation and Infotainment, we started production of a Teseo II-based antenna for navigation systems for a Japanese OEM, began production of an advanced telematics systems of Teseo II for a major European car maker, and ramped the new power-amplifier ICs for the newest model at Alpine and other major Japanese car-audio makers.

Turning to our Embedded Processing Solutions segment, in **MICROCONTROLLERS,** we saw increased design-in momentum for the STM32, which earned wins for, among others, an automotive voice-recognition system at a Japanese OEM and in a display card at a world leader in digital security. We also saw growing adoption of the ST31, our secure 32-bit MCU, in contact and contactless banking applications and we ramped production of an embedded ST33 Secure Element for a high-end Smartphone at a key OEM.

In **DIGITAL CONVERGENCE**, I'm pleased to say, we earned important design-ins in FD-SOI advanced CMOS technology, the next-generation process technology that ST is pioneering. We also captured a significant design win for Orly in a home-gateway application for a large European manufacturer and, as we just announced, Orly was selected by Sumitomo Electric Networks for the Advanced Generation of Smart IPTV Set-Top Boxes.

And in **IMAGING, BI-CMOS ASIC AND SILICON PHOTONICS**, we began volume shipments to camera integrators of our leading-edge image sensors using ST's proprietary backside-illumination (BSI) technology and are shipping the matching high-performance digital-imaging-processing chip to a leading smart-phone manufacturer to support the unique imaging capabilities of some of their handsets.

Let me switch topics now and move from revenues to our net operating expense program goal underway. As outlined we are re-sizing our net expense base to be within the range of $600 million to $650 million by the beginning of the first quarter in 2014.

The exit from ST-Ericsson will significantly reduce our R&D expenses and we started to see this in our first quarter results with R&D expenses declining sequentially by $52 million, benefiting principally from the ongoing restructuring initiatives at ST-Ericsson as well as, starting March 2nd, the charge back to Ericsson of the LTE Modem expenses.

SG&A expenses mostly benefited from the internal cost reduction initiatives that we have had in place, and this is visible on a year-over-year comparison with SG&A lower by 10% to $279 million.

Let me turn now to our cash flow and net financial position.

Free cash flow was negative $65 million in the first quarter, principally related to ST-Ericsson.

In mid-March we shared with you that our estimated total cash costs to exit ST-Ericsson, including covering the joint-venture's ongoing operations during the transition period, including the first quarter, and its restructuring costs related to the ST-Ericsson wind-down, were at between $350 million and $450 million. In Q1 we funded $83 million under the ST-Ericsson parent facility.

During the next two quarters we expect our cash flow will be negative as we complete the exit of ST-Ericsson. Thereafter we anticipate a return to positive free cash flow. As a result, our net financial position will decrease in each of the next two quarters as a result, but again, this should revert back up and we anticipate at year-end to be in a still healthy net financial position based upon current market assumptions.

In the first quarter, the Company paid $455 million to repay at maturity our outstanding 2013 senior bonds using available cash and distributed quarterly cash dividends of $89 million to shareholders.

Now, before concluding let me turn to our outlook. As we mentioned last quarter we continue to see some positive signs, with bookings, excluding Wireless, showing progressive improvement.

Within that context, we see a second quarter where net revenues are expected grow about 7% at the mid-point excluding Wireless. This is again better than seasonal performance. Based upon our visibility we see broad-based strength, thanks to Imaging, Microcontrollers, Analog and MEMS products. Wireless, meaning the ST-Ericsson activities, is expected to decline significantly, resulting in total revenue growth of about 3% at the mid-point of our guidance.

Our gross margin should benefit from improved loading and manufacturing performance as I indicated earlier in my remarks, leading to a gross margin outlook of about 32.7%, plus or minus 2.0 points.

While not part of our guidance, R&D in particular will again see a significant reduction in expenses.

To conclude, in a separate press release issued last night, ST's Supervisory Board will propose to Shareholders a resolution on the distribution of a cash dividend of US$0.10 for the second quarter and of US$0.10 for the third quarter, stable with respect to previous quarterly dividend distributions. Furthermore, the quarterly dividend distribution will be decided from now on semi-annually instead of annually. This change will better align to the industry practice, bringing greater flexibility to ST. The fourth quarter 2013 and first quarter 2014 dividend will be decided during the fourth quarter of 2013.

Overall, I see progress for ST with our product portfolio and five key growth drivers; in taking important actions on turning around our financial results by re-sizing expenses; in our channels with our efforts with customers and in improving our distribution channel opportunities; and in managing our cash resources to continue to reward our shareholders.

My colleagues and I are now ready to take your questions.