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# THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

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## COMPANY INTERVIEW

**STEVE SANGHI**

Microchip Technology Incorporated

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# Microchip Technology Incorporated (MCHP)



**STEVE SANGHI** was named the President of Microchip Technology Incorporated in August 1990, Chief Executive Officer in October 1991 and the Chairman of the Board of Directors in October 1993. In June 1995, Mr. Sanghi received an Arizona Entrepreneur of the Year award. He is co-author of the upcoming book *Driving Excellence: How the Aggregate System Turned Microchip Technology from a Failing Company to a Market Leader* (Wiley; April 2006), along with Michael J. Jones, Microchip's

former head of human resources. Before joining the company, Mr. Sanghi was Vice President of Operations at Waferscale Integration, Inc., a semiconductor company, from 1988 to 1990. Mr. Sanghi was employed by Intel Corporation from 1978 to 1988, where he held various positions in management and engineering, the most recent serving as General Manager of Programmable Memory Operations. Today, Mr. Sanghi is a member of the Board of Directors of Xyratex Ltd., a member of the State of Arizona Governor's Council on Innovation and Technology, and a member of the Board of Trustees of Kettering University. Mr. Sanghi holds a Master of Science degree in Electrical and Computer Engineering from the University of Massachusetts and a Bachelor of Science degree in Electronics and Communication from Punjab University, India.

## SECTOR – SEMICONDUCTORS

**(ADM604) TWST: Would you begin with a brief history of Microchip Technology and then bring us up to date on the company?**

**Mr. Sanghi:** Microchip Technology was founded in April 1989 as a spinoff from General Instrument. Prior to April 1989, it was about a \$60 million semiconductor subsidiary of General Instrument, but losing a lot of money for General Instrument, which decided to shut it down. At the last minute, a group of venture capital investors came in and bought the company from General Instrument. That really was the beginning of a private Microchip Technology.

I came to Microchip about a year later as sort of a turnaround guy, and I did in fact turn the company around — raised some new venture capital, made it profitable, took it public in March 1993. It was a very, very successful public offering. The stock went up 500% in the first year. We were the best performing initial public offering of 1993. And, subsequently, the stock has done extremely well. The company, which in 1993 was about an \$80 million company, will this year be worth well over \$900 million. So it has really progressed very well in the last 12 years since its public offering, with its stock up nearly 6,000%, 60 times our original initial public offering price.

Microchip is also the best performing semiconductor stock. When compared to any other semiconductor company, semiconductor equipment company or semiconductor material equipment supplier, out of 200-some companies in related semiconductor businesses, Microchip's stock has had the best performance for the last 13 years. I have recently completed a book, which is going to be published by Wiley in mid-April. The book is called *Driving Excellence: How The Aggregate System Turned Microchip Technology from a Failing Company to a Market Leader*. The "Aggregate System" in the title is the aggregate cultural system of Microchip, which I describe in that book. You'll find Microchip's method, its culture and so forth described very comprehensively in it, so you might be interested in reading the book when it comes out.

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***"We see substantial organic growth possibilities, internally. The three areas that stand out in my mind are 16-bit microcontrollers, analog and 8-bit Flash microcontrollers. The largest percentage growth we are likely to see is in 16-bit microcontrollers, followed by analog followed by 8-bit Flash microcontrollers. The largest dollar growth is likely to happen in 8-bit Flash microcontrollers followed by analog and followed by 16-bit."***

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In terms of its products, Microchip is the market leader today in 8-bit microcontrollers used for all sorts of electronic control applications, ranging from consumer applications to industrial applications, automotive, telecommunications and office automation type of applications. In the last five years, we have also made entries into the analog products business, so that too is a section of our business today. And just in the last year and a

half we have introduced a large number of 16-bit microcontrollers, which are readily being accepted in the marketplace. So we are seeing very substantial growth today in the areas of analog and 16-bit microcontrollers in addition to the continued growth of the 8-bit microcontrollers.

**TWST: What's the company's agenda? What are your priorities for the next 12 months for the company?**

**Mr. Sanghi:** In the next 12 months, we expect to see a dramatic acceleration of design-win activity in three different market segments. One is the analog, which I mentioned; second is the 16-bit microcontroller, which I also mentioned; third is the Flash 8-bit microcontroller. While the overall 8-bit microcontroller market is starting to slow, it's a mature market, the Flash 8-bit microcontrollers are growing very rapidly. Over the next 12 months, we'll harvest those three opportunities that we're seeing in our businesses.

**TWST: Give us an idea of what some of the innovations are that you're already working on or looking toward.**

**Mr. Sanghi:** In terms of innovation, Microchip has one of the best embedded Flash technologies in the industry. It is the industry's most reliable Flash technology. We are also the leaders in Flash microcontrollers. Secondly, we have a brand new 16-bit microcontroller architecture that we introduced last year. Two different magazines last year gave it awards. *EEPEN* named it the best microcontroller of 2005. And *Electronic Products* gave it the co-winner product of the year award for 2005. I think that clearly shows that it was a very innovative architecture we introduced, and it is doing very well in the marketplace, winning a lot of designs.

Analog is the third area where we see ourselves as innovative. We are a leader in low-power

operational amplifiers technology today. Because the analog market tends to be very diverse with hundreds of products, it is tough in a short amount of time to cover the breadth of it, but we are committed to bringing significant innovation into that marketplace. We were the fastest growing analog company last year, and if you look at calendar Q4 of 2005 versus the calendar Q4 of 2004, you see that Microchip's analog business was up 40% Q4-over-Q4, surpassing every single analog company in the industry.

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***"We're among the most profitable semiconductor companies, one of the top three or four most profitable semiconductor industry companies. We made 59.7% gross margin last quarter. I only know two or three other companies that have a higher gross margin than that. We made 36% operating profit, and that is the envy of the industry."***

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**TWST: How would you describe the dynamics as you look around at the competitive landscape today, and what will continue to distinguish Microchip from other companies in the industry? Do you see M&A playing a significant role?**

**Mr. Sanghi:** In terms of what's happening — trends, etc. — first is the significant growth of applications we see happening in the 16-bit microcontroller area. We are clearly benefiting from that.

Number two, let's remember that the world is really analog. Even though everybody talks about digital all the time, temperature, sound, music, video, etc., these are all analog functions, and there is a large and increasing amount of analog required to convert the signals from analog to digital and then process them within a microcontroller or a microprocessor — and then, at the end,

you still need to convert it back to analog to light a bulb, to make a sound, to turn a power switch on — in other words, to control something. The world forgets that the real world is analog. The real world does not operate in zeros and ones. Therefore, there is a continuous need for analog that Microchip continues to benefit from.

As far as M&A is concerned, there hasn't been a lot of M&A in the microcontroller industry. The reason for that is quite simple. Most companies have their own architectures for microcontrollers, and when you have your own architecture, an acquisition does not scale well. We have our own proprietary PIC<sup>®</sup> microcontroller architecture, and if we were to acquire somebody, another microcontroller company with a different architecture, then we would need to duplicate all the resources, create development tools and retrain architectural experts and application engineers. It does not scale well. The situation is different with memory products: if you make a dynamic RAM and somebody else makes a dynamic RAM, when you combine them, half the resources can go away and you get some consolidation advantage. You do not get that in microcontrollers. For that reason, there have been very, very few acquisitions in the microcontroller space. There have been some acquisitions in the analog space, but analog is still a very fragmented market where a great number of small to large companies continue to operate. Albeit, some big consolidations have taken place over the years. Texas Instruments buying Burr-Brown, I think that was one of the biggest. There have also been some smaller acquisitions. Microchip, about six years ago, bought a \$40 million company, TelCom Semiconductor, which was in the analog space. But these acquisitions have not been enough to narrow the field down.

**TWST: What is the formula for growth with Microchip? What role can M&A play? What role does organic growth play?**

**Mr. Sanghi:** Our current quarter guidance is \$242 million in sales. So we're really knocking on the door of \$1 billion in annual sales. And if you look at that billion dollars, it's all been really organic growth. We bought a \$40 million analog company and we bought another \$10 million or \$20 million company along the way, a few miscellaneous things, but most of our growth has been organic. We fundamentally believe in organic growth. You buy a small module here and there, perhaps a technology license or something, but then you've got to build the business around it. We see substantial organic growth possibilities, internally. Again, the three areas that stand out in my mind are 16-bit microcontrollers, analog and 8-bit Flash microcontrollers. The largest percentage growth we are likely to see is in 16-bit microcontrollers, followed by analog followed by 8-bit Flash microcontrollers. The largest dollar growth is likely to happen in 8-bit Flash microcontrollers followed by analog and followed by 16-bit.

**TWST: From a global perspective, where do you see your customers today? Is there anything significant about the global nature of your business that investors should particularly focus in on?**

**Mr. Sanghi:** There are many nuances to the global nature of the semiconductor business. Today, 46% of our business is in Asia, about 26% to 27% of our business is in Europe and the balance, which is another 27%-28%, is in the Americas. Now, an important thing to note is that, while 46% of our business is in Asia, a significant portion of that 46% — we believe as much as about 25% to a third of that Asian business, and the numbers are very tough to get because you don't

know exactly who does what — actually consists of designs made in the US, primarily the US but also some in Europe, which then transition to Asia for manufacturing at a subcontractor. Therefore, we need to continue to create significant demand in the US and Europe, getting our products targeted toward those customers, even though manufacturing will take place in Asia or China. You'll need to put in infrastructure around the world, not only to get design wins, but also to service the customers from a logistics perspective — through distributors or Microchip's direct service programming. That way, you give customers the technical support they need to succeed.

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***"Microchip is generating very, very strong free cash flow. This year we're generating in excess of \$350 million of free cash flow, and that's very substantial. Next year, we are expecting a similar amount, \$350-\$400 million in free cash flow from over \$1 billion of sales. You are talking about \$0.35 to \$0.40 of every dollar of free cash flow after investment in capital expenditures and all the expenses of the company, and that's a very, very strong cash flow earner. As a result, we are able to pay consistently very strong dividends."***

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**TWST: Introduce us to your top-level management team today, two or three of your key individuals.**

**Mr. Sanghi:** Other than me, the next one would be Ganesh Moorthy. He is the Vice President of the Advanced Microcontrollers and Memory Division. This is a super division. It has a large portion of our 8-bit microcontroller business, all of our 16-bit microcontroller business and our memory business. He runs this super division with the general managers who he needs at the sub segments. I have known Ganesh for a long time. I actually hired him out of college back in the early

1980s when I was at Intel, and he worked for me for a number of years in my organization. “A rising star,” I thought. I left Intel in 1988 to seek my fortune in the startup world, and he stayed with Intel another 15 to 18 years after I was gone. That was all in California. We reconnected several years ago here in Arizona. He had moved with Intel to Arizona and I was running Microchip. I re-hired him about four years ago to run my microcontroller divisions. He had done very well over the years at Intel, and he has done very, very well here at Microchip.

The next executive I can talk about is Mitchell Little. He was a marketing engineer, working in our memory group at Microchip when I first joined the company as a Senior VP of Operations in early 1990. Over the years he’s been a rising star, doing the job of memory marketing engineer and marketing manager and running the memory division for me for a while. He helped start up one of our microcontroller divisions when I broke a division into two and he headed up that group for me, and again did an outstanding job. In 1996, I restructured my sales organization and picked him as a prime candidate to head up the new sales organization. And for the last many years now, he has been the VP of Sales. Mitch has done an outstanding job growing Microchip for a number of years.

**TWST: Would you give us an idea of the bench-strength you have at the company? Are there any skill-set issues that you’re addressing, adding or augmenting positions?**

**Mr. Sanghi:** I’ll describe one or two more executives and then make some general comments about succession planning, which will point to the bench strength.

An executive I’d like to mention is Gordon Parnell, our CFO. Gordon Parnell has been with

Microchip since the very beginning. He was originally a Treasurer and Controller and, over the years, was promoted to Chief Financial Officer. He had worked for the predecessor company to Microchip under General Instrument. Born and raised in Scotland, he worked for General Instrument in the UK and transferred to the US many, many years ago. I have known him for a long time now. Ever since I’ve been at Microchip, for the last 16 years, he has worked for me, and he’s been great with the Street and great with the internal controls. With all the changes that have gone on with the Sarbanes-Oxley 404 internal controls, Microchip has passed with flying colors, with no material weakness identified. So he’s really done a wonderful job. It’s a tough job being a CFO these days in the current Sarbanes-Oxley environment, and he’s really done very well.

A fourth one I would mention would be Dave Lambert. I have known Dave Lambert for a very, very long time. I knew him at Intel when he was a diffusion engineer. When I came to Microchip, he was already here working. He was then in our Fab division as an engineering manager, and I saw to it that he advanced. He has done extremely well. Today, with his many years of experience at Intel and at Microchip behind him, he’s the VP of our fabs, and he runs some of the best-yielding fabs of the industry. Microchip is known for its very high yielding fabs and excellent statistical process control and shortened cycle times, among other things. I think Dave Lambert has been very, very instrumental in the success of Microchip by giving us this world-class, low-cost manufacturing environment.

Now, with respect to management, a general comment I would like to make is that we have very strong succession planning at Microchip. In the 13 years since our public offering, we are al-

ready on our second team. I'm the only one, I believe, who belongs to the original first team that took the company public in 1993. We had another CFO who left in the late 1990s. Then, Gordon Parnell became the CFO. So we're already on our second CFO. Our VP of the microcontroller division retired about four years ago, and that's when I hired Ganesh Moorthy. So we are on our second Microcontroller General Manager. When we went public, we had a VP of Fab Manufacturing, Timothy Billington, who retired about five years ago, and since then Dave Lambert has been the VP of Fab Operations, so we are on our second Fab VP. We are also on our second Human Resources Director. So all through the company, the first-level guys who took the company public have retired, and in the last three to eight years, as those various people retired, we have had the next guy ready. In all cases but one we promoted somebody from within. The one exception was Ganesh Moorthy, who we hired from outside. And many on the current management team are now talking about retirement in the next four to seven years, and we have the third management team already prepared and named. They've been told. They're being trained and groomed, and will continue to get further training. So Microchip is very, very strong in succession planning. We have a very, very deep bench.

**TWST: What, historically, has been the shareholder base with Microchip? Has that base itself undergone any changes?**

**Mr. Sanghi:** Microchip has had about 50% of its stock held in very stable, large institutional funds that have owned us for a number of years. They are not short-term traders or flippers. The other 40%, 50% of the stock is held by smaller shareholders, some of whom may be long-term shareholders — they may be with a hedge fund,

they may be retail investors, etc. But 50%-60% of our stock is in the very good, stable hands of investors who we see several times a year at various financial conferences. We are really quite fortunate that way. In fact, one of our shareholders is Don Valentine, who was the ex-Chairman of Microchip when the company went public. He was a venture capitalist, head of Sequoia Capital, and when Sequoia Capital distributed their shares to their individual partners, Don Valentine obviously got a lot of shares — and he tells me he has never sold a share. He still owns all the original shares from 1993 — and the stock is up 60 times since then, so he's a very a happy man!

In the last couple of years Microchip has started to pay significant dividends. We've been very, very profitable, which has generated a lot of cash. Today, we have the highest percentage dividend rate in the semiconductor industry. Indeed, our dividend is higher than the average dividend of the S&P 500. This quarter we announced a dividend of \$0.19. That's a rate of about \$0.76 a year, and on a \$36 stock, that is more than 2% that you get in dividends alone. So with that very strong dividend, we have also attracted some investors and mutual funds with a focus on income as well as growth, because the shares can provide strong income through dividends. So there's been somewhat of a shift in the shareholder base we have attracted recently, in that in the last couple of years people who are interested in generating income beyond growth have taken an interest in Microchip.

**TWST: In your discussions with analysts and investors, potential investors as well as current investors, do you encounter any misperceptions?**

**Mr. Sanghi:** Yes, we do. I think our stable investor base seems to be fine. The rest of the investor base, however — investors looking for

short-term opportunity; investors who look at earnings quarter-to-quarter or who just keep watching the news — that is a part of the investor community that tends to have misconceptions. Let me talk about some of them. I think the most prevalent one would be the assumption that the semiconductor industry largely runs by what's come to be known as Moore's Law, the statement made by Gordon Moore, ex-Chairman of Intel, that in the semiconductor industry the number of transistors on a chip doubles every 18 months. However, Moore's Law does not apply to analog. It does not apply to the microcontrollers either. And though it seems to be relatively well understood by the investors and analysts who look at the large analog companies — the analog businesses of Texas Instruments, STMicroelectronics, Linear and Maxim — that the analog business does not follow Moore's Law, these investors do not understand that the 8-bit microcontroller business does not follow Moore's Law. Our 8-bit microcontrollers control things like thermostats and remote controls and toasters and blenders and irons and refrigerators and industrial machinery and so on and so forth, and many of these parts do not require the power, the memory capability, the performance of 16-bit, 32-bit microcontrollers. So while industry pundits, including the industry analysts, have been calling the demise of 8-bit microcontrollers for the last 15 years, saying that the entire business is going to switch over to 16-bit and 32-bit microcontrollers — and indeed, the people who make 16-bit and 32-bit microcontrollers keep touting that — if you look back over those 15 years, the most successful microcontroller company has been Microchip. We've dominated 8-bit microcontrollers because we understood the trends. We understood that 8-bit microcontrollers would not migrate over because those applications I just

listed do not need the higher performance and transistor count of a 32-bit microcontroller. Yet the misconception continues. Year after year after year, Microchip makes a brand new record and achieves higher sales and significant growth and gains more market share in the 8-bit microcontrollers, yet every time they look at those results, investors and analysts say, "Well, you did that last year, but how is it possible to do it in the future when the business is going to 16 and then to 32?" Then we post another brand new record of 8-bit microcontrollers almost quarter-after-quarter. I think that's the largest misconception.

**TWST: What is it that investors should focus on when they review Microchip for inclusion in their current portfolios and as part of their longer-term investment strategies?**

**Mr. Sanghi:** I'd suggest they look at three areas: first is product lines; second, financials; third, consistency. Let me briefly summarize each of them.

As far as product lines are concerned, we are number one in 8-bit microcontrollers. That's a clear winning story that investors can see — and we continue to gain more territory in that, quarter-after-quarter and year-after-year. Then the two new businesses we have gotten into over the last five years, the 16-bit microcontrollers and analog, both are growing very, very substantially, significantly better than the industry, so we are gaining market share in those areas. Our analog last quarter was up 40% over the year before, and our 16-bit microcontrollers sequentially grew 19% quarter-over-quarter. So from a product-line standpoint, investors are looking at very, very substantial opportunity in analog and 16-bit microcontrollers on the top of continuing opportunity in the 8-bit Flash microcontrollers.

Financially, we're among the most profitable semiconductor companies, one of the top

three or four most profitable semiconductor industry companies. We made 59.7% gross margin last quarter. I only know two or three other companies that have a higher gross margin than that. We made 36% operating profit, and that is the envy of the industry. So it's financially a very, very strong company. We have grown every year in our 13 years of being public, except one year, which was the tech bust of 2000-2001. Other than that, we have grown every year. So it's a very, very strong financial company, very profitable, and the highest dividend paying company in the semiconductor industry.

The third area I'd emphasize is consistency. If you look at the revenue and earnings-per-share volatility of the company relative to the entire semiconductor company, Microchip is the least volatile in revenue and earnings over the industry cycle. The semiconductor industry continues to be cyclical, and we can never say there will not be another recession or another tech bust of some kind — these things have happened in the business cycle — but as you go through these business cycles, Microchip shows the lowest volatility in revenues and earnings of anybody in the semiconductor industry. I think that ought to be interesting to investors, that one can sleep comfortably at night with an investment in Microchip.

**TWST: Are there any particular points or issues that we may have overlooked?**

**Mr. Sanghi:** Microchip is generating very, very strong free cash flow, something we didn't talk about. This year we're generating in excess of \$350 million of free cash flow, and that's very substantial. Next year, we are expecting a similar amount, \$350-\$400 million in free cash flow from over \$1 billion of sales. You are talking about \$0.35 to \$0.40 of every dollar of free cash flow after investment in capital expenditures and all the expenses of the company, and that's a very, very strong cash flow earner. As a result, we are able to pay consistently very strong dividends — again, something that investors ought to be interested in.

**TWST: Thank you. (DWA)**

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