

# FINAL TRANSCRIPT

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## **ARM.L - Q1 2008 ARM Holdings plc Earnings Conference Call**

Event Date/Time: Apr. 29, 2008 / 3:30AM ET

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## PRESENTATION

### **Operator**

Thank you for standing by and welcome to Q1 analysts' call. At this time, all participants are in a listen-only mode. There will be a presentation, followed by a question and answer session. (OPERATOR INSTRUCTIONS). I must advise you that this conference is being recorded today, Tuesday, April 29, 2008. I would now like to hand the conference over to your first speaker today, Mr. Bruce Beckloff. Please go ahead, sir.

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**Bruce Beckloff** - ARM Holdings plc - VP IR

Thank you very much. Good morning, everyone. This is Bruce Beckloff, the VP of IR at ARM. On today's Q1 results conference call we have Warren East, the Chief Executive Officer, and Tim Score, Chief Financial Officer. On today's call, Warren and Tim will take us through some highlights and comments for the quarter results and then we'll open up the call to Q&A. As a reminder, the presentation and release can be found on the ARM Investor Relations website at [www.arm.com/ir](http://www.arm.com/ir).

Before I hand over to them, I have a few words to read out with respect to this conference call and what we are about to discuss. The contents of this conference call are being directed only to those of you who have professional experience in matters relating to investment, and the information communicated on this call is being made available only to investment professionals. Any person present on this call who does not have professional experience in matters relating to investment should not act or rely on the contents of this call.

The following conference call will contain forward-looking statements, which are other than statements of historical fact. The Company's actual results for future periods may differ materially from these statements, as they are based on current expectation and are subject to a number of risks and uncertainties.

On this note, I'll hand over to Warren.

**Warren East** - ARM Holdings plc - CEO

Thank you, Bruce. Good morning, everybody. Thank you for joining our Q1 '08 conference call. I'll start with some highlights, hand over to Tim, but I expect we can cover most of the content in Q&A format later.

So the headlines this morning, we're reporting a result for a solid quarter, a good start to 2008. PD royalties are back to long-term growth rates. There is an element of stability in the numbers we're reporting for our Physical IP division and our guidance for the year as a whole remains unchanged.

Now, we all know that during 2008 there's a period of economic uncertainty that we're facing. We can't do anything about that at ARM. But in spite of what's going on out there, we're continuing to aggressively drive our business forward for the long term, recall what we said at our Analysts' Day last year, by A, increasing the amount of ARM technology per electronic product, B, gaining share in non-mobile applications and C, establishing our physical IP technology as the standard for third party outsourced physical IP. And by the way, we're also continuing our drive for rigorous cost and balance sheet management.

We came into this year on the back of three years of strong processor licensing, last year it was up nearly 20%, and with a record order backlog. And in the first quarter we have enjoyed steady progress across all the product lines, producing record revenues, and it's a good start operationally as well for 2008.

A little bit of detail, moving first to the Processor division. It was a good licensing quarter. 15 licenses signed, including seven for our Cortex family, demonstrating a continued strong demand for all the latest technology. Our total installed base of licenses has now grown to over 540. The quarter -- it was a very high quality quarter for licensing, a rich mix of different licenses. And we exit the quarter with our backlog of orders not -- of orders already signed but not recognized as revenue yet remaining at the record high level that we reported at the end of 2007. We signed licenses with six new partners in Q1 and our Mali graphics technology continued to gain traction as well, with Broadcom taking a license in the quarter.

The licensing platform strength was really illustrated by the return to royalty revenue growth in excess of 20%. Processor royalties benefited, of course, from the usual seasonality associated with the run-up to Christmas, with a volume run rate in excess of 3.5b units per annum. Revenue up 22% year on year and 7% sequentially.

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But within those overall numbers, we're particularly encouraged to see the strong increase in the number of Smartphones driving growth in ARM11 shipments. ARM11 now accounts for 3% of the total volume. And the favorable mix exerted an upward pressure on the average royalty received per processor, which was up 5% quarter on quarter.

Other points of note here are that Cortex shipments, though relatively tiny, did amount to over 0.25m units, so that's truly volume production now. Also, shipments into the embedded segments, that's non-mobile, largely micro controllers, continued to grow very strongly with an increase of 55%. And thirdly, a large majority of the new processor licenses signed in the quarter were initially to target non-mobile applications.

It's been a good quarter operationally for the Processor division, with the release status of all lead partners being achieved around the end of the quarter for both the Cortex-A9 product, that's our flagship multi-core product for high-end Smartphone and mobile Internet devices, and also for the SC300, the secure derivative of Cortex-M3 for security applications.

So, whilst the engineering teams will work hard to complete the work on those products over the coming months, elsewhere the emphasis in that division is on roadmap development, including pushing the performance element and further development of the ARM ecosystem. The number of companies in ARM's connected community, that's our ecosystem, now exceeds 450, which is up from 400 a year ago.

Before moving on from discussing the Processor business, it's also worth noting that the ongoing litigation proceedings with Nazomi have now been concluded with a ruling in ARM's favor.

Now, I'll move to our Physical IP division. The business is transitioning there from technology catch-up phase of the first three years and this year we began with some restructuring, which we described at our presentation in February. Activities at five Physical IP design centers have been reorganized to give a specific focus at each one. And as we move towards 32 nanometers, we're also redesigning the development process for leading-edge technology. And in January some 30 positions in our U.S. operation were removed, laying the foundation here for increased efficiency, which is now emerging.

The Physical IP license revenue increased 9% sequentially. And of the 13 licenses signed, we're very pleased with two further purchases by top 10 semiconductor companies, three platform licenses, most of the licensing activity taking place at the 65 nanometer node. And we've now got 363 physical IP licenses in place, which is up from 300 a year ago.

And alongside the operational improvement measures, we're obviously continuing to push hard on new technology developments, creating new enhanced competitive features in our standard cell and memory product offering and undertaking basic advanced development work at 32 nanometers.

Moving to royalties, Physical IP royalties continued to grow both sequentially and year on year. And if you strip out royalty catch-up payments, underlying royalties increased significantly year on year, although they were flat sequentially. So, that illustrates at the moment a continued growth in market share in the context of declining foundry utilization. We can see that foundry utilization was down again in Q1, but opportunities for licensing look reasonable, and so we'd expect overall Physical IP revenue in Q2 to be actually quite similar to the Q1 level.

Our Development Systems business, that's tools, saw a modest growth year on year, 5%. The focus within the tools division was on planning a restructuring to improve efficiency and better position that business for further growth. The plan became effective at the beginning of Q2 and as a result, we've adjusted some product offerings in our ESL and debugger product lines, and a number of positions will be removed by the end of Q3.

So, looking ahead, I'd say in spite of the uncertainty in the economy, which is obvious and surrounds us, we can actually see a fairly typical opportunity pipeline. Design wins are happening across a wide range of applications. And, as noticed in February, the portfolio remains attractive. We would expect seasonality to play a part for royalty in Q2, so overall dollar royalties in Q2 -- overall dollar revenues, rather, in Q2 are unlikely to be greater than those reported today for Q1.

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Looking ahead to the rest of the year, we expect our new processor products to be fully released in late Q3. We expect 45 nanometer silicon incorporating our physical IP as well. So, overall, we're comfortable with the guidance we gave in February, for dollar revenue growth to be at least at the levels achieved in 2007.

And with that, I'll hand over to Tim.

#### Tim Score - ARM Holdings plc - CFO

Thanks, Warren. Morning, everybody. Just to remind you, the normal slide set that we provide on these quarterly results days is available on our website now. And I'd also draw your attention to the reconciliations at the back of the earnings release, in notes 6.20 and 6.21, where you'll find a line-by-line reconciliation of the normalized numbers, which tend to be the focus of analyst consensus estimates, to the U.S. GAAP numbers. So, that's 6.20 and 6.21 at the back of the release.

So a few highlights, then. In early February, we guided Q1 revenues to be broadly similar to the Q4 level of just over \$130m and today, as you've seen, we're reporting \$134.3m. Following 18% PD licensing growth in full year '07, Q1 '08 revenues, at \$36.3m, were a little bit shy of analysts' expectations. But encouragingly, as Warren has described, the mix was weighted towards our newest products, both Cortex and Mali. We also saw in Q1 sequential revenue growth in PIPD licensing after a difficult 2007, as we went through the later stage of the technology catch-up.

The royalty revenues were strong in both PD and PIPD. Having increased \$6.2m sequentially in Q4 '07, PD royalties again rose by about \$6m quarter on quarter to just under \$55m. And that's a year-on-year increase of 22% in the dollars on unit shipments, up 20% to 889m. So, ARM11 beginning to gather pace. As Warren said, 3% of the total. And therefore, we have seen the average royalty per device increase this quarter, from the \$0.059 in Q4 '07 to \$0.062 in Q1 '08.

Now, Q1 royalties, as you know, are based on Q4 shipments, as we report royalty revenues one quarter in arrears. Q2 is typically characterized by industry seasonality and the potential impact of the wider economic uncertainty on our royalties later in the year is hard to gauge at this stage. But regardless of these short-term dynamics, we are very encouraged by the underlying trend in PD royalties, seeing the growth rate in Q1 growing again on the 14% growth rate we saw in Q4 after the unwind of inventory correction earlier in 2007. And after stripping out catch-up revenues in both years in PIPD, underlying royalties were up by 20% compared to Q1 '07, despite the lower utilization that we saw in the last quarter in the foundries as a whole.

So, Group order backlog at the end of Q1 does remain at record levels reported end of '07. And in Q1 less than 40% of PD license revenues actually came from the backlog. That number is lower than usual. And the normal analysis of backlog maturity and composition is included in the slide set on the web, showing that 38% of total backlog is expected to be recognizable as revenue over the next two quarters.

Before moving on to our guidance for Q2 and the rest of '08, a few comments on margins, costs and the balance sheet. Gross margins in Q1 were 88.8% on a normalized basis. That's a little lower than in recent quarters and a little lower than the consensus, which was just over 89%. And that's due primarily to a higher revenue contribution from technology, which includes payments to collaborative partners recorded as cost of sale, mainly in the graphics area.

And the 39 -- moving on to OpEx, normalized OpEx was GBP39.5m in Q1 and that is very, very similar to one year ago, when it was GBP39.3m. And I think, as in 2007, it is likely, subject to the potential negative impacts that we face on a quarterly basis from currency movements on OpEx, it is likely that OpEx in the remaining quarters of 2008 is likely to be lower than in Q1. It is up sequentially from Q4 to Q1, primarily due to salary inflation which is effective in ARM from January 1, and also the quarterly phasing profile of certain accounting accruals, like vacation pay and sabbaticals, where you tend to get charges early in the year and credits later in the year as holidays and sabbaticals are taken.

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Headcount at the end of Q1 is net 21 down on the level at the beginning of the year, largely due to the reorganization activities undertaken in PIPD in Q1, for which there is a restructuring charge of approximately GBP700,000 which you will actually see in the reconciliation on note 6.20 as GBP718,000. And just thinking ahead, there will be a similar charge in Q2 relating to some ongoing reorganization which we're doing within our Development Systems business, so you'll see that similar number to the PIPD number in Q2.

We continue to maintain our focus on balance sheet efficiency. The Group generated free cash flow of GBP14m in Q1 and with GBP13m being spent on the ongoing share buyback program. And we closed Q1 with a net cash balance of GBP55m compared to the GBP51m at the end of 2007. And approximately GBP15m will be paid to shareholders in early May via the payment of the 2007 final dividend of GBP0.012 per share. The buyback program is expected to continue in Q2.

So, looking forward to the outlook for Q2 and the rest of '08, just reiterating what Warren said. We enter Q2 with a record backlog and good momentum in both PD and PIPD royalties. We do remain cautious in the short term, given the uncertainty in both the semiconductor industry and the wider macroeconomic environment. And given this backdrop and given the potential impact of industry seasonality on royalty revenues, total dollar revenues in Q2 are unlikely to be higher than the Q1 level.

However, consistent with the guidance we gave on February 5 with our full year '07 results, assuming no marked deterioration in the trading environment, we continue to expect to increase dollar revenues in the full year '08 by at least the growth rate achieved in '07, which was 6.3%, and with earnings growing faster than revenues, given the inherent leverage in the ARM business model and our medium-term objective of growing costs at approximately half the rate of revenues.

And with that, I'll pass over to Q&A.

## QUESTIONS AND ANSWERS

### Operator

Thank you. (OPERATOR INSTRUCTIONS). Your first question is coming from Adnaan Ahmad from Morgan Stanley. Please go ahead, sir.

### Adnaan Ahmad - Morgan Stanley - Analyst

Hi, good morning. First of all, just on PD royalties, what trends do you see on PD's royalties as we go through this year, especially after what we've heard from the likes of Nokia, Sony Ericsson, Texas and Qualcomm with respect to some potential issues at the high end of the marketplace? And then I have a follow-up.

### Warren East - ARM Holdings plc - CEO

Well, we do read and we do see the same things that you do, Adnaan. And I think it's fair to say that our expectations of the Smartphone development when we came into the year was that they would continue to grow and continue to have a positive uplift on our results and we -- that remains the case with us.

We -- as a business, we were never -- our expectations were never at the top end of Smartphone growth. We always had modest expectations. So, I think, as I said, towards the back end of the year it's really hard to gauge. But I think underlying we see some very positive trends and I think this movement in ARM11 as a proportion of royalties, which is obviously still very, very low at 3%, is going to inexorably increase. The pace at which it increases will, of course, be influenced to some extent by what happens in Smartphones in the balance of the year, but I think that's a fairly short-term phenomenon.

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**Adnaan Ahmad** - Morgan Stanley - Analyst

And just two bigger picture questions. First of all, the recent deals between NXP and STM, could you just give us some sort of gauge on what that actually means over the mid to the long term with respect to your PD license business and some of the swing factors there? Thank you.

**Warren East** - ARM Holdings plc - CEO

Well, in that specific case, NXP and ST Micro are both public subscription licensees of ARM anyway. And so, from a licensing point of view, since both of those subscriptions, as you know, were renewed last year, then we're not really expecting any material impact at all. Depending on how that venture goes, whether it eventually becomes completely independent or not, that's another thing. And of course, if it does, there's another entity there with the possibility for licensing going forward. And I would point out that both NXP and ST, as subscription licensees, make extensive use of ARM outside of the wireless space as well, and so we'd expect those relationships to continue even if this venture becomes a totally separate entity. So, actually, in the short term no real impact. Potentially, in the longer term there could be some upside there.

**Adnaan Ahmad** - Morgan Stanley - Analyst

Great. And just one final one, I don't want to hog the call. Just with respect to there's been a lot of chatter, more so than normal, around Intel and the competitive threat of Intel, if you could just give us an update of that.

As well as, Apple recently acquired a company called PA Semi. Could you just give us an update on whether that has any impact at all on your business moving forward with some of Apple's supply chain?

**Warren East** - ARM Holdings plc - CEO

Okay. Well, let me deal with the first question first. Obviously, Intel's the largest semiconductor company in the world. It's still an ARM partner, by the way, and utilizing ARM technology and paying ARM royalties. But we obviously consider Intel's public comments about gaining share in the mobile Internet device space seriously, because with a company of that technical capability and financial resources we have to consider them as a competitive threat to be taken seriously.

However, ARM has the share in the mobile space at the moment. ARM has the technology which is low power and appropriate for these applications. ARM has the business model to deliver that technology through the rest of the semiconductor company outside of Intel. Having -- and all the semiconductor companies have the ability to put system on chip devices together, rather than standalone microprocessors, and deliver them at appropriate price points for those applications.

So, I think the ARM architecture has a considerable lead at the moment. And, of course, we continue to drive our technology forward in both the performance direction and the power consumption direction. So, there's serious commercial and technical advantages behind the ARM architecture at the moment.

Moving on to the second question, when you talked about Apple in particular, well, of course, the iPhone is an iconic design and we're very pleased with the iPhone shipments that are happening at the moment, obviously containing multiple instances of ARM technology. Whether or not Apple have, through their rumored acquisition, acquired some additional expertise in microprocessor design, now, the PA team we know. We have a historic relationship with that team and some of the experts there cut their teeth on doing ARM implementation. So, I think it's no bad thing if a little bit more ARM expertise finds its way into companies like Apple. But as to what they intend to do with it, we've no comment and you need to talk to Apple about that, because it's nothing to do with us.

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**Adnaan Ahmad** - Morgan Stanley - Analyst

Great. Thank you.

**Operator**

Thank you. Your next question is coming from Sandeep Deshpande from JP Morgan. Please go ahead, sir.

**Sandeep Deshpande** - JP Morgan - Analyst

Hi. A couple of things, firstly regarding your guidance for the year. If you -- you have beaten numbers in terms of revenue in the first quarter, but you've maintained the full year guidance. So, are you saying that you see things are not that good going forward, or is that you're just being cautious overall because of the economic climate? And then I have a couple of follow-ups.

**Tim Score** - ARM Holdings plc - CFO

I think the thing to remember, Sandeep, is our guidance is at least the level that we saw in 2007 and our guidance remains at least to the level. Now, obviously, having beaten expectations by about \$5m in Q1, you could argue that the prospects for being at least are better than they were a quarter ago. We're a quarter into the year and it's been a good start. So, if anything, we're more optimistic rather than less.

**Sandeep Deshpande** - JP Morgan - Analyst

Thanks. And then regarding, overall, your PD royalties did very well in the last year. Clearly, the mix seems to have been shifting clearly towards the high end. Do you have any indication? It's almost 30 days into the next quarter. You've probably seen some of the early intake. Have you seen -- does this ARM11 licensing continue now going forward? Or is that because it is typically very seasonal in the second half that we can expect that sort of royalty per unit to be improving only in the second half and we will see a lull for a while?

**Tim Score** - ARM Holdings plc - CFO

I think you're right in the comment about seasonality, Sandeep. So, yes, we've benefited from seasonality in these numbers and ARM11 has grown. Now, the average royalty per processor that we actually get depends on the mix and things like microcontrollers are much less prone to seasonality. And so, looking forward over the next several quarters, we would expect more of the growth to be coming from that end of things than the consumer-oriented Smartphones. However, we would expect the consumer-oriented Smartphones to come back in the latter part of the year in the run up to Christmas 2008.

And as for reading anything into royalty reports, well, as we're only 29 days into the quarter, it's too early. We haven't really got any meaningful data out of the royalty reports that we've actually received. So, my previous comments were more general comments based on longer-term trends.

**Sandeep Deshpande** - JP Morgan - Analyst

Thank you.



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**Operator**

Thank you. Your next question is coming from Nicolas Gaudois from UBS. Please go ahead.

**Nicolas Gaudois - UBS - Analyst**

Yes, hi. Nic Gaudois from UBS. Just a first question on the Q2 guidance. So if we understand you well, you're saying that royalty revenues will come down with seasonality for processors, Physical IP overall flat. So, I guess implicitly that the licensing revenues for processors may not be up as much as royalties alone. Now, is this a function of you being a little bit cautious on your licensing outlook in the near term, or a reflection that royalties may come down more than seasonal because of what you have seen at some of your partners' [prospects]?

**Tim Score - ARM Holdings plc - CFO**

I think the sort of qualitative directional comments you made there, Nic, are true in the sense that there is seasonality in royalties and, as Warren said, we would broadly expect. But I think in a sense the margins, as in terms of the differences, are quite small. So, I wouldn't -- at this stage in the quarter, we have a high backlog, we have a good pipeline. And I think, as you know, it's quite difficult for us to call at this stage in the quarter precisely which licenses will close this side of the end of the quarter. You saw our numbers this Q1, being about \$1.5m below consensus. That essentially adds up to about half a license. So, these are -- these things are quite hard to call this far out.

But I think the overriding comment is licensing backlog is good, the pipeline is good, processor royalty underlying trends are good. Clearly, we are not immune from seasonality. If you look back in history, ARM has often been fairly flat in Q2, because of underlying growth against seasonality. So, we'll see how that pans out. But I wouldn't -- it's very difficult to be very precise on each of those revenue lines at this stage in the quarter. But our general comment is because of seasonality we wouldn't necessarily want the market to expect Q2 to be higher than Q1. If anything, it's likely to be -- unlikely to be higher.

**Nicolas Gaudois - UBS - Analyst**

Okay. And within that, would you expect to recognize more licensing revenues out of a backlog for processors in the second quarter versus the first quarter, as a base case?

**Tim Score - ARM Holdings plc - CFO**

Yes, probably a little bit.

**Nicolas Gaudois - UBS - Analyst**

Okay.

**Tim Score - ARM Holdings plc - CFO**

Yes. As I said, the -- if you look at the average, it's typically north of 40% in a given quarter and in Q1 it was south of that. So, I think it's reasonable to assume it could be a bit higher.

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**Nicolas Gaudois** - UBS - Analyst

Okay. And the last question is more longer term. Your -- we start -- we've seen a pretty decent licensing take once again for the Cortex, but in particular the M3. Is what we're seeing here the unfolding of the standard microcontroller push you're doing with the Cortex-M3 versus, in particular, the 8-bit market? Or is there anything else driving what has been a pretty solid momentum for this core in particular for the last two years?

**Warren East** - ARM Holdings plc - CEO

No, you're seeing the effects of the drive to microcontrollers. It's the former. We have a massive program with a reasonable number, now, of our licensees who are developing or have already launched standard microcontrollers based around the Cortex-M3. And the differences between 8-bit microcontrollers and the 32-bit microcontrollers, in price terms, have eroded significantly and the other benefits of 32 bit are coming to the fore.

So, it's what we've talked about for the last several years coming to fruition, yes. And coming to fruition is probably a little bit presumptuous, doing a lot of licensing at the moment and you're seeing the volumes grow strongly, but they're growing strongly off a relatively small base. I think we have a long, long way to go yet in microcontrollers, but we're certainly on the right road.

**Nicolas Gaudois** - UBS - Analyst

Excellent. Thank you.

**Operator**

(OPERATOR INSTRUCTIONS). Your next question is coming from Simon Schafer from Goldman Sachs. Please go ahead, sir.

**Simon Schafer** - Goldman Sachs - Analyst

Yes. Thanks so much. It kind of ties in with the previous question, but just from a near-term licensing perspective, I could see that the backlog was strong and you've commented that perhaps the percentage of [client] business, if you will, has actually grown. So a little bit more color on as to why that's recovering or what's changed would be very helpful.

**Tim Score** - ARM Holdings plc - CFO

Yes. I think it's -- I don't think anything has particularly changed. I think on a quarterly basis it really depends on the composition of the backlog, the status of engineering activities in terms of achieving revenue recognition milestones. We exited last year, very strong bookings quarter in Q4, record high backlog. That remains. And I think the opportunity pipeline, our comments are really about the timing and trying to gauge, at this stage, exactly which deals close this quarter. I think it's also fair to say that, at this stage, we haven't really seen any indication from our customers' behavior on licensing and aptitude for licensing that seems to be impacted by the economic uncertainty.

So, as we said in February, no current impact but I think it would be unwise to assume that there isn't the prospect of some uncertainty if the economic macro position stays as is or gets worse.

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**Simon Schafer** - *Goldman Sachs - Analyst*

Understood. Thank you. And then, Tim, I think maybe I misunderstood, but I think you in the initial remarks, or Warren, you may have been referring to some type of processor launch in Q3. I know there's kind of an annualized roadmap for that. But any more color as to whether that would be licensing revenue generative already in late 2008?

**Warren East** - *ARM Holdings plc - CEO*

Well, yes and no. I wasn't actually referring to a product launch. I was referring to a full release of some products that we've already launched, so Cortex-A9 and the SC300, which were launched, from a marketing perspective, last year but have just reached the crucial milestone of being fully released to the lead partners. The lead partners are away making silicone now. And we would anticipate that in approximately six months, i.e. around the end of Q3, those products we will fully release to licensing widely across the partnership. So, at that stage, or from then on, we would expect to see them contributing a little more to driving licensing from a revenue perspective.

**Simon Schafer** - *Goldman Sachs - Analyst*

Okay. Understood. Thank you.

**Operator**

Your next question is coming from Didier Scemama from ABN Amro. Please go ahead.

**Didier Scemama** - *ABNO Amro - Analyst*

Good morning, gentlemen. It's ABN Amro, actually, at least for a few more months. No hint there. In terms of OpEx, should we expect essentially the same sort of levels that you had in the three quarters after Q1 last year, i.e. in the GBP36m to GBP37m range? First question.

And my second question is just on the mix of royalties. We've seen basically pretty weak trends over the last 12 months in the enterprise and in the home segments. So I was just wondering if you could maybe explain a bit the underlying trends, because I think a lot of focus is obviously given to the mobile and embedded segments, but you still operate in other segments. So I'd just like to have a bit of color on that, if you may, please?

**Tim Score** - *ARM Holdings plc - CFO*

Okay, Didier. Thanks. I'll, Tim, deal with OpEx and Warren with the royalty question. What we say here in the release is that we expect the Q1 level of GBP39.5m of normalized OpEx to be, if you like, the peak of the year, with Q2, Q3 and Q4 being lower. I don't think you should expect it to be as low as Q2, Q3 and Q4 last year because we're running with a broadly similar headcount, but of course we have the salary inflation that kicked in at the beginning of the year. So I expect it to be lower.

But I think bear in mind our overall comment that we expect to grow costs at about half the rate of revenues. Don't forget, costs were flat in '07 over '06. And if you were to assume GBP36m and GBP37m for the rest of this year, you'd be flat again, and I'm not sure that's realistic in the growing business that has wage inflation.

**Didier Scemama** - *ABNO Amro - Analyst*

Understood. And on the mix, please?

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**Warren East** - ARM Holdings plc - CEO

And on the mix, particular reference to the enterprise question, it's true that enterprise has been quite flat over the last several quarters. And in particular we can see some customer inventory issues in printers, in hard disks, and we've also seen it quite flat in DSL modems. However, if I look to the year-on-year trend, looking forward, we do currently expect for 2008 as a whole in the enterprise sector to be at upper teens level growth in volume terms. And looking forward over the 18-month window to the end of 2009, we'd expect '09 over '08 growth in enterprise to be of the order of 20%.

**Didier Scemama** - ABNO Amro - Analyst

Great. Just a final follow-up, if I may. In terms of PD licensing, you seem to hint that Q2 would be slightly down or down because of the uncertainties. In terms of the negotiations you have at the moment with, let's say, second tier fabless companies in terms of licensing, is there any hesitation as to closing deals or are people still basically keeping their budgets for R&D essentially unchanged at this point?

**Warren East** - ARM Holdings plc - CEO

We're not really seeing any appreciable change in behavior on a customer-by-customer basis. The comment is one, as Tim said on the call, about the wider uncertainty and just the experience that we have built over the years, in that when there is more uncertainty there is more of a likelihood that deals get delayed. And so we are expecting that sort of behavior to crop up on some occasions. As for what we're seeing at the moment within the opportunity pipeline and within individual negotiations on particular opportunities, no, we're not really seeing any change in behavior.

**Didier Scemama** - ABNO Amro - Analyst

But you're basically a bit cautious for the second half on licensing on the back of that, for the time being at least?

**Warren East** - ARM Holdings plc - CEO

I think so. I mean the second half is still a long way away. We're talking six to nine months hence. And every time you open the newspapers, there's more gloom, doom and despondency on the economy at large. And we can see that that sort of gloom, doom and despondency is bound to spread into corporate decision-making and that could have an impact on licensing. We're not seeing it yet, but we know that it could do.

**Didier Scemama** - ABNO Amro - Analyst

Yes. Many thanks for your answers. Very clear.

**Operator**

Thank you. Your next question is coming from Andrew Gardiner from Lehman Brothers. Please go ahead.

**Andrew Gardiner** - Lehman Brothers - Analyst

Good morning. Thank you. I had a question on PIPD. As you pointed out, you had a good quarter there in the first quarter after a couple of quarters of more disappointing results. I was just interested in perhaps the sustainability of this improved performance,

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particularly relative to some of the comments you made in your prepared remarks regarding technology catch-up and the declining utilization and just how you see some of that playing out in the coming quarter, as well as perhaps further out.

**Warren East** - *ARM Holdings plc - CEO*

Okay. So I think you have to take it in two parts. There's the licensing story and the royalty story. On the licensing side of physical IP, it is related to the technology catch-up. And the disappointments that we saw during 2007 were, as we reported in 2007 and again back in February, quite substantially to do with having to prioritize engineering resource on the development of leading-edge technology products, because we needed to achieve the milestones that we set down to deliver those products and get through that technology catch-up phase.

As we reported in February, by the end of 2007 we had, to all intents and purposes, got to the end of that phase. And we're now going through transitioning the business from being purely focused on technology catch-up to being rather more about execution, about engagement with customers, engagement with our sales team on selling these products. And so the licensing stability that we've seen in Q1 we would expect to continue throughout the year.

And we've said, and still say, that in 2008 we would expect physical IP revenue, as a whole, to be higher than in 2007 in both licensing and royalty. That doesn't mean to say it's going to be sequentially improved on both lines every quarter. But it does mean that we would expect this stability to continue in the medium term and through 2008 as a whole.

On the royalty side, we commented about declining foundry utilization rates because we saw that happen in Q4 last year, which relates to the period that we're just reporting now. And we've seen continued decline in foundry utilization rates reported by the foundries in Q1, which is what we'll be reporting in a quarter's time. That said, we are seeing increased gains in market share in our physical IP and so we would expect there to be some offsetting of the decline in foundry utilization. Whether that means sequential increases every quarter, don't know, but we stand by the fact that it certainly means -- or we believe it means increased royalty revenues for the year as a whole. And I'd point out that the year's got off to a good start, with underlying royalty revenues in physical IP up by 20%. So I think that's about it on the story for physical IP stability.

**Andrew Gardiner** - *Lehman Brothers - Analyst*

Okay. Thanks very much. That's quite clear.

**Operator**

Your next question is coming from Lee Simpson from Jefferies, sorry. Please go ahead, sir.

**Lee Simpson** - *Jefferies - Analyst*

Hi. Good morning, gentlemen. Just following on from that about PIPD, I accept that there's been a transition in attitude, at least, towards more stability in the business, more execution. Terrific as that is, I just wanted to bring you back to comments you made previously about the process instabilities at the 45-nanometer node proving to be quite a huge hurdle. Is there any sort of visibility at this point as to the continuance of instabilities, and I'll leave that to you to describe what that is, in the development for 32-nanometer, and how you are vis-a-vis the ITRS roadmap? So when will we see product ready for 32 nanometers? And any sort of discussion levels that you're currently in with some of the top tier guys, IDMs.

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**Warren East** - ARM Holdings plc - CEO

Okay. Three questions there. The sort of what I've described as instabilities in 45 nanometers that we saw last year, absolutely, when new semiconductor processes are being developed, they are being developed. And there are iterations and instabilities there, as people go down one route, find that it doesn't work appropriately, bits of the recipe have to be changed, therefore operating parameters get changed and therefore there needs to be some iteration on the development of physical IP. We would expect to see that phenomenon at 32 nanometers.

Back in February, I explained, though, that we would expect to cope with that phenomenon more easily than we did at 45, because we're now trying to develop our 32-nanometer technology at the same rate as the industry, rather than at about two and a half times the rate of the industry, which is what we had to do for 45 nanometers. So, to an extent, we've got, if you like, a bit more breathing space, a bit more essentially engineering capacity to spend on that 32-nanometer development.

As for where we are, we are engaged in discussions with leading foundries and some of the leading semiconductor IDMs on their 32-nanometer plans, our 32-nanometer plans. As for products, I wouldn't expect to see any 32-nanometer products from this year, but absolutely we have developments underway. And I would expect to see some initial licensing on 32-nanometer products during 2008, as we saw on 45-nanometer products during 2006, in fact. So it is in line with semiconductor roadmaps coming down about two years after the 45-nanometer node.

**Lee Simpson** - Jefferies - Analyst

Great. Excellent. Just some of the comments you made earlier with regard to modest Smartphone growth. I wonder if you could give us a steer on, first of all, what do you think the average number of cores per handset have been towards the start of this year and how that will develop through the year. And if you can give me any steer on the incidence of dual core shipments within handsets, dual core within the actual processor.

**Warren East** - ARM Holdings plc - CEO

Okay. So the average at the moment is 1.7. We'd probably expect, by the time we take into account this year's Christmas seasonality, that to maybe nudge up a little. But we do expect continued replacements in particular and new subscribers in some of the developing regions to be more at the low end. So I don't think that mix or the number of calls per phone is going to increase dramatically over 2008. It's on a journey towards approximately 2. And it will get to approximately 2 when Smartphones are approximately half the -- taking half the volume of mobile phones in total, but that's still some way off.

As for instances of multi-core, if I caught your question correctly, I think you meant multiple microprocessor -- multi-core microprocessors as the main applications processor in a phone?

**Lee Simpson** - Jefferies - Analyst

Correct, yes. Yes.

**Warren East** - ARM Holdings plc - CEO

So at the moment I don't think we have any instances of phones actually shipping with multi-core products, but some of our semiconductor partners are working on multi-core versions of apps processors. I believe Nvidia, for instance, were showing off some prototypes of some ARM11 MP core devices earlier this year, but I don't know about the production status of any phones incorporating those.

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**Lee Simpson** - Jefferies - Analyst

And just a point of clarification. I think you mentioned earlier the gross margin under pressure because of the software reselling, I forget how you characterized that, but where you share the --

**Warren East** - ARM Holdings plc - CEO

Yes. We have some agreements with revenue share.

**Lee Simpson** - Jefferies - Analyst

Yes. Okay. So the volumes have been higher this quarter, basically?

**Tim Score** - ARM Holdings plc - CFO

That's right.

**Warren East** - ARM Holdings plc - CEO

Yes. Higher than -- everything's relative.

**Lee Simpson** - Jefferies - Analyst

Okay. Thanks a lot.

**Warren East** - ARM Holdings plc - CEO

(Multiple speakers) them very small.

**Lee Simpson** - Jefferies - Analyst

Okay. Thank you.

**Operator**

The next question is coming from James Crawshaw from Kaupthing. Please go ahead.

**James Crawshaw** - Kaupthing - Analyst

Thanks very much. Kaupthing is the name of the firm. Two questions, if I can, firstly for Tim. You say revenues are unlikely to be up sequentially in the second quarter. Should we interpret that as revenues are likely to be down?

And then secondly, for Warren, there was a recent strategy or technology update from TSMC that talked about their open innovation platform and plans to move it to IP. I wondered if you had any initial thoughts on how that might impact your business, particularly PIPD.

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**Tim Score** - ARM Holdings plc - CFO

James, if you examine words and deconstruct them, then I guess you have to make the assumption that if it's unlikely to be higher it's more likely to be lower. But I think it's more -- it's really the qualitative issues that I was discussing in response to earlier questions, particularly from Nic. You've heard how we are feeling about each of the revenue streams. But we don't -- we can't be precise about exactly how they're going to end up at the end of the quarter. What we're saying is, on balance, we don't expect Q2, given royalty seasonality, to be higher than Q1. We think it's unlikely to be higher. Now, that obviously means it could be higher, but it also means it could be lower.

**James Crawshaw** - Kaupthing - Analyst

All right. Thank you. And Warren?

**Warren East** - ARM Holdings plc - CEO

Switching to TSMC and TSMC as an IP provider, TSMC have been talking for some time about driving their business more from just being a pure-play foundry to offering more of the system. And part of that is offering blocks of IP. And there are many different pieces of semiconductor IP that a designer might use in building a system-on-chip device and manufacturing it with a foundry like TSMC.

Physical IP itself covers a multitude of sins. And in order to equip their customers with a broad portfolio of IP, companies like TSMC operate with a growing basket of their own IP and a network of third-party IP providers. ARM is one of those third-party IP providers with whom TSMC works and continues to work. And within our physical IP portfolio, there is an overlap with some in-house TSMC products.

And as I have said many times before on these sorts of calls and Q&A sessions, in much the same way as today, we see semiconductor companies with multiple microprocessors on a chip, ARM microprocessors, other third-party microprocessors and in-house microprocessors all together on one chip. We would expect to see the same sort of thing happening with physical IP, where you have chips built with some TSMC physical IP, some ARM physical IP, some other third-party physical IP and even some in-house physical IP. So, yes, there's competition out there and TSMC getting into this in some ways legitimizes the third-party market for physical IP. But we remain very active as a partner of TSMC and you'll find that our physical IP is available, for instance, via the TSMC website. So it does happen.

**James Crawshaw** - Kaupthing - Analyst

So there's nothing particularly new in this open innovation platform that changes the outlook for PIPD?

**Warren East** - ARM Holdings plc - CEO

Not at all, no. The outlook for PIPD in the short term I think is all about execution and stability, as described on earlier questions. And in the medium term it's driven by the economic trends and increased levels of outsourcing, the same sort of phenomenon as we've seen over the last 10 years in microprocessors.

**James Crawshaw** - Kaupthing - Analyst

Great. Thanks very much.



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**Operator**

The next question is coming from Nick Hyslop from RBC. Please go ahead, sir.

**Nick Hyslop - RBC - Analyst**

Morning, guys. I think most questions have been asked. But you've been asked extensively about royalties. I thought I'd just -- it is interesting that your average royalty rate has risen, I think, at the fastest rate at any point since one quarter in 2005. And when you look at the trajectory of ARM11 in that mix, which you see and we don't, if you would be brave enough to say that that might even be a tipping point in which way the average royalty rate goes from here.

**Warren East - ARM Holdings plc - CEO**

Yes. I think, Nick, we're not going to come away from what we've said about long-term trends. We haven't updated our 4.5b unit forecast properly for some time. When the number is around about that number or maybe a little bit higher, we would expect microcontrollers to be a serious contributor. Microcontrollers, as you know, push the average in one direction. High-end Smartphones push the average in another direction. And what happens is all about the balance of those two.

Looking at the trajectory for ARM11, I'd say look back at the 926 trajectory and you'll see ARM11 following a very, very similar path. I would expect that this year, for instance, still a small single-digit percentage of the overall volume to the ARM11, but that small single digit is probably going to be bigger than 3.

**Nick Hyslop - RBC - Analyst**

That would give you confidence, looking at that trajectory, that the average royalty rate might have finally stemmed its decline?

**Warren East - ARM Holdings plc - CEO**

The important thing is total dollars and we're very pleased that total dollars are going up. We've said before, really, getting fixated on the average rate can be a bit misleading because actually, if the average rate turns out for 2008 to be much higher than where it is now, A, I'd be surprised, and B, I'd be very pleased because it would be indicative of high volumes of Smartphone shipping. If it turned out to be much lower, I'd also be very surprised because I do expect Smartphones to continue to grow and ARM11, as I say, to continue to grow from where it is now. But I'd also be very pleased because it would be indicative of high volumes of microcontrollers shipping if the average royalty rate had turned out to be very low. So I can't read too much into the average royalty rate.

**Tim Score - ARM Holdings plc - CFO**

I think our overall message, Nick, is the same as it's been in the quarters when it goes down. We're not in any way going to be triumphalist about the fact that in the quarter it's gone up. I think what this reminds us of is that the average rate per device did not inexorably go down quarter on quarter. You referred to -- there have been other quarters where it goes up and, as Warren said, it's about mix. But our long-term expectations of the rate remain unchanged.

**Nick Hyslop - RBC - Analyst**

And then, just quickly on licenses, the average -- could you give us the average number of quarters that you recognize the licenses that you signed in this quarter is at the moment? I know that that figure can move around a bit, but what's the average?

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**Tim Score** - ARM Holdings plc - CFO

Do you mean for the new deals we signed (multiple speakers)?

**Nick Hyslop** - RBC - Analyst

For the ones you've signed, yes.

**Tim Score** - ARM Holdings plc - CFO

How long will it take to recognize the revenue?

**Nick Hyslop** - RBC - Analyst

Exactly.

**Tim Score** - ARM Holdings plc - CFO

On average, two to four quarters.

**Nick Hyslop** - RBC - Analyst

Okay. And presumably there's been no change in Cortex revenue recognition in terms of shortening, it's not gone from 6 to 4 or --?

**Tim Score** - ARM Holdings plc - CFO

Well, over time, obviously, as a product becomes more mature, and you heard Warren say that the Cortex-A9 goes out into more general release, those are all instances of revenue recognition moments. So as an ARM processor becomes more mature, the revenue recognition that actually goes straight to the P&L on signing increases. So yes, over time, all of the products gradually move to the right along the recognition line.

**Nick Hyslop** - RBC - Analyst

But no recent changes in that policy?

**Tim Score** - ARM Holdings plc - CFO

No dramatic -- no, no, the policy's absolutely unchanged and it's prescriptive and rule-driven.

**Nick Hyslop** - RBC - Analyst

Okay. And then just lastly, the share buyback, what should we expect for the rest of the year, roughly?

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**Tim Score** - ARM Holdings plc - CFO

I think the thing to bear in mind is that we've indicated that we plan to run the business probably through '08 at similar net cash levels than the ones we started the year and that we see at the end of Q1. And therefore the free cash flow generation that we will see in each quarter will be returned in one way or another. Obviously ARM, we have a history of doing some bolt-on acquisitions. We haven't done one for a while, but you wouldn't preclude that potential as well. So, hard to call the buyback specifically, but I think bear in mind we don't plan to rebuild a cash balance but, by the same token, we don't have any short-term plans to put any gearing on the business.

**Nick Hyslop** - RBC - Analyst

Okay. Brilliant. Thank you very much.

**Operator**

Thank you. Your next question is coming from Jonathan Crossfield from Merrill Lynch. Please go ahead, sir.

**Jonathan Crossfield** - Merrill Lynch - Analyst

Yes. Just a quick question on the PIPD. You mentioned two top-10 customers. Could you just confirm whether they were new customers to the business or whether they were repeat business with existing chip makers?

**Warren East** - ARM Holdings plc - CEO

Yes. It was one of each, one new and one existing.

**Jonathan Crossfield** - Merrill Lynch - Analyst

Okay. And then, in terms of the mix going forward of the PD licensing, I think you mentioned, Warren, we could see some more A9 deals coming in the second half. Should we also expect a number of R4 and A8 deals through the rest of the year?

**Warren East** - ARM Holdings plc - CEO

Yes, I think that's likely. I think A8 is an A profile, so that's similar to A9. These are processors designed to run a large operating system and so they are -- one is a high-performance uniprocessor, one is a high-performance multiprocessor, so it's very much horses for courses. And we have to provide designs that satisfy companies wanting to move in either direction. Cortex-R4 is all about real-time control. Yes, we're still seeing opportunities for R4 and expect to close some of those in the second half of the year as well.

**Jonathan Crossfield** - Merrill Lynch - Analyst

Great. Thanks very much.

**Operator**

(OPERATOR INSTRUCTIONS). Your next question is coming from William Wyman from Cazenove. Please go ahead, sir.

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**William Wyman** - Cazenove - Analyst

Morning. Just a follow-up question on PIPD. The restructuring there, the 30 positions cut, could you clarify if that's on top of what was already described at the Q4 results or do you expect to be able to cut out some more cost there going forwards? And, if so, is that part of the OpEx guidance as well? Thanks.

**Tim Score** - ARM Holdings plc - CFO

No, that's the same. We repeated it this release because it was actually a Q1 activity and the restructuring charge itself has gone through in Q1 but it's the same exercise that Simon described on February 5.

**William Wyman** - Cazenove - Analyst

Okay. Great. Can I ask another question on licensing? Sorry to harp back on it again, just a little unclear. I think, Warren, at the top, you said something about the focus moving towards the roadmap. If you could just clarify, in terms of timing, what's the risk for Q2 and Q3 in particular, just the engineering focus shifts back to developments, maybe away from backlog conversion, just for Q2 and Q3. Thanks.

**Warren East** - ARM Holdings plc - CEO

The comment was actually in respect of the processor division and not the physical IP division.

**William Wyman** - Cazenove - Analyst

Yes, the PD division, yes.

**Warren East** - ARM Holdings plc - CEO

Well, it's not really a shift of focus. I'm simply saying that these products which have been new products are going through the development process and getting to the end of the development process, and engineering teams are getting on with developing something which comes afterwards. We haven't actually announced the products that are coming afterwards. We won't be launching them for some time. But the purpose of talking about it was to reassure people that we are, in fact, actively engaged on driving the roadmap for higher levels of performance and better power efficiency.

**William Wyman** - Cazenove - Analyst

Okay. Thanks.

**Warren East** - ARM Holdings plc - CEO

So I think we've got time for one more question.

**Operator**

Okay. Your next question is coming from Robert Sanders from Dresdner. Please go ahead, sir.

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**Robert Sanders** - *Dresdner - Analyst*

Yes. Hi. Just maybe a follow-on question from William's, actually. I was just wondering if you thought you'd really finished right-sizing the Artisan business in the U.S. I suppose the reason I'm asking is because your 20-F shows that the PIPD margin's fallen to 0% in 2007. So I suppose the critical element to getting that margin up, apart from higher sales, would be taking costs out of the U.S. business.

**Tim Score** - *ARM Holdings plc - CFO*

Well, the restructuring activity that we saw in Q1 is about positioning the business for profitable growth. And having had a difficult revenue year in 2007, for the reasons that Warren's described on this call, we plan to grow physical IP both in the short term, i.e. this year, and beyond. Now, clearly the cost base of physical IP and where that cost base resides will refine over time, but that business is being positioned for growth not for being slimmed down. So we think it's an appropriate cost base for our growth plans.

**Robert Sanders** - *Dresdner - Analyst*

Do you plan at all to give out to us at some point a PIPD margin expectation, maybe by 2009?

**Tim Score** - *ARM Holdings plc - CFO*

Not really. Immediately after the acquisition, we disclosed these margins very separately. What's actually happening in reality, these businesses are moving much, much closer together every day. The technology collaboration that goes on between those divisions to develop both better physical IP and processor divisions is increasing. The sales force that sells these projects -- these products is unified. And therefore it's actually quite an artificial exercise to separate them out. But certainly our expectation, as PIPD grows its top line, is that margins grow.

**Robert Sanders** - *Dresdner - Analyst*

Thanks a lot.

**Warren East** - *ARM Holdings plc - CEO*

Okay. Well, perhaps we ought to wrap it up there. So thank you very much, everybody. I think the summary of these results, it's a solid start to 2008, revenues up for the year as a whole ahead of consensus, highlights in PD royalties growing over 20%, ARM11 helping to drive that. A quarter of stability in physical IP, from a licensing point of view. Underlying royalties up in physical IP 20% year on year.

Difficult economic conditions out there are not -- we're not seeing any immediate effects of that in our customer conversations, as we sit here today, but our guidance for the year remains unchanged. Revenue growth at least as good as 2007, with inherent leverage in the business model implying a profit growth ahead of that.

So, with that, thank you very much and we'll be back to talk to you after our half year results in July. Thank you.

**Operator**

That does conclude our conference for today. Thank you for participating. You may all disconnect.

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