

ON SEMICONDUCTOR CORPORATION

CALL SCRIPT
FOR
Q1-17 RESULTS CONFERENCE CALL

Parag Agarwal

Thank you <operator> .

Good morning and thank you for joining ON Semiconductor Corporation's first quarter 2017 quarterly results conference call. I'm joined today by Keith Jackson, our President and CEO, and Bernard Gutmann, our CFO. This call is being webcast on the "Investor Relations" section of our website, at www.onsemi.com. A replay of this broadcast, along with our earnings release for the first quarter of 2017, will be available on our website approximately one hour following this conference call, and the recorded broadcast will be available for approximately 30 days following this conference call. The script for today's call and additional information related to our end markets, business segments, geographies, and channels are also posted on our website.

Our earnings release and this presentation include certain non-GAAP financial measures. Reconciliations of these non-GAAP financial measures to the most directly comparable measures under GAAP are in our earnings release, which is posted separately on our website in the "Investor Relations" section.

During the course of this conference call, we will make projections or other forward-looking statements regarding future events or the future financial performance of the company. The words "believe," "estimate," "project," "anticipate," "intend," "may," "expect," "will," "plan," "should" or similar expressions are intended to identify forward-looking statements. We wish to caution that such statements are subject to risks and uncertainties that could cause actual events or results to differ materially from projections. Important factors which can affect our

business, including factors that could cause actual results to differ from our forward-looking statements, are described in our Form 10-Ks, Form 10-Qs and other filings with the Securities and Exchange Commission.

Additional factors are described in our earnings release for the first quarter of 2017. Our estimates may change, and the company assumes no obligation to update forward-looking statements to reflect actual results, changed assumptions, or other factors, except as required by law.

For all synergy related discussions on this call, we have used Fairchild's 2015 results as the base for all comparisons.

During the second quarter, we will be attending the Deutsche Bank AutoTech Conference in San Francisco on May 11th, JP Morgan Technology Conference in Boston on May 24th, and Bank of America Merrill Lynch Technology Conference in San Francisco on June 7th.

Now, let me turn it over to Bernard Gutmann, who will provide an overview of the first quarter 2017 results. Bernard....

Bernard Gutmann

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

Our execution momentum remains strong, and we once again delivered solid financial results, which exceeded our guidance and street consensus for all key metrics. Visibility into our business continues to strengthen, driven by strong demand for products in the automotive, industrial and communications end-markets. At the same time, we are making strong progress in integration of Fairchild, and we remain on track to deliver the higher targeted synergies from our acquisition of Fairchild as communicated during our recent analyst day. Our margin performance remained strong in the first quarter as we delivered operating leverage driven by strong performance on operations front. Our free cash flow more than tripled year over year

during the first quarter. Furthermore, to reduce our cash outlay for interest expenses, we repriced our Term Loan B debt at lower interest rate and issued new convertible notes.

Before I discuss additional details regarding our first quarter 2017 results, let me highlight a change related to revenue recognition. As we announced in our press release on April 4th, starting from first quarter of 2017, ON Semiconductor will recognize revenue from distributors using the sell-in method. As you are aware, prior to transitioning to the sell-in method, ON Semiconductor used the sell-through method to recognize revenue from distributors. As a result of change, the Company experienced a one-time benefit in various line items in its consolidated financial statements. To provide transparency and clarity in our financial results, we have provided quantitative impact to various line items associated with this change. Furthermore, in discussion of our non-GAAP results for first quarter of 2017, we have excluded the benefit from this change, and that benefit will not repeat. Our guidance for second quarter of 2017 is not impacted by this change.

Now, let me provide you additional details on our first quarter 2017 results.

Total revenue for the first quarter of 2017 was approximately \$1,437 million, an increase of approximately 76 percent year over year and 14 percent quarter over quarter.

First quarter 2017 non-GAAP revenue, which excludes one-time benefit of approximately \$155 million from change in revenue recognition for distributors, was approximately \$1,280 million. Our first quarter non-GAAP revenue grew by approximately 57 percent year over year and approximately 2 percent quarter over quarter.

GAAP net income for the first quarter was \$0.18 per diluted share. GAAP income before income tax for the first quarter was approximately \$115 million, as compared to \$18.2 million in the fourth quarter.

Non-GAAP income before income tax for the first quarter was approximately \$133 million. Net cash paid for taxes in the first quarter was approximately \$18.4 million and diluted shares

outstanding were approximately 426 million. Non-GAAP income before income tax for the fourth quarter was approximately \$132 million. Net cash paid for taxes in the fourth quarter was approximately \$8 million and diluted shares outstanding were approximately 427 million.

GAAP gross margin for the first quarter was 35 percent, as compared to 30.5 percent for the fourth quarter. Non-GAAP gross margin for the first quarter was 35.4 percent, as compared to 35.2 percent in the fourth quarter. Better than expected non-GAAP gross margin in the first quarter was driven by strong operational execution and higher than expected revenue.

GAAP operating margin for the first quarter of 2017 was approximately 12.8 percent, as compared to approximately 4.4 percent in the prior quarter. Our non-GAAP operating margin for the first quarter was 13.2 percent, as compared to 12.9 percent the fourth quarter.

GAAP operating expenses for the first quarter were approximately \$320 million, as compared to approximately \$329 million for the fourth quarter of 2016. Non-GAAP operating expenses for the first quarter were approximately \$285 million, as compared to approximately \$281 million in the fourth quarter. Non-GAAP operating expenses for the first quarter were at the higher end of our guidance due to higher revenue, accrual for higher variable compensation resulting from significantly better results, and investments in ADAS related strategic growth initiatives such as automotive radar and advanced image sensors.

We had strong free cash flow performance in the first quarter. We define free cash flow as cash flow from operations less capital expenditures. First quarter free cash flow was approximately \$156 million as compared to approximately \$179 million in the fourth quarter. On year over year basis, our free cash flow more than tripled in the first quarter. Operating cash flow for the first quarter was approximately \$209 million and capital expenditures were approximately \$53 million. Operating cash flow for the fourth quarter was approximately \$229 million and capital expenditures were approximately \$50 million.

We exited the first quarter of 2017 with cash, cash equivalents and short-term investments of approximately \$729 million, as compared to approximately \$1,028 million in the fourth quarter. During the first quarter, we re-priced our Term Loan B debt to reduce the interest rate to LIBOR plus 225 bps from LIBOR plus 325. We also issued \$575 million of Convertible Senior Notes due 2023. These notes bear a coupon of 1.625 percent and are convertible into 48.2567 shares of ON Semiconductor's common stock per \$1000 principal amount of the notes at maturity or under certain conditions. To avoid potential dilution of our equity upon conversion of these notes, we entered into note hedge and warrant transactions with the initial purchasers of these convertible notes. These transactions effectively raise the strike price for conversion of the convertible notes to \$30.70 per share, from \$20.72 per share. We used the net proceeds from the issuance of convertible notes to pay down our higher interest rate debt. In the first quarter, we used approximately \$445 million to redeem all of the outstanding 2.625% Convertible Senior Subordinated Notes due 2026, Series B.

At the end of the first quarter of 2017, days of inventory on hand, adjusted for fair market value step-up, were 111 days, down two days as compared to inventory days at end of the fourth quarter. For the first quarter of 2017, our lead times were approximately flat quarter over quarter. Our global factory utilization for the first quarter was slightly up sequentially.

Now let me provide you an update on performance of our business units, starting with Power Solutions Group, or PSG. GAAP Revenue for PSG was approximately \$744 million and non-GAAP revenue was approximately \$636 million. GAAP revenue for our Analog Solutions Group for the first quarter of 2017 was approximately \$504 million and non-GAAP revenue was approximately \$462 million. GAAP revenue for Image Sensor Group was approximately \$189 million and non-GAAP revenue was approximately \$184 million.

Now, I would like to turn the call over to Keith Jackson for additional comments on the business environment. Keith ...

Keith Jackson

Thanks, Bernard.

I am very pleased with our strong execution. Our results clearly demonstrate the progress that we have made in transforming ON into a highly diversified and broad-based supplier of power, analog and sensor solutions for automotive, industrial, and communications end-markets. As we highlighted at our recent analyst day, ON Semiconductor has now established itself as a leader in the power semiconductor market. The company is now a provider of key enabling technologies for automotive, industrial, and communications end-markets, and our results are indicative of our strong momentum in key markets. We continue to expand our margins and generate strong free cash flow.

We are making strong progress in integration of Fairchild, and we are tracking significantly ahead of our planned synergies targets. We are on track to begin realizing manufacturing synergies from Fairchild towards the end of the year as we start insourcing of Fairchild's backend operations. Recall that at our recent analyst day, we raised the synergy targets for Fairchild. We now expect to exit 2017 with annual synergies run rate of \$180 million, as compared to our prior target of \$160 million. We raised annualized synergies run rate exiting 2018 to \$220 million from \$200 million. Total annual synergies from Fairchild are now expected to be \$245 million, up from \$225 million. We expect to achieve annual synergies run-rate of \$245 million by end of 2019.

Performance of Fairchild continues to be strong. We had another record bookings quarter for Fairchild. During the first quarter, booking for Fairchild were at the highest level for the last three years. We continue to see high level of customer interest in Fairchild's products, and our design win pipeline for Fairchild's products continues to expand at a rapid pace. We expect to see strong growth in revenue contribution from Fairchild in near to mid-term.

Let me now comment on the business trends in the first quarter. During the first quarter, demand trends and bookings were strong across most end-markets and geographies. While there has been discussion in the investment community regarding peaking of the

semiconductor cycle, commentary from customers, coupled with our booking trends points to sustained improvement in demand environment for most end-markets. At this time, as opposed to demand, potential supply tightness arising out of improving demand environment is among the top concerns of our customers.

Also, there have been a few negative data points regarding health of the automotive market. However, our bookings point to near-term seasonal trends on back of a very strong first quarter. I must also point out that our automotive revenue base is highly diversified in terms of geographies, customers, and applications, and therefore temporary softness in a particular geography or application is not likely to have a material impact on our automotive business. Based on comments from global auto OEMs and other market participants, we believe that global automotive units should grow by low single digit percentage annual rate in 2017.

Now I'll provide details of the progress in our various end-markets for first quarter of 2017.

GAAP revenue for the **automotive** market in the first quarter was approximately \$439 million. On non-GAAP basis, the automotive end-market contributed revenue of approximately \$405 million and represented approximately 32 percent of our non-GAAP revenue in the first quarter. First quarter automotive non-GAAP revenue grew by approximately 28 percent year over year and approximately 10 percent quarter over quarter. As I indicated earlier, our automotive business remains strong, driven by leadership in fast growing applications such as ADAS and exposure to highly diversified customer base across the globe.

Our momentum in the automotive market for ADAS and viewing applications continues to accelerate. For the first quarter, image sensor revenue related to ADAS and viewing applications grew at an impressive high-teen percentage rate quarter over quarter. Our design win pipeline continues to grow for ADAS and active safety applications, and we expect robust growth in our ADAS related revenue to continue. As Bernard indicated in his prepared remarks, we are making investments in ADAS to further accelerate our growth in this market.

Other growth drivers for automotive applications include LED lighting, power management, power discretes, body electronics, in-vehicle networking solutions and powertrain ASICs. Our design win pipeline for automotive applications such as ultrasonic sensors and power management continues to grow, and we are engaged with leading global OEMs and tier-1 integrators on numerous projects for upcoming platforms.

Revenue in the second quarter for the automotive end-market is expected to be up quarter over quarter compared to non-GAAP automotive revenue in the first quarter.

The **Industrial** end-market, which includes military, aerospace, and medical, contributed revenue of approximately \$355 million in the first quarter. On non-GAAP basis, the industrial end-market contributed revenue of approximately \$320 million and represented approximately 25 percent of our non-GAAP revenue in the first quarter. First quarter industrial non-GAAP revenue grew by approximately 64 percent year over year and approximately 6 percent quarter over quarter.

Strength in the industrial end-market was broad based across products and geographies.

We are well positioned to benefit from growth in machine vision and industrial automation applications with our CMOS and CCD image sensors. Our Python line of CMOS image sensors for machine vision applications continues to grow at an impressive rate. We have been repurposing products from our consumer end-market for industrial applications, which drive higher margins and long-term sustainable revenues. In the industrial end-market, we have seen strong traction for our power modules, which were originally designed for consumer applications. We expect to see growth in 2017 for our defense related revenue as depleted military stocks are being replenished.

Revenue in the second quarter for the industrial end-market is expected to be up quarter over quarter compared to non-GAAP industrial revenue in the first quarter.

The **Communications** end-market, which includes both networking and wireless, contributed GAAP revenue of approximately \$282 million in the first quarter. On non-GAAP basis, the communications end-market contributed revenue of approximately \$243 million and represented approximately 19 percent of our non-GAAP revenue in the first quarter. First quarter communications non-GAAP revenue grew by approximately 75 percent year over year and declined by approximately 14 percent quarter over quarter due to seasonality and softness in the Chinese handset market.

We believe that much of the softness in the Chinese handset market is largely behind us, and we expect growth to resume in the second quarter. Our content in major global platforms continues to increase and we are well positioned to benefit from impending ramp of new platforms.

Revenue in the second quarter for communications end-market is expected to be up quarter over quarter compared to non-GAAP communications revenue in the first quarter.

The **Computing** end-market contributed GAAP revenue of approximately \$156 million in the first quarter. On non-GAAP basis, the computing end-market contributed revenue of approximately \$130 million and represented approximately 10 percent of our non-GAAP revenue in the first quarter. First quarter computing non-GAAP revenue grew by approximately 70 percent year over year and by approximately one percent quarter over quarter.

With products from Fairchild, we have won designs for power stage for cloud computing and server applications with addressable content of more than \$30, and we expect revenue from these wins to start ramping in near to mid-term.

Revenue in the second quarter for computing end-market is expected to be up quarter over quarter compared to non-GAAP computing revenue in the first quarter.

The **Consumer** end-market contributed GAAP revenue of approximately \$204 million in the first quarter. On non-GAAP basis, the consumer end-market contributed revenue of approximately

\$184 million and represented approximately 14 percent of our non-GAAP revenue in the first quarter. First quarter consumer non-GAAP revenue approximately doubled year over year and grew by approximately one percent quarter over quarter. The greater than seasonal strength in the first quarter was primarily driven by white goods.

Revenue in the second quarter for consumer end-market is expected to be up quarter over quarter compared to non-GAAP consumer revenue in the first quarter.

In summary, our execution momentum remains intact, and we continue to deliver solid results. Our margins continue to expand and our free cash flow generation is accelerating at rapid pace. Though there are have been significant investor consternation related to reports of slowdown in certain end-markets and potential peaking of the semiconductor cycle, our booking trends and commentary from customers point towards overall improving global demand environment.

Now, I would like to turn it back over to Bernard for forward-looking guidance. Bernard...

Bernard Gutmann

Thank you, Keith.

Before I get into the details of our guidance for second quarter of 2017, let me remind you that the change in revenue recognition for distributors has no impact on our second quarter guidance.

Based on product booking trends, backlog levels, and estimated turn levels, we anticipate that total ON Semiconductor revenues will be approximately \$1,285 million to \$1,335 million in the second quarter of 2017. Backlog levels for the second quarter of 2017 represent approximately 80 to 85 percent of our anticipated second quarter revenue.

For the second quarter of 2017, we expect GAAP gross margin in range of 34.5 percent and 36.4 percent and non-GAAP gross margin in range of approximately 34.7 percent to 36.7 percent. Factory utilization in the first quarter is likely to be up sequentially.

We expect total GAAP operating expenses of approximately \$311 million to \$332 million. Our GAAP operating expenses include the amortization of intangibles, restructuring, asset impairments, and other charges, which are expected to be approximately \$30 million to \$37 million. We expect total non-GAAP operating expenses of approximately \$281 million to \$295 million.

We anticipate second quarter GAAP net other income and expense, including interest expense will be approximately \$35 million to \$38 million, which include non-cash interest expense of approximately \$8 million to \$9 million. We anticipate our non-GAAP net other income and expense, including interest expense will be approximately \$27 million to \$29 million.

Cash paid for income taxes in the second quarter of 2017 is expected to be approximately \$12 million to \$16 million. We expect full year 2017 cash paid for income taxes to be approximately 10 percent of 2017 non-GAAP pre-tax income. We expect total capital expenditures of approximately \$75 million to \$85 million in the second quarter of 2017.

We also expect share based compensation of approximately \$20 million to \$22 million in the second quarter of 2017, of which approximately \$2 million is expected to be in cost of goods sold, and the remaining amount is expected to be in operating expenses. This expense is included in our non-GAAP financial measures.

Our diluted share count for the second quarter of 2017 is expected to be approximately 427 million shares, based on the current stock price. Further details on share count and earnings per share calculations are provided regularly in our quarterly and annual reports on Form 10-Q and Form 10-K.

With that, I would like to start the Q&A session. Thank you and <operator> please open up the line for questions.

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