ON SEMICONDUCTOR CORPORATION

CALL SCRIPT
FOR
Q2-18 RESULTS CONFERENCE CALL

Parag Agarwal

Thank you <operator>.

Good morning and thank you for joining ON Semiconductor Corporation's second quarter 2018 quarterly results conference call. I'm joined today by Keith Jackson, our President and CEO, and Bernard Gutmann, our CFO. This call is being webcast on the "Investor Relations" section of our website, at www.onsemi.com. A replay of this broadcast, along with our earnings release for second quarter of 2018, will be available on our website approximately one hour following this conference call, and recorded broadcast will be available for approximately 30 days following this conference call. The script for today's call and additional information related to our end-markets, business segments, geographies, channels and share count are also posted on our website.

Our earnings release and this presentation include certain non-GAAP financial measures. Reconciliations of these non-GAAP financial measures to the most directly comparable measures under GAAP are in our earnings release, which is posted separately on our website in the "Investor Relations" section.

During the course of this conference call, we will make projections or other forward-looking statements regarding future events or the future financial performance of the company. The words "believe," "estimate," “project,” "anticipate," "intend," “may,” "expect,” “will,” "plan," "should" or similar expressions are intended to identify forward-looking statements. We wish to caution that such statements are subject to risks and uncertainties that could cause actual events or results to differ materially from projections. Important factors which can affect our business, including factors that could cause actual results to differ from our forward-looking statements, are described in our Form 10-Ks, Form 10-Qs and other filings with the Securities and Exchange Commission.

Additional factors are described in our earnings release for second quarter of 2018. Our estimates may change, and the company assumes no obligation to update forward-looking statements to reflect actual results, changed assumptions, or other factors, except as required by law.

As announced earlier, we will host our 2019 Analyst Day on March 8th, in Scottsdale, Arizona. If you would like to attend the event and haven't received an invitation, please let us know.

During the third quarter, we will attend Citi Technology Conference in New York on September 6th and Deutsche Bank Technology conference in Las Vegas on September 12th.

Now, let me turn it over to Bernard Gutmann, who will provide an overview of second quarter 2018 results. Bernard….

Bernard Gutmann

Thank you Parag, and thank you everyone for joining us today.

We delivered yet another quarter of strong financial results, which exceeded our guidance and street consensus on all key metrics. Near to mid-term outlook for our business remains strong, and overhang related to trade policy and tariffs has not had any meaningful impact on our business or outlook. Long term outlook for our business continues to strengthen driven by our accelerating momentum in automotive, industrial, and server markets. Our margin performance remains strong with continuing expansion in both gross and operating margins.

Global macroeconomic environment remains favorable, and we are seeing strong demand from most geographies and end-markets. Customers are upbeat about near to mid-term outlook. However, the sustained strong demand has strained the semiconductor industry supply chain. As we indicated in the previous call, to further accelerate our revenue momentum and margin expansion, we are making prudent investments in our manufacturing infrastructure.

Now, let me provide you additional details on our second quarter 2018 results.

Total revenue for the second quarter of 2018 was $1,456 million, an increase of nine percent as compared to revenue of $1,338 million in the second quarter of 2017. GAAP net income for the second quarter was $0.35 per diluted share as compared to $0.22 in the second quarter of 2017. Non-GAAP net income for the second quarter was $0.46 per diluted share as compared to $0.36 in the second quarter of 2017.

GAAP and non-GAAP gross margin for the second quarter was 38.1 percent. On GAAP basis, our second quarter gross margin improved by 130 basis points year over year, and on non-GAAP basis, gross margin improved by 120 basis points year over year. This strong gross margin performance was driven by solid operational execution and improving mix resulting from higher contribution from our automotive, industrial, and server businesses. Second quarter gross margin was negatively impacted by the rise in certain input costs. With anticipated ramp in additional internal raw wafer capacity towards the end of the year, we expect to partially offset the impact of increased input costs. With tailwinds from additional manufacturing synergies, ramp of internal raw wafer capacity, and continuing mix improvement, we expect to make strong progress towards our target model in the current year.

GAAP operating margin for second quarter of 2018 was 13.5 percent, as compared to 11.5 percent in second quarter of 2017. Our non-GAAP operating margin for second quarter of 2018 was 16.3 percent, an increase of approximately 160 basis points over 14.7 percent in second quarter of 2017. On year-over-year revenue increase of 9 percent for second quarter of 2018, our non-GAAP operating income increased by 21 percent. This strong operating income performance demonstrates the leverage and strength of our operating model.

GAAP operating expenses for the second quarter were $358 million, as compared to $338 million for the second quarter of 2017. Non-GAAP operating expenses for the second quarter were $318 million, as compared to $297 million in the second quarter of 2017. We expect our non-GAAP operating expenses as percentage of revenue to decline for remainder of the year, and we expect to make strong progress in 2018 towards our target non-GAAP operating expense intensity of 21 percent.

Second quarter free cash flow was $117 million, and operating cash flow was $270 million. Capital expenditures during the second quarter were $153 million, which equate to capital intensity of ten percent. Recall that to meet accelerating demand for our products and to mitigate the impact of steep rise in prices of raw wafers, we expect a higher level of capital intensity in the current and next year. We continue to de-lever our balance sheet, and in the second quarter, we used $80 million to pay down our debt. We exited second quarter of 2018 with cash and cash equivalents of $850 million, as compared to $925 million at the end of first quarter of 2018. We used $40 million cash to repurchase 1.7 million shares of our stock.

At the end of the second quarter, days of inventory on hand were 122 days, down by a day as compared to 123 days in the first quarter. Inventory increased in absolute terms in the second quarter as compared to the first quarter. A part of the increase was driven by strategic build of inventory of certain raw materials. As I indicated earlier, the semiconductor supply chain is strained, and we are making prudent investments to ensure continuity of timely supply of our products to our customers. We intend to continue to build strategic inventory of raw material till supply situation stabilizes. We expect our internal inventories to continue to decline in terms of days in the third quarter. Distribution inventory declined quarter over quarter in the second quarter. We expect distribution inventories to remain within our normal range of 11 to 13 weeks in the near term. To mitigate the risk of excessive inventory in the channel, we are proactively managing inventory in the distribution channel. We have implemented systems to ensure that distributors don't carry more inventory than that is needed to support 11 to 13 weeks of resales.

For the second quarter of 2018, our lead times were up quarter over quarter. Our global factory utilization for the second quarter was down quarter over quarter.

Now let me provide you an update on performance of our business units, starting with Power Solutions Group, or PSG. Revenue for PSG for the second quarter was $748 million. Revenue for Analog Solutions Group for the second quarter of 2018 was $513 million, and revenue for Intelligent Sensing Group, formerly known as Image Sensor Group was $195 million.

Now, I would like to turn the call over to Keith Jackson for additional comments on the business environment. Keith …

Keith Jackson

Thanks, Bernard.

Second quarter of 2018 was yet another strong quarter for ON Semiconductor. We delivered strong revenue growth and robust margin expansion, which culminated in strong earnings performance for the company. Our momentum continues to accelerate driven by strong traction of our products in automotive, industrial, and server markets. Our design win pipeline continues to expand as customers increasingly engage with for power, analog and sensor semiconductor solutions for most demanding applications. We continue to strengthen our position as a key provider of enabling technologies for newly emerging and disruptive applications in automotive and industrial end-markets. With tailwinds from increasing favorable macroeconomic conditions and a strong momentum in our business, we continue to make strong progress towards our target financial model.

While we are benefiting from our leadership in key segments of automotive, industrial and server markets, overall business conditions remain favorable and demand continues to be strong across most end-markets. Pricing continues to be benign as compared to historic trends. Overhang related to trade policy and tariffs hasn't impacted the demand environment in any meaningful manner, and customers are upbeat about near to mid-term outlook for their businesses. As I have indicated in recent earnings calls, our business today is driven by sustainable secular growth drivers in the fastest growing semiconductor end-markets, as opposed to being driven by macroeconomic and industry cyclicality a few years ago. Through our investments over last many years in high growth segments and in highly differentiated products in automotive and industrial end-markets, we have radically transformed the nature of our business. Customers are increasingly relying on us as a key provider of enabling technologies for newly emerging and disruptive applications in automotive and industrial end-markets.

Along with strong revenue momentum, our execution on operations front has been outstanding. Our operating model has shown strong operating leverage. As Bernard mentioned earlier, on year-over-year revenue increase of nine percent for the second quarter, our non-GAAP operating income increased by 21 percent. Despite increase in certain input costs, which has negatively impacted the pace of our margin expansion, our margin drivers remain intact. With ramp of our internal raw wafer capacity later this year, we should be able to partially offset the increase in input costs. At the same time, mix shift towards margin rich automotive and industrial end-markets should drive additional margin expansion.

Now I'll provide details of the progress in our various end-markets for second quarter of 2018.

Revenue for the **automotive** market in the second quarter was $454 million and represented 31 percent of our revenue in the second quarter. Second quarter automotive revenue grew by an impressive 10 percent year-over-year. For the second quarter, we again saw strong, broad based demand for most product lines, and our momentum in the automotive market continues to accelerate, driven by a robust design win pipeline and leadership in fastest growing segments of the automotive market.

During the second quarter, we saw strong demand for our image sensors for ADAS applications. Out traction in ADAS image sensors continues to accelerate. With a complete line of image sensors, including 1, 2, and 8 Megapixels, we are the only provider of complete range of pixel densities on a single platform for next generation ADAS and autonomous driving applications. We believe that a complete line of image sensors on a single platform provides us with significant competitive advantage, and we continue working to extend our technology lead over our competitors.

Demand for power products for automotive applications continues to grow. With one of the broadest power portfolios for automotive applications, we continue to see strong growth in our power related revenue for automotive applications. Other growth drivers for the second quarter automotive revenue include power management for ADAS and instrument cluster, LED lighting, start stop alternators, and 48 Volt systems. Also, we are seeing strong growth for our silicon based power products in EV/HEV market.

Our Silicon Carbide development remains on track, and we expect to see Silicon Carbide related revenue from automotive market in second half of this year. Recently, we announced formal launch of our Silicon Carbide diodes for automotive market. Our Silicon Carbide related design win pipeline is expanding at an impressive rate.

We are well positioned to benefit from transition to 48V electric systems from 12V in automobiles. Due to proliferation of electric systems such as ADAS, infotainment, connectivity, etc., the 12V automotive electrical system is being burdened by technology. Furthermore, due to ever tightening global CO_2 emission regulations and increased demand for improved fuel economy, light vehicles are in need of more power as electro-mechanical systems transition to highly efficient full electrical systems. This need for higher power in light vehicles is driving transition to 48V electric systems. ON Semiconductor offers an expanding portfolio of 48V products including, a full line of MOSFETs, Integrated Power Modules, current sense amplifiers, gate drivers and eFuse devices.

Revenue in the third quarter for the automotive end-market is expected to be up quarter over quarter.

The **Industrial** end-market, which includes military, aerospace, and medical, contributed revenue of $402 million in the second quarter. The Industrial end-market represented 28 percent of our revenue in the second quarter. Our second quarter industrial revenue grew by solid 14 percent year-over-year. Strength in industrial market was very broad based, with all the sub-segments posting robust year over year growth.

With a broad range of power products for complete spectrum of voltages starting from low voltage to high voltage, we have one of the most comprehensive portfolios of power devices and modules. We have clearly emerged as a credible alternative to the current leader in power semiconductor market, and consequently, customers are engaging with us at an increasing rate. We expect the demand for our power products for the industrial market to continue to accelerate.

While EV/HEV market is a key driver for our automotive business, we are also seeing complementary growth in our IGBT business driven by charging stations for EV/HEV.

Along with our power products, machine vision is rapidly emerging as a key driver of our industrial revenue. As we have indicated earlier, according to independent research firms, ON Semiconductor is the leader in image sensors for industrial applications. We continue to leverage our expertise in automotive market to address most demanding applications in industrial and machine vision markets. Both of these markets are driven by artificial intelligence and face similar challenges, such as low light conditions, high dynamic range and harsh operating environment.

Revenue in the third quarter for the industrial end-market is expected to be down quarter over quarter.

The **Communications** end-market, which includes both networking and wireless, contributed revenue of $249 million in the second quarter. The communications end-market represented 17 percent of our revenue in the second quarter. Second quarter communications revenue declined by three percent year-over-year due to weakness in smartphone market.

While the smartphone market has slowed down during last few quarters, our content in smartphones has been increasing with every generation of new devices. We expect continued growth in our content on new smartphone devices in near to mid-term.

Revenue in the third quarter for the communications end-market is expected to be up quarter over quarter due to normal seasonality, increased content, and launch of new device models.

The **Computing** end-market contributed revenue of $147 million in the second quarter. The computing end-market represented 10 percent of our revenue in the second quarter. Second quarter computing revenue grew by 17 percent year-over-year. The year-over-year growth was driven primarily by ramp in our cloud and server business.

We are seeing strong traction is our server business. We are engaged with leading cloud and server players, and we are working with leading CPU providers on their next generation platforms. Our engagement with customers in cloud services and server eco-system continues to grow, and we expect continued growth in our server business in near to mid-term. In addition to on-board power management, we are seeing acceleration in demand for our mid-voltage and high-voltage power products for server power supplies.

Revenue in the third quarter for computing end-market is expected to be up quarter over quarter due to normal seasonality and continuing ramp in our server business.

The **Consumer** end-market contributed revenue of $203 million in the second quarter. The consumer end-market represented 14 percent of our revenue in the second quarter. Second quarter 2018 consumer revenue was up seven percent as compared to consumer revenue in second quarter of 2017. Strength in white goods was a key driver of year-over-year growth in consumer end-market in the second quarter.

Revenue in the third quarter for the consumer end-market is expected to be up quarter-over-quarter due to normal seasonality.

In summary, demand for our products is accelerating, driven by strong customer acceptance of our power, analog and sensor products for automotive, industrial, and server end-markets. In face of strong demand environment and constrained supply conditions in semiconductor industry, our execution remains solid on all fronts. We are investing to increase our manufacturing capacity and further strengthen our industry leading cost structure. We have established leadership in highly differentiated power, analog, and sensor semiconductor solutions. Customers are increasingly relying on us as a key provider of enabling technologies for newly emerging and disruptive applications in automotive and industrial end-markets. Along with strong revenue performance, we are driving significant margin expansion. We continue to make solid progress toward our target financial model.

Now, I would like to turn it back over to Bernard for forward-looking guidance. Bernard…..

Bernard Gutmann

Thank you, Keith.

Based on product booking trends, backlog levels, and estimated turn levels, we anticipate that total ON Semiconductor revenues will be $1,485 million to $1,535 million in third quarter of 2018.

For third quarter of 2018, we expect GAAP gross margin to be in range of 38.0 percent to 39.0 percent, and non-GAAP gross margin in range of 38.1 percent to 39.1 percent. Factory utilization in the third quarter is likely to be flat as compared to that in the second quarter.

We expect total GAAP operating expenses of $348 million to $366 million. Our GAAP operating expenses include the amortization of intangibles, restructuring, asset impairments, and other charges, which are expected to be $29 million to $33 million. We expect total non-GAAP operating expenses of $319 million to $333 million. We expect our non-GAAP operating expenses as percentage of revenue to decline from current level during remainder of the year.

We anticipate third quarter GAAP net other income and expense, including interest expense, will be $32 million to $35 million, which includes non-cash interest expense of $9 million to $10 million. We anticipate our non-GAAP net other income and expense, including interest expense, will be $23 million to $25 million.

Cash paid for income taxes in third quarter of 2018 is expected to be $11 million to $15 million. We expect our 2018 cash tax rate to be lower than 10 percent. We expect total capital expenditures of $120 million to $140 million in third quarter of 2018.

We also expect share based compensation of $19 million to $21 million in third quarter of 2018, of which approximately $2 million is expected to be in cost of goods sold, and the remaining amount is expected to be in operating expenses. This expense is included in our non-GAAP financial measures.

Our GAAP diluted share count for third quarter of 2018 is expected to be 445 million to 447 million shares, based on the current stock price. Our non-GAAP diluted share count for third quarter of 2018 is expected to be 432 million shares, based on the current stock price. Further details on share count and earnings per share calculations are provided regularly in our quarterly and annual reports on Form 10-Q and Form 10-K.

For full year 2018, we expect to generate free cash flow of approximately $800 million.

With that, I would like to start the Q&A session. Thank you and <operator> please open up the line for questions.

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