

FINAL TRANSCRIPT

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ARM.L - Q1 2009 ARM Holdings plc Earnings Presentation

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PRESENTATION

Operator

Thank you for standing by and welcome to the ARM Holdings plc Q1 results conference call. (Operator Instructions). I must advise you that this conference is being recorded today, Wednesday April 29, 2009. I would now like to hand the conference over to your speaker for today, Ian Thornton. Please go ahead, sir.

Ian Thornton - *ARM Holdings plc - Director of IR*

Thank you very much. Good morning everyone. This is Ian Thornton, Director of Investor Relations at ARM. On today's Q1 results conference call, we have Warren East, Chief Executive Officer, and Tim Score, Chief Financial Officer. On today's call, Warren and Tim will take us through the highlights and comments from the quarter's results and then we will open up the call to a Q&A session.

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As a reminder, the presentation and press release can be found on the ARM investor relations website at www.arm.com/ir.

Before I hand over to them, I just have to read out a few words with respect to this conference call and what we are about to discuss. The contents of this conference call are being directed only to those of you who have special experience in matters relating to investments and the information communicated on this call is being made available only to investment professionals. Any persons present on this call who do not have professional experience in matters relating to investments should not act or rely on the contents of this call.

The following conference call will contain forward-looking statements which are other than statements of historical fact. The Company's actual results for future periods may differ materially from these statements as they are based on current expectations and are subject to a number of risks and uncertainties.

And on this note, I'll hand over to Warren.

Warren East - *ARM Holdings plc - CEO*

Thank you, Ian. Good morning everybody. Thank you for joining our call. I'm going to start with some context, then run through the business highlights and hand over to Tim who will provide some more detail on the numbers. And I hope we'll cover much of the content in Q&A.

So a bit of context, we come into this year having generated record revenues by a large margin in Q4 and at that time our partners were already experiencing sharp volume and revenue decline throughout Q4. So given approximately 50% of our revenues are generated by royalties which we recognize one quarter in arrears, it was expected that the downturn would impact on ARM in Q1.

And as we all know, the first quarter's been another very difficult period for our customers, the semiconductor companies and for electronics product manufacturers in general. Everybody is managing costs very tightly and that does have a knock-on effect to development projects which, in turn, makes it a very challenging environment for IP companies like ARM.

That said, we're feeling good this morning about the results we're announcing with further evidence of market share gains driving unit shipments and royalty revenues and having grown our base of licenses for generating future royalties in both the Processor and the Physical IP business. We're continuing to manage our costs very carefully at ARM, which is enabling us to maintain investments in the technology innovation for when economic conditions improve.

So a little bit of color on the different parts of the business and I'll start with the Processor division. 17 licenses signed in the quarter is illustrative of companies' continuing desire to embark on new ARM-based designs. The new product, codenamed Sparrow, which has been licensed ahead of its launch, and we sold a further license for the new Cortex-M0 product which was also flagged in the February earnings release. And at that stage we were referring to it as Swift.

We're pleased to see the licensing activity generated by these new processors sit alongside the older Cortex products and the traditional ARM7s, 9s and 11s. And so it's a very broad spread of licensing for the quarter, and encouragingly we've seen a continuation of our non-mobile application areas driving demand for new licenses.

One further highlight there, our Mali graphics technology is also continuing to enjoy some traction, with five Mali graphics licenses signed during the quarter. Overall then our processor license base out in the market now, at the end of Q1, has grown to over 600 licenses.

Switching to royalties, our royalty revenues are reported, as we all know, one quarter in arrears. And so the Q1 royalty was generated from devices sold in Q4. And in Q4 there was a very marked sequential decline for the overall semiconductor revenue,

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and a year-on-year decline, in fact, of 20% versus Q4 '07. But the strength of ARM's licensing platform which is helping to produce significant growth in market share is evident when you compare this 20% decline number for the industry as a whole, with an 8% year-on-year decline number in ARM's Q1 royalties.

Smarter phones helped to push the average royalty rate up from \$0.054 last quarter to \$0.06 and smarter phones also helped drive the proportion of ARM11-based chips up. But ARM11 is just 5% of total shipments today and the Cortex-based products are really only just starting to shift. So it's clear there's significant value yet to come from the ARM11 and Cortex licenses which we've been selling over the last several years.

A little color on those market share gains. For mobile, ARM volumes fell by 16% against a market decline of 25% and in microcontrollers, ARM volumes grew by 20% versus a market decline of 5%. So such movements, such outperformance were repeated across other applications, with stronger share gains, as you'd expect, in non-mobile, things like digital TVs and hard disk drive controllers. So overall the total proportion of ARM's shipments represented by non-mobile applications rose from 30% in Q1 '08 to 37% this quarter.

So that's it for Processor division. For Physical IP division, we saw 12 licenses sold in the quarter, including six at advanced nodes, 65 nanometers and below, including a platform license for 32-nanometer SOI.

Physical IP royalties were benefited from some catch-up, as happened virtually in most quarters. Our underlying Physical IP royalties were down about 20%, compared to overall foundry revenues in the corresponding period being down about 30%. So again indicative of increasing market share.

Switching to the Development Systems business, that enjoyed strong sequential growth. But actually, as we note in the release, that was driven primarily by a significant agreement with a top-tier OEM equipping multiple design centers with software design tools. The focus within our Development Systems business has been on developing new tools which will be released in due course later this year.

Some general comments on operations and marketing, in these conditions we've had a focus on cost control, but we have to balance that against a requirement to invest in new product development, create the technology roadmaps that our customers want. The Logipard team, that's the video acquisition that -- the team we acquired in December. That's now been fully integrated in our media products division. The pay freeze we implemented at the start of the year remains in place and we exited the quarter with 11 fewer people in the organization than on January 1. And we expect to manage our costs very tightly through the remainder of 2009.

Q1 saw the world's largest mobile communications conference and exhibition in Barcelona, the MWC, and of note this year we announced the 10 billionth ARM device in mobile. People who attended the conference were able to see several ARM-based netbook prototypes. And with silicon from a handful of ARM semiconductor partners finding its way into netbook designs and an ever-improving Ecosystem, we expect more of those at Computex in advance of production later this year.

This is a market for which the Ecosystem is very important. And we continue to develop the ARM connected community. That's now at 525 companies, up from 450 a year ago, and 400 the year before that, so continuing trend of strengthening the ARM Ecosystem.

Also in Barcelona we announced our first 32-nanometer Cortex processor which was built using development versions of our 32-nanometer Physical IP. And in our Physical IP business, we continue to create a balanced portfolio, working with the common platform process and with TSMC. In fact, after the end of Q1 we very recently announced the industry's broadest physical IP platform for TSMC's 40-nanometer high-performance process.

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Just to comment on microcontrollers, at the Embedded World Conference in February we launched the Cortex-M0 processor which we referred to in the February earnings release as Swift. It's the smallest processor in the ARM portfolio and it's targeted at very low-power, high-volume microcontroller applications. And we've already been enjoying some licensing on that product.

Q2 has actually started well. We have had some initial licensing in April. So if we look ahead, we can say we've had an encouraging start so far to 2009. We've outperformed the semiconductor industry. We've grown our license base.

The numbers are clearly showing continued growth in ARM's market share. We're reiterating our guidance for the full year for dollar revenues and we'll be supporting that with firm financial discipline. And we do expect some further help to come when the recent currency movement works its way through the backlog as the year unfolds.

And, with that, I'll hand over to Tim. Thank you.

Tim Score - ARM Holdings plc - CFO

Thanks, Warren. Good morning everyone. I'm assuming that most of you have had a chance to have a quick look at our earnings release. And, as Ian said, the quarterly slide set is available on our website as usual.

And don't forget, worth noting, I think, that at the back of the earnings release, in notes 4.19 and 4.20 you'll find a line-by-line reconciliation of the normalized numbers which tend to be the focus of analyst consensus estimates to the IFRS numbers. And remember also that this is the first quarter that ARM has reported results only under IFRS and not under US GAAP.

I think Warren's given a thorough overview of the business and of the revenue dynamics in the quarter. So I'm going to focus my comments more on some of the FX impacts which have seen our dollar revenues being ahead of consensus but the bottom-line EPS a little behind. So I'm going to talk about one or two of the FX dynamics running through the P&L and also a little bit more detail on costs and what we can expect going forward.

So, as Warren said, overall dollar revenues just under \$121m, 10% down year on year in the context of 30% down in corresponding period in the industry. But with the dollar having strengthened materially since a year ago, sterling revenues at GBP80m, 18% higher.

Now you'll note from these results that the effective FX rate for translation of revenues in Q1 is \$1.51 and that compares to a consensus of \$1.46. And that consensus was actually sourced from a range that was from \$1.40 to \$1.58. So a fairly broad range of estimates being used that formed the consensus, but we are 5 points higher. And that \$1.51 is above the actual average rate for the quarter which was in the mid \$1.40s.

And to understand that, we need to go, just to go into a little bit into the revenue streams themselves. But if you look at the detail at the front of the release, you'll see that the effective rate for licensing and service revenues, part of which of course is sourced from backlog and deferred revenue, was just under over \$1.60. Whilst the rate for royalties in Developments System which are revenues that occur evenly through the quarter, effectively turns business, was in the mid \$1.40s. And clearly for revenue the effective rate in any quarter is a combination of the average spot rates used when invoicing turns business that I've just described, and the rates of revenue that's recognized from the backlog and deferred revenue.

Now typically, in most quarters, the difference is not really material. In Q1 it's a more significant gap, simply because the deals that were signed three, four, five quarters ago that went into backlog and deferred revenue were signed at rates much closer to \$2 before the fairly dramatic shift at the beginning of August as we started moving down.

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So looking ahead to Q2, I would expect the difference between the actual average exchange rate, whatever that turns out to be, and ARM's effective revenue translation rate to be somewhat similar to Q1, the gap. But then I would expect the difference to narrow over the following quarters as the, if you like, weaker dollar deals start to work their way through the P&L.

And, of course, in due course, this works both ways. And if the dollar were to weaken in due course then you might actually see ARM benefiting from deals coming out of backlog and deferred revenue that have been put in there in recent quarters in the \$1.40s and \$1.50s. So it works both ways, but I thought worthy of going through that because obviously it has an impact on Q1 versus expectation.

But underlying that, of course, a robust dollar revenue performance which, combined with the cost management and a stronger dollar, yielded an 18% year-on-year earnings growth. We retain a cash-rich, debt-free balance sheet. Q1 saw continued good, strong cash generation. We end the quarter with GBP91m, up from GBP79m at the start of the year. And whilst the Company's share buyback program remains in place, there were no purchases in the first quarter.

Moving a little bit to the backlog, you've seen from the release that the backlog was down at the end of Q1 just under 10% lower than it was at the beginning of the year. But we have specifically stated in the release that when looking at the size and the composition of the opportunity pipeline for licensing in the second quarter, that indicates to us that the backlog is unlikely to fall further at the half year. The usual analysis of backlog maturity and composition is included in the slides on the website and it shows that 36% of total backlog is expected to be recognized as revenue over the next two quarters.

A couple of questions -- points on margin. Gross margins in the first quarter, normalized basis, were 90.2%, a little bit higher than consensus, higher than Q4 and quite well up on Q1 a year ago.

You will have heard me speak before about the allocation of PIPD engineering time between research and development when generic technology development is being undertaken, and cost of sales when particular customization is being undertaken. When comparing Q1 and Q4, more of that cost, working on the leading-edge technology, was written off R&D, less as cost of sales. So in a sense there was a reclassification when comparing quarter on quarter between OpEx and cost of sales. And that decreased cost of sales quarter on quarter by GBP0.6m and increased OpEx similarly by that amount, which ended up as gross margin being higher.

And moving on to normalized OpEx, GBP48.5m in Q1. That's GBP3.3m lower than last quarter. And the sequential decrease is due primarily to the net impact of accounting for the derivative instruments and the forward contracts. In Q1 the end result was more favorable than it was in Q4. And this sequential decrease in OpEx would have been greater were it not for, A, the gross margin change that I just mentioned where there was a GBP600,000 reclassification quarter on quarter between OpEx and cost of sales, but also, more significantly, the impact of the stronger dollar against sterling on the translation of the Group's US-dollar-denominated costs.

In Q1 the effective exchange rate for translation of US-dollar costs which, as you know, account for about half of our costs, was \$1.41 average through the quarter, compared to \$1.52 in Q4, because although Q1 started at \$1.46 and ended at \$1.43, you will recall that the rate was in the high \$1.30s for a lot of the quarter. And as those costs were being incurred, that obviously impacts our translation rate. And this change, \$1.52 to \$1.41 accounts for -- adds about GBP2m to operating expenses in Q1 2009.

But, as Warren said, underlying that, the costs continue to be carefully managed. Group headcount is down at the end of the first quarter versus the beginning. The pay freeze that was implemented with effect from January 1 remains in place. And so for Q2 normalized operating expenses, assuming effective exchange rates similar to current levels, we would expect to ease down a little bit further into the range GBP46m to GBP48m.

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A quick comment on interest received in Q1, total interest of GBP0.4m obviously reflecting the significant reduction in interest rates in recent quarters. And assuming that the net cash balance stays at or around current levels or grows slightly, I would expect the quarterly interest to be similar in subsequent quarters this year than it has been in Q1, at about that level.

So just reminding again, on outlook, we saw the industry slow down markedly in Q4. We've seen activity continue to decline in Q1, although signs of improving visibility in some sectors towards the end of the quarter. But I think it's true to say that the near term remains uncertain.

But demand for ARM's portfolio of products remains healthy. And therefore we are reiterating our previous guidance for 2009 that we set out in February at the time of our '08 full year results, in that we expect dollar revenues for the full year to be at least in line with market expectations unless conditions deteriorate to a greater extent that is generally anticipated. And just to remind you, generally anticipated, in our reading, is that the industry's going to be down somewhere between 25% and 30% in the full year, with handsets being down 10% to 15%, but a more positive outlook for smartphones.

So, with that, it's over to Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Your first question comes from Nicolas Gaudois from UBS. Please ask your question.

Nicolas Gaudois - UBS - Analyst

Yes, hi. Two questions. Firstly, maybe if you could give us a bit more qualitative color on what has been supporting licensing activity in Processors in the last quarter. We're back to reasonably normalized level of licensing activity as we described it full cycle and you said that the start of Q2 is reasonably encouraging. So is it a function of much broader product portfolio, I guess, than a few years back? Also potentially some of your last bastions of non-users of ARM at large, are semiconductor companies effectively feeling more internal pressure perhaps to move to ARM potentially?

And secondly, if you could give us maybe, Tim, a bit more color on how you look at OpEx for rest of year, would be useful as well. Thank you.

Warren East - ARM Holdings plc - CEO

Okay. I'll start with the question on licensing, Nic. I think it is really the breadth of products in the ARM portfolio at the moment. You'll see in the midst of licenses that we actually signed out of the 17, we had some graphics. We had some Cortex processors. We had some of the new processors that we've only just launched, or in fact one of them was even prior to launch. But we've also sold three ARM11 licenses, a couple of ARM9s and even some ARM7. So it's very broad.

As in previous quarters a lot of these first applications for licensing, about two -- in effect two thirds of those fee applications for licensing is non-mobile. So we are seeing it's a result of a broad product portfolio and broad adoption of ARM in the semiconductor community.

As for the companies where you refer to as the last bastions of in-house, then it's true that these economic conditions do make people think about outsourcing and we do have more conversations ongoing perhaps than ever before about using ARM in applications where ARM has not been used before with those semiconductor companies. However, it's too early to translate

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those encouraging conversations into actual licensing. But I hope that some of those will turn into licensing as we go through the remainder of this year and into next.

And with that I think it's over to Tim.

Tim Score - *ARM Holdings plc - CFO*

Yes, on costs, as we said this morning, we -- essentially our underlying costs are flat at the moment. There's no salary inflation and at the moment there's no net increase in headcount and so therefore broadly I would expect it to be similar to what we've guided for Q2. There are clearly some variations on that that we know through FX, which is very hard to forecast.

But in an underlying sense what would drive it slightly up or slightly down from there would be our expectation -- or how the second half starts to unfold from a trading environment sense and how it's looking into 2010. A little bit of this is about the pace of investment. But our general view at the moment, whilst the near term remains uncertain, is to be pretty cautious in terms of cost.

Nicolas Gaudois - *UBS - Analyst*

Okay. Perfect. Thank you.

Operator

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

Sandeep Deshpande - *JP Morgan - Analyst*

Hi. Thanks for taking my question. Couple of questions. Firstly on the shorter term, in terms of the guidance, you're saying that you expect your dollar revenues to be in line with market expectations. But these market expectations change all the time so what is the dollar guidance that you're giving at this point?

Tim Score - *ARM Holdings plc - CFO*

Sorry, Sandeep, were you asking what the dollar full year revenue expectation is?

Sandeep Deshpande - *JP Morgan - Analyst*

Yes.

Tim Score - *ARM Holdings plc - CFO*

Yes. It's \$456m, \$457m for the full year. And of course our guidance is to be at least in line with that.

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Sandeep Deshpande - JP Morgan - Analyst

Okay, and then secondly, a longer-term question, it's almost now five years since you acquired the PIPD business. And in terms of licensing there, it does seem to have shown some stabilization, but it is overall still at much lower levels than it was when you bought the business. How do you see this developing?

Will -- even on the royalty front, unlike the core business this -- it had -- the royalties in PIPD have not really set the house on fire. So how do you see this changing at all, or this business is going to be underperforming with respect to the PD business.

Warren East - ARM Holdings plc - CEO

Yes. I'll answer both of those questions. I think if you look at the licensing that's going on, it has been through a huge transition over that period. And of the 12 licenses sold in the last quarter, for instance, half of those licenses are at -- for advanced technology 65 nanometers and below. And so once upon a time the business was very much a turns business, with mature technology being licensed.

It's now, rather like our Processor business, a mixture of mature technologies and advanced technologies. And in fact for all the most advanced 32 nanometers and for much of the 40-nanometer stuff, we have licensed products but we've not recognized any revenue from those licenses to date. And so I think it's a matter of a lot of revenue is delayed as we're transitioning that from the older technology to the new technology. But the encouraging thing is that new technology is indeed licensing.

And as for royalties, I think right now, as you know, the dynamics are very similar to our Processor business. In our Processor business we've always said it's about four years from licensing to when you get shipments that move the royalty dial. And if you look over the period, royalty has actually increased, but a lot of the royalties are still coming from the older licenses. And though volumes there are very, very tightly linked to foundry shipment, and therefore when you have quarters like the quarters that we're going through at the moment with the foundries under a lot of pressure, our Physical IP royalties are going to be under pressure.

You can see evidence of royalties coming through from the newer licenses. And in the numbers today, for instance, our Q1 PIPD royalties are well ahead of the foundry revenues for the corresponding period, so indicative of growing market share which is from those new licenses.

Tim Score - ARM Holdings plc - CFO

And Sandeep, it's probably worth remembering also that in the full year of 2008 PIPD royalties were up 24% year on year compared to the Processor division royalties which were up 28% year on year. So it's not all bad. But we're obviously -- we're right in the middle of, or in the terms of the quarter, one quarter in arrears right in the middle of a major impact on overall foundry utilization which clearly is reflected in PIPD royalties in the short term.

Sandeep Deshpande - JP Morgan - Analyst

Okay, thanks. And just one quick question on the netbook market. There has been a lot of excitement about ARM and the Cortex being used in the netbook market, but also on the other side there's been a lot of things in the trade press about the supposed having things which are not there in the Cortex, etc. Do you see, from what you are hearing from your customers, this being a major driver for ARM in the second half of this year?

And is ARM supporting this move, aggressive move into a netbook market or is ARM just going to support the regular level of how it has supported customers through the handset market?

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Warren East - ARM Holdings plc - CEO

As far as ARM support is concerned, we do see it as an important market, but not really for the second half of this year. We see it as much more of a long-term thing, the evolution of high-end smartphones and the evolution of PCs and how the netbooks might just be a product category which grows substantially over the next several years as those products evolve. So that's why we see it as important.

In terms of actually driving our business in the second half of the year, then no, I don't think you'll notice it in the numbers at all. So we are supporting it. It's important to us in the medium term. But don't expect to notice an impact from the ARM-based netbooks that we'll ship this year. We're expecting about 20m netbooks to ship in total. Last year, as you know, there were 4b ARM microprocessors shipped. So it's not really going to make much difference.

Sandeep Deshpande - JP Morgan - Analyst

Thanks a lot.

Operator

Your next question comes from Didier Scemama from RBS. Please ask your question.

Didier Scemama - Royal Bank of Scotland - Analyst

Morning gentlemen. Thanks for taking my question. I'm glad you actually commented on netbooks, quite interesting.

My question is on the PD royalty of \$0.06 which was, I think, quite strong. But at the same time the units that were, I think, a bit below some of the market consensus numbers out there. So obviously a bit difficult to draw conclusions because we are in the middle of a big destocking cycle for you guys in Q1. But I was just wondering if you could help us maybe for the future with this royalty rate and maybe dissociate what ARM11 royalty rate is versus, say, ARM9 and ARM7. That would be helpful. And I've got a follow-up.

Warren East - ARM Holdings plc - CEO

Yes, alright. I'll start on that and perhaps Tim might want to add some color there. You'll note that there are quarters when our average royalty rate increases as well as decreases. In fact, 12 months ago to the day we were probably having the same conversation. So that is entirely a feature of product mix and there is an element of seasonality to it. Smartphones tend to be a consumer-oriented product and therefore a bit more seasonal than microcontrollers, which are much more exposed to white goods in the industrial segment and that's more of a steady-state progression for us.

And so in the medium term we don't have any changes to make to our expectations for this number. As microcontrollers grow then the average royalty rate will be pulled down and we're expecting a number in between \$0.05 and \$0.06 for the next several to half a dozen quarters. And when smartphones have a period, a quarter where they grow more than microcontrollers, then you'll see the average increase. And it's really just all about that product mix.

Tim Score - ARM Holdings plc - CFO

Yes. I think more generally, the fact that ARM11 is now just nudging over 5% and Cortex is just beginning to get on to the dial, these are essentially going to be upward pressure factors as we go forward, offsetting the downward pressure from significant

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volume growth in microcontrollers. So in a way, Didier, it's the same discussion that we have. I think what this quarter and what a year ago reminds us is that it doesn't routinely go in one southerly direction.

Warren East - *ARM Holdings plc - CEO*

We should, as we normally note, this parameter is an arithmetical artifact of the royalty revenue and the total volume shift. And we mention it because we know that people do track it. But at the end of the day, all royalty is good royalty, because it's all 100% margins.

Didier Scemama - *Royal Bank of Scotland - Analyst*

So in other words, when the market re-stock, as it does currently, you would think that perhaps the mix would potentially deteriorate because the headset market normalizes and you've got maybe -- even though a growing proportion of smartphones. But you've got maybe a bit more microcontrollers and stuff like that in the mix?

Warren East - *ARM Holdings plc - CEO*

As you say, when you're in the midst of a destocking cycle, as we have been, it's very difficult to separate out the chip shipment trends from the end product shipment trends. But we would expect in a normal year the middle quarters of the year to have some downward pressure because of the general microcontroller increasing. This quarter's no exception. We're rapidly outgrowing the market and growing our share in microcontrollers and that does exert downward pressure. But then we would expect towards the end of this year there to be a pull from smartphones, more of the Cortex products shipping into smartphones, and that will pull it the other way.

Didier Scemama - *Royal Bank of Scotland - Analyst*

Okay, and just a quick follow-up on the backlog in licensing pipeline. You said it was down 10% and would not materially decline going forward. Can you comment whether the decline was primarily on the PD business, on the PIPD business?

And also if there any moving parts in the coming quarter, i.e. one business offsetting the other while they are both moving in the same direction?

Warren East - *ARM Holdings plc - CEO*

I think very broadly they're in the same direction. One question one often gets asked on these calls is the contribution from backlog to licensing, PD licensing this quarter was just over 60%, which long-term followers will recognize as at the higher end, not outside of the range, but at the higher end. It moves between 40% and 60%-odd. So obviously there was some, in a sense, erosion of backlog there. But I think the divisions generally, the businesses, it's broadly in the same -- moving along in the same direction.

Didier Scemama - *Royal Bank of Scotland - Analyst*

All right, thanks very much.

Operator

Your next question comes from James Crawshaw from S&P Equity Research. Please ask your question.

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James Crawshaw - *Standard & Poor's Equity Research - Analyst*

Hi, thanks for taking my question. Just if we can revisit the netbook story, in particular the issues that people have cited are support for Adobe Flash to run natively on ARM cores and also a standard for different variants of Linux to run applications on ARM cores. I think you previously said that you were working together with Adobe to come out with something in 2009. I just wondered if there was any update on that?

And then more broadly, what should we expect for a standard for Linux?

Warren East - *ARM Holdings plc - CEO*

There's no change on the Adobe Flash. That activity has been announced and it's ongoing and Adobe will release the product as and when Adobe want to release them.

We do expect a gradually improving ecosystem as far as Adobe, as far as other key application software and middleware is concerned, as indeed a standardization and enrichment in the Linux world. It's a gradual process. ARM is working with key Linux providers. Our partners are working with key Linux providers. And it's recognized that that is an essential improvement that has to happen in this ecosystem for ARM-based netbooks to really take off.

James Crawshaw - *Standard & Poor's Equity Research - Analyst*

Okay, thanks very much.

Operator

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

Simon Schafer - *Goldman Sachs - Analyst*

Yes, hi, good morning. Not to harp on this netbook debate too much, but looking at it from the flipside, there's obviously some sort of convergence between form factors, which is, as people have been following obviously has drawn Intel into this debate. I was wondering whether long term, just as that competitive environment changes and as these form factors coincide, if you will, whether there was any risk that your average royalty rate, which obviously is a function of the ASP to some extent, but in rough terms, is revenue at risk if that average rate starts coming down, longer term?

Warren East - *ARM Holdings plc - CEO*

I think if you look at the prices of Intel processors and the prices of the application processors from the key ARM semiconductor partners in supplying into the wireless space, there's still a substantial price advantage to the ARM semiconductor partners. And so I don't really see the potential Intel presence in this space as driving the price down.

I think over the medium term you will see normal price dynamics as we have seen with ARM9 based smartphones, where the application processors start at one level and competition and maturity tend to drive those prices down. We'll see the same thing with the ARM11s and with the Cortex products.

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But there a roadmap. At the moment Cortex-A8 products are really only just starting to ship in tiny volumes. Cortex-A9 products have yet to ship. And ARM has a roadmap going out to way beyond that. So same dynamics as we have seen, and they're going to persist into the future.

Simon Schafer - *Goldman Sachs - Analyst*

Understood, thanks Warren. My second question would be, obviously this won't show up in royalties in the sense -- until a bit later in the sense that you're reporting on a quarter in arrears. But obviously a number of your channel partners, if you will, are reporting on some sort of perhaps improved visibility or certainly an element of restocking into Q2 and Q3, perhaps. But as you talk to them more on the licensing side, have you seen any change in appetite there just because obviously maybe their budget freezes is perhaps part of the (inaudible). Is that an improvement, just in the last couple of months, or not, not really, too early to say?

Warren East - *ARM Holdings plc - CEO*

I think it's too early for that one. We haven't really seen any change in behavior. But that said, 17 licenses signed in the quarter. We're seeing people recognizing that it's a tough environment, but we haven't really seen any significant downward turn as we've gone into this cycle in the level of design activity. Key players look through the cycle, they want to remain competitive and so they're still engaged in development projects. So there's not really been a massive change either way.

Simon Schafer - *Goldman Sachs - Analyst*

Got it. Thanks, Warren.

Warren East - *ARM Holdings plc - CEO*

Thank you.

Operator

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

Gunnar Plagge - *Nomura Asset Management - Analyst*

Yes, hello, I wanted to come back on the relationship between PIPD royalties and foundry utilization. You've said in the past that it's not appropriate to look at overall utilization levels. So could you give us, or indicate, some specific node levels where we should look at to get a feeling where PIPD royalties are going over the next quarters?

Warren East - *ARM Holdings plc - CEO*

I think what we've said in the past is that overall utilization levels are definitely colored by shipments at 90 nanometers and below from the foundries. But the companies that account for most of that volume of the 90 nanometers and below, these would be the Qualcomms and the Broadcoms of this world, the big fabless semiconductor suppliers, they don't use ARM Physical IP in significant quantity today. And most of ARM's physical IP royalty comes from -- today, comes from the older geometries.

And that's the guidance that we've given in the past and that still exists today. So when you look at overall utilization, you'll get a number. You have to look for the older geometries to give you more information on ARM's physical IP royalties.

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Gunnar Plagge - *Nomura Asset Management - Analyst*

Okay, thanks. And on Mali, could you give us a little bit there, an overview, what the competitive situation is and what are the chances that you can replace Imagination as one of the key application processor projects?

Warren East - *ARM Holdings plc - CEO*

I think the competitive situation is that ARM has helped Imagination design the MBX into most of the world's application processors for smartphones today. And that's good and that's success that we enjoyed with Imagination earlier. We have enjoyed good licensing over the last several years since we bought into the Mali technology. That continues.

I would expect that we'll gain some success in the application processor space. In fact I think we had one announced last year. But actually it's much broader than that. We're licensing our Mali graphics processors into a range of applications, as graphics get added to things like digital televisions and advanced remote controllers and all those sorts of consumer electronic products.

Gunnar Plagge - *Nomura Asset Management - Analyst*

Thank you.

Operator

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

Nick James - *Panmure Gordon - Analyst*

Yes, good morning. I just had a couple of questions. Firstly, on PD licensing, the average license fee seems to have come down over the last couple of quarters, it had been in the \$2.5m to \$3m range and it's more around \$2m the last two quarters. I just wanted to understand the dynamics of that.

And the second question is again on the netbooks theme. I guess there's quite a bit of speculation as to what operating system these devices will be based on and with a new Windows 7 maybe being released later in the year. If that market goes towards Windows 7 rather than Linux or Android, when will the ARM community be able to serve that marketplace?

Warren East - *ARM Holdings plc - CEO*

Right. Okay. Shall I just start with the second question first about netbooks and that sort of thing? I think there is going to be a bit of a battle over the next several years between Linux, or the Linux world including Google's Android and Microsoft. Linux is a different sort of experience today than Windows, but Linux is getting much more usable with every day that passes.

And Google is a significant new entrant into this space. But today I would highlight that Google's Android operating system really is aimed very much at the phone space rather than the netbook space. And it's up to others rather than ARM really to drive direction of change there.

Microsoft will continue to play an important part in this space. If there was Windows support for the ARM processor today, clearly it would be a very different marketplace. Perhaps there will be support in future, but that's really for Microsoft to comment on and not for us to comment on, I'm afraid. So I can't give you a full answer to your second question.

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Licensing?

Tim Score - ARM Holdings plc - CFO

Yes, I think, Nick, obviously it's a dangerous calculation to just take license revenue and divide by the number of licenses because obviously in any given quarter you've got a combination of contribution from backlog, which doesn't come with a unit number associated, and new licenses. And then of course you've got to look at mix of licenses. Now Q4, for example, where we had a very strong PD, MPD licensing quarter, we specifically drew out a significant contribution from backlog which upped the number. Now that clearly would raise the average dollars per announced license.

I think when you look in Q1 there's a number of Cortex end-style licenses in the quarter, and there's a number of Mali licenses and I just think when you average it across, you are going to get these quarterly variations. In terms of underlying pricing there's very little change. And there's no downward pressure on the actual the licensing rate of the various cores themselves.

Warren East - ARM Holdings plc - CEO

And just to add on that, you specifically asked the question with relation to a couple of quarters and I think that's how we're answering it. I highlight here that if you look over the last several years at -- and do that calculation over the last several years, you'll see there's an underlying trend of higher priced licensing as our license revenue has grown strongly over the last several years compared with the number of licenses signed. And that's a feature of the product mix and the broader range of processors that we have for licensing now including some very high end processors.

Nick James - Panmure Gordon - Analyst

Okay, thanks.

Operator

Your next question comes from Paul Morland from Blue Oar. Please ask your question.

Paul Morland - Blue Oar Securities - Analyst

Hi, I've got two questions. One is on that R&D line. I know you said some of the cost had shifted down from cost of sales and there's also currency impact, but that doesn't seem to explain the full differences. Is there some other reason why the R&D costs were particularly high this quarter?

And the second question is on cash generation. It appears to be about the same as you generated last year on a lower operating profit and I just wondered what was happening there. I see there was a working capital outflow I think of about GBP7m. One might have expected an inflow there with debtors coming down more than the deferred income line coming down, which would compensate that of course. So comments around that working capital, please.

Tim Score - ARM Holdings plc - CFO

On the R&D line, Paul, there obviously is an impact from the cost of sales classification. Most of the difference is actually translation and that's obviously about where the weight of the engineers reside. There's bits in the detail, but fundamentally that is the reason.

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I think in terms of cash generation, without wanting to get over-complicated, you and I had a discussion at the end of the Q4 about embedded derivatives and marking to market the forward contracts. And in a sense, some of the impact of those contracts being out of the money is obviously reflected, gets reflected in the actual cash receipt after the time. So our -- if currencies had been constant, our cash generation would have been a little bit higher in Q1. I think that's probably the underlying reason with regard to your question.

Paul Morland - *Blue Oar Securities - Analyst*

Okay, thanks. So in terms of the R&D we should be modeling that sort of level going forward, rather than expecting any quarterly one-off cost from Q1 to be dropping out for the remainder of the year?

Tim Score - *ARM Holdings plc - CFO*

I don't think there's anything specific that I would draw out that changes the quarterly on that, no. Clearly the translation impact will probably outweigh any underlying business reason because fundamentally the number of engineers is broadly flat, there's no wage inflation and there's not that much geographical rebalancing going on between the various sites.

Paul Morland - *Blue Oar Securities - Analyst*

Okay, thank you.

Operator

Your next question comes from Lee Simpson from Jefferies. Please ask your question.

Lee Simpson - *Jefferies & Company - Analyst*

Hi, good morning, gentlemen. Just one or two quick questions. I wonder if you can see any immediate read through for PIPD royalties this year given UMC's comments this morning of 110% increase in wafer shipment this quarter?

Tim Score - *ARM Holdings plc - CFO*

UMC were of course very hard hit and so substantial swings either way. Yes, these things are going to affect our PIPD royalties broadly. I can't tell you exactly what the mapping is from UMC's overall numbers, because a couple of questions ago we had a question about different generations of process technology. But ARM's Physical IP is used by UMC customers and so a reversal of fortunes for UMC, to better times for them can only be positive for our Physical IP numbers. But the extent to which it is, I'm afraid, it's too early for us to comment. We haven't specifically got an answer on that.

Lee Simpson - *Jefferies & Company - Analyst*

Right. Maybe just a quick update on the developments for the Sparrow core. I presume we're getting into the final stages here.

Warren East - *ARM Holdings plc - CEO*

Yes, we are.

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Lee Simpson - *Jefferies & Company - Analyst*

I'm going to -- sorry.

Warren East - *ARM Holdings plc - CEO*

We are getting into final stages.

Lee Simpson - *Jefferies & Company - Analyst*

I presume that you've got lead partners set up here. I just wonder how we should -- what we should think about upon release? With the 4Q horizon being expected, how do we categorize the customer, the immediate lead partners, the number of them? And what sort of impact do you think that will have on licensing for tail end of this year and into next?

Warren East - *ARM Holdings plc - CEO*

We're announcing the first Sparrow licensee today, or not today, we -- it has recently been announced that we've got a Sparrow licensee. I think the identity of that licensee will become evident over the next several weeks and we do have others in the pipeline.

This is not an ARM -- it's not going to transform ARM's fortunes. This is another new product in the portfolio and the portfolio is around 20 processors that we're actively licensing. So you should expect a few lead partners to sign. You should expect a product launch towards the back end of the year. And of course as a new product although we sign some licenses it won't make any impact on revenue whatsoever.

Lee Simpson - *Jefferies & Company - Analyst*

Right. Maybe just finally on as we see some chip developers moving towards, or heavily moving towards dual and quad-core in some of the high-end portable devices, I wonder if you could give us a feel for how this might affect your royalties, royalty rates for top line, and whether that would be noticeable in 2010 or if this is a further out impact?

Warren East - *ARM Holdings plc - CEO*

I think it's a much further out impact in terms of moving the dial on ARM's royalty. As we've said last time and now this morning, Cortex-A8 is in very, very tiny volumes at the moment in relative terms. Yes, there are a number of phone designs out there, but in the overall volume that's shipping on Cortex-A8 is tiny.

The Cortex-A9 which is the first genuine Cortex multi-core, we have an ARM-11 multi-core but only one -- that's only one product so far and most of the ARM-11s that are shipping are not that multi-core product. It's happening, there are products out there but you just won't notice the difference for -- I would say 2010 is far too early to notice the difference.

Ian Thornton - *ARM Holdings plc - Director of IR*

Thanks very much for your questions. I think we've got time for one more question before we move on, unfortunately.

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Operator

Your last question comes from Arun George from Noble. Please ask your question.

Arun George - Noble Financial Group - Analyst

Good morning, guys. Two quick questions. Tim, while discussing the outlook, you said that there was signs of improving visibility in some sectors. Just hoping if you can give us some color what sectors these are and what's driving this visibility. And then I have a quick follow-on.

Tim Score - ARM Holdings plc - CFO

I think you've seen some -- I think we've all seen in recent weeks a general probably improvement in the news flow. I think as we've discussed earlier in the call, the uncertainty is really about to what extent are we still moving through inventory changes versus seeing a predictable trajectory emerging in underlying demand. But I think we're just really reflecting on the fact that towards the end of Q1 and early in Q2 there's more positive newsflow than there has been in four, five months before that.

Arun George - Noble Financial Group - Analyst

Alright, I understand that. Just a quick follow-on, in terms of the industry expectations, you said that overall handset market currently is about 10% to 15% decline. But in terms of smartphones this seems to be quite a wide range of industry expectations. So it would be helpful if you could tell us in terms of your budgeting process for the year, what sort of smartphone growth or even decline are you assuming?

Warren East - ARM Holdings plc - CEO

We're expecting an increase in smartphones of approximately 15% year-on-year.

Arun George - Noble Financial Group - Analyst

Alright, thank you.

Warren East - ARM Holdings plc - CEO

But we look at the same numbers as you, and we can see that there's a big range. But don't see any reason to move our estimate for the time being.

Arun George - Noble Financial Group - Analyst

Alright, that's very useful. Thanks.

Warren East - ARM Holdings plc - CEO

Thank you. With that we'll wrap up.

I think the summary is that it's been a good start so far. We're continuing to outperform the industry at large. There's a lot of design activity around ARM technology in -- for both our processes and our physical IP products and the numbers are showing

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continued growth in ARM's market share generally. And we're reiterating our guidance for the full year. So with that, thank you very much and we'll be back in July with the half year results.

Operator

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

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