

ON SEMICONDUCTOR CORPORATION

CALL SCRIPT
FOR
Q3-18 RESULTS CONFERENCE CALL

Parag Agarwal

Thank you <operator>.

Good morning and thank you for joining ON Semiconductor Corporation's third 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 third 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 third 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 third 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. Our results for the third quarter and guidance for the fourth quarter of 2018 have exceeded expectations on all key metrics. This strong financial performance was driven by our multiple secular drivers in various end-markets and by solid execution on the operational front. Our robust financial results over last several quarters clearly demonstrate the strength of our business and our steadfast operational execution.

Despite overhang of trade tensions, rising bond yields, and fears of slowing global growth, overall demand environment remains favorable. We have seen a few spots of some weakness, especially in greater China region in industrial and white goods segments. However, we have been able to offset this softness in greater China with strength in other markets. Our near to mid-term outlook for our business remains healthy driven by significant increase in our content in automotive, industrial, and cloud power solutions for datacenters and 5G deployments.

Secular drivers powering our business remain intact, and our traction in our strategic markets, which include automotive, industrial, and cloud power continues to be strong.

Although we are confident of our near to mid-term outlook, we are managing our business in a very prudent manner. Our channel inventory remains at the lower-end of our target range of 11 to 13 weeks, and we have meaningfully reduced days of inventory on our balance sheet. At the same time, we continue to invest in our operations and in our R&D efforts to drive long-term growth in our key strategic markets, and to improve our profitability.

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

Total revenue for the third quarter of 2018 was \$1,542 million, an increase of 11 percent as compared to revenue of \$1,391 million in the third quarter of 2017. GAAP net income for the third quarter was \$0.38 per diluted share as compared to \$0.25 in the third quarter of 2017. Non-GAAP net income for the third quarter was \$0.57 per diluted share as compared to \$0.44 in the third quarter of 2017.

GAAP and non-GAAP gross margin for the third quarter was 38.7 percent. On GAAP basis, our third quarter gross margin improved by 100 basis points year over year, and on non-GAAP basis, gross margin improved by 80 basis points year over year. This strong gross margin performance was driven by solid operational execution and by improving mix resulting from higher contribution from our automotive, industrial, and server businesses. On year-over-year basis, third quarter 2018 gross margin was negatively impacted by the rise in certain input costs. With the anticipated ramp in additional internal raw wafer capacity towards the end of this year, we expect to partially offset the impact of increased input costs.

Our GAAP operating margin for third quarter of 2018 was 15.7 percent, as compared to 12.7 percent in third quarter of 2017. Our non-GAAP operating margin for the third quarter of 2018 was 17.8 percent, an increase of approximately 120 basis points over 16.6 percent in the third quarter of 2017. On year-over-year revenue increase of 11 percent for the third quarter of

2018, our non-GAAP operating income increased by 19 percent. This strong operating income performance demonstrates the leverage and strength of our operating model.

GAAP operating expenses for the third quarter were \$355 million, as compared to \$347 million for the third quarter of 2017. Non-GAAP operating expenses for the third quarter were \$322 million, as compared to \$296 million in the third quarter of 2017.

Third quarter free cash flow was \$228 million, and operating cash flow was \$358 million. Capital expenditures during the third quarter were \$130 million, which equates to capital intensity of 8.5 percent. Recall that to meet increasing demand for our products and to mitigate the impact of the steep rise in prices of raw wafers, we expect a higher level of capital intensity for this year and next. We continue to de-lever our balance sheet, and in the third quarter, we used \$65 million to pay down debt. We exited third quarter of 2018 with cash and cash equivalents of \$951 million, as compared to \$850 million at the end of second quarter of 2018. We used \$75 million of cash to repurchase 3.6 million shares of our stock in the third quarter.

At the end of the third quarter, days of inventory on hand were 116 days, down by six days as compared to 122 days in the second quarter. Distribution inventory in terms of weeks declined quarter-over-quarter in the third quarter, and currently distribution inventories are at lower end of 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. 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.

Earlier in the fourth quarter, we announced the purchase of an incremental 20 percent share of the manufacturing joint venture for an 8-inch wafer fab located in Aizu-Wakamatsu, Japan. With this purchase, ON Semiconductor now owns 60 percent share in the joint venture, and consequently we will report operational results of this joint venture in our consolidated financial statements beginning in fourth quarter of 2018. We have named the joint venture ON

Semiconductor Aizu Co., Ltd., or OSA. As part of the joint venture agreement, we may provide manufacturing services to our joint venture partner for up to six quarters starting with the fourth quarter of 2018. We expect revenue from manufacturing services to be approximately \$20 million per quarter at a nominal gross profit.

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 third quarter was \$810 million. Revenue for Analog Solutions Group for the third quarter of 2018 was \$532 million, and revenue for Intelligent Sensing Group was \$200 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.

Third quarter of 2018 was yet another strong quarter for ON Semiconductor. We continued on our trajectory of delivering strong revenue growth and robust margin expansion. Overall demand for our products continues to be healthy, despite concerns related to trade tensions, rising bond yields and expectations of slowing global growth. However, as Bernard noted earlier, we have seen a few spots of some weakness, especially in greater China region in industrial and white goods segments.

The key driver of our business is significant content increase in many applications in automotive, industrial, cloud-server, and 5G infrastructure end-markets, as opposed to underlying unit growth in these end-markets. In the automotive end-market, vehicle electrification and active safety are expected to drive steep growth in our addressable content for power devices and image sensors. In industrial market, need for power efficiency in industrial systems, is expected to drive many fold increase in power products from our PSG business unit. In cloud-server market, we continue to see solid growth for analog power

management products from our ASG business unit. In 5G infrastructure market, we are seeing many fold increase in our medium voltage power content as compared to that in 4G and 3G systems. Our business today is driven by sustainable secular growth drivers in the fastest growing semiconductor end-markets, as opposed to being driven by macroeconomic conditions and semiconductor industry cyclicality a few years ago.

Through our investments over last several 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. Significant part of our business comes from highly differentiated power, analog, and sensor products for automotive, industrial and cloud power end-markets. 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.

Overall business conditions remain favorable, and demand continues to be healthy across most end-markets. We have noticed some weakness in greater China region in industrial and white goods segments, but we have been able to offset that weakness with strength in other areas. In fact, we continue to sign long term supply agreements with our customers. On supply side, we believe that inventories in semiconductor supply chain are generally healthy, and we do not see any signs of excess inventory with our distributors and customers. In fact, as Bernard indicated in his prepared remarks, our inventory at our distributors is towards lower end of our target range of 11 to 13 weeks. Pricing continues to be benign as compared to historic trends.

Along with our strong revenue performance, our execution on operational front continues to be outstanding. Our operating model has shown strong operating leverage. As Bernard mentioned earlier, on year-over-year revenue increase of 11 percent for the third quarter, our non-GAAP operating income increased by 19 percent. We achieved this solid margin performance in spite of significant rise in input costs. We remain on track to ramp our internal raw wafer capacity by the end of current year, and with this ramp, we should be able to

partially offset the increase in input costs. At the same time, mix shift towards margin rich automotive, industrial, and cloud power end-markets should drive additional margin expansion.

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

Revenue for the **automotive** market in the third quarter was \$464 million and represented 30 percent of our revenue in the third quarter. Third quarter automotive revenue grew by an impressive 12 percent year-over-year. Despite some volatility in automotive supply chain, we posted strong year-over-year and sequential growth in the third quarter. We believe that ongoing content increases, new production introduction, and share gains drove our strong revenue performance, despite reports of volatility in global automotive supply chain. We expect that secular trend of meaningful semiconductor content increase in automotive will continue for foreseeable future, regardless of temporary changes in market dynamics. With a strong portfolio of power, analog, and sensor products, we are well positioned to disproportionately benefit from tremendous increase in semiconductor content driven by electrification, active safety, and fuel efficiency in automotive.

Our momentum in automotive image sensors continues to accelerate. Key factors driving our growth in the automotive image sensor market are significant technology lead over competition, and industry's most extensive product portfolio, giving customers more choices than before. 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. Furthermore, with our recent acquisition of SensL, we now have capability to provide LiDAR sensors, in addition to image sensors, radar, and ultrasonic sensors. We are the only semiconductor supplier with capability to provide all four types of sensors for ADAS and autonomous driving. We believe that this capability will not only drive significant content increase for us, but also it will provide a key differentiating advantage to us as automotive industry moves to sensor fusion architecture for ADAS and autonomous driving.

We recorded our first Silicon Carbide revenue from automotive end-market in the third quarter. We are actively engaged with leading global automotive OEMs on many Silicon Carbide projects. We expect Silicon Carbide will be a significant driver of our automotive content increase, driven by electrification of drive train. We expect to see strong acceleration in our automotive Silicon Carbide revenue for foreseeable future.

Demand for our power products, 48V systems, and LED lighting products remains strong. We are also seeing strong adoption of switch mode power management systems for camera systems and radar systems. In addition, we are seeing strong growth for our silicon based power products in EV/HEV market.

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

The **Industrial** end-market, which includes military, aerospace, and medical, contributed revenue of \$400 million in the third quarter. The Industrial end-market represented 26 percent of our revenue in the third quarter. Our third quarter industrial revenue grew by solid 12 percent year-over-year.

Ever increasing energy efficiency requirements continue to be key drivers of increase in power management content in industrial systems. We are seeing several fold increase in our power content in many industrial systems. In the industrial end-market, we are benefitting from our comprehensive power product portfolio encompassing the complete voltage range. Design activity for power products in the industrial market remains strong, and we are engaging with leading global industrial OEMs on their next generation designs. Within the industrial market, we are seeing strong traction for our Power Integrated Modules for applications in alternative energy market.

Machine vision is another area of strong growth in the industrial market. With recently introduced X-class image sensors, we expect to further strengthen our leadership in machine vision and robotics markets.

Revenue in the fourth quarter for the industrial end-market is expected to be down quarter over quarter, as opposed to seasonality of flat 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 \$314 million in the third quarter. The communications end-market represented 20 percent of our revenue in the third quarter. Third quarter communications revenue increased by 13 percent year-over-year.

In the third quarter, we benefitted from launch of new smartphone models. As has been the case over last few years, our content in new generation smartphones continues to increase in a meaningful manner.

On the infrastructure front, we are beginning to see ramp of our high-efficiency medium voltage power products for 5G systems. We expect that our power content in 5G infrastructure systems will be many times that in 4G or 3G systems. We have been designed in for significant power management content in 5G systems, and we expect to see strong revenue ramp with increased deployment of 5G infrastructure.

Revenue in the fourth quarter for the communications end-market is expected to be flat quarter over quarter as opposed to normal seasonality of sequential decline.

The **Computing** end-market contributed revenue of \$163 million in the third quarter. The computing end-market represented 11 percent of our revenue in the third quarter. Third quarter computing revenue grew by 16 percent year-over-year. The year-over-year growth was driven primarily by accelerating strength in our cloud power business and ramp of our analog power management solutions for graphics processors.

As we have indicated in previous earnings calls, we are engaged with leading cloud and server players, and we are working with leading processor providers on their next generation platforms. With upcoming generation of processors, we expect to increase our analog content through introduction of new products.

Revenue in the fourth quarter for computing end-market is expected to be approximately flat quarter-over-quarter, as opposed to normal seasonality of sequential decline. Continuing ramp of our cloud power business is the primary driver of better than season trend in our computing business.

The **Consumer** end-market contributed revenue of \$200 million in the third quarter. The consumer end-market represented 13 percent of our revenue in the third quarter. Third quarter 2018 consumer revenue was down one percent as compared to consumer revenue in third quarter of 2017. The decline was due to our selective participation in certain areas of consumer electronics market.

Revenue in the fourth quarter for the consumer end-market is expected to be down quarter-over-quarter primarily due to softness in white goods market and normal seasonality.

In summary, demand environment for our products remains healthy, driven by secular megatrends in industrial, automotive, and cloud power markets. The key driver of our business is significant content increase in many applications in automotive, industrial, cloud-server, and 5G infrastructure end-markets, as opposed to underlying unit growth in these end-markets. Trade tensions, rising bond yields, and expectations of slowing global economy have not impacted our business in significant manner. 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. While our business remains healthy, we are fully cognizant of risks arising from potential slowdown in global economy. We are very prudently managing our business with aggressive

and proactive inventory management to respond quickly to any changes in market conditions. 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 \$1,480 million to \$1,530 million in fourth quarter of 2018. Included in our fourth quarter revenue guidance is approximately \$20 million revenue from manufacturing services provided by ON Semiconductor Aizu Company Ltd., which, as I indicated earlier, is our joint venture in an 8-inch fab. Excluding impact of OSA, our fourth quarter 2018 revenue is expected to be in range of \$1,460 million to \$1,510 million. Recall that as part of joint venture agreement, we may provide manufacturing services to our joint venture partner for up to six quarters starting with fourth quarter of 2018.

For fourth quarter of 2018, we expect gross margin to be in range of 37.1 percent to 38.1 percent. Our fourth quarter gross margin guidance includes negative impact of 50 basis points from manufacturing services provided by OSA. Excluding impact of OSA, our fourth quarter 2018 gross margin is expected to be in range of 37.6 percent to 38.6 percent.

We expect total GAAP operating expenses of \$348 million to \$366 million. Our GAAP operating expenses include 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 in the fourth quarter. The quarter over quarter increase in our non-GAAP operating expenses in the fourth quarter is primarily driven by three additional days in the fourth quarter of 2018 as compared to those in the third quarter of 2018.

We anticipate fourth quarter 2018 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 fourth quarter of 2018 is expected to be \$8 million to \$12 million. We expect total capital expenditures of \$135 million to \$145 million in fourth quarter of 2018.

We also expect share based compensation of \$19 million to \$21 million in fourth 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 diluted share count for fourth quarter of 2018 is expected to be 428 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.

For full year 2018, we expect to generate free cash flow in neighborhood of \$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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