

## — MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone and welcome to the Texas Instruments Second Quarter 2009 Earnings Conference Call. At this time, I'd like to turn the conference over to Mr. Ron Slaymaker. Please go ahead, sir.

### **Ron Slaymaker, Vice President and Head of Investor Relations**

Good afternoon and thank you for joining our second quarter earnings conference call. As usual, Kevin March, TI's CFO, is with me today. For any of you who missed the release, you can find it on our website at ti.com/ir. This call is being broadcast live over the web and can be accessed through TI's website. A replay will be available through the web.

This call will include forward-looking statements that involve risk factors that could cause TI's results to differ materially from management's current expectations. We encourage you to review the Safe Harbor Statement contained in the earnings release published today as well as TI's most recent SEC filings for a complete description.

Our mid-quarter update to our outlook is scheduled this quarter for September 9. We expect to narrow or adjust the revenue and earnings guidance ranges as appropriate with this update. In today's call, we'll address key questions such as: what is driving the strong sequential growth in TI revenue? Does TI growing faster than end demand growth mean that inventory is building, setting the stage for an impending correction? Also, how much does TI's Wireless baseband revenue impact TI's results? Strategically, we'll talk about what we've been doing to strengthen our positions in Analog and Embedded Processing. Finally, we will discuss the drivers behind the increase in TI's profitability and the sustainability of the increase.

I'll start by noting that revenue and earnings for the second quarter settled in the upper half of the guidance range we provided in June. As you may recall, that range had been raised from our initial estimates in April so the end result for the quarter was substantially better than our original expectation. TI revenue grew 18% sequentially and was down 27% from a year ago. We were especially pleased with the growth in our core areas of Analog and Embedded Processing. Analog was the biggest driver of TI's sequential growth with all three of its major businesses contributing: High-Volume Analog and Logic, or HVAL; Power; and High-Performance Analog.

Although we still have work to do, we're encouraged by the early signs of progress in our HVAL business. We've been talking with you for some time about our efforts to reinvigorate growth in this area, and we believe we're on the cusp of this turnaround. In total, Analog revenue grew 21% sequentially and was down 24% from a year ago. Embedded Processing grew 11% sequentially due mostly to strength in catalog products. This segment declined 20% from a year ago. Wireless revenue increased 9% sequentially and declined 33% from a year ago. Our connectivity product line for smart phones drove most of this sequential growth. OMAP applications processors and baseband products also grew sequentially, although by a smaller amount.

From a regional and end equipment perspective, I'll note that sequential growth was driven primarily by high-volume equipment manufactured in Asia. Notebook PCs, hard disk drives, smart phones and consumer products such as TVs and video games systems were all strong in the quarter. Our sales in Europe and the U.S. continue to be weak although these regions are both much smaller in terms of revenues than Asia and are more heavily dominated by manufacturers who sell into industrial markets. Year to date, more than 90% of our revenue is from outside of the U.S.

Now I'll characterize sequential growth as we believe it relates to inventory and end demand. As customers and distributors slow the rate at which they are reducing inventory, our shipments continue to rise towards the level of end demand.

Although it is difficult to identify specific inventory levels and trends at OEM and EMS customers, we don't believe inventory is generally building. Instead, it likely continued to decline in the second quarter although at a lesser rate than in the first quarter.

We have better clarity on inventory at our distributors. Working with our distributors, we reduced inventory in the channel by about 10% in the quarter. As you would expect, this rate of inventory reduction is less than last quarter as our sales into the channel began to approach the rate at which our distributors are selling TI products out of the channel. You will recall that the middle of the expected growth range we provided in April, projected about 4% sequential growth, mostly coming from the seasonal increase in calculator sales.

As demand from our semiconductor customers surged in the quarter, our factories responded, ultimately delivering 18% growth in revenue. We understand that uncertainty continues in the end demand environment, and we will keep our operations flexible to respond to changing customer needs.

Before we move on to profitability, I want to take a moment to provide you with revenue information for our baseband product line that we are winding down over the next few years. By providing this revenue breakout we believe you will have better insight into the declining importance of baseband to our long-term revenue growth.

Specifically, baseband revenue was \$410 million in the second quarter, up 3% sequentially and down 40% from a year ago. We have posted a chart on our website so that you can see quarterly baseband revenue back to the first quarter of 2008. For the second quarter, when baseband is excluded, you can now calculate that TI's sequential growth was several percentage points higher at 21%.

I'll conclude my portion of our comments by mentioning the strategic action we took in the second quarter to strengthen Embedded Processing, one of our key growth areas, by acquiring a company called Luminary Micro.

Luminary has a strong lineup of advanced 32-bit microcontrollers based on ARM's Cortex-M3 architecture. With this acquisition we have transitioned from minimal presence in the 32-bit catalog microcontroller market to having more than 140 products in this fast growing space, essentially overnight. The leverage from this type of acquisition is significant as many of our 2000 field sales representatives and application engineers have now been trained on this product line and are busy uncovering new opportunities.

Now Kevin will review profitability and our outlook.

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**Kevin March, Senior Vice President and Chief Financial Officer**


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Thanks, Ron, and good afternoon everyone. The combination of higher revenue and higher factory utilization contributed to gross profit increasing by 39% sequentially. Gross margin increased 710 basis points sequentially to 45.7% of revenue although remained below the gross margin of 52.2% in the year-ago quarter.

This quarter was a solid step towards the 55% goal we have set for the company's gross margin. As we continue to improve our product mix with more Analog and Embedded Processing revenue,

continue to more fully utilize our factory capacity, and continue to lower our depreciation expense, we expect additional progress towards this goal.

Operating expenses were about even with the first quarter although declined \$220 million from a year ago. Restructuring charges in the second quarter were \$85 million or 3.5% of revenue. The distribution of these charges across our segments is included in our earnings release.

Operating profit for the quarter was \$343 million. Excluding the restructuring charges, operating profit was \$428 million or 17.4% of revenue. Our annual effective tax rate increased to 27%, higher than the 24% we had previously estimated reflecting our updated 2009 forecast. Net income was \$260 million or \$0.20 per share. Excluding the restructuring charges, net income was \$315 million or \$0.25 per share.

I'll leave most of the cash flow and balance sheet items for you to review in the release. However, let me make just a few comments. Cash flow from operations increased to \$557 million in the quarter. This is an increase from both the year-ago and the prior quarter levels. Capital expenditures were \$47 million in the quarter. We used \$251 million in the quarter to repurchase 13.4 million shares of TI common stock and paid dividends of \$139 million in the quarter.

We increased cash and short-term investments to \$2.56 billion in the quarter. Our balance sheet continues to remain strong and is a competitive advantage for TI in this environment.

Inventory declined \$35 million in the quarter. Inventory days declined to 72 at the end of the quarter compared with 93 days at the end of the year-ago quarter and 77 days at the end of the first quarter. TI orders in the quarter were \$2.80 billion up 27% sequentially. TI book-to-bill increased to 1.14 in the quarter from 1.05 in the prior quarter. Visibility entering the third quarter has improved markedly.

Turning to our outlook, we expect TI revenue in the range of 2.50 billion to \$2.80 billion in the third quarter. You will note this is a sequential increase of 2% to 14%. Compared with a year ago, this range reflects a revenue decline of 26% to 17%. We expect earnings per share to be in the range of \$0.29 to \$0.39. This EPS estimate includes \$0.01 per share negative impact resulting from expected restructuring charges. We expect a similar impact for restructuring charges in the fourth quarter. For 2009 our estimates for R&D, capital expenditures, and depreciation are unchanged and are described in the earnings release.

In summary, after the markets' sharp inventory correction in the fourth and first quarters, we are encouraged that our revenue is moving back toward the level of end demand. Along with higher revenue our factory utilization is improving and our profitability is increasing. Although end demand trends remain uncertain, we have shaped our strategies such that TI benefits from an improving mix of Analog and Embedded Processing products. At the same time the actions we took early to reshape and lower our expense will continue to contribute toward healthy trends in our profitability.

Further, we've been investing to strengthen our product lines even through the depths of the downturn and our strong cash generation will allow us to continue to make beneficial strategic choices. Whenever demand begins to recover, we believe the growth that will result will make it increasingly evident that there are no better markets for TI than Analog and Embedded Processing.

With that, let me turn it back to Ron.

**Ron Slaymaker, Vice President and Head of Investor Relations**

Thanks, Kevin. Jamie, you can now open the lines up for questions. In order to provide as many of you as possible an opportunity to ask your questions, please limit yourself to a single, single-part question. After our response, we'll provide you an opportunity for an additional follow-up. Operator?

**QUESTION AND ANSWER SECTION**

Operator: [Operator Instructions]. And we'll take our first question from Uche Orji with UBS.

**<Q – Uche Orji>**: Thank you very much. Ron, my first question is on the Wireless business, just to understand the profitability of the non-baseband business. So if I look at the baseband business, exclusive of the wireless, if I look at the margin itself, it's close to the same margin as Analog. So I just want to understand how the profitability of the baseband business to non-baseband business is trending, just to get a sense of the sustainability?

**<A – Ron Slaymaker>**: Kevin, do you have – you want to talk about profitability there?

**<A – Kevin March>**: Yeah. I think that if you take a look at – roughly 70% of our revenue in the second quarter was baseband and the rest of it was about evenly divided between the applications processors and the connectivity products. We have been talking for – I think since about October of last year, that we're removing the expenses through the balance of this year from the R&D standpoint, from the baseband part of that portfolio, and redeploying those over particularly into the applications processing side to expand that portfolio of products.

So as we move through that transition, the relative profitability of the two will change. I won't get into specifics, simply to say that the profitability on baseband will get a little bit better than it has been traditionally. And those resources will then – some of those resources will be absorbed by the applications processor side.

You might recall that we had characterized in the past that the total Wireless had margins or gross margins that were probably in the mid-40s and operating PFO kind of in the 20ish kind of level, that was prior to this downturn we're in right now. So once again, we'll see profitability on baseband increase simply because a lot of the operating expenses are going to come off of that as we wind down the development efforts on that by the end of this year.

**<A – Ron Slaymaker>**: Do you have a follow-up Uche?

**<Q – Uche Orji>**: Yes, I do. Maybe a separate question actually. If I look at your operating expenses, especially on the R&D line, this is probably close to an all-time low for TI and similarly SG&A is at fairly low levels. Granted, most of the OpEx reduction has been a reaction to the markets. What should we think is the normalized level for OpEx as the markets start to come back? Should we expect costs to start to increase as some of the tightness to costs starts to ease?

**<A – Kevin March>**: Uche, we have talked for a while, a couple of years ago when we set the goal for profitability for the company at 55% gross and 30% operating margin that really said, there is about 25% that you'd expect in the OpEx categories of cost that's R&D and SG&A. We're certainly closing in on that although we're not there yet. And as you pointed out, we've brought those operating expenses down pretty sharply here as a result of the restructurings that we did back in the first quarter.

Going forward, we are expecting OpEx to continue to decline a little bit more over the next couple of quarters, such that it should reach about the \$660 million level in the fourth quarter. To the extent that we see that changing as we move out in time that will be more a function of changes in pay and benefit type of factors as opposed to anything else. So from that point, our mission then is to go off and grow the revenue to make sure that that stays at a 25% kind of level.

**<A – Ron Slaymaker>**: Uche, thanks for your question.

Operator: We'll take our next question from Jim Covello with Goldman Sachs.

**<Q – Jim Covello>**: Good evening, guys. Thanks so much for taking the question. First, I wonder if you guys could run through the lead times across the product portfolio. Has there been any stretching of lead times in any of the various products as the business conditions have improved?

**<A – Ron Slaymaker>**: Jim, I don't know that I can run all the way across the product portfolio, I can make some general statements on lead time. For the most part, I would describe lead times as generally stable. There have been some product areas where, as demand surged in the second quarter, it got ahead of our supply and we necessarily stretched out lead times somewhat. And we're as rapidly as possible trying to ramp our production in those areas to get lead times back down to those short, normal levels. But I would just say, and again, I don't have specific product areas to call out for you other than to acknowledge there have been a few areas where lead times have stretched out during the quarter.

Do you have a follow-on, Jim?

**<Q – Jim Covello>**: Sure. Could you talk about what you expect for inventory on your own balance sheet and then in the channel for the third quarter?

**<A – Kevin March>**: Jim, I think that we don't normally forecast inventory, but I would just point out that we just drained, I guess it was another 35 million or so out of inventory this quarter taking us down to 72 days. And you may recall in the last quarter we talked about inventory being at what we'd call ideal levels. Right now I'd probably characterize inventories being somewhat lean. So we would probably look to build those a little bit more as we see demand stabilizing.

We have been draining inventory in the channel – the distribution channel drained about another 10% this past quarter. We know that some of our larger customers have reported already and we've seen evidence where they have been reducing their inventories as well according to their public reporting. So we believe inventory in the channel also is quite low and still coming down a bit, although at a slower pace.

And going forward, we would imagine that inventories begin to match up a lot more closely with true end demand, and not necessarily see inventories building in the channel. We may build a little bit on our own balance sheet, simply because as Ron mentioned, we're a little bit behind on just a couple of parts, that we need to go ahead and bring the levels back up too, but I wouldn't expect a significant change.

**<A – Ron Slaymaker>**: Hey, Jim, let me just make a few additional comments just also on trends with distributor inventory. We've been speaking with you for, oh, I guess a year now about the consignment program that we're in the process of deploying with distributors. We now have about 25% of our distributor revenue supported by consignment inventory programs where we own that inventory as opposed to the distributors having it on their balance sheet.

The net effect of us continuing to expand that program will be that distributors own inventory will or the distributor – what would be generally be considered channel inventory – will continue to decline as we go ahead. So just to kind of give you a milestone of where we are on that, I think you've historically heard us talk about, oh, average inventory levels anywhere from eight to nine weeks at distribution.

We're down probably in the 6.5 week range with about a quarter of that revenue being supported by consignment and even though over time, not everything will go to consignment, probably something like half of it will. So that's that distributor inventory in general would be expected to continue to go down over the course of time as we deploy that program.

So the net effect on our revenue is, we probably lose what looks like, for example, in the second quarter, a little bit of revenue growth as we transition over to that consignment program, but we don't lose revenue, that's just simply a matter of when that revenue is recognized.

So anyway, I just thought that was a good opportunity to talk about that program. Thank you for your questions, Jim. And let's go to the next caller, operator.

Operator: We'll go next to Srinu Pajjuri with CLSA.

**<Q – Srinu Pajjuri>**: Thank you. Ron, you said, you're making decent progress in the High-Volume Analog segment. I'm just wondering, how much of the strength in Q2 and Q3 is related to share gains versus just the market coming back a bit here?

**<A – Ron Slaymaker>**: Srinu, I wish I had a good answer for you, but I don't know that we have that quantified, especially when you look at a single quarter effect like that. There have been programs over the last couple of quarters that have moved into production that we can clearly identify as share gain. But also in many of those markets such as, oh, I don't know, storage would be one example, first quarter, there was a significant inventory correction taking place at those customers that we're now coming back off of. So I don't have – clearly it's a mix, but I don't have it quantified for you.

Do you have a follow-on, Srinu?

**<Q – Srinu Pajjuri>**: Yeah. Sure. For Kevin, Kevin more of a longer-term margin question for you, I guess when you first gave us the 55% target, obviously I'm guessing that you assumed that Wireless would be in the mix. Now that Wireless is going to be out of the mix looking two to three years from now, why wouldn't the gross margins be higher than 55? Is there any secular reason for that? Thank you.

**<A – Kevin March>**: Srinu, it's a good challenging question. I would say there is no secular reason why they couldn't be higher, but we need to achieve first a mix that gets us to 55 and 30, and then we can revisit the trade-off between further expansion of that mix to rates of revenue growth that we can actually deliver to our shareholders.

**<A – Ron Slaymaker>**: Okay. Srinu, thanks for your questions.

Operator: We'll take our next question from Cody Acree with Stifel Nicolaus.

**<Q – Cody Acree>**: Thanks, guys and congrats. Ex-baseband – or actually, including baseband, can you talk about crossover with Embedded and Analog and apps processor, when you think we start to see a crossover revenue?

**<A – Ron Slaymaker>**: Boy, I'm not sure I completely understand your question Cody. You're saying when do we think we've seen growth in those other areas enough to offset a decline in baseband? Is that your question?

**<Q – Cody Acree>**: Yeah. You have 601 million in baseband, Analog, Embedded, apps processing. When do those grow to a point that it's no longer an issue?

**<A – Kevin March>**: Okay. Cody, let me offer a different way to think about it. We actually had 601 million in overall Wireless revenue, 410 was in basebands. We've talked about the baseband revenue working its way to zero by the end of 2012. In other words, 2013, there's no revenue. So you can take a look and say, well, that's probably what ten quarters away from us. So I think if you just drew yourself a linear line and figured out the rate of quarterly decline, you can see that it's

really not as severe as you might think it would be, given where we're at right now at around a \$410 million quarter that we just came out of on baseband.

And so it's not all that out of the question that the rest the portfolio can certainly absorb that and in fact offset it and show total growth for TI. I won't make any specific predictions but I do want to make sure you kind of have the numbers framed so you can see that it's really a declining drag on us as we move forward in time.

**<Q – Cody Acree>**: Right.

**<A – Ron Slaymaker>**: But Cody, let me also just say, I don't think we sit around here trying to figure out how – what do we need to do in Analog, what's the right level of investment to make in Analog and Embedded Processing to fill the hole that is created by baseband. Those are two completely independent business decisions.

What we're doing in baseband is the right decision for that that particular market opportunity. What we're doing in Analog and Embedded Processing is an investment level that pretty much maximizes the returns from the opportunity in that space as well. And I think especially over the next few years, as Kevin explained, we have the opportunity to drive some very nice cash flow out of our baseband operations as we pull operating expense off. I actually believe looking at just the top-line revenue decline there, probably is not as much the important factor as much as kind of the more bottom-line contribution over the remaining lifespan for that product area. Do you have follow-on, Cody?

**<Q – Cody Acree>**: Sure, the 27% order increase, can you give any granularity there?

**<A – Ron Slaymaker>**: We don't break it out by product area. I don't know that it was – there is nothing that comes to my mind that was particularly weighted in one area versus the other, but I think similar to what you saw this quarter in terms of pretty broad base of revenue growth, I think orders generally would have reflected a similar type of distribution.

Okay, Cody. Thank you for your questions.

Operator: We'll go next to Edward Snyder with Charter Equity Research.

**<Q – Edward Snyder>**: Thanks a lot. Couple of them. You're moving to consignment is going to give you better visibility at the cost of higher working capital. And it sounds like you've got a nice chunk of it now going to 50%. As you move to that kind of a model, what are you seeing in terms of throughput – are there any surprises there at all? But more importantly, is this going to give you better forecasting for that business? That's a pretty fragmented market to begin with and it's not clear that that the trade off is necessarily going to give you much better in terms of planning.

**<A – Kevin March>**: Ed, you're talking, the consignment for the distribution channel I'm presuming?

**<Q – Edward Snyder>**: Correct.

**<A – Kevin March>**: Yeah, that certainly will cause our inventory levels to increase some as we take on ownership of that. And just probably shifts the ownership by roughly 90 days because for the most part, as Ron indicated earlier, that channel turns over the inventory pretty quick. So the working capital that we're going to take on to carry that is really not all that significant. The fact of the matter is, the arrangements we have with the distribution customers is such that we get more favorable treatment on our products that they ship in exchange for this program. And so there is a mutual benefit, both for them and for us.



From an overall planning standpoint, we actually think this will give us better visibility, because we will actually – because we're holding the inventory if you will, we don't have to stock pockets into a series of warehouses at our distributors and therefore have a lot of inventory around the world if you will. We'll actually be able to hold a little bit more of it back and move it across the various distributor warehouses where there is demand over time. So we think that will allow us to be more responsive to changes in demand, whether it is up or down, and give us improved visibility at a fairly small cost on the working capital side.

**<A – Ron Slaymaker>**: More efficient and flexible inventory, but I would also say, Ed, the big driver for us doing this is, we believe it will translate to market share increases for TI inside of our distributors.

**<Q – Edward Snyder>**: So the 35 million you talked about in terms of burning that off this quarter, that's including the growth in the consignment. So it actually should have gone up a little bit or has it been all put on kind of hold during the downturn here?

**<A – Kevin March>**: You mean the movement to consignment? It has not been put on hold. We started this program a little less than a year ago, and we've continued that right through the downturn.

**<Q – Edward Snyder>**: And then...

**<A – Kevin March>**: We're not letting the downturn get in the way of it. This is operationally better for us and as Ron pointed out, we believe, certainly over the long-term, better strategically, because we get more mind share with the distribution channel.

**<A – Ron Slaymaker>**: But Ed, you're very correct. The \$35 million decline in TI inventory included us increasing the amount of consignment inventory during the quarter to support distribution.

Do you have a follow-on? Okay, I believe that was your follow-on, Ed. Thank you for your questions.

Operator: And we'll take our next question from Glen Yeung with Citi.

**<Q – Glen Yeung>**: Thanks. I think I'm getting something like 51% implied in your guidance for Q3 gross margins and I guess the question I have is, when I look at sales of, call it, 2.6, 2.7, something like that for Q3, on 51% gross margin, do I need to see revenues increase kind of in step with that to get to 55 or can mix alone at some point in and around the revenue levels you're projecting for Q3 get me to my target model?

**<A – Kevin March>**: Glen, I won't comment on the gross profit margin that you're forecasting there, we actually don't provide that, as you well know. I would say though that, again with baseband on its way down and traditionally at lower gross margins than we have on the rest of the portfolio, clearly as Analog and Embedded Processing become a larger and larger portion of our total revenue, that has a clearly favorable impact on our gross margins.

In addition, as we go into third quarter, the only comment I would make there is, I did mention earlier that we're quite lean on inventories right now, that our projection is for revenue to increase in third quarter versus second quarter and so by definition, we'll have to step up production somewhat in order to do that. And so that should have some favorable impact on our utilization going into the third quarter.

**<A – Ron Slaymaker>**: And then finally I think you mentioned in your prepared remarks, we've seen favorable trends on depreciation, probably not as impactful as the other two areas, but certainly a continuous one that will continue to benefit us even into next year as well.

Do you have a follow-on Glen?

**<Q – Glen Yeung>**: Yeah, kind of a qualitative question. I think also in the prepared remarks, Kevin you'd mentioned that visibility has improved markedly. And it's obvious, in a way, because your bookings were up and your backlog is higher. But are there anything else or is there anything else that you're hearing or seeing from your customers, that says to you this is a more sustainable – what we're seeing is more sustainable than one might have thought a quarter ago.

**<A – Kevin March>**: Well, the signals that we're seeing, Glen, really have to do with the rate of decline that we're seeing in their inventory levels. It has slowed substantially, which certainly signals to us that they believe their inventories are much better aligned now with their true end demand. And so that's probably one of the better signals that we're seeing from them.

And second side of course is the orders. We actually saw our backlog for the current quarter increase about 27% versus where we were ninety days ago. In other words, starting the quarter, we had 27% more backlog than we did starting the second quarter. And so that's given us increased visibility and confidence on the outlook for third quarter.

**<A – Ron Slaymaker>**: Okay. Thank you, Glen. Let's move to the next caller please, Operator?

Operator: We'll go to the next question from Stacy Rasgon with Sanford Bernstein.

**<Q – Stacy Rasgon>**: Hi, guys, thanks for taking my questions. Ron, quick question on the communications infrastructure, so that was about flat in the quarter. I know this has been a source of growth for you guys over the last couple of quarters. Is that pausing now or do you still anticipate growth going forward? And is the fact that ASICs were actually down also indicative of this?

**<A – Ron Slaymaker>**: Stacy, I think certainly what we saw in first quarter was highly driven by the China infrastructure build. Our view is that's kind of running on a one-year cycle in terms of the different phases of that deployment. So I think we believe there is growth there and that it's multi-year growth but it may happen more in steps as opposed to continuous quarter-by-quarter growth, even as what you've seen thus far. So I won't necessarily comment on second half expectations, but we saw nice growth in first quarter, we saw it flatten out in the second quarter, additional phases will roll out, as I said, kind of on a year-by-year type of basis is our expectation.

**<Q – Stacy Rasgon>**: Got it, so a little lumpier then?

**<A – Ron Slaymaker>**: Right.

**<Q – Stacy Rasgon>**: Got it. And I guess for my follow-up, just around your guidance and upside in next quarter, so the midpoint would be up, what is it, 7.8% from where you came in in Q2? I'm just curious how much of that you really do feel is kind of demand versus any sort of restocking which might occur in the channel. I'd just note that a little more seasonal might be up maybe like 3 to 4%.

**<A – Ron Slaymaker>**: Yes, I don't – Stacy, it's really difficult – as I said in the opening remarks where we have great visibility in terms of actually knowing the specifics of inventory trends will be at distribution. Once we start moving out into the OEMs and EMS, we generally will have a feel for what's going on. But it's difficult to be specific. Kevin pointed out that if you just look at, for example, last quarter our largest customer, which did report now last week, announced that they reduced

their inventory 14%. The other area where I said we had great visibility was at distribution where we saw inventory go down 10%.

So there are a – between those two guys alone they represent half of our revenue a trend that said in second quarter we continued to ship below – maybe not end consumption but the rate at which they're shipping out. So that says – and by the way that's just – those are two areas – two customers or a customer and distribution where we have now quantified results.

The other half of our revenue basically we think there are general trends that probably match the other half – the first half I described. So going into third quarter, we know based upon the half that I just described, our revenue, our shipments entering the quarter are below the rate at which the customers are shipping out. So we know or we believe there is more room to go in terms of what I would call the convergence of our shipments and the rate at which our customers are going.

Does it go beyond that and have those customers start to replenish inventory? That wouldn't be surprising just given the seasonality of third quarter coming into the holiday market, but I don't want to speculate on what will or will not happen other than a normal seasonal trend would indicate that.

Do you have anything further, Kevin?

**<A – Kevin March>**: Yeah, Stacy, just to add a little clarity to that, we look at our five-year average for third quarter. We normally – that five-year average would say, we'd expect third quarter to be up about 5% sequentially and as you note, our midpoint is up a couple points higher than that and it's really again to our belief that we're just catching with end demand with our customers. Our belief is really the whole supply chain is coming into much better balance from semiconductor suppliers all the way to our customers, to their end customers and so the inventory correction is largely completing itself and we're just – we're probably in the last stages of that rebalancing.

**<A – Ron Slaymaker>**: But, Stacy, I also will just add, I've seen from other semiconductor vendors' conference calls that they believe there is some inventory restocking that's going to take place in PC market or otherwise and some of those guys may have visibility into those channels that would be better than what we're seeing specifically. But we'll probably – we'll probably have better visibility on that once we come out of the quarter.

All right, Stacy, thank you for your questions and let's go to the next caller, please.

Operator: And we'll go next to John Pitzer with Credit Suisse.

**<Q – John Pitzer>**: Yeah, thanks, and congratulations. Ron, I guess as a follow-on to that, when you look at the revenue guidance for September, I completely understand the upper half of the range. Given your book-to-bill, bookings, backlog, the fact that you're shipping below consumption and some of the share gains you're expecting in the high volume, I'm having a hard time understanding the lower half of the range. Other than just sort of macro uncertainty, is there anything else that you're seeing in the business that's actually driving kind of the lower half of the range?

**<A – Ron Slaymaker>**: I think you've identified most of the variables that I can think of. And clearly, the macro environment – I mean the macro environment for the most part continues weak. As we said, at least what we saw in the second quarter was mainly driven by TI coming out of the inventory correction moving back toward end demand. I would say the biggest downside risk factor continues to be the overall macro environment and the uncertainty that ties to that. That's not saying that's something that we're forecasting, but clearly that's one of the downside risks that would exist in the third quarter.

**Texas Instruments  
Incorporated**  
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**<A – Kevin March>**: To put a little additional color on that, John. I mean, if we just kind of look at macro economy, as Ron just said, it's not growing yet, albeit, it may be getting closer to bottoming. But if you just look at the unemployment rate in the U.S., a year ago this time, it was probably around 5, 5.5%, now we're at 9%, pushing 10%. It's unclear where we're going to see much of a bump in growth going forward with those kinds of economic realities. And so that explains the range that we've got is that, in fact, if we're closer to meeting end-demand with our customers than what we believe, then we may actually come in at the lower end of the range. If we have a little bit more correction or finalize on inventory matching then we're probably closer to the middle or upper end of the range as we indicated.

**<A – Ron Slaymaker>**: Do you have a follow-on, John.

**<Q – John Pitzer>**: Yes, as my follow-on, Ron, when you look at the baseband business and you kind of look at both gross and op margin, can you help me understand fixed versus variable cost in that business so that if we don't get this smooth transition of baseband revenue going down being offset by other areas of the business, how do we think about your ability to manage cost as that business winds down?

**<A – Kevin March>**: John, all we've got left really is to wind up the last of the development programs that will be done by the end of this year. So we've really only got a couple – less than a couple of quarters to go to finish that up. After that, the cost that we have on that business is truly sized to just the demand, so as the demand drops we can – it's almost completely variable, there's very little fixed cost.

**<Q – Ron Slaymaker>**: And what about on the manufacturing side?

**<A – Kevin March>**: That's a good point. On the manufacturing side, the overall majority of this is outsourced, especially on the wafer side. So it's not an issue for us when it comes to the wafer fabs.

**<A – Ron Slaymaker>**: Okay, John. Thank you for your questions. Let's go to the next caller please.

Operator: We'll go next Doug Freedman with Broadpoint.

**<Q – Doug Freedman>**: Great. Thanks guys. Can you talk a little bit about what – where you're seeing this High-Volume Analog strength and what market segments are driving some of that growth in the future?

**<A – Ron Slaymaker>**: Okay, Doug, I think we identified some that were already – that were in the current quarter. So for example I think we talked about storage, I think we talked about not yet – I'm just – I'm going blank in terms of the various pieces here. Storage certainly was a piece of it and certainly consumer was part of that as well. I think some of the consumer included things for example, like personal navigation devices, I think TVs were part of what we saw also in HVAL as well as some of the gaming opportunities and programs that we have over in Japan.

Going forward, I would say it would be more in those various segments as we've been able to take some of those customers where we had relationships, expand our presence in those existing systems. The other thing that we've been able to do is take, for example, some of our capabilities an example I would say is motor-drive skill that came out of our work in hard disk drives and basically be able to apply that in what we call adjacent markets, for example just the broader motor servo control market with varying products.

And then finally one that we've talked about for some time is in Wireless, where wireless Analog has been a significant drag on our overall Analog growth and specifically our HVAL growth for a number of years now. I think for some time we have been projecting that we would expect that to bottom out in the first half of this year and then translate to growth in second half as we have new programs that we've been working on for some time shift into production. And nothing has changed. In fact, those programs are well underway, and we continue to expect growth in the HVAL wireless piece in the second half of this year.

Do you have a follow-on Doug?

**<Q – Doug Freedman>**: Yeah. If you could spend a few minutes talking a little bit about the company's acquisition strategy and the deal pipeline that you might be thinking about. Am I correct in stating that it looks to me like you're doing about one sort of bolt-on acquisition per quarter and is that something – is that sort of a rate we should expect to see you guys continue to do deals at?

**<A – Kevin March>**: Doug, I wouldn't be so bold as to forecast that it would be at that same rate, but you're certainly correct in observing, it has been at that rate the last few quarters. Certainly we just closed on Luminary this past quarter and CICLON the quarter before. Of course, we're always looking. As we've mentioned before, what we find somewhat attractive about this kind of economic environment is that companies tend to be a little bit more open to the idea of acquisition than they might be in a robust, well-funded economy. And we look to use that strategy to supplement any holes that we have in technology or capability, or to accelerate our overall revenue growth. So clearly we're looking, we always look, there is always a lot under the spotlight, but it's almost impossible to forecast the rate at which you might actually succeed in closing on those deals.

**<A – Ron Slaymaker>**: Okay. Thank you, Doug.

Operator: We'll take our next question from John Barton with Cowen and Company.

**<Q – John Barton>**: Thank you. You've mentioned both in your prepared statements and in the written documentation that you're going to keep operations flexible, because the demand trends are uncertain. Could you give us a feel how flexible you can be? I'm thinking about in both directions. If we see greater than expected upturn, how quickly can you react to that both internally manufacturing wafers, as well as the foundry domain and then what are your thoughts on how quickly you would turn things down if necessary?

**<A – Kevin March>**: Well, John, I'd point to the current quarter as an example. Again we came into the quarter anticipating about a 4% sequential revenue growth at the midpoint of our guidance that we gave 90 days ago with most of that actually coming from our calculator business and it turned out, we just delivered 18% growth. So I would say that our ability to flex up is pretty good as indicated by the last 90 days. And we do that really by supplementing our manufacturing operations, not only with foundry for wafers, but also with contract labor in some of our various sites so that we can hire those folks back on pretty quickly, and correspondingly if we see demand flip sharply in the other direction, we can do exactly the reverse of what we just did. And we can do it in quite short order. So we're pretty confident about our ability to move quite quickly in either direction on that front.

**<A – Ron Slaymaker>**: Do you have a follow-on, John?

**<Q – John Barton>**: Yeah. You highlighted the acquisition of Luminary and the fact that you now have it in the hands of the 2000 field personnel. Putting aside design cycles or time from design to production at the customers, how quickly can you educate that field force and actually how quickly do customers start to embrace it now that it's under the TI umbrella?

**<A – Ron Slaymaker>**: I will make some comments and Kevin might want to add on. I think, in terms of training of the sales force that can happen very quickly, and it will happen to varying degrees over time. So initially it's a matter of giving them collateral, helping them understand general the parts, how those different products fit into different applications and application A, you should – the sales person should be looking at Luminary part, application B, consider the TI DSP or whatever. So it's a matter of helping them fill out kind of a product application matrix to just be able to know when do you start talking part A versus part B.

The other thing that happens just over time that happens naturally with those various customer interactions is just the deeper applications knowledge that happens and that's just with time and experience and they will get better and better over time.

What – in terms of how fast can the customers and do the customers engage, in some cases, there will be customers that considered working with the small company, whether it would be Luminary or you need to go back to first quarter CICLON. But were not – they didn't have enough confidence in that company, especially in this type of environment, basically to risk a product line, in some cases, risk their company on that small company as a supplier. And so a lot of times, there is already intimacy between the customer and that – the acquired company's strategy and product line and product roadmap and week one of us announcing the deal, we have customers calling us, not us calling customers, saying, good deal, let's get together, we want to engage.

Both in Luminary's case and also in CICLON's case, we've had that situation exist. And I know in the case of CICLON, for example, big customers that were familiar with the technology, but were not comfortable engaging with that small of a company, calling TI executives the day after that acquisition saying, come in here, we need to talk, we want to work with you on this product line.

So it can be embraced very quickly but at the same time, John, don't translate that to an upside in third quarter. From the time you engage with these customers, especially in the case of a microcontroller, it very well can be 18 months or so before you're seeing – we're seeing revenue from those engagements. So great opportunity, good opportunity to continue driving long-term growth in Embedded Processing and Analog but give us a little bit of time before we start showing those results.

Okay, John, thank you for your questions and let's move to the next caller please.

Operator: We'll take our next question from Tore Svanberg with Thomas Weisel Partners.

**<Q – Tore Svanberg>**: Yes, my first question is: historically you would have had to hit maybe 3 billion in revenues to get to 50% gross margin. Just based on the new mix, is there a chance you can get there before hitting 3 billion a quarter?

**<A – Kevin March>**: Tore, it certainly would be a desirable outcome. But I won't go as far to predict that. I would just simply remind what I've talked about earlier that we will be close to – at our current revenue levels we'll be close to a 25% operating expenditure kind of mix and so it won't take a whole lot of extra revenue to actually – especially in the right mix, to get us to 50% kind of gross margin after that and begin to push up towards that 55% goal we set for ourselves.

**<A – Ron Slaymaker>**: And Tore, I don't know if – about the math that you did to get to 3 billion, but whatever that number was, it will be lower. The revenue level will be lower just given Analog and Embedded Processing have historically had gross margins above the company average and baseband had gross margins below the company average. So as we get faster growth in Analog and Embedded Processing and as baseband becomes less and less part of the mix we're getting -- we will benefit on the gross margin both from the top side and the bottom side of that equation.

Okay, do you have a follow-on, Tore?

<Q – Tore Svanberg>: Yeah, where is utilization today and where do you expect that to be in Q3?

<A – Ron Slaymaker>: Tore, we don't break out specific utilization levels any longer. What I can say is second quarter was a step up from where we had been in the first-quarter level. I don't have a projection for you in third quarter although our factory loadings will continue to reflect our demand not only in the third quarter but in this case it would also be our anticipated demand in the fourth quarter as well as any adjustments that we need to make to our inventory levels. So again I don't have a specific utilization number to provide you going forward.

Okay, Tore, thank you for your questions. And we'll move to next caller.

Operator: We'll go next Sumit Dhanda with Banc of America-Merrill Lynch.

<Q – Sumit Dhanda>: Yes, hi, Ron and Kevin. Couple of questions. You mentioned that with the consignment arrangement you get potentially favorable treatment from your distributors. Any implications in terms of your margins given that clearly the distributors get sort of impact your margins given how much was going through -- going directly through distribution before, does that impact reduce given the consignment approach?

<A – Kevin March>: Sumit, the -- that's a market driven kind of pricing thing, and it's not going to have -- we won't have any impact on margins and that's not what this is really about. It's really about gaining greater mind share with the distributors and helping to accelerate our rate of growth and our total market share. But I wouldn't expect any impact, pro or con, on the margin front as a result of this program.

<A – Ron Slaymaker>: What could be a consideration, although it's probably more indirect are the products that move through distribution tend to be areas like High-Performance Analog, the catalog Power devices, and the catalog Embedded Processing devices. All of those areas tend to have pretty rich margins. So to the extent it translates to market share gains and therefore mix improvement, we'll benefit.

Your follow-on question, Sumit?

<Q – Sumit Dhanda>: Yes. Kevin, if you could break out, within basebands, the merchant business versus the custom business, is that a possibility?

<A – Kevin March>: Sumit, I think we're going to keep it to where the recent break out that we've just done, and we'll just begin to call out specifically baseband so you can track that. They're both kind of moving. We've talked before about what the merchant business was. It will tail off before the custom business does, but what's more meaningful, I think, is the profile that we've given you from the history that's on the web site and the way we've suggested you model that over the next 10 quarters of decline.

<A – Ron Slaymaker>: Yeah, Sumit, I don't have the specifics, but let me just say that baseband revenue is far weighted towards custom as opposed to merchant. But again, I don't have the specific mix.

Okay, thank you for your question, Sumit.

Operator: And we'll go next to Chris Danely with JPM [JP Morgan].

**<Q – Christopher Danely>**: Okay, thanks guys. So, Ron or Kevin, you guys talked about the lead times stretching out on some certain products and then also the desire for the channel to maybe take up the inventory a little bit this quarter. Do you think that things will be “normalized” by the end of Q3 or could we see these extended lead times and low inventories spill into Q4?

**<A – Kevin March>**: Chris, I'm not sure that we were talking about the channel increasing their inventory, I think what we were talking about is that we would like to increase ours a little bit. 72 days is a little bit lean and consequently on some parts, demand has exceeded our available supply. And that's what we're trying to step up our internal inventory onto meet that. We're not trying to get the channel to increase its inventory.

**<A – Ron Slaymaker>**: Yeah, in fact, I think what I said is the longer term trend for distribution is that their inventory levels will continue to go down because of the consignment program we have in place.

Do you have a follow-on, Chris?

**<Q – Christopher Danely>**: Actually if you guys could finish the comment on the lead times and then I will ask a follow-on to the question on lead times.

**<A – Ron Slaymaker>**: Right. So your question is do we expect to have lead times pulled back in by the end of third quarter and that's really a demand question. I mean, we're doing what we can to get on top of it and get our supply matched to end demand but again that's always a moving target in terms of what end demand is doing. So other than to say we're going to try to do it as quickly as possible, I don't have a projection for you as to when we expect to have that accomplished.

Okay, would you – let's move on to your follow-up now?

**<Q – Christopher Danely>**: Sure. And then just on demand, I mean if you guys can give us your perspectives. Do you see it, broadly speaking, getting better out there? Is it fairly stable? I'd just appreciate your thoughts.

**<A – Ron Slaymaker>**: On end demand?

**<Q – Christopher Danely>**: Yeah.

**<A – Ron Slaymaker>**: I think, Chris, we recognize first of all that the general macro environment is weak and continues weak. One thing I would say on demand is we don't know because we're not feeling it yet. Our growth is – we're kind of feeling the vacuum of our customers lowering their rate of reduction of inventory and so we're still not at their shipment levels. We're not at the end demand level. Our growth is coming off of that inventory correction. So we don't have any direct visibility into what end demand is doing and certainly not any better visibility than what you guys would have through your own various ties into the market.

Kevin, do you have anything to add?

**<A – Kevin March>**: No, I think you were pretty comprehensive.

**<A – Ron Slaymaker>**: Okay, Chris. Thank you for your questions.

Operator: And we'll go next to Tim Luke with Barclays Capital.

**<Q – Tim Luke>**: Thanks so much. Just with respect, Kevin, to the linearity that you've seen in the quarter, did – have things – it sounded like they continued to firm as you went through June and



maybe you comment on whether you'd seen that continue into July. And as an extension of that, as you've begun to see the environment stabilize, in your words, I think, maybe you could give us your sense of – or just remind us how we should perceive seasonality as you move into the fourth calendar quarter and what some of the puts and takes may be there?

**<A – Kevin March>**: Okay. On linearity we saw as orders came in – new orders came in, they were fairly strong in the first part of second quarter, moderated a bit as we went through the quarter, and have restrengthened coming into this quarter.

From a revenue standpoint, they were fairly normal across the months in the quarter. So nothing unusual or noteworthy there. It's just a fairly steady increase through the quarter, but nothing out of the ordinary. I mentioned earlier that normal seasonality for us would be to see about a 5% quarter-over-quarter growth in the third quarter for our revenue. That's the five-year average, but a lot of variability about that I might add and that same five-year average seasonality would be to see our revenues decline by about 5% in the fourth quarter.

Right now, we're not forecasting the fourth quarter. But I would kind of point back again to a comment I made a few minutes ago that it's a little bit different this year in that a year ago, coming out of third quarter going into fourth, we had unemployment levels in this country, five or 6%, now we're talking 9 or 10%. One would have to guess that that's going to have some effect on total demand through the economy. If nothing else, just keeping any recovery off of the bottom pretty modest from a growth standpoint. And that's quite frankly how we have tried to align the cost structure of the company to be ready in case we're faced with an environment like that.

**<A – Ron Slaymaker>**: Tim, let me just offer, as I always do, the range on TI's fourth-quarter growth for the last five years has been minus 26% to flat. So I'll let you figure out how much you want to weight that average number.

Okay, Tim, do you have a follow-on?

**<Q – Tim Luke>**: Just as a follow-on then would be a) just to clarify what you said about the linearity, I think you said that July saw a resurgence of strength or restart of stronger orders and then my question would be just with respect to the tax rate is now going lower to 27, that's what we should use next year as well, is it?

**<A – Kevin March>**: On the linearity, you're correct on what I said. That is that we have seen orders strengthen back up again as we've come into July. On the tax rate, our estimate right now is 27% for this year and I would recommend that you not necessarily assume 27% next year, that you do what we do, that is: take what your outlook is for incremental profit, tax it at the U.S. tax rate of 35% and let that tax fall through to a new computed rate.

**<A – Ron Slaymaker>**: Okay. Thank you for your questions, Tim.

Operator: We'll go next to Mark Lipacis with Morgan Stanley.

**<Q – Mark Lipacis>**: Thank you for taking my question. Ron and Kevin, I'm still trying to reconcile the 18% sequential revenue growth with the comment that you're lowering inventories in the channel, is the answer that your direct business to OEMs that perhaps they're doing at least a partial restock or you're seeing potentially a restock at the retail base? Thanks.

**<A – Ron Slaymaker>**: Let me just take a piece of it, which will be distribution and then Kevin maybe if you have – you can think about anything I might miss. First of all, distribution resale, sales out of the channel, grew at about the same rate as our revenue did overall. So that would be one piece of it, yet, because they were growing – they were reducing inventory last quarter and that

reduction this quarter was significantly less, even with 10% reduction in inventory, that was significantly less than what it was last quarter, we felt an acceleration or an additional lift of demand from the distributors that was well in excess of the rate at which resales were occurring.

So it's just the math of – you start off in TI's case of shipments going out of the channel at 15%. If inventory was in equilibrium, we would have been shipping in at 15%, our growth would have been 15% likely as well. But because we were coming off an inventory correction, our growth into the channel was in excess of the rate at which they were selling out.

So again, it's just a case of – if you run through the math of what happens, it's not just a matter of how our growth compared to distributors or how our growth compared to the various OEMs. You have to look at the different starting point of whether in the point at which you're measuring growth from was inventory being reduced or was it being grown? In this case, since it was being reduced, we will get a significant uplift as they bring their inventory into balance versus just what their own growth rate would be.

Do you have anything to add, Kevin?

<A – Kevin March>: Yeah, it is a hard topic to explain. I think...

<A – Ron Slaymaker>: We need a chalkboard.

<A – Kevin March>: If we keep in mind that in the fourth quarter and first quarter, TI's revenues arguably dropped faster than our customers', that's really because our customers just stopped ordering material while they drained their own inventory. Once they got that inventory close to where they wanted it, now they start turning orders back on for us so that what we're shipping in is close to what they are shipping out. We believe we're getting close to that point. That has the effect of causing our revenue to grow quite a bit because we're coming off a deflated period, if you will, when they had ceased orders on us. And now we're coming back into – during this quarter, we believe, into alignment where what we're shipping into them is much more reflective of what we believe they are consuming and shipping directly out to their customers.

<A – Ron Slaymaker>: Do you have a follow-on, Mark.

<Q – Mark Lipacis>: Yes, please. Historically, you guys have run a pretty conservative balance sheet. What's the – would you consider taking on debt to buy back stock and what's the argument against doing something like that especially since your capital requirements are declining? Thanks.

<A – Kevin March>: Mark, we like our balance sheet the way it is, without debt. We're not sure that taking on debt to buy back stock necessarily is in the best interest of our strategic growth although it may have some short-term impact potentially on EPS. We think it's best to protect our balance sheet and use it for purposes where we can really leverage our strategic growth. And that's what you've seen us do, and you'll probably continue to see us behave in that fashion.

<A – Ron Slaymaker>: Okay, thank you for your questions, Mark. And operator, I think we have time for one more caller.

Operator: Thank you, sir. We'll take that final question from Craig Ellis with Caris & Co.

<Q – Craig Ellis>: Thanks for sneaking me in guys. Ron, can you provide some clarification on the outlook specifically with the mid-point at 8%, do you expect all of your segments to grow? And specifically do you expect baseband to be up in the third quarter?

**<A – Ron Slaymaker>**: Craig, we really don't provide the breakout of our outlook by various segments and various product groups so I probably just need to leave it at that. And even – I wouldn't mind typically talking about seasonal patterns historically, but we all know there is more moving in the Wireless space, specifically with baseband, than just seasonal patterns, so I'll probably even avoid that.

Do you have a follow-on, though?

**<Q – Craig Ellis>**: Yeah. Can you provide a little bit more color in terms of what you saw in the second quarter in High-Performance Analog, Ron, and just comment specifically on what you're seeing in the industrial end market within that business?

**<A – Ron Slaymaker>**: Industrial – and this applies to High-Performance Analog but I'll also say it just as a general matter of course, we're not seeing much life at all out of industrial. And even if you look at, I think, some of our opening comments, if you look at the geographies where we're seeing strength and where we're not seeing strength, weakness continues to prevail in the U.S. market and in the European market and both of those are heavily in terms of shipments that we actually incur in those markets, they are heavily industrial influenced. So again we really haven't seen growth there at all.

I think if you look at High-Performance Analog, I don't know that I can give you – it's just kind of the nature of High-Performance Analog, it goes across so many different markets and geographies that it's difficult to point specifically at what was driving growth besides some of the general comments that I've made.

What I can kind of say is that as we – as we continue to grow High-Performance Analog, as we continue to grow Power, you've seen those shift up in terms of the mix. So for example this first half, we now have Power that's about 30% of our Analog revenue, High-Performance Analog is at similar level, about 30%, and HVAL is at about 40. If you look at a year ago, Power would have been 25, HPA would have been 30, and HVAL would have been more about 45. So again, I know I didn't give you specific drivers of our High-Performance Analog growth in the near term. But at least my peace offering of giving you some of that breakout might help a bit.

So, Craig, thank you for your questions and with this we're going to wrap up. Thank you for joining us. A replay of this call is available on our web site. Good evening.

Operator: This does conclude today's conference. We do thank you for your participation.

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