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Risk Factors

The semiconductor industry is highly cyclical, and periodic downturns in the semiconductor industry affect our business and results of operations.

The semiconductor industry is highly cyclical and has been subject to significant economic downturns at various times. Downturns are typically characterized by production overcapacity, accelerated erosion of average selling prices, high inventory levels, diminished demand and reduced revenues. Downturns may be the result of industry-specific factors such as excess capacity, product obsolescence, price erosion, evolving standards, changes in end-customer demand, and/or macroeconomic trends impacting the economies of one or more of the world’s major regions: Asia, United States, Europe and Japan.

According to published industry data, worldwide sales of semiconductor products, while generally increasing over the long term, have fluctuated significantly on a yearly basis over the past several years. According to trade association data, sales increased in 1995, 1997, 1999, 2000, 2003 and 2004, but decreased in 1996, 1998 and 2001. For 2000, 2003 and 2004, the increase was approximately 37%, 18% and 28%, respectively, while it decreased by approximately 32% in 2001.

In certain years, the increase in the sale of semiconductor products is driven primarily by an increase in the number of units sold, while industry overcapacity and excess supply over demand worldwide have continued to exercise a downward pressure on average selling prices. In 2004, the market increase was driven by the strong demand particularly in the first half of the year and also by an average selling price increase.

We have experienced revenue volatility and market downturns in the past and may experience them in the future. For example, we expect year-over-year semiconductor revenue growth will substantially decrease in 2005.

Downturns in the semiconductor industry, reduction in demand for end products which incorporate the semiconductor products we supply, or increased competition driven by overcapacity exercising a downward pressure on prices, have in the past, and could in the future, have a significant adverse impact on our results of operations.

Increases in production capacity for semiconductor products may lead to overcapacity, which in turn may lead to plant closures, asset impairments, restructuring charges and inventory write-offs.

Capital investments for semiconductor manufacturing equipment are made both by integrated semiconductor companies like us and by specialist semiconductor foundry companies, which are subcontractors that manufacture semiconductors designed by others.

According to data published by IC Insights Inc. and other industry sources, investments in worldwide semiconductor fabrication capacity totaled approximately $61 billion in 2000, $38 billion in 2001, $27 billion in 2002, $30 billion in 2003, and an estimated $45 billion in 2004, or approximately 30%, 27%, 19%, 18% and an estimated 21%, respectively, of the total available market for such years. The net increase of manufacturing capacity, defined as the difference between capacity additions and capacity reductions pursuant to closures, may exceed demand requirements, leading to over-supply situations, price erosion, and industry downturns. Overcapacity has led us, in recent years, to close manufacturing facilities that used more mature process technologies. In 2001, we closed our 150mm wafer manufacturing facility in Ottawa. In 2002, we closed our 150mm wafer manufacturing facility in Rancho Bernardo, California, and in 2004, we closed our 150mm wafer manufacturing facility in Rennes, France and our back-end facility in Tuas, Singapore. Pursuant to these closures and as a result of some of our more mature fabrication facility capacity being only partially used, we recorded in 2001 a total tangible asset impairment of $200 million, additional charges of approximately $97 million relating to the impairment of purchased technologies, $22 million related to certain investments and approximately $27 million related to restructuring charges. In 2002, we recorded impairment, restructuring charges and related closure costs of $34 million. In 2003, we recorded impairment, restructuring charges and other related closure costs of $205 million in connection with the plan announced in October 2003 to increase our cost competitiveness by restructuring our 150mm fab operations and part of our back-end operations. In 2004, the amount of restructuring charges and other related closure pre-tax costs amounted to $76 million. See “Item 5. Operating and Financial Review and Prospects—Impairment Restructuring Changes and Other Related Closure Costs”.

Through the period ended December 31, 2004, we have incurred $281 million of the announced approximate $350 million in pre-tax charges associated with the restructuring plan that was defined on October 22, 2003, and which is now expected to be completed by mid-2006.

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In 2005, we decided and announced plans to reduce our Access technology programs for customer premises equipment (“CPE”) modem products. This decision made in 2005 could result in potential impairment charges of approximately $60 million in the first quarter of 2005 for intangible assets and goodwill related to the CPE product lines and certain additional restructuring charges to be further estimated.

No assurances can be given that future changes in the market demand for our products, overcapacity, obsolescence in our manufacturing facilities, and market downturns may not require us to test for and record additional impairment and restructuring charges, which may have a material adverse effect on our business, financial condition and results of operations.

Competition in the semiconductor industry is intense, and we may not be able to compete successfully if our product design technologies, process technologies and products do not meet market requirements.

We compete on the basis of a variety of factors, and our success depends on our ability to compete successfully in all of the relevant areas. We compete in different product lines to various degrees on the following basis:

- price
- technical performance
- product features
- product system compatibility
- product design and technology
- product availability
- manufacturing yields
- sales and technical support

Competition in the semiconductor industry as a whole is intense, and if our products are not selected based on any of these factors, our business, financial condition and results of operations would be materially adversely affected.

We also face significant competition in each of our product lines. Like us, many of our competitors offer a large variety of products. Some of our competitors may have greater financial and/or more focused research and development resources than we do. If these competitors substantially increase the resources they devote to developing and marketing products which compete with ours, we may not be able to compete effectively. Any consolidation among our competitors could enhance their product offerings, manufacturing efficiency and financial resources, further strengthening their competitive position.

To improve our financial performance we have recently announced plans to eliminate certain low-volume, non-strategic product families whose return on assets in the current environment does not meet internal targets.

In many of the market segments in which we compete for business, we depend on winning highly competitive selection processes to design products and technologies for use in our customers’ equipment and products, and failure to be selected or to execute could materially adversely affect our business in that market segment. Even after we win and begin a product design, a customer may decide to cancel or change its product plans, which could cause us to generate no sales from a product and adversely affect our results of operations.

One of our focuses is on winning competitive bid selection processes, known as “product design wins”, to develop products for use in our customers’ equipment and products. These selection processes can be lengthy and require us to incur significant design and development expenditures, with no guarantee of winning or generating revenue. Delays in developing new products with anticipated technological advances and failure to win new design projects for customers or in commencing volume shipments of new products may have an adverse effect on our business. In addition, there can be no assurance that new products, if introduced, will gain market acceptance or will not be adversely affected by new technological changes or new product announcements by other competitors that may have greater resources or are more focused than we are. Because we typically focus on only a few customers in a product area, the loss of a design win can sometimes result in our failure to offer a generation of a product. This can result in lost sales and could hurt our position in future competitive selection processes because we may be perceived as not being a technology leader.

After winning a product design from one of our customers, we may still experience delays in generating revenue from our products as a result of the lengthy development and design cycle. In addition, a delay or cancellation of a customer's plans could significantly adversely affect our financial results, as we may have incurred significant expense and generated no revenue. Finally, if our customers fail to successfully market and sell their equipment it could materially adversely affect our business, financial condition and results of operations as the demand for our products falls.

Semiconductor and other products we design and manufacture are characterized by rapidly changing technology, and our success depends on our ability to develop and manufacture complex products cost-effectively and to scale.

The market for our products is characterized by rapidly changing technology. Some of our products have average life cycles of less than one year. Therefore, our success is highly dependent upon our ability to develop and manufacture increasingly complex new products quickly and on a cost-effective basis and to scale. Semiconductor design and process technologies are also subject to constant technological improvements and require large expenditures for capital investment, advanced research and technology development. If we experience substantial delays or are unable to develop new design or process technologies, our results of operations could be adversely affected. In certain cases, it may be necessary to incur costs to acquire technology from third parties, which may affect our results of operations and margins without any guarantee of success. We charged $76 million as annual amortization expense on our statement of income in 2004, related to technologies and licenses acquired from third parties through the end of 2004; as of December 31, 2004, the residual value, net of amortization, registered in our balance sheets for these technologies and licenses was $176 million.

In difficult market conditions, our high fixed costs adversely impact our results.

In less favorable industry environments, we are driven to reduce prices in response to competitive pressures and we are also faced with a decline in the utilization rates of our manufacturing facilities due to decreases in product demand. Since the semiconductor industry is characterized by high fixed costs, we are not always able to reduce our total costs in line with revenue declines. Reduced average selling prices for our products therefore adversely affect our results of operations. Furthermore, in periods of reduced customer demand for our products, our fabs do not operate at full capacity and the costs associated with the excess capacity are charged directly to cost of sales. Over the last five years, our gross profit margin has varied from a high of 47.4% in the fourth quarter of 2000 to a low of 31.7% in the fourth quarter of 2001. We cannot guarantee that difficult market conditions will not adversely affect the capacity utilization of our fabs and consequently our future gross margins. We cannot guarantee that increased competition in our core product markets will not lead to further price erosion, lower revenue growth rates and lower margins in the future.

In particular, while the U.S. dollar is our reporting currency, a significant portion of our fixed costs, such as manufacturing labor costs and depreciation charges, selling general and administrative expenses, and research and development expenses, are currently incurred in euros and currencies other than the U.S. dollar, and have significantly increased in 2004 due to the decline of the U.S. dollar, thus reducing our profitability. See "—Our financial results can be adversely affected by fluctuations in exchange rates, principally in the value of the U.S. dollar" and "Item 5. Operating and Financial Review and Prospects—Impact of Changes in Exchange Rates".

In order to address our fixed costs, we have recently announced our decision to accelerate cost-reduction initiatives, including a more selective process in dedicating capacity to new orders, with priority to high margin products; optimization of the product and production mix in memory; consolidation of certain central function activities to control overhead; and launching an aggressive cost savings program focused on purchasing. There is no assurance that the aforementioned initiatives will be successful, and that our fixed costs will not remain high, particularly in the event of a further decline in the value of the U.S. dollar versus the euro.

Our financial results can be adversely affected by fluctuations in exchange rates, principally in the value of the U.S. dollar.

A significant variation of the value of the U.S. dollar against the principal currencies which have a material impact on us (primarily the euro, but also certain Asian and other currencies of countries where we have operations) could result in a favorable impact on our net income in the case of an appreciation of the U.S. dollar, or a negative impact on our net income if the U.S. dollar depreciates relative to these currencies. Certain significant costs incurred by us, such as manufacturing labor costs and depreciation charges, selling, general and administrative expenses, and research and development expenses, are incurred in the currencies of the jurisdictions in which our operations are located. Currency exchange rate fluctuations affect our results of operations because our reporting currency is the U.S. dollar, in which we receive the major part of our revenues, while, more importantly, we incur the majority of our costs in currencies other than the U.S. dollar. In 2004, the U.S. dollar depreciated in value significantly, in particular against the euro, causing us to report higher expenses, and negatively impacting both our gross margin and operating income. Our Consolidated Financial Statements for 2004 include income and expense items translated at the average rate for the period. The average rate of the euro to the U.S. dollar was €1.00 for $1.236 in 2004 and $1.125 in 2003; see "Item 5. Operating and Financial Review and Prospects—Impact of Changes in Exchange Rates" and "Item 11. Quantitative and Qualitative Disclosures About Market Risk". The continued decline of the U.S. dollar compared to the other major currencies that affect our operations would negatively impact our expenses, margins and profitability, especially if we are unable to balance or shift our euro-denominated costs to other currency areas or to U.S. dollars. Any such actions may not be immediately effective, could prove costly and their implementation could prove demanding on our management resources. In order to reduce the exposure of our financial results to the fluctuations in exchange rates, our principal strategy has been to balance as much as possible the proportion of sales to our customers denominated in U.S. dollars with the amount of purchases from our suppliers denominated in U.S. dollars, and to reduce the weight of the other costs, including labor costs and depreciation, denominated in euros and in other currencies. In order to further reduce the exposure to U.S. dollar exchange rate fluctuations, we have hedged certain line items on our income statement, in particular with respect to a portion of the cost of goods sold, most of the research and development expenses and certain selling and general and administrative expenses located in the euro zone. No assurance can be given that our hedging policy will be successful in its objective, or that the value of the U.S. dollar will not actually appreciate with the hedging transaction potentially preventing us from benefiting from lower euro- denominated manufacturing costs when translated into our U.S. dollar-based accounts. See "Item 11 Quantitative and Qualitative Disclosures About Market Risk" for the relevant amounts and contracts.

Because we have our own manufacturing facilities, our capital needs are high compared to competitors who do not produce their own products.

As a result of our strategic choice to maintain control of our advanced proprietary manufacturing technologies to serve our customer base and develop our strategic alliances, we require significant amounts of capital to build, expand, modernize and maintain our facilities. Some of our competitors, however, do not manufacture their own products and therefore do not require significant capital expenditures for their facilities. Our capital expenditures have been significant in recent years. See "—Selected Financial Data" for the amount of our capital expenditures in the past five fiscal years. We currently expect our 2005 capital expenditures to be approximately $1.5 billion. Our costs are also increasing as the complexity of the individual manufacturing equipment increases. We have the flexibility to modulate our investments up or down in response to changes in market conditions, and we are prepared to accelerate investments in leading-edge technologies if market conditions require. We will continue to monitor our level of capital spending taking into consideration factors such as trends in the semiconductor market and capacity utilization.

To stay competitive in the semiconductor industry, we must transition certain products to 300 millimeter manufacturing technology, which is much more expensive than 150 mm or 200 mm technologies. Currently, all of our fabs process wafers with diameters of 150 mm or 200 mm. We are developing 300 mm process technology on a pilot line at Crolles2, with our partners Philips Semiconductor and Freescale Semiconductor, Inc.

If we are unable to access 300 mm technology for volume production, our ability to develop and market new products could suffer, which could, in turn, have a material adverse effect on our business, financial condition and results of operations.

We may also need additional funding in the coming years to finance our investments or purchase other companies or technology developed by third parties.

We have constructed a building in Catania, which we have not yet started to equip, for the volume production of 300 mm wafers. In addition, in an increasingly complex and competitive environment, we may need to invest in the acquisition of other companies or third party technology to maintain our competitive position in the market. Furthermore, we may consider acquisitions to complement or expand our existing business.

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Any of the foregoing may require us to issue additional debt or equity, or both, and if we are unable to access such capital on acceptable terms, this may adversely affect our business and results of operations. The timing and size of any new share, convertible bond or straight bond offering would depend upon market conditions as well as a variety of factors and any such transaction or an announcement concerning such a transaction could materially impact market price of our common shares. We currently have no financial covenants under our existing debt instruments. If we were to issue additional debt, however, it could require that we undertake and comply with certain financial covenants.

Our research and development efforts in the field of CMOS process development are dependent on alliances, and our business, results of operations and prospects could be materially adversely affected by the failure of such alliances in developing new process technologies in line with market requirements.

We are cooperating with Freescale Semiconductor, Inc. (formerly a division of Motorola Inc.) and Philips Semiconductors International B.V. for the joint research and development of complementary metal-on silicon oxide semiconductor ("CMOS") process technology to provide 90-nm to 32-nm chip technologies on 300mm wafers, as well as the operation of a 300mm wafer pilot line fab in Crolles, France ("Crolles2"). There can be no assurance that our alliances with Philips and Freescale will be successful or will enable us to develop new technologies in due time, in a cost-effective manner and/or to meet customer demands. Furthermore, if the alliances fail to accomplish their intended goals, we may lose our investment, or incur additional unforeseen costs, and our business, results of operations and prospects could be materially adversely affected. If the Crolles2 alliance or other alliances we enter do not succeed in developing technologies that are commercially accepted, or if we are unable to develop such new technologies independently, we may fail to keep pace with the rapid technology advances in the semiconductor industry, and customers may not buy our products.

Our operating results may vary significantly from quarter to quarter and annually and may differ significantly from our expectations or guidance.

Our operating results are affected by a wide variety of factors that could materially and adversely affect revenues and profitability or lead to significant variability of operating results. These factors include, among others, the cyclicality of the semiconductor and electronic systems industries, capital requirements, inventory management, availability of funding, competition, new product developments, technological changes, and manufacturing problems. Furthermore, our effective tax rate takes into consideration certain tax regimes which, in the future, may not be available to us. See Note 24 to the Consolidated Financial Statements. In addition, a number of other factors could lead to fluctuations in quarterly and annual operating results, including:

- performance of our key customers in the markets they serve;
- order cancellations or reschedulings by customers;
- excess inventory held by customers leading to reduced bookings or product returns by key customers;
- manufacturing capacity and utilization rates;
- restructuring and impairment charges;
- fluctuations in currency exchange rates, particularly between the U.S. dollar and other currencies in jurisdictions where we have activities;
- intellectual property developments;
- changes in distribution and sales arrangements;
- failure to win new design projects;
- manufacturing performance and yields;
- product liability or warranty claims;
- litigation;
- possible acquisitions;
- problems in obtaining adequate raw materials or production equipment on a timely basis; and
- property damage or business interruption losses resulting from a catastrophic event not covered by insurance.

Unfavorable changes in the above factors, some of which are further described in this section, have in the past and may in the future adversely affect our operating results. Furthermore, in periods of industry overcapacity or when our key customers encounter difficulties in their end markets, orders are more exposed to cancellations, reductions, price renegotiation or postponements, which in turn reduce our management’s ability to forecast the next quarter or full year production levels, revenues and margins. For these reasons and others that we may not yet have identified, our revenues and operating results may differ materially from our expectations or guidance as visibility is reduced. See “Item 4. Information on the Company—Backlog”.

The demand for our products depends in large part on continued growth in the industries and segments into which they are sold. A market decline in any of these industries could have a material adverse effect on our results of operations.

We derive and expect to continue to derive significant sales from the telecommunications equipment and automotive industries, as well as the home, personal and consumer segments generally.

Growth of demand in the telecommunications equipment and automotive industries as well as the home, personal and consumer segments, has in the past and may in the future, fluctuate significantly based on numerous factors, including:

- spending levels of telecommunications equipment and/or automotive providers;
- development of new consumer products or applications requiring high semiconductor content;
- evolving industry standards;
- the rate of adoption of new or alternative technologies, and
- demand for automobiles, consumer confidence and general economic conditions.

We cannot assure you of the rate, or the extent to which, the telecommunications equipment or automotive industries or the home, personal or consumer segments, will grow, if at all. Any continued decline in these industries or segments could result in slower growth or a decline in demand for our products, which could have a material adverse effect on our business, financial condition and results of operations. In recent years, our sales have increased at a slower pace than the semiconductor industry as a whole and our market share has declined.

In addition, projected industry growth rates may not materialize as forecasted, resulting in spending on process and product development well ahead of market requirements, which could have a material adverse effect on our business, financial condition and results of operations.

We operate in many jurisdictions with highly complex and varied tax regimes. Changes in tax rules or the outcome of tax assessments and audits could cause a material adverse effect on our results.

We operate in many jurisdictions with highly complex and varied tax regimes. Changes in tax rules or the outcome of tax assessments and audits could have a material adverse effect on our results in any particular quarter. For example, in 2004, we had an income tax expense of $68 million, as compared to an income tax benefit of $14 million in 2003, due to the impact in 2003 of impairment, restructuring charges and other related closure costs that we incurred in jurisdictions with tax rates higher than our average tax rate. In 2004, we also benefited from a favorable reassessment of our deferred tax assets and liabilities due to changes in enacted tax rates, and a favorable settlement of certain minor items relating to prior years’ tax audits. Our tax rate is variable and depends on changes in the level of operating profits within various local jurisdictions and on changes in the applicable taxation rates of these jurisdictions, as well as changes in estimated tax provisions due to new events. We currently enjoy certain tax benefits in some countries, and these benefits may not be available in the future due to changes within the local jurisdictions, our effective tax rate could increase in the coming years.

Our operating results can also vary significantly due to impairment of goodwill and other intangible assets incurred in the course of acquisitions, as well as to impairment of tangible assets due to changes in the business environment.

Our operating results can also vary significantly due to impairment of goodwill booked pursuant to acquisitions and to the purchase of technologies and licenses from third parties. As of December 31, 2004, the value registered on our audited consolidated balance sheet for goodwill was $264 million and the value for technologies and licenses acquired from third parties was $176 million, net of amortization. Because the market for our products is characterized by rapidly changing technologies, and because of significant changes in the semiconductor industry, our future cash flows may not support the value of goodwill and other intangibles registered in our balance sheet. Furthermore, the ability to generate revenues for our fixed assets located in Europe may be impaired by the increase in the value of the euro with respect to the U.S. dollar, as the revenues from the use of such assets are generated in U.S. dollars. We are required to annually test goodwill and to assess the carrying values of intangible and tangible assets when impairment indicators exist. As a result of such tests, we could be required to book an impairment in our statement of income if the carrying value in our balance sheet is in excess of the fair value. The amount of any potential impairment is not predictable as it depends on our estimates of projected market trends, results of operations and cash flows. Any potential impairment, if required, could have a material adverse impact on our results of operations.

Disruptions in our relationships with any one of our key customers could adversely affect our results of operations.

A substantial portion of our sales are derived from several large customers, some of whom have entered into strategic alliances with us. As of December 31, 2004, our largest customer was Nokia, which accounted for 17.1% of our 2004 net revenues, compared to 17.9% in 2003 and 17.6% in 2002. In 2004, our top 10 original equipment manufacturer customers accounted for approximately 44% of our net revenues, compared to approximately 46% of our 2003 net revenues and 49% of our 2002 net revenues. We cannot guarantee that our largest customers will continue to book the same level of sales with us that they have in the past and will not solicit alternative suppliers. Many of our key customers operate in cyclical businesses that are also highly competitive, and their own demands and market positions may vary considerably. Such customers have in the past, and may in the future, vary order levels significantly from period to period, request postponements to scheduled delivery dates or modify their bookings. Approximately 16% of our net revenues were made through distributors in 2002, increasing in 2003 to approximately 18% and to 21% in 2004. We cannot guarantee that we will be able to maintain or enhance our market share with our key customers or distributors. If we were to lose one or more design wins for our products with our key customers or distributors, or if any key customer were to reduce or change its bookings, seek alternate suppliers, increase its product returns or fail to meet its payment obligations, our business financial condition and results of operation could be materially adversely affected. If orders are cancelled, we may not be able to resell products previously made or require the customers who have ordered these products to pay for them. Furthermore, developing industry trends, including customers’ use of outsourcing and new and revised supply chain models, may reduce our ability to forecast the purchase date for our products and evolving customer demand, thereby affecting our revenues and working capital requirements. For example, pursuant to recent industry developments, we are required to deliver our products on consignment to customer sites with recognition of revenue delayed until the moment, which must occur within a defined period of time, when the customer chooses to take delivery of our products from our consignment stock.

Because we depend on a limited number of suppliers for raw materials and certain equipment, we may experience supply disruptions if suppliers interrupt supply or increase prices.

Our ability to meet our customers’ demand to manufacture our products depends upon obtaining adequate supplies of quality raw materials on a timely basis. A number of materials are available only from a limited number of suppliers, or only from a limited number of suppliers in a particular region. In addition, we purchase raw materials such as silicon wafers, lead frames, mold compounds, ceramic packages and chemicals and gases from a number of suppliers on a just-in-time basis. Although supplies for the raw materials we currently use are adequate, shortages could occur in various essential materials due to interruption of supply or increased demand in the industry. We also purchase semiconductor manufacturing equipment from a limited number of suppliers and because such equipment is complex it is difficult to replace one supplier with another or to substitute one piece of equipment for another. In addition, suppliers may extend lead times, limit our supply or increase prices due to capacity constraints or other factors. Shortages of supplies have in the past impacted the semiconductor industry. Although we work closely with our suppliers to avoid these types of shortages, there can be no assurances that we will not encounter these problems in the future. Our quarterly or annual results of operations would be adversely affected if we were unable to obtain adequate supplies of raw materials or equipment in a timely manner or if there were significant increases in the costs of raw materials or problems with the quality of these raw materials.

Our manufacturing processes are highly complex, costly and potentially vulnerable to impurities, disruptions or inefficient implementation of production changes that can significantly increase our costs and delay product shipments to our customers.

Our manufacturing processes are highly complex, require advanced and increasingly costly equipment and are continuously being modified or maintained in an effort to improve yields and product performance. Impurities or other difficulties in the manufacturing process can lower yields, interrupt production or result in losses of products in process. As system complexity has increased and sub-micron technology has become more advanced, manufacturing tolerances have been reduced and requirements for precision have become even more demanding. Although in the past few years we have significantly enhanced our manufacturing capability in terms of efficiency, precision and capacity, we have from time to time experienced bottlenecks and production difficulties that have caused delivery delays and quality control problems, as is common in the semiconductor industry. We cannot guarantee that we will not experience bottlenecks, production or transition difficulties in the future. In addition, during past periods of high demand for our products, our manufacturing facilities have operated at high capacity, which has led to production constraints. Furthermore, if production at a manufacturing facility is interrupted, we may not be able to shift production to other facilities on a timely basis, or customers may purchase products from other suppliers. In either case, the loss of revenue and damage to the relationship with our customer could be significant. Furthermore, we periodically transfer production equipment between production facilities and must ramp up and test such equipment once installed in the new facility before it can reach its optimal production level.

As is common in the semiconductor industry, we have, from time to time, experienced and may in the future experience difficulties in transferring equipment between our sites, ramping up production at new facilities or effecting transitions to new manufacturing processes. Our operating results may be adversely affected by an increase in fixed costs and operating expenses linked to production if revenues do not increase commensurately with such fixed costs and operating expenses.

If our outside foundry suppliers fail to perform, this could adversely affect our ability to exploit growth opportunities.

In order to meet anticipated requirements for high-speed complementary metal-on silicon oxide semiconductor (“HCMOS”) wafers and nonvolatile memory technology, in the past, we have used outside suppliers, or “foundries”. If our outside suppliers are unable to satisfy our demand, or experience manufacturing difficulties, delays or reduced yields, our results of operations and ability to satisfy customer demand could suffer. In addition, purchasing rather than manufacturing these products may adversely affect our gross profit margin if the purchase costs of these products are higher than our own manufacturing costs. Our internal manufacturing costs include depreciation and other fixed costs, while costs for products outsourced are based on market conditions. Prices for foundry products also vary depending on capacity utilization rates at our suppliers, quantities demanded, product technology and geometry. Furthermore, these outsourcing costs can vary materially from quarter-to-quarter and, in cases of industry shortages, they can increase significantly further, negatively impacting our gross margin.

We depend on patents to protect our rights to our technology.

We depend on our ability to obtain patents and other intellectual property rights covering our products and their design and manufacturing processes. We intend to continue to seek patents on our inventions relating to product designs and manufacturing processes. However, the process of seeking patent protection can be long and expensive, and we cannot guarantee that we will receive patents from currently pending or future applications. Even if patents are issued, they may not be of sufficient scope or strength to provide meaningful protection or any commercial advantage. In addition, effective patent, copyright and trade secret protection may be unavailable or limited in some countries. Competitors may also develop technologies that are protected by patents and other intellectual property and therefore either be unavailable to us or be made available to us subject to adverse terms and conditions. We have negotiated in the past broad patent cross-licenses with many of our competitors enabling us to design, manufacture and sell semiconductor products, without fear of infringing patents held by such competitors. We may not, however, in the future be able to obtain licenses or other rights to protect necessary intellectual property on acceptable terms for the conduct of our business, and such failure may adversely impact our results of operations.

We have from time to time received, and may in the future receive, communications alleging possible infringement of patents and other intellectual property rights of others. Furthermore, we may become involved in costly litigation brought against us regarding patents, mask works, copyrights, trademarks or trade secrets. See “Item 8. Financial Information—Legal Proceedings”. In the event that the outcome of any litigation would be unfavorable to us, we may be required to obtain a license to the underlying intellectual property right upon economically unfavorable terms and conditions, possibly pay damages for prior use and/or face an injunction, all of which, singly or in the aggregate, could have a material adverse effect on our results of operations and ability to compete.

Finally, litigation could cost us financial and management resources necessary to enforce our patents and other intellectual property rights or to defend against third party intellectual property claims, when we believe that the amounts requested for a license are unreasonable.

We are required to prepare consolidated financial statements using both International Financial Reporting Standards (“IFRS”) as from 2005 in addition to our consolidated financial statements prepared pursuant to Generally Accepted Accounting Principles in the United States (“U.S. GAAP”) and dual reporting may impair the clarity of our financial reporting.

We are incorporated in the Netherlands and our shares are listed on Euronext Paris and on the Borsa Italiana, and, consequently, we are subject to a European Union (“EU”) regulation issued on September 29, 2003 requiring us to report our results of operations and consolidated financial statements using IFRS (previously known as International Accounting Standards or “IAS”). Since our creation in 1987, we have always prepared our Consolidated Financial Statements under U.S. GAAP and intend to continue to do so, while at the same time complying with our reporting obligations under IFRS by presenting a complementary set of accounts in our 2005 Dutch statutory annual report or as may be otherwise requested by local stock exchange authorities. Our decision to continue to apply U.S. GAAP in our financial reporting is designed to ensure the comparability of our results to those of our competitors and the continuity of our reporting, thereby providing our investors a clear understanding of our financial performance.

The obligation to report our Consolidated Financial Statements under IFRS will require us to prepare our results of operations using two different sets of reporting standards, U.S. GAAP and IFRS, which are currently not consistent. Such dual reporting could materially impair the clarity of our investor communications. The main potential area of discrepancy concerns capitalization and later amortization of development expenses potentially required under IFRS. Furthermore, while we believe all of our accounting systems are in place to prepare a separate set of accounts pursuant to IFRS starting in January 2005, we may not be able to account for capitalization of development expenses pursuant to IFRS in previous periods for comparative purposes. Our financial condition and results of operations reported in accordance with IFRS may differ from our financial condition and results of operations reported in accordance with U.S. GAAP, which could adversely affect the market price of our common shares.

Certain accounting principles of U.S. GAAP are in flux and may lead to significant changes in the way we account for our convertible debt instruments. These changes may lead to significant changes in our financial statements.

Certain U.S. GAAP accounting principles are in flux and pending proposed amendments are likely to be made. Certain of these proposed changes may bring U.S. GAAP more closely into line with IFRS, while others are independent of the move to converge generally accepted accounting principles. This state of flux makes it difficult for us to predict how accounting rules may evolve over the near- and medium-term.

In particular, the Financial Accounting Standards Board (“FASB”) has identified accounting for zero coupon convertible debt instruments as an emerging accounting issue. FASB’s current proposal would involve uncoupling the debt and equity components of convertible debt instruments, in line with the fair market value of the debt. Recognition of interest expense in line with market rates under the FASB proposal may be considerably higher than the interest currently being charged. In particular, we may be required to show a high interest charge in respect of our 2013 Bonds, even if it is bearing a negative yield. Balance sheets of companies with outstanding convertible debt instruments would also be impacted because shareholders’ equity would be adjusted to show increased additional paid-in capital for the value of the embedded conversion option. The current proposal could apply both to our existing convertible debt instruments and any such instruments issued in the future. FASB’s proposal date of effect is not yet defined. If a new rule is adopted in line with the current proposals, and if there is no provision that limits its applicability to only those instruments issued in the future, we may be required to change the accounting for our convertible 2013 Bonds on our statement of income and on our balance sheet. There can be no assurance that these proposed rules and regulations or any other laws, rules or regulations, will not be adopted in the future, any of which could adversely affect our financial statements, make compliance more difficult or expensive, or otherwise adversely affect our business, financial condition or prospects.

New U.S. GAAP accounting rules require that share-based compensation to employees be charged against net income, and this could have a material adverse effect on our reported income.

On December 16, 2004, FASB issued Statement of Financial Accounting Standards No. 123 (revised 2004) “Share-Based Payment” (FAS 123R), which requires that share-based compensation to employees in the form of stock options or similar instruments be considered as a compensation expense and requires recognition of a charge to the income statement, measured on the basis of the fair value of the option at the grant date (with limited exceptions). The cost will be recognized over the period during which an employee is required to provide service in exchange for the share-based compensation. Employee share purchase plans will not result in recognition of compensation cost if certain conditions are met (similar to those in Statement No. 123). We have reviewed our past employee share purchase plans and concluded that they do not meet these conditions and consequently qualify as compensatory. The impact of the new rule such a change is described in Note 2.23 to the Consolidated Financial Statements, currently computed on the basis of FAS 123.

Some of our production processes and materials are environmentally sensitive, which could lead to increased costs due to environmental regulations or to damage to the environment.

We are subject to a variety of laws and regulations relating, among other things, to the use, storage, discharge and disposal of chemicals, gases and other hazardous substances used in our manufacturing processes, air emissions, waste water discharges, waste disposal, as well as the investigation and remediation of soil and ground water contamination. A recent directive in the European Union imposes a “take back” obligation on manufacturers for the financing of the collection, recovery and disposal of electrical and electronic equipment. Additional European legislation will ban the use of lead and some flame retardants in electronic components beginning in 2006. Our activities in the European Union are also subject to the European Directive 2003/87 establishing a scheme for green-house gas allowance trading, and to the applicable national implementing legislation. In addition, a legislative proposal by the European Commission will require the registration, evaluation and authorizations of a large number of chemicals (“REACH”). The implementation of any such legislation could adversely affect our manufacturing costs or product sales by requiring us to acquire costly equipment, materials or green-house gas allowances, or to incur other significant expenses in adapting our manufacturing processes or waste and emission disposal processes. We are not in a position to quantify specific costs, in part because these costs are part of our business process. Furthermore, environmental claims or our failure to comply with present or future regulations could result in the assessment of damages or imposition of fines against us, suspension of production or a cessation of operations and, as with other companies engaged in similar activities, any failure by us to control the use of, or adequately restrict the discharge of chemicals or hazardous substances could subject us to future liabilities. Any specific liabilities we identify as probable would be reflected in our balance sheet. To date, we have not identified any such specific liabilities. We therefore have not booked specific reserves for any specific environmental risks. See “Item 4. Information on the Company—Environmental Matters”.

Loss of key employees could hurt our competitive position.

As is common in the semiconductor industry, success depends to a significant extent upon our key senior executives and research and development, engineering, marketing, sales, manufacturing, support and other personnel. Our success also depends upon our ability to continue to attract, retain and motivate qualified personnel. The competition for such employees is intense, and the loss of the services of any of these key personnel without adequate replacement or the inability to attract new qualified personnel could have a material adverse effect on us.

Changes to our senior management organization, as well as our new top management team’s ability to adapt our strategy to evolving market conditions, could adversely affect our operations, if continuity of our relationships with our key customers, partners and suppliers is impaired.

Our common share price, operating results, net income, net income per share and net financial position may be negatively affected by potential acquisitions.

While our growth to date has primarily been organic, we have in the past and may in the future make selected acquisitions that we believe would complement or expand our existing business. We may pay for future acquisitions with cash, our common shares or some combination of both. Acquisitions, if they occur, may have a dilutive effect for existing shareholders and, whether they are paid for in cash or common shares, may negatively affect our common share price. Announcements concerning potential acquisitions could be made at any time.

Acquisitions involve a number of risks that could adversely affect our operating results, including:

- the diversion of management's attention;
- the integration of acquired company operations and personnel;
- the assumption of potential liabilities, disclosed or undisclosed, associated with the business acquired, which liabilities may exceed the amount of indemnification available from the seller;
- the risk that the financial and accounting systems utilized by the business acquired will not meet our standards;
- the risk that the businesses acquired will not maintain the quality of products and services that we have historically provided;
- whether we are able to attract and retain qualified management for the acquired business;
- whether we are able to retain customers of the acquired entity; and
- the risk of goodwill and other intangible asset impairment, due to the inability of the business to meet management's expectations at the time of the acquisition.

There can be no assurance that (a) we will be able to consummate future acquisitions on satisfactory terms, if at all, (b) adequate financing will be available for future acquisitions on terms acceptable to us, if at all, or (c) any operations acquired will be successfully integrated or that such operations will ultimately have a positive impact on our business.

We may be faced with product liability or warranty claims.

Despite our corporate quality programs and commitment, our products may not in each case comply with specifications or customer requirements. Warranty or product liability claims could result in significant expenses relating to costs of defending against such claims, damages awarded or related compensation payments in line with industry or business practices or to maintain good customer relationships. When faced in the past with potential warranty claims in respect of products supplied by us, we have in certain instances paid compensation to customers and may do so again in the future.

We may invest our cash in short-term financial instruments as part of our treasury management strategy, which has certain inherent risks.

From time to time, we may use cash on hand to purchase short-term financial instruments as part of our treasury management strategy. These instruments may have returns that depend on certain credit events of reference debt obligations issued by reference issuers consisting of different banks with a minimum credit rating. Interest is payable to us on such instruments through the final maturity, typically before the end of the financial year, unless suspended upon an earlier credit event under the relevant reference debt or of the relevant reference issuer. For certain short-term financial instruments, principal would be repaid to us at final maturity, unless such a credit event occurs, in which event early repayment of principal would be reduced based on the decline in value of the relevant reference debt. While we place our cash and cash equivalents with high credit quality financial institutions and manage the credit risks associated with financial instruments through credit approvals, investment limits, we do not normally require collateral or other security from the parties to the financial instruments. Thus, no assurance can be given that a rapid, unanticipated crisis in the global financial system would not have an adverse impact on our results of operations and cash flow. See "Item 11. Quantitative and Qualitative Disclosures about Market Risk".

Furthermore, notwithstanding the fact that we are careful in the selection of financial institutions with which we enter into such agreements, a default event pursuant to the relevant contract may materially impact our financial position.

Reduction in the amount of state funding available to us or demands for repayment may increase our costs and impact our results of operations.

Like many other manufacturers operating in Europe, we benefit from governmental funding for research and development expenses and industrialization costs (which include some of the costs incurred to bring prototype products to the production stage), as well as from incentive programs for the economic development of underdeveloped regions. Public funding may also be characterized by grants and/or low-interest financing for capital investment. See “Item 4. Information on the Company—Public Funding”. We have entered into public funding agreements in France and Italy, which set forth the parameters for state support to us under selected programs. These funding agreements may require compliance with EU regulations and approval by EU authorities.

We rely on receiving funds on a timely basis pursuant to the terms of the funding agreements. However, funding of programs in France and Italy is subject to annual appropriation of available resources, which is outside our control, as well as to our continuing compliance with all eligibility requirements. If we are unable to receive anticipated funding on a timely basis, or if existing government-funded programs were curtailed or discontinued, or if we were unable to fulfill our eligibility requirements, this could have a material adverse effect on our business, operating results and financial condition. There is no assurance that any alternative funding would be available, or that, if available, it could be provided in sufficient amounts or on similar terms.

The application for and implementation of such grants often involves compliance with extensive regulatory requirements including, in the case of subsidies to be granted within the European Union, notification to the European Commission by the member state making the contemplated grant prior to disbursement. In particular, compliance with project-related ceilings on aggregate subsidies defined under EU law often involves highly complex economic evaluations. Furthermore, public funding arrangements are generally subject to annual and project-by- project reviews and approvals. If we fail to meet applicable formal or other requirements, we may not be able to receive the relevant subsidies or may be obliged to repay them which could have a material adverse effect on our results of operations.

The interests of our controlling shareholders, which are in turn controlled respectively by the French and Italian governments, may conflict with investors’ interests.

We have been informed that as of December 31, 2004, STMicroelectronics Holding II B.V. (“ST Holding II”), a wholly owned subsidiary of STMicroelectronics Holding N.V. (“ST Holding”), owned 278,483,280 shares, or approximately 30.8%, of our issued common shares. ST Holding is therefore effectively in a position to control actions that require shareholder approval, including corporate actions, the election of our Supervisory Board and our Managing Board and the issuance of new shares or other securities.

We have also been informed that the shareholders’ agreement among ST Holding’s shareholders (the “STH Shareholders’ Agreement”), to which we are not a party, governs relations between our indirect shareholders Areva Group, Cassa Depositi e Prestiti S.p.A., Finmeccanica S.p.A. and France Telecom, each of which is ultimately controlled by the French or Italian government, see “Item 7. Major Shareholders and Related-Party Transactions—Major Shareholders”. The STH Shareholders’ Agreement includes provisions requiring the unanimous approval by shareholders of ST Holding before ST Holding can make any decision with respect to certain actions to be taken by us. Furthermore, as permitted by our articles of association, the Supervisory Board has specified selected actions by the Managing Board that require the approval of the Supervisory Board. See “Item 6. Directors, Senior Management and Employees—Directors and Senior Management—Managing Board”. These requirements for the prior approval of various actions to be taken by us and our subsidiaries may give rise to a conflict of interest between our interests and investors’ interests, on the one hand, and the interests of the individual shareholders approving such actions, on the other, and may affect the ability of our Managing Board to respond as may be necessary in the rapidly changing environment of the semiconductor industry. Furthermore, our ability to issue new shares or other securities may be limited by the existing shareholders’ desire to maintain their proportionate shareholding at a certain minimum level. Such approval process is, however, subject to the provisions of Dutch law requiring members of our Supervisory Board to act independently in supervising our management.

Our shareholder structure and our preference shares may deter a change of control.

On May 31, 1999, our shareholders at the annual general meeting approved the creation of up to 180,000,000 preference shares. Pursuant to the 3-for-1 stock split effected in May 2000, the number of such preference shares has increased to 540,000,000. These preference shares entitle a holder to full voting rights at any meeting of shareholders and to a preferential right to dividends and distributions upon liquidation. Pursuant to approval from our shareholders, and in order to protect ourselves from a hostile takeover or other similar action, we entered into an option agreement with ST Holding II, which provides that up to 540,000,000 preference shares shall be issued to ST Holding II upon its request and subject to the adoption of a resolution of our Supervisory Board giving our consent to the exercise of the option and upon payment of the par value of the preference shares to be issued. The option may only be exercised if ST Holding II owns at least 19% of our issued share capital at the time of exercise. No preference shares have been issued to date. The effect of the preference shares may be to deter potential acquirers from effecting an unsolicited acquisition resulting in a change of control. In addition, any issuance of additional capital within the limits of our authorized share capital, as approved by our shareholders, is subject to the approval of our Supervisory Board.

Our direct or indirect shareholders may sell our existing common shares or issue financial instruments exchangeable into our common shares at any time while at the same time seeking to retain their rights regarding our preference shares. In addition, substantial sales by us of new common shares or convertible bonds could cause our common share price to drop significantly.

The STH Shareholders’ Agreement, to which we are not a party, permits our respective French and Italian indirect shareholders to cause ST Holding to dispose of its stake in us at its sole discretion at any time from their current level, and to reduce the current level of their respective indirect interests in our common shares to 9.5%. The details of the STH Shareholders’ Agreement as declared by ST Holding II in its Schedule 13G/A filing dated February 14, 2005, are further explained in “Item 7. Major Shareholders and Related-Party Transactions—Major Shareholders”. Disposals of our shares by the parties to the STH Shareholders’ Agreement can be made by way of the issuance of financial instruments exchangeable for our shares, equity swaps, structured finance transactions or sales of our shares. An announcement with respect to one or more of such dispositions could be made at any time without our advance knowledge.

In addition, €442.2 million aggregate principal amount of France Telecom 6.75% notes are due on August 6, 2005, (the “2002 Notes”). The 2002 Notes are mandatorily exchangeable into a maximum of 26.42 million of our existing common shares and a minimum of 20.13 million of our existing common shares, depending on our share price at maturity of the 2002 Notes. Finmeccanica Finance S.p.A., a subsidiary of Finmeccanica has issued €501 million aggregate principal amount of exchangeable notes, exchangeable into up to 20 million of our existing common shares due 2010 (the “Finmeccanica Notes”). The Finmeccanica Notes have been exchangeable at the option of the holder into our existing common shares since January 2, 2004. Furthermore, Finmeccanica has entered into securities lending and other arrangements that could potentially lead to sales of up to an additional 30 million of our existing common shares potentially at any time. Maturity and/or exchange of the aforementioned 2002 Notes and/or Finmeccanica Notes, into a large number of our existing common shares or sales by Finmeccanica could impact the market price of our common shares.

In addition, substantial sales of our common shares or bonds exchangeable into our common shares or any announcements concerning a potential sale by our shareholders, could materially impact the market price of our common shares. The timing and size of any future share or exchangeable bond offering by our direct or indirect shareholders would depend upon market conditions as well as a variety of factors.

Because we are a Dutch company subject to the corporate law of the Netherlands, U.S. investors might have more difficulty protecting their interests in a court of law or otherwise than if we were a U.S. company.

Our corporate affairs are governed by our articles of association and by the laws governing corporations incorporated in the Netherlands. The corporate affairs of each of our consolidated subsidiaries are governed by the articles of association and by the laws governing such corporations in the jurisdiction in which such consolidated subsidiary is incorporated. The rights of the investors and the responsibilities of members of our Supervisory Board and Managing Board under Dutch law are not as clearly established as under the rules of some U.S. jurisdictions. Therefore, U.S. investors may have more difficulty in protecting their interests in the face of actions by our management, members of our Supervisory Board or our controlling shareholders than U.S. investors would have if we were incorporated in the United States.

Our executive offices and a substantial portion of our assets are located outside the United States. In addition, ST Holding II and most members of our Managing and Supervisory Boards are residents of jurisdictions other than the United States and Canada. As a result, it may be difficult or impossible for shareholders to effect service within the United States or Canada upon us, ST Holding II, or members of our Managing or Supervisory Boards. It may also be difficult or impossible for shareholders to enforce outside the United States or Canada judgments obtained against such persons in U.S. or Canadian courts, or to enforce in U.S. or Canadian courts judgments obtained against such persons in courts in jurisdictions outside the United States or Canada. This could be true in any legal action, including actions predicated upon the civil liability provisions of U.S. securities laws. In addition, it may be difficult or impossible for shareholders to enforce, in original actions brought in courts in jurisdictions located outside the United States, rights predicated upon U.S. securities laws.

We have been advised by our Dutch counsel, De Brauw Blackstone Westbroek N.V., that the United States and the Netherlands do not currently have a treaty providing for reciprocal recognition and enforcement of judgments (other than arbitration awards) in civil and commercial matters. As a consequence, a final judgment for the payment of money rendered by any federal or state court in the United States based on civil liability, whether or not predicated solely upon the federal securities laws of the United States, will not be enforceable in the Netherlands. However, if the party in whose favor such final judgment is rendered brings a new suit in a competent court in the Netherlands, such party may submit to the Netherlands court the final judgment that has been rendered in the United States. If the Netherlands court finds that the jurisdiction of the federal or state court in the United States has been based on grounds that are internationally acceptable and that proper legal procedures have been observed, the court in the Netherlands would, under current practice, give binding effect to the final judgment that has been rendered in the United States unless such judgment contravenes the Netherlands’ public policy.

Removal of our common shares from the CAC 40 on Euronext Paris, the S&P/MIB on the Borsa Italiana or the Philadelphia Stock Exchange Semiconductor Sector Index could cause the market price of our common shares to drop significantly.

Our common shares have been included in the CAC 40 index on Euronext Paris since November 12, 1997; the S&P/MIB on the Borsa Italiana, or Italian Stock Exchange since March 18, 2002; and the Philadelphia Stock Exchange Semiconductor Index (or “SOX”) since June 23, 2003. However, our common shares could be removed from the CAC 40, the S&P/MIB or the SOX at any time, and any such removal or announcement thereof could cause the market price of our common shares to drop significantly.