

Spansion's Road To Profitability May Be Bumpy Close

By Matt Andrejczak

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SAN FRANCISCO (Dow Jones) - Advanced Micro Devices Inc. Chief Executive Hector Ruiz, on a conference call with analysts last January, was blunt in describing the financial results of the chip maker's flash memory unit.

"It makes me puke," Ruiz said in response to a question about the operation's mounting losses.

With the unit, known as Spansion, set to begin trading Friday morning as a separate company (SPSN), Ruiz's characterization of the money-losing business is one that investors hope won't be repeated.

But given that it's taken eight months and a price cut to get Spansion's initial stock sale to market, such optimism might be misplaced.

Late Thursday, Spansion priced its IPO of 42.2 million shares at \$12 each, raising \$506.4 million. The pricing came in below the expected range of \$13 to \$14 a share, which was lowered from a range of \$16 to \$18 a share earlier in the day. The offering of 42.2 million shares is up from an earlier proposal of 39.2 million shares.

Spansion is set to become the first publicly-traded U.S. company dedicated exclusively to making chips that use a technology known as NOR flash. While the technology is widely used in cell phones, personal computers, TV set-top boxes and DVD players, excess supply and falling prices have made the NOR flash market an unprofitable one for Spansion.

Through the nine months ended Sept. 25, Spansion had reported operating losses of \$257 million on revenue of \$1.4 billion. That compares with a profit of \$6.9 million on revenue of \$1.8 billion a year earlier. AMD has said it expects another operating loss is for the current quarter, due in part to stiff competition from large rivals like Intel Corp. (INTC) and Samsung.

While the NOR market appears to be rebounding from the worst of this year's doldrums, the business isn't growing as fast as some other chip markets. It will also require large amounts of capital investment, which will make it tough for Spansion to make money consistently.

"The business is breakeven at best," said Doug Freedman, a semiconductor analyst at American Technology Research, which rates shares of AMD (AMD) a buy. "It doesn't offer sustained profitability."

That may explain why Spansion's lead investment bankers, Citigroup and CS First Boston, cut the price range of the offering this week from its previous range of \$16 to \$18 a share. They also added more underwriters to help sell the offering, which was first registered with federal securities regulators in April.

To repay a portion of its debt to AMD and Fujitsu, which owned 40% of the pre-IPO Spansion, the company is raising \$400 million in debt concurrent with the initial stock sale.

Although Spansion has its work cut out for it, its debut on the Nasdaq under the ticker "SPSN" comes as conditions in the NOR flash market may be turning the corner. Industry-wide sales are expected to rebound in 2006 after suffering from oversupply and price cuts.

Average selling prices for the chips started to stabilize in August and are anticipated to climb through 2007, said Mark DeVoss, senior flash memory analyst at iSuppli.

That's helped boost Spansion's sales, which rose from \$433 million in the first quarter to \$516 million in the third quarter. The unit's losses have also shrunk each consecutive quarter as the company has had some success with its latest product for mobile phones.

Spansion narrowed its first-quarter loss of \$108 million to \$62 million for the quarter ended Sept. 25.

Sunnyvale, Calif.-based Spansion, the world's second largest supplier of NOR flash, counts some of the largest cell phone makers as customers. And that should help moving forward as cell phone unit shipments are estimated to steadily climb through 2009.

One key to the future growth of Spansion is whether it can develop the next-generation of flash memory technology that will combine the best of NOR and NAND, analysts said.

The company is developing such as product, dubbed Ormand. It might hit the market in 2006. Companies like Samsung and M-Systems are working on a similar technology.

"They (Spansion) recognize they have to move," said Mark Mowrey, senior technology analyst at the AI Frank Funds.

In the near-term, Spansion may benefit if Intel decides to sacrifice some of its NOR flash manufacturing capacity in favor of producing more chipsets, Think Equity analyst Eric Ross said. This year, Intel has struggled to meet demand for chipsets, which are a collection of chips that work as a group to perform certain functions in computers.

And investors may take solace in the fact that shares of one of the last big chip spinoffs is performing well. Freescale Semiconductor Inc. (FSL), a maker of cell phone chips separated from Motorola Inc. in July 2004, is up about 50% year-to-date.

Separating from AMD is expected to take a toll on Spansion's cash reserves, as its expenses will increase due to higher administrative and operating costs that AMD formerly paid.

Its research and development bill will also rise. To stay abreast of advances in chip manufacturing that some of its competitors are using to reduce unit costs, Spansion plans to build a new factory sometime in 2007.

In its regulatory filing, the company said its capital spending will increase to around \$800 million in 2006, more than the \$519 million it expects to spend this year.

And Spansion is being cut loose from AMD just as a competing flash technology known as NAND is surpassing NOR flash in growth.

NAND sales are set to explode over the next few years, spurred in part by Apple Computer Inc.'s booming iPod music player business. NOR and NAND have been competing technologies since the early 1980s. NOR acts like a computer's main memory, while NAND works like a hard disk.

According to Jim Handy of Semico Research, NAND flash revenue will balloon to \$36.5 billion in 2008 from \$10.2 billion in 2005. Meanwhile, worldwide NOR flash sales are expected to post more modest growth, climbing to \$12.8 billion in 2008 from \$7.6 billion in 2005.

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