ON Semiconductor®

ON SEMICONDUCTOR CORPORATION

SCRIPT FOR
Q4-19 RESULTS CONFERENCE CALL

Parag Agarwal

Thank you <operator>.

Good morning and thank you for joining ON Semiconductor Corporation's fourth quarter 2019 quarterly results conference call. I'm joined today by Keith Jackson, our President and CEO, and Bernard Gutmann, our CFO. This call is being webcast on the "Investor Relations" section of our website, at www.onsemi.com. A replay of this broadcast, along with our 2019 fourth quarter earnings release, will be available on our website approximately one hour following this conference call, and the recorded broadcast will be available for approximately 30 days following this conference call. The script for today's call and additional information related to our end-markets, business segments, geographies, channels, share count, and 2020 fiscal calendar are also posted on our website.

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

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

Additional factors are described in our earnings release for fourth quarter of 2019. Our estimates, or other forward-looking statements may change, and the company assumes no obligation to update forward-looking statements to reflect actual results, changed assumptions, or other factors, except as required by law.

On August 18, 2020, we will host an event for investment community in New York City to provide a strategic update on our business. At this event, we will update the investment community on our business, strategy, and markets. In addition, we will provide information on our manufacturing consolidation plans and economics of our 300mm manufacturing strategy. We will send invitations for the event shortly.

Now, let me turn it over to Bernard Gutmann, who will provide an overview of our fourth quarter 2019 results. Bernard….

Bernard Gutmann

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

Following stabilization in the third quarter, we have seen improving business trends in the fourth quarter. Order trends continued to improve through the fourth quarter. We believe that in addition to normalization of supply chain, improving demand across most end-markets is driving improved order rates. Based on our order rates and conversations with customers, we believe that the pace of recovery is moderate, rather than a sharp upturn in demand. Macroeconomic data from most major economies is increasingly favorable, and industrial activity is showing signs of modest improvement. At the same time, we are cognizant of potential risks arising from emerging coronavirus crisis, and we are diligently monitoring this rapidly evolving situation.

Our traction in our key strategic markets continues to accelerate, and our design-win pipeline continues to grow at a rapid pace. Our content in fastest growing segments of automotive, industrial, and cloud-power markets continues to increase. Our customers are adopting our solutions for automotive, industrial, and cloud-power market at an accelerated rate. We believe that a highly diversified customer base, growing content in fastest growing applications in semiconductor market, and long life cycle of many of our products should enable us to continue to outperform most of our peers.

To accelerate our progress towards our gross margin target, we have begun to make structural changes to our manufacturing footprint. This morning, we announced that we are exploring sale of our six-inch fab in Belgium. We will provide updates on financial impact of this action as we firm up our production transition plans. Keith will further expand on our plans for the Belgium fab later during this call.

Along with making structural changes to improve our gross margin, we are streamlining our investments in various markets. Towards this end, we took limited restructuring actions in the first quarter to reduce our operating expenses by approximately $25 million per year. We should begin to see nominal impact of this action in the second quarter of 2020, and full impact should be apparent by fourth quarter of 2020.

Now, let me provide you additional details on our fourth quarter 2019 results.

Total revenue for the fourth quarter of 2019 was $1,402 million, a decrease of seven percent as compared to revenue of $1,503 million in the fourth quarter of 2018. The year-over-year decline in revenue was primarily driven by well-publicized macroeconomic and geopolitical factors, which have affected the overall semiconductor industry. GAAP net income for the fourth quarter was $0.14 per diluted share as compared to a net income of $0.39 in the fourth quarter of 2018.

Non-GAAP net income for fourth quarter of 2019 was $0.30 per diluted share as compared to $0.53 in fourth quarter of 2018.

GAAP and non-GAAP gross margin for fourth quarter of 2019 was 34.6 percent as compared to 37.9 percent in fourth quarter of 2018. Fourth quarter gross margin was lower than our expectation due to a combination of certain transitory mix and operational issues. We had an unexpectedly high demand for a low-margin product line in our consumer segment during the fourth quarter. We expect this strong demand to continue in the first quarter as well. We intend to either discontinue this product line or significantly raise prices after the first quarter. On operations front, we had certain facilities related and scrap issues. We expect these issues will be resolved by end of the first quarter of 2020.

In near-term, we expect to see headwinds from fixed costs to our gross margins. As you are aware, we expanded our manufacturing capacity in 2018 and 2019. However, revenue has lagged our expectation due to well-understood macroeconomic and geopolitical factors. Therefore, with addition of manufacturing capacity and lack of revenue growth, we are now facing underutilization charges and higher depreciation expenses. With expected revenue growth in 2020, we should be able to offset the impact from underutilization and depreciation. We expect higher than 50 percent incremental gross margin for 2020 starting in the second quarter of the year.

Our GAAP operating margin for the fourth quarter of 2019 was 9.9 percent, as compared to 14.8 percent in the fourth quarter of 2018. Our non-GAAP operating margin for the fourth quarter of 2019 was 12.3 percent, as compared to 16.8 percent in fourth quarter of 2018. The year-over-year decline in operating margin was largely driven by lower gross margin.

GAAP operating expenses for the fourth quarter were $347 million, flat as compared to those for the fourth quarter of 2018. Non-GAAP operating expenses for the fourth quarter were $314 million, as compared to $317 million in the fourth quarter of 2018. Recall that our 2019 operating expenses included more than two quarter of expenses from our acquisition of Quantenna

Communications. The year-over-year decline in fourth quarter operating expenses was driven by aggressive expense control and zero bonus accrual.

Fourth quarter free cash flow was negative $21 million and operating cash flow was $92 million. Fourth quarter free cash flow and operating free cash flow were negatively impacted by one-time payment of approximately $175 million to Power Integration for previously disclosed settlement of intellectual property litigation. Capital expenditures during the fourth quarter were $112 million, which equate to a capital intensity of eight percent. Going forward, we anticipate that a sizeable part of capex will be spent on enabling our 300mm East Fishkill fab. We exited the fourth quarter of 2019 with cash and cash equivalents of $894 million, as compared to $929 million at the end of third quarter 2019.

At the end of the fourth quarter, days of inventory on hand were 123 days, down by 5 days as compared to 128 days in the third quarter of 2019. Distribution inventory increased slightly, but is within our comfort zone. The increase was driven by specific customer programs.

Now let me provide you an update on performance of our business units, starting with Power Solutions Group, or PSG. Revenue for PSG for the fourth quarter was $696 million. Revenue for Advanced Solutions Group, previously known as Analog Solutions Group, for the fourth quarter was $507 million, and revenue for our Intelligent Sensing Group was $199 million.

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

Keith Jackson

Thanks, Bernard.

I will start by reviewing our progress in 2019, and then touch on our objectives for 2020.

Despite the macroeconomic and geopolitical challenges faced by the semiconductor industry in 2019, our execution was solid, and we expect to outperform most of our peers in the analog and power semiconductor group. Our performance in 2019 clearly demonstrates the transforming nature of our business, and strength of our business model, and execution discipline. Our exposure to secular megatrends in automotive, industrial, and cloud-power end-markets has enabled us to outgrow most of our peers. Despite macroeconomic and geopolitical headwinds, key secular megatrends driving our business remain intact. Our content in the fastest growing applications in automotive, industrial, and cloud-power power applications continues to grow, and we continue to strengthen our leadership in key markets such as ADAS, power management for servers and 5G infrastructure, and high-power solutions for electric vehicles. We announced our plan to acquire our first 300mm fab, and we expect to start production of our power products at this facility soon. Also in 2019, we closed our acquisition of Quantenna Communications, and we are making solid progress toward launching connectivity solutions for Industrial IoT applications.

While we are pleased with our performance in 2019, we understand the need to take aggressive, substantial, and immediate measures to accelerate our progress towards our margin targets. As Bernard indicated earlier, we announced this morning that we are exploring sale of our six-inch fab in Belgium. We are looking for partners that are willing to enter into an arrangement on mutually beneficial terms that enable smooth and orderly transition for both parties. Our fab in Belgium is an attractive manufacturing asset with robust tool-set and highly skilled workforce. It is automotive qualified, and its close proximity to world's leading automotive innovation and manufacturing hub is a very compelling attribute.

We believe that our 300mm East Fishkill fab affords us significant flexibility in optimizing our front-end footprint, and we will continue to work to improve efficiency of our manufacturing network. Recall that in our third quarter 2019 earnings conference call, we announced that we had initiated the process of closing down our six-inch fab in Rochester, New York.

We are making strong progress towards ramping production at our 300mm fab in East Fishkill. At this point, we are tracking significantly ahead of schedule, and now we expect to begin initial production in middle of 2020, as compared to our previous expectation to begin in latter half of 2020. The results and yields of initial wafer runs have been spectacular. Based on our experience thus far with the East Fishkill fab, we are even more confident that transition of production to this fab will be a major inflection point for our manufacturing cost structure as we consolidate our front end-network. We will provide further details on the financial impact of our 300mm fab transition at our Strategic Business Update on August 18th in New York.

In addition to making structural changes to our operational cost structure, we have taken measures to optimize our operating expenses. As previously discussed, we took limited restructuring actions to streamline our investments in certain markets, and these actions are expected to result in annual savings of approximately $25 million. A reduction of approximately $25 million per year should accelerate our progress towards our target operating expense intensity of 21 percent.

Let me now comment on the current business environment.

We saw moderate improvement in our order rates in the fourth quarter and improvement has continued thus far in the current quarter. We believe that this improvement is driven by improving macroeconomic and geopolitical conditions, and normalization of supply chain inventories. Macroeconomic data from most geographies suggests improving GDP outlook and modest improvement in manufacturing activity. Data from China pointing towards relatively resilient manufacturing activity has been especially encouraging. Based on publicly available data and inputs from our partners, we believe that the current inventory levels are in-line with our near term demand outlook. While we are encouraged by near term trends, we are fully aware of risks emerging from ongoing coronavirus crisis, and we are diligently monitoring this rapidly evolving situation.

Despite the gyrations in macroeconomic and geopolitical environment, we remain focused on our key strategic markets. At the same time, we are taking substantial measures to make structural changes to our manufacturing footprint with the goal of expanding our margins and further improving our industry leading cost structure. We believe that automotive, industrial, and cloud-power will be fastest growing semiconductor end-markets for next five years. With highly differentiated portfolio of power, analog, sensor, and connectivity products, we are well positioned to outgrow the semiconductor industry as we grow our content in the fastest growing applications in our strategic markets. Furthermore, with improving operational efficiency, we expect to meaningfully expand our margins and grow our free cash flow.

Now I'll provide details of the progress in our various end-markets for fourth quarter of 2019.

Revenue for the **automotive** market in the fourth quarter was $462 million and represented 33 percent of our revenue in the fourth quarter. Fourth quarter automotive revenue declined three percent year-over-year. Although our automotive revenue declined year over year, we continue to see improving trends in the market with ongoing recovery in China.

Our momentum in ADAS and vehicle electrification continues to accelerate.

During the fourth quarter of 2019, we secured design wins for key platforms for ADAS and in-cabin viewing applications. Our design funnel for ADAS continues to expand at a robust pace. As we noted in our previous earnings call, we have won 16 of the 17 2-megapixel and 8-megapixel platforms awarded in 2019 for level-2 and level-3 vehicles.

Our LiDAR and radar products are gaining strong traction, and our design funnel for these products continues to expand at a rapid pace. We believe that we are enabling democratization of LiDAR with a solid-state solution, which is a fraction of cost of other existing solutions. Our low cost advantage is enabled by a CMOS based architecture as opposed to that based on exotic materials. Based on our design win pipeline, we expect to have leading share with top five global LiDAR module makers. In addition, customer feedback on our radar solutions has been very positive, and we have emerged as a key contender for upcoming round of design wins. Based on our engagement with leading radar tier-1 integrators, we expect to gain a very meaningful share in this market as next round of designs are announced.

On vehicle electrification front, our engagement for Silicon Carbide modules with major global automakers continues to grow. We are seeing strong ramp of our IGBT modules for drivetrain of electric vehicles in Asia and in Europe, and based on our design wins and backlog, we expect continuing acceleration in this ramp during 2020 and beyond.

We are beginning to see ramp in analog power management for ADAS processors. We are engaged with all leading processor providers for automotive ecosystem, and expect strong revenue contribution from this product line. We expect to see strong growth in our analog power management solutions for instrument clusters, in-vehicle networking, and advanced lighting.

Revenue in the first quarter of 2020 for the automotive end-market is expected to be up quarter-over-quarter.

The **Industrial** end-market, which includes military, aerospace, and medical, contributed revenue of $344 million in the fourth quarter. The Industrial end-market represented 25 percent of our revenue in the fourth quarter. Year-over-year, our fourth quarter industrial revenue declined 12 percent.

While macroeconomic data points to moderately improving manufacturing activity, we haven't seen significant improvement in order activity from our industrial customers. It appears that industrial customers are still in process of realigning their inventories. Despite soft end-market conditions, key secular trends driving our business remain intact. We are seeing strong traction for our Silicon Carbide modules, and we have commenced shipments of these modules to leading global industrial OEMs.

An emerging area of growth for our industrial business is e-commerce. We have built a strong design win pipeline for our CMOS image sensors for warehouse automation and delivery robots. We are engaged with the leading e-commerce retailers on many programs, and we expect strong contribution from this segment of the industrial market.

Revenue in the first quarter of 2020 for the industrial end-market is expected to be flat to down slightly quarter-over-quarter.

The **Communications** end-market, which includes both networking and wireless, contributed revenue of $289 million in the fourth quarter. The communications end-market represented 21 percent of our revenue in the fourth quarter. Fourth quarter communications revenue declined three percent year-over-year. The decline was primarily due to weakness in our smartphone related business. On quarter over quarter basis, we saw strong growth in our smartphone business in the fourth quarter, but 5G related business was weak as customers continue to realign their inventories.

Revenue in the first quarter of 2020 for the communications end-market is expected to be down quarter-over-quarter.

The **Computing** end-market contributed revenue of $153 million in the fourth quarter. The computing end-market represented 11 percent of our revenue in the fourth quarter. Fourth quarter computing revenue declined eight percent year-over-year.

We continue to see strong momentum in our server related computing business. On sequential basis, we saw growth in our client computing business driven by improved supply of Intel processors.

Revenue in the first quarter of 2020 for the computing end-market is expected to be down slightly quarter-over-quarter. We expect that strength in our server business should help mitigate the impact of normal seasonality.

The **Consumer** end-market contributed revenue of $153 million in the fourth quarter. The consumer end-market represented 11 percent of our revenue in the fourth quarter. Fourth quarter consumer revenue declined by 10 percent year-over-year. The year-over-year decline was due to continuing broad-based weakness in consumer electronics.

On quarter-over-quarter basis, revenue for consumer end-market was flat as compared to our expectation of a decline due to previously discussed unexpected demand for a low margin product line.

Revenue in the first quarter of 2020 for the consumer end-market is expected to be down quarter-over-quarter.

In summary, we are taking substantial actions to make structural changes to our cost model with the goal of accelerating our progress towards our target financial model. At the same time, we have accelerated the timeline for production ramp at our 300mm fab, as we now anticipate that initial production will start in the middle of 2020, as opposed to our prior expectation of second half of the year. Secular megatrends driving our business remain intact, and we are upbeat about our medium to long-term prospects. We are focused on the fastest growing end-markets of semiconductor industry, and with our design wins, we expect that our content in automotive, industrial, and cloud-power applications will continue to grow. Our performance in 2019 clearly demonstrates the transforming nature of our business, strength of our business model, and execution discipline.

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

Bernard Gutmann

Thank you, Keith.

Our guidance for the first quarter of 2020 does not include the impact from potential supply-chain disruption resulting from prevailing coronavirus crises. As we indicated earlier, we are diligently monitoring the situation, but at this time, we don’t have enough information on potential impact on our business from this rapidly evolving crisis.

Based on product booking trends, backlog levels, and estimated turn levels, we anticipate that total ON Semiconductor revenue is expected to be in range of $1,355 million to $1,405 million in first quarter of 2020.

For first quarter of 2020, we expect GAAP and non-GAAP gross margin between 33.7 percent to 34.7 percent. The quarter-over-quarter decline in first quarter gross margin is driven primarily by annual contract pricing reset.

We expect total GAAP operating expenses of $357 million to $377 million. Our GAAP operating expenses include amortization of intangibles, restructuring, asset impairments, and other charges, which are expected to be $30 million to $34 million. We expect total non-GAAP operating expenses of $327 million to $343 million in the first quarter. The anticipated quarter-over-quarter increase in GAAP and non-GAAP operating expenses is primarily driven by acceleration of process transfer activity at our 300mm fab, resumption of variable compensation accrual for 2020, and end of tactical expense control measures in fourth quarter of 2019.

We anticipate first quarter of 2020 GAAP net other income and expense, including interest expense, will be $38 million to $41 million, which includes non-cash interest expense of $9 million to $10 million. We anticipate our non-GAAP net other income and expense, including interest expense, will be $29 million to $31 million.

Net cash paid for income taxes in first quarter of 2020 is expected to be $14 million to $18 million. We expect total capital expenditures of $125 million to $145 million in first quarter of 2020. We are currently targeting an overwhelming proportion our capex for enabling our 300mm fab at an accelerated pace. We expect our capex intensity to subside in the latter half of the current year.

We also expect share based compensation of $19 million to $21 million in first quarter of 2020, of which approximately $2 million is expected to be in cost of goods sold, and the remaining amount is expected to be in operating expenses. This expense is included in our non-GAAP financial measures.

Our GAAP diluted share count for first quarter of 2020 is expected to be 418 million shares, and our non-GAAP diluted share count is expected to be 413 million shares, based on our current stock price. Further details on share count and earnings per share calculations are provided regularly in our quarterly and annual reports on Form 10-Q and Form 10-K, respectively.

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

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