ON SEMICONDUCTOR CORPORATION

CALL SCRIPT
FOR
Q1-18 RESULTS CONFERENCE CALL

Parag Agarwal

Thank you <operator>.

Good morning and thank you for joining ON Semiconductor Corporation's first quarter 2018 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 2018, 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 first quarter of 2018. 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.

We will host our 2019 Analyst Day on March 8, in Scottsdale, Arizona. We will send the Invitations for the event shortly.

Now, let me turn it over to Bernard Gutmann, who will provide an overview of the first quarter 2018 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 key metrics. Near to mid-term outlook for our business remains strong. Furthermore, long-term outlook for our business continues to improve, and we are seeing an inflection in long-term demand for our products. We continue to expand our gross and operating margins, and we are making prudent investments to drive future revenue growth and margin expansion. With strong revenue growth, coupled with margin expansion, our free cash flow generation remains robust. We are making strong progress towards our target financial model.

We continue to see solid strength in our business. Indications from our customers and macroeconomic data point to continuing strength in demand for our products in near to mid-

term. Our design win pipeline continues to expand, driven by a strong product portfolio for emerging and fast growing applications in the automotive and industrial end-markets. Global macroeconomic environment remains highly favorable, and we are seeing strong demand from all geographies.

We see an upwards inflection in long-term demand for our products, especially for automotive and industrial end-markets. This inflection in demand is driven by strong traction of our power management products for medium and high voltage applications. We continue to further strengthen our position in imaging market for automotive and industrial applications, and demand outlook for our imaging products continues to strengthen. We have established ourselves as a strategic long-term partner for our customers, and our customers are increasingly relying on us to meet long term demand for power management and sensor semiconductor products. With increasing strategic engagement with us, many customers are now asking us to enter into long term supply agreements. Accelerating long-term demand for our products, and customer requests for long-term supply agreements necessitate us to increase level of investment in our manufacturing capacity.

We continue to invest to drive our revenue and margins. We are also increasing our investment in our captive raw wafer manufacturing capacity in Czech Republic. The primary objective of our increased investment in our raw wafer manufacturing capacity is to offset the impact of steep rise in market prices for raw wafers. This investment should help us expand our margins, as we don’t expect any moderation in raw wafer pricing for foreseeable future. I must point out that we are among a very few semiconductor companies with capability to manufacture their own raw wafers.

As a result of our increased capital investment, our capital intensity for 2018 and 2019 will likely be in 8 to 9 percent range, as opposed to our target of seven percent. As I indicated earlier, the increase in capital expenditure is driven need to make investments to adjust to higher growth environment and to further improve our manufacturing cost structure. We believe that after

making higher capital investments in 2018 and 2019, our long term capital intensity rate should come down to seven percent.

Free cash flow generation remains a key priority for the company. Despite higher capital investments, we expect to generate approximately $800 million of free cash flow in 2018. We intend to use this free cash for deleveraging and share repurchases. I am very pleased to announce that we have reinitiated our stock repurchase program in the second quarter. 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 repurchase of our shares at current price levels is a very attractive use of our cash.

Now, let me provide you additional details on our first quarter 2018 results.

Total revenue for first quarter of 2018 was $1,378 million, a decrease of 4 percent as compared to GAAP revenue of $1,437 million in first quarter of 2017. Our revenue for the first quarter increased by 7 percent as compared to non-GAAP revenue of $1,282 million in the first quarter of 2017. Recall that in first quarter of 2017, we had a one-time benefit of $155 million to our revenue due to change from sell-through to sell-in revenue recognition.

GAAP net income for the first quarter was $0.31 per diluted share as compared to $0.18 in the first quarter of 2017. Non-GAAP net income for the first quarter was $0.40 per diluted share as compared to $0.27 in the first quarter of 2017.

GAAP and non-GAAP gross margin for the first quarter was 37.6 percent. On GAAP basis, our first quarter gross margin improved by 260 basis points year over year, and on non-GAAP basis gross margin improved by 220 basis points year over year. This strong gross margin performance was driven by solid operational execution and improving mix resulting from higher contribution from our automotive, industrial, and server businesses. With tailwinds from additional manufacturing synergies from Fairchild, mix improvement, and portfolio optimization, we expect to make strong progress towards our target model in the current year.

GAAP operating margin for first quarter of 2018 was 13.5 percent, as compared to 12.7 percent in first quarter of 2017. Our non-GAAP operating margin for first quarter of 2018 was 15.7 percent, an increase of approximately 250 basis points over 13.2 percent in first quarter of 2017. On year-over-year non-GAAP revenue increase of 7 percent for the first quarter of 2018, our non-GAAP operating income increased by 28 percent. This strong operating income performance demonstrates the leverage and strength of our operating model.

GAAP operating expenses for the first quarter were $332 million, as compared to $320 million for the first quarter of 2017. Non-GAAP operating expenses for the first quarter were $301 million, as compared to $285 million in the first quarter of 2017. Operating expenses for the first quarter were higher than the mid-point of the guidance due to higher revenue and increased R&D investment to support newly emerging opportunities in automotive and industrial end-markets. We expect our non-GAAP operating expenses as percentage of revenue to continue to decline for remainder of the year, and we expect to make strong progress in 2018 towards our target non-GAAP operating expense intensity of 21 percent.

First quarter free cash flow was $127 million, and operating cash flow was $226.5 million. Capital expenditures during the first quarter were $100 million, which equate to capital intensity of seven percent. We continue to de-lever our balance sheet, and in the first quarter, we used $136 million to pay down our debt. We exited first quarter of 2018 with cash and cash equivalents of $925 million, as compared to $949 million in the fourth quarter of 2017.

At the end of first quarter of 2018, days of inventory on hand were 123 days, up by eight days as compared to 115 days at end of the fourth quarter of 2017. The increase in inventory was driven by expectation of continuing strong demand our products in near to mid-term. Semiconductor industry supply has been strained in recent months due a strong demand environment, and by maintaining an adequate level of inventory in line with expected demand, we want to ensure that we are able to meet our customers' requirements. We expect our internal inventories to decline in terms of days in the second quarter of 2018. After successive

declines in last three quarters, distribution inventory went up in the first quarter. This increase was driven by expectation of strong distribution sell-through in the second quarter. We expect distribution inventories to remain within our normal range of 11 to 13 weeks in the near term. To mitigate the risk of excessive inventory in the channel, we are pro-actively managing inventory in the distribution channel. We have implemented systems to ensure that distributors don't carry more inventory than that is needed to support 11 to 13 weeks of resales.

For the first quarter of 2018, our lead times were up slightly quarter over quarter. Our global factory utilization for the first quarter was slightly up 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 $693 million. Revenue for Analog Solutions Group for the first quarter of 2018 was $496 million, and revenue for Image Sensor Group was $189 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.

First quarter of 2018 was another successive quarter of strong results and solid all-round performance. We continue to deliver strong revenue growth, along with solid margin expansion and robust free cash flow generation. Our momentum in our key strategic markets continues to accelerate, driven by new products and our exposure to the fastest growing sub-segments in automotive and industrial markets. We are seeing strong growth in ADAS, LED lighting, machine vision, and energy efficiency applications. With tailwinds from increasing favorable macroeconomic conditions and a strong momentum in our business, we are well positioned to make strong progress towards our target financial model in 2018.

Business conditions remain favorable, and demand continues to strengthen across most end-markets. Pricing continues to be benign as compared to historic trends. We are seeing strong demand for our products in automotive and industrial end-markets. As I have indicated in recent earnings calls, 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.

The sustained demand for semiconductors over several past quarters has put pressure on industry's ability to meet the demand. We expect this strength in demand to continue for foreseeable future, driven primarily by structural changes in the end-market dynamics and a strong global macroeconomic environment. We expect demand for semiconductors from automotive and industrial end-markets to continue to grow at a steady pace for next few years. Furthermore, revival of computing end-market by artificial intelligence and data centers, and emergence of new applications such as IoT should result in strong demand for a broad array of semiconductor products. Given the increasingly strategic nature of our engagement with our customers and a generally tight semiconductor industry supply environment, many customers now want to enter into a long term supply agreement with us. To ensure that we are well positioned to address our customers' demand, we intend to put in capacity to address areas of strategic thrust in automotive and industrial end-markets. We are also making strong progress in expanding our capacity in our eight-inch joint venture fab in Japan.

As Bernard noted in his remarks, prices for raw wafers have increased substantially in last few months. As we are among a very few semiconductor device manufacturers with captive wafer manufacturing operations, we have been able to moderate the impact of rise in cost of raw wafers. Given our outlook for semiconductor industry growth for next few years, we believe

that prices for raw materials for semiconductor manufacturing will continue to be a challenge for the semiconductor industry. We are raising our investment to further extend our competitive advantage from our captive raw wafer operations.

With higher level of investments in strategic capacity for fast growing products and in our captive raw wafer manufacturing operations, we expect to see a rise in our capital intensity for 2018 and 2019. We expect capital intensity of 8 to 9 percent for 2018 and 2019, slightly higher than our target model of seven percent. As Bernard indicated in his remarks, this higher level of capital intensity is driven by need to make investments to adjust to better and expected demand for our products. We expect capital intensity to subside to 7 percent after 2019.

Our margin performance continues to be stellar. Our operating model has shown strong operating leverage. As Bernard mentioned earlier, on year-over-year revenue increase of 7 percent for the first quarter of 2018, our non-GAAP operating income increased by 28 percent. Insourcing of Fairchild's back-end operations remains on track, and this insourcing should drive meaningful margin expansion in 2018 and 2019. At the same time, mix shift towards margin rich automotive and industrial end-markets and further divestiture of non-core businesses should drive additional margin expansion, despite increase in prices for raw materials.

Now I'll provide details of the progress in our various end-markets for first quarter of 2018.

Revenue for the **automotive** market in the first quarter was $445 million and represented 32 percent of our revenue in the first quarter. First quarter automotive revenue grew by 8 percent year-over-year. For the first quarter, we again saw strong broad based demand for most product lines.

We continue to see strong demand for our image sensors for ADAS applications. With a complete line of image sensors including 1, 2, and 8 Megapixels, we are the only provider of complete range of pixel densities on a single platform for next generation ADAS and autonomous driving applications. We believe that a complete line of image sensors on a single

platform provides us with significant competitive advantage, and we continue working to extend our technology lead over our competitors.

Our design win pipeline for ADAS continues to grow at a rapid pace. We are actively engaged with our eco-system partners for development of next generation ADAS systems, and we remain the primary image sensor partner for leading ADAS and autonomous driving technology leaders. Driven by our technology lead, we are seeing strong traction for our image sensors for ADAS applications in China.

Our Silicon Carbide development remains on track and we expect to see Silicon Carbide related revenue from automotive market in the second half of this year.

In addition to image sensors, we experienced strong growth in our mixed signal ASIC, power modules, and MOSFETs. Growth in our LED lighting business continues to accelerate, driven by ramp of design wins and increased penetration of LEDs in automotive lighting.

Our design win momentum continues to be strong in the automotive market. As car makers are increasing focusing on reducing carbon dioxide emissions, they are relying on us to provide highly efficient IGBTs and other power management devices.

Revenue in the second 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 $362 million in the first quarter. The Industrial end-market represented 26 percent of our revenue in the first quarter. Our first quarter industrial revenue grew by solid 11 percent year-over-year. The strength in industrial market was very broad based with all the sub-segments posting robust year over year growth.

We continue to benefit from demand for our power modules and power management semiconductor solutions for the industrial markets. Our power module business for industrial

applications continues to grow at a tremendous pace, and we expect this momentum to continue for next few years as we launch new products with higher efficiency. With focus on energy efficiency around the globe, our design win pipeline for our power modules continues to expand at a rapid rate, and we expect power modules to be a long-term driver for our industrial business.

We believe that we have one of the most comprehensive industrial power management portfolios, comprising of a broad range of devices across the power spectrum. This portfolio of devices is further complemented by a rapidly expanding portfolio of power modules for a broad range of applications, ranging from alternative energy to commercial air-conditioning. Customers are increasingly relying on us as a credible alternative to the current market leader for medium to high voltage power semiconductor solutions.

In the machine vision market, we continue our momentum with our Python line of image sensors. According to Yole Development, a leading market research firm, ON Semiconductor is the leader in image sensors for industrial applications. With leadership in industrial and automotive markets, ON Semiconductor has emerged as a powerhouse for most demanding and challenging imaging applications. As I indicated on previous earnings calls, we continue to develop synergies with our expertise in the automotive imaging market to accelerate our growth in the machine vision market, as both of these markets are driven by artificial intelligence and face similar challenges, such as low light conditions, dynamic range and harsh operating environment.

Revenue in the second quarter for the industrial end-market is expected to be up quarter over quarter.

The **Communications** end-market, which includes both networking and wireless, contributed revenue of $240 million in the first quarter. The communications end-market represented 17 percent of our revenue in the first quarter. First quarter communications revenue declined by 3 percent year-over-year due to weakness in smartphone market, but, with higher content and

increasing penetration at large global OEMs, we were able to mitigate the impact of softness in overall market.

Revenue in the second quarter for the communications end-market is expected to be flat to down quarter over quarter due to softness in end-market demand.

The **Computing** end-market contributed revenue of $149 million in the first quarter. The computing end-market represented 11 percent of our revenue in the first quarter. First quarter computing revenue grew by 20 percent year-over-year. The year-over-year growth was driven primarily by ramp in our cloud and server business, and a generally healthy client PC market.

Momentum in our server business continues to accelerate. As we indicated earlier, we expect our server business to be a meaningful part of our computing business in 2018. We are engaged with leading cloud and server players, and we are working with leading CPU providers on their next generation platforms.

Revenue in the second quarter for computing end-market is expected to be up quarter over quarter due to normal seasonality and continuing ramp in our server business.

The **Consumer** end-market contributed revenue of $182 million in the first quarter. The consumer end-market represented 13 percent of our revenue in the first quarter. First quarter 2018 consumer revenue was up 7 percent as compared to consumer revenue in first quarter of 2017.

Revenue in the second quarter for the consumer end-market is expected to be approximately flat quarter-over-quarter.

In summary, demand for our products continues to strengthen and we are putting in additional capacity to ensure that we are able to meet customer demand for next few years. At the same time, we are making investments in our captive raw wafer manufacturing capacity to extend our competitive advantage. Our execution remains solid on all fronts. We are establishing

leadership in highly differentiated power, analog, and sensor semiconductor solutions. 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 performance, we are driving significant margin expansion. We solidly remain on track to make strong progress in 2018 towards our target financial model.

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 $1,405 million to $1,455 million in the second quarter of 2018.

For the second quarter of 2018, we expect GAAP and non-GAAP gross margin in range of 37 percent to 39 percent. Factory utilization in the second quarter is likely to be down as compared to that in the first quarter.

We expect total GAAP operating expenses of $333 million to $351 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 $305 million to $319 million. The quarter over quarter increase in operating expenses in the second quarter is driven primarily by seasonality of our stock based compensation grants. We expect our non-GAAP operating expenses as percentage of revenue to continue to decline for remainder of the year, and we expect to make strong progress in 2018 towards our target non-GAAP operating expense intensity of 21 percent.

We anticipate second quarter GAAP net other income and expense, including interest expense, will be $32 million to $35 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 $24 million to $26 million.

Cash paid for income taxes in the second quarter of 2018 is expected to be $11 million to $15 million. We expect our 2018 cash tax rate to be 10 percent or lower. We expect total capital expenditures of $130 million to $150 million in the second quarter of 2018.

We also expect share based compensation of $24 million to $26 million in the second 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 second 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 second 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.

For full year 2018, we expect to generate free cash flow of approximately $800 million.

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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