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ARM.L - Q3 2011 ARM Holdings plc Earnings Conference Call

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PRESENTATION

Operator

Thank you for standing by, and welcome to the Q3 results conference call. At this time, all participants are in a listen-only mode. There will be a presentation, followed by a question and answer session. (Operator Instructions). I would now like to hand the conference over to your speaker today, Ian Thornton. Please go ahead, sir.

Ian Thornton - *ARM Holdings plc - VP of IR*

Thank you, Nick. Good morning, everybody. This is Ian Thornton, VP of Investor Relations at ARM.

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On today's Q3 results conference call we have Warren East, Chief Executive Officer, and Tim Score, Chief Financial Officer. On today's call, Warren and Tim will take us through the highlights and comments from the quarter's results, and then we'll open the call up to a Q&A session. As a reminder, the presentation and press release can be found on the ARM Investor Relations website at www.arm.com/ir.

Before I hand over to them, I just have to read out a few words with respect to this conference call and what we are about to discuss. The contents of this conference call are being directed only to those of you who have professional experience in matters relating to investment, and the information communicated on this call is being made available only to investment professionals. Any person present on this call who does not have professional experience in matters relating to investment should not act or rely on the contents of this call.

The following conference call will contain forward-looking statements which are other than statements of historical fact. The Company's actual results for future periods may differ materially from these statements, as they are based on current expectations and are subject to a number of risks and uncertainties.

And on this note, I'll hand over to Warren.

Warren East - *ARM Holdings plc - CEO*

Good morning, everyone, and thank you for joining our call this morning.

So I'm going to run through the business highlights and then hand over to Tim, who will provide some more detail on the financial implications. But as usual, we expect that much of the content will be covered in the question and answers.

Quick overview. We reported our first-half results three months ago, and when we did that we highlighted the increased level of design activity, with our customers developing even more of their chips based on ARM technology. And the good news is that that level of design activity has continued, even though semiconductor sales have been lower over the summer than some industry analysts had expected earlier in the year.

We entered the third quarter with a healthy order backlog, at historically high levels, and we had ongoing market share gains in long-term structural growth markets. During the third quarter, we continued to outperform the semiconductor industry with good strong year-on-year growth in licensing and royalties against an industry that is broadly flat year on year. And we benefited from the sales of smart consumer products and lots of low power embedded electronics.

And the demand for these products is really what's driven licensing, with 28 processor licenses sold in the quarter and royalties, with shipments of ARM products growing year on year by 25%. And that's resulted in revenue growth and that's enabled us to continue to invest further in R&D, at the same time as growing earnings by 47% year on year and delivering good levels of cash generation.

So we're going into the final quarter of 2011 with a strong order backlog. Semiconductor companies are looking to develop more of their products round ARM technology. And this combination points to another strong quarter for license revenue. ARM Q4 royalty revenues are generated from Q3 shipments from our semiconductor partners, and our data for the third quarter indicates that relevant industry revenues were broadly flat sequentially.

Now, I'll just discuss the drivers for revenue in the different parts of the business in a bit more detail. We'll start with processors. We signed 28 licenses in the quarter with a very broad range of end markets, including deeply embedded designs for powertrain in Automotive, sensors, smartcards and microcontrollers. It also included some consumer electronic product design wins in things like digital TVs, mobile phones and mobile computers.



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14 of the 28 licenses were bought by new customers, and most of these new customers were actually established semiconductor companies who are now building their first ARM-based chip. And this is the highest number of new customers that we've yet seen in a quarter. And as the trend towards smarter products continues and gains pace, so semiconductor companies are finding ARM technology quite instrumental in helping them gain a share in increasingly competitive marketplaces.

24 of the licenses were signed for the Cortex family of processors. We sold nine Cortex-A licenses, mainly for smartphones, digital TVs, mobile computers and some embedded computers; 14 licenses for Cortex-M processors into microcontrollers and smartcards. And this included another lead licensee for the next generation of ARM processors for microcontrollers, and I expect that we'll be announcing that product next year.

So, in total now, 120 Cortex-M licenses have been bought by our customers for microcontrollers. And if you combine that with recent new product introductions by leading microcontroller companies like Atmel, TI, Samsung, ST, NXP, this is really an illustration of just how rapidly ARM technology is being adopted and deployed in the microcontroller market.

Two of the processor licenses we sold were for our Mali graphics processor, to be used initially in digital TVs and mobile computing. And this included another license for our latest [T600 series], which will deliver a big performance uplift over the graphics processors that you find in today's high-end smartphones.

So, switching to the royalty side of our business, ARM royalty, remember, is reported one quarter in arrears, so our royalties for Q3 were generated from chips sold by the semiconductor companies in Q2. Processor royalty was up 20% year on year. Total volume was 1.9b units. And that's driven by growth in our target markets. Particularly, non-mobile devices was interesting, growing at over 50% year on year.

And in our earnings release we've included a more complete breakdown of the volume shipments, so I won't go into that here. And that breakdown is also included in the presentation that we have put on our website in the Investor Relations section.

In mobile, ARM is benefiting from an increase in the Cortex-A family chips used in smartphones and tablets. In fact, Cortex-A shipments into mobile devices grew 300% year on year, and a recent market analyst report said that dual-core Cortex-A9 chips can now be found in 14% of smartphones that were shipped in Q2. So that's the sort of activity driving the royalty that we're reporting right now.

Cortex products collectively are now 22% of total volume, with 14% coming from the Cortex-M products in microcontrollers and the like and 5% from Cortex-A processors.

Switching to our Physical IP division, Physical IP revenue was up 17% overall at \$26m, and that was helped by license revenue growing 23% year on year. And as with the microprocessor part of our business, we're continuing to see good levels of design activity, with both foundry and fabless companies choosing to work with ARM's Physical IP at the advanced nodes. For example, during the quarter we signed a license with UMC to develop physical IP for their new 28-nanometer processor.

We've continued to see demand for the processor optimization packages, the POPs, so-called. And this -- as a reminder, these enable our Cortex-A9 and Cortex-A15 customers to more readily achieve high-performance, low-power processor implementations using specifically optimized physical IP. And for every chip implemented using a POP, remember, ARM receives a royalty both for the processor in the chip and for the physical IP. During the quarter we signed a further four POP licenses, including the first one for Cortex-A15 on 28 nanometers. The underlying Physical IP royalties were up 3% sequentially, and that was in line with the foundry industry.

Looking within the business at what we've been up to within the business, we've continued to make investments in R&D; we've grown our engineering teams, particularly those working on the advanced processors and the graphics products. We added 53 people in the third quarter. That's a total of 150 since the start of the year. And we do expect to continue that investment into Q4.

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The result of all this activity can be seen last week, when we announced our latest ARM processor, the Cortex-A7, which was formerly known as Kingfisher. Cortex-A7 is aimed at extremely energy-efficient applications. Along with this, Cortex-A7 also enables an innovative technology to reduce dramatically the energy consumption of a system-on-chip device. And when we launch this, we're calling it big.LITTLE processing, where you have a very low-power Cortex-A7 tightly integrated with a high-performance Cortex-A15 in a multiprocessor configuration.

And as the user of the product changes application, the performance requirements change and the workload on the microprocessor changes. The workload is seamlessly migrated between the two processors, and the application or the operating system is not even aware of which processor is being used, so all the legacy applications work. And this results in a chip that can be both very high performance and very, very energy efficient.

So over the next few days, actually, ARM engineers, customers and developers are all meeting at the ARM Technology Conference in Santa Clara. We're expecting close to 4,000 visitors. And there will be more announcements about where ARM and our customers have been investing our R&D. So keep an eye on the ARM website, and those announcements will be made public over the next couple of days.

So, with that, I'll hand over to Tim, who'll provide some further detail on the numbers.

Tim Score - ARM Holdings plc - CFO

Thanks, Warren. Morning, everyone. Yes, just a quick overview of some of the numbers before we move into questions.

You've seen the headlines, \$192.3m of total revenue. That's just under \$5m ahead of the consensus expectation and that's up 22% year on year. Particularly strong growth in license revenues, with a 41% increase in the Processor Division and a 23% increase in the Physical IP Division. PD, Processor Division license revenue was just under \$60m, and we've now seen four sequential quarters with licensing over \$50m. And we expect license revenues to continue this trend in Q4, as we start the quarter with a high level of backlog and a strong opportunity pipeline.

The usual analysis of backlog, maturity and composition is included in the slide set that Warren referred to, which is on our website. And that shows that just under 30% of total backlog is expected to be recognized as revenue over the next two quarters. And in Q3, approximately 60% of PD license revenues were generated from backlog, and that's at the upper end of the typical 40% to 60% range.

Processor royalties also grew strongly in Q3, up 20% year on year to just over \$84m. However, as indicated last quarter, Q3 royalty revenue has been impacted to some extent by the slowdown of sales by Japanese semiconductor companies. The earthquake and subsequent tsunami disrupted energy supplies and the semiconductor supply chain in the second quarter.

In previous years, normal seasonality has resulted in about a \$10m sequential increase in royalty revenues from Q3 to Q4. Data for the third quarter indicates that relevant industry revenues were broadly flat sequentially. So, as noted at our half-year results at the end of July, we may see below seasonal royalty revenue growth into Q4.

Normalized OpEx in Q3 was GBP60.5m, compared to the guidance given in July of GBP60m to GBP62m. As noted in the earnings release, we benefited from a net credit due to the impact of a stronger dollar on the accounting of derivative instruments. Normalized OpEx for Q4 is expected to be in the range GBP63m to GBP65m, assuming current exchange rates. Sequential increase is partly due to the assumption that the impact of accounting derivative instruments will be neutral in Q4, and partly due to the effect of hiring in Q3 and Q4 as we invest in the development and deployment of new technology.



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Normalized operating margins in Q3 were over 44.5%, compared to 38% a year ago. And cash generation continued to be strong, demonstrating that we are continuing to increase profitability and generate good levels of cash whilst increasing investment in future product development and organizational capability.

Now on to -- just to reiterate outlook. As previously mentioned, both the order backlog and the licensing pipeline are robust, pointing to another quarter of strong licensing. ARM Q4 royalty revenues are generated from third-quarter chip shipments, and as mentioned earlier relevant data for the third quarter indicates that industry-wide revenues were broadly flat sequentially.

So, notwithstanding the below seasonal activity levels in the wider semiconductor industry, at the moment we expect that Group dollar revenues for the full year 2011 will be in line with current market expectations, which are around \$763m for the full year.

And now, over to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Your first question comes from the line of Gareth Jenkins of UBS. Please go ahead.

Gareth Jenkins - UBS - Analyst

Yes. Thanks for taking the question. Just a quick one. The strong order pipeline into Q4, Tim, could you just give a sense of, I know it's probably early days, but how that shapes up for 2012? Is this the new baseline that we should be using for our licensing revenue assumptions into 2012?

And then, just secondly, I wonder if you could just give us a bit more around big.LITTLE and the potential impact on royalty rates going forwards. Thank you.

Tim Score - ARM Holdings plc - CFO

Yes. Hi, Gareth. As we -- as I just said, I think Q4 we expect the strong licensing trend to continue. We also say in the earnings release that if you look into the opportunity pipeline for the fourth quarter then the prospects for the exit backlog at the end of the year are promising, which means we expect it to be up. So that's going to provide an even more solid base than we currently have for licensing in 2012.

And with things like Cortex-A7 and other still relatively recently introduced products and more to come, we have a pretty rich portfolio of processors for licensing in 2012. So putting macro environments, etc., aside, then we believe we are very well placed to continue strong licensing next year.

Warren East - ARM Holdings plc - CEO

And I'll answer the big.LITTLE question and the royalty implications. I think it's too complicated to be very detailed about how the royalty agreements work out, but the net effect is that, A, big.LITTLE will be used in high-end chips, typically, and so they're more expensive devices. And as you know, our royalties are a percentage of the chip price. And secondly, by definition, these are multiprocessor capable products and so with that higher level of functionality they continue the trend of higher royalty

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rates for higher levels of functionality. So we would expect to see more royalty from a big.LITTLE configuration than a typical multiprocessor configuration, where you just have an A7 or an A15.

But to be very precise about the numbers, it's probably too early to say how these are going to show through in the mix. As you know, high-end Cortex-A15 products command a higher royalty rate than A9s on their own, and so typically we're at the 2% end of the 1% to 2% range and the big.LITTLE configuration will push things further.

Gareth Jenkins - UBS - Analyst

Thanks.

Operator

Your next question comes from the line of Gunnar Plagge of Citi. Please go ahead.

Gunnar Plagge - Citigroup - Analyst

Yes. Hello. Thanks for taking my questions. Two on the ecosystem, the first one on computing. It looks as if Android is starting to become optimized for the Intel architecture, so with ports to x86 starting a lot of work to recompile a native ARM application. So I was wondering to what extent are you following this and to what extent are you factoring in changes in the ecosystem landscape? So that's the first one.

And on graphics, also ecosystem, I see now four main companies in the space, Autodesk, Mentor, Polabit and Gameloft, working on ARM. So my question would be how much of the ecosystem is in place now and what do you think would be desirable to have short term, to really make further impact? Thank you.

Warren East - ARM Holdings plc - CEO

Okay. Let me talk about Android to start with. This is an open operating system, and ports are available for multiple architectures. At the moment, the situation is that initial implementations are being rolled out on ARM-based devices, the latest Ice Cream Sandwich that was released the other day with an OMAP device. And the reality is that it is possible to port this operating system to alternative architectures with effort, and certainly Intel has the ability to work with Google to create these ports very quickly.

And the thing about Android is it's a thriving competitive ecosystem with multiple chips supporting Android designs, and that has always been the case and will continue to be so. And we certainly factor into our expectations the notion of the progress that Intel is making in the smartphone world generally. But we would contend that our architecture is more appropriate and will continue to be more appropriate, and product launches like the big.LITTLE A7 launch that we did last week continue to demonstrate our leadership in that area.

With regard to the graphics ecosystem around Mali architectures, then that does continue to develop, as we've said many times before. Ecosystem around the Mali graphics architecture is less mature than some others. 2011 is an important year for that ecosystem maturity to accelerate. And that acceleration is happening, as significant volumes of Mali-based devices are starting to ship. We're expecting tens of millions of Mali products shipping in 2011, driving the maturity of that ecosystem, and that is indeed the path that we're on for 2011.

Gunnar Plagge - Citigroup - Analyst

Thanks.

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Operator

Your next question comes from the line of Sandeep Deshpande of JP Morgan. Please go ahead.

Sandeep Deshpande - *JP Morgan - Analyst*

Yes. Hi. If I may, a quick question on the royalties. You talk about that your dual-core Cortex are in 15% of the smartphone market now, and you've also talked about in the past that the Cortex has a higher royalty per device. But we are not seeing any impact of that yet. Maybe you can talk about also with relation to where -- how much -- how the mobile phone market itself is. Is it because such a huge change in the other market that you're not seeing any impact on the royalty per device in the dual-core Cortexes?

And then, secondly, with regard to the licensing revenue, you've had a lot of new semiconductor companies you've mentioned signing up, but most major semiconductor companies other than very minor ones were always ARM licensees. So can we talk about -- are these all new semiconductor companies who are signing up?

Warren East - *ARM Holdings plc - CEO*

Two questions there. Let's start off with the royalty one. I think you have to remember that we're saying with these results Cortex-A processors are accounting for 5% of the total volume. And yes, they typically go into higher-price devices, and certainly the dual-core A9s are at the high end of the apps processor price range. But 14% of the volume, that is effectively three times the volume, are Cortex-M products. And we continue to see very, very strong growth in the microcontroller sector generally. A lot of those microcontrollers that are shipping today are still based on ARM 7s and ARM 9s, so it isn't just the 14% that is Cortex-M.

And we're simply seeing -- when you do the arithmetic and look at the royalty in dollars and cents that we're earning per chip, then the downward pressure on that number from the very high volumes of very low-price chips is continuing to dominate the arithmetic, even though the Cortex-A products, when you look at that effect on its own, the Cortex-A products are substantially increasing the royalty that we're earning on chips going into smartphones and mobile computers.

So it is just those two effects that we have talked about before, and that's continuing to happen. It's still giving us an overall royalty revenue increase, and of course it's the total royalty revenue, all at near 100% margin, that's what we're interested in. And we're interested in growing our share in microcontrollers overall as well, and we can foresee considerable growth yet to come in microcontrollers on the back of all the licensing that's been done for Cortex-M products.

Tim Score - *ARM Holdings plc - CFO*

Yes. On licensing and licenses, Sandeep, most of the -- in recent quarters, most of the new licensees have been in the microcontroller area, taking Cortex-M products. And these may typically have been companies that weren't necessarily in a position to deploy ARM technology in their previous lives. But it's not just that. There is a range.

And I think, generally, we've been talking about the number of licensees and potential saturation and things like that now since I've been here, which is about 10 years ago. And I think we had around about 80 or 90 licensees and I was told on arrival that we were saturated. We've now got 275 plus. And I think what's driving it is the broadening applicability of ARM's technology across the breadth of the computing spectrum. I think Ian also wants to add a comment.

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Ian Thornton - *ARM Holdings plc - VP of IR*

Yes. Sandeep, I have some analysis on who these companies are and where they've come from, mainly to see were they all start-ups, and the answer is absolutely not. Very few of them are start-ups, probably unsurprisingly, because there aren't that many -- isn't that much seed funding at the moment for those companies to go and get access to.

So the majority of them are either microcontrollers -- microcontroller companies who basically have never needed a 32-bit microprocessor in their chips, so they're making very simple chips or they're making just analog or just sensor chips and now they're putting the microcontroller technology into that chip as well, or they are established companies in other markets who maybe have used another architecture, either one they've developed in themselves or from one of our competitor companies as well.

Sandeep Deshpande - *JP Morgan - Analyst*

Thank you.

Operator

Your next question comes from the line of Didier Scemama of RBS. Please go ahead.

Didier Scemama - *RBS - Analyst*

Yes. Good morning, gentlemen. Thanks for taking my question. Two quick ones, if I may. First of all, on the OpEx guidance for Q4, can you maybe elaborate a little bit on the key areas of investments? And secondly, if you can give us an idea whether that's a base for 2012? That's my first question.

Then, secondly, on the royalty rate, big.LITTLE processing, Warren, you alluded that that number is going to be slightly up or up versus, let's say, current high-end architecture. What I was wondering is, is that technology also applicable to other ARM chips? So, for instance, can we marry a Cortex-A8 with an ARM-11 or things like that, so that we also benefit in the mid and low end, say?

Tim Score - *ARM Holdings plc - CFO*

On the OpEx, Didier, the vast majority of the investment that you've seen in ARM in the last couple of years has been into the R&D capability within our Processor Division, i.e. the Processor Division and the Media Processor Division. That is where most of the investment has been.

I think, as we think about 2012 OpEx, I think Q4 will probably be a reasonable base. Sometimes in the fourth quarter we end the year with a very strong finish on order taking and things like that, which can lead to a slightly artificial high incentive payments which wouldn't be there going forward. But generally speaking, I think the fourth quarter is a reasonable base, and then obviously you need to think about the full-year effect in 2012 of the hires in 2011.

Warren East - *ARM Holdings plc - CEO*

And, Didier, on the big.LITTLE and wider use of the big.LITTLE, it's -- there's nothing stopping you having a big and a little processor combination, like an A8 and a something else. However, in that instance, the software has to be knowledgeable about where the application is actually running, on the big processor or on the little processor.

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What we've done with the big.LITTLE announcement last week was talk about processors that have been specifically designed together and to run in big.LITTLE configuration together, so that the application -- either the application or the operating system, even, doesn't need to comprehend the fact that there are two processors down there and the software doesn't need to know on which processor it's actually running. It's just another lower-power state of the processor subsystem.

And so the answer to your question is effectively no, you can't get the full benefits of big.LITTLE with all the legacy applications with combinations of other processors that we have. However, as we look forward, we will be taking the big.LITTLE concept into newer products from ARM, and that will become a feature of our road map.

And as we look to things like the Mali graphics processors, which of course, compared with general purpose processors, graphics processors, are taking increasingly large chunks of area on the chip and therefore consuming more power, as we look to improve the efficiency of graphics processors then we'll be designing those in conjunction with our general purpose processors and in conjunction with each other. And I'm sure you'll see some big.LITTLE activity there as well.

Didier Scemama - RBS - Analyst

If I may, if I understand correctly, that's a very strong incentive for the ARM community to license Cortex-A15, effectively?

Warren East - ARM Holdings plc - CEO

Yes. A15 and A7 are the first two products designed with this in mind. As I say, you'll see more of it in future and you'll see it creeping into our graphics offerings too.

Didier Scemama - RBS - Analyst

Great. Thank you so much.

Operator

Your next question comes from the line of Nick James of Numis. Please go ahead.

Nick James - Numis - Analyst

Yes. Good morning. Just a couple of questions. One was on the announcement earlier in the month about the first tape-out for 20-nanometer ARM Cortex-A15. I guess on Intel's conference call they said they were going into volume on their 22-nanometer process. I know it's destined for PCs in the initial version, but they are quite highly focused on getting that into mobile. So I just wonder when we can be expecting 20-nanometer-type generations of ARM-based chips for the mobile segment.

And the second question was just on PIPD. The licensing revenue's been growing nicely. The royalty revenue still seems to be tracking the overall market. When should we be expecting the PIPD royalty revenues to begin to outperform the overall market?

Warren East - ARM Holdings plc - CEO

Two questions. They're quite similar, really. And it's about the time lag between design and production. And typically we've always said for ARM processors, the licensing activity, then it's about four years from licensing to when significant volumes of people are going into shops, buying products, triggering chip shipments and royalties. And that four years is more or less constant.

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And to take your second question, applying that principle to the royalty revenues that we'll see in the more advanced processes for our physical IP, I think we're still a good couple of years away from that. I think we've seen advanced process licensing happening for about the last -- certainly quite reliably for the last two years or so. We are starting to see 45-nanometer shipments are happening today. There will be 28-nanometer shipments happening really very, very soon. But in terms of moving the dial, then these things have to accumulate. And I wouldn't expect to see significant dial moving from those advanced processes for another 18 months to two years.

On the 20 nanometers and when you'll see production of ARM-based 20 nanometers, I think that's a couple of years out as well. TSMC and UMC and GlobalFoundries all have their road maps, and devices will go into production as and when they are able to take them into production. The important thing, as far as we are concerned, is that the designs are happening on these advanced processes, and that's why we were very keen to support the press release with TSMC and the press release with Cadence that happened on the Cortex-A15. And we're keen that people continue to use ARM processors as an essential part of their development of these new technologies.

Intel, of course, can control the manufacturing as well as the design. And as and when they choose to introduce 28 nanometers -- sorry, 20-nanometer designs or their 22-nanometer fin-fed design, that's up to them.

Nick James - Numis - Analyst

Okay. Great. Thank you.

Operator

Your next question comes from the line of Simon Schafer of Goldman Sachs. Please go ahead.

Simon Schafer - Goldman Sachs - Analyst

Yes. Thanks so much. I want to go back on this discussion on licensing revenue, if I may. Tim, just on the \$60m, obviously a very high run rate that, as you said, you feel like it's sustainable, but perhaps some of the initial licensing income from the MCU customers tailing off into next year. What is it that you expect this level to keep as high as it is? Is it ARM-7 or is it something else, just to get a little bit more color as to what gives you the confidence that can be a high? It seems like it's been running at an abnormally high level, perhaps. Or maybe that's wrong; maybe you just think it's the new run rate. Thank you.

Tim Score - ARM Holdings plc - CFO

Well, as I say, we've now done four quarters over \$50m, and what I said is I see that trend continuing. Clearly, one quarter is still a short reporting period for this type of business model, and so you can -- we can get lumpiness. And we shouldn't be alarmed if we see a lower licensing quarter followed by a higher licensing quarter.

But generally speaking, what underpins the comments I made before is the fact that we have a historically high backlog at the end of the third quarter; we're making comments in the release which give us confidence that we think it's going to be higher at the end of the year. And we -- when we look into the product portfolio that we have for licensing next year and the -- what we think and believe that our customers and potential customers would want to license from us in that period, that -- when we model that out, that gives us a lot of confidence that strong licensing is going to continue.

It's not one particular product to a small handful of customers that's going to make the difference. It's the breadth of the portfolio and the breadth of the customer base that's underpinning our confidence.

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Simon Schafer - Goldman Sachs - Analyst

Got it. Thank you. And my second question would be more, as you look into your cost model for next year and your budgeting, what sort of OpEx step-up are we looking at? Is there a lot of investment that you still need to do on an annualized basis, as you look into next year, to support higher investment for the higher licensing revenue run rate? Just to get a sense as to what you think maybe annualized OpEx growth may be, assuming some sort of normal industry environment. Thank you.

Tim Score - ARM Holdings plc - CFO

Well, I think in a normal industry environment we would expect to continue investing in our R&D capability next year. But as we've seen before with ARM, the pace of that can be moderated according to industry conditions. And we'll see. But we have lots of opportunity to -- we have ideas to be developing, innovative technology which we'd like to get to market sooner rather than later, and that's why we're investing.

Simon Schafer - Goldman Sachs - Analyst

Okay. Thanks so much.

Operator

Your next question comes from the line of Sumant Wahi of Redburn Partners. Please go ahead.

Sumant Wahi - Redburn Partners - Analyst

Hi. Thanks for taking my question. My question was -- one was on PIPD. Over the past few halves, you kindly do give out PIPD-specific revenue and operating costs. And looking at H1 '11, it did seem that your operating costs were going down a little bit. But I was just wondering that currently, looking at the strong licensing and you're reducing costs in the PIPD Division, do we expect PIPD operating profit to break even in the near term? Are we talking about next year or, as Warren said, it's going to be another 18 months to two years before we see a breakeven in the PIPD Division? And then I have a follow-up.

Tim Score - ARM Holdings plc - CFO

Well, I think Warren was specifically referring to a question about the development of the royalty trajectory, which will obviously be helpful to that. I think you're right. In the half-year statement and the full-year accounts, we give full segmental analysis where we allocate all of the central ARM cost, if you like. And that analysis has indicated that, very broadly, once physical IP starts going through \$100m of revenue per year, then on a purely allocated basis it moves into profitability. That's the position.

Sumant Wahi - Redburn Partners - Analyst

Okay. And I just wanted another further clarification of this patent tax. I think I understood it correctly, but I just want to clarify. When you talk about the patent tax which may come in over 2012/2013, which reduces your tax rate applicable from 24% to probably 10%, 15%, just wondering whether this is applied retrospectively to patents which were issued before the tax ruling comes into place or, i.e., after ruling does the tax rate get effected immediately or do the earnings only get benefited from this new tax rate with a delay of a few years?



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Tim Score - ARM Holdings plc - CFO

I think the answer to your question is those are implementation details for this legislation or potential legislation which have not yet been finalized. What we expect is that the -- certain revenues generated by ARM will benefit from the new patent box legislation from 2013 onwards. But in terms of exactly how much and in what way and from when, we'll have to wait and see the legislation and the consultation documents that come along with it.

Sumant Wahi - Redburn Partners - Analyst

Thank you. And just one final one on Cortex-A7. Could you give us an idea of the pricing of it, please? Thanks.

Warren East - ARM Holdings plc - CEO

Yes. In terms of license fee, it's a high-end processor if you look at it in the context of our overall road map. It's an advanced processor with a lot of functionality, so it's at the higher end of the price spectrum for license fees.

For royalties, we're going to see two use cases for Cortex-A7. As we said in the launch, we're going to see it in -- on its own as an applications processor in apps processes that are going to be at the lower price points for lower-end smartphones of the day. By the way, they'll still be smarter than the high-end smartphones that we enjoy today, but by the time we're enjoying them they're going to be low end.

But you're also going to see it in high-end configurations strapped alongside A15s in the big.LITTLE configuration. And those chips will be at the high end of the apps processor price spectrum. And the royalty rates there will be higher as well because it's being used in configuration with A15, and so there's going to be significant upward pressure on the royalty from those sorts of products.

Sumant Wahi - Redburn Partners - Analyst

So we're talking about 4% royalty sort of level at that point?

Warren East - ARM Holdings plc - CEO

Well, I think there's a lot of factors that come together to generate 4%. And in our February earnings presentation, we went through some detail there about how things are made up. And those sorts of numbers are not out of the question, but you do have to have a lot of ARM technology on a chip to generate more than 3%, but it's certainly not out of the question.

Sumant Wahi - Redburn Partners - Analyst

Thank you.

Operator

Your next question comes from the line of Janardan Menon of Liberum Capital. Please go ahead.



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Janardan Menon - *Liberum Capital - Analyst*

Yes. Thanks for taking the question. My first question is just on Windows 8. There's some views that the ecosystem from a software application point of view may not be developed fast enough on the ARM platform, especially for legacy applications, when Microsoft launches Windows 8, and this could be -- could constrain the level of implementation of ARM on that operating system. I'm just wondering whether ARM is doing anything right now to proactively help the development of an ecosystem for its architecture on Windows 8, or is that something that'll have to happen once the operating system is actually available -- launched in the market?

Secondly, just a clarification. When you say relevant industry revenue for Q3 was broadly flat sequentially, does that include the ARM market share gain? Is that for ARM-based shipments, or is that for industry shipments and you would expect your shipments to be higher because of market share gains?

Tim Score - *ARM Holdings plc - CFO*

Yes. Janardan, I'll just take the second one. Tim. That is a comment about industry data. So we would expect ARM to outperform in some fashion, as is normal.

Janardan Menon - *Liberum Capital - Analyst*

Sure.

Warren East - *ARM Holdings plc - CEO*

And on Windows 8, I think Microsoft revealed a deal of information a few weeks ago. And in terms of legacy applications, then applications which rely on the fact that there is an x86 processor underneath, i.e. applications that go around the operating system, then those will certainly not run on ARM-based platforms. Applications -- legacy applications which behave can simply be recompiled to ARM, and the tools will clearly be available for that.

But ARM's activity is confined to supporting Microsoft in their endeavors to get some of the key applications, like the Office applications, out and running on the ARM-based platforms, and to help Microsoft with the operating system itself and work with the ecosystem in the provision of tools. But as for individual applications providers, then whether they choose to simply recompile because they've got a very well-behaved application or if they haven't got a well-behaved application if they choose to port that to ARM-based platforms, that's up to them.

Janardan Menon - *Liberum Capital - Analyst*

Okay. And a last question, if I might. Just in terms of -- you're saying you had new -- 50% of your new licensees were new semiconductor -- established semiconductor companies which were new to the ARM architecture. Do you have a feel for how many more of such companies exist, which is established companies, excluding start-ups, but relatively established companies which are yet to adopt the ARM architecture? Is that still a significant number, or have you pretty much covered the vast majority of that?

Warren East - *ARM Holdings plc - CEO*

When we say established, we mean a company that's ongoing and is not a start-up. That doesn't necessarily mean it's one of the top semiconductor companies that everybody's heard of. And when you look into it and look around the world, there are many hundreds of established semiconductor companies.

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And as Tim said a little while ago, we're now at around 275 licensees. So there are many hundreds more semiconductor companies that are established semiconductor companies that today don't use ARM technology. Sometimes they don't use microprocessors. Sometimes they use microprocessors but they're simple 8-bit microprocessors. There's a lot of opportunity out there for new companies that haven't -- sorry, not new companies, established companies that haven't yet used ARM technology to deploy ARM technology.

Janardan Menon - *Liberum Capital - Analyst*

Got it. Thanks a lot.

Operator

Your next question comes from the line of Johannes Schaller of Deutsche Bank. Please go ahead.

Johannes Schaller - *Deutsche Bank - Analyst*

Yes. Thank you for taking my question. Just coming back to processor royalties, obviously royalty ASPs have declined over the last quarters in general, and I think we all understand the drivers probably quite well. I just wanted to see if you can give us a bit of a feeling maybe when you think this trend can stop or slow down, or when could we reach trough levels and what could those trough levels potentially be, given that you have also obviously some offsetting factors in there?

And then, more specifically on the royalty rate for your quad-core A15 processors, what is the rate you think is realistic for this, say in 2013? Is that roughly the 3% you have already talked about, or should that even be more? Thank you.

Warren East - *ARM Holdings plc - CEO*

Gosh. What a lot of questions (multiple speakers).

Tim Score - *ARM Holdings plc - CFO*

Well, I think on the -- Johannes, on the first question, in a sense Warren has really already addressed it. What you've got here is a number of markets in which ARM is growing its penetration at different rates. We know that one of the very high-volume opportunities for ARM is microcontrollers, characterized by lower-price chips and therefore lower royalties per device. But we also know that we're only 5% of Cortex-A shipments, and there's been a lot of licensing done in recent years and ongoing which is going to gradually increase that Cortex-A proportion.

Exactly how those two factors play out, one being a distinct upward pressure on the average rate and one being a downward pressure on the average rate, only time will tell. But the trend that we have seen over the last couple of years has been absolutely consistent with what we've messaged and what we've expected, as ARM has started to make significant process in 32-bit microcontrollers. But really I think we'd all have a slightly different model of the relative growth rates of the end markets.

Warren East - *ARM Holdings plc - CEO*

Okay. And the second question, about what sort of royalties should we actually expect from things like quad-core A15 devices, the A15 is itself a very highly functional processor, and the multiprocessor capability is an example of that increased functionality. So I think what we've said before is that if you take a range of 1% to 2%, then Cortex-A15 will be at the higher end of that range, say it's about 1.75%.

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Increasingly, we are finding people adopting our physical IP for advanced semiconductor processes, and the greater than 50% attach rate of the processor optimization packages on Cortex-A9 is an indicator of that. And when a chip is designed with our processor optimization package, we're then going to earn a royalty on the processor itself and the physical IP royalty, which would typically be another 0.5% or so.

Those sorts of devices are also devices that typically will include other ARM microprocessors, perhaps for a power management function or some other auxiliary function on the apps processor. And though there is a multi-core discount for the second ARM processor and subsequent ARM processors, again, typically you're going to be adding a significant portion of 1% on top of that again. And by the time you've added an extra percent for graphics, then you're north of the 3% mark.

And that's the analysis I went through in February, on the conference call. It's there in our presentations on the Investor Relations website. I can't quite remember the slide number right now, but it's starting to be a quite well-known slide. And so the potential is there for these devices to be commanding well north of 2%, up towards 4%, as we look forward.

And our customers don't mind that, because they are getting increased functionality out of all that ARM technology on the devices and it's enabling them to produce competitive apps processors. And then you have to remember that those apps processes themselves, with all that functionality, will be high-priced chips. So, in absolute dollars and cents terms, we're going to be earning relatively large royalties on those sorts of devices.

Johannes Schaller - Deutsche Bank - Analyst

Very clear. Thank you.

Warren East - ARM Holdings plc - CEO

Thanks.

Operator

Your next question comes from the line of Francois Meunier of Morgan Stanley. Please go ahead.

Francois Meunier - Morgan Stanley - Analyst

Yes. Thanks for taking my questions. Actually, I've got three, if I may. ASPs are going down for the -- I think it's the second or third quarter now. Is there any chance actually it could go up in Q1 2012, with iPhone 4s moving into the equation? That would be my first question.

Then two questions on Windows 8. The first one is on the manufacturers of tablets. I guess you're probably aware of who's going to try to make those, and if you could tell us who do you think are best placed to launch and manufacture those tablets. Is it the natural PC manufacturers, or are those like new entrants or guys coming from maybe the smartphone world?

And the third question as well is on the application ecosystem, to follow up on Janardan's question. I'm sure you're talking to the big software companies, whether they will port their software to ARM. Do you know how well advanced they are on this? And if you could name maybe the few software you know will be ported at the launch. Thank you.

Tim Score - ARM Holdings plc - CFO

Shall I do the first one, Francois?



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Francois Meunier - Morgan Stanley - Analyst

Thanks.

Tim Score - ARM Holdings plc - CFO

I think if you look at the evolution of the average royalty rate for ARM over time, you can detect an element of seasonality. And it is true to say that in Q1 of 2008 and Q1 of 2009 and Q1 of 2011, the average rate did go up quarter on quarter. And in Q1 2010 it was fairly flat. So we'll see. It'll be a function of the relative growth rate and the relative ARM penetration in those markets, but there certainly is some history which says it's possible.

Warren East - ARM Holdings plc - CEO

Right. And with regard to your other two questions, Francois, I'll take them together, if that's all right. The simple answer, can I name people, either people who are going to make tablets or applications providers, then the answer is no. We can't talk publicly about people's plans around ARM technology until they're ready to talk about it, and that's always been the case.

With regard to the apps porting, which people -- I think that's the root of some of these questions, then already applications or software companies who have apps that are running on PCs are porting those apps to ARM-based platforms that are coming out in tablet form factors. And we're seeing that for Android and we're seeing it for the iOS-type tablets. That's happening today. And that trend will probably continue with the Microsoft operating system as well. But it's very much a matter for the individual software companies themselves, as they have to weigh up the cost of doing that port and the potential upside in terms of the number of new products that they're going to sell.

And what we can see is that when we look into the whole mobile computing space, over the next few years, we can see traditional form factors continuing to grow. But we can see new form factors growing much, much more strongly, which is why, when we look at the overall market and see how that grows over the next few years, we can talk about gaining 40% of that market.

Francois Meunier - Morgan Stanley - Analyst

So I understand you can't name exactly the companies, but maybe to give us an idea, as I was asking about the manufacturers, do you feel like it's more likely to be the old PC manufacturers or more coming from smartphone-type people?

Warren East - ARM Holdings plc - CEO

Well, I think there's just a whole host of them. And when you go and look at things like the Consumer Electronics Show, you'll see loads of manufacturers from both camps with plans out there for tablets and plans out there for supporting Microsoft's new operating system. We just can't talk about individual companies.

Francois Meunier - Morgan Stanley - Analyst

Okay. So loads of prototypes in January, basically?

Warren East - ARM Holdings plc - CEO

There's a tremendous amount of activity out there as we speak.

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I'm just being told that we have only time for one more question, by the way. I'm sorry.

Francois Meunier - *Morgan Stanley - Analyst*

Okay. Sorry. Thank you. Bye.

Operator

Thank you. Your final question comes from Andrew Gardiner of Barclays Capital. Please go ahead.

Andrew Gardiner - *Barclays Capital - Analyst*

Thanks very much. I just had a follow-up on the Mali side of things. You have highlighted again today, and it's something that you've seen saying for the last couple of quarters, that this is a year for the ecosystem to mature or the maturity to accelerate. You've said that again today, yet we've seen the pace of license signings slow over the last few quarters now to just two in the third quarter, even though you have announced a new series of licenses. I was just wondering how you're seeing discussions progress with potential customers in the industry. And I suppose more pointedly, are you expecting licensing to ramp again next year?

Warren East - *ARM Holdings plc - CEO*

Well, I think the number of licenses that are sold in an individual quarter is a number which will fluctuate and go up and down. It is lumpy. We happened to sell two in the last quarter. I think if you step back from it and look over a period of years, you'll see that we've roughly doubled the number of licenses that have been sold on an annual basis, year by year, for the last three years or so that we've been selling these licenses. And I suspect when the reckoning for 2011 takes place, then we'll be on that sort of trend. So, to say that licensing and Mali products is slowing is just a fallacy, I'm afraid.

Year to date, as of the half-year, this year we'd sold 14 licenses. In the whole of 2009, we sold 14 licenses. In 2008 we sold eight and in 2007 we sold four. So the number is tracking continually upwards right now.

And the maturity of the ecosystem comment, that's definitely something which the maturity needs to develop in order to allow that licensing to happen more readily. But it is maturing. I said at the beginning of the year we expected to see tens of millions of Mali products shipped this year, which would help accelerate that trend, and we're absolutely in line for that to happen. And more and more of these software companies who do need to port to the Mali architecture are indeed doing so.

Andrew Gardiner - *Barclays Capital - Analyst*

Right. Sounds good. Thanks very much.

Warren East - *ARM Holdings plc - CEO*

Thank you.

Ian Thornton - *ARM Holdings plc - VP of IR*

Operator, time to hand back to yourself, I think.

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Warren East - *ARM Holdings plc - CEO*

So, yes, well I just want to say thank you all very much for dialing in. We're quite pleased with the results we're announcing this morning. We are going into the fourth quarter with a healthy pipeline. We're going into the fourth quarter with momentum in market share gains and with an order backlog at the near record levels. So things are looking pretty good as we head into the end of the year, and we'll be back in February with our full-year results. Thank you very much.

Operator

Ladies and gentlemen, that does conclude our conference for today. Thank you for participating. You may all disconnect.

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