Q213 Earnings Conference Call Remarks – Final
Tuesday, July 23, 2013
Carlo Bozotti, President and Chief Executive Officer

Thank you very much for joining us today. Let me share some brief summary comments and then we can go into a detailed review of the quarter.

First, I am encouraged by the progress we are making with regard to each of our three objectives – sales growth, gross margin improvement and expense reduction. With respect to sales growth we had a strong quarter excluding our Wireless product line. From a gross margin perspective we came in above the mid-point thanks to manufacturing efficiencies and higher volumes. And with regard to expense reduction you can see the substantial progress quarter on quarter and compared to the year-ago timeframe.

Second, we will discuss the product portfolio shortly, but here let me highlight the sales initiatives to strengthen our geographic coverage, greatly expanding our small to mid-size customer base as well as expanding our sales through distributors. In the second quarter distribution represented 26% of sales, up about 4 points from last year and some further improvement from the prior two quarters. Our mid-term goal is to move closer to 30%.

Third, while market uncertainty continues we saw a progressive improvement in bookings in the second quarter, although we experienced a softening in the smartphone market also impacting ST products towards the end of the second quarter.

And fourth, we anticipate the ST-Ericsson transaction to close in early August.

So let’s begin the detailed review with our second quarter sales results. We delivered revenue in line with our outlook, with total revenues growing 1.8% sequentially to $2.05 billion, even with the 31% decrease in existing product sales at ST-Ericsson. Net loss attributable to ST was $152 million reflecting a one-time non-cash charge of $69 million on ST’s equity value in 3Sun due to impairment charges reported by the 3Sun joint venture.

We saw solid sequential sales growth of 6.8% in our product portfolio excluding the Wireless product line. The increase came from several key areas: Microcontrollers, Industrial and Power, Automotive and Imaging – so progress in both of our product segments, Sense & Power and Automotive as well as Embedded Processing Solutions.

Turning first to Sense & Power and Automotive Products, revenues increased 7.3% sequentially. Automotive had a good sequential sales evolution, and it was broad in terms of sales growth across all of the regions. The second half should see further progress for Automotive, with a strong backlog thanks to our broader customer base and ST’s increasing content within cars. We also saw a good sequential progression for Industrial and Power products. MEMS continued to grow sequentially but was somewhat impacted by softness in the smartphone market.

Sense & Power and Automotive Products operating margin decreased to 3.5%, reflecting in part the wind-down process for the ST-Ericsson joint venture as we assumed certain costs for R&D activities for the people who will be moving to ST as we strengthen our efforts on new product development. The decrease also reflects price pressure mainly impacting MEMS and a less favorable product mix.

Looking at our Embedded Processing Solutions group, there were some encouraging signs demonstrating that our goal to improve performance in this group is gaining some traction. Second quarter revenues, excluding the Wireless product line, increased 6.6% sequentially. In Imaging, we saw an increase of about 29% on a sequential basis and we are on track to see a further ramp in the second half of this year. So the recovery is clearly moving forward for Imaging. Microcontrollers also delivered strong sequential growth of 17% thanks to both general purpose and secure microcontrollers.

Embedded Processing Solutions operating margin was a negative 12.8% with the improvement reflecting significantly lower expenses principally in connection with the ST-Ericsson wind-down. Looking forward, we again expect a further significant reduction in expenses and a favorable product mix evolution.

Moving to gross margin, it increased 150 basis points sequentially to 32.8% in the second quarter, slightly above the mid-point of our guidance. We benefited from an improved level of utilization at about 81%, compared to 72% in the prior quarter resulting in negligible unused capacity charges. Increased volumes and resulting manufacturing efficiencies also contributed to gross margin sequential progress. Gross margin improvement was partially offset by usual price pressure.

Just a brief comment on inventory. Our goal was to keep inventory steady and in line with the expected growth in the quarter and we did. Inventory turns were at 4.1 turns or 88 days, so basically flat with the first quarter.

Now, let me turn to our product highlights:

From our **ANALOG, MEMS AND SENSORS** Group, our very low power RF tranceivers are gaining traction. For example, Paris, the “City of Light”, has begun deploying our SPIRIT1 device to remotely control street lights along the river Seine. We also earned some healthcare successes by bringing to market products that help improve the quality of medical equipment. Products like our Pulser IC, which is useful in medical ultrasound applications for waveshaping and transmitting pulses of sound. Our MEMS microphones are also gaining traction and our high-end digital top-port microphone will be coming to market soon in an exciting new tablet. We are also continuing to build on our solid leadership position in motion MEMS, ramping production of a 6-axis accelerometer and gyroscope for new smartphones and we entered into production with a 9-axis inertial module for several innovative navigation-related applications from top-tier American manufacturers.

We are building momentum in **POWER AND SMARTPOWER** with solutions that allow our customers to create smaller, more energy efficient end devices. First of all with our innovative STLux platform, the world's first programmable digital controller specifically optimized for lighting and power-supply applications. Here we captured multiple wins for several projects with major European lighting customers. Our ViperPlus high-voltage converters earned design wins in several server switched-mode power supply platforms from a major Taiwanese manufacturer. And again in Taiwan our RF antenna-tuner solution was chosen by a leading OEM for its smartphones. We were also pleased to see our discrete IGBTs and IGBT Intelligent Modules achieve big wins for welding and motor-control applications.

As vehicles become safer and more comfortable, our **AUTOMOTIVE Product Group** continued to demonstrate its mastery of all the technologies in the car and the strength of our relationships with top-tier customers. The ongoing increase in the pervasion of semiconductor content in vehicles plays to ST's advantage, and this quarter, our successes and design wins have covered the full range of automotive applications: from 32-bit automotive microcontrollers for an airbag application to a microcontroller companion chip that integrates all the key functions for stability-control systems. We captured wins in Infotainment with a multi-standard digital terrestrial tuner from a leading European Tier 1 and we had success with several awards for Vertical Intelligence Power technology in Body Control Modules from leading Tier 1s.

We continue to see success in **MICROCONTROLLERS and MEMORIES.** Our STM32 family earned multiple design wins for smart-watch applications at major global OEMs, as a sensor-hub in various mobile applications at a major manufacturer, and in a next-generation low-power fitness-monitoring system at a key Americas OEM. We also began to ramp production of STM32 controllers for Wi-Fi modules for Internet of Things applications at various customers.

In **DIGITAL CONVERGENCE**, we are winning business in all the key areas of our focused strategy. More and more ASIC customers are becoming convinced by the benefits of our faster, cooler and simpler 28nm FD-SOI technology and we have been able to add two new design wins for networking and consumer applications. We continued our success with worldwide customers for new set-top box Class2 products and obtained the full certification from Nagra and Viaccess. We have also begun an important design at a key customer for the US cable modem based on our Orly platform.

And, finally, in **IMAGING, BI-CMOS ASIC AND SILICON PHOTONICS**, we made progress in silicon photonics, capturing design wins for ASICs with two of the world's top optical communications manufacturers and winning almost 30 new ASIC projects from customers that use either BiCMOS or Silicon Photonics. We were also chosen to supply an Image Signal Processor to a leading phone manufacturer.

So, in summary, I think we are making solid progress in improving our product portfolio, and in parallel, we are making solid progress in improving our go to market strategy for sales thanks to the work we did last year which is beginning to pay off.

Now, I would like to discuss with you the second area of improvement which is expense reduction. Net operating expenses totaled $736 million in the second quarter, down $72 million compared to Q1 and substantially lower than one year ago, when we were at $887 million. Most of the reduction is related to R&D as we wind-down ST-Ericsson, resulting in the charge-back of expenses to Ericsson as well as cost reduction initiatives.

Looking forward, we anticipate closing the joint venture transaction in early August and as a result the remaining ST-Ericsson activities will be deconsolidated. We again expect a significant decrease in expenses in the third quarter and we are well aligned with our objective to be at a $600 to $650 million quarterly run rate for net operating expenses by Q1 2014.

Turning to our cash flow, we had indicated that the ST-Ericsson wind-down would result in a few quarters of negative free cash flow. In the second quarter it was negative $134 million. While the third quarter will experience a similar negative impact we expect to be significantly free cash flow positive in the fourth quarter based on current market visibility.

With our net financial position of $954 million we will be able to well manage through this period and retain our financial strength. As I outlined last quarter we had anticipated two quarters of negative impact on our net financial position, in Q2 and in Q3. We will look to rapidly strengthen our net financial position, focusing on free cash flow generation as one of our top financial priorities as we move into the fourth quarter and 2014.

Now, turning to the joint venture, we are quickly approaching the final days to closure. Carlo Ferro and his team have done an outstanding job of managing through this period. Thanks to them and the team here at ST we are on track to the plan, and in fact we have improved the anticipated exit costs.

Our total cash costs to exit the JV are now estimated at between $300 and $350 million, net of the expected proceeds from ST-Ericsson's sale of its connectivity business, and well below the original estimate range of between $350 and $450 million.

Turning to our outlook, the market environment remains similar to what we have shared with you over the last three months. We saw positive signals in the second quarter for bookings with and overall book-to-bill, excluding the Wireless product line, of 1.1 – and yet at the same time there is still some uncertainty in the market place, in particular in the smartphone market.

Looking ahead, we continue to expect the ramp of key products in MEMS, Automotive, Microcontrollers and Imaging in the second half of this year, leading to higher sequential revenue results for both the third and fourth quarters of this year.

With respect to our sales outlook, we are anticipating sequential sales growth of 3.5% excluding the Wireless product line and flat including the Wireless product line. We expect to see sequential gross margin progression in the third quarter, on improved manufacturing efficiencies, higher volumes and better product mix, leading to a gross margin outlook at about 33.5%, plus or minus 2.0 points. We also expect a further significant decrease in expenses thanks to the deconsolidation of ST-Ericsson and to seasonality.

Going forward, we anticipate progressive improvement in our gross margin. First, with fab utilization at a more stable and optimal level we plan to continue to grow our business in our targeted growth drivers. Second, we are focused on better utilizing and optimizing our technology portfolio. Third, we are now in a position to more aggressively manage our product mix in order to prune lower margin products from our portfolio. To successfully achieve this, we will make gradual structural changes to our manufacturing footprint to ensure that it matches our needs, complemented by our foundry sourcing. As a result, we plan to gradually expand 8-inch capacity in Singapore and Catania, Italy while winding down certain 6-inch manufacturing lines and consolidate our back-end activities in China to Shenzhen.

Finally, let me mention yesterday's important news. We had the honor to host the French Prime Minister and 3 other ministers at our site in Crolles where we announced a key frame agreement with the French government for the 'Nano2017' program which supports our proprietary R&D activities for CMOS derivative technology. This program will strengthen our leadership in key technologies: FD-SOI for logic, next-generation imaging and next-generation embedded non-volatile memories for microcontrollers. I want to be clear that this agreement was contemplated and is already fully reflected in our plans and financial model.

So to close, I believe we have shown that we are moving in the right direction and making progress steadily quarter-by-quarter. We remain focused on delivering on our three main objectives: sales growth, gross margin improvement and expense reduction.

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