Company Name: Qualcomm
Company Ticker: QCOM US
Date: 2018-04-25
Event Description: Q2 2018 Earnings Call

Market Cap: 73,760.46
Current PX: 49.75
YTD Change($): -14.27
YTD Change(%): -22.290

Bloomberg Estimates - EPS
Current Quarter: 0.758
Current Year: 3.357
Bloomberg Estimates - Sales
Current Quarter: 5444.882
Current Year: 22227.842

Q2 2018 Earnings Call

Company Participants

- John T. Sinnott
- Steven M. Mollenkopf
- George S. Davis
- Alexander Rogers
- Cristiano R. Amon

Other Participants

- Tal Liani
- Chris Caso
- T. Michael Walkley
- Amit Daryanani
- Timothy Patrick Long
- Stacy Aaron Rasgon
- James E. Faucette
- Ross C. Seymore
- Romit Jitendra Shah
- Timothy Arcuri
- Christopher Brett Danely
- Srini Pajjuri
- Brett Simpson

MANAGEMENT DISCUSSION SECTION

John T. Sinnott

GAAP and Non-GAAP Financial Measures

During the call today, we will use non-GAAP financial measures as defined in Regulation G and you can find the related reconciliations to GAAP on our website

Steven M. Mollenkopf

Q2 Highlights

Non-GAAP EPS

- Our fiscal second quarter results were strong with non-GAAP EPS 14% above the midpoint of our guidance range, driven by continued strong performance in QCT and cost management throughout the company, which was balanced by some headwinds from weaker industry conditions and litigation costs in QTL

Stockholders and Dividend Rate

- We returned approximately $1B to stockholders in the quarter, including $845mm of dividends paid and $200mm in stock repurchases
- We also announced a 9% increase to our quarterly dividend rate in the quarter, effective for dividends starting in the June quarter

Near-Term Headwind

- Looking ahead, we see some near-term headwinds, but our longer-term outlook is consistent with our FY2019 targets that we shared with you in January
- Our fiscal third quarter guidance reflects some softness in global 3G/4G device shipments, particularly in China, the impact of some changes we have made to our licensing framework, as well as the impact of increased litigation expenses in our licensing business

China

- QCT continues to execute well with strong performance in China and growth in adjacent areas, offset by some impact of lower modem shipments
- For calendar 2018, we are adjusting our growth estimate for global 3G/4G device shipments lower
  - However, handset selling prices continue to be stronger than expected, which continues to be a favorable trend

Snapdragon 845 Platform

- As we navigate the short-term industry weakness in QCT, we continue to execute well in that business and our market share remains strong
- The Snapdragon 845 platform, our latest premium tier offering, has achieved substantial commercial success with over 100 design wins already, including launched flagship devices by Samsung, Sony, ASUS and Xiaomi

Market Transition

- Our modem leadership continues
- We recently announced our X24 LTE modem, which is the world's first 2 gigabit 4G modem and the world's first announced 7 nanometer chip
- As the market transitions to 5G, the engineering challenges embedded in the 5G opportunity play directly to Qualcomm's strengths and the focused investment we have made over the last several years
- We are leading the industry to 5G and we are pleased to see the strength of our roadmap helping to enable the upcoming commercial launches of 5G networks and devices, including the 18 network operators and 20 manufacturers that have selected our X50 5G modem for trials and 5G devices

5G Module Solutions

- We also recently announced the world's first 5G module solutions, which include highly integrated turnkey 5G modules, including application processor, baseband, transceiver, memory, power management, RF front-end, antennas and other components that are designed to expand the ecosystem and accelerate 5G deployments

- Our products continue to be differentiated, driven by our unique systems-based approach to the complexities across wireless networks and devices
- We are delivering industry-leading technologies and performance, which translates into a more efficient use of spectrum for operators and a lower bill of materials for device makers, delivering attractive economics for our partners and higher device content share for us

Auto

- In auto, our backlog of awarded design wins has increased to $4B, as automakers and Tier 1 suppliers begin gearing up for 5G-enabled cars in 2021
- We continue to be the supplier of choice, given our decades of wireless technology leadership
- In infotainment, we have designs with 14 of the top 25 global automaker brands, including:
  - Audi
  - BYD
  - Geely
  - Honda
  - Jaguar Land Rover
  - PSA and Volkswagen

Networking

- In networking, we see favorable trends with continued share gains and growth in the Wi-Fi infrastructure opportunity across enterprise, retail and carriers
- And we launched the world's first draft 802.11ax carrier gateway, which started shipping in March in KDDI and NEC
- In summary, we are well positioned to grow in our adjacent opportunities of auto, IoT, networking and compute as we leverage our core competencies to gain share in these emerging areas

Global Framework

- In November 2017, we announced a global framework for licensing Qualcomm's standard essential patents at an effective rate of 3.25%, covering multimode devices inclusive of 5G Release 15 standards
- We also recently set the selling price cap for a handset at $400 for all licensees
  - This global rate is consistent with the SEP-only licensing program we successfully established in China since 2015, which has resulted in over 120 agreements for 3G and 4G devices
- We are now in negotiations for license extensions under the new program announced in November that include rights to our 5G patents and expect to conclude a number of agreements in Q3

Worldwide SEP-only Licensing Program

- The transparency of our worldwide SEP-only licensing program, including announced rates for 5G Release 15, facilitates the effort to conclude agreements and extensions in 2018 and early 2019, providing for a seamless transition for the launch of 5G devices in 2019

- Longer term, we believe this SEP-only licensing program enhances the stability of QTL with extended contract terms that incorporate 5G pricing
  - While execution of new agreements with existing handset licensees will create some near-term revenue impact in QTL, they are consistent with our assumptions that we set for FY2019 EPS targets

Strategy

- Looking ahead, we are focused on executing on our strategy to deliver our FY2019 EPS targets
- We have identified a number of specific strategic areas as part of that plan, and we will be updating you on our ongoing progress
- First, we continue to focus on closing the NXP transaction
- As we announced last week at the request of MOFCOM, we withdrew and refiled our application for Chinese regulatory approval
  - We also agreed with NXP to extend the purchase agreement to July 25
- While we continue to work closely with the Chinese regulators and remain optimistic about getting the necessary regulatory approvals there, it is clear that the geopolitical environment and trade actions are having an impact

Steven M. Mollenkopf

Q2 Highlights

Performance

- On the timelines we previously discussed and should converge toward multiple important milestones later this year
- In addition, our breach of contract case against Apple's contract manufacturers and our claim against Apple for interfering with those contracts is on schedule to be prepared for trial setting by the end of the year
- As the legal cases progress, we continue our direct engagement with Apple and prefer to ultimately reach a negotiated settlement
- Regarding our other dispute with a large licensee, we are in discussions toward a negotiated resolution and those discussions are very active

SG&A and R&D

- Third, we are progressing on our previously announced plans to reduce our spending by $1B
- We have made good progress on this commitment, taking steps to reduce spending across SG&A and R&D
  - We are also focused on spending reductions in our noncore product areas

Investments

- Fourth, we are executing our product roadmap and continue to make the investments necessary to maintain our technology and product leadership, lead the industry to 5G and grow our adjacent areas across the RF front end, automotive, IoT, networking and mobile compute

Stockholders

- In closing, we are pleased to report strong results this quarter and we remain 100% focused on delivering on our FY2019 commitments and creating that value for stockholders
- We look forward to continuing to update you on our progress

George S. Davis

Q2 Highlights

Revenue and Non-GAAP EPS

- Our fiscal second quarter results were above the midpoint of our guidance with revenues of $5.3B and non-GAAP EPS of $0.80 per share, $0.10 above the midpoint of our guidance
- The non-GAAP EPS outperformance in the quarter was driven by higher MSM shipments, improved gross margins in QCT, a more favorable tax rate from lower domestic vs. foreign earnings and lower operating expenses

QCT

- In QCT, MSM chip shipments were $187mm, towards the high end of our guidance range
- QCT revenues were $3.9B, in line with expectations
- As we expected, QCT results this quarter reflected the normal seasonal effects of lower demand, typical in the calendar first quarter, a reduction in orders sequentially from a large modem customer and reduced demand from customers in China as they reduced inventory balances
- As a result, we saw handset inventory balances in China come down in line with long term trends
  - While we remain conservative on demand for H2, we think the lower level of inventory is a very healthy development

EBT Margin

- QCT's earnings before tax was up 28% y-over-y, the eighth consecutive quarter of y-over-y growth
- QCT EBT margin was 16%, above the high end of our guidance range, reflecting stronger than expected gross margins in mobile, primarily in product cost benefits, including some discrete benefits related to conclusion of negotiations with a supplier

3G/4G Units

- QTL fiscal second quarter revenues were $1.26B, slightly above the midpoint of guidance and included a modestly higher amount of out of period catch-up that we anticipated offset by lower than expected 3G/4G units reported by licensees for the December quarter, particularly in the emerging regions

Apple's Products

- Note that these results exclude royalty revenues on Apple's products and the other licensee in dispute
- It is also worth noting that in the December quarter we continue to see strong y-over-y trends in global 3G/4G handset ASPs across various price levels

Litigation Matters

- We are seeing significantly higher run rate spending this year driven by litigation matters related to Apple and the FTC
- In the second fiscal quarter, we spent approximately $125mm on these cases and expect that to ramp further in Q3
- Spending is somewhat more heavily weighted in H2 our FY, in line with broad-based discovery activities and the timing of IP cases globally
  - We will provide information on our OpEx, both with and without excess litigation, so that the underlying cost structure changes are more visible

Expenses

- QTL earnings before tax was $850mm, or 67% of revenues, above the midpoint of expectations or 78% if you adjust for extraordinary litigation expense
- For Qualcomm overall, non-GAAP combined R&D and SG&A expenses decreased approximately 2% sequentially or down 4% if you adjust for extraordinary litigation expense

Cost Plan

- We began implementing our $1B cost plan that will accelerate in the latter part of the year
- In Q2 we booked restructuring and related charges under the cost plan of $310mm or $0.18 per share
  - These items were excluded from non-GAAP results
- It is important to note that these initiatives will not impact our strong investment in 5G and our commitment to grow in mobile, RFFE, IoT, automotive, networking and mobile compute

Non-GAAP Effective Tax Rate

- Our non-GAAP effective tax rate during the fiscal second quarter was 4%, favorable relative to our prior guidance due to the catch-up associated with a lower estimated annual effective tax rate on lower domestic vs. foreign earnings mix
- We ended the quarter with cash and marketable securities of $39.6B or $16.5B net of outstanding debt

Guidance

Revenue and Non-GAAP EPS

- Turning to our financial guidance for the fiscal third quarter
- We estimate revenues to be in the range of approximately $4.8B to $5.6B and non-GAAP EPS to be in the range of approximately $0.65 to $0.75 per share
- Our guidance incorporates a relatively balanced mix of positive and negative factors in the quarter with tax benefits related to potential restructuring opportunities under tax reform offsetting the impacts of initial plan changes in our licensing program, higher litigation costs in the quarter and approximately $0.03 of expected ZTE order effects across the company

QTL

- In QTL, we are expecting QTL fiscal third quarter revenues of approximately $950mm at the midpoint, down sequentially approximately $300mm
- This outlook reflects three primary issues
  - First, about half of the sequential decline reflects the combined impact of a seasonably low quarter along with generally weak industry conditions along with approximately $40mm in higher onetime catch-up payments in Q2 relative to our outlook for Q3
  - Second, we have begun to recognize this quarter the impact related to the recent amendments to our Samsung licensing agreement, including the effects of the expanded cross-license agreement
  - And third, we are seeing the initial run rate impact of the licensing SEP-only framework including 5G that Steve described earlier
- Slightly less than half of the sequential impact on revenue is from the changes to the Samsung agreement and other licensing program terms

Net Selling Price

- I should note that we have also implemented a voluntary revised cap in which the maximum net selling price of a handset on which the royalty is based will be capped at $400 per device, down from $500 per device
- This will be broadly implemented in fiscal Q4 and we do not expect a material impact overall

QTL EBT Margin

- We expect QTL EBT margin to be approximately 50% to 54% in the fiscal third quarter, down sequentially at the midpoint on lower revenues and increased litigation cost
- Without the extraordinary litigation expenses, QTL EBT margin expectations would be approximately 65% to 69%

QCT

- Turning to QCT, we anticipate MSM shipments of approximately 185mm to 205mm units during the June quarter, higher sequentially at the midpoint on increased demand in China as inventory improved in the last two months of the fiscal second quarter
- We expect QCT’s fiscal third quarter EBT margin to be approximately 13% to 15%, down sequentially, primarily due to seasonally weaker product mix including lower thin modem shipments and the absence of the discrete product cost benefit in Q2

R&D and SG&A Expenses

- We expect fiscal third quarter non-GAAP combined R&D and SG&A expenses will be roughly flat to up approximately 2% sequentially, primarily due to increased litigation expenses as we continue to defend our business model, somewhat mitigated by the impacts of our cost efforts
- Excluding the elevated litigation costs, we estimate that our non-GAAP combined R&D and SG&A expenses would otherwise be down approximately 1%
- Non-GAAP interest expense net of investment income in the fiscal third quarter is expected to be roughly flat sequentially

Tax Legislation

- Turning to tax matters
- As a result of the recent tax legislation enacted in the U.S., we anticipate implementing certain restructuring options that will reduce our current year tax rate and have been factored into our fiscal third quarter guidance
- As a result, we expect our non-GAAP effective tax rate for the fiscal third quarter to be a benefit of approximately 20% to 25%, which we expect to provide a benefit to non-GAAP EPS of $0.10 to $0.15 per share

3G/4G Device Shipment

- Regarding our 3G/4G device shipment forecast, we are updating our unit estimates for CY global device shipments for both 2017 and 2018
- For CY2017, we now estimate approximately 1.755B global 3G/4G devices shipped, up approximately 3% y-over-y at the low end of our prior estimates, primarily due to lengthening replacement rates in North America and China in the fourth calendar quarter

CY2018

- For CY2018, we now estimate approximately 1.8B to 1.9B global 3G/4G device shipments or growth of approximately 5% y-over-y
- This is lower from our prior estimate by 50mm units at the midpoint, reflecting a lower 2017 base as well as reduced demand expected in China
- Within this population, handset growth is expected to be approximately 3% y-over-y

Global 3G/4G Device Sales

- With respect to global 3G/4G device sales for FY2018, we now expect growth of approximately 10% y-over-y at the midpoint, as the reduction in our estimate of global 3G/4G units in the year is expected to be more than offset by strength in ASPs
- Within this population, 3G/4G global handset sales are expected to grow at similar percentage in FY2018, driven primarily by strength in handset ASPs y-over-y

Cost Plan

- I will provide some additional color on our committed 2019 targets

- As I noted earlier, we are making good progress on the $1B cost plan
- This is a critical element of our $5.25 non-GAAP EPS target, along with closing NXP, or alternatively moving ahead with our option to repurchase stock

Licensing Business

- For our licensing business, the 5G royalty rates, the reduced NSP cap and the effects of the amended long-term Samsung license agreement were all factored into our FY2019 guidance
- Taking into consideration these items and the expectation of continued growth in global 3G/4G handset sales in FY2019, we expect QTL quarterly revenues in the near and medium term to be in the range of $1B to $1.1B on average, excluding the royalties from Apple's products and the other licensee in dispute
- Of course, the amount in any one quarter will be subject to seasonal fluctuations, OEM mix, out-of-period catch-up amounts and continued progress on the licensing and compliance front, among other factors

QCT

- In QCT, we expect that FY2019 performance will benefit from continued handset growth, particularly in emerging regions, continued strength in our China share in the mid, high and premium tiers, and growth in adjacent opportunities, including automotive, IoT, networking and mobile compute

QUESTION AND ANSWER SECTION

<Q - Tal Liani>: Well, good. Can you repeat the reasons for the weak QTL guidance for next quarter? And how does it change going forward, especially what happens with Release 15 licensing? What I didn't understand is so far – and maybe it's just my understanding – so far your license covered all the patents and clients had to pay regardless of what patent you're using. Does it mean that LTE licensing is separate? And is the royalty rate for LTE licensing different, lower than the general licensing rate?

<A - George S. Davis>: So, what I'll do – Tal, this is George – I'll cover the questions on the bridge, and then maybe Alex can talk a little bit about the structure of the SEP-only program.

So if you look at the sequential bridge, we said that it's down about $300mm. Some of that is the normal seasonal drop-off that we get, because this – remember, we're reporting on a lag, so this is calendar Q1 activities. This is where we saw the significant pullback in demand across four devices in general. So, we have a weak market. We also have the pullback that's just natural with Q1. The other piece is we also had some higher onetime amounts in Q2 than we're reporting Q3. So, that's about a little more than half of the $300mm.

The other half is the changes that we talked about, reflecting both the amendment to the Samsung agreement, which among other things includes the cross-license rights that are quite extensive, and the changes that we anticipate to see in the quarter to contracts for licensees that will take an SEP-only license, which has a number of favorable characteristics that I'm sure Alex will cover.

<A - Alexander Rogers>: So, this is Alex, picking up where George left off. Just a little bit of context, I think, is helpful. Since 2015, we established a very successful licensing program in China for SEP licenses for 3G and 4G through Release 11 at a set of rates that came out of the resolution of the China matter. And what we've done and what we announced in November of 2017 is that we were extending that set of rates to a worldwide program for SEP-only licensing for 3G and 4G through the remaining releases also to include the first release of 5G, where the standard, the specification was finalized in December of last year.

That is our SEP-only licensing program going forward. Of course, we still have a portfolio-wide licensing program at the standard rate of 5%, but we expect on a go-forward basis that there will be a number of licensees who are interested in extensions and renewals who may want to have SEP-only license agreements. And of course, we'll negotiate those sorts of agreements, and we expect that there will be a few of those agreements being reached even in this quarter.

So, the program is rooted in a very successful program that came out of China with over 120 license agreements. We expect this program to be successful and to facilitate a very good transition to 5G in H2 2019. We expect there will be a number of licensees who want to maintain portfolio-wide agreements worldwide, but there will also be licensees who want to have SEP-only agreements on a worldwide basis. And that is, of course, something that we can accommodate on a case-by-case basis.

<Q - Tal Liani>: And I apologize if it sounds stupid, but would you mind to discuss what does it mean SEP-only?

<A - Alexander Rogers>: No problem. Standard essential patents, so our standard essential patents that have been declared for 3G/4G, and the first 5G standard. Those patents as distinguished from nonessential patents, implementation patents, other patents that are relevant to other standards other than cellular standards. So when we refer to SEPs, we're referring generally to cellular standard essential patents for the technology generations that we all understand to be 3G, 4G, and 5G.

<Q - Chris Caso>: Just to follow up on the previous discussion a little bit, with regard to the FY2019 guidance, you talked about that this new licensing scheme was included in that. Could you walk us through a bit of how you get to that FY2019 EPS guidance, what are the puts and takes there and how this new licensing scheme falls into that as well?

<A - George S. Davis>: Yeah. This is George, Chris. The $5.25 base, as we said, included approximately $1.50 from NXP accretion. It included the benefit of $1B in the year of OpEx reduction and then it had the underlying run rate of the business absent the Apple license payments, new Apple business that we presume would be held up as part of the process of the litigation. And so we said to help people model, we indicated in my script that for modeling the levels of licensing revenue excluding Apple and the other licensee, you can plan on, on average between $1B and $1.1B per quarter.

Obviously that can fluctuate a little bit depending on some of the onetime items that show up or the strength of the market overall changing. We think that's a reasonable number. The balance of that, then, is going to be driven by fundamentally the performance of the QCT mobile business and the adjacent businesses as part of that. And I think the $5.25 is consistent with the basic position we have in QCT today and continued growth in the adjacents.

<Q - T. Michael Walkley>: Just for the $5.25 in guidance for that out year, can you walk us through maybe what you expect for QCT in terms of margin targets that you expect to hit as the cost reductions come out of the business model implied in that guidance? And then also for the $5.25, what is management's plans should China continue to block NXP? When do you finally just pull the plug and is the buyback really the best thing to do with that cash to get to that $5.25? Thank you.

<A - George S. Davis>: Yeah. We haven't put out margin targets for QCT. Obviously we've said that we expect to get to our long-term margin target of greater than 20% over time, and certainly you would expect to see that as part of the kind of recovery case that the $6.75 to $7.50 envisions where we start to get some product business back that was taken away and also probably additional RF front end business is part of that. So I think overall, the $5.25 is really just a continuation for QCT of their current position strength in China, strength in the premium tier, which has been a positive relative to what we've seen with the fall-off in the thin modem business and then growth in the adjacents.

<A - Steven M. Mollenkopf>: Mike, this is Steve. Maybe on your question related to NXP, there was probably a point in there, as I understand in the audio where people couldn't hear my comments related to NXP, but in short what I said was that we continue to work closely with China. The environment is obviously quite difficult from a geopolitical point of view, at least right now. However, we expect to ultimately receive approval and I'd just remind folks that we have eight of nine jurisdictions that have already ruled on it.

So although we remain committed to it and we think it's going to get done. However if it does not get done, as you mentioned, we think we have the ability to move very rapidly on a buyback as we communicated earlier in the January timeframe. I'll just remind everyone that we did a 90-day extension to the merger agreement and we're going to work very hard to get that done. And if it doesn't get done, we're going to move onto another approach. So hopefully that answers the question.

<Q - Amit Daryanani>: I guess, Steve, maybe just to follow up on the line you had earlier, is July 25 sort of the drop dead deadline where if this is not done by then, you will move to plan B, i.e. buybacks or would you just extend the merger agreement further? And then any sense on what the MOFCOM issues are or what remedies they want above and beyond which you agreed to in other jurisdictions?

<A - Steven M. Mollenkopf>: Well, I would say, Amit, with respect to the agreement, yes, we have just extended it by 90 days. So I think both companies are moving toward that timeline and we certainly have other ability and avenues to drive value and that's how we're thinking about the issue. Of course things can always change as we move through the process but that's the way that it's set up right now.

With respect to MOFCOM and remedies, our evaluation of the environment is such that, really, I think the issue is probably more related to the higher level discussions between the countries as opposed to any individual issue related to MOFCOM. Of course, we continue to work with the regulators and work through any issues that pop up, but I think the environmental issues between the countries are probably more the situation today than anything else but obviously we work closely with the regulator.

<Q - Timothy Patrick Long>: Just wanted to closeout one more on the QTL part and then a question on the QCT piece. So, Alex, I just wanted make sure I understand this. So the impact of the SEP-only and 5G licenses that's hitting revenues, is that because those deals will have a lower rate structure? Or is it because there's some kind of onetime impact of nonpayment as those deals are being negotiated?

And then on the QCT side, units are holding up very well. I think you mentioned some ZTE hit in the quarter. You mentioned inventory reductions but it's a pretty weak market in China. And I guess we got a new set of iPhones coming out, and you guys have intimated that you potentially could do a little bit worse there or you're at least planning that you might not have as much share in that win. So could you just maybe is this predominantly market share that you think is keeping your numbers better I'd say than the end market for the last few quarters? That would be helpful. Thank you.

<A - George S. Davis>: Hey, Tim. This is George. Maybe I'll take the point on what is the impact that we're seeing from these changes. Again, what we said is a little less than half of the $300mm is related to what I would call the run rate changes associated with the amendments to the Samsung agreement that we announced last quarter and also the SEP-only expected impacts that we expect to be in the run rate this quarter. So it would be effectively a lower effective rate for those licensees than if they had had a portfolio license prior to that time.

<A - Alexander Rogers>: This is Alex. What I think it's important to note that again, some licensees may choose to have an SEP-only agreement, including the 5G IP rights going forward. And they may choose to expand on that basis. But others will prefer a portfolio-wide agreement for obvious reasons. They enjoy the benefits of the entire portfolio and protected under the entire portfolio. And these are going to be determined on a case-by-case basis as we get into these negotiations, but we do believe that some licensees will choose SEP-only on a worldwide basis.

<A - George S. Davis>: Hey, Tim. Let me add one more thing I think before Cristiano comes in on some of the demand things, the demand environment for QCT. As I look at Q3, one of the difficult stories is because we're seeing some, this is the quarter where QCT is seeing some of the weakness in reports that we talked about because they report a month lag, so those are the weakness that QCT saw in Q2 but is seeing recovery in Q3.

But we continue to see an underlying growth in the licensing markets when you look at units and ASPs. If we just looked back to Q3 2017 and we looked at the market as for the licensees that are paying today, and we look at today the market has grown to the point where essentially the cost of these changes in the program on a run-rate basis is being covered by the growth in the market because of the strength of both units and in particular ASPs. Cristiano, did you want to?

<A - Cristiano R. Amon>: Yes. Hi, Tim. So on QCT, it's exactly a simple story. Q2 has been a great quarter for us, particularly if you look compared to our y-over-y. I think we saw continued strength in our portfolio. As we look forward, and that's I think George said that we still take a conservative approach. However, we do see that the inventory levels came down back to normal in China.

So it's a story that we look at the units, we still think there is overall the drivers of our strength in China business continue. I think we see an improvement of mix. We see an improvement of handset ASPs. We have some interesting transitions ahead of us, such as China Mobile recently got a license for FDD. We have 5G coming in 2019. So I think the story is good. We're just dealing with how we think about the overall industry is in H2, and we have seen a decline in thin modems, probably consistent with everybody else in the industry.

<Q - Stacy Aaron Rasgon>: I just want to make sure I have this straight. So basically, you're folding 5G now into the licensing model and you're getting paid less for it and you're talking about it like it's a good thing. Why is this a good thing? Is this being proactive to halt the spread of other disputes? Or like what's the driving force behind doing this?

<A - Alexander Rogers>: Stacy, this is Alex. We are including 5G in the SEP-only licensing model. We're not getting paid less for it. I think the best way to think about this is building a foundation for long-term stability in QTL. The current program that we've announced for SEPs that we announced back in November has tremendous consistency with the program that we successfully established in China coming out of the China investigation. We actually now have over 150 SEP-only licensees through the 3G and 4G program there.

And in addition, with the announcement in November ahead of the adoption of the first release of 5G, we have tremendous transparency for the program going forward. And so, what we've done is we purposely built the program to facilitate a transition to 5G in a way that successfully enables us to bring on new licensees and extend their agreements for longer terms. And so, this creates tremendous stability. Now, we do expect that a number of licensees will want to have portfolio-wide licenses, and so there's going to be a mix. But the effect of all of this has been considered in our FY2019 numbers. So, we've looked at this and purposely built this program for stability long term.

<Q - James E. Faucette>: I wanted to, I guess, follow up on that question or at least as it pertains to the unnamed licensee. I guess with the new structure, how should we expect the impact to compliance and ability to assure compliance, firstly?

And secondly, I guess I'm wondering a little bit why anybody would offer a portfolio-wide license, especially when from the time that you introduced the standard essential patent licensing program in China, you had indicated that negotiations around nonessential IP would be done separately. But I don't think we've really seen any movement there. So, it seems like you're moving towards a standard essential patent-only licensing program, and I'm wondering how we should expect you to be able to collect on nonessential IP and how this may impact bringing the non-complying unnamed licensee into compliance. Thank you.

<A - Alexander Rogers>: So with respect to the unnamed licensee, having a consistent program that's widely adopted is very good thing from a comp perspective. So, it actually creates an environment that enables us to essentially engage in the ongoing negotiations with that licensee from a position of strength, essentially saying that this is a widely adopted program. So, that unnamed licensee is an outlier.

In terms of SEP-only in the rest of the portfolio, there are a number of licensees that still have portfolio-wide agreements and will continue with those portfolio-wide agreements. And we expect that to happen. As I said, it will be a mix. The rest of the portfolio is still valuable. It's a very large portfolio, as you know, 130 patents and pending applications.

<A - George S. Davis>: 130,000.

<A - Alexander Rogers>: 130,000 patents and pending applications. And the value and strength of that portfolio, I think, is demonstrated in the assertions that we've had when we've had to have them, including against a company in China that signed up to a license and the assertions that we're making now in our litigation where over 40 nonessential – excuse me, over 50 nonessential patents are being asserted. So, the rest of the portfolio is still valuable and licensees will still want to have portfolio-wide protection. In fact, we have many portfolio-wide agreements that will continue. It will be a mix.

<Q - Ross C. Seymore>: Just one question and one follow-up. So, I guess, two questions here. Just to wrap up the QTL side of things, embedded in the $5.25 base and then the road towards $7, et cetera, in your 2019 goal, do you believe that the implied royalty rate that we had before of roughly 2.9% will be higher or lower given all the moving parts that you've described on today's call?

And then the second question more for George, specifically, on the OpEx cuts and the $1B number, can you talk a little bit about the linearity of that, when are we going to start to see some of those absolute dollars come out? And how important is that litigation that's currently elevated, going back to some normalized level, how important is that in getting to the $1B annualized savings? Thank you.

<A - George S. Davis>: Yeah. Hi, Ross. This is George. So on the implied royalty rate, obviously, there's a lot of moving parts when you have two major licensees, one of which is reporting, one of which is not reporting. So it's really not a very meaningful number, which is why we have stopped guiding total reported device sales and some of these other items.

We think the rates that are embedded in the SEP-only licenses are fully consistent, as we said, in the run rate that we had factored into the FY2019 numbers. As you remember, we actually announced the 5G program in last November. Also, if you applied them to the volumes, these same standards to the volumes of the non-paying licensees, you would very easily get to our $6.75 to $7.50 range. So, I think that's a key point.

And with respect to litigation normalization, the cost reduction program expects to take out $1B in the run rate without relying on a change in the litigation run rate of the company. I would describe that as a peace dividend that would flow through post the resolution of the litigation matters.

<Q - Romit Jitendra Shah>: I had two questions. One, George, just the litigation costs rising a little bit in June. Should we assume this level for litigation for the foreseeable future? That's the first question.

The second question, I just wanted to ask about just the smartphone market overall and unit growth. You guys mentioned in your monologue that replacement rates are going out. When we saw this happen with PCs, unit growth actually went negative and today we're seeing weakness in smartphones that for the most part seems fairly broad-based. And I guess my question is what makes you confident that this weakness we're seeing is just temporary and that the market overall can grow from here? Thank you.

<A - George S. Davis>: So on the litigation pattern, where we're in a period during this quarter, Q3, where we have very, very significant discovery processes and active preparation for multiple cases. So I would like to believe that this represents kind of a high water mark, but of course it's very important that we get this right. So we're going to spend what we need to spend as we see necessary to protect our licensing program. But I would say H2 is going to be heavier in the FY2018 than H1, but we're kind of at a level now where we're supporting a lot of activity on multiple fronts. So I don't expect it to be significantly higher on a run-rate basis, but it could be sustained at this level for a little period of time.

In terms of the handset market and units, what you're really seeing is the impact of replacement rates has really slowed growth. In the developed markets you're getting a little bit of growth in Europe. But the emerging markets continue to be a positive source of growth, and in particular in India, in Southeast Asia, in Middle East, Africa, we're continuing to still see healthy mid to high, well you've seen double-digit growth in India and mid to high single digit growth in some of these other areas. So I think that remains a positive.

Also we think in 2019, you're starting to see the first 5G phones come into the marketplace, and as you go in 2019 and into 2020, you could start to see a replacement cycle just really driven by people wanting to take advantage of the capabilities that 5G brings.

<Q - Timothy Arcuri>: George, I actually had two questions. The first is I'm wondering how you handicapped for the FY2019 guidance, how you handicapped the potential for the trade issues to broaden. Obviously, there's news now that

Huawei's being looked at as well. So I'm wondering how you handicap that in your guidance, number one. And then number two, the guidance for the June quarter. If I read your comments right, are you basically saying that the normalized earnings guidance, if you assume that 8% tax rate that you had said previously, would be like $0.50? Thanks.

<A - George S. Davis>: Tim, so on the first, obviously the trade talks are current, and it's very hard to forecast. Those were not part of our thinking, and we've seen even in China some pretty big swings in demand intra-quarter. So there's always going to be market fluctuations, but we think the fundamentals, if we think about the licensing business, the fundamentals, particularly on ASPs, are a real tailwind for that business going into 2019. We also like the growth that we're seeing in our adjacent businesses and we like our position overall in China. But we'll have to see. The trade issues are an intangible. We'll have to see how that plays out.

In terms of the June quarter, what I would say is if you back out simply the tax items, which to me are really fundamentally offsetting what is a weaker market. Also clearly ZTE is coming out of there. We have the absence of some onetime items that were in our Q2 that are not in Q3. So I think it would be wrong to draw a line to $0.50, which is what I think your question was.

<Q - Christopher Brett Danely>: Just a question on plan B if NXP does not happen. Could you give us any color on what the potential size and timing of a buyback would be? And then if this does not go through, does this necessarily sort of end any M&A potential for you guys? Or would you look at doing something else?

<A - George S. Davis>: So on plan B, it would be a large, very large program. It would be in the $20B to $30B range. Obviously, at these prices we think the stock price is quite attractive. We don't think M&A would necessarily be closed off to the company. We think these are pretty unusual circumstances that we're seeing today. So we will continue to look at opportunities to add to the portfolio over time. We will generate the kind of cash flow that will allow us to consider other options down the road.

<Q - Srini Pajjuri>: I just have a clarification. I guess, Alex, can you talk about where we are in the SEP-only transition in terms of how long will it take? And then I guess the real question is you're guiding for $950mm in QTL revenue for Q2 or the next quarter. And then you also said that that run rate will come back to $1B to $1.1B. So I'm just trying to understand what will drive that incremental growth.

<A - George S. Davis>: So this is George. Maybe I'll take the second question first and then Alex can jump in. So remember that our Q3 is the very weak calendar Q1 quarter for QTL, so you're seeing some seasonal elements there. That being said, we believe in addition to some of the other moving parts that I talked about, not to mention just the general, the broader market weakness and the seasonal elements, the lower out-of-period, you factor all of those elements in and also we're continuing to see very strong ASPs and ASP growth in the marketplace. That all moves you towards the $1B to $1.1B number.

<A - Alexander Rogers>: And then with respect to the first part of the question, the chronology is that in November when we announced the 5G program, the SEP program including 5G release 2015, we're anticipating devices coming to market in H2 2019, so we've got close to a two-year window. And there are a number of agreements that will extend through this entire timeframe. Those agreements, there are a number of agreements that will simply remain in place but there are other agreements that will come up for extensions and renewals.

And so the timing of the announcement was to essentially provide transparency before the release, the specification was adopted but also to facilitate a transition to negotiating these agreements, these extensions and renewals during this current timeframe. And we expect that to happen with significant pace. So we do expect a number of agreements to be reached or renewals and extensions to be reached even in this quarter and in the following quarters, both on an SEP-only basis but also on a portfolio-wide basis.

<Q - Brett Simpson>: I have a question for Alex and a follow-up for Cristiano. Alex, I just wanted to talk about the non-SEP part of the portfolio. So you said there was a transition where you'll be offering SEP-only licenses. Can you talk about the nonstandard essential portfolio and how you plan to monetize the patents here from a licensing perspective? What royalty rates do you think can be achieved here and how many deals have you signed already for non-SEP only deals thus far?

<A - Alexander Rogers>: So the history of the licensing business is that most licensees have wanted full portfolio agreements. It's the most efficient and most cost efficient way to take a license to this portfolio. And so the commercialization of the non-SEPs has always been in the context of full portfolio agreements. It is very rare that a company asks us for a separate license to non-SEPs only. So typically a company will want a full portfolio agreement if they want full protection. Again, that has happened historically the majority of the time. We don't have a separate distinct program at this point in time for non-SEPs.

Again, our primary commercial objective is to license the full portfolio, but we do have a number of aspects of the portfolio, for example, in multimedia, in position location and then other areas where if we decide to do it, we can license them on a disaggregated basis, But that's really all that I can say about that at this point.

<Q - Brett Simpson>: And so you have not licensed any company who have taken SEP only. There's a whole raft of nonessential patents that you have not licensed to these companies that are taking SEP-only deals. Is there a plan to monetize that out with doing platform deals, trading up to a platform deal so to speak?

<A - Alexander Rogers>: Again, I'll go back to what I said before. I apologize if it wasn't clear, but the licensees have typically wanted, overwhelmingly wanted, full portfolio agreements. SEP-only licensing has been primarily a function of the program that we laid out in China and very successfully established in China since 2015. And we do expect that on a go-forward basis, even though we've offered SEP-only in the past, on a go forward basis there will be more companies that want SEP-only to include 5G. But the primary commercialization of the rest of the portfolio will be in the context of full portfolio licensing.