ON SEMICONDUCTOR CORPORATION

CALL SCRIPT
FOR
Q2-19 RESULTS CONFERENCE CALL

Parag Agarwal

Thank you <operator>.

Good morning and thank you for joining ON Semiconductor Corporation's second quarter 2019 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 2019, will be available on our website approximately one hour following this conference call, and the 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 Securities and Exchange Commission.

Additional factors are described in our earnings release for second quarter of 2019. Our estimates, or other forward-looking statements 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.

During the third quarter, we will attend Jefferies 2019 Semiconductor, Hardware and Communications Infrastructure Summit in Chicago on August 27th, Citi Global Technology Conference in New York on September 5th, and Deutsche Bank Technology Conference in Las Vegas on September 10th.

Now, let me turn it over to Bernard Gutmann, who will provide an overview of our second quarter 2019 results. Bernard….

Bernard Gutmann

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

Geopolitical and macroeconomic factors impacted our second quarter revenue. Sharper than expected broad-based inventory correction, especially in automotive market, was the driver of lower than expected revenue in the second quarter. Furthermore, we saw weakness in our communications revenue as we temporarily halted shipments to a major customer to comply with US federal law. Despite headwinds to our topline during current cyclical downturn in semiconductor industry, our execution continues to be solid, and we continue to post strong margin and earnings performance. So far, in the current downturn, cyclicality in our revenue and margins has been lower than that of our peer group. Our performance thus far speaks to the transformed nature of our business, and our focus on highly differentiated power, analog, sensor and connectivity products for automotive, industrial, and cloud-power end-markets.

Key secular trends in automotive, industrial, and cloud-power end-markets remain intact, and we continue to make prudent investments to strengthen our competitive position in our strategic end-markets, and further improve our industry leading cost structure. Our design win pipeline in key growth areas continues to expand at a rapid pace.

Though the second quarter was challenging from revenue perspective, current booking trends point towards stabilization in business conditions. Demand trends from automotive customers have stabilized, and bookings from communications customers have improved. We believe that distribution inventory correction should be nearly complete by the end of the third quarter or early fourth quarter of 2019. Although we are seeing stabilization in demand at lower level of revenue, we are not seeing much evidence of any meaningful recovery in demand.

While we are encouraged by stabilization in business conditions, we are cognizant of risks arising from unforeseen geopolitical and macroeconomic events, and we are managing our business to adjust to this near-term volatility in demand. We have taken measures to control our operating expenses in-line with relatively soft business conditions. 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 as compared to broader analog and power semiconductor industry.

We remain upbeat about our future, and, as I noted earlier, we are making prudent strategic investments to strengthen and build our leadership in key strategic markets, and to improve our cost structure. In the second quarter, we closed our acquisition of Quantenna Communications, which we believe will strengthen our presence in connectivity applications for industrial and automotive end-markets. We also recently announced our plans to add the first 300 mm fab to our manufacturing network in a phased transaction over next four years. The addition of this fab in a staged process should accelerate our progress towards our 2022 target financial model, enable savings of approximately $1 billion in capital expenditure over next several years, and provide sufficient capacity to support our long-term growth at highly competitive cost structure.

Now, let me provide you additional details on our second quarter 2019 results.

Total revenue for the second quarter of 2019 was $1,348 million, a decrease of 7 percent as compared to revenue of $1,456 million in the second quarter of 2018. The year-over-year decline in revenue was primarily driven by well-publicized macroeconomic and geopolitical factors, which have impacted the overall semiconductor industry. GAAP net income for the second quarter was $0.24 per diluted share as compared to $0.35 in the second quarter of 2018. Non-GAAP net income for the second quarter was $0.42 per diluted share as compared to $0.46 in second quarter of 2018.

GAAP gross margin for the second quarter was 37 percent. Non-GAAP gross margin for the second quarter was 37.1 percent. Year-over-year, our second quarter 2019 non-GAAP gross margin declined by 106 basis points, primarily due to lower revenue. Despite a meaningful quarter-over-quarter decline in revenue in the second quarter, we delivered solid gross margin performance with gross margin flat as compared to that in the first quarter.

Our GAAP operating margin for the second quarter of 2019 was 11.7 percent, as compared to 13.5 percent in the second quarter of 2018. Our non-GAAP operating margin for the second quarter of 2019 was 15.7 percent as compared to 16.3 percent in second quarter of 2018. The year-over-year decline in operating margin was driven largely by lower gross margin.

GAAP operating expenses for the second quarter were $341 million, as compared to $358 million for the second quarter of 2018. Non-GAAP operating expenses for the second quarter were $288 million, as compared to $318 million in the second quarter of 2018. The year-over-year decline in second quarter operating expenses was driven by aggressive expense control, zero bonus accrual, and reversal of bonuses accrued during first quarter of 2019.

Second quarter free cash flow was $69 million and operating cash flow was $222 million. Capital expenditures during the second quarter were $154 million, which equates to a capital intensity of 11 percent. We exited the second quarter of 2019 with cash and cash equivalents of $885 million, as compared to $940 million at the end of first quarter 2019. We used $50 million of cash to repurchase 2.6 million shares of our stock during the second quarter.

At the end of the second quarter, days of inventory on hand were 137 days, up by 9 days as compared to 128 days in the first quarter of 2019. This increase in inventory was driven primarily by inclusion of Quantenna's results for a few days during the second quarter, and by fair market value step up of Quantenna's inventory. Had we included Quantenna's results without fair market value step up of inventory for entire second quarter, our days of inventory at the end of second quarter would have been 132 days, up four days as compared to 128 days in the first quarter. We intend to lower the days of inventory on our balance sheet in the third quarter.

Distribution resales increased meaningfully in the second quarter over the first quarter. Distribution inventory in terms of weeks declined quarter-over-quarter in the second quarter, and is now within our target range of 11 to 13 weeks. We expect to see further reduction in our distribution inventories in terms of days in the third quarter. As we have noted in our previous earnings conference calls, we are aggressively managing our distribution inventory to ensure healthy level of inventory in distribution channel. We believe that in addition to secular growth drivers in automotive, industrial, and cloud-power markets, our proactive management of distribution inventory has been a key reason behind relatively lower level of volatility in our revenue over last several quarters as compared to volatility in revenue of our peers.

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 $701 million. Revenue for Analog Solutions Group for the second quarter of 2019 was $462 million and revenue for Intelligent Sensing Group was $185 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.

Our execution remains strong, despite demand weakness in overall semiconductor market. In the second quarter, we delivered strong margin and earning performance despite strong headwinds from geopolitical and macroeconomic factors. While near-term business conditions are tepid, the foundation of our business, with exposure to secular megatrends in automotive, industrial and cloud-power end-markets, remains solid. With strong execution discipline, we are well positioned to navigate through current soft patch in demand.

Much anticipated recovery in demand conditions has not materialized yet, but current booking trends point towards stabilization of demand trends. Based on commentary from our distribution partners, it appears that ongoing inventory correction in the distribution channel should be nearly complete by the end of the third quarter or early fourth quarter. While we have a strong visibility into distribution channel, geopolitical and macroeconomic factors are difficult to forecast. No matter what direction business conditions take, we are well prepared to respond in an expeditious manner.

Despite the current slowdown in demand, we continue to make prudent investments to strengthen our competitive position and to further improve our industry leading cost structure. During the second quarter, we announced the completion of our acquisition of Quantenna Communications, a provider of market leading connectivity semiconductor solutions for Wi-Fi. We believe that connectivity capability is a primary requirement for success in industrial IoT market. As we have announced earlier, we intend to leverage Quantenna's market leading connectivity capabilities to gain technology leadership in the connectivity market for industrial IoT. At the same time, we will continue to invest in Quantenna to grow its carrier business.

Customer feedback has been very positive and customers are excited about the benefits that combined of technical, financial, and market resources of Quantenna and ON Semiconductor will bring to them. Integration of Quantenna is on track, and the teams are working on product roadmaps, and on achieving synergies targets. Due to ongoing softness in the semiconductor industry, Quantenna has experienced a slowdown in its business as well, and it is expected to be mildly dilutive in the third quarter. However, as we realize synergies and reduce costs, we expect that Quantenna will deliver targeted accretion.

We are also making strong process towards ramping our production at 300mm East Fishkill Fab in upstate New York. Process development for porting our power products has started and is progressing at a rapid pace. We are solidly on track to start shipping our first 300mm power products from East Fishkill fab in 2020. As we have indicated earlier, our 300mm East Fishkill fab accelerates our progress towards our 2022 target model, enables efficiencies in our manufacturing network, and further strengthens our industry leading cost structure. We believe that ramp of our 300mm production will be a major inflection point in our manufacturing strategy and in our manufacturing cost structure.

Key secular trends driving our business remain intact, and our momentum in our key strategic markets continues to accelerate. We continue to see meaningful increase in our content in automotive, industrial, and cloud-power applications. We believe that automotive, industrial and cloud-power end-markets will be among the fastest growing semiconductor end-markets for a long time. In the automotive market, accelerating adoption of electric vehicles and active safety should drive strong growth in our power semiconductor and sensor businesses. In the industrial market, we are seeing strong traction for our power semiconductors, 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. The current slowdown in demand, driven by macroeconomic and geopolitical factors, does not change our view on our long-term growth potential.

Now I'll provide details of the progress in our various end-markets for second quarter of 2019.

Revenue for the **automotive** market in the second quarter was $434 million and represented 32 percent of our revenue in the second quarter. Second quarter automotive revenue declined by five percent year-over-year. Asia, including Greater China was the primary contributor to this year-over-year decline. Weakness in the US and European automotive markets also contributed to this year-over-year decline. On quarter-over-quarter basis, we saw some stabilization in automotive revenue from Greater China region in the second quarter. We expect that year-over-year decline in China light vehicle production units to moderate in second half of the current year. On global basis, we expect that global light vehicle production in terms of units will decline by three to four percent year over year in 2019. US and European automotive units will likely decline by two to three percent range year-over-year in 2019.

We continue to see a strong adoption of our products in vehicle electrification, active safety, and in various analog power management applications, and our content in automotive applications continues to grow. Content in applications such as EV/HEV, LED Lighting, and in-vehicle networking is growing in meaningful manner.

We are seeing strong customer interest for our Silicon Carbide products, and our customer engagement is growing worldwide. Customer interest in our Silicon Carbide modules for traction invertors and on-board chargers has been very strong, and we are engaged with many customers for their upcoming EV platforms. Demand for our silicon based power products for vehicle electrification continues to accelerate, and we are seeing strong growth in our power MOSFET business. In the current quarter, we are starting pre-production of high-voltage IGBT modules to support customer ramp in the fourth quarter and in 2020.

In ADAS applications, momentum for our sensor products continues to grow. We continue to gain traction with our portfolio of automotive image sensor products and customers are increasingly relying on us to provide them with a complete product suite for automotive 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. Adoption of rear and surround view cameras, as well as increased volumes from Level 2 and 3 ADAS and autonomous vehicle systems continues to be a catalyst for growth. We continue to grow strategic engagements for automotive radar products and we have delivered first evaluation samples to customers.

Our analog power management products for ADAS, Instrument Clusters, as well as in-vehicle networking solutions continue to grow at a healthy rate. Growth within our advanced lighting power management and LED driver solutions continues to be strong globally.

Revenue in the third quarter for the automotive end-market is expected to be slightly up quarter-over-quarter, as opposed to seasonality of sequential decline in revenue.

The **Industrial** end-market, which includes military, aerospace, and medical, contributed revenue of $363 million in the second quarter. The Industrial end-market represented 27 percent of our revenue in the second quarter. Year-over-year, our second quarter industrial revenue declined by 12 percent. Greater China region has been the primary source of weakness in the industrial market, but we have recently seen stabilization in business trends.

We believe that our product offerings for increased power efficiency requirements for industrial systems will allow us to take advantage of the secular megatrends ahead. We continue to see increased momentum with our mid and high voltage power semiconductor products such as FETs and IGBTs, and modules in the industrial end-market. We continue to see strength in the China solar market with our power modules and IGBTs, and our breadth of customer engagements in China continues to expand.

Within Industrial, we are gaining traction in medical with our Bluetooth low-energy products. Our technology and design expertise is well recognized by our customer base, and we expect strong growth in the future. We continue to see strong demand for our products in implantable devices, personal diagnostics and hearing health market.

Revenue in the third quarter for the industrial end-market is expected to be down quarter-over-quarter, due to normal seasonality and ongoing softness in industrial end-market.

The **Communications** end-market, which includes both networking and wireless, contributed revenue of $248 million in the second quarter. The communications end-market represented 18 percent of our revenue in the second quarter. Second quarter communications revenue increased by 7 percent year-over-year. Much of the year-over-year increase was driven by strength in 5G ramp. Smartphone related revenue in the second quarter was also up year-over-year. We did not have meaningful revenue from Quantenna in the second quarter as the acquisition closed on June 19th.

As noted earlier, our 5G related revenue in the second quarter was disrupted as we halted shipments to a major customer in accordance with US federal law. We have now resumed partial shipments to this customer in accordance with US law. Despite near term uncertainty, current engagement with our customers points to meaningful deployment rates for 5G systems in the near to mid-term.

On smartphone front, our revenue grew year-over-year. We expect to see increase in our content in new platforms slated for launch later this year.

Revenue in the third quarter for the communications end-market is expected to be up quarter-over-quarter due to launch of new smartphone platforms, and inclusion of Quantenna's results for a full quarter.

The **Computing** end-market contributed revenue of $139 million in the second quarter. The computing end-market represented ten percent of our revenue in the second quarter. Second quarter computing revenue declined by seven percent year-over-year. However, our server business posted very solid growth on year-over-year basis during the second quarter.

We are seeing a temporary pause in our server business in the current quarter as customers adjust their inventory levels. In future generations of server platforms, we expect meaningful increase in our content.

Revenue in the third quarter for computing end-market is expected to be down quarter-over-quarter due to decline in our client and server businesses.

The **Consumer** end-market contributed revenue of $164 million in the second quarter. The consumer end-market represented 12 percent of our revenue in the second quarter. Second quarter consumer revenue declined by 21 percent year-over-year. The year-over-year decline was due to continuing broad-based weakness in consumer electronics and white-goods markets, and our selective participation in these markets.

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

In summary, thus far in the current downturn, cyclicality in our revenue and margins has been lower than that of our peer group. Our performance speaks to the transformed nature of our business, and our focus on highly differentiated power, analog, sensor and connectivity products for automotive, industrial, and cloud-power end markets. We are seeing stabilization in business trends in our key markets. However, demand continues to be sub-seasonal as macroeconomic and geopolitical factors continue to weigh on end-demand. We believe that ongoing distribution inventory correction should be nearly complete by end of the third quarter of early fourth quarter of 2019. Despite current weakness in businesses trends across the industry, secular megatrends driving our business remain intact, and we are upbeat about our medium to long-term prospects. We are focused on the fastest growing end-markets of semiconductor industry, and with our design wins, we expect that our content in automotive, industrial, and cloud-power applications will continue to grow. To adjust to slowing macroeconomic environment, we are prudently managing our business with sharp focus on controlling expenses. Our operational execution remains solid.

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 $1,355 million to $1,405 million in third quarter of 2019.

For third quarter of 2019, we expect GAAP gross margin to be in range of 35.2 percent to 36.2 percent, and non-GAAP gross margin to be in range of 36.7 to 37.7 percent.

We expect total GAAP operating expenses of $349 million to $369 million. Our GAAP operating expenses include amortization of intangibles, restructuring, asset impairments, and other charges, which are expected to be $34 million to $38 million. We expect total non-GAAP operating expenses of $315 million to $331 million in the third quarter. The quarter over quarter increase in operating expenses for the third quarter over those of the second quarter is driven primarily by inclusion of Quantenna's results for full quarter, process transfer costs related to the 300mm fab at East Fishkill, annual merit increase, and absence of bonus reversal, which significantly lowered second quarter operating expenses. We expect to see meaningful decrease in Quantenna related operating expenses as we realize targeted synergies, and reduce costs. Offsetting increase in third quarter operating expenses are savings resulting from tight operating expense control.

We anticipate third quarter of 2019 GAAP net other income and expense, including interest expense, will be $38 million to $41 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 $29 million to $31 million.

Net cash paid for income taxes in third quarter of 2019 is expected to be $11 million to $15 million. We expect total capital expenditures of $125 million to $135 million in third quarter of 2019.

We also expect share based compensation of $21 million to $23 million in third 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 third quarter of 2019 is expected to be 414 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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