

FINAL TRANSCRIPT

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ARM.L - Q3 2009 ARM Holdings plc Earnings Conference Call

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PRESENTATION

Operator

Thank you for standing by, and welcome to the ARM Holdings Q3 results conference call. At this time, all participants are in listen only mode. There will be a presentation, followed by a question and answer session. (Operator Instructions). I must advise

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you that this conference is being recorded today, Tuesday October 27, 2009.

I would now like to hand the conference over to your speaker, Ian Thornton. Please go ahead, sir.

Ian Thornton - ARM Holdings plc - Director of Investor Relations

Thank you. Good morning. This is Ian Thornton, Director of Investor Relations at ARM. 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 this quarter's results and then, we'll open the call 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 Warren and Tim, I just have to read out a few words with respect to this conference call and what we're 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 investments. And the information communicated on this call is being made available only to investment professionals. Any persons present on this call who does not have professional experience in matters relating to investments 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're 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

Thanks, Ian. Good morning, everybody and thank you for joining our Q3 results conference call. As usual, I will cover some business and operational highlights, and Tim will add some detail on financial performance. And then we will open the floor to your questions.

So Q3. Given the significant destocking in the whole industry since Q4 2008, which continued well into Q1 this year, and the restocking which kicked in around Easter, then setting expectations for 2009 as a whole has been challenging throughout the year.

And so, we're actually very pleased today to be announcing results for Q3, which is traditionally a very short quarter. And we're pleased to be announcing results that are ahead of consensus expectations; expectations which themselves have been gradually increasing throughout the year.

We're reporting revenue which is up strongly from Q2. And that, combined with continued careful management of costs, has given rise to significant improvements in profit, margin and earnings. Now, we have exposure to applications that are benefiting from structural growth, as well as there being an underlying industry recovery, which means volume shipments of ARM processors have bounced back to the 1 billion units per quarter level, which was the same level as Q3 last year.

Over the last 12 months, there have been tough trading conditions, but we've maintained our headcount broadly flat. And that's enabled us to protect our development schedules and so provide a healthy portfolio of new products to license. And

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there's been some of that this quarter. And that's enabled our licensing activity to hold up well, right across our business, throughout the downturn, and provide us with a healthy pipeline of future opportunities.

So, just looking at the business in a bit more detail. In the Processor Division, we signed a healthy 28 licenses in Q3. And looking at those, it reflects continued caution amongst our partners, that included more term licensing and single use licenses than usual. There was a high proportion of newer processors and it was a period, therefore, of strong growth in the Processor Division backlog, which was up 10% at the end of the quarter.

If I look now at the quality the business actually transacted, then it really was a very strong period for processor licensing. And we're very pleased with the adoption of our technology. So, of the 28 licenses sold, there were 21 Cortex, including eight licenses for Cortex-A type products. The total also included four licenses with lead partners for new Cortex processors still under development, to be launched in 2010. On top of that, we sold a further two licenses for Mali graphics processors and four licenses for ARM9 and an ARM11 license.

So, year-to-date, we've got 62 licenses already sold. That's grown the installed base to now over 640. And if I look at where those products are intended to go, then it's a continuation of the recent trend, with more than 60% of the licenses sold to partners whose first intended use for the technology was outside mobile applications.

Switching to Royalty; Royalty revenue was up 28% sequentially, but down 4% year-on-year. And that contrasts with an industry decline of 20% in the corresponding period, indicating continued growth in market share.

And, as has been the case for some time, the key drivers for Royalty were strong growth in microcontrollers and in smartphones. And over the last several months, we've seen key microcontroller product announcements based on Cortex-M3 from key players like Fujitsu, Toshiba, TI, ST, NXP and Cypress. Last week, Xilinx announced the adoption of Cortex processors for their FPGA products.

Smartphones are continuing to capture the headlines in the mobile area. The Cortex-A8 processor is now shipping in volume. And it's enabling the latest products using multitasking, high level operating systems that you find on products like the Palm Pre and the Nokia 900, and all the new android phones.

And during the quarter, we also received our very first royalty for Cortex-A9. And just to note, the average number of ARM processors per phone for the quarter was 2.1, which was up from 2.0 at the half year.

Switching to Development Systems, the underlying business continued to run at the lower levels that we've seen this year, through August. But in September, we did see some initial signs of improvement, which was very encouraging.

In addition, we had some orders from three larger customers for substantial numbers of seats of development tools. And that helped the overall numbers for this division.

Within that division, we've been active bringing a new debugger product to market, which we launched in late September, and generally upgrading our portfolio to enable software developers to write higher performance code and write it more efficiently.

Recently also in that division, we announced a product called mbed, which enables very low cost, very rapid microcontroller software development. mbed is really an online development environment, which is targeting large numbers of developers and people like students, working with the Cortex-M3 based microcontrollers. That was launched in conjunction with NXP and their M3 based microcontroller portfolio.

Now, switching to Physical IP. We've adhered to our strategy of focusing on leading edge processes. 2009 has certainly then been a year when we can say the business has truly transitioned beyond catch-up, to absolute technology leadership.



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Recently, we announced we have sold significant platform licenses, 28nm, to a leading fabless company. And early in October, we announced an agreement with Global Foundries for a 28nm platform license, which aims to deliver Cortex-A9 processors at very high performance levels. These leading edge products, of course, don't yield any short term revenue but the backlog is up significantly.

During the quarter, we announced with TSMC further developments in ultra low power physical IP products, which are optimized for their embedded flash process. And these products enable very low power microcontroller implementations.

At the other end of this spectrum, we announced Osprey, a 2GHz dual core A9 product. And that really highlights the huge improvements that we get in performance and power consumption, available to ARM partners, by combining our processor and physical IP designs.

Physical IP royalty meanwhile was up 15% sequentially, with the underlying royalty, i.e. excluding catch-up, up 80% sequentially and flat year-on-year, versus a foundry revenue decline of 20% for the corresponding period. So, that indicates continued gains in market share and penetration for our Physical IP.

Now, before concluding, I'll just say a few words about market development. At this time of year, in Q3, we hold our regular ARM partner meeting in Cambridge. For the best part of a week, we discussed future technologies with representatives from all our key semiconductor partners and other companies that collectively comprise the ARM Ecosystem.

And this year, in spite of a challenging business environment for everybody, we actually had record numbers attending. We conducted well over 1,000 one-on-one meetings between ARM representatives and our key customer base. Demonstrations of products there included ARM-based servers and high end multimedia processing.

We always provide an Internet cafe at that event. And this year, the Internet cafe was delivered on ARM-based computers.

So, over recent weeks, we've seen all sorts of announcements in the mobile computing area, around products based on ARM technology, from leading companies like Dell, Acer, HTC, Sharp. We've seen activity building generally around ARM-based netbook type products. And we expect several more product launches ahead of the winter holiday season.

We've seen Adobe announce the availability of Flash 10.1 for ARM products. We've continued to invest alongside our semiconductor partners in Linux optimizations. And during the quarter, we've had Google announcing a collaboration with leading laptop manufacturers, developing Linux-based operating system for PCs using ARM chips. And products using the Chrome OS will be available in the second half of 2010.

So, now we're three quarters through 2009, it's clear that businesses in our space are cautiously advancing beyond the stock replenishment stage, which happened earlier in the year. That's very encouraging for our royalties as we look into the first period of 2010.

It's even more encouraging that our semiconductor partners are actively embracing product developments for sales that will take place in 2011 and 2012, and beyond. That's driving our licensing activity. We've now got 90 Cortex processor licenses sold. We've begun to sell licenses to lead partners for second generation Cortex products.

Market share gains are continuing across a whole range of applications. The mobile Internet's becoming reality. Consumer electronics companies are installing Internet connectivity in all sorts of products.

Semiconductor companies are pursuing leading edge processes for volume products. 2010 incidentally will see volume production of 32nm devices. Consumers and suppliers are demanding ever more in their search for energy efficiency as well. And ARM is clearly an architecture which delivers energy efficiency and the mobile Internet with implementations on leading edge semiconductor processes.



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So whilst we can look at underlying economic factors affecting 2010 and see that they remain unclear for everybody, then the exposure that ARM has to structural growth through generic multi-year shifts in industry trends, that positions us very well as we look to the end of 2009 and looking forward, going into 2010.

And so that's the summary of business and operations. I'll now hand over to Tim.

Tim Score - *ARM Holdings plc - CFO*

Thanks, Warren. Morning, everyone. I think Warren's given a thorough overview there of the business so we'll try and pull out some of the financial aspects and hopefully many of you will have had a chance to have a quick look at the Q3 '09 release. The quarterly slide set is available on the website as usual; usual format of slides.

And just remind again, you might find it useful when looking at the models to review notes 4.24 to 4.27 at the back of the release, which provide the line-by-line reconciliation of the normalized numbers, which tend to be the focus of the analysts' consensus estimates to the IFRS numbers.

So overall, Q3 dollar revenues were, as Warren said, \$123 million, up 17% sequentially, down 8% year-on-year in an environment where the industry was down about 20% in the corresponding period.

And the good news this quarter is that the FX rate within the numbers is broadly in line with consensus, so we don't have to spend a lot of time talking about the impact of foreign exchange on these numbers.

So the improved quarterly revenue performance, combined with ongoing careful management of costs, which has been place throughout this year and before, that's yielded a sequential almost 7 point increase in operating margin to back over 30% at just under 32%.

Q3 also saw a very strong quarter for net cash generation. The net inflow GBP28.2 million, which is the second best quarterly outcome that we have reported, and, as a result, we end Q3 with GBP122 million net on the balance sheet.

A little bit more detail on the numbers. Warren explained Q3 was a very good quarter for PD licensing, very strong take up of Cortex and good initial licensing of the next generation products.

And just to stress from the revenue recognition standpoint, obviously we're aware that 28 licenses and just over \$30 million of revenue is, in a sense, quite an unusual relationship.

But, as Warren said, although most semiconductor companies are maintaining their product development activity, we have seen constrained R&D budgets through the year and, in some cases, we've met the continuing demand for our products by offering term single licenses and these licenses typically have a lower upfront fee but a higher ongoing royalty rate.

And, of course, customers, when they want to design in the next ARM processor, come back for further single use and term licenses.

Following the higher levels of industry activity in Q2, ARM's royalties grew strongly quarter-on-quarter, \$53 million up from \$41 million last quarter, coming from sales of just over \$1 billion ARM technology-based chips.

ARM11 now representing 5%, but ARM7 and ARM9 still the vast majority, at 94%, with Cortex rounding to 1% but actually growing very strongly quarter-on-quarter and we're now moving into the ramp-up phase of Cortex royalties. So that percentage will increase over the next few quarters.



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We continue to gain share in non-mobile end markets. Microcontrollers were a feature this quarter, up 75% sequentially compared to about 30% growth for the overall microcontroller market; much of this growth due to the sale of Cortex-M3-based chips, and these chips, as you know, go into a wide range of price-sensitive markets.

And so this strong sequential growth has resulted in the average royalty rate decreasing to \$0.053 in the quarter, from \$0.057 in the prior quarter and \$0.055 in Q3 a year ago.

Development Systems revenues at \$14 million, up from \$10.3 million last quarter; the sequential increase partly due to two large software tools licenses being signed in the quarter.

And, as we've said once or twice in recent quarters, deals of this type are infrequent in this division, or at least don't recur every quarter, and so Development Systems revenues in Q4 2009 are expected to be closer to the underlying quarterly revenue run rate of that division of \$10 million to \$12 million.

And, as noted by Warren, PIPD continues to make steady progress with encouraging licensing activity as a leading edge and a very healthy trend in underlying royalty revenues.

Group order backlog at the end of Q3 was up by 3%, of which Processor Division was up 10%, and that's sequentially. But following licensing activity early in the fourth quarter, Group order backlog is now about 10% higher than it was at the half year.

The backlog analysis is in the slides on the website and that shows that just over 30% of total backlog is expected to be recognizable as revenue over the next two quarters and in the third quarter just over 30% of PD license revenues in Q3 were generated from backlog.

Before moving on to guidance, a few comments on margins and costs. Gross margins in Q3 were 92.9% compared to 91.2% in the last quarter and just under 90% a year ago. And I think this trend reflects the increasing proportion of royalty revenues as a proportion of the total.

GBP46 million of normalized OpEx in Q3 was in line with our guidance given last quarter, of GBP45 million to GBP47 million. OpEx in Q4 is expected to be in the range GBP46 million to GBP48 million, assuming similar exchange rates prevailing through the quarter.

Underlying costs, as we know, are broadly flat in terms of people and employee-related costs.

During the quarter we did initiate the closing of our office in Leuven, in Belgium, and you'll see in the notes at the back of the release the restructuring charge of GBP6.6 million. This is expected to give rise to annualized savings of approximately GBP3 million per annum.

So on to the outlook, going into the final quarter of 2009, ARM -- we're encouraged by the improving confidence in our customer base and we reiterate guidance that we expect Group dollar revenues for the full year to be at least in line with the current market expectations.

And although in the short term the trajectory of consumer demand for electronic devices, as well as many other products, remains unclear, in looking ahead through 2010, ARM is well positioned to take advantage of what I think are now generally anticipated improvements in the industry for next year.

And with that, we'll hand over to Q&A.



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QUESTIONS AND ANSWERS

Operator

Thank you. We will now begin the Question-and-Answer session. (Operator Instructions). Your first question comes from Didier Scemama from RBS. Please ask your question.

Didier Scemama - RBS - Analyst

Yes. Thanks for taking my question. Good morning, gentlemen. Just going back on the nitty gritty of Q4, I know you're saying at least in line but it looks like your guidance is just a little bit light if I take just literally what you're saying about \$127 million for Q4. So I was just wondering given what your licenses have reported for Q3 why you haven't raised your guidance for the full year? And I have a follow-up.

Tim Score - ARM Holdings plc - CFO

I think what we're saying -- hi, Didier. What we're saying is that we expect to be at least in line for the full-year dollar revenues. Actually the consensus for the fourth quarter coming into these results is about \$131 million. And we're not seeking to necessarily change that.

Didier Scemama - RBS - Analyst

Okay.

Tim Score - ARM Holdings plc - CFO

What we're actually saying is, as we have done in Q3, I think the likelihood is we're saying we'll be at least in line. But the consensus, of course, has been gradually moving up through the year. Coming into these results the full year was just over \$476 million and, as I say, we're not seeking to change the Q4 number.

Didier Scemama - RBS - Analyst

Excellent. Okay, great. And in terms of a follow-up, I was just wondering in terms of OpEx, you've been pretty explicit for Q4, so I was wondering for 2010 I suspect the pay freeze won't be able to continue so I guess you have to pay a little bit more your employees there. Is there any reason why your R&D expenses and SG&A expenses should grow at the rate that would be different from the one you've guided, like about half of the rate of the dollar revenue underlying?

Tim Score - ARM Holdings plc - CFO

Well, of course the relationship of costs growing at half the rate of revenues is really a multi-period view and I think, let's face it, if next year's very buoyant for the industry and ARM's top line is flying, we wouldn't necessarily be increasing costs to match half of revenues.

So I think the way to think about costs for next year, it is in all -- we are likely to have some pay inflation. I think it's unlikely we'd want a pay freeze in the current environment into next year. And we've got important investment opportunities that we can pursue to improve our competitive position etc.

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So I think looking at the consensus expectation for next year, which is in the mid \$190 millions, I think that's a sensible place for it to be versus the mid \$180 millions that it is currently. Sorry, the mid \$180 millions that is expected for 2009 full year.

Didier Scemama - RBS - Analyst

Okay. Great. Thanks so much.

Warren East - ARM Holdings plc - CEO

Thank you.

Operator

Your next question comes from Gunnar Plagge from Nomura. Please ask your question.

Gunnar Plagge - Nomura - Analyst

Yes. Thanks for taking my question. I wanted to ask about the gross margin. Did you in Q3 shift further PIPD costs from COGS into OpEx? And should we expect a further shift in Q4 or is this process mainly concluded?

Tim Score - ARM Holdings plc - CFO

The amount of PIPD engineering time charged to cost of sales versus OpEx was a little bit lower this quarter. But this is a number that does move around. As you know, it depends on where the focus of the activity is between leading edge development and more mature nodes.

But I think in terms of the general trend in gross margin, it's really much more about the proportion of royalty revenues as a whole and therefore it is an increasing trend. We're not saying here today that just under 93% is a base or anything like that, but I think, versus the consensus that we came into this quarter at of just over 90%, I think it's likely to be higher than that as we move through 2010.

Gunnar Plagge - Nomura - Analyst

Okay, thanks. And on the A9 hard macro implementation for TSMC, normally you don't sell really hard macro designs. Is that maybe a trend that we could see more in the future that you combine further PIPD with PD?

And could you maybe comment how many licenses you've signed to date?

And maybe quickly also how would you actually split revenues between PD and PIPD for these contracts?

Warren East - ARM Holdings plc - CEO

That particular implementation, it's the first of its kind that we've announced and sold as a product, although we've been talking for some time about the beneficial effects of combining the processor design and the physical IP design and doing the design together.



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So you are likely to see more of that type of activity going forward, though I don't think it's going to be a major, major part of our product portfolio. However, if somebody wants to achieve a high performance implementation and a fast time to market, then it's a convenient way for a semiconductor partner to achieve that, to do it with something that we have ready prepared.

Clearly we can't do that -- most of these microprocessors are quite configurable in terms of how they sit in a system and we can't possibly hope to provide optimized hard macros for every conceivable configuration.

So no, it's not going to be a regular part of the product portfolio but we will do things like the Osprey product from time to time as we go forward.

Specifically so far we only just announced the product and we've sold one license.

Gunnar Plagge - *Nomura - Analyst*

Okay. And quickly on the split between PD and PIPD, how would you recognize these revenues?

Warren East - *ARM Holdings plc - CEO*

Well, that is a Processor Division revenue.

Tim Score - *ARM Holdings plc - CFO*

Generally speaking, Gunnar, obviously we are, if you like, increasing -- there are increasing evidence of combined deals that involve Processor and Physical IP Division, but most of them it's fairly clear about how the revenues splits in terms of which products are part of the transaction. And so they will be split accordingly as to which division they come from.

But I think there's an increasing trend here of ARM technology being sold together, Processor and Physical IP, and some of the technology synergies that we've been talking about for many years are beginning to manifest themselves more obviously.

Warren East - *ARM Holdings plc - CEO*

Just to conclude the color on that, the Osprey product is a Processor Division product. It's an implementation of a dual-core Cortex-A9 using our Physical IP. That would be used in a system on chip device and the libraries used in construction of the remainder of that system on chip device may or may not be ARM Physical IP libraries.

Now obviously we would hope that they are and in demonstrating the performance with Cortex-A9 then, as Tim says, it's a useful sales tool. And it could be that such sales lead to enhanced sales of our Physical IP.

Gunnar Plagge - *Nomura - Analyst*

Yes, thanks.

Operator

Your next question comes from Gareth Jenkins from UBS. Please ask your question.

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Gareth Jenkins - UBS - Analyst

Yes, a couple if I could, gentlemen, please. I just wondered whether the 10% q-over-q order book, including the deals signed after Q4, does that include both Globalfoundries and the other foundry that you signed as well as the fabless semis company?

And could you just give us a sense of the pipeline for PIPD specifically in 28nm node?

And then just finally in terms of usage of cash, your net cash is much higher than certainly we were expecting. I just wondered what you feel your use of cash flow going forward will be. Thank you.

Tim Score - ARM Holdings plc - CFO

Yes, the 10% position on backlog does include the Globalfoundries deal and other early licensing activity in Q4. I think the specific ones you drew out were actually third quarter deals. But yes, it includes all licensing that we've done subsequent to the end of the third quarter and it does include Globalfoundries.

Warren East - ARM Holdings plc - CEO

And as for the pipeline of opportunity for 28nm, then we have done some 32nm licensing, 28 tends to be a shrink or an alternative to 32nm and so it's the same list of suspects; people who are working with 28nm are all opportunity for us to sell our 28nm product.

I would stress on this 28nm stuff, as with the 32nm, this is new technology and so when we talk very enthusiastically about signing deals and building our backlog then let's not get carried away about recognizable revenue in the short term and in 2010. This revenue's going to be recognized over multiple quarters and certainly there won't be anything hitting our revenue until the middle of 2010 at the earliest.

Gareth Jenkins - UBS - Analyst

And then just, Tim, on the use of cash. I think you said historically that you would look at some small acquisitions. How do you balance that with shareholder returns?

Tim Score - ARM Holdings plc - CFO

Yes, I think there's a combination of factors. We have a stated policy that we have a progressive dividend in place that the growth of which is going to be consistent with earnings growth.

We've had a share buyback program that has been inactive now for a few quarters. We have no immediate short-term intent to reactivate that but it remains available to us if we think it's the right thing to do.

And, of course, we are looking always at opportunities to accelerate implementation of our strategy. And that could involve, as it did at the end of last year with the video acquisition, some acquisition activity.

So we're not in the mode of building up a war chest or building up a cash balance but we're only just coming through a pretty difficult trading environment and hopefully coming into sunnier times. And we'll probably have more to say about the capital structure at the beginning of next year.

But certainly, if you like, the anchor position at the moment is progressive dividends that are consistent with earnings growth over time.

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Gareth Jenkins - UBS - Analyst

Thanks.

Operator

Your next question comes from Simon Schafer from Goldman Sachs. Please ask your question.

Simon Schafer - Goldman Sachs - Analyst

Yes, thanks a lot. I want to ask you a question about Physical IP and you said clearly out of this, I think what you described as catch-up mode, also some encouraging new deals being placed and so on. Just based on what you think is the likely revenue recognition then for some of these deals, any sort of sense as to when this could be getting into a breakeven type territory? Or are you going to be still in investment mode whereby your operating expenses are still going to be relatively high to generate more licensing business in the near term? I'm just wondering what the trade-off there is and whether you're managing that towards profitability or how long they may take.

Warren East - ARM Holdings plc - CEO

Yes, I think at the half year we started talking about this and we said that if you look over the next couple of years then as we expect to see our Physical IP revenues increase, so headcount in Physical IP, if anything, is likely to marginally decline and so that should help control our costs and increase the margin in our Physical IP Division.

We said that around the half year. This quarter there's been no change to that. It's a gradual process. We've been working both on new technology development and on improvements in the design process itself, leading to greater efficiencies.

And that's what's enabling us to see that over multiple quarters, at least a couple of years, then a gradual decline in headcount, a gradual modest decline in our headcount in that division, which should accompany the increased revenue, and then you'll see an improvement in margin.

Simon Schafer - Goldman Sachs - Analyst

Right. But just to understand that, are you saying you're trying to manage it towards profitability? Or are you going to be still in investment mode just to generate some licensings that would keep that in a loss zone?

Tim Score - ARM Holdings plc - CFO

I think what we're saying, Simon, is if you look at the last few years of PIPD, we've clearly been effectively on a dual track R&D mode of moving ourselves into the technology leadership position at the same time as keeping the base business going. And that's meant we've been developing technology at a faster rate.

Now, we're now moving into an environment where we can develop technology at a steady state and so what we see out ahead of us is a period of improving productivity and, as Warren says, gradually decreasing headcount.

Now, the issue of profitability clearly is one about -- ARM is, as you know, quite an integrated Company. We have a unified sales force, we have unified finance, HR functions everything else, unified marketing, a lot of this is about how you allocate costs.



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PIPD already makes a very positive contribution to the Group and to the allocation of the costs around the Group. And increases in revenue, in an environment where costs are being well controlled, has a very positive impact on the Group profitability.

Simon Schafer - *Goldman Sachs - Analyst*

Thanks. My follow-up question would be for Warren, just any news on, in terms of Microsoft portability. Was there anything as part of the Windows 7 launch last week that would give you more or less confidence about some sort of eventual portability for main OS?

Warren East - *ARM Holdings plc - CEO*

Yes. I don't think there's been any change on that. We'll stick to our view that we certainly can see that ARM's progress in computing would certainly benefit from early use of big Windows on ARM. However, this is a matter for Microsoft and not really for ARM. We've had a long technology relationship with Microsoft, and it's very -- we're very present in the smaller versions of Windows, but as for big Windows it's a matter for Microsoft.

Simon Schafer - *Goldman Sachs - Analyst*

Okay. Thank you very much.

Operator

Your next question comes from David Wu from GC Research Ltd. Please ask your question.

David Wu - *GC Research Ltd - Analyst*

Good morning. I have a couple of questions please. The first one I want to ask is there are recently updated views about the semiconductor industry in calendar 2010 that we may be actually recover to close to calendar '08 revenue levels for the whole semiconductor industry. Should that come to pass, and hopefully not all driven by higher memory prices, how would ARM do from a revenue standpoint, relative to that kind of double digit revenue increase forecast? That's my first one.

The second one was when your mix of, I guess, licenses and royalties, particularly royalties, are moving in this direction, do you think that we can count on something in the 92%, 93% area in terms of pro forma gross margin in the next year, calendar 2010?

And the last one I have is I was curious how many parallel -- how many engineering teams do you have to deploy in design? I assume parallel effort on A extending the Cortex family and B working on the next generation of super instruction set family after the Cortex one?

Warren East - *ARM Holdings plc - CEO*

Okay. Comprehensive set of questions there. I'll start with the industry one. We are not forecasters on the industry, but there is a generally anticipated growth in the semiconductor industry of about 15% next year.

If you look historically at ARM, then we tend to outperform growth in the semiconductor industry; about 50% of ARM's revenue is royalty and ARM's royalty CAGR, if you look over the last 5 years or so, is about 20% versus an industry revenue CAGR of about 4%. So, we consistently outgrow the semiconductor industry and that's because our technology is well-positioned for areas of

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strong structural growth. Things like microcontrollers, more use of 32-bit processing in a whole range of consumer electronic products.

So, we would expect, we don't see any reason why there shouldn't be, a continuation of that trend of outperformance of the semiconductor industry as we look into and through 2010. And as for how much the industry will grow in 2010, then we can look at the same forecasts as you do.

Tim Score - *ARM Holdings plc - CFO*

Yes, on your second question David about gross margins, and I think -- as I said earlier in the call, this is -- an improving gross margin is really a long-term trend. And I think when I look at consensus for full-year 2010, which is currently between 90% and 90.5%, I think the outcome is highly likely to be better than that.

David Wu - *GC Research Ltd - Analyst*

Thank you.

Warren East - *ARM Holdings plc - CEO*

And to go onto your third question about engineering teams. We do have multiple engineering teams. Our main processor design centers are in Cambridge, in Austin, Texas and in Sophia in the south of France. We do a lot of work in our design center in Bangalore as well. So we can have multiple microprocessor developments going on at the same time.

We also have a separate R&D team, which is really looking further ahead at new architectures beyond the current road map. So that's how we manage multiple tasks. And yes, there is activity going on to develop architectures beyond what you see on the road map today.

David Wu - *GC Research Ltd - Analyst*

Thank you.

Operator

Your next question comes from Sandeep Deshpande from JP Morgan. Please ask your question.

Sandeep Deshpande - *JP Morgan - Analyst*

Yes, hi, couple of questions, firstly on the royalty front. You've talked about -- the smartphone market has been a provider of the royalties. There has been a decline in the royalty you -- for device in the quarter, can you give some more color regarding the microcontroller shipments, or what is happening here, which is causing this? Because overall the ASPs in the semiconductor industry are not probably going down as much at this point as you seem to be seeing a decline in royalty for you there.

Warren East - *ARM Holdings plc - CEO*

Yes, that's right Sandeep, but that's because the ARM average royalty rate, it fluctuates due to product mix, and along with that fluctuation there is this strong growth in microcontrollers, which we've been benefiting from for the last several years.

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And even in the latest set of numbers, we're seeing a huge growth in ARM microcontrollers; we're seeing the big semiconductor partners that support ARM in microcontrollers roll-out new products, their sales are going very well. So that is a trend, which I think is going to continue.

And if we go back a few years to when we put out some long-term volume projections, we accompanied that by saying that long term we would expect some decline in average royalty per ARM microprocessor, as the volume of ARM-based microcontrollers grows. And we would anticipate that by the time ARM-based microcontrollers are accounting for around 1 billion units per annum, then maybe the average royalty rate would have declined from about \$0.06 to about \$0.05.

Right now, we don't see any reason to change that long-term modeling. The reality is that all of these microcontrollers are making a positive 100% margin contribution to ARM's profit, and so we'd much rather have those microcontrollers be ARM-powered than not.

Sandeep Deshpande - JP Morgan - Analyst

Thanks. One more, you guys have often given devices containing your higher-end processors in the mobile handset area etc. Are there any major devices containing ARM microcontrollers at this point?

Warren East - ARM Holdings plc - CEO

It's -- we don't tend to focus so much on drawing these out as separate products. You do find ARM microcontrollers performing utilitarian functions in high profile products like some TVs and some phones.

But because that whole market is much more fragmented, it comprises many, many designs of different products that are shipping in the individual thousands of units to hundreds of thousands of units. That's very different from the multi-millions of units that we talk about for things like high-end phones. So we simply don't have the direct contact in the microcontroller space with the customers in the same way.

Sandeep Deshpande - JP Morgan - Analyst

And one final one on the royalties again. You've been selling these term licenses and per-use licenses now for a few years and you've always talked about those licenses having higher royalties, versus the perpetual licenses. But we have -- is it that the volumes in terms of royalty units from these customers is not substantial enough that it does not make a big difference to the overall ASPs?

Warren East - ARM Holdings plc - CEO

Yes, I think that's absolutely right. The sorts of customers that buy these products would either be smaller customers who are going to ship fewer units in total, and therefore, make a really very small impact on the huge volumes that are shipping out in a quarter.

Or, they're larger customers and although those larger customers ship large volumes for the specific products that -- for which they've targeted the core that they bought a single use license for, it's a very small impact again on a very big number.

And the third fact is that these -- some of these products, which are based on single use licenses or term licenses, which command a higher royalty, quite often the customer comes back and converts that license into a perpetual license anyway. And so we enjoy a little bit of upside on the license revenue.

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Sandeep Deshpande - JP Morgan - Analyst

Thanks a lot.

Warren East - ARM Holdings plc - CEO

Thank you.

Operator

(Operator Instructions). Your next question comes from Lee Simpson from Jefferies. Please ask your question.

Lee Simpson - Jefferies & Co - Analyst

Hi, good morning everyone. Just three quick questions if I may. How would you characterize the PIPD component of backlog? It suggests that you've got a q-on-q drop in the backlog from PIPD, and I just wondered if this subsequent recovery that you've seen in early 4Q has any element of PIPD inside it?

Secondly, there was a notable change in the deal nature over recent quarters towards term deals. I wonder if you can see anything in 4Q, or coming down the negotiating pipe, that suggests some shift, if you like, back towards perpetual deals?

And maybe just one quick question to check that the uplift in G&A really was coming from that restructuring charge in the Belgian office. Thanks a lot.

Warren East - ARM Holdings plc - CEO

Thanks Lee. Yes Tim, I'll take those three. Yes, as we said at the end of September, the Group backlog was up 3% and the PD part of that was up 10%, implying, as you say, that other elements were down. And we've also pulled out specifically the Globalfoundries deal as one of the early licenses in the fourth quarter. And that is a PIPD deal. So, yes, PIPD has benefited from early licensing activity in the fourth quarter.

On the 28 licenses and the per-use and the term, I think it is fair to say that, looking into the opportunity pipeline, it is likely that we revert to a more normal relationship in the next couple of quarters than the one we have seen. That doesn't mean to say that per-use and term won't continue to be a feature of our licensing program because it works well for some of our customers, particularly in this environment. But I think as conditions improve, it's more likely to move back.

On the G&A, if you look at the normalized numbers, the restructuring charge is called out separately. So if you're looking at normalized G&A, the reason for the uplift is actually the absence of the foreign exchange credit that we had last quarter. If you remember, we had a fairly significant mark-to-market credit last quarter, as a result of the volatility in FX and our forward contracts being significantly in the money. So that's why G&A is higher quarter-on-quarter on the normalized basis, the absence of that credit.

Lee Simpson - Jefferies & Co - Analyst

Great. Thanks a lot.

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Operator

Your next question comes from Paul Morland from Astaire Securities. Please ask your question.

Paul Morland - *Astaire Securities - Analyst*

Hi. I had a couple of questions, one was on the tax rate, which in the normalized EPS looked a bit higher than I was expecting. I made it about 28% and it was lower than that in the first half of the year. Is that right, and if so, what's the reasoning behind it?

And the second question is on DSOs. Perhaps I can take the calculation of that offline, but I can't quite get to your 43 days. Perhaps on that point you could explain the reasoning behind the very strong working capital performance in the course of the GBP17 million inflow because it doesn't appear to have some from debtors; there doesn't seem to have been too much movement in the overall debtors figure. I presume DSOs came down because sales were higher, but if you could just comment on that GBP17 million inflow on working capital? Thanks.

Tim Score - *ARM Holdings plc - CFO*

The tax rate Paul was, you're right, 28%, 28.1% in the quarter. I think what you're obviously trying to do with the tax rate is as you go through the quarters, you're trying to forecast the full-year rate. And as the profitability profile changes and changes by territory, it flexes a little bit.

I think the key point is that the year-to-date normalized tax rate is 26.6%, pretty much in line with the 26% to 27% that we have guided. So I would focus on that number as, if you like, the forecast for the full-year rate, somewhere between 26% and 27%.

Yes, the DSO calculation is based around sales and invoicing and in a sense you won't be able to read it directly from the data, so we will have to do that offline. It's done on a consistent basis, but you're also right that the GBP17 million inflow is not really about debtors. There's a significant reduction in cash receivable from December to September, but not from June to September.

That inflow that you see, the GBP17 million, which is an inflow, and that's, in a sense that's a reconciliation from the IFRS numbers, a lot of that is, for example, the restructuring charge that is in the IFRS P&L, but the cash has not yet gone out.

Paul Morland - *Astaire Securities - Analyst*

Okay. Thanks.

Operator

Your next question comes from Andrew Gardiner from Barclays Capital. Please ask your question.

Andrew Gardiner - *Barclays Capital - Analyst*

Good morning, thank you very much. I just had another question around the licensing activity. Warren, you'd highlighted some of the drivers, I'd say both cyclical and structural, that have an impact on why you're seeing your customer base move towards single use or term at the moment.

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I was just wondering if you can give us any more detail about the, either so far this year or in the quarter, exactly what portion of that movement in the direction towards single use and term, away from perpetual, came from either the cyclical side with large customers being a bit constrained, versus the increasing number of smaller customers taking those kind of licenses.

Warren East - *ARM Holdings plc - CEO*

Yes. I would say that it is largely a cyclical thing. We do see this move around as we go through the cycles in the semiconductor industry. And as somebody pointed out earlier in the call, we have been doing term licensing and single use licensing for several years now.

I think it was a particularly good quarter in terms of number of licenses we've done, 62 licenses year-to-date. If you look over the last several years, on an annual basis, we've done 60 to 70 licenses, and so I don't think this year's going to work out particularly far off the top end of that range.

If you look within the licensing this quarter, we pointed out there are actually four licenses for some newer products signed up with lead partners, that's tied to product cycle rather than anything else. And I think we are benefiting at the moment, there were eight Cortex-A-type licenses. We're certainly benefiting at the moment from the increased focus on smartphones and mobile computing driving licensing at that end of the roadmap.

So a number of factors have come together to give us a large number of licenses this quarter. The cyclical effect, economic cyclical effect, has been the main driver of the single use and per-license use. And as Tim said a moment ago we see this move both directions, we would expect that to trend back to something more normal over the next several quarters.

Tim Score - *ARM Holdings plc - CFO*

And I think the key point to make here, Andrew, really is that there is no change in the pricing structure of ARM's licensing, so when you do a per-use or single license you obviously pay less but you get less in terms of rights. And you usually end up signing up to a higher royalty rate.

But if you look at the individual prices of the different types of license, there is no reduction. So there's no value being transferred here. ARM's licensing pricing is holding up well.

Andrew Gardiner - *Barclays Capital - Analyst*

That's clear. Thanks very much.

Warren East - *ARM Holdings plc - CEO*

Thank you.

Operator

Your next question comes from Nick Hyslop from RBC Capital. Please ask your question.



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Nick Hyslop - HBC Capital Markets - Analyst

Morning. I think most have been asked, but I had just a couple of questions on royalties. If we start with smartphones, it's pretty clear there are a big range of views out there of where smartphones go as a percentage of overall handset markets. I'm interested in you sharing your views with us on that.

And then perhaps, secondly, given it becomes an increasingly important factor in the number of royalties coming through, whether you'd be prepared to give us a little bit more granularity, or even identify the number of royalties coming specifically from smartphones, and how that's been trending.

Warren East - ARM Holdings plc - CEO

Okay. So to answer the first one about where do we see smartphones going generally, our sort of multi-year planning assumptions haven't really changed, and you'll find these in the slides that are already on our website.

We would anticipate that about half the number of overall phones eventually, in a matter of maybe four or five years, will be what we call smartphones today, i.e., supporting some form of heavy operating system with a separate applications processor.

Looking to the second question and what's actually happening today, if you look at unit shipments that we're talking about, then Cortex processors overall, that is Cortex-A and the Cortex-M3, which of course is not really smartphones, are only accounting for 1% of shipments. ARM11, which is the next processor back that's really capable of running high performance heavy operating system, that is 5% at the moment.

And so I think most of the smartphones today are still, in volume terms, would still be on 926 product, and we're seeing ARM11 follow the same sort of growth trajectory as we saw, as the ARM9, and in particular the ARM926 follow, but right now it's early days. These volumes are only, as I said, 5% for ARM11 and less than 1% for the Cortex-A products.

And as we look forward we can see smartphones being about half the total number of phones. So hopefully that's enough color on those. Has that answered the question?

Nick Hyslop - HBC Capital Markets - Analyst

Yes, it has. Do you think at some point you might start to break it out? There are obviously all sorts of other chips around that which makes up the smart element. So as the proportion of these grow, it becomes a fairly large chunk. Do you separately identify those?

Warren East - ARM Holdings plc - CEO

So I think right now the numbers are still too small for us to break out on a quarterly basis because you'll end up with fluctuations and issues around the law of relatively small numbers. However, it's perfectly reasonable, I agree, that as these things develop we should explore different ways of making clear what's happening.

Nick Hyslop - HBC Capital Markets - Analyst

Okay. Thank you.

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Operator

Your next question comes from Brett Simpson from Arete Research. Please ask your question.

Brett Simpson - Arete Research - Analyst

Thanks very much. Couple of questions for Warren. First up, just on PD licensing. I'm trying to get a sense for what more you can do to offer PD licensing customers beyond A9, because you're already getting 2GHz performance from A9 cores in recent announcements.

So I'm trying to get a sense for how much appetite there is out there from the licensees to take on performance beyond what A9 offers today.

And maybe a quick follow up on PD royalties. We're starting to see some price cuts in smartphones coming through in the third quarter results, and overall value growth in handsets has been fairly sluggish of late, which historically wasn't the case.

I'm trying to get a sense for how this overall impacts ARM's mobile phone royalty business, and what growth outlook you think mobile phone royalties offers over the next two or three years. Thanks.

Warren East - ARM Holdings plc - CEO

Okay. So on the licensing one first. Absolutely we see continued demand for application processors, and the trends are really all about delivering acceptable performance but at ever improving capabilities in terms of efficiency. So it's processing efficiency, it's amount of processing that you can do in an individual cycle.

So, 2GHz with a Cortex-A9 processor delivers you a lot more performance than 2GHz on, hypothetically, if you ran an ARM11 at 2GHz for instance. So it's all about efficiency of the processing, and that's what gives us a roadmap.

The A5 product, for example, that we just recently launched is an example of an applications processor that is aimed at a lower performance point, but delivers efficiency in terms of the processing that you actually do, and a very small area, so it's aimed at a lower cost applications processor chip.

So there's both a general efficiency direction, and there's a lower cost type direction to achieve in terms of developing our roadmap for application processors going forward.

There's also, by the way, people demanding ever more performance because people are talking about computer power in your pocket at pocketable power consumption levels that really only exist on the desktop today. So, there's a great future for application processors.

In terms of the royalty that we generate from mobile phones and from smartphones, then I still come back to the answer in the previous question really about where we see smartphones going generally as a proportion of the total phones that are out there. That hasn't really changed, and our royalty projections are really very simple models, we don't get too sophisticated about it.

An applications processor will typically come into the market and is priced quite highly around \$25 or more, or over a few years it declines to maybe \$10 to \$15, maybe even in the lower price points towards about \$8, and that happens over several years.

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We see no reason for that trend, which seems to be pretty endemic in the semiconductor industry, to continue. And our models are built on those simple assumptions, and if we try to get more sophisticated about it, then I think you can spend a lot of time modeling and end up with the same answer.

Brett Simpson - *Arete Research - Analyst*

Thanks.

Operator

Your next question comes from Robert Owens from Cazenove. Please ask your question.

Robert Owens - *Cazenove - Analyst*

Hi, guys. Thanks for taking my question. Not many left at this stage, but basically looking at your ASPs, it seems to be -- well, we've seen a ramp in microcontrollers clearly having an impact, but at what stage do you see that flattening out? And the impact of smartphones really pushing through and stabilizing that ASP rate, it is 2010, is it beyond? And just looking at the licensing, with the mix looking to go towards the Cortex-M series, not exactly supportive of longer-term ASPs.

Warren East - *ARM Holdings plc - CEO*

Well, there's two things there. You talked about smartphones counteracting microcontrollers. I think if you look over the last eight quarters or so, at least, you'll see the average number move around on a quarterly basis, and in quarters, which relates to shipments, which are very consumer oriented, they tend to be a lot more seasonal than microcontrollers.

And so, in the quarter like we've just had, which is Q2 semiconductor shipments, this is very away from the sort of period where people are building products for consumers, and that tends to peak in the next couple of quarters. So you'll see the smartphones fight back, if you like, over the next couple of quarters and that will pull the average in the opposite direction.

And then underlying, you've got a multi-year improvement in ARM's penetration in microcontrollers. And so, in the non-seasonal quarters you see the average go back the other way. That's going to continue happening, and as I said a few moments ago, we expect microcontrollers to grow today. ARM microcontrollers are several hundreds of millions of units per annum.

ARM penetration within microcontrollers is going very strongly at the moment, 75% sequential increase versus microcontrollers overall at 30% in the last couple of quarters. We're going towards that 1 billion units, and I think once we get to about a billion units then we'll be at such a share in the microcontrollers that you will see it start to flatten off.

Tim Score - *ARM Holdings plc - CFO*

Rob, I think one other point to make on that is, if you look at the average royalty rate this quarter of \$0.053, and compare it to a year ago, which was \$0.055, the number of ARM based microcontrollers this year is significantly ahead of the number of microcontrollers last year, and yet the average royalty rate is only just below last year.

So, you know, I think it's dangerous to sort of try and read in long-term trends into all these quarterly numbers. And between now and then, of course, we've had \$0.06 a quarter tied in, which is exactly what Warren's just been saying, about the seasonality of smartphones, and we've had a \$0.057. So, I think you shouldn't assume this is only going in one direction, this thing is still going to move around based on the quarterly growth mix profiles.

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Robert Owens - *Cazenove - Analyst*

Okay. Sure. Got it. Thanks very much.

Operator

Your next question comes from Nick James from Panmure Gordon. Please ask your question.

Nick James - *Panmure Gordon & Co. Limited - Analyst*

Yes, good morning. Just one quick final question. I just wanted to ask about the office in Belgium. What were the activities of that office, and what was the reason behind closing it?

Warren East - *ARM Holdings plc - CEO*

Okay. So the activities in the office in Belgium concern some technology that we acquired back in 2003. And what happens is that we gradually absorb technology we acquire. Sometimes we keep the offices where we want them, but generally smaller offices are less efficient and from time to time we will seek to basically simplify our operation, and once we've transferred the technology into the main Group, then we actually don't have a sensible reason for keeping a small office open, it's quite inefficient. And from time to time we do close offices.

Nick James - *Panmure Gordon & Co. Limited - Analyst*

Okay. Could you just remind us what activities they were you acquired in 2003?

Warren East - *ARM Holdings plc - CEO*

That was DSP-type technology.

Nick James - *Panmure Gordon & Co. Limited - Analyst*

Thank you.

Operator

Your next question comes from Jonathan Crossfield from Bank of America Merrill Lynch. Please ask your question.

Jonathan Crossfield - *Bank of America Merrill Lynch Intl. - Analyst*

Yes, good morning. Thanks. A couple of quick questions. First of all with the eight Cortex-A9 and A8 deals in Q3, how's the pipeline for further deals on those two cores looking over the next few quarters? Do you think there was some pent-up demand, which you served in Q3?

And then, secondly, coming out of the ARM Partner Meeting, did you see any, from all your 1,000 one-on-ones, did you see any internal or external shifts in the perception of Intel as a threat in the medium term?

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Tim Score - ARM Holdings plc - CFO

I'll do the first one, Jonathan. No, I think you should not assume that because we've had a very healthy quarter for Cortex-A class that you're going to see a dearth. The pipeline is looking quite healthy in that regard.

Warren East - ARM Holdings plc - CEO

And to the second question then, I think Intel have been very clear that they want to move their architecture from predominantly APC-based architecture to an embedded architecture, and as such that represents a challenge to all the ARM partners who are active in mobile phones and in other embedded applications.

During the ARM Partner Meeting we didn't see any particular changes in people's views as regards Intel, they're very capable, very good architecture, lots of good process technology, and lots of money to spend on the issues. They're still a very, very long way away from ARM in terms of power consumption in all the applications really, where ARM processors are very targeted.

Jonathan Crossfield - Bank of America Merrill Lynch Intl. - Analyst

Great. Thank you.

Warren East - ARM Holdings plc - CEO

Good. So, I think we must be coming to about the end of questions. So with that I'll just summarize.

We're very pleased with this set of results for Q3. We're ahead of expectations in terms of earnings, margin, and revenue, driven by strong royalty growth, which is indicative of continued market share.

We've seen some very good licensing activity in both our main divisions, with leading edge processors in Physical IP, new processors in our Processor Division, and we have a healthy opportunity pipeline.

So although the short-term trajectory for consumer demand is a bit uncertain, as we look through 2010, we can see ARM exposed to areas of strong structural growth, and we're very well positioned for any generally anticipated upturn that exists in the semiconductor industry for 2010.

And with that we'll conclude the call and look forward to talking again in February. Thank you.

Operator

That does conclude our conference for today. Thank you for participating, you may all disconnect.

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