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AMD - Q3 2013 Advanced Micro Devices Earnings Conference Call

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OVERVIEW:

AMD reported 3Q13 revenues of \$1.46b and non-GAAP net income of \$31m or \$0.04 per share. Expects 4Q13 revenues to increase 5% sequentially, plus or minus 3%.



CORPORATE PARTICIPANTS

Ruth Cotter *Advanced Micro Devices Inc - VP of IR*

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PRESENTATION

Operator

Good afternoon. My name is Huey and I'll be your conference operator for today. At this time, I would like to welcome everyone to AMD's third-quarter 2013 earnings conference call. All lines have been placed on a listen-only mode at this time. After the speakers' remarks, you'll be invited to participate in a question-and-answer session. As a reminder, this conference is being recorded today.

I would now like to turn conference over to Ms. Ruth Cotter, Vice President of Investor Relations for AMD. Please go ahead.

Ruth Cotter - *Advanced Micro Devices Inc - VP of IR*

Thank you and welcome to AMD's third-quarter earnings conference call. By now you should have had the opportunity to review a copy of our earnings release and the CFO commentary and slides. If you have not reviewed these documents, they can be found on AMD's website at quarterlyearnings.amd.com. Participants on today's conference call are Rory Read, our President and Chief Executive Officer; Devinder Kumar, our Senior Vice President and Chief Financial Officer; and Lisa Su, our Senior Vice President and General Manager, Global Business Units, will be present for the QA portion of the call. This is a live call and will be replayed via webcast on AMD.com.

I would like to highlight a few dates for you. Devinder Kumar will attend the Credit Suisse Technology Conference on December 3 in Arizona. John Byrne, our Senior Vice President and Chief Sales Officer, will attend the Raymond James IT Supply Chain Conference on December 10 and the BMO 2013 Tech and Media Conference on December 11. Our fourth-quarter quiet time will begin at the close of business on Friday, December 13. And



lastly, we intend to announce our fourth-quarter and year-end earnings on January 21, 2014. Dial-in information for the call will be provided in mid-December.

Please note that non-GAAP financial measures referenced during this call are reconciled to their most directly comparable GAAP financial measure in the press release and CFO commentary posted on our website, at quarterlyearnings.amd.com. Before we begin today, let me remind everyone that the discussion contains forward-looking statements based on the environment as we currently see it. Those statements are based on current belief, assumptions and expectations, speak only as of the current date and as such, involve risks and uncertainties that could actually cause results to differ materially from our current expectation. Please refer to the cautionary statement in our press release for more information. You may also find detailed discussions about our risk factors in our filings with the SEC, and in particular, AMD's quarterly report on Form 10-Q for the quarter ended June 29, 2013.

Now with that, I'd like to hand the call over to Rory. Rory?

Rory Read - *Advanced Micro Devices Inc - President and CEO*

Thank you, Ruth. Third-quarter revenue of \$1.46 billion increased 26% sequentially and 15% year-over-year, as we returned to profitability and delivered positive free cash flow. Revenue was higher than guided, based on incremental demand for our new semi-custom SoC's. The three-step turnaround plan we outlined a year ago to restructure, accelerate, and ultimately transform AMD is clearly paying off. We completed the restructuring phase of our plan, maintaining cash at optimal levels, and beating our \$450 million quarterly operating expense goal in the third quarter.

We are now in the second phase of our strategy, accelerating our performance by consistently executing our product road maps, while growing our new businesses to drive a return to profitability and positive free cash flow. We are also laying the foundation for the third phase of our strategy, as we transform AMD to compete across a set of high-growth markets. Our progress on this front was evident in the third quarter, as we generated more than 30% of our revenue from our semi-custom and embedded businesses.

Over the next two years, we will continue to transform AMD to expand beyond a slowing, transitioning PC industry, as we create a more diverse company and look to generate approximately 50% of our revenue from these new high-growth markets. We have strategically targeted the semi-custom ultra-low power client, embedded, dense server and the professional graphics markets, where we can offer differentiated products that leverage our APU and graphic IP. Our strategy allows us to continue to invest in the products that will drive growth, while effectively managing operating expenses. This is best exemplified by the 10% sequential reduction in our expense to revenue ratio, as we drive to best-in-class performance on this key metric.

Several of our growth businesses passed key milestones in the third quarter. Most significantly, our semi-custom business ramped in the quarter. We successfully shipped millions of units to support Sony and Microsoft, as they prepare to launch their next generation game consoles. Our game console wins are generating a lot of customer interest, as we demonstrate our ability to design and reliably ramp production on two of the most complex SoC's ever built for high-volume consumer devices. We have several strong semi-custom design opportunities moving through the pipeline, as customers look to tap into AMD's IP, design and integration expertise to create differentiated, winning solutions.

We made good progress in our embedded business in the third quarter. We expanded our current embedded SoC offerings and detailed our plans to be the only company to offer both 64-bit x86 and ARM solutions beginning in 2014. We have developed a strong embedded design pipeline, which we expect will drive further growth for this business across 2014. We also continue to make steady progress in another of our growth businesses in the third quarter, as we delivered our fifth consecutive quarter of revenue and share growth in the professional graphics area. We believe we can continue to gain share in this lucrative part of the GPU market, based on our product portfolio, design wins in-flight, and enhanced channel programs.

In the server market, the industry is at the initial stages of a multi-year transition that will fundamentally change the competitive dynamic. Cloud providers are placing a growing importance on how they get better performance from their data centers, while also reducing the physical footprint and power consumption of their server solutions. This will become the defining metric of this industry and will be a key growth driver for the market and the new AMD. AMD is leading this emerging trend in the server market and we are committed to defining a leadership position. Earlier this

quarter, we had a significant public endorsement of our dense server strategy, as Verizon announced a high-performance public cloud that uses our SeaMicro technology and Opteron processors. We remain on track to introduce new low-power x86 and 64-bit ARM processors next year, and we believe we will offer the industry-leading ARM-based servers.

Now looking at our traditional businesses. In the third quarter, our graphics business was in transition, as our AIB partners prepared to launch new products based on our new R-7 and R-9 graphics chips. The transition is now complete and we are seeing strong demand for our new products, which we believe will drive consistent growth in the coming quarters. A key innovation in these new chips is Mantle. Mantle was developed in conjunction with game developers to allow them to take better advantage of the capability of AMD's latest graphics cores, resulting in dramatically better performance and power efficiency. Mantle also means the investments developers make to create great content for the Sony and Microsoft consoles translates into optimized experience for all AMD APUs and GPUs moving forward.

Turning to the PC business. The 300 million plus unit market remains an important part of our business. But the market is clearly in transition, as evidenced in the third quarter by consumer notebook softness, which we expect to continue for the next several quarters, as tablets adoption increases and our customers' inventory levels remain lean. We expect PC industry unit shipments will decline approximately 10% this year and by a similar amount in 2014. We have the right product and IP and will continue to compete effectively in this market. We are well-positioned to expand our channel business and strategic OEM partnerships around consumer notebooks and commercial products. Kabini continues to ramp and support of a number of high-volume OEM platforms and Temash adoption is growing. Toshiba and HP announced the first Temash powered convertibles, and we expect more designs from other OEMs to launch this quarter.

Our work to strengthen our desktop business is gaining momentum. We delivered a second straight quarter of channel revenue growth based on strong demand for our high-end A-8 and A-10 APUs and FX CPUs. We expect this trend to continue. We remain on track to begin shipping our next generation Cabari APU for the channel this quarter, and key motherboard partners are already offering new products in anticipation of this launch.

So in summary, we are successfully hitting key milestones of our three-step strategy to diversify and transform our business. We have completed the first step, restructuring AMD and stabilizing our business. We effectively managed cash at the optimal levels and beat our \$450 million quarterly operating expense goal in the third quarter. We are now in the second phase, accelerating our performance by consistently executing our product road map and growing our new businesses. Our success here drove 26% sequential revenue growth and returned AMD to profitability and generated free cash flow in the third quarter. Our progress sets us up to ultimately transform AMD in the third and final step, as we leverage our IP and design expertise from our traditional businesses to generate approximately 50% of our future revenues from high-growth markets over the next two years. We are in the middle of a multi-year journey we outlined over a year ago to redefine AMD as a leader across a more diverse set of growth markets.

I'd like to take this opportunity to thank AMDers across the world who have pulled together to deliver on our commitment and successfully execute our plan. The job is not done, but we are making good and real progress. I look forward to the next steps of our strategic transformation.

Now I'd like to hand the call over to Devinder. Devinder?

Devinder Kumar - *Advanced Micro Devices Inc - SVP and CFO*

Thank you, Rory.

Our third-quarter results met or exceeded our guidance for revenue, gross margin, operating expenses and cash, although inventory was higher than guided. We completed the first phase of our three-step plan to transform AMD, the reset and restructure phase, and we are performing well in the second phase, accelerating our business and executing on our 2013 product road map. In the third quarter, we made progress towards our goal of diversifying our product portfolio, as we successfully ramped our semi-custom products; specifically, our semi-custom and embedded revenue accounted for more than 30% of total Company revenue, exceeding the target of 20% of revenue by the fourth quarter of 2013. Financially, we returned to profitability, both in operating and net income, met our target of reducing operating expenses to \$450 million, and generated positive free cash flow ahead of plan. Significant change is underway at AMD, as we continue our transformation into 2014 and beyond.



Now let me turn to the specifics of the quarter. Revenue for the third quarter of 2013 was \$1.46 billion, an increase of 26% on the second quarter and an increase of 15% year-over-year. This represents the highest sequential revenue growth in the past five years. The increase was driven by a more than doubling of our graphics and visual solutions segment revenue quarter-on-quarter, primarily from the ramp of our semi-custom SoC's. Gross margin was 36%, down 4 percentage points sequentially and in line with our expectations, as we grew our semi-custom business, which has lower than corporate average margins, but significant revenue and earnings power as volumes ramp. You will recall that the semi-custom NRE operating model drives significantly lower operating expenses for this business, with the majority of its gross margin dollars falling through to operating income. The third quarter result includes a \$19 million benefit for approximately 1 percentage point from the sale of inventory previously reserved in the third quarter of 2012, as compared to an \$11 million benefit, or approximately 1 percentage point, in the second quarter of 2013.

Non-GAAP operating expenses were \$443 million, slightly below our targeted level of \$450 million, primarily due to the timing of certain marketing-related expenses. Non-GAAP operating income was \$78 million and non-GAAP net income was \$31 million, both of which exclude a gain of \$22 million from the real estate transactions in the quarter. Non-GAAP earnings per share were \$0.04, calculated using 764 million diluted shares. Adjusted EBITDA was \$153 million, an increase of \$99 million from the prior quarter, primarily due to improved operating income.

Now turning to the business segments. Computing Solutions segment revenue was \$790 million, down 6% sequentially, due to lower notebook and chip set unit shipments, partially offset by higher desktop unit shipments. Computing Solutions operating income was \$22 million, up from \$2 million in the second quarter, despite the sequential 6% decline in revenue driven by lower operating expenses. Graphics and Visual Solutions segment revenue was \$671 million, more than double last quarter's level, driven by shipment of game console semi-custom SoC's. Graphics and Visual Solutions segment operating income was \$79 million, compared to breakeven in the prior quarter, primarily due to the semi-custom business. Operating margin for the semi-custom business was in the mid-teens, primarily due to higher revenue and a very smooth ramp in our first full quarter of production. Moving forward, we expect semi-custom operating margin performance to continue to improve as the business gains traction, volumes increase, and costs improve.

Turning to the balance sheet, our cash, cash equivalents and marketable securities balance, including long-term marketable securities, was \$1.2 billion. Third quarter real estate transactions generated cash proceeds of \$56 million. We remain committed to operating and funding the business appropriately and continue to have a number of liquidity bolstering opportunities available. Inventory, as I stated earlier, was higher than guided at \$922 million, largely driven by next-generation game console product ramps in preparation for fourth quarter shipments of our new graphics products. That, as the end of the quarter, was \$2 billion, flat from the prior quarter. Accounts payable at the end of the quarter was \$574 million, up \$172 million from the second quarter, due to the timing of purchases and payments. Depreciation and amortization was \$52 million, down \$2 million sequentially. And lastly, we generated positive free cash flow of \$6 million in the quarter.

Now turning to the outlook. For the fourth quarter of 2013, AMD expects revenue to increase 5% sequentially, plus or minus 3%. Non-GAAP gross margin is expected to be approximately 35%, as our semi-custom business continues to represent a greater portion of our overall revenue. We expect to continue to maintain quarterly non-GAAP operating expenses in the \$450 million range and expect to be profitable at the net income level. Inventory is expected to be flat from third quarter levels, and cash is expected to be approximately \$1.2 billion. Capital expenditures for the full year 2013 are expected to be approximately \$110 million, down from our prior guidance of \$150 million.

In summary, our execution and product diversification strategy is showing results, as evidenced by our return to profitability in the third quarter of 2013. We are pleased to have delivered on our financial commitments so far this year, some ahead of schedule, and expect to continue these positive trends in the fourth quarter.

With that, I'll turn it back to Ruth. Ruth?

Ruth Cotter - *Advanced Micro Devices Inc - VP of IR*

Thank you, Devinder. Operator, we'd be happy for you to poll the audience, please, for some questions.



QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

David Wong, Wells Fargo.

David Wong - Wells Fargo Securities, LLC - Analyst

Thanks very much. I think in your CFO commentary, you pointed out that Graphics had declined because of the transition to the new products. And you also said that the new products have transitioned. So do we expect a jump in Graphics revenue in the fourth quarter? And also, what does your guidance assume in terms of microprocessor revenue sequential growth, is it up or down in the fourth quarter?

Lisa Su - Advanced Micro Devices Inc - SVP & GM, Global Business Units

Hello, David. This is Lisa. Let me take the Graphics question. So first, we've talked about Graphics as a multi-quarter growth strategy for us in terms of market share, and we are certainly seem that we are executing on that path. When we look at the third quarter relative to the fourth quarter and where we are going, we have built a very strong product portfolio. We just announced our full line-up for the R-7 and R-9 series, and those were launched in September and shipping in October. So we did see a little bit of a transition at the end of the third quarter, but we do expect to gain share in the fourth quarter with our Graphics business.

Rory Read - Advanced Micro Devices Inc - President and CEO

And from a CPU standpoint, David, I think you'll see that the market continues to be in transition. There's no doubt for 2013, we have seen the market down 10%. We see that continuing into 2014. As we manage our portfolio into fourth quarter, we want to keep a long view to the quarter. We know 1Q and 2Q are going to be seasonally light. That's just how it is. And we want to make sure we're managing inventory and positioning properly. So I would expect we'll continue to see the market feel pressure down year-to-year, and I would expect that we'll manage this and not lean into it, to make sure we have a more consistent revenue path as we go into 2014.

David Wong - Wells Fargo Securities, LLC - Analyst

Okay. Great. And one final one. I think you noted your semi-custom business operating margin was in the mid-teens. That was quite a bit better than you'd expected initially. Can you improve it from here, or is this the right operating margin for us to think of for the current console semi-customs business?

Devinder Kumar - Advanced Micro Devices Inc - SVP and CFO

I think, David, you're right. The operating margin, when we discussed this last quarter, I had said low double digits. It came in at the mid-teens. And really that's credit to the higher revenue that we had in the quarter and the successful execution of a very steep ramp in a product in the first full quarter of production. And as you know, as we gain traction and get more volume and cost improvement, the operating margin could improve from the mid-teen level.

Rory Read - Advanced Micro Devices Inc - President and CEO

I think it's also important to see the kind of execution that we delivered in semi-custom in this ramp. This is one of the most complex ramps that we've seen with this set of SoC's. And what's really encouraging is how our customers are looking at this in terms of the innovation that we've



created here, as well as our execution. And that's driving some serious interest in terms of our pipeline and opportunities in the semi-custom space that are moving through at this time.

David Wong - *Wells Fargo Securities, LLC - Analyst*

Great. Thanks.

Devinder Kumar - *Advanced Micro Devices Inc - SVP and CFO*

Thank you

Operator

Hans Mosesmann, Raymond James.

Hans Mosesmann - *Raymond James & Associates - Analyst*

Thank you, and congratulations on the execution on the semi-custom. Can you provide a road map or some granularity regarding process node transitions in 2014 and '15 as it relates to thin set by Graphics and APU? Thanks

Lisa Su - *Advanced Micro Devices Inc - SVP & GM, Global Business Units*

Hello, Hans. Thanks for your question. And relative to where we are in terms of process technology node transition, we are typically at the leading edge of process technology nodes. We are fully top to bottom in 28-nanometer now across all of our products, and we are transitioning to both 20-nanometer and to FinFET over the next couple of quarters, in terms of designs. So we'll continue to do that across our foundry partners.

Hans Mosesmann - *Raymond James & Associates - Analyst*

Specifically to FinFET, if you don't mind.

Lisa Su - *Advanced Micro Devices Inc - SVP & GM, Global Business Units*

We will do 20-nanometer first, Hans, and then we will go to FinFET.

Hans Mosesmann - *Raymond James & Associates - Analyst*

Okay. Thank you.

Operator

Vivek Arya, Bank of America Merrill Lynch.



Vivek Arya - *BofA Merrill Lynch - Analyst*

Thanks for taking my question. Rory, maybe one more on the PC business, now that Intel is starting to become more aggressive in the lower-priced segments of the market, also in the tablet category, with Bay Trail. And these are segments where you have traditionally held a larger market share, on a relative basis. So, if you are expecting the PC market to decline 10% next year and Intel continues to be aggressive in that lower-priced segment of the market, how do you think your PC sales will trend next year? Just conceptually. I understand it's too early to make a specific prediction.

Rory Read - *Advanced Micro Devices Inc - President and CEO*

From my perspective, Vivek, I think that we've created a very interesting product set with the current products. And the feedback I'm getting from our customers in terms of the design wins and the ramps, they look solid. Our volume is solid in that space. And the next generation products, the silicon's already in shop. So that's positioning us well to continue to compete in this segment.

But make no mistake about it, the PC industry is clearly in transition and will continue to be in transition as tablet continues to tap, particularly in the consumer segment. We think we can compete well, and it will make a significant portion to our business moving forward.

But think about it, two years ago, we were 90% to 95% of our business centered over PCs. And we've launched a clear strategy to diversify our portfolio, taking our IP -- leadership IP -- in Graphics and CPU, and taking it into adjacent segments where there's high growth for 3, 5, 7 years and stick your opportunities. We see that as an opportunity to drive 50% or more of our business over that time horizon.

And if you look at the results in the third quarter, we're already seeing the benefits of that opportunity, with over 30% of our revenue now coming from semi-custom and our embedded businesses. We see it as an important business in PC, but its time is changing and the go-go era is over. We need to move and attack the new opportunities where the market is going. And that's what we're doing.

Vivek Arya - *BofA Merrill Lynch - Analyst*

Got it. And maybe one for Devinder, on the cash side. I think Devinder, in the prepared comments, you said that you expect to be at \$1.2 billion at the end of Q4, so slightly up sequentially, and then you do expect to be at the \$1.1 billion optimal level by Q1. But given the \$200 million payment due in Q1, does it mean you expect to generate cash also in Q1, which is seasonally a weaker quarter? Thank you.

Devinder Kumar - *Advanced Micro Devices Inc - SVP and CFO*

Vivek, if you look at the last one year, I think that was exactly what we said about a year ago, about maintaining cash at the \$1.1 billion level, well above the target minimum. And as you have seen, despite a very challenging year that we have gone through, we have successfully maintained \$1.1 billion of cash without, by the way, getting any extended financing.

And with the ramp in the business that we see here at the level that we came in in Q3 and what we are projecting for Q4, and with any levers available to us, if wanted, I am very confident we can maintain cash at those levels.

Vivek Arya - *BofA Merrill Lynch - Analyst*

Got it. Thank you.

Operator

John Pitzer, Credit Suisse.



John Pitzer - *Credit Suisse - Analyst*

Good afternoon, guys. Thanks for letting me ask the question. Rory, I guess what I'm trying to understand a little bit better is where do you believe the trajectory of the gaming ramp flattens out? So you've got some benefits here in the September and December quarter with initial builds. As we look into the first half of next year, what's the right steady-state run rate? And I guess specifically, now that you've broken through the breakeven mark on the P&L, do you think you can stay above breakeven in what's usually a seasonally soft quarter, in calendar first quarter?

Devinder Kumar - *Advanced Micro Devices Inc - SVP and CFO*

We won't be giving guidance on first quarter at this point; but clearly, it's our objective to get back in black in third quarter and continue to deliver that in fourth quarter. And this year is the tale of two halves, the first half and improving second half. As we look to '14, we need to look at the full year and drive a business that drives revenue growth and profitability for the full year. That needs to be the next step in our transformation.

Now in terms of the question about gaming -- gaming is going to be an important driver of the business. And if you think about consoles traditionally, that's a five-plus year business, and it generally peaks in the third year. It will have some seasonality in the first half of the year, but we think there's strong demand and opportunity for us to continue to have a very good business. And we'll share the specifics of that as we give the guidance for 1Q next quarter.

But I think it's important to think about it, as we continue to go after this pipeline in semi-custom, we'll look to close additional deals over the next two years, one-year and two-year, that will allow us to continue to fill out that business with this nice sticky flow of revenue, both in embedded and semi-custom. And while we're in the early phases of this transformation, as you move out and take the long view, you'll see the portfolio drive a much more consistent level of revenue moving forward.

But again, it's our objective, as we stated before, to get back in black, which we did in third quarter, and then to move forward in fourth quarter to continue to accelerate; and then for '14 is to drive a business that's profitable for the full year and drives revenue growth for the full year.

John Pitzer - *Credit Suisse - Analyst*

Thanks, Rory. And as my follow-up, Devinder, do you have an inventory target for the December quarter, and can you just bring us up to speed on where we stand with the wafer supply agreement with GLOBALFOUNDRIES for this year relative to your obligations that you had in Q3, Q4?

Devinder Kumar - *Advanced Micro Devices Inc - SVP and CFO*

As I said in my prepared remarks, I expect inventory levels to remain essentially flat from where we ended Q3. Recall that it's a steep ramp in the business. We introduced the semi-custom products, the new products that Lisa referenced earlier, the R-7, R-9 series. So, I expect that in the Q4 timeframe, when we report the results, we'll be essentially flat to Q3.

Talking about the WSA from GLOBALFOUNDRIES, we're on track to meet the commitment for the 2013 WSA. And on the 2014, if that's what you're referring to, we are in discussion to figure out the pricing and the wafer volumes for 2014, and I expect those to close within the next 30 to 60 days.

John Pitzer - *Credit Suisse - Analyst*

Thanks, guys.

Operator

Ross Seymore, Deutsche Bank

Ross Seymore - *Deutsche Bank - Analyst*

Hello. Thanks for letting me ask a question. One clarification from the prior question. Do you expect seasonality in the gaming console business in the first half of '14, or is the early stage at which we are in the ramp and the geographic distribution expanding for those launches something that could offset that seasonality?

Lisa Su - *Advanced Micro Devices Inc - SVP & GM, Global Business Units*

Hello, Ross. This is Lisa. Let me answer that question. So again, we do -- the game console business is a consumer business, so we do expect some level of seasonality. You're absolutely right, it's the first year of launch and there's pent-up demand. So we'll see some seasonality as we go into the first half of the year, but probably a little bit different than normal years.

Ross Seymore - *Deutsche Bank - Analyst*

Then one other clarification for Devinder, on the gross margin guidance of 35%, what does that assume as far as sales of previously reserved inventory? Are you going to get that one point again?

Devinder Kumar - *Advanced Micro Devices Inc - SVP and CFO*

Actually, that's not included. I think, as we've said earlier, we remain opportunistic. If an opportunity comes along, we go ahead and sell the chips. But there are no plans to go ahead and do that at this point. We have about \$40 million left of the previously reserved inventory, which we took in Q3 of 2012 to the tune of \$100 million.

Ross Seymore - *Deutsche Bank - Analyst*

The final question, more of a structural one as we look forward into next year. You did a great job of getting down even under the \$450 million in OpEx that you've talked about. If we think about next year conceptually, how should we expect the Company's OpEx to change alongside of revenues? Do you think \$450 million is something you can hold throughout the year, or what are the puts and takes from a bigger picture perspective?

Devinder Kumar - *Advanced Micro Devices Inc - SVP and CFO*

I think the key I would leave you with is we've been very disciplined from an OpEx management standpoint. We actually beat the target of \$450 million that we set. And projecting to be around \$450 million for Q4. The thing you're going to see about AMD, with the mix in the business and the changing model, is we're very focused on operating margin.

So obviously, if revenue goes up significantly, there's a possibility that OpEx might go up. But I think you're going to see us being very disciplined from a viewpoint of how OpEx modulates against a revenue increase or decline.

Rory Read - *Advanced Micro Devices Inc - President and CEO*

And Ross, I want to add a little something here to get a perspective on how we see this business evolving over time. Look at the semi-custom business and how we're reusing IP in a series of high-growth segments. And semi-custom is an NRE model, where there's an investment around engineering. In the quarter, we drove \$300 million of additional revenue, up 26%. And at the same time, we had expense decline almost 10%,

following a year we'd driven down 25%. Clearly, that says we're getting a strong leverage in that model. And as we consider that in some of our core businesses, they'll continue to see pressure, they're at a different point in their maturity, we'll drive for higher efficiencies in those segments, and at the same time look for opportunities to make investments to capture the new growth segments, like growth businesses like Pro Graphics, embedded, and semi-custom. But overall, I think it's fair to say we will look for more efficiencies as we move forward, but it will be balanced.

Ross Seymore - *Deutsche Bank - Analyst*

Thank you.

Operator

Romit Shah, Nomura.

Romit Shah - *Nomura Asset Management - Analyst*

Hello. Thanks for letting me ask a question. The computing results are my biggest concern, looking at the quarter. And Rory, you chalked up the weakness to just general softness in consumer notebooks. But if I look at your numbers, the computing business was down 6% sequentially, so desktops were up, which means notebooks were probably down more than 10%, and I compare that to Intel, whose PC business was up, I think, mid-single digits. And IDC and Gartner were also up. So how do we reconcile the difference between AMD's consumer business, notebook business and Intel, and just the general market?

Rory Read - *Advanced Micro Devices Inc - President and CEO*

I think you summed it up properly. The consumer market is feeling more pressure, but all parts of the PC market are down. This market, this industry is down 10%, and at rates it's never experienced before. It's going to continue. From our perspective, AMD is over indexed to client notebook. We've always been. We've had-- just like we have to diversify our portfolio across high-growth segments, we need to diversify this core business. We need to move stronger into desktop. And as we talked about a year ago, we worked on the inventory in the desktop segment, and we built and repaired that, and we've seen two quarters of consistent revenue growth in that segment. And we believe that we have the right product stack to continue to make hay, make progress, in that part of our business, as well.

But there's no doubt that the PC client segment, particularly at the entry level, will feel pressure from tablets. And it's a competitive space. We're going to be in there and we're going to compete, because we have very good product. But that is a key driver why we're moving in the direction of this transformation, this multi-year strategic transformation. We'll invest in those growth markets and we'll attack these base businesses around efficiency and where we can diversify the portfolio and gain revenue.

Devinder Kumar - *Advanced Micro Devices Inc - SVP and CFO*

And I would add, from a financial standpoint, just to level set with what we saw coming and what the reset and restructure and the acceleration and transformation is all about. If you look at that particular segment from a revenue standpoint year-over-year, revenue is down about \$140 million, profitability is up about \$36 million. Quarter-on-quarter, revenue is down about \$51 million and the profitability went from essentially breakeven to what we ended up in Q3, at \$22 million. And that is essentially the power of the expense model, how we are deploying the resources from a transformation standpoint into what we call the growth businesses, including the semi-custom and the PC business, which obviously is under pressure.



Romit Shah - *Nomura Asset Management - Analyst*

All right. That's helpful. And then, sorry if I missed this, but in Q4, embedded in the 5% sequential growth, are you assuming that computing is stable or growing?

Rory Read - *Advanced Micro Devices Inc - President and CEO*

I think from a computing standpoint, I think there's no doubt that that market will continue to see pressure, I think at the industry level, as well as in the consumer segment. We're planning not to lean into that, but to manage the inventory, because we'd much more like to see a consistent revenue through that weak part of 2014 where seasonality affects it. So we don't want to get a bumpy move there. I think we'll see it continue to trend slightly down, but I think as we move into 1Q and 2Q, we can continue to build off that base, as we add the new revenues as part of our strategy.

Romit Shah - *Nomura Asset Management - Analyst*

Thanks, Rory.

Rory Read - *Advanced Micro Devices Inc - President and CEO*

You're welcome

Operator

Joe Moore, Morgan Stanley

Joe Moore - *Morgan Stanley - Analyst*

Great. Thank you. I wanted to go back to the wafer supply agreement question with GLOBALFOUNDRIES. It looked like you used up 46% of that as of the 2Q 10-Q. The Computing Solutions business, it looks like, will be down second half, and I think you've moved some of that business to TSMC. So I guess some further clarity on why you're confident that you'll use the entire amount of that?

Devinder Kumar - *Advanced Micro Devices Inc - SVP and CFO*

The total amount that we committed to purchase in 2013 is \$1.15 billion. And looking at the numbers that I'm looking at, we are on track to satisfy the obligation for the WSA for 2013.

Joe Moore - *Morgan Stanley - Analyst*

Okay. Great. Thanks. And then the inventory build -- do you need to maintain inventory at this level, if your revenues were growing only about, looks like about \$75 million in the fourth quarter?

Devinder Kumar - *Advanced Micro Devices Inc - SVP and CFO*

It's the timing, right? So you go ahead and have the build in inventory from a viewpoint of the steep ramp in revenue, and you can have the timing from a viewpoint of when the wafers come in and when we have the pods. And what we are doing from a management standpoint is over Q3 and Q4 keeping the inventory flat, while the revenue has gone up 26% from Q2 to Q3 and projected to go up again in Q4. So I think you need to take



the longer view in terms of the six-month period, how much the revenue has gone up from first half to the second half. And inventory essentially has gone from \$600 million to \$900 million. And by the way, the revenue is up significantly in both quarters compared to the prior quarters.

Joe Moore - *Morgan Stanley - Analyst*

Great. Thank you very much.

Operator

Chris Rolland, FBR.

Chris Rolland - *FBR & Co. - Analyst*

Hello, guys. How are you? Back to the op margin, the incremental op margin in Graphics probably implying mid-teens, maybe even a little bit better, on the gaming console business. As we think about that going forward, once this product's really on cruise control, even if it's a couple years from now, what sort of incremental improvements are we talking about when there's really not that much SG&A to support this, R&D to support this? Are we talking maybe another 500 or even 1000 basis points in op margin improvements, at its peak?

Devinder Kumar - *Advanced Micro Devices Inc - SVP and CFO*

Without giving the granularity -- and I'll let Lisa comment -- overall, as you can see, when you have a ramp in revenue for a new business like semi-custom, there's a certain amount of money you spend on an OpEx standpoint. The semi-custom business, and in particular the game console business, is built on an NRE model. The R&D costs have been incurred upfront. The gross margins, as we've been very transparent, are lower than the corporate average. But the majority of that falls to the operating margin line.

In Q3 alone, thinking that we were at the low double digits when we talked about it last quarter, we came in at the mid-teens. As we gain traction, as we extract more efficiencies, as we go ahead and increase the volume and get cost improvements, the operating margin could go up from the mid-teens higher than where we came in in Q3. I'll let Lisa comment from a business standpoint, too.

Lisa Su - *Advanced Micro Devices Inc - SVP & GM, Global Business Units*

Yes, Chris. Just to give you a little bit more color on that. So the operating margins did come in a little bit better than we'd originally planned, and that was primarily because the ramp was actually quite smooth and it went very well.

As we look forward, again, this is a very nice product. It's one of those -- each of these products are high-volume. They give us a lot of opportunity to optimize yields and costs and other things. So we're going to be working hard to improve that operating margin over the next number of quarters, and it's something that we believe there's leverage in.

Rory Read - *Advanced Micro Devices Inc - President and CEO*

And Chris, one of the things you really got to think about in this business, these are just the first two wins in this semi-custom space. We have a pipeline of additional products, and it's our intention to win and mix in a whole set of semi-custom offerings as we build out this exciting and important new business.



And also, as you think about that NRE model, look at the expense to revenue ratio. When we historically ran this business at different margin, it was much higher, the high 30s, even into the 40s. In this quarter, we saw a 10% reduction in E to R with that significant revenue gain, and we're going to drive that efficiency moving forward. Think about building that business and how the power of this model continues to grow over time.

Chris Rolland - *FBR & Co. - Analyst*

Okay. Thank you, guys.

Operator

Srini Pajjuri, CLSA Securities.

Srini Pajjuri - *CLSA Securities - Analyst*

Thank you. Maybe for Lisa. Lisa, given that the product life in game consoles is quite long, I'm trying to understand how your own product refreshes work. For example, you're starting at 28, and will these products stay at 28 forever or are you going to switch to 20 at some point? And when that happens, what happens -- obviously, the costs are going to increase, and I'm wondering what happens to the margin side of the equation?

Lisa Su - *Advanced Micro Devices Inc - SVP & GM, Global Business Units*

Yes, Srini, good question. So it is a long life cycled product, over 5 to 7 years. Certainly, when we look at cost reduction opportunities, one of the important ones is to move technology nodes. So we will in this timeframe certainly move from 28- to 20-nanometer. And the reason to do that is both for pure die cost savings, as well as all the power savings that our customer benefits from. So I think we'll see leverage in the model as we continue to improve the costs, and as the costs improve, the volumes will also go up.

Srini Pajjuri - *CLSA Securities - Analyst*

So you actually expect the cost to go down as you move to 20, not go up?

Lisa Su - *Advanced Micro Devices Inc - SVP & GM, Global Business Units*

Absolutely. On a unit basis, yes.

Srini Pajjuri - *CLSA Securities - Analyst*

Okay. Great. And then just a couple of clarifications. I think there was a mention about SeaMicro winning some designs from Verizon. And just wondering if you could give us an update on that business. It's been a while since you acquired that, how that's tracking and if you could quantify how big that is, that would be great. Thank you.

Lisa Su - *Advanced Micro Devices Inc - SVP & GM, Global Business Units*

Absolutely. The SeaMicro business, we are very pleased with the pipeline that we have there. Verizon was the first major data center win that we could talk about publicly. We've been working that relationship for the last two years. So it's actually nice to be able to talk about it. We do see it as a major opportunity that will give us revenue potential in 2014. And we continue to see a strong pipeline of opportunities with SeaMicro, as more of the data center guys are looking at how to incorporate these dense servers into their new cloud infrastructures.



Srini Pajjuri - *CLSA Securities - Analyst*

Thank you.

Operator

Kevin Cassidy, Stifel.

Kevin Cassidy - *Stifel Nicolaus - Analyst*

Thanks for taking my question. And just for a little more granularity on the Verizon, are you only shipping a SeaMicro product with AMD Opteron, or does it also have Xeon and Adam?

Lisa Su - *Advanced Micro Devices Inc - SVP & GM, Global Business Units*

Yes. So the clarification around SeaMicro servers. As I said, the Verizon engagement has lasted over the past two years, so some of the initial deployments were with the Intel processors. But we do have significant deployments with AMD Opteron, as well.

Kevin Cassidy - *Stifel Nicolaus - Analyst*

Okay. And going forward, will it switch more to Opteron, heavier -- ?

Lisa Su - *Advanced Micro Devices Inc - SVP & GM, Global Business Units*

We do see the percentage of Opteron processors increasing, because that's what we would like to do.

Kevin Cassidy - *Stifel Nicolaus - Analyst*

Great. Okay. Thank you.

Ruth Cotter - *Advanced Micro Devices Inc - VP of IR*

Operator, we'll take two more questions, please

Operator

Understood. Ambrish Srivastava, BMO.

Ambrish Srivastava - *BMO Capital Markets - Analyst*

Thank you. Lisa, since you're on a roll, I'll just follow-up on the server road map. What's the timing for 64-bit, and then with ARM? And then specifically, give us some insights into -- to the extent you can -- on how you aim to combine SeaMicro x86 and ARM? Thank you.



Lisa Su - *Advanced Micro Devices Inc - SVP & GM, Global Business Units*

Thanks, Ambrish, for the question. Again, we're very excited about the server space. It's a very good market. It's a market where there's a lot of innovation and change. In terms of 64-bit ARM, you will see us sampling that product in the first quarter of 2014. That development is on schedule, and we're very excited about that. All of the customer discussions has been very positive.

And then we will combine both the 64-bit ARM chip with our SeaMicro servers to have a full solution, as well. So I think we view this combination of IP as really beneficial to accelerating the dense server market, both on the chip side and then also on the solution side with the customer set.

Ambrish Srivastava - *BMO Capital Markets - Analyst*

What will be the timing for that, Lisa, for SeaMicro plus ARM?

Lisa Su - *Advanced Micro Devices Inc - SVP & GM, Global Business Units*

So you'll see that in 2014.

Ambrish Srivastava - *BMO Capital Markets - Analyst*

Okay. Thank you.

Operator

Patrick Wang, Evercore.

Patrick Wang - *Evercore Partners - Analyst*

Thanks for squeezing me in. I've just got two questions. First, I guess I'm a little bit confused about the way to think about the console semi-custom contribution in the fourth quarter. It sounds like you guys are saying that Graphics with the R-7, R-9 launches are probably going to be up, CPUs down modestly with the market. And then of course, earlier this morning we heard TSMC also talk about an expectation that console would be down a little bit in the fourth quarter, in terms of wafer starts. So can you help us -- maybe give a little bit more color in terms of the type of growth that we should be factoring in to the fourth quarter?

Lisa Su - *Advanced Micro Devices Inc - SVP & GM, Global Business Units*

Yes, Patrick. Let me try to help with that. If you look at the combined quarterly shipments for Q3 and Q4, they're very much on track with what we would have expected. If you look at the supply chain cycle, we buy wafers earlier to ship. And the peak months are going to be October, November.

So I think all of the data is consistent. We did ship a few more units in Q3 than we originally planned, just because of the strength of the production ramp. But we will see game console revenue go up Q4 versus Q3, just as both Microsoft and Sony are preparing for their holiday launches.

Patrick Wang - *Evercore Partners - Analyst*

Okay. So sounds like it's more of a timing thing. And just my second question, for Devinder. When I take a look at your guidance, CFO commentary, you talk about positive free cash flow in the fourth-quarter. Can you help provide us the timing of your payments to GLOBALFOUNDRIES? I see a liability on your balance sheet. I know you've got another \$200 million coming within the first quarter. But how does that play out and how does that work with your positive free cash flow?

Devinder Kumar - *Advanced Micro Devices Inc - SVP and CFO*

I think there are two parts to it. We have wafer purchased from GLOBALFOUNDRIES that we have purchased throughout this year. Earlier this year, we did have some special payments that we made related to the limited exclusivity, a waiver that we got way back in 2012. And then we did have the termination payment. We made about \$120 million payment of that.

There's another \$200 million of that left to be paid in Q1, 2014. So if you relate that from a cash standpoint, we have, as I projected, \$1.2 billion of cash, revenues can be up in Q4, and then when we get to Q1, we collect the cash for the revenue that we're going to have in Q4, pay the \$200 million. And that's where I'm projecting maintaining at the optimal range of the \$1.1 billion from a cash standpoint.

Patrick Wang - *Evercore Partners - Analyst*

I see. Okay. Thanks so much, guys.

Devinder Kumar - *Advanced Micro Devices Inc - SVP and CFO*

Thank you.

Ruth Cotter - *Advanced Micro Devices Inc - VP of IR*

Thank you, Operator. That concludes today's call and we'd like you to sign us off, please.

Operator

Thank you, presenters, and thank you, ladies and gentlemen. Again, this does conclude today's call. Thank you for your participation and have a wonderful day. You may now all disconnect.

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