ON SEMICONDUCTOR CORPORATION

CALL SCRIPT
FOR
Q4-18 RESULTS CONFERENCE CALL

Parag Agarwal

Thank you <operator>.

Good morning and thank you for joining ON Semiconductor Corporation's fourth 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 fourth 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 fourth 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.

Now, let me turn it over to Bernard Gutmann, who will provide an overview of fourth 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, despite challenging macroeconomic conditions. Key secular drivers powering our business remain intact, and our execution on operations front remains solid, as evident by margin performance in last several quarters. Our design win pipeline in our strategic markets, which include automotive, industrial, and cloud-power continues to grow, and we continue to strengthen our competitive position in those markets. We remain upbeat about our future.

Since our last earnings call in November of last year, we have noticed a significant slowdown in demand from Greater China region. This slowdown further accelerated early this year, when we noticed a sharp slowdown in bookings, especially from distribution channel. This steep decline in bookings has reversed course during last couple of weeks, and we have seen modest pickup. Demand from other geographies appears to be in line with seasonality. Although weakening macroeconomic conditions could pose challenges, based on current macroeconomic outlook, we expect to continue to grow our revenue and expand our margins in the current year. Based on our current outlook, we believe that after greater than seasonal decline in first quarter of 2019, we should grow sequentially in second quarter of 2019. Key megatrends driving growth in our content in automotive, industrial, and cloud-power applications remain intact, and we expect to continue to benefit from these trends in foreseeable future.

Although we remain confident of our outlook, we are managing our business prudently to rapidly adjust to slowing macroeconomic growth. We are taking measures to control our expenses, and we intend to adjust our working capital in-line with our expected revenue. We plan to continue to expand our margins and grow our free cash flow, despite current macroeconomic slowdown. We believe that a highly diversified customer base, exposure to the fastest growing semiconductor end-markets, and long life cycle of many of our products should help us better navigate the current slowdown in demand. Our largest customer in 2018 was approximately five percent of our revenue.

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

Total revenue for the fourth quarter of 2018 was $1,503 million, an increase of nine percent as compared to revenue of $1,378 million in the fourth quarter of 2017. Fourth quarter 2018 revenue included contribution of $19 million from ON Semiconductor Aizu Co., Ltd., also known as OSA. As we announced in our third quarter 2018 earnings conference call, OSA is our manufacturing joint venture for an 8-inch wafer fab located in Aizu-Wakamatsu, Japan. GAAP net income for the fourth quarter was $0.39 per diluted share as compared to $1.22 in the fourth quarter of 2017. Non-GAAP net income for the fourth quarter was $0.53 per diluted share as compared to $0.39 in the fourth quarter of 2017.

GAAP and non-GAAP gross margin for the fourth quarter was 37.9 percent. OSA had negative impact of 50 basis points on our fourth quarter 2018 gross margin. On GAAP and non-GAAP basis, our fourth quarter gross margin improved by 40 basis points year-over-year. Again, this year-over-year increase was negatively impacted by 50 basis points by OSA. Another factor negatively impacting our fourth quarter 2018 gross margin on year-over-year basis has been the rise in certain input costs. Our strong year-over-year gross margin performance was driven by solid operational execution and by improving mix.

Our GAAP operating margin for fourth quarter of 2018 was 14.8 percent, as compared to 12.2 percent in fourth quarter of 2017. Our non-GAAP operating margin for fourth quarter of 2018 was 16.8 percent as compared to 15.3 percent in fourth quarter of 2017. Our fourth quarter 2018 non-GAAP operating margin was negatively impacted by 20 basis points by OSA. On year-over-year revenue increase of nine percent for fourth quarter of 2018, and our non-GAAP operating income increased by 20 percent. This strong operating income performance demonstrates the leverage and strength of our operating model.

GAAP operating expenses for the fourth quarter were $347 million, as compared to $349 million for the fourth quarter of 2017. Non-GAAP operating expenses for the fourth quarter were $317 million, as compared to $305 million in the fourth quarter of 2017.

Fourth quarter free cash flow was $289 million, and operating cash flow was $421 million. For full year 2018, we generated free cash flow of $759 million as compared to $707 million in 2017. Capital expenditures during the fourth quarter were $132 million, which equates to capital intensity of nine percent. Recall that to meet increasing demand for our products and to mitigate the impact of steep rise in price for raw wafers, we expect a higher level of capital intensity for the current year. We exited fourth quarter 2018 with cash and cash equivalents of $1,070 million, as compared to $951 million at the end of third quarter 2018. We used $200 million of cash to repurchase 11.5 million shares of our stock in the fourth quarter.

At the end of the fourth quarter, days of inventory on hand were 120 days, up by four days as compared to 116 days in the third quarter. Distribution inventory in terms of weeks increased quarter-over-quarter in the fourth quarter, but is within our target range of 11 to 13 weeks. We expect distribution inventories to remain within our normal range of 11 to 13 weeks in the near-term. As we indicated earlier, 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 what is needed to support 11 to 13 weeks of resales.

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 fourth quarter was $787 million. Revenue for Analog Solutions Group for the fourth quarter of 2018 was $530 million, and revenue for Intelligent Sensing Group was $186 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.

Fourth quarter of 2018 was yet another strong quarter for ON Semiconductor. Despite a meaningful slowdown in demand from Greater China region, we delivered strong revenue and margin performance. Though the current macroeconomic outlook has impacted our near-term outlook, we remain upbeat about our mid to long term prospects. We believe that secular trends in our key markets driving our revenue will continue to strengthen, and we expect to outgrow the broader analog and power semiconductor group in a meaningful manner. Our design-win pipeline in our strategic markets is growing at a strong pace, our customer engagements are strengthening, and our competitive position is improving significantly.

As I mentioned earlier, key megatrends driving our business continue to strengthen. In the automotive market, accelerating adoption of electric vehicles and active safety is driving strong growth in our power semiconductor and sensor businesses. In the industrial markets, we are seeing steep growth in our power semiconductor content driven by higher power efficiency requirements for industrial systems. In cloud-power market, we are seeing robust growth for our analog power management products for servers and power semiconductors for 5G infrastructure markets.

Before I get into details of the fourth quarter, let me highlight the business performance for 2018 and lay out priorities for 2019. 2018 was a strong year for ON Semiconductor and we delivered solid results on all fronts. Our 2018 revenue, excluding OSA, grew by nine percent year over year. Our 2018 non-GAAP gross margin expanded by 120 basis points year over year. We achieved this strong gross margin expansion despite significant year over year increases in raw material costs in 2018. Our non-GAAP operating margin expanded by 170 basis points year over year. On year over year non-GAAP revenue increase of nine percent, our non-GAAP operating income increased by 22 percent in 2018. Our 2018 free cash flow was $759 million, as compared to $707 million in 2017.

We expect to continue to grow in 2019, although headwinds from slowing macroeconomic environment will likely impact our growth rate. Customers are increasingly relying on us as a key provider of leading-edge power semiconductor, analog, and sensing technologies, and we are working diligently to ensure success of our customers. We intend to grow faster than our analog and power semiconductor peer group, driven by our strong momentum in automotive, industrial, and cloud power markets.

On margin front, we expect continued expansion in our gross margins in 2019 driven by ongoing operational improvements, and improving mix of automotive, industrial, and cloud-power related products. Furthermore, we do not expect incremental headwinds from increases in raw-material costs in 2019. On operating expense front, we intend to tightly manage our expenses in light of changing macroeconomic conditions. Our above industry revenue growth coupled with strong margin performance should result in strong free cash flow generation in 2019. In summary, we intend to deliver solid all-around performance in 2019.

Let me now comment on the business environment. Since our last earnings announcement in November of last year, we have seen continued softening in demand from Greater China region with steep decline in order rates across all end-markets. Industrial and consumer end-markets have been especially weak in Greater China region. Decline in demand there is further corroborated by weakening macroeconomic indicators, such as GDP, PMI and export-import data. As Bernard noted in his remarks, in recent days, we have seen stabilization, followed by modest pickup in bookings from Greater China Region. Demand from other geographies is along historic seasonal trends. We are also experiencing much publicized weakness in global smartphone market, although our fourth quarter smartphone related revenue was in-line with expectations. On supply side, channel inventories are generally healthy, but based on order patterns, it appears that distributors in Greater China region are aggressively reducing inventory. We expect that softening macroeconomic conditions will have an impact on our near term growth outlook. However, based on current macroeconomic outlook and our momentum in industrial, automotive, and cloud-power markets, we expect to grow at a reasonable pace in 2019.

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

Revenue for the **automotive** market in the fourth quarter was $475 million and represented 32 percent of our revenue in the fourth quarter. Fourth quarter automotive revenue grew by nine percent year-over-year. Excluding contribution of $14 million from OSA, our fourth quarter automotive revenue grew by five percent year over year. We noticed significant weakness in automotive market in China during the fourth quarter.

Our design-win pipeline in automotive market continues to grow at a solid pace. We are seeing strong adoption of our products in vehicle electrification, active safety, and in various analog power management applications. Despite a slowdown in economic growth outlook, we expect to see continuing meaningful increase in our content in automotive applications.

We are seeing strong momentum for our power products, especially MOSFETs, traction IGBTs, high power modules, and gate drivers in vehicle electrification. We are seeing strong momentum in China EV market with our Silicon Carbide and FET products, and we expect many customers to ramp traction invertors with our power semiconductors in near term. To capitalize on steep expected growth in China EV market, we continue to invest in that market. In other markets, we are seeing significant excitement from customers related to our expanding Silicon Carbide and IGBT product portfolio.

Momentum for our sensor products for ADAS and viewing applications is accelerating, and we are meaningfully extending our competitive lead in that market by a huge margin. According to latest report by TSR, a leading independent market research firm, our overall market share in the automotive image sensor market is now 62 percent and our share in ADAS segment of automotive imaging market is 81 percent. Customers are increasingly relying on us to provide them with leading-edge technologies and complete product portfolio for automotive imaging applications. As I have indicated before, we are the only provider of automotive image sensors with complete portfolio of 1 MP, 2 MP and 8 MP image sensors. The breadth of our portfolio enabled us to secure a major design win with a German automotive OEM for our 2MP and 8MP image sensors for level 2 and level 3 ADAS systems in the fourth quarter.

On analog power management front, we continue to make progress on our power management programs for automotive processors. We are engaged will all leading processor providers for automotive applications. We are also seeing strong traction for our LED drivers for lighting applications.

Revenue in the first quarter for the automotive end-market is expected to be flat to slightly down quarter-over-quarter, as opposed to seasonally higher sequential revenue. Weaker than seasonal growth in our automotive business is driven primarily by softness in greater China market.

The **Industrial** end-market, which includes military, aerospace, and medical, contributed revenue of $390 million in the fourth quarter. Contribution from OSA to fourth quarter industrial revenue was not meaningful. The Industrial end-market represented 26 percent of our revenue in the fourth quarter, and grew by eight percent year-over-year.

We continue to see strong traction for our power semiconductor products and modules in the industrial end-market. With a broad range of medium and high voltage power semiconductors and modules, we are well positioned to capitalize on secular trend of increased power efficiency requirements for industrial systems. Despite slowing macroeconomic conditions, demand for our power semiconductors and modules continues to be strong, and our customer engagement continues to expand.

Within Industrial, medical was an area of solid strength in the fourth quarter. We are seeing strong traction for our products in personal diagnostics and hearing health market.

Revenue in the first quarter for the industrial end-market is expected to be flat to slightly down quarter-over- quarter, as opposed to seasonally higher sequential revenue. Weaker than seasonal growth in our industrial business is driven primarily by softness in Greater China market.

The **Communications** end-market, which includes both networking and wireless, contributed revenue of $300 million in the fourth quarter. There was no contribution from OSA towards fourth quarter 2018 communications revenue. The communications end-market represented 20 percent of our revenue in the fourth quarter. Fourth quarter communications revenue increased by 20 percent year-over-year.

We are beginning to see strong ramp in our medium voltage MOSFETs in 5G infrastructure market. We expect this ramp to accelerate in 2019 as with start of early 5G deployments in a few parts of the world. Current indications from our customers point to better than expected rate of deployment for 5G systems in near term. As we indicated earlier, our power content in 5G infrastructure systems is many times that in 4G systems. Furthermore, our participation in 5G systems is expected to be significantly higher than our participation in 4G systems.

On smartphone front, our revenue in the fourth quarter declined only slightly quarter-over-quarter as content increases helped offset decline in units.

Revenue in the first quarter for the communications end-market is expected to be down quarter-over-quarter. Revenue decline in the first quarter will likely be significantly greater than normal seasonality due to weakness in the global smartphone market.

The **Computing** end-market contributed revenue of $167 million in the fourth quarter. There was no contribution from OSA towards fourth quarter 2018 computing revenue. The computing end-market represented 11 percent of our revenue in the fourth quarter. Fourth quarter computing revenue grew by 22 percent year-over-year. The year-over-year growth was driven primarily by strength in our server business.

We expect strength in computing to continue in 2019, although we expect moderation in capital expenditures by leading cloud service providers. In future generations of server platforms, we expect meaningful increase in our content.

Revenue in the first quarter for computing end-market is expected to be down quarter-over-quarter due to normal seasonality and softening macroeconomic conditions.

The **Consumer** end-market contributed revenue of $171 million in the fourth quarter. The consumer end-market represented 11 percent of our revenue in the fourth quarter. Excluding contribution of $4.2 million from OSA, fourth quarter 2018 consumer revenue was down 13 percent as compared to consumer revenue in fourth quarter of 2017. The decline was due to weakness in Greater China region and our selective participation in certain areas of consumer electronics market.

Revenue in the first quarter for the consumer end-market is expected to be down quarter-over-quarter primarily due to continuing weakness in Greater China region and normal seasonality.

In summary, we have seen weakness in demand from Greater China region. However, despite current weakness in macroeconomic environment, secular megatrends driving our business remain intact, and we are upbeat about our medium to long term prospects. The key driver of our business is significant content increase in many applications in automotive, industrial and cloud power end-markets, as opposed to underlying unit growth in these end-markets. We have established leadership in highly differentiated power, analog, and sensor semiconductor solutions, and we believe that customers are increasingly relying on us as a key provider of enabling technologies for newly emerging and disruptive applications in automotive, industrial, and cloud-power end-markets. To adjust to slowing macro environment, we are prudently managing our business with sharp focus on expenses and working capital. Our operational execution remains solid. We have continued to expand our margins and generate strong free cash flow.

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 revenue is expected to be in range of $1,365 million to $1,415 million in first quarter of 2019. Included in our first quarter revenue guidance is approximately $20 million revenue from manufacturing services provided by OSA. As I indicated earlier, the greater than seasonal decline in the first quarter is primarily driven by weakness in Greater China region. Based on our current outlook, assuming no further decline in macroeconomic conditions, we expect to grow sequentially in second quarter of 2019.

For first quarter of 2019, we expect gross margin to be in range of 36.4 percent to 37.4 percent. Our first quarter gross margin guidance includes negative impact of 50 basis points from manufacturing services provided by OSA.

We expect total GAAP operating expenses of $330 million to $348 million. Our GAAP operating expenses include amortization of intangibles, restructuring, asset impairments, and other charges, which are expected to be $30 million to $34 million. We expect total non-GAAP operating expenses of $300 million to $314 million in the first quarter.

We anticipate first quarter of 2019 GAAP net other income and expense, including interest expense, will be $31 million to $34 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 $22 million to $24 million.

Cash paid for income taxes in first quarter of 2019 is expected to be $16 million to $20 million. We expect total capital expenditures of $170 million to $180 million in first quarter of 2019. We expect capital intensity for 2019 to be approximately nine percent.

We also expect share based compensation of $19 million to $21 million in first quarter of 2019, 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 diluted share count for first quarter of 2019 is expected to be 420 million shares, based on 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.

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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