Back to Contents

Index to Financial Statements

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 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, European Union 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, 2002 and 2003, but decreased in 1996, 1998 and 2001. For 2000, 2002 and 2003, the increase was approximately 37%, 1% and 18%, respectively, while in 2001 the decrease was approximately 32%.

In certain years, as was the case in 2002 and 2003, 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 prices.

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 $33 billion in 1999, $61 billion in 2000, $38 billion in 2001, $27 billion in 2002 and an estimated $30 billion in 2003, or approximately 22%, 30%, 27%, 19% and an estimated 18%, 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 oversupply 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 announced and closed our 150mm wafer manufacturing facility in Ottawa, and in 2002, we completed the closure of our 150mm wafer manufacturing facility in Rancho Bernardo, California. 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. See "Item 5. Operating and Financial Review and Prospects—2003 Highlights".

We anticipate that the restructuring plan and related manufacturing initiatives announced in October 2003 will result in a further pre-tax charge of approximately $150 million over the coming years. There may be no assurances, however, that future overcapacity, obsolescence in our manufacturing facilities, and market downturns may not have a material adverse effect on our business, financial condition and results of operations or require us to take further restructuring charges.

Back to Contents

Index to Financial Statements

Competition in the semiconductor industry is intense, and we may not be able to compete successfully if our 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
- product availability
- manufacturing yields
- sales and technical support

In particular, 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 on a cost-effective basis, to introduce new products in the marketplace on a timely basis, and to have them selected for design into future products of leading systems manufacturers. Because new product development commitments must be made well in advance of sales, however, our new product decisions must anticipate both future demand and the technology that will be available to supply such demand. 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 in developing 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. 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. We charged $68 million as annual amortization expense on our statement of income in 2003, related to technologies and licenses acquired from third parties through the end of 2003; as of December 31, 2003, the residual value, net of amortization, registered in our balance sheets for these technologies and licenses was $222 million.

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.

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, such as in 2001 and 2002, our fabrication facilities, or fabs, do not operate at full capacity and the costs associated with the excess capacity are charged directly to cost of sales. Our gross profit margin declined from 38.9% in 1997 to 38.3% in 1998 during difficult market conditions. Our gross profit margin declined from 46.0% in 2000 to 36.3% in 2001, 36.4% in 2002 and 35.5% in 2003. In the difficult market conditions encountered since 2001, our gross profit margin has varied significantly from quarter to quarter and was, in 2002, 33.4% for the first quarter, 37.6% for the second quarter and 37.0% for each of the third and fourth

Back to Contents

Index to Financial Statements

quarters. In 2003, our gross profit margin was 35.0% in the first quarter, 35.7% in the second quarter, 35.1% in the third quarter and 36.0% in the fourth quarter. In the first quarter of 2004, our gross profit margin was 35.4%. We cannot guarantee that difficult market conditions will not continue to 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.

Furthermore 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 euro and currencies other than the U.S. dollar, and have in 2003 been severely impacted by the decline of the U.S. dollar, which is our reporting currency. 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”.

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 totaled $0.9 billion in 1998, $1.3 billion in 1999 and $3.3 billion in 2000. Due to market conditions, we reduced our capital expenditures for 2001 to $1.7 billion. For 2002, we further reduced capital expenditures to total approximately $1.0 billion. In 2003, our capital expenditures were approximately $1.2 billion. We currently intend to increase our capital investment to approximately $2.2 billion in 2004 from the $1.6 billion previously budgeted. 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. Our costs are increasing as the complexity of the individual manufacturing equipment increases. We will continue to monitor our level of capital spending taking into consideration factors such as trends in the semiconductor market and capacity utilization.

We may be required to redeem our convertible debt securities in cash and in advance of their maturity dates.

On September 22, 1999, we issued Zero Coupon Subordinated Convertible Liquid Yield Option Notes due 2009 (the “2009 bonds”) for net proceeds of $708 million, and on November 3, 2000, we issued Zero Coupon Senior Convertible Bonds due 2010 (the “2010 bonds”) for net proceeds of $1,458 million. Pursuant to the terms of the 2009 and 2010 bonds, holders have the right, subject to certain conditions, to put such convertible bonds back to us on September 22, 2004 and January 17, 2005, respectively. Because the market price of our commons shares is currently significantly below the respective conversion prices of the 2009 and 2010 bonds, and if our share price does not sufficiently increase by the respective put-option dates, holders may require us to make early redemption on the respective put-option dates.

In the event the 2009 and 2010 bonds were put back to us by all of the holders, the amounts payable would be $813 million on September 22, 2004 (payable at our option in cash or shares, the number of shares being computed based on market prices at the time) and $380 million on January 17, 2005 (payable in cash), respectively, causing our cash resources to be significantly reduced. In 2003, we repurchased approximately $1,674 million of the aggregate principal amount at maturity of our 2010 bonds, representing nearly 78% of the total amount originally issued, for which we paid approximately $1,304 million. The repurchased 2010 convertible bonds have been cancelled. We may proceed with future repurchases of our 2010 bonds in accordance with applicable laws, regulations and stock exchange requirements.

We may also need additional funding in the coming years to finance our investments.

The cost of new manufacturing facilities is increasing due to the requirements of advanced sub-micron facilities and technologies as well as the migration from 200mm wafer to the new, more complex and more expensive 300mm wafer manufacturing equipment. Furthermore, our 300mm research and development pilot line in Crolles, France, which has been built and is operated pursuant to a joint investment agreement with Philips Semiconductors International B.V. and Motorola Inc. as well as with the participation of TSMC, may require $1.5 billion in capital expenditures. We have constructed a building in Catania, which we have not yet started to equip, for the volume production of 300mm wafers. In addition, in an increasingly complex and competitive environment, we may need to invest in the acquisition of technology developed by third parties to maintain our competitive position in the market. Furthermore, we may consider acquisitions to complement or expand our existing business; in each of such circumstances, we may need 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.

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

A significant variation in 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 2003, 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 2003 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 for $1.125 in 2003; See “Item 5. Operating and Financial Review and Prospects—Impact of Changes in Exchange Rates”. In the first quarter of 2004, the average rate of the euro to the U.S. dollar was €1 for $1.260. The 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.

Our financial results can be adversely affected by changes in interest rates.

In the course of our business, we are exposed to changes in interest rates, linked primarily to how we invest cash on hand, which is typically at variable market rates, and the interest rate of our long-term indebtedness used to finance our operations, which is typically subject to fixed rates. The nature and amount of our long-term indebtedness can vary significantly due to our future financing needs, market conditions and other factors. If interest rates decline, we receive less interest on our cash investments, while we continue to pay higher interest on our fixed rate indebtedness, which has a negative effect on our financial condition and results of operations. In 2003, when short-term interest rates on our U.S. dollar-denominated funds were lower than in 2002, we repurchased a portion of our outstanding fixed rate indebtedness (approximately $1,674 million aggregate principal amount at maturity of our 3.75% Zero Coupon Senior Convertible Bonds due 2010) which reduced our exposure to the difference in interest rates on our long-term debt and the interest rates on our short term deposits. Our net interest expense (net of interest income of approximately $37 million) was $52 million in 2003, decreasing from a net interest expense of $68 million in 2002 (net of $49 million in interest income), and a net interest expense of $13 million in 2001 (net of interest income of $100 million). See Note 22 to the Consolidated Financial Statements and, for a detailed breakdown of our average interest rate received on cash equivalents and average interest paid on long-term debt, see “Item 11. Quantitative and Qualitative Disclosures About Market Risk”. For a discussion of related risks, see also “—We may invest our cash in short-term financial instruments as part of our treasury management strategy, which has certain inherent risks”.

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 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 nanometer to 32 nanometer chip technologies on 300mm wafers, as well as the operation of a 300mm wafer pilot line fabrication facility (or “fab”) in Crolles, France. TSMC is also involved in specific aspects of the cooperation agreement. There can be no assurance that our alliances with Philips Semiconductors International B.V., Motorola Inc. and/or TSMC 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, or that our business, results of operations and prospects will not be materially adversely affected by unforeseen events and/or the sizeable risks related to the development of new technologies, including unforeseen extra costs.

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 benefits 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 market 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;
- problems with manufacturing 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”.

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 2003, we had an income tax benefit of $14 million due to the impact of impairment, restructuring charges and other related closure costs that we incurred in jurisdictions with tax rates higher than our average tax rate, as well as reassessments of our deferred tax assets and liabilities due to changes in tax rates, as well as favorable settlements of certain minor items relating to prior years’ tax audits. In 2002, we had income tax expense of $89 million. 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; as such 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.

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, 2003, the value registered on our audited consolidated balance sheet for goodwill was $267 million and the value for technologies and licenses acquired from third parties was $222 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, the future cash flows may not support the value of goodwill and other intangibles registered in our balance sheet. We are required to test periodically to assess the fair value of such valuations. 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.

We have several large customers, some of whom have entered into strategic alliances with us. As of December 31, 2003, our largest customer was Nokia, which accounted for 17.9% of our 2003 net revenues, compared to 17.6% in 2002 and 19.3% in 2001. In 2003, our top 10 original equipment manufacturer customers accounted for approximately 46% of our net revenues, compared to approximately 49% of our 2002 and 2001 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. 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 2001 and 2002, increasing in 2003 to approximately 18%. 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, increase its product returns or fail to meet its payment obligations, our operating results could be 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 their deployment of new and revised supply chain models, requiring notably product delivery on consignment to our customers' sites with sales recognized when the customer, within a specified time period, picks-up the goods from our stock, may reduce our ability to forecast the purchase date for our products and evolving customer demand, thereby affecting our revenues and working capital requirements.

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 manufacturing operations depend 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 use are currently 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 by 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. 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. The development of fabrication facilities that include 200mm or 300mm capabilities, or which require advanced technologies, has increased the potential for losses associated with production difficulties, imperfections or other causes of defects. Our operating results could also be adversely affected by the increase in fixed costs and operating expenses related to increases in production capacity or manufacturing difficulties 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”, for the supply of up to a maximum of 20% of our requirements for these wafers. We do not intend to increase our reliance on front-end manufacturing through external foundries substantially beyond this level. 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 is based on market forces. Prices for foundry products also vary depending on capacity utilization rates at our suppliers, quantities demanded, product technology and geometry, making it difficult to generally compare overall costs of manufacturing products ourselves with costs of outsourcing our production. 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. For a description of current claims and litigation, see “Item 4. Information on the Company—Intellectual Property—Intellectual Property Litigation” and “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 may be required to prepare consolidated financial statements using both International Financial Reporting Standards (“IFRS”) and Generally Accepted Accounting Principles in the United States (“U.S. GAAP”) as from 2005.

We are incorporated in the Netherlands and our shares are listed on Euronext France and Borsa di Milano, and, consequently, we are subject to an 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”). We currently prepare our Consolidated Financial Statements under U.S. GAAP pursuant to our listing on the NYSE. Since our creation in 1987, we have always prepared our Consolidated Financial Statements under U.S. GAAP and intend to continue to do so. The obligation to prepare our Consolidated Financial Statements under IFRS, if implemented in 2005 by the Dutch Parliament, would consequently oblige us to report our results of operations using two different sets of reporting standards. Such reporting could materially impair the clarity of our investor communications. 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 and stock options. These changes may lead to significant changes in our financial statements.

Proposals to amend accounting rules under U.S. GAAP have been published for public comment, and additional 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 market interest. Recognition of interest expense under the FASB proposal may be considerably higher than the interest currently being charged in respect of our zero coupon convertible debt instruments due 2009, 2010 and 2013, which are included in “interest expense (net)” on our income statement. 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 less the debt portion of the instrument. The current proposal could apply both to our existing convertible debt instruments and any such instruments issued in the future. FASB’s proposal would potentially take effect as of January 1, 2005. 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 of the convertible debt instruments 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.

On March 31, 2004 FASB published an exposure document “Share-Based Payment—an Amendment of Statements No. 123 and 95”, which would require that share-based compensation to employees in the form of stock options or similar instruments be considered as a compensation expense and therefore require recognition of a charge to the income statement, measured on the basis of the fair value of the option at the grant date. If adopted, it could have a material adverse impact on our net income. The potential impact of such a change is described in Note 2.22 to the Consolidated Financial Statements, currently computed on the basis of FAS 148.

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. In addition, a new legislative proposal by the European Commission may require the registration, evaluation and authorizations 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 or materials, 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 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.

Mr. Pasquale Pistorio, age 68, has been the sole member of our Managing Board and our President and Chief Executive Officer since our formation in 1987. Mr. Pistorio was reappointed at our 2002 annual shareholders' meeting for a three-year term expiring at our annual general meeting to be held in 2005. Mr. Pistorio has announced that he will step down as sole member of our Managing Board and President and Chief Executive Officer after the 2005 annual shareholders' meeting. In March 2004, our Supervisory Board approved Mr. Pistorio's recommendation to propose to our shareholders at our 2005 annual general meeting the appointment of Mr. Carlo Bozotti as sole member of our Managing Board and President and Chief Executive Officer. Furthermore, as part of our management succession plan, the Supervisory Board has announced its intention to endorse, upon the proposal of Mr. Bozotti, the appointment of Mr. Alain Dutheil as Chief Operating Officer reporting to the President and CEO.

Several of our executive officers who have worked with us since our creation in 1987 and are over 60, may retire in the near- to medium-term.

Changes to our senior management organization 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. In 2003, we made acquisitions of assets and businesses for aggregate cash consideration of approximately $188 million. See "Item 5. Operating and Financial Review and Prospects—2003 Highlights—Other Developments in 2003". 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.

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 and centralized monitoring procedures, 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”.

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 funding agreements with France and Italy, which set forth the parameters for state support to us under selected programs.

These funding agreements require compliance with EU regulations and approval by EU authorities and annual and project-by-project reviews and approvals.

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 government resources, which is outside our control, as well as to our continuing compliance with all eligibility requirements. If these governments were unable to provide 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. 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.

Our controlling shareholders' interests may conflict with investors' interests.

At December 31, 2003, STMicroelectronics Holding II B.V. ("ST Holding II"), a wholly owned subsidiary of STMicroelectronics Holding N.V. ("ST Holding"), owned 311,483,280 shares, or approximately 34.5%, 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.

The recently announced 2004 Shareholders Agreement permits our respective French and Italian indirect shareholders to reduce their respective indirect interests in our common shares to 9.5% each without losing their rights to exercise certain control rights provided for in the agreement. For a description of the 2004 Shareholders Agreement and our indirect shareholders Areva Group, 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 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 result in a delay in the ability of our Managing Board to respond as quickly as may be necessary in the rapidly changing environment of the semiconductor industry. In particular, 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. On the same day, 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 at least 25% of the par value of the preference shares to be issued. The option as amended is contingent upon ST Holding II retaining at least 30% of our issued share capital at the time of exercise. The 2004 Shareholders Agreement provides that ST Holding II and its indirect shareholders will seek to reduce the percentage to 19%. 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 preferences shares.

The recently announced 2004 Shareholders Agreement permits our respective French and Italian indirect shareholders to reduce from their current level their respective indirect interests in our common shares to 9.5% each and states that the intention of such shareholders is to seek to enter into an amended option agreement with respect to the preference shares lowering the required percentage from 30% to 19%. The details of the 2004 Shareholders Agreement are further explained in "Item 7. Major Shareholders and Related-Party Transactions—Major Shareholders". Disposals of our shares by the parties to the 2004 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.

Substantial sales of our common shares into the market could cause the market price of our common shares to drop significantly.

At December 31, 2003, 889,369,734 of our common shares were outstanding, not including (i) common shares issuable under our various employee stock option plans or employee share purchase plans, (ii) common shares issuable upon conversion of our outstanding convertible debt securities, and (iii) 13,400,000 common shares repurchased in 2001 and 2002. As of December 31, 2003, our total issued common shares, including shares held in treasury from repurchases by us in 2001 and 2002, was 902,769,734. Substantial sales of our common shares or additional securities exchangeable into our existing shares, or newly issued shares or convertible bonds by us or our shareholders, as well as any announcement containing a potential sale, could cause the market price of our common shares to drop significantly. The timing and size of any future primary or secondary equity or convertible or exchangeable bond offerings will 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 MIB 30 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 MIB 30 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 MIB 30 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.