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STMicroelectronics: Q316 Earnings Results
Thursday, October 27, 2016

Thank you for joining us this morning on our third-quarter earnings conference call.

We had a solid quarter in terms of revenues, gross margin, operating expenses and free cash flow.

These results are fully in line with the objectives we outlined during our Capital Markets Day in May: first, restart revenue growth on a year-over-year basis leveraging our strategic focus on Smart Driving and Internet of Things; and, second, improve our operating profitability through the combination of revenue growth, gross margin expansion and operating expense control. Three words: growth, discipline and leverage, summarize our focus and will drive ST forward.

Now let's review our key figures.

Net revenues increased 5.5% sequentially to $1.80 billion, exactly in line with the mid-point of our guidance. More ST content in smartphones, wearables and IoT applications –from 6-axis gyroscopes to Time-of-Flight imaging sensors to STM32 microcontrollers- drove the sequential increase. Also, amid an improving semiconductor market, we continued to see positive momentum in industrial, the mass market and in particular, the distribution channel with point-of-sales up 12% year-over-year. We also made progress towards our goal to return to growth in 2016, as revenues in Q3 increased 1.9% year-over-year, or 3.4% excluding the businesses undergoing a phase-out.

Third quarter gross margin significantly improved to 35.8%, up 190 basis points sequentially and 100 basis points year-over-year. This gross margin result was better than the mid-point of our guidance and was mainly driven by manufacturing efficiencies. As anticipated, unused capacity charges in the quarter negatively impacted gross margin by about 60 basis points.

Combined R&D and SG&A expenses were $542 million in the third quarter, in line with our expectations. We continue to exercise discipline controlling our costs and again, I can confirm that we are on track to capture about $100 million of annualized cost savings from our set-top box restructuring program exiting 2016.

We also delivered a substantial improvement in operating profitability. Third quarter operating income before impairment and restructuring increased to $119 million, or 6.6% of revenues, from $40 million and $102 million in the prior and year-ago quarter, respectively, on higher revenues and gross profit and lower operating expenses.

Free cash flow in the third quarter significantly improved. Before the business acquisition of NFC and RFID reader assets in Q3, free cash flow increased sharply to $178 million compared to $47 million and $85 million in the prior and year-ago quarter, respectively.

Now let’s move to a more detailed business review.

In ADG -our Automotive and Discrete group-, revenues decreased 2.3% sequentially to $704 million, reflecting seasonality in automotive and substantially flat revenues in power discrete. On a year-over-year basis automotive revenues grew, while power discrete products were negatively impacted by the weak PC and computer peripheral markets.

ADG operating income was $58 million in the third quarter with an operating margin of 8.2%.

Year-to-date sales growth and operating margin improvement in ADG came from automotive and from our focus on **smart driving**.

Therefore, let me turn now to some of the wins that ADG achieved during the quarter in this focus area.

Regarding **greener** driving, we continued to generate wins for a variety of car electrification products. We had design wins with silicon carbide diodes with a major Chinese manufacturer and wins with low-voltage trench-technology for leading Asia-Pacific and European manufacturers. In addition, we launched a strategic cooperation with a European Tier1 for a new generation of car-body applications using our 40nm 32-bit microcontrollers; we also captured a win for our 40nm powertrain microcontrollers for an automatic transmission from another major European Tier1.

In the area of infotainment for **connected** cars, we further expanded the market presence of our Accordo tuner families with a high-volume car radio win with a major American OEM. We also earned additional wins for our audio amplifiers in telematics platforms for a European car manufacturer.

In the area of automotive **safety**, we continued to grow our position, with one important win for 24 GHz radar and two wins for 77 GHz radar applications, with major European and Asian Tier1s. The momentum of ADAS (advanced safety systems) design wins was strong also during this quarter.

Moving next to AMG, our Analog and MEMS Group performed well in line with our expectations. AMG revenues increased 7.1% sequentially, on double-digit growth in MEMS, driven by motion MEMs and microphones. Importantly, our analog products also contributed to the sequential increase.

AMG's operating margin increased significantly in the third quarter to 5.8%, compared to 0.2% in the second quarter, thanks to higher revenues as well as improved product mix within MEMS. Year-to-date operating performance for AMG remains below the year-ago period reflecting lower sales as well as price pressure. But we are making progress in terms of customer opportunities and I will now share some examples.

In Q3, we recorded the highest quarterly shipment of devices since we started our MEMS business, thanks to the design wins we discussed in previous quarters for our **consumer MEMS** business with smartphone and wearable leaders and with customers across the globe. Our 6-Axis Motion MEMS device, integrating an accelerometer and a dual core gyroscope for Optical Image Stabilization and User Interface, has become the solution of choice for these markets thanks to its performance and ultra-low power consumption. Our MEMS microphones have also recovered in the third quarter. And we continue to grow our MEMS businesses for other IoT applications and for automotive. Overall in MEMS, and across our broad customer base, we see the opportunity for another quarter of sequential growth.

In **connectivity,** we are continuing to see good market traction for our Bluetooth Low Energy and SPIRIT Sub-GHz RF products for consumer and industrial applications and we expect further progress with the market introduction of our latest-generation, single-chip Bluetooth Low Energy solution announced last quarter. We also introduced a high-efficiency wireless battery-charging chipset which enables manufacturers to design smaller and simpler wearable devices.

Smart industry is another key area of focus, for AMG and for ST. In the third quarter we registered an important win with our IO-Link solution for a leader in factory automation. Real-time control of sensors and actuators is critical in factory automation and the IO-Link standard enables this, while significantly reducing electrical installation costs versus previous standards.

We also continued to expand our STSPIN family with the introduction of the world's smallest drivers for controlling the motors at the heart of devices like portable medical pumps, personal wellness devices, portable point-of-sale devices, miniature robots, precision tools, and portable printers.

Turning now to our Microcontroller and Digital ICs Group, MDG's net revenues increased 5.5% sequentially and totaled $587 million. Microcontrollers represent the large majority of the sales in this group, and were the principal driver of sequential revenue growth, thanks to our general purpose STM32 family. We also saw growth in digital ASICS for networking. Year-over-year, microcontroller sales were higher by about 4%, while digital ICs' revenues reflected the ongoing phase-out of discontinued products.

In Q3, MDG's operating margin increased sharply to 7.5% from 1.5% in Q2. The operating margin expansion reflected both higher revenues for microcontrollers and digital ICs and a further important reduction in operating expenses resulting from the ongoing set-top box restructuring plan. Year-to-date, MDG's operating income is up substantially.

Turning to the products in this group, I will start from our general purpose microcontrollers.

In Q3 we again achieved record billings for our STM32 family, with half of the revenues generated through our distribution channel. Here, I would like to mention a couple of wins that show the breadth of applications we address with our STM32: a smartwatch from a major Chinese OEM with our high performance F7 device; and gas meters and motor controls for industrial pumps at major European OEMs with our ultra-low power L4 device.

To support our focus on Internet of Things applications we released a new STM32-based LoRa Kit for low-power wide area wireless connectivity.

We also certified the STM32 cryptographic library according to the US Cryptographic Algorithm Validation Program as part of our offer for security in the IoT.

And, moving to Security let me detail the acquisition of ams' NFC and RFID Reader assets that we made in the quarter. ST acquired IP, technologies and products to strengthen our secure microcontroller solutions which embed NFC connectivity. We also welcomed 46 highly-skilled engineers who have become a very important part of our secure microcontroller division. We are already sampling products integrating this technology to customers for a broad range of applications such as next-generation mobile and Internet of Things devices. In addition, the acquisition of RFID Readers complement our NFC/RFID EEPROM tag offering. ST acquired the assets for a cash payment of $78 million plus a deferred earn-out contingent on future results.

Finally, in our custom silicon business we shipped our 1 millionth ASIC to a networking-equipment market leader, a remarkable achievement for this type of business.

Moving now to our Imaging Product Division, which we report in “Other”, we had a very strong sequential increase in sales, due to the success of our new specialized image sensors, based on our proprietary Time-of-Flight Technology. In fact, we are seeing strong momentum globally: during the third quarter, we were present in eleven new smartphones, including a new product in flagship phones, launched on the market. In addition, in Q3 the Imaging Product Division turned to profit.

Now let's move to our business outlook.

We are targeting to grow revenues on a sequential basis by about 3.2%, plus or minus 3.5%, reflecting continued strong demand in the smartphone market and positive automotive and industrial trends. At the mid-point on a year-over-year basis this would represent a growth of 11.2%. From a macro perspective we see less near-term risk than we did in the second quarter.

We also expect to continue our gross margin progression, targeting a fourth quarter gross margin of about 37.0% plus or minus 2.0%.

Let me now conclude with three remarks.

First, based upon our fourth quarter revenue outlook, we expect to achieve substantial **year-over-year growth for the second half of 2016**, as we outlined during our Capital Markets Day in May. All of our product groups are expected to contribute to this growth, except discontinued business.

Second, thanks to our strategic focus on Smart Driving and IoT, the increased traction we are seeing with our new products and positive semiconductor market trends, ST is positioned to achieve **year-over-year growth for 2016** driven by automotive, specialized image sensors and microcontrollers.

Third, based on this anticipated revenue growth and product mix, we expect to improve the utilization of our fabs and also to leverage manufacturing efficiencies **to expand our gross margin** in the fourth quarter.

My colleagues and I would now be happy to take your questions.
Thank you.