ON SEMICONDUCTOR CORPORATION

CALL SCRIPT
FOR
Q4-17 RESULTS CONFERENCE CALL

Parag Agarwal

Thank you <operator>.

Good morning and thank you for joining ON Semiconductor Corporation's fourth 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 fourth 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, channels and share count are also posted on our website.

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

During the course of this conference call, we will make projections or other forward-looking statements regarding future events or the future financial performance of the company. The words "believe," "estimate," “project,” "anticipate," "intend," “may,” "expect,” “will,” "plan," "should" or similar expressions are intended to identify forward-looking statements. We wish to caution that such statements are subject to risks and uncertainties that could cause actual events or results to differ materially from projections. Important factors which can affect our business, including factors that could cause actual results to differ from our forward-looking statements, are described in our Form 10-Ks, Form 10-Qs and other filings with the Securities and Exchange Commission.

Additional factors are described in our earnings release for fourth 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 first quarter of 2018, we will be attending Morgan Stanley Technology Conference in San Francisco on February 26.

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

Bernard Gutmann

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

We delivered yet another quarter of strong financial results, which exceeded our guidance and street consensus on all metrics. Momentum in our business remains strong, and our execution continues to be solid. Strong revenue growth in our key strategic markets accompanied by impressive margin expansion and robust free cash flow in last many quarters clearly demonstrates our market leadership and our strong execution.

While we have made tremendous progress in 2017, we believe that a large part of potential of our model remains untapped, and we intend to make strong progress in 2018 towards our 2020 target financial model. We intend to drive meaningful margin expansion and free cash flow growth in 2018, driven by benefits from manufacturing synergies from Fairchild, above market revenue growth, and favorable mix improvement driven by growth in our automotive and industrial businesses.

Our business remains strong, and indications from customers and macroeconomic data point to continuing strength in demand across most end-markets and geographies in near to mid-term. With a strong product portfolio and robust design win pipeline, coupled with tailwinds from increasingly favorable macroeconomic environment and a friendlier tax regime in United States, we are very well positioned to make significant progress towards our target model in the current year.

We continue to focus on key metrics that drive shareholder value. During 2017, we generated free cash flow of $707 million, a little less than double of $371 million we generated in 2016. We expanded our non-GAAP gross margin by 200 basis points and non-GAAP operating margin by 270 basis points in 2017. We intend to sustain our momentum in 2018 driven by increasingly favorable macroeconomic environment, strong customer acceptance of our products, and solid execution on operational front.

As we have aggressively de-levered our balance sheet, we intend to reinitiate our stock repurchase program starting in second quarter of 2018. Given our accelerating momentum in key strategic markets and our roadmap for margin expansion and free cash flow generation, we are very upbeat about our future outlook, and we believe that at current level, our stock offers a compelling investment opportunity. Along with deploying our capital for repurchase of our shares, we will continue to de-lever our balance sheet to mitigate the risk of higher interest rates resulting from stronger macroeconomic growth. In first quarter of 2018, $129 million of debt is maturing, and we intend to use our free cash flow in the first quarter to pay down that debt.

Moving on to taxes. We believe that the recently enacted tax legislation is very favorable to us as it will enable us to repatriate our foreign cash at very attractive terms after we exhaust our net operating losses and other tax attributes. Without the tax legislation, after the exhaustion of our net operating loss and tax attributes, we would have been required to pay tax at rate of 35 percent to repatriate cash to United States. The new tax legislation unlocks our ability to effectively deploy our foreign cash to generate value for our shareholders through capital returns and acquisitions. Based on our analysis of the available information on the new tax legislation, we anticipate that our cash tax rate will be approximately 10 percent until 2020. I must caution that as tax legislation was enacted only a month ago, our knowledge of new tax laws is limited, and therefore our outlook for our taxes can change as we get more clarity on the recently enacted tax laws.

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

Total revenue for fourth quarter of 2017 was $1,378 million, an increase of 9 percent as compared to revenue of $1,261 million in fourth quarter of 2016.

GAAP net income for the fourth quarter was $1.22 per diluted share as compared to $0.26 in the fourth quarter of 2016. Non-GAAP net income for the fourth quarter was $0.39 per diluted share as compared to $0.29 in the fourth quarter of 2016. For the full year of 2017, our GAAP earnings per share was $1.89, and non-GAAP earnings per share was $1.46, as compared to GAAP earnings per share of $0.43 and non-GAAP earnings per share of $0.91 in 2016.

GAAP gross margin for the fourth quarter was 37.3 percent, as compared to 30.5 percent for fourth quarter of 2016. Non-GAAP gross margin for the fourth quarter was 37.5 percent, an impressive increase of approximately 230 basis points over 35.2 percent in the fourth quarter of 2016. This strong year-over-year gross margin performance was driven by solid operational execution and revenue performance. Improving product mix also contributed to higher gross margin. With tailwinds from additional manufacturing synergies from Fairchild, mix improvement, and portfolio optimization, we remain on track to achieve our target non-GAAP gross margin of 40 percent by 2020.

GAAP operating margin for fourth quarter of 2017 was 12.1 percent, as compared to 4.4 percent in fourth quarter of 2016. Our non-GAAP operating margin for fourth quarter of 2017 was 15.4 percent, an increase of approximately 250 basis points over 12.9 percent in fourth quarter of 2016. On year-over-year revenue increase of 9 percent for the fourth quarter of 2017, our non-GAAP operating income increased by 30 percent. This strong operating income performance demonstrates the leverage and strength of our operating model.

GAAP operating expenses for the fourth quarter were $348 million, as compared to $329 million for the fourth quarter of 2016. Non-GAAP operating expenses for the fourth quarter were $305 million, as compared to $281 million in the fourth quarter of 2016. Operating expenses for the fourth quarter were higher than the mid-point of the guidance due to higher revenue.

This is preliminary, but our fourth quarter results include a one-time GAAP income tax benefit of $450 million as a result of U.S. corporate tax reform enacted in December. This benefit includes charges related to the mandatory repatriation tax and the re-measurement of deferred tax assets for the lower U.S. statutory rate of 21%, offset by a reduction of the Company's deferred tax liability on unremitted foreign earnings. As a result of tax reform, our estimate of the mandatory repatriation tax is $219 million. However, we can use $191 million of our existing U.S. tax credit carry-forward to offset the mandatory repatriation tax. After use of our tax credits, remaining cash tax payable of $28 million is payable over eight years with $2.3 million due in 2018.

Fourth quarter free cash flow was $49 million, and operating cash flow was $224 million. Capital expenditures during the fourth quarter were $176 million. Capital intensity, based on non-GAAP revenue for 2017 was seven percent. We exited fourth quarter of 2017 with cash and cash equivalents of $949 million, as compared to $901.2 million in the third quarter.

At the end of fourth quarter of 2017, days of inventory on hand were 115 days, up by six days as compared to inventory days at end of the third quarter. The increase in inventory was driven by strategic build of inventory to support ramp in certain automotive programs in the first half of 2018 and deliberate reduction in distribution inventory. Distribution inventory in days declined substantially by approximately a week in the fourth quarter as compared to that in the third quarter.

For the fourth quarter of 2017, our lead times were approximately flat quarter over quarter. Our global factory utilization for the fourth quarter was down slightly quarter over quarter.

Now let me provide you an update on performance of our business units, starting with Power Solutions Group, or PSG. Revenue for PSG was $698 million. Revenue for Analog Solutions Group for the fourth quarter of 2017 was $487 million, and revenue for Image Sensor Group was $192 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.

We delivered yet another strong quarter, marked by solid all-round performance. Over the last many quarters, we have posted strong revenue performance, especially in our strategic end-markets. At the same time, we delivered impressive margin expansion, robust free cash flow and strong operating leverage. With strong momentum in our business and increasingly favorable macroeconomic conditions, we intend to make strong progress towards our 2020 target financial model in the current year.

While 2017 was a spectacular year for ON Semiconductor, I am very excited about our future outlook as we work to realize full potential of our product portfolio and operating model. We believe that we are in early stages of realizing benefits of our investments in the automotive and industrial end-markets. Increased adoption of ADAS, EV/HEVs, machine vision, robotics etc. should drive further acceleration in our revenue and margins.

As I indicated in the earnings call for third quarter of 2017, our business today is driven by sustainable secular growth drivers in the fastest growing semiconductor end-markets, as opposed to being driven by macroeconomic and industry cyclicality a few years ago. Through our investments over last many years in high growth segments and in highly differentiated products in automotive, industrial and communications end-markets, we have radically transformed the nature of our business. Customers are increasingly relying on us as a key provider of enabling technologies for newly emerging and disruptive applications in automotive and industrial end-markets.

Along with strong revenue growth in our strategic end-markets, we are delivering strong operating leverage driven by impressive margin expansion. As Bernard mentioned earlier, on year-over-year revenue increase of 9 percent for the fourth quarter of 2017, our non-GAAP operating income increased by 30 percent. We intend to grow faster than the semiconductor industry, and this growth should enable us to expand margins driven by operating leverage. Insourcing of Fairchild's backend operations remain on track, and this insourcing should be a meaningful margin contributor in 2018 and 2019. At the same time, mix shift towards margin rich industrial and automotive end-markets and ongoing divestiture of non-core businesses should drive additional margin expansion.

The current demand environment continues to be strong, despite some softness in a few spots in the communications end-market. We continue to see strong demand for our products for most end-markets and from most geographies as customers are increasingly relying on us as their key partner in emerging disruptive technologies such as ADAS, electric vehicles, factory automation, machine vision, cloud power management, artificial intelligence, and industrial power management. Our traction in ADAS continues to accelerate, and we are further extending our competitive lead in the ADAS with new products, both for image sensors and processor power management. We have secured design wins for Silicon Carbide for electric vehicles, and we remain on track for revenue in latter half of current year. For the industrial end-market, we are making strong progress in the machine vision and power modules with existing and new products. In cloud and server power management market, our traction with leading server CPU providers continues to accelerate and near to mid-term outlook appears to be very strong. Our USB-C products are gaining traction in the automotive market, in addition to ramps in the smartphone and computing markets.

Let me now comment on the business trends in the fourth quarter. During the fourth quarter, demand trends and bookings were strong. Supply-demand dynamics in the fourth quarter were stable as compared to supply-demand dynamics in the third quarter. Lead times were approximately flat quarter-over-quarter, and as Bernard mentioned in his prepared remarks, we significantly reduced distribution inventory levels from third quarter of 2017. Pricing continues to be benign as compared to historic trends. Our customers are upbeat on demand for their products and they expect the strength in demand to continue for near to mid-term.

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

Revenue for the **automotive** market in the fourth quarter was $437 million and represented 32 percent of our revenue in the fourth quarter. Fourth quarter automotive revenue grew by impressive 18 percent year-over-year. For the fourth quarter, we again saw strong broad based demand for most product lines and from most geographies.

Our momentum in ADAS market continues to accelerate with strong demand for our 1 Megapixel and 2 Megapixel image sensors. We recently launched an 8 Megapixel image sensor for ADAS, and with this launch we are the only provider of complete line of 1, 2 and 8 megapixel image sensors on a single platform for next generation ADAS and autonomous driving systems. A complete line of image sensors on a single platform reduces qualification time, lowers cost for our customers, and enables our customers to seamlessly port their algorithms across our product line. We believe that our complete line of image sensors on a single platform provides us with a significant competitive advantage and further extends our technology lead over our competitors.

A superior product portfolio complemented by a large installed base, deep and long term relationships with leading ADAS and autonomous driving processor companies, our leading edge technology including self-correcting sensors with on-board cyber security and functional safety, and a strong application support has helped us strengthen our position within the ADAS and autonomous driving ecosystem. Based on inputs from our ecosystem partners, we believe that we are now the lead imaging partner for all ADAS platform providers. We further solidified our presence in the ADAS and autonomous driving eco-system with our recently announced partnership with Baidu. We were recently selected by Baidu as the sole supplier of image sensors for its Apollo autonomous driving platform.

As I mentioned earlier, our Silicon Carbide development remains on track. We are currently sampling products to customers, and we remain on track to generate revenue in latter half of 2018.

We are seeing ramp of our IGBTs and FETs for electric vehicle charger designs. We are working with leading eco-system players on power management solutions for processors and other related applications in automotive. We recently announced a strategic partnership with Audi to drive electronics innovation and quality in upcoming autonomous and electric vehicles.

Business in other areas of automotive market was strong as well. Our analog power management products reached record revenue, driven by active safety, powertrain, body electronics, and lighting applications. We saw strong growth in our LED lighting business as new programs ramped in Europe and China.

Revenue in the first quarter for the automotive end-market is expected to be up quarter over quarter.

The **Industrial** end-market, which includes military, aerospace, and medical, contributed revenue of $358 million in the fourth quarter. The Industrial end-market represented 26 percent of our revenue in the fourth quarter. Our fourth quarter industrial revenue grew by solid 17 percent year-over-year.

Demand from industrial end-market remains strong driven by favorable macroeconomic conditions and secular trends such automation, energy efficiency and machine vision. We expect recently enacted tax legislation in United States to drive higher industrial capital expenditure in areas such as factory automation and robotics, which in turn should drive demand for semiconductors for industrial applications.

We continue to benefit from demand for our power modules and power management semiconductor solutions for power generation and commercial air-conditioning. Our power module business for industrial applications continues to grow at a tremendous pace, and we expect this momentum to continue in 2018 as we launch new products with higher efficiency. In machine vision market, we continue to make significant progress. We broke a record of shipments with our Python line of image sensors in 2017 and we are in the process of launching a new platform of products to address a wider swath of the industrial market. The new machine vision product platform will bring unprecedented levels of image quality, speed, pixel technology and price to the fast growing machine vision industry. We continue to develop synergies with our expertise in the automotive imaging market to accelerate our growth in the machine vision market as both these markets are driven by artificial intelligence and face similar challenges, such as low light conditions, dynamic range and harsh operating environment.

In addition to growth from secular strength in Industrial end-market, we expect to benefit from share gains. With expanded capabilities in power modules, and with addition of Fairchild's portfolio, we have one of the most comprehensive portfolios in the market for the industrial power management. Customers are increasingly relying on us as a credible alternative to the current market leader.

Revenue in the first quarter for the industrial end-market is expected to be flat quarter over quarter.

The **Communications** end-market, which includes both networking and wireless, contributed revenue of $268 million in the fourth quarter. The communications end-market represented 19 percent of our revenue in the fourth quarter. Fourth quarter communications revenue declined by 4 percent year-over-year due to softness in certain geographies, but we offset a significant part of that weakness with increased penetration into other key global accounts.

Revenue in the first quarter for the communications end-market is expected to be down quarter over quarter due to normal seasonality.

The **Computing** end-market contributed revenue of $139 million in the fourth quarter. The computing end-market represented 10 percent of our revenue in the fourth quarter. Fourth quarter computing revenue grew by 6 percent year-over-year. The year-over-year growth in the fourth quarter computing revenue was driven primarily by ramp in our server business.

Our server business continues to strengthen, and we expect that in 2018 our server business will be a meaningful part of our computing business. We are working closely with leading server CPU providers on their next generation of processors. On the customer front, we are actively engaged on designs with cloud service providers and traditional server OEMs. In addition, we are in leading position to provide power management solutions for accelerators that are increasingly being adopted for artificial intelligence and machine learning in server applications.

Revenue in the first quarter for computing end-market is expected to be down quarter over quarter due to normal seasonality.

The **Consumer** end-market contributed revenue of $175 million in the fourth quarter. The consumer end-market represented 13 percent of our revenue in the fourth quarter. Fourth quarter 2017 consumer revenue was up one percent as compared to consumer revenue in fourth quarter of 2016.

Revenue in the first quarter for the consumer end-market is expected to be approximately flat quarter-over-quarter due to ramp of certain customer programs.

In summary, demand for our products remains strong, and our customers are upbeat about near to mid-term outlook for their businesses. We continue to deliver solid results, driven by strong execution on all fronts. Through our investments over last many years in high growth segments and in highly differentiated products in automotive, industrial and communications end-markets, we have radically transformed the nature of our business. Customers are increasingly relying on us as a key provider of enabling technologies for newly emerging and disruptive applications in automotive and industrial end-markets. With favorable macroeconomic tailwinds and a strong product portfolio for industrial and automotive markets, we are well positioned to make solid progress towards our target financial model in 2018.

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

Bernard Gutmann

Thank you, Keith.

Based on product booking trends, backlog levels, and estimated turn levels, we anticipate that total ON Semiconductor revenues will be $1,340 million to $1,390 million in the first quarter of 2018.

For the first quarter of 2018, we expect GAAP and non-GAAP gross margin in range of 36.4 percent and 38.4 percent. Factory utilization in the first quarter is likely to be approximately flat as compared to that in the fourth quarter.

We expect total GAAP operating expenses of $318 million to $336 million. Our GAAP operating expenses include the amortization of intangibles, restructuring, asset impairments, and other charges, which are expected to be $28 million to $32 million. We expect total non-GAAP operating expenses of $290 million to $304 million.

We anticipate first quarter GAAP net other income and expense, including interest expense, will be $33 million to $36 million, which includes non-cash interest expense of $8 million to $9 million. We anticipate our non-GAAP net other income and expense, including interest expense, will be $25 million to $27 million.

Cash paid for income taxes in the first quarter of 2018 is expected to be $18 million to $22 million. We expect our 2018 cash tax rate to be 10 percent or lower. We expect total capital expenditures of $70 million to $90 million in the first quarter of 2018.

We also expect share based compensation of $18 million to $20 million in the first quarter of 2018, of which approximately $2 million is expected to be in cost of goods sold, and the remaining amount is expected to be in operating expenses. This expense is included in our non-GAAP financial measures.

Our GAAP diluted share count for the first quarter of 2018 is expected to be 445 million to 447 million shares, based on the current stock price. Our non-GAAP diluted share count for the first quarter of 2018 is expected to be 432 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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