Analyst Call Regarding the Issuance of Stock Options
(March 25, 2019)
Q&A

(Shibata CFO)

Today Renesas announced “Notice Regarding Issuance of Stock Acquisition Rights as Stock Options” regarding the IDT acquisition. There have been instances, outside of the IR perspective such as media coverage, where our intentions have not been appropriately communicated. This has become a concern, and therefore we held a conference call today in order to communicate our intentions carefully and accurately. For further information, we would like you to refer to the press release available on our website. The amount of stock acquisition rights issued resolved today are calculated based on a stock price of 500 yen per share at an exchange rate of 113 yen to the US dollar. Multiply this by 100 and it will give you the actual amount of shares to be issued. The final number of stock acquisition rights will be determined in approximately two days confirming the actual exchange rate and stock price.

The figures provided are not finalized definitive figures and may fluctuate. For further understanding, we have provided a diagram on the final page of the press release for your reference and will be used to explain. We held the Annual General Meeting of Shareholders on March 20, and the proposal for a certain amount of stock option issuance for employees residing in the State of California was approved. The stock option amount which was a topic of discussion at the Annual General Meeting of Shareholders are presented in the shaded areas in the diagram. These areas include some of the stock option issuance announced in today’s press release. However, it also includes the stock option issuance which have not been decided upon. These are the top sections of each trapezoid labeled “Renesas’ annual grants” and “IDT’s annual grants” in the diagram, where stock option is issued as an equity incentive annually. To repeat myself, this timeline and scale is undecided, though this was approved at the Annual General Meeting of Shareholders as part of the issuance for employees residing in the State of California. In the diagram, the assumed scale has been illustrated to provide a reference. The areas inside the dotted line, below the diagram labeled “Conversion of the existing RSUs and PSUs following IDT acquisition, etc.” is what was decided this time. Though some does include the issuance for employees residing in the State of California, the decision also includes other employees residing in other areas, mainly in Japan.

The issuance this time are mostly relating to the IDT acquisition, and to replace the equity incentive IDT’s management and employees had with Renesas’ equity incentive. To increase retention rates until the completion of the acquisition, some parts of IDT management and employees' incentive vesting period has been accelerated. For the three rectangles labeled "Renesas' annual grants", "IDT's annual grants" and "Conversion of the existing RSUs and PSUs following IDT acquisition, etc.", which are vested on the date of allocation, the vesting period has been accelerated in order to increase retention rates until the completion of the acquisition. The remaining trapezoidal sections will follow the vesting schedule of incentives held by IDT's management and employees.

To summarize today: 1) The announcement regarding stock option issuance released today does have similarities with the proposal made at the Annual General Meeting of Shareholders, but some of the targets differ; 2) the stock option issuance released today are mainly to replace equity incentive IDT's management and employees had with Renesas' equity incentive; 3) in order to increase retention rates toward the completion of the acquisition, some of the vesting schedule has been accelerated. The remainder will follow the original schedule and be replaced with Renesas' equity incentive.

Q) Although you said the annual grant figures have not been decided, assuming it has been decided, what impact would it give to the GAAP-based operating profit?
A) There will be some impact in GAAP-based calculations. It will be an expense, so it will hit the cost items on the PL statement.

Q) The annual grant for Renesas employees this year is looking to be 6-7 billion yen, but would it be a negative factor in terms of profit?
A) It could be possible, but in terms of the annual grant, this is not a new phenomenon starting from this year. Therefore, it does not mean there will be significant differences to our historical PL statements.

Q) In regard to stock option, it appears that Renesas' and IDT's annual grant is around 6-7 billion yen each, but the number of employees in Renesas is 10 times as many as the employees in IDT. While there are gaps in pay and stock options, how will you maintain employees' motivation?
A) Although this is something that troubles us, it will have to be done through trial and error. It's not necessarily a gap between Renesas and IDT employees, but a geographical gap. Simply put, Japanese wages are cheap. We are concerned how long we will be able to maintain this, or what would be the ideal, but we are slowly working towards an improvement. Until our financial performance improves, we will be met with large criticism if we were to raise Japanese employees' wages. Therefore, we must first focus on improving

our financial performance, and eventually fill in the gaps.

Q) There are concerns that, since IDT's GAAP net income is around 15-20 billion yen, the cost of acquisition comes to around 700 billion yen and therefore is expensive. What would IDT's profits look like in 5 years' time, and what would the management environment be, and what would the return on investments be like?

A) After 5 years, IDT will not be a standalone entity, so therefore it will not be appropriate to discuss its outlook. We will be updating our mid- to long-term plan at the appropriate timing, so please wait for that.

Q) What are you imagining for management's compensation system? You said you will proceed through trial and error, but how will you combine fixed pay and performance-based stock option? When you say performance-based, what aspect of the financial performance is the index?

A) As a major premise, a large portion of the current management compensation in Japan is performance-based. This is clearly related to the net income. However, if you look at it as cash and equity, the structure is still cash heavy. Although I cannot tell you the details, from past experiences, we have formed the current model. Compensation systems in companies like IDT and Intersil based in the west coast of the United States, cash payment is mostly fixed, and performance-based is mostly equity. If we were to merge our model, it will be natural to follow this system. However, the total amount is vastly different. There is a significant gap in the way equity incentives are handled, taxed and its usability in Japan and the US. In the Japanese annual financial reports, equity related compensation is calculated based on a certain logic and described as a single year's compensation amount, but for Renesas, managements' compensation follows a TSR (Total Shareholder Return) based structure, as performance stock unit. With our current stock price, this performance stock unit will eventually become zero. However, there are some value at the timing of grant, and therefore it is listed in the annual financial report. On the report, an amount far larger than the actual amount management receives will be listed. We must consider all aspects carefully and follow the most appropriate method and timing. For the most part, we believe that an equity heavy model will be better in order to align with shareholders' incentive.

Q) Is the net income used for your index Non-GAAP basis?

A) Yes.

Q) The IDT acquisition is to be completed on March 30 JST, but how will your sales segments change from Automotive, Industrial and Broad-based afterwards? What impact would IDT give?

A) It has not been confirmed, but we are considering how we disclose our sales. The non-Automotive portion will become larger, not only in terms of financial figures but as employee headcount, positioning etc., so therefore we believe to operate separating Automotive and non-Automotive may be appropriate. In the non-Automotive segment, new areas which was one of the reasons why we acquired IDT such as communication infrastructure and data center will be ramping up, and we would like to provide segment information which highlights those areas more than before.

Q) The share buy-back this time is 20,000,000 shares, or 10 billion yen, but what made you decide on conducting this buy-back? Is this for shareholder return, or to adjust the shareholder's holding ratio of voting right following the date of allocation when equity will increase? If it was for shareholder return, you have not conducted any shareholder returns since INCJ's investment, but after capital expenditure has peaked out, for your use of free cash flow going forward, is it appropriate to think it will be for paying down debt from the IDT acquisition, capital expenditure for manufacturing equipment and shareholder return?

A) We are not expecting any shareholding status adjustments. We have announced this share buy-back with the idea to reduce dilution as much as possible. This stock option issuance is a one-time only event, but the incentive issuance will be held annually. Unmanaged, it will become diluted, so we want to treat that part. If afterwards we start to have some margin in our cash, we would like to conduct share buy-backs from the perspective of intrinsic, shareholder return. Of course, there is the option to give dividends, but our priority is share buy-backs, followed by dividends. We will conduct shareholder return with consideration to balance. In terms of capital expenditure, although it was fairly large in 2016 and 2017, as far as we can see going forward, we do not have any large capital expenditures planned and therefore the weighting in comparison will be small. As for how we plan to use our cash, not only acquisitions of large companies, we would like to acquire smaller scale companies or create partnerships, and along with shareholder return, would like to find the best use.

Q) What is the cost synergy realization outlook? The synergy realization for Intersil was slower than expected, but do you have a clear outlook for the IDT synergy to be realized on schedule?

A) Just to clarify, although the Intersil cost synergy realization was slower than initially planned, in our second year, the cost synergy was larger than what we initially expected. Please do not misunderstand that the cost synergy was just slow. In addition, as Intersil was our first acquisition, we were not expecting such large cost synergies. In comparison, we expect to realize cost synergies with IDT to the scale of other US mergers. With that in mind, we believe we are on schedule at this moment in time. The synergy realization is calculated in a short time scale, so there may be some delays or acceleration compared to our plan, but we do not feel any sense of crisis and everything appears to be on track.

Q) What would the risk tolerance level of your balance sheet be, including the share buy-back? Your balance sheet after the IDT acquisition will significantly inflate, but what are your indexes, and financial discipline will you follow as the standard?
A) Our standard will be cash flow or EBITDA. Cash flow or EBITDA against the gross or net debt will be the multiple.

Q) Do you have any outlooks, for example, if free cash flow can be produced steadily to a certain amount, what would the net debt equity ratio within an x number of years?
A) Nothing has changed. The free cash flow and debt fluctuates will fluctuate with each ratio. We have not changed the way we form an outlook.

Q) Internally, are you looking at recovering debt vs EBIDTA in around 3 years?
A) Debt changes according to the environment. We do not expect it to stay at the same level forever, but looking at our peers, when comparing gross debt vs EBITDA, the peak is around 4.5 times to 5 times. We can tolerate those levels momentarily, and as long as we can foresee that we can reduce this to 2 to 2.5 times in the short term, we think this will be fairly safe.

Q) The IDT closing is said to be on March 30 JST in your press release, but after closing, what does the timeline for legal procedures and consolidation procedures look like? Will IDT be consolidated in the April to June quarter and 9 months' worth of figures be consolidated?
A) All legal procedures have been completed. In terms of consolidation, that is the outlook we currently have.