

FINAL TRANSCRIPT

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ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

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Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

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PRESENTATION

Operator

Thank you for standing by and welcome to the ARM Holdings Q1 earnings call. (Operator Instructions). I must advise you that this conference is being recorded today on Tuesday, April 27, 2010. I would now like to hand the conference over to your first

Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

speaker today, Ian Thornton. Please go ahead, sir.

Ian Thornton - *ARM Holdings plc - VP of Investor Relations*

Thank you very much indeed. Good morning. This is Ian Thornton, VP 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 comment on the quarter's results, and then we'll open up to a Q&A session. As a reminder, the presentation and 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 professional 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 Q1 2010 conference call. I'll run through some of the business highlights and then hand over to Tim to provide some more detail on the numbers. I expect, though, that we will cover much of the content during the Q&A.

I'll just start with a bit of context. Yesterday, at 3pm actually, was the 25th anniversary of the first ARM processor coming to life at Acorn. So this morning, 25 years and very nearly 20b ARM processors later, we're pleased to be announcing what we think is an excellent set of results for Q1 2010. There are lots of healthy indicators of ARM's growing strength for the medium and longer term, as well.

We've entered 2010 with a record backlog. Several new products ready for launch during the year and a strong competitive position as we're gaining market share in long term, structural growth markets right across our applications spectrum.

During Q1 the market has continued to recover from last year's downturn. And ARM has continued to move forward in line with our expectations. We've again outperformed the semiconductor industry as a whole, with all of our businesses making an encouraging start to the year.

We're continuing to gain share in all our target markets. Shipments of ARM based chips increased by 50% compared with a year ago, which is contributing to earnings growth of 49% and record levels of cash generation. Today we're confirming that we expect our full year 2010 dollar revenues to be in line with current market expectations, which have been rising steadily through the first four months of the year.

Now I'll just discuss some of the drivers for revenue in different parts of the business in a bit more detail. We'll start with the Processor Division. In the Processor Division we signed 17 licenses in the quarter, with non-mobile applications continuing to drive the majority of those licenses. We saw demand for ARM in smart meters, intelligent sensors, solid-state drives, industrial control and automotive applications.

Cortex products accounted for 13 of those licenses, including three licenses for Cortex-A products driven by smartphone and mobile computing applications, and nine licenses for Cortex-M products, mainly for use in microcontrollers and sensors. And



Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

alongside these new Cortex products a further four licenses were sold for older ARM processors, ARM7s ARM9s and ARM11s. And whilst there were no Mali licenses sold in Q1, the opportunity pipeline for Mali looks healthy for the remainder of the year.

Switching to royalty now and, just as a reminder, ARM's royalty revenues are reported one quarter in arrears. So our royalty for Q1 was generated from semiconductor devices sold in the fourth quarter of 2009. It was a record quarter by some margin for volumes of ARM processors shipped by our partners, who delivered a total of 1.4b ARM processors to their customers.

There has been a doubling of shipments in Cortex-M products, as they're starting to ship in volume now, driven primarily by microcontroller and Bluetooth products. And this, combined with a doubling of Cortex-A shipments, which was driven by smartphone growth, means that Cortex overall is now contributing 5% of the total volume, up from 2% in the fourth quarter of '09. Meanwhile, ARM11 is now representing 6% of overall volume. Again, that was largely driven by smartphones.

Royalty revenue increased to record levels. It was up 33% year-on-year versus growth for the industry, when you exclude memory and analogue, of 18% for the corresponding period. And this difference is a measure of ARM's continued market share gain and particularly in storage, set-top box and digital TV. And, as I noted earlier, in microcontrollers, where we've also seen many new product announcements from our partners in recent months, indicating more volume to come in the microcontroller space.

In Mobile we saw overall growth in the fourth quarter of '09, but smartphones grew particularly strongly, up about 40% year-on-year. So on average this makes now 2.4 ARM processors per phone, versus 1.9 a year ago.

Now I'll move to our Physical IP Division. Physical IP revenue was broadly flat quarter-on-quarter and up 17% year-on-year. We secured two new platform licenses, which will help drive long-term royalty revenue. These were for 130 nanometers and 90 nanometer technology, which demonstrates the longevity of semiconductor processes and also the potential for new product development at the older nodes.

And at the leading edge we now have 32 nanometer product available via the established Free Library program available for download from our web. And we expect first customer tape-outs during the first half of this year. With first 32 nanometer royalty by the end of 2010. So far for advanced processes, that's those at 65 nanometers and below, we now have 11 platforms generating royalty, which is accounting for 10% of the total Physical IP royalty.

Physical IP royalty for the quarter was up 35% year-on-year, but excluding catch-ups the underlying royalty was up 60%, which compares with foundry revenues for the corresponding period up 45%. So once again we're seeing further growth in ARM's market share.

Mentioning our Tools Division, the system design division there enjoyed a good quarter driven by a recovery in the underlying run-rate of business. And we expect that to continue. Q1 also included additional revenue from some milestone payments relating to two large software deals that were signed in previous years.

Now I'll touch on some operational and marketing matters. Following what has actually been a lengthy period in which we've maintained the Group's headcount at a pretty similar level, we're focusing this year on selective hiring, which we expect to continue throughout 2010. And our investments there are concentrated on the processor and media processing parts of our business. Together with activities to strengthen the ecosystem, particularly for computing and smart phone applications where Linux is a priority for us.

We highlighted back in February that we plan to launch three new processes this year. The first of these, codenamed Merlin, was launched in the first quarter as Cortex-M4. That's the latest of our microcontroller processes. And that has additional DSV capability. And the product's aimed at motor control, industrial control and automotive applications. And we already have lead licensees in place.



Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

First quarter saw two large conferences and exhibitions. We -- the Mobile World Congress, which we attended in Barcelona, is a very important one for us. We went there and demonstrated several of our customers' dual Cortex-A9 platforms. And they're now being designed into the next generation of smart phones and mobile computers, and we expect to see those shipping later this year. And we also had a preview of some of the mobile computers that OEMs are planning to start selling over the next few months. And a host of ARM-based products were launched by our customers at the Mobile World Congress utilizing ARM11s and Cortex-A based processors in apps processes. So we expect 2010 will see continued strong growth in smart phones.

And a few weeks later we attended Embedded World and that's increasingly becoming a key event for us as well, especially for our microcontroller initiatives. This year we launched the Cortex-M4 and the new tools suite from our Tools division, DS-5. And there were 70 companies from the ARM-connected community present promoting their ARM-based or ARM-related offerings.

And talking of the connected community, the development of the ecosystem around the ARM architecture is becoming even more important as we broaden our market reach. And we're continuing to develop that connected community, which now has 700 companies, up from 525 a year ago and 450 the year before that at the end of first quarter '08. So that continues to develop.

With that, I'll hand over to Tim.

Tim Score - ARM Holdings plc - CFO

Thanks Warren. Morning everyone. Hopefully most of you will have had a chance to have at least had a quick look at the numbers in the Q1 earnings release. Just a reminder, the quarterly slide set, which hopefully helps you with models, is available on the website as usual. And you might also find it useful to review notes 4/11 and 4/12 at the back of the earnings release where you'll find the line-by-line reconciliation of normalized numbers to the IFRS numbers.

So the headline level, Q1 dollar revenues, up just over \$143m, slightly above consensus. Up 19% year-on-year with the growth really being driven by both PD and PIPD royalties. Licensing, Development Systems and Services all reflect an encouraging start to the year. The effective FX rate for revenue and costs on translation basis was 1.55 for both revenue and costs. And these strong royalty revenues in Q1 have driven margin expansion and excellent net-cash generation.

Now a little bit more detail on the numbers. And Warren has had a good run through there on Q1 revenues so I will focus on backlog, cost, margins and then finish up with the outlook.

As you've probably seen in the release, Group order backlog at the end of the quarter was about 7% lower than the record level we saw at the end of 2009, but remains about 25% higher than it was a year ago. Looking at the mix of potential deals in the opportunity pipeline from here, we would say the prospects for backlog over the next few quarters are promising. The usual analysis of backlog maturity and composition is included in the slide set on the web and that shows that 30% of total backlog is expected to be recognizable as revenue over the next two quarters. And just under 60% of PD License revenues in Q1 were generated from backlogs, so at the higher end of the normal range of between 40% and 60%.

Gross margins in the first quarter were 93% compared to 94% last quarter and just over 90% a year ago, generally reflecting the impact of the increasing proportion of royalty revenues. And as I explained last quarter, the gross margin will move around a little bit from quarter to quarter, but it will typically be higher than 92%. And is on a long-term improving trend as royalty revenues become a higher proportion of total revenues.

Normalized OpEx in Q1 was GBP49m. OpEx in Q2 is expected to be in the range of GBP50m to GBP52m. Assuming that FX rates are at a similar level to the 1.55 we saw in Q1. And this, as Warren says, is as the Group continues to invest in key R&D programs, particularly in the Processor Division and in the Media Processor Division. And this trajectory is consistent with the current full year 2010 normalized OpEx consensus of about GBP202m. Which, if you adjust for the Q1 exchange rate, gives you approximately GBP204m, GBP205m for the full year.



Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

Just a quick reminder about the impact of FX movements on the translation of ARM's results. As you're aware, most of our revenues are earned in dollars, more than 95%, and more than 40% of our costs are incurred in dollars. We have seen some recent forecast revisions where sterling revenues have been adjusted to account for changes in exchange rates, but sterling costs have been left unchanged and that will clearly be inconsistent. This is just a reminder there on the translation impacts.

Record royalties and a pretty meaningful working capital inflow during the first quarter have driven a record level of cash generation. The first time we've reported net cash in excess of GBP40m.

And now finishing on the outlook, looking forward, we made an encouraging start to 2010 in improving trading conditions, although there does still remain a lack of certainty as to the impact of the broader macroeconomic environment on end-consumer demand later in the year. But in this context and as ARM continues to execute its strategy, we expect Group dollar revenues for the full year 2010 to be in line with current market expectations. And, as Warren said, those expectations have been increasing. They were around about \$555m when we announced our results at the beginning of February and coming in to today they're around \$576m, for information.

And now over to questions.

QUESTIONS AND ANSWERS

Operator

We will now begin the question and answer session. (Operator Instructions). Your first question comes from S. Deshpande from JP Morgan. Please ask your question.

Sandeep Deshpande - JP Morgan - Analyst

Yes, hi. Sandeep Deshpande here. Just a couple of questions. Firstly, in terms of your guidance you're not giving any specific guidance for the full year other than saying what you're comfortable what's in the numbers. Given that you've already beaten quite significantly in the first quarter, why is it that you're not changing full year numbers? Given that there does seem to be signs in the semiconductor industry that things are looking pretty good overall. Rather than what we had last year, when things were pretty unclear.

Secondly on PIPD, in PIPD in fourth quarter things looked pretty good in the semiconductor space, up 5% to 10%, whereas PIPD royalties are essentially flat quarter-on-quarter. What is happening there on the PIPD royalties? Is something, is there issue with one customer or one or two customers, or rather there is some other issue associated with the PIP royalties? Thanks.

Tim Score - ARM Holdings plc - CFO

Yes, on guidance, Sandeep, I think we are -- if you like, the form and context of our guidance, I think we're trying to be consistent with how we've guided in the past. And I don't think we have ever tried to identify a range for the full year. But what we've observed and what we're saying is that we see the estimates industry as a whole, we don't see any specific reason why those estimates are not going to come through, but we don't have visibility right through to the end of the year. But we do see consensus that's been increasing fairly inexorably. So our guidance is really in that context, very similar to how it's been I guess over the last six quarters or so.

Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

Sandeep Deshpande - JP Morgan - Analyst

Are you saying at this point that you expect that consensus to go up on this or are you saying that, you are saying that you are comfortable with what is in the numbers?

Tim Score - ARM Holdings plc - CFO

We're comfortable with what's in the numbers. I think with obviously the Q1 numbers have beat -- the consensus has been going up I would say inexorably now for the last 18 months and I think it would be a reasonable assumption to assume that will continue.

Sandeep Deshpande - JP Morgan - Analyst

Okay.

Warren East - ARM Holdings plc - CEO

Yes, Sandeep, it's Warren. I'll answer the Physical IP question and I'll point you at one of the slides that should now be on our website, the update to our presentation. And if you look there at the Physical IP slide you will see us comparing the underlying royalty in the Physical IP Division with foundry revenues for the corresponding period. Now, by our reckoning, foundry revenues were \$5.95b for Q3 last year and \$5.99b for Q4, which is essentially flat. And the underlying royalty revenues in Physical IP Division were \$10.3m and \$10.2b -- \$10.2m, sorry, for those two of for our royalties corresponding to those two periods. In other words, flat. So I think there are slight fluctuations but it's a law of small numbers. Essentially it's flat.

Sandeep Deshpande - JP Morgan - Analyst

So, Warren, would that indicate that you're not taking -- no new products are not taking share within this business like you have seen? Because we've seen clear signs of momentum within your processors quarter-on-quarter whereas you're not seeing that in PIPD?

Warren East - ARM Holdings plc - CEO

Again I think we've got issues with small numbers in quarter-on-quarter. I point out to what I just said in the opening commentary. If I look at underlying Physical IP royalties on a year-on-year basis then we're seeing up 60% versus an industry up 45%. So, no, I continue to look at it on a slightly longer term basis than every quarter, particularly when the numbers themselves are small and the movements are very small.

Sandeep Deshpande - JP Morgan - Analyst

Thank you.

Operator

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



Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

Simon Schafer - Goldman Sachs - Analyst

Yes, thanks very much. My first question actually was more surrounding the balance sheet. Tim, you mentioned it yourself. Really for the first time you've got this level of excess cash perhaps on the books, with almost 15p now. Any updated thoughts as to what may be the usage for that perhaps excess balance sheet?

Tim Score - ARM Holdings plc - CFO

No particular change, Simon, to what we've been saying over recent quarters. We -- the current plan of record here is that we have a progressive dividend policy. It's grown consistently at 10% a year for the last two choppy years. Progressive dividend policy in our language means that over time it grows broadly in relationship to earnings. So I think it would be reasonable to expect, as we move through a phase of more significant earnings growth, that the dividend will reflect that.

But, generally speaking, cash just under GBP200m and a market cap of GBP3.3b, it's a -- we don't see it's an uncomfortable level of cash at this time. But we will continue to update the market as and when we've got something new to say. But the current thinking is still progressive dividend policy, as we look forward.

Simon Schafer - Goldman Sachs - Analyst

I guess another way of maybe asking it, do you think there is a threshold for yourself in terms of level of M&A you would commit to in terms of size? Just thinking back to obviously 2003 when your cash level was similar, actually slightly higher. Just thinking as to what size of acquisitions, if you were to commit to something, would be a maximum threshold?

Tim Score - ARM Holdings plc - CFO

No, we don't look at it like that. And we have no intention of building a cash pile for acquisitions, if that's -- if the question's partly coming from that angle. We're happy to run this business at the moment with a fairly modest cash balance in the context of our overall valuation but we're certainly not intending to grow that cash pile for M&A.

As you know, we have a history of doing acquisitions to develop this business. We've done a whole series on bolt-on acquisitions. We've done one major acquisition. We haven't done one for a while. We continue to view that as a way of executing on our strategy. But I wouldn't try and draw too close a linkage between the cash balance and the execution of the strategy in that sense. But I'll re-iterate for the third time, we don't plan to build a cash pile for acquisitions.

Simon Schafer - Goldman Sachs - Analyst

Yes, okay. And my second question for Warren, this whole debate about when or whether, if at some point Windows 7 main operating system may or may not get portability onto the ARM architecture, any updates on that?

Warren East - ARM Holdings plc - CEO

Sorry Simon, I'm afraid there are no updates on that. I'll say what I said a couple of months ago, that the whole development of ARM in mobile computers seems to be happening and it's happening right now with or without Microsoft. Obviously we do understand that if the Microsoft operating system was running on ARM then it would seriously accelerate our progress into mobile computers.

Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

Simon Schafer - Goldman Sachs - Analyst

Okay. Thanks very much.

Warren East - ARM Holdings plc - CEO

Thanks.

Operator

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

Lee Simpson - Jeffries & Co. - Analyst

Hi, good morning everyone. Just given that smartphone ramp you talked about, what is the incidence now of multi-core shipments within that 1.4b chip shipments? I understand that's not cores, that's chip shipments, from what I understood in your press release. And I wonder if you can tell me, is that -- are these still shipping these multi-cores for 1.2% to 1.5% royalty rate?

Warren East - ARM Holdings plc - CEO

Yes, I think if I'm interpreting the multi-core correctly there Lee, what you mean is multiple ARM microprocessors on a single chip?

Lee Simpson - Jeffries & Co. - Analyst

Yes.

Warren East - ARM Holdings plc - CEO

And typically for most of our license deals, then second and subsequent cores increment the royalty. But there's a substantial discount of the order of 50% and then further, which would give you a net royalty per chip of 1.5%, near or thereabouts, probably more actually, compared with a chip that just has a single microprocessor in it.

Lee Simpson - Jeffries & Co. - Analyst

Right. And that's in all cases when there's multiple processors, as you call it, inside of a single chip?

Warren East - ARM Holdings plc - CEO

It's not in all cases. In most of our license deals they're done like that. Some partners who had the foresight to think that they were going to do multiple cores from the word go have negotiated different discount structures, but that's normally compensated by the fact that they pay a higher level of royalty in the first place.

Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

Lee Simpson - *Jeffries & Co. - Analyst*

Right. Given that we hear a lot of talk about Dual Core A9s coming to market, design wins currently here, we've got U8500 etc., there's a lot going around that 2% plus royalty rates are possible. I wonder is this a potential here for you that's 2011 or is it 2012?

And secondly how do these royalty rates compare with, for instance, a Snapdragon where you've got an architecture deal? So do you give it away in the license for architecture deals? And do they have different royalty rate structures?

Warren East - *ARM Holdings plc - CEO*

Okay. Typically - there are a lot of questions there. Starting with the last one, architecture licenses tend to have exactly the same types of royalty structure as implementation licenses. So from a royalty point of view they are the same thing.

And Cortex-A9 Dual Core designs, there are a few of those there now. So yes, Cortex -A9 is a high-value product so within this range then our royalty rates for Cortex-A9 are at the top end of the range. And clearly it's a multi-core design and it's therefore -- we expect to see implementations with more than one Cortex-A9 and that should drive increased levels of royalty. However, I draw your attention to the fact that, A, these products haven't really started shipping yet. And, B, even when they do start shipping it's going to be relatively, very, very small volumes compared with the 1.4b cores shipped in the quarter. So you're not actually going to see a big impact in the short term on our overall royalty revenue.

Lee Simpson - *Jeffries & Co. - Analyst*

Great. Thanks for that.

Warren East - *ARM Holdings plc - CEO*

Thanks.

Operator

Your next question comes from Arun George from Execution Noble. Please ask your question.

Arun George - *Execution Noble - Analyst*

Good morning, guys. I have two questions. Warren, firstly in your prepared remarks you mentioned that the Mali pipeline looks healthy. Can you just comment on the mix of the potential deals out there? Is that largely new names or is it existing Mali customers taking additional licenses?

And my second question is for Tim, on the gross margin side of things. Tim, in the Q4 results you said the gross margin base for the full year should be around 92%, which was what consensus was factoring in at that time. But based on the comments today, it looks like you're suggesting maybe the Q1 gross margins of 93% is what you should be factoring in for the full year. Is that the right way to understand it? Thanks.

Warren East - *ARM Holdings plc - CEO*

Okay, I'll do the Mali question first. The comments really referred to the quantity of Mali license opportunities that we have in our pipeline. I think the last quarter we said we would expect to sign a few licenses every quarter. Last year we signed 13 Mali

Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

licenses. The year before we signed eight Mali licenses. I felt it important to comment this morning because our Q1 was a quarter of no Mali licenses. Looking at the pipeline, we would expect the annual run-rate to be in line with what we've seen over the last couple of years.

As for the types of customers involved, then it's a mixture of new people and people who have been with ARM for a long time.

Tim Score - *ARM Holdings plc - CFO*

And on the gross margin, Arun, the reason I can't be too definitive is it does, as I say, move around a little bit. Because, for example - as I think you know - engineering time particularly in Physical IP sometimes gets charged to cost of sales and sometimes to OpEx. But I did say today that in most quarters the gross margin would be higher than 92%. And therefore it would not be surprising I think if the consensus gross margin eased up towards the 93% for this year.

Arun George - *Execution Noble - Analyst*

Alright. Thank you.

Operator

Your next question comes from Jerome Ramel from Exane BNP Paribas. Please ask your question.

Jerome Ramel - *Exane BNP Paribas - Analyst*

Good morning. Two questions. Concerning your backlog, it was down 7% quarter-on-quarter. But you said that, looking at the pipeline you have, it looks promising for the rest of the year. Could you quantify a little bit what you mean by promising?

And second question concerning the royalties on Enterprise. It seems that you have quite a nice jump. Could you explain a little bit what happened there?

Tim Score - *ARM Holdings plc - CFO*

Yes, hi Jerome. As you know, given the different shapes and sizes and the range of licensing models that we deploy it is very hard to, in a sense, quantify promising. But I think you can interpret that as an indication from us that we expect the backlog to go up over the next few quarters. And again we don't really talk about sequential trend as such, but the mix of deals in the pipeline and the balance of them, and the likelihood of closure, suggest to us that the backlog's going up.

Warren East - *ARM Holdings plc - CEO*

Okay. And comment on the Enterprise number that you highlighted. This is actually due to our hard disk drives, where the volumes were up over 100%, and that's not particularly extraordinary. It's a manifestation of a trend which has been happening for some time and we've talked about for some time, where ARM has been designed into designs from all the hard disk drive manufacturers, but not necessarily in all of their designs. And, in particular, we've been designed into the higher-end products. And what happens over time is those higher-end designs migrate towards lower-end products coming out of those companies, and as they do then overall volumes go up. And that's what we've seen.

Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

Jerome Ramel - *Exane BNP Paribas - Analyst*

Thanks a lot.

Operator

Your next question comes from Brett Simpson from Arete. Please ask your question.

Brett Simpson - *Arete Research - Analyst*

Yes. Thanks very much. I had a couple of questions on the wireless PD royalty side. Can you maybe just clarify what happened in the March quarter because it looks like the unit number was only marginally up in the March quarter which I guess is shipments in the December quarter? And can you confirm whether you actually grew your revenues sequentially in wireless PD royalties?

And maybe just a follow-up for Warren. There's been a lot of talk about pricing in both handsets and chips in the wireless side. Some sizeable smartphone price declines at Nokia last week, and there's also some talk from Qualcomm and MediaTek about price pressure intensifying. Can you maybe just talk about how this impacts your business and whether ARM can continue to grow its absolute royalty ASP per phone in this environment?

Warren East - *ARM Holdings plc - CEO*

Yes. So I'll start off and look at some numbers for wireless. And essentially the volumes are flat. There's a slight increase, but the volumes in wireless are flat.

And the second question was about ASPs in smartphones and I guess this has really been stimulated by Nokia last week and Qualcomm a quarter ago. And what we find here is yes there is certainly pressure on handset pricing. We can see that amongst our customers. And we can see a mix shift going on. And there are certainly lower prices on average in highly featured phones. But that has to be viewed in the context of greater numbers of higher featured phones. And so no, frankly, from a price of the application processes point of view, we're not at all concerned and expect to see upward pressure continuing.

Brett Simpson - *Arete Research - Analyst*

And Warren --

Ian Thornton - *ARM Holdings plc - VP of Investor Relations*

Sorry, it's Ian here. Looking sequentially at unit shipments, I daren't say I've been particularly helpful just because of all the different moving parts there are when you're going from one quarter to another quarter in terms of inventory movement and things like that. You need really to look year on year to find out what the overall trends are rather than sequential on sequential.

Brett Simpson - *Arete Research - Analyst*

Okay. Thanks.

Operator

Your next question comes from Gareth Jenkins from UBS. Please ask your question.

Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

Gareth Jenkins - UBS - Analyst

Thanks. A few if I could. You mentioned the Eagle, the lead licensee. And I just wondered if you could talk about the pipeline for Eagle and what you're seeing in terms of products for that particular product.

Secondly, I think you mentioned just in terms of hiring around Linux, and I just wondered whether the Linux-based netbook and tablet market is proceeding as you now plan.

And then I guess finally, just in terms of the kind of tier three and four customers, are they coming back in droves in terms of licensing? Thank you.

Warren East - ARM Holdings plc - CEO

Okay. So on Eagle, Eagle is at the stage where we have lead partners signed up and we're not really looking for signing up additional lead partners at the moment until we deliver the first deliverables from Eagle, which will happen later this year. However, there is a lot of interest in Eagle and people wanting to get hold of this product. So we're at the stage where we're, if you like, keeping those people interested. But we have to trade off between actually finishing the development of the product and supporting those lead partners, which is why we're not seeking additional licensees for Eagle at the moment.

And, sorry, your second question?

Gareth Jenkins - UBS - Analyst

It was just on Linux base. I think you mentioned when you talked about hiring that some of it will be re-pointed to helping out Linux or Linux-based development. I just wondered whether the Linux market is developing for netbooks and tablets as you expected.

Warren East - ARM Holdings plc - CEO

Yes. I think it is. And my comment was more about how we see Linux becoming used not just in things like netbooks, but becoming more widely used across the embedded space. And we're seeing this as an area where it's necessary for us to make some investment to keep our ecosystem at the leading edge.

Tim Score - ARM Holdings plc - CFO

I think your last question was about tier three and tier four, I think you called them licensees. I think coming back in droves is probably a little bit heavy, but certainly the trading environment does feel more benign and I think people's -- people have a slightly more flexible budgetary environment in which they're operating. So I think we would expect to see a little bit of a healthy underlying run rate from the smaller companies.

Gareth Jenkins - UBS - Analyst

Thanks.

Operator

Your next question comes from Janardan Menon from Liberum Capital. Please ask your question.

Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

Janardan Menon - *Liberum Capital - Analyst*

Hi. Thanks for taking the question. One question on share-based compensation which doubled year on year compared to the last year. And I was just wondering what are the trends there which change that number around as we go through years and what are your policies going forward on share-based payments.

Also the second question is the additional R&D spend that you are -- you're seeing, going up to about GBP50m, GBP52m. How does that change? Does that -- will that result in any tangible change in either the speed of introduction of new processors or the width of new processors? Are you widening out into any new areas? Or is it just more customization work and things like that which is leading to this increase?

Tim Score - *ARM Holdings plc - CFO*

Janardan, Tim on share-based. Our underlying approach to share-based remuneration hasn't changed. It's really based on all of our employees essentially getting shares each year to -- as a percentage of their salary, if you like. What happened, the difference you refer to is really largely a function of share price and the fair value of what is essentially the same value of shares has of course increased significantly.

Now as we look forward, assuming that share prices stay where they are all right, then the number of shares that will be issued will go down because we're talking about a value of salary here, not an absolute number of shares. So in that sense it's quite self-regulating. But on average we tend to issue something close to about 1% of our issued share capital per annum, and that obviously hasn't changed.

Janardan Menon - *Liberum Capital - Analyst*

Okay.

Warren East - *ARM Holdings plc - CEO*

On the R&D question, I think you'll note that we've gone through a period where we've maintained our headcount very flat. And that was due to the economic conditions last year where we had to take a very hard line on costs. What happens is that during that period there is a little bit of pent-up demand, if you like, for development. The industry is in a much better place than it was 12 months ago. We are gaining share across multiple applications and we need to accelerate the development of our roadmap.

And so right now on conference call we're not going to talk about any specific product, other than what I've said, which is that the investments are concentrated in our Processor Division and our Media Processing Division. But those are the areas of the business where it's happening. As for specific products, I can't comment at this stage.

Janardan Menon - *Liberum Capital - Analyst*

Okay. Thank you very much.

Operator

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

Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

Gunnar Plagge - *Nomura - Analyst*

Yes, hello. I just wanted to come back on the hiring. I was wondering, Tim, PIP headcount, will that actually be reduced in the current year or if you could comment?

Tim Score - *ARM Holdings plc - CFO*

I think we've said before that our medium-term view of PIPD is that headcount in that division does not grow in the same way as that it might do around PD and MPD. And that's really about the fact that, as you know, in recent years we've been doing accelerated R&D. And we also have opportunities in the division for process improvement and productivity gains. So without wanting to talk about short-term periods, our longer-term view is that the cost base in that division does not grow at the same rate as Processor Division or Media Processing Division.

Gunnar Plagge - *Nomura - Analyst*

Okay, thanks. And if you could just comment on the PD license purchasing behavior in terms of single licenses where they're due to license, has that fully come back? Is that normalized?

Tim Score - *ARM Holdings plc - CFO*

I think it normalizes a bit. Apart from anything else, it's hard to establish what's completely normal. But I think as we come out, if operating in an improved trading environment, a more typical mix of deals you're likely to see, whereas in the back end of last year we saw an unusually high number of unit deals signed in each quarter, but of course a lot of them were single use and term. So yes, we would expect a more normal spread, ranging from subscription licenses at one end to single use at the other, but probably a more normal spread now.

Gunnar Plagge - *Nomura - Analyst*

Okay. Thanks.

Operator

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

Didier Scemama - *Royal Bank of Scotland - Analyst*

Good morning, gentlemen. Managed to squeeze in at the end. One question or a couple of questions, if I may. First of all, Tim, could you just help us with the free cash flow? It sounds like you had some adjustments on the share option. So I would just like you just to explain what happened there.

And second of your questions to Warren, in terms of the market shares that you're showing which are pretty obvious on the HDD side, set-top box and DTV. At which point do you think that the end market shipments will track more in line with your own shipments, or maybe the other way round? Thanks.

Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

Tim Score - ARM Holdings plc - CFO

Didier, the -- each quarter where we disclose net cash generation, and in the notes we describe exactly what we mean by that, and that is unchanged. But net cash generation as defined excludes things like payment of dividend. It excludes monies coming in, for example from the exercise of options. And so when you look at the table, you might be referring to taking out from cash flow and arriving at net cash flow the amount coming in from options.

So there aren't any adjustments. It's just that we did actually receive -- there was quite a lot of option exercised in the first quarter so the number that adjusts is bigger than normal. But the 44m headline net cash generation excludes all of that type of cash flow. It's pure underlying cash flow in the business.

Didier Scemama - Royal Bank of Scotland - Analyst

Okay.

Warren East - ARM Holdings plc - CEO

Okay. And on the market shares, you're right obviously, when we achieve a very, very high market share then our shipments will track the products that actually ship. However, for hard disk drives at the moment we estimate that we are around about 65%, and for DTV and set-top box then it's still only about 30%. And so there's a lot of room for ARM shipments to outstrip end product shipment for some time to come.

Didier Scemama - Royal Bank of Scotland - Analyst

Okay. And just a quick follow-up, if I may, just on the portable computing and maybe computer and large -- that large market segment, can you comment perhaps on the sort of momentum you're seeing on netbooks because it seems like this category as a whole is losing momentum, while the table is gaining momentum? I guess for your own sake it doesn't make much difference. But I was just wondering if you've seen any change in the design momentum of your processors into these markets?

And also there's been some comments recently of potential ARM processors being designed in servers. So I'd just like to have your thoughts on that. Thank you.

Warren East - ARM Holdings plc - CEO

Okay. So on netbooks and tablets, you're right. We tend to regard these as being the same sort of product category. And the sockets that we're very interested in are the application processor socket. We tend to already have a significant share of the Bluetooth and the WiFi and the power management and those sorts of functions within these products.

Probably yes, compared with 12 months ago there's certainly more tablet activity, whereas this time last year it was more netbooks. However, there are still some interesting netbook designs. We saw some new designs across both CES and Mobile World Congress in Q1. And we would expect to see a number more ARM-based designs for both the netbook form factor and the tablet form factor at Computex at the beginning of June. Momentum hasn't appreciably changed. Obviously there's been a lot of publicity around the Apple announcement in January and the Apple launch later in the quarter. But apart from that there's been no real underlying momentum change.

And servers, your question on servers. We've talked about servers for some time. We are seeing some take-up of that, both in the press and also out in the industry where people are researching into this. And we believe it's undoubtedly an area in future where people will experiment with ARM processors and we're encouraging those experiments.

Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

Didier Scemama - *Royal Bank of Scotland - Analyst*

But how far is that? And those markets are very high ASPs for Intel, albeit on a low volume market clearly, but a very profitable business for Intel. I was just wondering how far you think ARM penetration in servers is.

Warren East - *ARM Holdings plc - CEO*

Yes, we can see the application developing as far as ARM's concerned and the use of ARM in there as a possibility. Exactly what sort of levels of penetration are achieved depends on what sort of products our partners are able to produce. And it's far too early to call that at the moment. Right now we're encouraging and supporting our partners moving in that direction. It's far too early to talk about how successful they're going to be.

Didier Scemama - *Royal Bank of Scotland - Analyst*

Wonderful. Thank you.

Warren East - *ARM Holdings plc - CEO*

Thanks.

Operator

Your next question comes from Nick Hyslop from RBC Capital Markets. Please ask your question.

Nick Hyslop - *RBC Capital Markets - Analyst*

Morning and thanks for taking the question. I had a different question on M&A. There's clearly been speculation recently and if we go back a few years there was speculation that perhaps one of your major customers might consider wanting to buy you. I think you've, Warren, issued some very eloquent defenses that they don't need to buy you, they can buy your technology. But if someone was to bid, do you have a view on how the regulators might view that from a competitive standpoint?

Warren East - *ARM Holdings plc - CEO*

Obviously that depends very much on who the bidder is and we just have commonsense views in that direction. So no, I don't think we've got anything to add really on over and above what I said last week, in that newspaper interview last week. No, there's a lot of value in the ARM business in ARM's independence. And as we've talked about, our growing market shares across many different applications, the current position of our market share overall across the embedded space sat at around just north of 25%. A huge amount of room to grow and a huge amount of value in future in ARM's independence with the current business model. And we think that's the best route forward for the business.

Nick Hyslop - *RBC Capital Markets - Analyst*

Is it fair to say that given some of the people who were speculated, if they were to do something, is it fair to assume the regulator would view that as anticompetitive which presumably would be one of the prime reasons for a move of that nature?

Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

Warren East - ARM Holdings plc - CEO

As I say, it depends entirely on who the potential acquirer would be. Clearly if that acquirer was a purveyor of microprocessors, then we're a microprocessor company and there'd probably be some discussion along those lines. But there are all sorts of people out there who might think about buying ARM.

But as I said last week, when you peel back a layer of detail and think about it in a little more depth, then there are much more cost-effective ways of acquiring the ARM technology than acquiring the Company. From a customer and technology company point of view and from a shareholder point of view, there's a huge amount of value in the business in the future. So it really doesn't make a lot of sense either way.

Nick Hyslop - RBC Capital Markets - Analyst

Okay, thank you. Enough on that one. But just to change tack, when you started your script you talked about 33% royalty revenue growth versus the market, at 18% of the markets you serve. And I'm just wondering, when you look at the full year, which of the forecasters of semi revenue growth are the ones that you respect? And roughly what do you think they're at at the moment?

Warren East - ARM Holdings plc - CEO

Right then. Ian, why don't you have a go at answering this one then because you're the --

Ian Thornton - ARM Holdings plc - VP of Investor Relations

Okay. So the ones I collect, we're looking like with the consensus for ARM in, excluding memories, excluding analogue, for the industry for 2010 is going to be about 10% to 15% ahead of 2009.

Nick Hyslop - RBC Capital Markets - Analyst

Okay.

Tim Score - ARM Holdings plc - CFO

We read -- we read them all. We read them all and same as you do really. We're not really in the respect game in particular.

Warren East - ARM Holdings plc - CEO

And actually they all have slightly different reputations. Some of these companies will always stick their necks out in a slightly contrarian position, but they generally have a reasoned argument for that and we take those arguments on board and think about them. But we make our estimates based on this basket that Ian monitors and also on our own intelligence from our semiconductor partners.

Nick Hyslop - RBC Capital Markets - Analyst

Okay. Thanks very much.

Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

Operator

Your next question comes from Kai Korschelt from Deutsche Bank. Please ask your question.

Kai Korschelt - *Deutsche Bank - Analyst*

Yes. Good morning. A couple of questions, please. The first one is on OpEx, and I think you said the current consensus is GBP202m, but I think you also suggested that we may see upgrades to consensus revenue expectations throughout the year. So I'm just wondering, if we see those revenue upgrades, whether you would invest some of the extra revenues in OpEx.

And my second question is on the graphic side. It looks like some of your smaller competitors are starting to do joint alliances on the graphics side. Again, is that something that worries or concerns you or do you think you're pretty well positioned here? Thank you.

Tim Score - *ARM Holdings plc - CFO*

Yes. Hi, Kai. Yes, what I was saying was the current OpEx consensus was about GBP202m for the full year at the current consensus exchange rate for the full year, which is about \$1.58. And I was saying that if you take that as Q1 rate then it would edge up to GBP204m, GBP205m. I also said in answer to Sandeep's question that we had seen the revenue consensus grow gradually and I felt it was a reasonable assumption that that might continue.

Our plans for investment through this year are more about plans on what we feel we need to do. And whilst they may be influenced, to some extent, on the upside or the downside by the market, they're plans that are really set fair for the business. So we won't be seeking to try to find ways of spending any overage on revenue specifically, so I think that's probably the right context for you.

Warren East - *ARM Holdings plc - CEO*

And on the graphics and our smaller competitors, I think you're probably referring to the announcement about Imagination and MIPS Technologies. So we think that we're positioned very well. We think that our Mali technology is the right sort of technology for our target market. And obviously we'd love it if people were to buy our graphics processors to sit alongside our ARM microprocessors.

But having said that, most of the volume which is shipping today is ARM microprocessors sat alongside Imagination processors that we licensed as part of our partnership with Imagination Technologies some years ago. And we have sold some Mali licenses for use alongside MIPS microprocessors, and we're very happy to do that because I'd much rather sell a Mali graphics core to a MIPS customer than not to sell a Mali graphics core to a MIPS customer. And in due course then obviously we hope to convert those customers from the MIPS core to ARM.

Kai Korschelt - *Deutsche Bank - Analyst*

Okay. That's very clear. Thank you.

Warren East - *ARM Holdings plc - CEO*

Thank you.



Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

Operator

Your next question comes from Adnaan Ahmad from Berenberg. Please ask your question.

Adnaan Ahmad - Berenberg Bank - Analyst

Hi. Thanks for taking my question. Just two questions, one for Tim and one for Warren. First of all for Warren, if I look at your ARM11 and Cortex mix, that went up to 11% this quarter from 7% last quarter and your average royalty went down slightly to \$0.048. Can you explain what went on here given that your embedded market percentage also went down to 16% versus 18% in the last quarter?

And the second question for Tim. If I look at your gross margin, the royalty mix was higher this quarter relative to the last quarter, at about 54% relative to 53%. Could you just take me through what led to the gross margins coming down on a sequential basis? Thanks a lot.

Warren East - ARM Holdings plc - CEO

Okay. Shall I do the -- that one first? So on the royalty and the Cortex products and so on, it's all about the detail of the product mix. In reality, the average that's worked out \$0.048 this quarter, \$0.049 last quarter, it's a very similar number and it's very, very close, but we round to one decimal place, so it's essentially flat. However, it does look strange in the light of Cortex products going -- increasing. But I'd highlight that in that increase in Cortex products we've got an increase in absolute numbers of Cortex-M products, both in microcontrollers but in particular in Bluetooth.

And that is really the answer to the conundrum. There's been an increase in Bluetooth-type products. And of course we count those as mobile, not embedded. So even though you saw the proportion of embedded reduce, along with huge growth in microcontrollers in absolute terms, we also saw a growth in our Bluetooth market share and that's what's changed things.

Adnaan Ahmad - Berenberg Bank - Analyst

Okay. Thanks.

Tim Score - ARM Holdings plc - CFO

Yes. And on gross margin, Adnaan, there are a number of moving parts. They don't change the outcome materially but they do change it by small numbers and certainly a percent change between quarters is not significant. It depends on, as I said earlier, there's an allocation of engineering time each quarter with the Physical IP Division between OpEx and cost of sales. There's also cost of sales attached to our deferred -- development system revenue, and there's a cost of sale attached to our service revenues. And it's really the blend of those in each quarter which can move the gross margin around a little. But as again, as said, it's on a long-term improving trend and in most quarters it's going to be north of 92%.

Adnaan Ahmad - Berenberg Bank - Analyst

Great. Thanks a lot.

Operator

Your next question comes from Andrew Gardiner from Barclays. Please ask your question.

Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

Andrew Gardiner - Barclays Capital - Analyst

Thank you. Good morning. My question's regarding R&D, in particular how that's relating to your licensing activity. Tim, you've highlighted the consensus level of OpEx and also where you expect 2Q to go. Can we expect that that 2Q level therefore is a pretty stable level for the remainder of the year?

And in particular, just on the licensing side, you're clearly showing a shift away from your former core mobile markets and steadily towards other non-mobile areas. Is that -- are you still able to leverage the existing R&D overall of these new areas or are we likely to see a bit more R&D creep as we go through the year or even into next year as the licensing broadens further? Thank you.

Tim Score - ARM Holdings plc - CFO

On the first question, Andrew, in getting from where we are to something in the GBP204m, GBP205m area. What we would actually expect to see is a very gradual increase through the year as the net headcount increases. So it's -- the Q2 level is quite likely to be -- and when I look at the sort of consensus shape, which has it GBP51m, GBP52m, GBP53m, that's not a bad way to think about it, frankly.

Warren East - ARM Holdings plc - CEO

And on the slightly more medium-term question of direction of R&D expense and licensing activity, as we move into a broader range of applications, most of the technology that's developed for mobile in the first place does apply to the other application areas. But we do do some specific developments for different product categories. In particular we've been highlighting the microcontroller specific cores. There's not a hugely significant amount of different R&D to do. They are derived from the architectures that have developed in the first place for mobile.

But as we broaden, then we will do some special flavors. But also we need to remember that we're still servicing the wireless sector. And that's where we're developing our leading edge products. And growth in R&D is necessary to keep developing in that leading edge.

Andrew Gardiner - Barclays Capital - Analyst

And that latter point is the primary driver behind the increase you're talking about for this year then?

Warren East - ARM Holdings plc - CEO

Yes, it is.

Andrew Gardiner - Barclays Capital - Analyst

Yes. Thank you.

Ian Thornton - ARM Holdings plc - VP of Investor Relations

I think we've got time for one more question.



Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

Operator

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

Didier Scemama - *Royal Bank of Scotland - Analyst*

Yes. Thanks for taking my follow-up. Warren and Tim, congratulations. 40% operating margin in Q1. We expected that for the full year or maybe even for next year, in fact. What's the next target?

Tim Score - *ARM Holdings plc - CFO*

Thank you, Didier, for looking for the grand finale. No, I think our, in a sense, our guidance on margins hasn't changed. We've said now for some time that we expect 40% to be a sustainable medium-term target. We've probably hit it, in a sense, for the first time a little bit earlier than we might have expected. Clearly, as I've said many times, the route to 40% is accelerated by a stronger dollar and is decelerated by a weaker dollar. We have a relatively strong dollar at the moment, which helps. And we are early on in a year where we're reducing heads.

I think the current consensus that's out there of margins in the 36%, 37% area still feels about right. But our target is to keep growing the profitability and cash of this business. And part of that is going to be margin expansion, with the operating leverage in the model as the royalties grow.

Didier Scemama - *Royal Bank of Scotland - Analyst*

When do you think you could set new targets, because presumably no-one's going to believe you that you're going to make 37% margin this year. And the share price obviously wants more than 40% margin. So when do you think you could give us a new target?

Tim Score - *ARM Holdings plc - CFO*

I think we -- this is a, quarterly reporting is a difficult game giving specific targets for margins. But one target we do have is that that margin's continued to increase and they've just gone from 34% to 37% to 40%. So it's quite encouraging. Yes. I don't think it really helps giving hard-and-fast numbers in limited timescales for this type of business.

Didier Scemama - *Royal Bank of Scotland - Analyst*

Okay. Many thanks and congratulations.

Warren East - *ARM Holdings plc - CEO*

Thanks, Didier. And so we'll summarize and say good set of results. Encouraging start to 2010. Record volumes. Record levels of profitability and cash generation. We're comfortable with the start to 2010. And as the consensus expectations have been rising during the first few months, we continue to remain comfortable with those expectations as they sit for the remainder of the year.

We look forward to coming back at the end of July with our half year results. Thank you very much.

Apr. 27. 2010 / 7:30AM, ARM.L - Q1 2010 ARM Holdings plc Earnings Conference Call

Operator

That does conclude our conference for today. For those of you wishing to review this conference, the replay facility can be accessed by dialing within the UK on 0845-245-5205. That's 0845-245-5205. Or alternatively on country code plus-44-1452-55-00-00. That's plus-44-1452-55-00-00. And the reservation number is 67906772. Thank you for participating. You may all disconnect.

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