STMICROELECTRONICS NV
Form 20-F
March 03, 2006

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As filed with the Securities and Exchange Commission on March 3, 2006

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 20-F

o **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2005

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

o **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Date of event requiring this shell company report

Commission file number: 1-13546
STMicroelectronics N.V.
(Exact name of registrant as specified in its charter)

Not Applicable	**The Netherlands**
(Translation of registrant s name into English)	*(Jurisdiction of incorporation or organization)*

39, Chemin du Champ des Filles
1228 Plan-Les-Ouates
Geneva
Switzerland
(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of Each Class:	**Name of Each Exchange on Which Registered:**
Common shares, nominal value 1.04 per share	New York Stock Exchange

Securities registered or to be registered pursuant to Section 12(g) of the Act: None
Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: None

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the annual report:

894,424,279 common shares at December 31, 2005

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes þ No o

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes o No þ

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days:

Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

Indicate by check mark which financial statement item the registrant has elected to follow:

Item 17 o Item 18 þ

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

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PRESENTATION OF FINANCIAL AND OTHER INFORMATION

In this annual report or Form 20-F (the Form 20-F), references to we and us are to STMicroelectronics N.V. together with its consolidated subsidiaries, references to EU are to the European Union, references to and the euro a to the euro currency of the EU, references to the United States and U.S. are to the United States of America and references to $ or to U.S. dollars are to United States dollars. References to mm are to millimeters and references to nm are to nanometers.

We have compiled the market share, market size and competitive ranking data in this annual report using statistics and other information obtained from several third-party sources. Except as otherwise disclosed herein, all references to our competitive positions in this annual report are based on 2005 revenues according to provisional industry data published by iSuppli and 2004 revenues according to industry data published by iSuppli and Gartner, Inc., and references to trade association data are references to World Semiconductor Trade Statistics (WSTS). Certain terms used in this annual report are defined in Certain Terms .

We report our financial statements in U.S. dollars and prepare our consolidated financial statements in accordance with generally accepted accounting principles in the United States (U.S. GAAP). Furthermore, starting in 2005, we are required by Dutch law to report our statutory and consolidated financial statements, previously reported using generally accepted accounting principles in the Netherlands, in International Financial Reporting Standards (IFRS). The financial statements reported in IFRS can differ materially from the statements reported in U.S. GAAP.

Various amounts and percentages used in this Form 20-F have been rounded and, accordingly, they may not total 100%.

We and our affiliates own or otherwise have rights to the trademarks and trade names, including those mentioned in this annual report, used in conjunction with the marketing and sale of our products.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Some of the statements contained in this Form 20-F that are not historical facts, particularly in Item 3. Key Information Risk Factors , Item 4. Information on the Company and Item 5. Operating and Financial Review and Prospects and Business Outlook , are statements of future expectations and other forward-looking statements (within the meaning of Section 27A of the Securities Act of 1933 or Section 21E of the Securities Exchange Act of 1934, each as amended) that are based on management s current views and assumptions and are conditioned upon, and also involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those in such statements due to, among other factors:

- future developments of the world semiconductor market, in particular the future demand for semiconductor products in the key application markets and from key customers served by our products;
- pricing pressures, losses or curtailments of purchases from key customers;
- the financial impact of inadequate or excess inventories if actual demand differs from our anticipations;
- changes in the exchange rates between the U.S. dollar and the euro and between the U.S. dollar and the currencies of the other major countries in which we have our operating infrastructure;
- our ability to be successful in our strategic research and development initiatives to develop new products to meet anticipated market demand, as well as our ability to achieve our corporate performance roadmap by completing successfully and in a timely manner our other various announced initiatives to improve our overall efficiency and our financial performance;
- the anticipated benefits of research and development alliances and cooperative activities and the continued pursuit of our various alliances, in the field of development of new advanced technologies or products;
- the ability of our suppliers to meet our demands for products and to offer competitive pricing;

changes in the economic, social or political environment, as well as natural events such as severe weather, health risks, epidemics or earthquakes in the countries in which we and our key customers operate;

changes in our overall tax position as a result of changes in tax laws or the outcome of tax audits;

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product liability or warranty claims for a product containing one of our parts; and

our ability to obtain required licenses on third-party intellectual property, the outcome of litigation and the results of actions by our competitors.

Such forward-looking statements are subject to various risks and uncertainties, which may cause actual results and performance of our business to differ materially and adversely from the forward-looking statements. Certain forward-looking statements can be identified by the use of forward-looking terminology, such as believes , expects , may , are expected to , will , will continue , should , would be , seeks or anticipates or similar expressions o thereof or other variations thereof or comparable terminology, or by discussions of strategy, plans or intentions. Some of these risk factors are set forth and are discussed in more detail in Item 3. Key Information Risk Factors . Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described in this Form 20-F as anticipated, believed or expected. We do not intend, and do not assume any obligation, to update any industry information or forward-looking statements set forth in this Form 20-F to reflect subsequent events or circumstances.

Unfavorable changes in the above or other factors listed under Item 3. Key Information Risk Factors from time to time in our Securities and Exchange Commission (SEC) filings, could have a material adverse effect on our business and/or financial condition.

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PART I

Item 1. Identity of Directors, Senior Management and Advisers

Not applicable.

Item 2. Offer Statistics and Expected Timetable

Not applicable.

Item 3. Key Information

Selected Financial Data

The table below sets forth our selected consolidated financial data for each of the years in the five-year period ended December 31, 2005. Such data have been derived from our consolidated financial statements. Consolidated audited financial statements for each of the years in the three-year periods ended December 31, 2005, including the Notes thereto (collectively, the Consolidated Financial Statements), are included elsewhere in this Form 20-F, while data for prior periods have been derived from our consolidated financial statements used in such periods.

The following information should be read in conjunction with Item 5. Operating and Financial Review and Prospects , the Consolidated Financial Statements and the related Notes thereto included in Item 8. Financial Statements in this Form 20-F.

	Year Ended December 31,				
	2005(1)	2004(1)	2003(1)	2002(1)	2001(1)
	(In millions except per share and ratio data)				
Consolidated Statement of Income Data:					
Net sales	$ 8,876	$ 8,756	$ 7,234	$ 6,270	$ 6,304
Other revenues	6	4	4	48	53
Net revenues	8,882	8,760	7,238	6,318	6,357
Cost of sales	(5,845)	(5,532)	(4,672)	(4,020)	(4,047)
Gross profit	3,037	3,228	2,566	2,298	2,310
Operating expenses:					
Selling, general and administrative	(1,026)	(947)	(785)	(648)	(641)
Research and development(2)	(1,630)	(1,532)	(1,238)	(1,022)	(978)
Other income and expenses, net(2)	(9)	10	(4)	7	(6)
Impairment, restructuring charges and other related closure costs	(128)	(76)	(205)	(34)	(346)
Total operating expenses	(2,793)	(2,545)	(2,232)	(1,697)	(1,971)
Operating income	244	683	334	601	339
Interest income (expense), net	34	(3)	(52)	(68)	(13)
Loss on equity investments	(3)	(4)	(1)	(11)	(5)
Loss on extinguishment of convertible debt		(4)	(39)		
Income before income taxes and minority interests	275	672	242	522	321
Income tax benefit (expense)	(8)	(68)	14	(89)	(61)
Income before minority interests	267	604	256	433	260

Minority interests	(1)	(3)	(3)	(4)	(3)
Net income	$ 266	$ 601	$ 253	$ 429	$ 257
Earnings per share (basic)	$ 0.30	$ 0.67	$ 0.29	$ 0.48	$ 0.29
Earnings per share (diluted)	$ 0.29	$ 0.65	$ 0.27	$ 0.48	$ 0.29
Number of shares used in calculating earnings per share (basic)	892.8	891.2	888.2	887.6	893.3
Number of shares used in calculating earnings per share (diluted)	935.6	935.1	937.1	893.0	902.0

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	Year Ended December 31,				
	2005(1)	2004(1)	2003(1)	2002(1)	2001(1)
	(In millions except per share and ratio data)				
Consolidated Balance Sheet Data (end of period):					
Cash and cash equivalents(1)	$ 2,027	$ 1,950	$ 2,998	$ 2,564	$ 2,444
Total assets	12,439	13,800	13,477	12,004	10,798
Short-term debt (including current portion of long-term debt)	1,533	191	151	165	130
Long-term debt (excluding current portion)(1)	269	1,767	2,944	2,797	2,772
Shareholders equity(1)	8,480	9,110	8,100	6,994	6,075
Capital stock(3)	3,120	3,074	3,051	3,008	2,978
Other Data:					
Dividends per share	$ 0.12	$ 0.12	$ 0.08	$ 0.04	$ 0.04
Capital expenditures(4)	1,441	2,050	1,221	995	1,700
Net cash provided by operating activities	1,798	2,342	1,920	1,713	2,057
Depreciation and amortization(4)	1,944	1,837	1,608	1,382	1,320
Net debt (cash) to total shareholders equity ratio(5)	(0.026)	0.001	0.012	0.057	0.075

(1) On November 16, 2000, we issued $2,146 million initial aggregate principal amount of zero-coupon senior convertible bonds due 2010 (the 2010 Bonds), for net proceeds of $1,458 million; in 2003, we repurchased on the market approximately $1,674 million aggregate principal amount at maturity of 2010 Bonds. During 2004, we completed the repurchase of our 2010 Bonds and repurchased on the market approximately $472 million aggregate principal amount at maturity for a total amount paid of $375 million. In 2001, we redeemed the remaining $52 million of our outstanding Liquid Yield Option Notes due 2008 (our 2008 LYONs) and converted them into common shares in May and June 2001. In 2001, we repurchased 9,400,000 common shares for $233 million, and in 2002, we repurchased an additional 4,000,000 shares for $115 million. We reflected these purchases at cost as a reduction of shareholders equity. The repurchased shares have been designated to fund share compensation granted to employees under our 2001 employee stock plan and may be used for subsequent grants. In August 2003, we issued $1,332 million principal amount at maturity of our 2013 Bonds with a negative yield of 0.5% that resulted in a higher principal amount at issuance of $1,400 million and net proceeds of $1,386 million. During 2004, we repurchased all of our outstanding Liquid Yield Option Notes due 2009 (our 2009 LYONs) for a total amount of cash paid of $813 million.

(2) Other income and expenses, net includes, among other things, funds received through government agencies for research and development expenses, the cost of new production facilities start-ups, foreign currency gains and losses, gains on sales of marketable securities, the costs of certain activities relating to intellectual property and, for periods prior to 2002, goodwill amortization. Our reported research and development expenses are mainly in the areas of product design, technology and development, and do not include marketing design center costs, which are accounted for as selling expenses, or process engineering, pre-production and process-transfer costs, which are accounted for as cost of sales.

(3) Capital stock consists of common stock and capital surplus.

(4) Capital expenditures are net of certain funds received through government agencies, the effect of which is to decrease depreciation.

(5) Net debt (cash) to total shareholders equity ratio is a non-U.S. GAAP financial measure. The most directly comparable U.S. GAAP financial measure is considered to be Debt-to-Equity Ratio . However, this ratio measures gross debt relative to equity, and does not reflect the current cash position of the Company. We believe that our net debt (cash) to total shareholders equity ratio is useful to investors as a measure of our financial position and leverage. The ratio is computed on the basis of our net financial position divided by total shareholders equity. Our net financial position is the difference between our total cash position (cash and cash equivalents) net of total financial debt (bank overdrafts, current portion of long-term debt and long-term debt). For more information on our net financial position, see Item 5. Operating and Financial Review and Prospects Liquidity and Capital Resources Capital Resources Net financial position . Our computation of net debt (cash) to total shareholders equity ratio may not be consistent with that of other companies, which could make comparability difficult.

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Risk Factors

Risks Related to the Semiconductor Industry

The semiconductor industry is highly cyclical and periodic downturns in the semiconductor industry affect our business and results of operations.

The semiconductor industry is highly cyclical and has been subject to significant economic downturns at various times. Downturns are typically characterized by production overcapacity, accelerated erosion of average selling prices, high inventory levels, diminished demand and reduced revenues. Downturns may be the result of industry-specific factors, such as excess capacity, product obsolescence, price erosion, evolving standards, changes in end-customer demand, and/or macroeconomic trends impacting the economies of one or more of the world s major regions: Asia, the United States, Europe and Japan.

According to published industry data, worldwide sales of semiconductor products, while generally increasing over the long term, have fluctuated significantly on a yearly basis over the past several years. According to the World Semiconductor Trade Statistics (WSTS), sales increased in 1995, 1997, 1999, 2000, 2002, 2003, 2004 and 2005 but decreased in 1996 and 1998. For 2001, the market also decreased by approximately 32%. For 2002, 2003, 2004 and 2005, the increase was approximately 1%, 18%, 28% and 7%, respectively.

In certain years, the increase in the sales of semiconductor products is driven primarily by an increase in the number of units sold, while industry overcapacity and excess supply over demand worldwide have continued to exercise a downward pressure on average selling prices. In 2005, the market increase was driven both by improved demand and by an average selling price increase, although in each case the improvement was less than in 2004.

Such macroeconomic trends relate to the semiconductor industry as a whole and not necessarily to the individual semiconductor markets to which we sell our products.

We have experienced revenue volatility and market downturns in the past and may experience them in the future.

Downturns in the semiconductor industry, reduction in demand for end products which incorporate the semiconductor products we supply, or increased competition driven by overcapacity exercising a downward pressure on prices, have in the past, and could in the future, have a significant adverse impact on our results of operations.

Increases in production capacity for semiconductor products may lead to overcapacity, which in turn may lead to plant closures, asset impairments, restructuring charges and inventory write-offs.

Capital investments for semiconductor manufacturing equipment are made both by integrated semiconductor companies like us and by specialist semiconductor foundry companies, which are subcontractors that manufacture semiconductors designed by others.

According to data published by industry sources, investments in worldwide semiconductor fabrication capacity totaled approximately $37.7 billion in 2001, $26.1 billion in 2002, $29.5 billion in 2003, $45.7 billion in 2004 and an estimated $46.1 billion in 2005, or approximately 27%, 19%, 18%, 22% and 20%, respectively, of the total available market for these years. The net increase of manufacturing capacity, defined as the difference between capacity additions and capacity reductions pursuant to closures, may exceed demand requirements, leading to over-supply situations, price erosion, and industry downturns. Overcapacity and cost optimization have led us, in recent years, to close manufacturing facilities that used more mature process technologies. In 2001, we closed our 150-mm wafer manufacturing facility in Ottawa, Canada. In 2002, we closed our 150-mm wafer manufacturing facility in Rancho Bernardo, California, and in 2004, we closed our 150-mm wafer manufacturing facility in Rennes, France and our back-end facility in Tuas, Singapore. Pursuant to these closures and as a result of some of our more mature fabrication facility capacity being only partially used, in 2001 we recorded impairment, restructuring charges and related closure costs totaling $346 million. In 2002, we recorded impairment, restructuring charges and related closure costs of $34 million. In 2003, we recorded impairment, restructuring charges and other related closure costs of $205 million in connection with the plan announced in October 2003 to increase our cost competitiveness by restructuring our 150-mm fab operations and part of our back-end operations. In 2004, we recorded impairment, restructuring charges and related closure costs of $76 million. In 2005, the amount of impairment, restructuring charges and other related closure pre-tax costs

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amounted to $128 million. See Item 5. Operating and Financial Review and Prospects Impairment, Restructuring Charges and Other Related Closure Costs .

Through the period ended December 31, 2005, we have incurred $294 million of the announced approximate $350 million in pre-tax charges associated with the restructuring plan that was defined on October 22, 2003, and which is now expected to be substantially completed in the second half of 2006.

In January 2005, we announced plans to reduce our Access technology programs for customer premises equipment (CPE) modem products. On May 16, 2005, we announced a head count restructuring plan that, combined with other already announced initiatives, will aim to reduce our workforce by 3,000 outside Asia by the second half of 2006. From these new measures estimated to cost between $100 to $130 million, we anticipate additional savings of $90 million per year, at completion of the plan. On June 8, 2005, we specified our restructuring efforts by announcing the following: our workforce gross reduction in Europe will represent about 2,300 jobs of the 3,000 already announced; we will pursue the conversion of 150-mm and 200-mm production tools; we will optimize on a global scale our Electrical Wafer Sorting (EWS) activities; we will harmonize and rationalize our support functions and we will disengage from certain activities.

As of December 31, 2005, these decisions had resulted in total charges of approximately $114 million for intangible assets and goodwill related to the CPE product lines and the other restructuring charges, out of an estimated range of $175 to $205 million.

No assurances can be given that future changes in the market demand for our products, overcapacity, obsolescence in our manufacturing facilities and market downturns may not require us to test for and record additional impairment and restructuring charges, which may have a material adverse effect on our business, financial condition and results of operations.

Competition in the semiconductor industry is intense, and we may not be able to compete successfully if our product design technologies, process technologies and products do not meet market requirements.

We compete in different product lines to various degrees on the following characteristics:

price;

technical performance;

product features;

product system compatibility;

product design and technology;

timely introduction of new products;

product availability;

manufacturing yields; and

sales and technical support.

Competition in the semiconductor industry as a whole is intense, and if our products are not selected based on any of these factors, our business, financial condition and results of operations could be materially adversely affected.

We also face significant competition in each of our product lines. Like us, many of our competitors offer a large variety of products. Some of our competitors may have greater financial and/or more focused research and development resources than we do. If these competitors substantially increase the resources they devote to developing and marketing products which compete with ours, we may not be able to compete effectively. Any consolidation among our competitors could enhance their product offerings, manufacturing efficiency and financial resources,

further strengthening their competitive position.

In many of the market segments in which we compete for business, we depend on winning highly competitive selection processes to design products and technologies for use in our customers equipment and products, and failure to be selected or to execute could materially adversely affect our business in that market segment. Even after we win and begin a product design, a customer may cancel or change

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its product plans, which could cause us to generate no sales from a product and materially adversely affect our results of operations.

One of our focuses is on winning competitive bid selection processes, known as product design wins , to develop products for use in our customers equipment and products. These selection processes can be lengthy and require us to incur significant design and development expenditures, with no guarantee of winning or generating revenue. Delays in developing new products with anticipated technological advances and failure to win new design projects for customers or in commencing volume shipments of new products may have an adverse effect on our business. In addition, there can be no assurance that new products, if introduced, will gain market acceptance or will not be adversely affected by new technological changes or new product announcements by other competitors that may have greater resources or are more focused than we are. Because we typically focus on only a few customers in a product area, the loss of a design win can sometimes result in our failure to offer a generation of a product. This can result in lost sales and could hurt our position in future competitive selection processes because we may be perceived as not being a technology or industry leader.

After winning a product design from one of our customers, we may still experience delays in generating revenue from our products as a result of the lengthy development and design cycle. In addition, a delay or cancellation of a customer s plans could significantly adversely affect our financial results, as we may have incurred significant expense and generated no revenue. Finally, if our customers fail to successfully market and sell their own products, it could materially adversely affect our business, financial condition and results of operations as the demand for our products falls.

Semiconductor and other products we design and manufacture are characterized by rapidly changing technology, and our success depends on our ability to develop and manufacture complex products cost-effectively and to scale.

The market for our products is characterized by rapidly changing technology. Some of our products have average life cycles of less than one year. Therefore, our success is highly dependent upon our ability to develop and manufacture increasingly complex new products quickly on a cost-effective basis and to scale. Semiconductor design and process technologies are also subject to constant technological improvements and require large expenditures for capital investment, advanced research and technology development. If we experience substantial delays or are unable to develop new design or process technologies, our results of operations could be adversely affected. In certain cases, it may be necessary to incur costs to acquire technology from third parties, which may affect our results of operations and margins without any guarantee of success. We charged $58 million as annual amortization expense on our consolidated statement of income in 2005, related to technologies and licenses acquired from third parties through the end of 2005. As of December 31, 2005, the residual value, net of amortization, registered in our consolidated balance sheet for these technologies and licenses was $110 million.

The competitive environment of the semiconductor industry may lead to further measures to improve our competitive position and cost structure, which in turn may result in loss of revenues, asset impairments and/or capital losses.

We are continuously considering various measures to improve our competitive position and cost structure in the semiconductor industry. In February 2005, we decided to stop work on a reference design chipset for the GSM/ GPRS market and announced plans to reduce our Access technology programs for CPE products. In May 2005, we announced additional restructuring efforts to improve profitability. See Increases in production capacity for semiconductor products may lead to overcapacity, which in turn may lead to plant closures, asset impairments, restructuring charges and inventory write-offs . In recent years our sales have increased at a slower pace than the semiconductor industry as a whole and our market share has declined. There is no assurance that such decline will not continue or accelerate, if we are not able to accelerate product innovation, extend our customer base, realize manufacturing improvements and/or otherwise control our costs. We may also in the future, if we consider that market conditions so require, consider additional measures to improve our cost structure and competitiveness in the semiconductor market, which may lead to discontinuation of certain product families or additional restructurings, which in turn may result in loss of revenues, asset impairments and/or capital losses.

The competitive environment of the semiconductor industry may lead to conditions in which we may seek to acquire a competitor or become an acquisition target.

The competitive environment of the semiconductor industry and the high costs associated with developing our products and manufacturing technologies may lead to further consolidation in the industry in order to

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improve economies of scale or improve the focus of our product portfolio and/or market applications. In this environment, we may seek to acquire a competitor to improve our market position and related applications and products. We also may become a target for a company looking to improve its competitive position. Such an occurrence may take place at any time with consequences that we are not in a position to predict.

Risks Related to Our Operations

Our research and development efforts are increasingly expensive and dependent on alliances, and our business, results of operations and prospects could be materially adversely affected by the failure or termination of such alliances in developing new process technologies in line with market requirements.

We are increasingly dependent on alliances to develop or access new technologies. For example, we are cooperating with Freescale (formerly a division of Motorola Inc.) and Philips for the joint research and development of CMOS process technology to provide 90-nm to 32-nm chip technologies on 300-mm wafers, as well as the operation of a 300-mm wafer pilot line fab in Crolles2 under a long-term agreement whose initial term has been set through December 31, 2007 and which will be automatically extended until December 3, 2010, unless either Freescale, Philips or we serve a written notice of termination prior to December 31, 2006. In 2005, we extended this agreement to cover 300-mm wafer testing and packaging, as well as the development and licensing of core libraries and IP. There can be no assurance that we will be able to renew this agreement upon expiration of its final term. Additionally, the agreement allows for termination of the agreement if a change of control occurs in one of the parties. The non-renewal or termination of our Crolles2 alliance could have a material adverse effect on our ability to continue the development of advanced CMOS process technologies as currently proposed because it could require us to significantly increase our expenses and/or require us to find additional parties with no guarantee of success. Furthermore, we have a joint development agreement with Hynix for the development of NAND Flash memories and to build and operate a front-end memory-manufacturing facility in Wuxi City, Jiangsu Province, China. The development is dependent on financing from Hynix and from local government authorities, which we cannot assure will occur.

There can be no assurance that our alliances will be successful or will enable us to develop and access new technologies in due time, in a cost-effective manner and/or to meet customer demands. Furthermore, if these alliances fail to accomplish their intended goals or terminate before our intended goals are accomplished we may lose our investment, or incur additional unforeseen costs, and our business, results of operations and prospects could be materially adversely affected. In addition, if the Crolles2 or Hynix alliances or other alliances we enter into do not succeed in developing or accessing technologies that are commercially accepted, or if we are unable to develop or otherwise access such new technologies independently, we may fail to keep pace with the rapid technology advances in the semiconductor industry, our participation in the overall semiconductor industry may decrease and we may also lose market share in the market addressed by our products.

Loss of key employees could hurt our competitive position.

As is common in the semiconductor industry, success depends to a significant extent upon our key senior executives and research and development, engineering, marketing, sales, manufacturing, support and other personnel. Our success also depends upon our ability to continue to attract, retain and motivate qualified personnel. The competition for such employees is intense, and the loss of the services of any of these key personnel without adequate replacement or the inability to attract new qualified personnel could have a material adverse effect on us.

In difficult market conditions, our high fixed costs adversely impact our results.

In less favorable industry environments, we are driven to reduce prices in response to competitive pressures and we are also faced with a decline in the utilization rates of our manufacturing facilities due to decreases in product demand. Since the semiconductor industry is characterized by high fixed costs, we are not always able to reduce our total costs in line with revenue declines. Reduced average selling prices for our products, therefore adversely affect our results of operations. Furthermore, in periods of reduced customer demand for our products, our wafer fabrication plants (fabs) do not operate at full capacity and the costs associated with the excess capacity are charged directly to cost of sales. Over the last five years, our gross profit margin has varied from a high of 44.5% in the first quarter of 2001 to a low of 31.7% in the fourth quarter of 2001. We cannot guarantee that difficult market conditions will not

adversely affect the capacity utilization of our fabs and, consequently our future gross margins. We cannot guarantee that increased competition in our core product markets will not lead to further price erosion, lower revenue growth rates and lower margins in the future.

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Our financial results can be adversely affected by fluctuations in exchange rates, principally in the value of the U.S. dollar.

A significant variation of the value of the U.S. dollar against the principal currencies which have a material impact on us (primarily the euro, but also certain other currencies of countries where we have operations) could result in a favorable impact on our net income in the case of an appreciation of the U.S. dollar, or a negative impact on our net income if the U.S. dollar depreciates relative to these currencies. Currency exchange rate fluctuations affect our results of operations because our reporting currency is the U.S. dollar, in which we receive the major part of our revenues, while, more importantly, we incur the majority of our costs in currencies other than the U.S. dollar. Certain significant costs incurred by us, such as manufacturing labor costs and depreciation charges, selling, general and administrative expenses, and research and development expenses, are incurred in the currencies of the jurisdictions in which our operations are located.

In order to reduce the exposure of our financial results to the fluctuations in exchange rates, our principal strategy has been to balance as much as possible the proportion of sales to our customers denominated in U.S. dollars with the amount of purchases from our suppliers denominated in U.S. dollars and to reduce the weight of the other costs, including labor costs and depreciation, denominated in euros and in other currencies. In order to further reduce our exposure to U.S. dollar exchange rate fluctuations, we have hedged certain line items on our income statement, in particular with respect to a portion of the cost of goods sold, most of the research and development expenses and certain selling and general and administrative expenses located in the euro zone. No assurance can be given that the value of the U.S. dollar will not actually appreciate with the hedging transaction potentially preventing us from benefiting from lower euro-denominated manufacturing costs when translated into our U.S. dollar-based accounts. See Item 5. Operating and Financial Review and Prospects Impact of Changes in Exchange Rates and Item 11. Quantitative and Qualitative Disclosures About Market Risk .

Our Consolidated Financial Statements for 2005 include income and expense items translated at the average rate for the period. In 2005, the effective average U.S. dollar exchange rate, which reflects the current exchange rate levels and the impact of certain hedging contracts was 1.00 for $1.28 compared to an actual exchange rate of 1.00 for $1.23 in 2004.

A decline of the U.S. dollar compared to the other major currencies that affect our operations negatively impacts our expenses, margins and profitability, especially if we are unable to balance or shift our euro-denominated costs to other currency areas or to U.S. dollars. Any such actions may not be immediately effective, could prove costly and their implementation could prove demanding on our management resources.

Because we have our own manufacturing facilities, our capital needs are high compared to competitors who do not produce their own products.

As a result of our strategic choice to maintain control of our advanced proprietary manufacturing technologies to serve our customer base and develop our strategic alliances, we require significant amounts of capital to build, expand, modernize and maintain our facilities. Some of our competitors, however, do not manufacture their own products and therefore do not require significant capital expenditures for their facilities. Our capital expenditures have been significant in recent years. See Item 5. Operating and Financial Review and Prospects Liquidity and Capital Resources . Our capital expenditures were $1.4 billion in 2005 and we currently expect our 2006 capital expenditures to be approximately $1.8 billion. Our costs are also increasing as the complexity of the individual manufacturing equipment increases. We have the flexibility to modulate our investments up or down in response to changes in market conditions, and we are prepared to accelerate investments in leading-edge technologies if market conditions require. We will continue to monitor our level of capital spending taking into consideration factors such as trends in the semiconductor market and capacity utilization.

To stay competitive in the semiconductor industry, we must transition certain products to 300-mm manufacturing technology, which is much more expensive than 150-mm or 200-mm technologies. Currently, all of our fabs process wafers with diameters of 150-mm or 200-mm. We are developing 300-mm process technology on a pilot line at Crolles2, with our partners Philips and Freescale. We have also constructed a building in Catania (Italy), which is not yet equipped, for the volume production of 300-mm wafers. In addition, we are developing 300-mm technology for the production of memory products with our joint venture partner Hynix.

There can be no assurance that we will be successful in transitioning certain products to 300-mm technology or that we will be able to make further investments in developing 300-mm technology. If we are unable to make further investments in or access 300-mm technology or build 300-mm manufacturing facilities for volume

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production, our ability to develop and market new products could suffer, which could, in turn, have a material adverse effect on our business, financial condition and results of operations.

Any of the foregoing may require us to issue additional debt or equity, or both, and if we are unable to access such capital on acceptable terms, this may adversely affect our business and results of operations. The timing and size of any new share, convertible bond or straight bond offering would depend upon market conditions as well as a variety of factors, and any such transaction or any announcement concerning such a transaction could materially impact market price of our common shares.

We may also need additional funding in the coming years to finance our investments, or purchase other companies or technologies developed by third parties.

In an increasingly complex and competitive environment, we may need to invest in other companies, and/or in technology developed by third parties to improve our position on the market. We may also consider acquisitions to complement or expand our existing business. Furthermore, we may need to rely on public funding as we transition to 300-mm manufacturing technology. We are dependent on public funding for equipping the 300-mm wafers production facility in Catania (Italy) and there can be no assurance that we will obtain this public funding, as planned. If such planned funding does not materialize, we may lack financial resources to continue with our investment plan for this facility, which in turn could lead us to discontinue our investment in such facility and consequentially incur significant impairments. Any of the foregoing may also require us to issue additional debt, equity, or both. If we are unable to access such capital on acceptable terms this may adversely affect our business and results of operations. Existing loan agreements for local funding of our Singapore and China legal entities contain financial covenants.

Our operating results may vary significantly from quarter to quarter and annually and may differ significantly from our expectations or guidance.

Our operating results are affected by a wide variety of factors that could materially and adversely affect revenues and profitability or lead to significant variability of operating results. These factors include, among others, the cyclicality of the semiconductor and electronic systems industries, capital requirements, inventory management, availability of funding, competition, new product developments, technological changes and manufacturing problems. Furthermore, our effective tax rate currently takes into consideration certain favorable tax rates and incentives, which, in the future, may not be available to us. See Note 21 to our Consolidated Financial Statements. In addition, a number of other factors could lead to fluctuations in quarterly and annual operating results, including:

performance of our key customers in the markets they serve;

order cancellations or reschedulings by customers;

excess inventory held by customers leading to reduced bookings or product returns by key customers;

manufacturing capacity and utilization rates;

restructuring and impairment charges;

fluctuations in currency exchange rates, particularly between the U.S. dollar and other currencies in jurisdictions where we have activities;

intellectual property developments;

changes in distribution and sales arrangements;

failure to win new design projects;

manufacturing performance and yields;

product liability or warranty claims;

litigation;

acquisitions or divestitures;

problems in obtaining adequate raw materials or production equipment on a timely basis; and

property damage or business interruption losses resulting from a catastrophic event not covered by insurance.

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Unfavorable changes in any of the above factors have in the past and may in the future adversely affect our operating results. Furthermore, in periods of industry overcapacity or when our key customers encounter difficulties in their end markets, orders are more exposed to cancellations, reductions, price renegotiation or postponements, which in turn reduce our management s ability to forecast the next quarter or full year production levels, revenues and margins. For these reasons and others that we may not yet have identified, our revenues and operating results may differ materially from our expectations or guidance as visibility is reduced. See Item 4. Information on the Company Backlog .

Our business is dependent in large part on continued growth in the industries and segments into which our products are sold and in our ability to attract and retain new customers. A market decline in any of these industries or our inability to attract new customers could have a material adverse effect on our results of operations.

We derive and expect to continue to derive significant sales from the telecommunications equipment and automotive industries, as well as the home, personal and consumer segments generally. Growth of demand in the telecommunications equipment and automotive industries as well as the home, personal and consumer segments, has in the past and may in the future, fluctuate significantly based on numerous factors, including:

spending levels of telecommunications equipment and/or automotive providers;

development of new consumer products or applications requiring high semiconductor content;

evolving industry standards;

the rate of adoption of new or alternative technologies; and

demand for automobiles, consumer confidence and general economic conditions.

We cannot assure you of the rate, or the extent to which, the telecommunications equipment or automotive industries or the home, personal or consumer segments will grow, if at all. Any decline in these industries or segments could result in slower growth or a decline in demand for our products, which could have a material adverse effect on our business, financial condition and results of operations. In recent years, our sales have increased at a slower pace than the semiconductor industry as a whole and our market share has declined.

In addition, projected industry growth rates may not materialize as forecasted, resulting in spending on process and product development well ahead of market requirements, which could have a material adverse effect on our business, financial condition and results of operations.

Our business is dependent upon our ability to attract and retain new customers. The competition for such new customers is intense. There can be no assurance that we will be successful in attracting and retaining new customers. Our failure to do so could materially adversely affect our business, financial position and results of operations.

Our operating results can also vary significantly due to impairment of goodwill and other intangible assets incurred in the course of acquisitions, as well as to impairment of tangible assets due to changes in the business environment.

Our operating results can also vary significantly due to impairment of goodwill booked pursuant to acquisitions and to the purchase of technologies and licenses from third parties. As of December 31, 2005, the value registered on our audited consolidated balance sheet for goodwill was $221 million and the value for technologies and licenses acquired from third parties was $110 million, net of amortization. Because the market for our products is characterized by rapidly changing technologies, and because of significant changes in the semiconductor industry, our future cash flows may not support the value of goodwill and other intangibles registered in our balance sheet. Furthermore, the ability to generate revenues for our fixed assets located in Europe may be impaired by an increase in the value of the euro with respect to the U.S. dollar, as the revenues from the use of such assets are generated in U.S. dollars. We are required to annually test goodwill and to assess the carrying values of intangible and tangible assets when impairment indicators exist. As a result of such tests, we could be required to book impairment in our statement of income if the

carrying value in our balance sheet is in excess of the fair value. The amount of any potential impairment is not predictable as it depends on our estimates of projected market trends, results of operations and cash flows. Any potential impairment, if required, could have a material adverse impact on our results of operations.

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Disruptions in our relationships with any one of our key customers could adversely affect our results of operations.

A substantial portion of our sales is derived from several large customers, some of whom have entered into strategic alliances with us. As of December 31, 2005, our largest customer was Nokia, which accounted for 22.4% of our 2005 net revenues, compared to 17.1% in 2004 and 17.9% in 2003. In 2005, our top ten OEM customers accounted for approximately 50% of our net revenues, compared to approximately 44% of our 2004 net revenues and 46% of our 2003 net revenues. We cannot guarantee that our largest customers will continue to book the same level of sales with us that they have in the past and will not solicit alternative suppliers. Many of our key customers operate in cyclical businesses that are also highly competitive, and their own demands and market positions may vary considerably. Such customers have in the past, and may in the future, vary order levels significantly from period to period, request postponements to scheduled delivery dates or modify their bookings. Approximately 18% of our net revenues were made through distributors in 2003, increasing in 2004 to approximately 21% and decreasing back to approximately 18% in 2005. We cannot guarantee that we will be able to maintain or enhance our market share with our key customers or distributors. If we were to lose one or more design wins for our products with our key customers or distributors, or if any key customer were to reduce or change its bookings, seek alternate suppliers, increase its product returns or fail to meet its payment obligations, our business financial condition and results of operation could be materially adversely affected. If customers do not purchase products made specifically for them, we may not be able to resell such products to other customers or require the customers who have ordered these products to pay a cancellation fee. Furthermore, developing industry trends, including customers use of outsourcing and new and revised supply chain models, may reduce our ability to forecast the purchase date for our products and evolving customer demand, thereby affecting our revenues and working capital requirements. For example, pursuant to industry developments, some of our products are required to be delivered on consignment to customer sites with recognition of revenue delayed until such time, which must occur within a defined period of time, when the customer chooses to take delivery of our products from our consignment stock.

Because we depend on a limited number of suppliers for raw materials and certain equipment, we may experience supply disruptions if suppliers interrupt supply or increase prices.

Our ability to meet our customers demand to manufacture our products depends upon obtaining adequate supplies of quality raw materials on a timely basis. A number of materials are available only from a limited number of suppliers, or only from a limited number of suppliers in a particular region. In addition, we purchase raw materials such as silicon wafers, lead frames, mold compounds, ceramic packages and chemicals and gases from a number of suppliers on a just-in-time basis. Although supplies for the raw materials we currently use are adequate, shortages could occur in various essential materials due to interruption of supply or increased demand in the industry. We also purchase semiconductor manufacturing equipment from a limited number of suppliers and because such equipment is complex it is difficult to replace one supplier with another or to substitute one piece of equipment for another. In addition, suppliers may extend lead times, limit our supply or increase prices due to capacity constraints or other factors. Furthermore, suppliers tend to focus their investments on providing the most technologically advanced equipment and materials and may not be in a position to address our requirements for equipment or materials of older generations. Shortages of supplies have in the past impacted and may in the future impact the semiconductor industry, in particular with respect to silicon wafers due to increased demand and decreased production. Although we work closely with our suppliers to avoid these types of shortages, there can be no assurances that we will not encounter these problems in the future. Our quarterly or annual results of operations would be adversely affected if we were unable to obtain adequate supplies of raw materials or equipment in a timely manner or if there were significant increases in the costs of raw materials or problems with the quality of these raw materials.

Our manufacturing processes are highly complex, costly and potentially vulnerable to impurities, disruptions or inefficient implementation of production changes that can significantly increase our costs and delay product shipments to our customers.

Our manufacturing processes are highly complex, require advanced and increasingly costly equipment and are continuously being modified or maintained in an effort to improve yields and product performance. Impurities or other difficulties in the manufacturing process can lower yields, interrupt production or result in losses of products in

process. As system complexity and production changes have increased and sub-micron technology has become more advanced, manufacturing tolerances have been reduced and requirements for precision have become even more demanding. Although in the past few years we have significantly enhanced our manufacturing capability in terms of efficiency, precision and capacity, we have from time to time experienced bottlenecks and

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production difficulties that have caused delivery delays and quality control problems, as is common in the semiconductor industry. We cannot guarantee that we will not experience bottlenecks, production or transition difficulties in the future. In addition, during past periods of high demand for our products, our manufacturing facilities have operated at high capacity, which has led to production constraints. Furthermore, if production at a manufacturing facility is interrupted, we may not be able to shift production to other facilities on a timely basis, or customers may purchase products from other suppliers. In either case, the loss of revenue and damage to the relationship with our customer could be significant. Furthermore, we periodically transfer production equipment between production facilities and must ramp up and test such equipment once installed in the new facility before it can reach its optimal production level.

As is common in the semiconductor industry, we have, from time to time, experienced and may in the future experience difficulties in transferring equipment between our sites, ramping up production at new facilities or effecting transitions to new manufacturing processes. Our operating results may be adversely affected by an increase in fixed costs and operating expenses linked to production if revenues do not increase commensurately with such fixed costs and operating expenses.

We may be faced with product liability or warranty claims.

Despite our corporate quality programs and commitment, our products may not in each case comply with specifications or customer requirements. Although our practice, in line with industry standards, is to contractually limit our liability to the repair, replacement or refund of defective products, warranty or product liability claims could result in significant expenses relating to compensation payments to maintain good customer relationships or related to the costs of defending against such claims and damages awarded if litigation occurs. In the event of a warranty claim, we may also incur costs if we decide to compensate the affected customer. There is no guarantee that our insurance policies will be available or adequate to protect against all such claims. In addition, it is possible for one of our customers to recall a product containing one of our parts. Costs or payments we may make in connection with warranty claims or product recalls may adversely affect our results of operation.

If our outside foundry suppliers fail to perform, this could adversely affect our ability to exploit growth opportunities.

We currently use outside suppliers or foundries primarily for high-speed complementary metal-on silicon oxide semiconductor (HCMOS) wafers and nonvolatile memory technology. If our outside suppliers are unable to satisfy our demand, or experience manufacturing difficulties, delays or reduced yields, our results of operations and ability to satisfy customer demand could suffer. In addition, purchasing rather than manufacturing these products may adversely affect our gross profit margin if the purchase costs of these products are higher than our own manufacturing costs. Our internal manufacturing costs include depreciation and other fixed costs, while costs for products outsourced are based on market conditions. Prices for foundry products also vary depending on capacity utilization rates at our suppliers, quantities demanded, product technology and geometry. Furthermore, these outsourcing costs can vary materially from quarter-to-quarter and, in cases of industry shortages, they can increase significantly further, negatively impacting our gross margin.

We depend on patents to protect our rights to our technology.

We depend on our ability to obtain patents and other intellectual property rights covering our products and their design and manufacturing processes. We intend to continue to seek patents on our inventions relating to product designs and manufacturing processes. However, the process of seeking patent protection can be long and expensive, and we cannot guarantee that we will receive patents from currently pending or future applications. Even if patents are issued, they may not be of sufficient scope or strength to provide meaningful protection or any commercial advantage. In addition, effective patent, copyright and trade secret protection may be unavailable or limited in some countries. Competitors may also develop technologies that are protected by patents and other intellectual property and therefore either be unavailable to us or be made available to us subject to adverse terms and conditions. We have in the past used our patent portfolio to negotiate broad patent cross-licenses with many of our competitors enabling us to design, manufacture and sell semiconductor products, without fear of infringing patents held by such competitors. We may not, however, in the future be able to obtain licenses or other rights to protect necessary intellectual property on

acceptable terms for the conduct of our business, and such failure may adversely impact our results of operations.

We have from time to time received, and may in the future receive, communications alleging possible infringement of patents and other intellectual property rights of others. Furthermore, we may become involved in costly litigation brought against us regarding patents, mask works, copyrights, trademarks or trade secrets. We are

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currently involved in patent litigation with SanDisk Corporation with respect to our flash memory products and in litigation with Tessera, Inc. See Item 8. Financial Information Legal Proceedings . In the event that the outcome of any litigation would be unfavorable to us, we may be required to obtain a license to the underlying intellectual property right upon economically unfavorable terms and conditions, possibly pay damages for prior use and/or face an injunction, all of which, singly or in the aggregate, could have a material adverse effect on our results of operations and ability to compete.

Finally, litigation could cost us financial and management resources necessary to enforce our patents and other intellectual property rights or to defend against third party intellectual property claims, when we believe that the amounts requested for a license are unreasonable.

Some of our production processes and materials are environmentally sensitive, which could lead to increased costs due to environmental regulations or to damage to the environment.

We are subject to a variety of laws and regulations relating, among other things, to the use, storage, discharge and disposal of chemicals, gases and other hazardous substances used in our manufacturing processes, air emissions, waste water discharges, waste disposal, as well as the investigation and remediation of soil and ground water contamination. European Directive 2002/96/ EC (WEEE Directive) imposes a take back obligation on manufacturers for the financing of the collection, recovery and disposal of electrical and electronic equipment. Additionally, European Directive 2002/95/ EC (ROHS Directive) will ban the use of lead and some flame retardants in electronic components beginning in July 2006. Our activities in the EU are also subject to the European Directive 2003/87/ EC establishing a scheme for greenhouse gas allowance trading, and to the applicable national implementing legislation. In addition, legislative proposals by the European Commission will require the registration, evaluation and authorizations of a large number of chemicals (REACH). The implementation of any such legislation could adversely affect our manufacturing costs or product sales by requiring us to acquire costly equipment, materials or green-house gas allowances, or to incur other significant expenses in adapting our manufacturing processes or waste and emission disposal processes. We are not in a position to quantify specific costs, in part because these costs are part of our business process. Furthermore, environmental claims or our failure to comply with present or future regulations could result in the assessment of damages or imposition of fines against us, suspension of production or a cessation of operations and, as with other companies engaged in similar activities, any failure by us to control the use of, or adequately restrict the discharge of chemicals or hazardous substances could subject us to future liabilities. Any specific liabilities we identify as probable would be reflected in our balance sheet. To date, we have not identified any such specific liabilities. We therefore have not booked specific reserves for any specific environmental risks. See Item 4. Information on the Company Environmental Matters .

We operate in many jurisdictions with highly complex and varied tax regimes. Changes in tax rules or the outcome of tax assessments and audits could cause a material adverse effect on our results.

We operate in many jurisdictions with highly complex and varied tax regimes. Changes in tax rules or the outcome of tax assessments and audits could have a material adverse effect on our results in any particular quarter. For example, in 2005, we had an income tax expense of $8 million, as compared to an income tax expense of $68 million in 2004. In 2005, we benefitted from a favorable reassessment of our deferred tax assets and liabilities due to changes in enacted tax rates, and a favorable settlement of certain minor items relating to prior years tax audits. Our tax rate is variable and depends on changes in the level of operating profits within various local jurisdictions and on changes in the applicable taxation rates of these jurisdictions, as well as changes in estimated tax provisions due to new events. We currently enjoy certain tax benefits in some countries, and these benefits may not be available in the future due to changes within the local jurisdictions. As a result, our effective tax rate could increase in the coming years.

We are subject to the possibility of loss contingencies arising out of tax claims and provisions for specifically identified income tax exposures. There can be no assurance that we will be successful in resolving such tax claims. Our failure to do so and/or the need to increase our provisions for such claims could materially adversely affect our financial position.

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We are required to prepare consolidated financial statements using both International Financial Reporting Standards (IFRS) beginning with our 2005 results in addition to our consolidated financial statements prepared pursuant to Generally Accepted Accounting Principles in the United States (U.S. GAAP) and dual reporting may impair the clarity of our financial reporting.

We are incorporated in the Netherlands and our shares are listed on Euronext Paris and on the Borsa Italiana, and, consequently, we are subject to an EU regulation issued on September 29, 2003 requiring us to report our results of operations and consolidated financial statements using IFRS (previously known as International Accounting Standards or IAS). Since our creation in 1987, we have always prepared our Consolidated Financial Statements under U.S. GAAP and intend to continue to do so, while at the same time complying with our reporting obligations under IFRS by preparing a complementary set of our 2005 accounts or as may be otherwise requested by local stock exchange authorities. Our decision to continue to apply U.S. GAAP in our financial reporting is designed to ensure the comparability of our results to those of our competitors and the continuity of our reporting, thereby providing our investors a clear understanding of our financial performance.

The obligation to report our Consolidated Financial Statements under IFRS will require us to prepare our results of operations using two different sets of reporting standards, U.S. GAAP and IFRS, which are currently not consistent. Such dual reporting could materially impair the clarity of our investor communications. The main potential areas of discrepancy concern capitalization and amortization of development expenses required under IFRS and the accounting for compound financial instruments. Furthermore, while we believe that all of our accounting systems were in place in order to prepare a separate set of accounts pursuant to IFRS in January 2005, we may not be able to account for capitalization of development expenses pursuant to IFRS in previous periods for comparative purposes. Our financial condition and results of operations reported in accordance with IFRS will differ from our financial condition and results of operations reported in accordance with U.S. GAAP, which could adversely affect the market price of our common shares.

Certain accounting principles of U.S. GAAP are in flux and may lead to significant changes in the way we account for our convertible debt instruments. These changes may lead to significant changes in our financial statements.

Certain U.S. GAAP accounting principles are in flux and pending proposed amendments are likely to be made. Certain of these proposed changes may bring U.S. GAAP more closely into line with IFRS, while others are independent of the move to converge generally accepted accounting principles. This state of flux makes it difficult for us to predict how accounting rules may evolve over the near- and medium-term.

In particular, the Financial Accounting Standards Board (FASB) has identified accounting for convertible debt instruments as an emerging accounting issue. FASB has announced a proposal that would involve uncoupling the debt and equity components of convertible debt instruments, in line with the fair market value of the debt. Recognition of interest expense in line with market rates under the FASB proposal may be considerably higher than the interest currently being charged. In particular, we may be required to show a high interest charge with respect to our 2013 Bonds, if not redeemed in August 2006, and to our zero-coupon senior convertible bonds due 2016 (2016 Bonds), which we issued on February 23, 2006. See Item 5 Operating and Financial Review and Prospects Capital Resources . Balance sheets would also be impacted because shareholders equity would be adjusted to show increased additional paid-in capital for the value of the embedded conversion option. The current proposal could apply both to our existing convertible debt instruments and any such instruments issued in the future. FASB s proposal draft and date of effect is not yet defined. If a new rule is adopted in line with the above proposals, and if there is no provision that limits its applicability to only those instruments issued in the future, we may be required to change the accounting for our convertible bonds on our statement of income and on our balance sheet. There can be no assurance that these proposed rules and regulations or any other laws, rules or regulations, will not be adopted in the future, any of which could adversely affect our financial statements, make compliance more difficult or expensive, or otherwise adversely affect our financial condition.

Changes in the accounting treatment of stock options and other share-based compensation could adversely affect our results of operations.

We have in the past accounted for share-based compensation to employees in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and as such generally recognize no compensation cost for employee stock options. In December 2004, the FASB issued revised FAS No. 123, Share-Based Payment, or FAS 123R, which requires companies to expense employee share-based compensation for financial reporting purposes. We adopted FAS 123R in the fourth quarter of 2005. See Item 5. Operating and Financial Review and Prospects and the Notes to the Consolidated Financial Statements. As a result, in the case

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of a distribution of new stock-based compensation, we are now required to value our employee stock-based compensation pursuant to a financial valuation model, and then amortize that value against our reported earnings over the vesting period in effect for those share-based compensation awards. This change in accounting treatment of employee stock and other forms of stock-based compensation could materially and adversely affect our results of operations, as the share-based compensation expense would be charged directly against our earnings. This change resulted in a charge in the fourth quarter of 2005 and could have, in the future, an effect on our earnings per share, which could negatively impact our future stock price.

In addition, we have, through the first part of 2005, used stock options as a key component of employee compensation in order to align employees interests with the interests of our shareholders, encourage employee retention, and provide competitive compensation packages. To the extent that FAS No. 123R or other new regulations make it more difficult or expensive to grant options or other forms of stock-based compensation to employees, we may incur increased compensation costs, change our equity compensation strategy, or find it difficult to attract, retain, and motivate employees. Any of these results could materially and adversely affect our business and operating results.

Our common share price, operating results, net income, net income per share and net financial position may be negatively affected by potential acquisitions.

While our growth to date has primarily been organic, we have in the past and may in the future make selected acquisitions that we believe would complement or expand our existing business. We may pay for future acquisitions with cash, our common shares or a combination of both. Acquisitions, if they occur, may have a dilutive effect for existing shareholders and, whether they are paid for in cash or common shares, may negatively affect our common share price. Announcements concerning potential acquisitions could be made at any time.

Acquisitions involve a number of risks that could adversely affect our operating results, including:

- the diversion of management s attention;
- the integration of acquired company operations and personnel;
- the assumption of potential liabilities, disclosed or undisclosed, associated with the business acquired, which liabilities may exceed the amount of indemnification available from the seller;
- the risk that the financial and accounting systems utilized by the business acquired will not meet our standards;
- the risk that the businesses acquired will not maintain the quality of products and services that we have historically provided;
- whether we are able to attract and retain qualified management for the acquired business;
- whether we are able to retain customers of the acquired entity; and
- the risk of goodwill and other intangible asset impairment, due to the inability of the business to meet management s expectations at the time of the acquisition.

There can be no assurance that (a) we will be able to consummate future acquisitions on satisfactory terms, if at all, (b) adequate financing will be available for future acquisitions on terms acceptable to us, if at all, or (c) any operations acquired will be successfully integrated or that such operations will ultimately have a positive impact on our business.

Reduction in the amount of state funding available to us or demands for repayment may increase our costs and impact our results of operations.

Like many other manufacturers operating in Europe, we benefit from governmental funding for research and development expenses and industrialization costs (which include some of the costs incurred to bring prototype products to the production stage), as well as from incentive programs for the economic development of

underdeveloped regions. Public funding may also be characterized by grants and/or low-interest financing for capital investment and/or tax credit investments. See Item 4. Information on the Company Public Funding . We have entered into public funding agreements in France and Italy, which set forth the parameters for state support to us under selected programs. These funding agreements may require compliance with EU regulations and approval by EU authorities.

We rely on receiving funds on a timely basis pursuant to the terms of the funding agreements. However, funding of programs in France and Italy is subject to annual appropriation of available resources and

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compatibility with the fiscal provisions of their annual budgets, which we do not control, as well as to our continuing compliance with all eligibility requirements. If we are unable to receive anticipated funding on a timely basis, or if existing government-funded programs were curtailed or discontinued, or if we were unable to fulfill our eligibility requirements, this could have a material adverse effect on our business, operating results and financial condition. There is no assurance that any alternative funding would be available, or that, if available, it could be provided in sufficient amounts or on similar terms.

The application for and implementation of such grants often involves compliance with extensive regulatory requirements including, in the case of subsidies to be granted within the EU, notification to the European Commission by the member state making the contemplated grant prior to disbursement. In particular, compliance with project-related ceilings on aggregate subsidies defined under EU law often involves highly complex economic evaluations. Furthermore, public funding arrangements are generally subject to annual and project-by-project reviews and approvals. If we fail to meet applicable formal or other requirements, we may not be able to receive the relevant subsidies or may be obliged to repay them which could have a material adverse effect on our results of operations.

The interests of our controlling shareholders, which are in turn controlled respectively by the French and Italian governments, may conflict with investors interests.

We have been informed that as of December 31, 2005, STMicroelectronics Holding II B.V. (ST Holding II), a wholly-owned subsidiary of STMicroelectronics Holding N.V. (ST Holding), owned 250,704,754 shares, or approximately 27.6%, of our issued common shares. ST Holding is therefore effectively in a position to control actions that require shareholder approval, including corporate actions, the election of our Supervisory Board and our Managing Board and the issuance of new shares or other securities.

We have also been informed that the shareholders agreement among ST Holding s shareholders (the STH Shareholders Agreement), to which we are not a party, governs relations between our current indirect shareholders Areva Group, Cassa Depositi e Prestiti S.p.A. (CDP) and Finmeccanica S.p.A. (Finmeccanica), each of which is ultimately controlled by the French or Italian government, see Item 7. Major Shareholders and Related-Party Transactions Major Shareholders . The STH Shareholders Agreement includes provisions requiring the unanimous approval by shareholders of ST Holding before ST Holding can make any decision with respect to certain actions to be taken by us. Furthermore, as permitted by our articles of association, the Supervisory Board has specified selected actions by the Managing Board that require the approval of the Supervisory Board. See Item 7. Major Shareholders and Related-Party Transactions Major Shareholders . These requirements for the prior approval of various actions to be taken by us and our subsidiaries may give rise to a conflict of interest between our interests and investors interests, on the one hand, and the interests of the individual shareholders approving such actions, on the other, and may affect the ability of our Managing Board to respond as may be necessary in the rapidly changing environment of the semiconductor industry. Furthermore, our ability to issue new shares or other securities may be limited by the existing shareholders desire to maintain their proportionate shareholding at a certain minimum level. Such approval process is, however, subject to the provisions of Dutch law requiring members of our Supervisory Board to act independently in supervising our management and applicable Dutch and non-Dutch corporate governance standards.

Our shareholder structure and our preference shares may deter a change of control.

On May 31, 1999, our shareholders approved the creation of preference shares that entitle a holder to full voting rights at any meeting of shareholders and to a preferential right to dividends and distributions upon liquidation. Pursuant to approval from our shareholders, and in order to protect ourselves from a hostile takeover or other similar action, we entered into an option agreement with ST Holding II, which provides that up to 540,000,000 preference shares shall be issued to ST Holding II upon its request and subject to the adoption of a resolution of our Supervisory Board giving our consent to the exercise of the option and upon payment of at least 25% of the par value of the preference shares to be issued. The option may only be exercised if ST Holding II owns at least 19% of our issued share capital at the time of exercise. No preference shares have been issued to date. The effect of the preference shares may be to deter potential acquirers from effecting an unsolicited acquisition resulting in a change of control. In addition, any issuance of additional capital within the limits of our authorized share capital, as approved by our shareholders, is subject to the approval of our Supervisory Board.

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Our direct or indirect shareholders may sell our existing common shares or issue financial instruments exchangeable into our common shares at any time while at the same time seeking to retain their rights regarding our preference shares. In addition, substantial sales by us of new common shares or convertible bonds could cause our common share price to drop significantly.

The STH Shareholders Agreement, to which we are not a party, permits our respective French and Italian indirect shareholders to cause ST Holding to dispose of its stake in us at its sole discretion at any time from their current level, and to reduce the current level of their respective indirect interests in our common shares to 9.5%. The details of the STH Shareholders Agreement as declared by ST Holding II in its Schedule 13G/ A filing dated February 14, 2006, are further explained in Item 7. Major Shareholders and Related-Party Transactions Major Shareholders . Disposals of our shares by the parties to the STH Shareholders Agreement can be made by way of the issuance of financial instruments exchangeable for our shares, equity swaps, structured finance transactions or sales of our shares. An announcement with respect to one or more of such dispositions could be made at any time without our advance knowledge.

In addition, Finmeccanica Finance S.A. (Finmeccanica Finance), a subsidiary of Finmeccanica, has issued 501 million aggregate principal amount of exchangeable notes, exchangeable into up to 20 million of our existing common shares due 2010 (the Finmeccanica Notes). The Finmeccanica Notes have been exchangeable at the option of the holder into our existing common shares since January 2, 2004. In September 2005, France Telecom caused the sale of approximately 26 million of our common shares pursuant to the terms of a convertible bond issued by France Telecom. In December 2005, Finmeccanica caused the sale of approximately 1.5 million of our common shares.

Further sales of our common shares or issue of bonds exchangeable into our common shares or any announcements concerning a potential sale by ST Holding, Areva, CDP or Finmeccanica, could materially impact the market price of our common shares. The timing and size of any future share or exchangeable bond offering by ST Holding, Areva, CDP or Finmeccanica would depend upon market conditions as well as a variety of factors.

Because we are a Dutch company subject to the corporate law of the Netherlands, U.S. investors might have more difficulty protecting their interests in a court of law or otherwise than if we were a U.S. company.

Our corporate affairs are governed by our articles of association and by the laws governing corporations incorporated in the Netherlands. The corporate affairs of each of our consolidated subsidiaries are governed by the articles of association and by the laws governing such corporations in the jurisdiction in which such consolidated subsidiary is incorporated. The rights of the investors and the responsibilities of members of our Supervisory Board and Managing Board under Dutch law are not as clearly established as under the rules of some U.S. jurisdictions. Therefore, U.S. investors may have more difficulty in protecting their interests in the face of actions by our management, members of our Supervisory Board or our controlling shareholders than U.S. investors would have if we were incorporated in the United States.

Our executive offices and a substantial portion of our assets are located outside the United States. In addition, ST Holding II and most members of our Managing and Supervisory Boards are residents of jurisdictions other than the United States and Canada. As a result, it may be difficult or impossible for shareholders to effect service within the United States or Canada upon us, ST Holding II, or members of our Managing or Supervisory Boards. It may also be difficult or impossible for shareholders to enforce outside the United States or Canada judgments obtained against such persons in U.S. or Canadian courts, or to enforce in U.S. or Canadian courts judgments obtained against such persons in courts in jurisdictions outside the United States or Canada. This could be true in any legal action, including actions predicated upon the civil liability provisions of U.S. securities laws. In addition, it may be difficult or impossible for shareholders to enforce, in original actions brought in courts in jurisdictions located outside the United States, rights predicated upon U.S. securities laws.

We have been advised by our Dutch counsel, De Brauw Blackstone Westbroek N.V., that the United States and the Netherlands do not currently have a treaty providing for reciprocal recognition and enforcement of judgments (other than arbitration awards) in civil and commercial matters. As a consequence, a final judgment for the payment of money rendered by any federal or state court in the United States based on civil liability, whether or not predicated solely upon the federal securities laws of the United States, will not be enforceable in the Netherlands. However, if the party in whose favor such final judgment is rendered brings a new suit in a competent court in the Netherlands, such party may submit to the Netherlands court the final judgment that has been rendered in the United States. If the

Netherlands court finds that the jurisdiction of the federal or state court in the United States has been based on grounds that are internationally acceptable and that proper legal procedures have been observed, the court in the Netherlands would, under current practice, give binding effect to

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the final judgment that has been rendered in the United States unless such judgment contravenes the Netherlands public policy.

Removal of our common shares from the CAC 40 on Euronext Paris, the S&P/ MIB on the Borsa Italiana or the Philadelphia Stock Exchange Semiconductor Sector Index could cause the market price of our common shares to drop significantly.

Our common shares have been included in the CAC 40 index on Euronext Paris since November 12, 1997; the S&P/ MIB on the Borsa Italiana, or Italian Stock Exchange since March 18, 2002; and the Philadelphia Stock Exchange Semiconductor Index (or the SOX) since June 23, 2003. However, our common shares could be removed from the CAC 40, the S&P/ MIB or the SOX at any time, and any such removal or announcement thereof could cause the market price of our common shares to drop significantly.

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Item 4. Information on the Company

History and Development of the Company

STMicroelectronics N.V. was formed and incorporated in 1987 and resulted from the combination of the semiconductor business of SGS Microelettronica (then owned by Società Finanziaria Telefonica (S.T.E.T.), an Italian corporation) and the non-military business of Thomson Semiconducteurs (then owned by the former Thomson-CSF, now Thales, a French corporation). Until 1998, we operated as SGS-Thomson Microelectronics N.V. Our length of life is indefinite. We are organized under the laws of the Netherlands, we have our corporate legal seat in Amsterdam and our head offices at WTC Schiphol Airport, Schiphol Boulevard 265, 1118 BH Schiphol Airport, Amsterdam, the Netherlands. Our telephone number there is (+31-20) 406-9604. Our headquarters and operational offices are located at 39 Chemin du Champ des Filles, 1228 Plan-Les-Ouates, Geneva, Switzerland. Our main telephone number there is (+41-22) 929-2929. Our agent for service of process in the United States related to our registration under the U.S. Securities Exchange Act of 1934, as amended, is STMicroelectronics, Inc., 1310 Electronics Drive, Carrollton, Texas, 75006-5039 and the main telephone number there is (+1-972) 466-6000. Our operations are also conducted through our various subsidiaries, which are organized and operated according to the laws of their country of incorporation, and consolidated by STMicroelectronics NV.

We completed our initial public offering in December 1994 with simultaneous listings on Euronext Paris and the New York Stock Exchange. In 1998, we listed our shares on the Borsa Italiana.

Business Overview

We are a global independent semiconductor company that designs, develops, manufactures and markets a broad range of semiconductor products used in a wide variety of microelectronic applications, including automotive products, computer peripherals, telecommunications systems, consumer products, industrial automation and control systems. According to provisional industry data published by iSuppli, we have been ranked the world s fifth largest semiconductor company based on forecasted 2005 total market sales and we held leading positions in sales of Analog Products, Application Specific Integrated Circuits (or ASICs) and Application Specific Standard Products (or ASSPs). Based on provisional 2005 results published by iSuppli, we believe we were also number one in discretes and number two in automotive electronics, industrial products and analog products and number three in NOR Flash. Based on 2004 industry results, we also believe we ranked as a leading supplier of semiconductors in 2005 for set-top boxes, Smart cards and power management devices. Furthermore, based on our relationship with Hewlett-Packard, which has a leading position in the printhead market, we believe that we are a leading supplier of integrated circuits for printheads. Major customers include Axalto, Alcatel, Bosch, Delphi, Delta, Ericsson, Hewlett-Packard, LG Electronics, Marelli, Maxtor, Motorola, Nokia, Philips, Pioneer, Samsung, Scientific Atlanta, Seagate, Siemens, Thomson, Vestel, Visteon and Western Digital. We also sell our products through global distributors and retailers, including Arrow Electronics, Avnet, BSI Group, Wintech and Yosun.

The semiconductor industry has historically been a cyclical one and we have responded through emphasizing balance in our product portfolio, in the applications we serve, and in the regional markets we address. Consequently, from 1994 through 2005, our revenues grew at a compounded annual growth rate of 11.6% compared to 7.6% for the industry as a whole.

We offer a diversified product portfolio and develop products for a wide range of market applications to reduce our dependence on any single product, application or end market. Within our diversified portfolio, we have focused on developing products that leverage our technological strengths in creating customized, system-level solutions with high-growth digital and mixed-signal content. Our product families include differentiated application specific products (which we define as being our dedicated analog, mixed signal and digital ASIC and ASSP offerings and semicustom devices), power microcontrollers and discrete products and non-volatile memory and Smart cards. Application specific products, which are generally less vulnerable to market cycles than standard commodity products, accounted for approximately 56% of our net revenues in 2005. Memory product sales accounted for approximately 22% of our net revenues in 2005, while sales of Micro linear and discrete products accounted for approximately 21% of our net revenues in 2005.

Our products are manufactured and designed using a broad range of manufacturing processes and proprietary design methods. We use all of the prevalent function-oriented process technologies, including complementary metal-on silicon oxide semiconductor (CMOS), bipolar and nonvolatile memory technologies. In addition, by combining basic processes, we have developed advanced systems-oriented technologies that enable us to produce differentiated and application-specific products, including bipolar CMOS technologies

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(BiCMOS) for mixed-signal applications and diffused metal-on silicon oxide semiconductor (DMOS) technology (BCD technologies) for intelligent power applications and embedded memory technologies. This broad technology portfolio, a cornerstone of our strategy for many years, enables us to meet the increasing demand for System-on-Chip (SoC) solutions. Complementing this depth and diversity of process and design technology is our broad intellectual property portfolio that we also use to enter into important patent cross-licensing agreements with other major semiconductor companies.

Effective January 1, 2005, we realigned our product groups to increase market focus and realize the full potential of our products, technologies and sales and marketing channels. Since such date we report our sales and operating income in three product segments:

- the Application Specific Product Group (ASG) segment, comprised of three product lines our Home, Personal and Communication Products (HPC), our Computer Peripherals Products (CPG) and our Automotive Products (APG). Our HPC products are comprised of the telecommunications and the audio divisions from the former Telecommunications, Peripherals and Automotive Groups combined with the consumer group from the former Consumer Microcontroller Groups. Our CPG products cover computer peripherals products, specifically disk drives and printers, and our APG products now comprise all of our major complex products related to automotive applications formerly within the automotive group of Telecommunications, Peripherals and Automotive Groups and in other product groups (notably from the former Discrete and Standard ICs Group and the Microcontroller Group);

- the Memory Products Group (MPG) segment, comprised of our memories and Smart card businesses; and

- the Micro, Linear and Discrete Product Group (MLD) segment, comprised of the greater part of our former Discrete and Standard ICs Group and our standard microcontroller and industrial devices (including the programmable systems memories (PSM) division previously forming part of MPG).

Our principal investment and resource allocation decisions in the semiconductor business area are for expenditures on research and development and capital investments in front-end and back-end manufacturing facilities. These decisions are not made by product segments, but on the basis of the semiconductor business area. All these product segments share common research and development for process technology and manufacturing capacity for most of their products.

We have in 2005 pursued various initiatives to reshape our company by (i) reorganizing our management team and setting up an executive committee, (ii) increasing our research and development effectiveness through a program focus on 20 key initiatives, improved project control and redeployment of certain resources with the aim to improve time to market for both technologies and products, (iii) promoting sales expansion for mass market application and new major key accounts with a special focus on the Chinese and Japanese markets with a view to increased overall efficiencies, (iv) executing a plan to improve our manufacturing competitiveness through the restructuring of our 150-mm wafer production capacity and (v) launching and implementing various further cost reduction initiatives through procurement savings, improved asset management, general and administration centralization and head count restructuring.

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Results of Operations

The tables below set forth information on our net revenues by product segment and by geographic region:

	Year Ended December 31,		
	2005	2004	2003
	(In millions, except percentages)		
Net Revenues by Product Segment			
Application Specific Product Group Segment (ASG)	$ 4,991	$ 4,902	$ 4,405
Memory Products Group Segment (MPG)	1,948	1,887	1,294
Micro, Linear and Discrete Product Group Segment (MLD)	1,882	1,902	1,469
Others(1)	61	69	70
Total	$ 8,882	$ 8,760	$ 7,238
Net Revenues by Location of Order Shipment(2)			
Europe(3)	$ 2,789	$ 2,827	$ 2,306
North America	1,141	1,211	985
Asia Pacific	4,063	3,711	3,190
Japan	307	403	337
Emerging Markets(3)(4)	582	608	420
Total	$ 8,882	$ 8,760	$ 7,238
Net Revenues by Product Segment			
Application Specific Product Group Segment (ASG)	56.2%	56.0%	60.9%
Memory Products Group Segment (MPG)	21.9	21.5	17.9
Micro, Linear and Discrete Product Group Segment (MLD)	21.2	21.7	20.3
Others(1)	0.7	0.8	0.9
Total	100.0%	100.0%	100.0%
Net Revenues by Location of Order Shipment(2)			
Europe(3)	31.4%	32.3%	31.9%
North America	12.8	13.8	13.6
Asia Pacific	45.7	42.4	44.1
Japan	3.5	4.6	4.6
Emerging Markets(3)(4)	6.6	6.9	5.8
Total	100.0%	100.0%	100.0%

(1) Includes revenues from sales of subsystems and other revenues not allocated to product segments.

(2) Net revenues by location of order shipment are classified by location of customer invoiced. For example, products ordered by companies to be invoiced to Asia Pacific affiliates are classified as Asia Pacific revenues.

(3) Since January 1, 2005, the region Europe includes the former East European countries that joined the EU in 2004. These countries were part of the Emerging Markets region in the previous periods. Net revenues for Europe and Emerging Markets for prior periods were restated to include such countries in the Europe region for such periods.

(4) Emerging Markets in 2005 included markets such as India, Latin America, the Middle East and Africa, Europe (non-EU and non-EFTA) and Russia.

Strategy

The semiconductor industry is undergoing several significant structural changes characterized by:

the changing long-term structural growth of the overall market for semiconductor products;

the strong development of new emerging applications in areas such as wireless communications, solid state storage, digital TV and video products and games;

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the increasing importance of the Asia Pacific region and emerging countries, particularly China, which represents the fastest growing regional market;

the importance of convergence between wireless consumer and computer applications, which drives customer demand for new system-level, turnkey solutions; and

the evolution of the customer base from original equipment manufacturers (OEM) to a mix of OEM, electronic manufacturing service providers (EMS) and original design manufacturers (ODM).

Our strategy within this challenging environment is designed to focus on the following complementary key elements:

Broad, balanced market exposure. We offer a diversified product portfolio and develop products for a wide range of market applications, thereby reducing our dependence on any single product, application or end market. Within our diversified portfolio, we have focused on developing products that leverage our technological strengths in creating customized, system-level solutions for high-growth digital and mixed-signal applications. We target five key markets comprised of: (i) communications, including wireless connectivity, mobile phone imaging, portable multimedia and infrastructure; (ii) computer peripherals, including data storage, printers, monitors, displays and optical mouse; (iii) digital consumer, including set-top boxes, DVD, digital TVs, digital cameras and digital audio; (iv) automotive, including engine, body and safety, car radio, car multimedia and telematics; and (v) industrial products, including banking, user ID/security, telephone Smart card, power management and industrial control.

Product strategy. We aim to: (i) maintain and further establish existing leadership positions for platforms and chipset solutions for digital consumer, wireless and multimedia digital cores offerings; (ii) maintain a leadership position in conventional semiconductor products such as discretes for power management, automotive and analog and mixed signal applications, which require less research and development effort and manufacturing capital intensity than more advanced and complex application specific devices; and (iii) participate, as appropriate, in the non-volatile memory market for selected key applications.

Alliances and customer base expansion. We work with our key customers to identify evolving needs and new applications and to develop innovative products and product features. We also leverage our position as a supplier of application-specific products in seeking to sell a broad range of products and emphasize strategic customer alliances to expand our customer base. We have formal alliances with certain strategic customers that allow us and our customers (with whom we jointly share certain product developments) to exchange information and give our customers access to our process technologies and manufacturing infrastructure. We have formed alliances with customers such as Alcatel, Bosch, Hewlett-Packard, Marelli, Nokia, Nortel, Pioneer, Seagate, Siemens VDO, Thomson and Western Digital, among others. Our twelve strategic alliances with key customers have been a major growth driver for us. In 2003, 2004 and 2005, revenues from strategic customer alliances accounted for approximately 43%, 39% and 44% respectively of our net revenues. We are targeting new major key accounts, particularly in the United States and in the Asia Pacific region, with a focus on China and Japan where we are also developing specific marketing efforts to increase our market penetration. Furthermore, we have set up a new organization with specific e-tools, design and support resources to address broader market applications.

Global integrated manufacturing infrastructure. We have a diversified, leading-edge manufacturing infrastructure capable of producing silicon wafers using our broad process technology portfolio, including our CMOS, BiCMOS, BCD technologies and memories. Assembling, testing and packaging of our semiconductor products take place in our large and modern back-end facilities, which generally are located in low-cost areas. We have also developed relationships with outside contractors for foundry and back-end services. We view these relationships as giving us the flexibility when required by market demand to outsource up to a maximum of 20% of each of our front-end and back-end production requirements, enabling us to manage the supply chain to our customers without a commensurate increase in capital spending. In 2005, we decided to combine our front-end manufacturing and our technology research and development into one organization in order to improve our manufacturing competitiveness and efficiency and our technology research and development effectiveness. In the current competitive environment, we have launched various cost reduction initiatives in the area of manufacturing and our strategy consists of: (i) establishing in

the Asia Pacific region the major portion of our 150-mm manufacturing activity; (ii) organizing our 200-mm manufacturing to increase operational efficiency through yield improvements, improved leverage due to reduced depreciation from mature assets and full saturation of all clean room areas; (iii) addressing projected increase in demand for 300-mm manufacturing through an appropriate ramp-up of internal capacity; and (iv) gaining flexibility in terms of capacity needs and employed capital through selected sourcing from foundry manufacturers.

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Industry partnerships. Partnerships with other semiconductor companies and suppliers enable us to share the increasing costs and technological risks involved in the research and development of state-of-the-art processes, product architectures and digital cores and to shorten the product development time of certain products. For example, we are currently working under a joint research and development technology cooperation program with Freescale Semiconductor, Inc. (Freescale) and Philips Semiconductors International B.V. (Philips) for the joint research and development of CMOS process technology in Crolles, France (Crolles2). In 2005, we extended this agreement to cover 300-mm wafer testing and packaging, as well as the development and licensing of core libraries and IP. Additionally, we are co-developing NAND Flash memory products with Hynix Semiconductor Inc. (Hynix) and have started to build a jointly owned dedicated memory manufacturing facility in China. Furthermore, we recently announced an agreement with Intel Corporation (Intel) to standardize hardware and software interfaces used in leading edge NOR Flash products in the wireless market and are working on various further initiatives.

Broad range of design and process technologies. We continue to utilize our expertise and experience with a wide range of process and design technologies to further develop our capabilities. We are committed to maintaining and, in certain areas, to increasing expenditures on core research and development projects as well as to developing alliances with other semiconductor companies and suppliers of software development tools, as appropriate. In 2005, we redeployed approximately 1,000 employees or 10% of our research and development work force to emphasize our focus and commitment to higher priority projects. Technological advances in the areas of transistor performance and interconnection technologies are being developed for our CMOS logic products and semicustom devices. We work on an ongoing basis with key suppliers to develop advanced and standardized design methodologies for our CMOS, mixed signal and non-volatile memory processes, as well as libraries of macrofunctions and megafunctions for many of our products, and are focusing on improving our concurrent engineering practices to better coordinate design activities and reduce overall product development time.

Integrated presence in key regional markets. We have sought to develop a competitive advantage by building an integrated presence in each of the world s major economic zones: Europe, Asia (including China), North America and Emerging Markets. An integrated presence means having manufacturing and design, as well as sales and marketing capabilities in each region, in order to ensure that we are well positioned to anticipate and respond to our customers business requirements. We have leading-edge, front-end manufacturing facilities in Europe, in the United States and increasingly in Asia where we sourced from internal and external manufacturers approximately 44% of our wafers at the end of 2005. Our more labor-intensive back-end facilities are located in Malaysia, Malta, Morocco, Singapore and China, enabling us to take advantage of more favorable production cost structures, particularly lower labor costs. Major design centers and local sales and marketing groups are within close proximity of key customers in each region, which we believe enhances our ability to maintain strong relationships with our customers. As appropriate, we intend to continue to build our integrated local presence in those regions where we compete, such as China, which has recently been set up as a separate marketing region and where we have both a back-end facility and a design center and have started to build with Hynix a jointly owned front-end memory manufacturing plant in Wuxi City, as well as India, where we have been expanding our design and software development centers. We have also continued to develop our sales and support organization for Emerging Markets.

Product Quality Excellence. We aim to develop a product of quality excellence in the various applications we serve and are planning the launch of a company-wide Product Quality Awareness program built around a three-pronged approach: (i) the improvement of our full product cycle involving robust design and manufacturing, improved detection of potential defects, and better anticipation of failures through improved risk assessment, particularly in the areas of product and process changes, (ii) improved responsiveness to customer demands and (iii) ever increasing focus on quality and discipline in execution.

Products and Technology

We design, develop, manufacture and market a broad range of products used in a wide variety of microelectronic applications, including telecommunications systems, computer systems, consumer goods, automotive products and industrial automation and control systems. Our products include discrete, memories and standard commodity components, ASICs (full custom devices and semicustom devices) and ASSPs for analog, digital, and mixed-signal applications. In addition, following the acquisition of Incard, we manufacture Smart cards. Historically, we have not

produced dynamic random access memory (DRAMs) or x86 microprocessors, despite seeking to develop or acquire the necessary intellectual property (IP) to use them as components in SoC.

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We run our business along product lines and manage our revenues and internal operating income performance based on the following product segments:

Application Specific Product Group segment;

Memory Products Group segment; and

Micro, Linear and Discrete Product Group segment.

We also design, develop, manufacture and market subsystems and modules for the telecom, automotive and industrial markets including mobile phone accessories, battery chargers, ISDN power supplies and in-vehicle equipment for electronic toll payment in our Subsystems division. Based on its immateriality, we do not report information separately for Subsystems.

Application Specific Product Group Segment

The Application Specific Product Group (ASG) segment is responsible for the design, development and manufacture of application-specific products using advanced bipolar, CMOS, BiCMOS mixed-signal and power technologies, as well as mixed analog/digital semicustom-devices and Micro-Electro-Mechanical System (MEMS) products. The businesses in the ASG offer complete system solutions to customers in several application markets. All products are ASSPs, full-custom or semicustom devices that may also include digital signal processor (DSP) and microcontroller cores. The businesses in the ASG particularly emphasize dedicated ICs for automotive, computer peripherals, consumer and industrial application segments, as well as for mobile and fixed communication, computing and networking application segments.

Our businesses in the ASG work closely with customers to develop application-specific products using our technologies, intellectual property, and manufacturing capabilities. The breadth of our customer and application base provides us with a better source of stability in the cyclical semiconductor market.

The ASG is comprised of three product lines our Home, Personal and Communication Products (HPC), our Computer Peripherals Products (CPG) and our Automotive Products (APG).

Home, Personal and Communication Products

This product line encompasses two of our largest application segments: wireless and consumer.

(i) *Personal and Multimedia Group.* Our Personal and Multimedia Group (PMG) is focused on products serving wireless and mobile product application space and is organized into four divisions.

(a) *Cellular Communications Division.* We focus our product offerings on cellular phones serving several major OEMs, with differentiated ICs. In this market, we are strategically positioned in energy management, audio coding and decoding function (CODEC) and radio frequency ICs. In February 2005, we decided to stop work on a reference design chipset for the GSM/ GPRS market. Research and development engineers dedicated to this program were redeployed to other wireless projects. We ship mobile phone energy-management devices in volume to two of the world s top five OEMs. We are transitioning from ICs to modules in the field of radio frequency and energy management for 3G telephones, which results in a higher content of semiconductors expressed in U.S. dollars. In addition, we are currently developing ASIC solutions for use in 3G basebands for the OEM marketplace.

(b) *Application Processor Division.* We offer a family of products addressing the market for multimedia application processor chips, known as the Nomadik family of products. These products are designed for 2.5/3G mobile phones, portable wireless products and other applications, and the chips are being sampled by a wide range of potential customers. We have several design wins in 2.5/3G mobile phones for tier-one European and Asian customers for smart phones and feature phones.

(c) *Imaging Division.* Our Imaging Division focuses on the wireless handset image sensor market. We are in production of CMOS, camera modules and processors for video graphic arrays (VGA), 1 and 2 mega pixels. We have cumulatively shipped over 100 million CMOS camera phone solutions since entering this market in 2003.

According to Prismark, we were the number one camera module manufacturer for 2005.

(d) *Connectivity Division.* To respond to the market need for increased functionality of handsets, we created the Connectivity Division to address wireless LAN, Bluetooth and connectivity requirements. Our product offerings include Wireless LAN and Bluetooth chips designed for low power consumption and a small form factor. We have multiple design wins and volume production for several customers in Asia and Europe for our bluetooth and wireless products. In particular, we have started to manufacture in volume our

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single-chip STLC2500A Bluetooth IC for multiple cellular phones and our single-chip Enhanced-Data-Rate STLC2500C with V2.0 capability has been adopted in more than 15 mobile-phone designs by several customers, including a tier-one cellphone manufacturer. Additionally, volume production has started on our compact STLC4370 IEEE802.11g wireless local area network (WLAN) module IC, which is being used in a new cellular phone from a tier-one manufacturer.

(ii) *Home Entertainment Group.* Our Home Entertainment Group (HEG) addresses product requirements for the digital consumer application market and has four divisions.

(a) *Home Video Division.* This division aims at retail and satellite set-top box products and digital television offerings. We continued to expand our product offerings and customer base by introducing solutions for the set-top box market with features such as web-browsing, digital video recording and time-shifting capabilities. We reinforced the market leadership of our OMEGA family of set-top box back-end decoders with the introduction of the STi710x series of products, the latest member of our OMEGA family of set-top box decoder solutions. This family of single chip SoC device addresses the high definition market, performs at an advanced speed and has enhanced graphics and security features as well as integrated DVR capability, while retaining compatibility with our earlier products. We continue to strengthen our product offerings by addressing software solutions supporting multiple codes, including DVB-MHP (Java) and Microsoft Windows Media based systems.

In 2005, we launched the STB7109, our second-generation H.264 high-definition TV (HDTV) AVC and VC-1 decoder. Building on the success of the STB7100, the world s first single-chip AVC and MPEG-2 decoder, the STB7109 adds VC-1 decoding, improved security, connectivity features, and support for emerging DVD formats and security standards.

Furthermore, adding to the multiple design wins already achieved by both our STB7100 and STB7109, in 2005 Loewe GmbH adopted our STB7100 for use across its high-end integrated DTV product range and we announced with Sagem the availability of the world s first MPEG-4 set-top boxes based on a single-chip decoder, enabling broadcasters and service operators worldwide to offer end users HDTV and/or many more TV channels, by using their existing broadcast network. The new STB7100-based boxes are being rolled out for satellite, IPTV, and terrestrial broadcast by several operators, including Canal+, France-Telecom and Telecom Italia. Additionally, the STB7100, together with our STB0899 front-end satellite demodulator, is being used in a Philips STB for Premiere.

We address the analog and digital television markets with a wide range of highly integrated ASSPs and application-specific microcontrollers. We have several design wins in Asia (China, Korea and Japan) for the STD2000, our single chip solution in 90-nm for integrated Digital TV, which supports all display types and both standard and high definition formats and are planning to sample our STD1000 in the second quarter of 2006.

Finally, we have announced the development of an affordable, ready-to-implement HDTV platform for the Japanese market with BHA Corporation, designed to catalyze the adoption of digital TV in Japan. In China, our affiliate company Shanghai-BMC released a complete middleware solution for STBs intended for the Chinese market, as well as for international operators. And for the first time in Brazil, by working in conjunction with the leading Brazilian laboratories and universities, in 2005 we publicly demonstrated the transmission of digital terrestrial TV (DTT) signal in HDTV format from a transmitter to an end-user terminal.

(b) *Cable and IP Division.* We offer products designed specifically for the cable and IP set-top box markets that take advantage of our significant expertise, product know-how and years of experience in supplying operator supported video markets. Our latest products in standard definition and high definition are designed to serve the evolving requirements in the growing global cable segment and the emerging IP set-top box market and we have multiple design wins in these areas.

(c) *Home Display Peripherals Division.* This division offers products aimed at the analog TV market, switches and sound processors as well as CRT monitors.

(d) *Audio Division.* We design and manufacture a wide variety of components for use in audio applications. Our audio products include audio power amplifiers, audio processors and graphic-equalizer ICs. We recently introduced a family of class D audio amplifier offerings that improve sound quality while reducing power

consumption, size and cost aimed primarily at home, desktop and mobile applications.

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(iii) *Communications Infrastructure and Displays Group.* Our Communications Infrastructure and Displays Group (CID) provides solutions for the wireless and wireless infrastructure segments as well as displays and is organized into three divisions.

(a) *Wireless Infrastructure Division.* We formed the Wireless Communications Infrastructure division to develop dedicated infrastructure chip solutions that will be focused on primarily the new third-generation telecom standards, but supporting existing standards as well. We have already developed all of the technologies required for the wireless infrastructure ASIC market due to our many years of experience in the fields of digital baseband chip, radio frequency and mixed signal products.

During 2005, we unveiled a chipset for pico-cell base-station modems, combining the market s first SoC baseband processor for wireless infrastructure applications, the STW51000, with multi-standard software libraries, optimized for GSM, EDGE, W CDMA, and WiMAX networks.

(b) *Wireline Infrastructure Division.* Our wireline telecommunications products, both ASIC and ASSP, are used in telephone sets, modems, subscriber line interface cards (SLICs) for digital central office switching equipment and the high-speed electronic and optical communications networks. In January 2005, we announced that we would scale back our presence in the CPE ADSL modem market. This initiative resulted in an impairment charge of $61 million and was recorded in the first quarter of 2005.

(c) *Display Division.* We offer products for the monitor and television peripheral market, as well as plasma display drivers and small-scale displays. Our display drivers address a number of display solutions, including thin film transistors, liquid crystal displays and organic light emitting diodes.

Computer Peripherals Products

(i) *Data Storage Division.* We produce ICs for several data storage applications, specializing in disk drives with advanced solutions for read and write digital channels, disk controllers, host interfaces, digital power processing, preamplifiers and micromachinery. We are actively working on super-integrating these macro-functions into SoC solutions. We believe that we are one of the largest semiconductor companies supplying the hard-disk-drive market based on sales.

A market leader in the data storage market selected our SoC for its next generation desktop drives. This SoC includes a rich variety of our own IP including our read/write channel, Serial ATA controller and microcomputer core. Complementing our leading position in components for desktop and server applications, we supply a kit including a SoC disk controller and a motion control power combo to a leading maker of drives for mobile applications. We have SoC solutions based on proprietary IP in production at 130-nm. In 2005, we also shipped 177 million units of our motor controller product. We are also expanding our presence in preamplifiers with new design wins for desktop and laptops at major hard disk drive manufacturers.

(ii) *Printer Division.* We are focusing on inkjet and multifunction printer components and are an important supplier of pen chips, motor drivers, head drivers, digital engines, including those in high-performance photo-quality applications and digital color copiers. We are also expanding our offerings to include a reconfigurable ASSP product family, known as SPEAr, designed for flexibility and ease of use by printer manufacturers. We have successfully validated and released our SPEAr Head, a new member of our SPEAr (Structured Processor Enhanced Architecture) family of configurable SoCs that address various applications, including digital engines for printers, scanners, and other embedded-control applications. Additionally in this area, our partnership with one of our major customers expanded with two new digital engine designs wins in next-generation printer and MultiFunction platforms.

(iii) *Microfluidics Division.* This division builds on the years of our success in the field of microfluidic product design, developed primarily for the inkjet print head product line, and expands our offering into related fields, such as molecular and health diagnostics. As a result, we announced an agreement with MobiDiag to create a complete system for genomic-based detection of infectious diseases based on our silicon MEMS Lab-on-Chip technology and with Veredus for the detection of the Avian Flu.

Automotive Products

Our automotive products include alternator regulators, airbag controls, anti-skid braking systems, ignition circuits, injection circuits, multiplex wiring kits and products for body and chassis electronics, engine management, instrumentation systems and car multimedia. We hold a leading position in the IC market for automotive products.

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(i) *Powertrain and Safety Division.* From engine and transmission control to mechanical-electronic solutions, microelectronics are steadily pervading all sectors of the automotive industry. Our robust family of automotive products, including MEMS accelerometers, complete standard solutions for DC-motor control and automotive grade 16-bit microcontrollers with embedded Flash memory, provide a broad range of features that enhance performance, safety and comfort while reducing the environmental impact of the automobile. We have in particular obtained design wins for (i) new generation braking systems (ABS vehicle control and traction control) from Bosch for 2009 models; (ii) power steering applications, with production in 2008 from a major Japanese tier-one customer; (iii) engine control from a major European system maker to be used in 2008 models having as final customers GM, Ford, and Chrysler; and (iv) a new car networking kit for a major European manufacturer for the U.S. market. We are working with Mobileye to develop, produce and commercialize chips for the visual-aid driving-assistance segment of the automotive market.

(ii) *Car Body Division.* We manufacture products for the body and chassis electronics requirements of the car. These products range from microcontrollers used in lighting, door and window/wiper applications to junction boxes, power solutions, dashboards and climate control needs.

(iii) *Car, Radio and Multimedia Division.* We provide auto manufacturers with full solutions for analog and digital car radio solutions for wireless communication, tolling, navigation and other telematic functionalities. The increasingly complex requirements of the car/driver interface have opened a market for us in the area of car multimedia. We have the know-how and experience to offer to the market complete telematics solutions, which include circuits for GPS navigation, voice recognition, audio amplification and audio signal processing. In 2005, we also made available new software libraries for our STA2051 32-bit GPS baseband controller, which enables the delivery of both higher performance and additional functionality for GPS and telematics applications.

(iv) *Digital Broadcast Radio Division.* Our products are used by the fast growing satellite radio segment. We provide a number of components to this application, including base band products for the reception of signals by the market leaders. Our penetration in the digital satellite broadcast market is growing with the success of the two American providers who reached more than 9 million subscribers in the fourth quarter of 2005.

Memory Products Group Segment

The Memory Products Group segment designs, develops and manufactures a broad range of semiconductor memory and Smart card products.

Flash memory technology, which is one of the enablers of digital convergence, is the core of our nonvolatile memory activity. The products developed by the various nonvolatile memory divisions are complementary and are addressing different functions and/or market segments.

In 2003, we made two acquisitions which complemented our product portfolio in the Smart card field: Proton World International (a company with expertise in the field of operating software and applications development) and Incard (a company with expertise in card manufacturing and electrical and graphical personalization and global delivery and support for the Smart card market, particularly in the high-end mobile phone market).

(i) *Wireless Flash Memories Division.* Wireless applications have very specific requirements in terms of power consumption, packaging and memory addressing. We offer a very wide portfolio of wireless Flash memories. The latest 512 Megabit (M-bit), 2 bit/cell, 1.8V serves the needs of the next generation of multimedia phones. The production of 2 bit per cell wireless Flash was approximately 80% of our wireless NOR Flash in the fourth quarter of 2005 helping us enrich the mix of our product offerings. We also offer multi-memory subsystems, which combine LP-SDRAM and NAND memory.

We recently announced an agreement with Intel to standardize hardware and software interfaces used in leading edge NOR Flash products in the wireless market. The goal of this initiative is to allow handset OEMs to lower their development costs and improve their time to market by ensuring through similar ST and Intel technical roadmaps and common specifications, availability of hardware and software compatible NOR Flash products for feature rich phones. Accordingly, we introduced our first 90-nm NOR Flash-based multi-chip memory subsystems, which combine our 512-and 256M-bit NOR devices with PSRAM and LP-SDRAM memory.

(ii) *Standard Nonvolatile Memories Division.* We produce a broad range of industry standard, general purpose Flash memories from 1 to 64 M-bit and we are in the process of producing Flash memories that will go up to 128 M-bit. We also produce the more mature erasable programmable read-only memory (EPROM), from 16 Kilobit (K-bit) to 32 M-bit. Efficient manufacturing, together with our sales and distribution channels, has

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contributed to the exploitation of our technological advantage in EPROM. The same approach is being applied to industry standard Flash.

(iii) *Serial Nonvolatile Memories Division.* We offer serial Electronically Erasable Programmable Read-Only Memory (EEPROM) up to 512 K-bit, and serial Flash memories (SNVM). Serial EEPROMs are the most popular type of EEPROMs and are used in computer, automotive and consumer applications. Combining the typical interface of serial EEPROM and Flash technology, we pioneered the concept of serial Flash. Serial Flash allows integration of up to 64 M-bit and 128 M-bit in an 8-pin package for a large variety of applications.

(iv) *NAND Flash and Storage Media Division.* In 2004, we began offering NAND Flash memory products pursuant to a co-development and manufacturing agreement with Hynix. Our efforts are targeted at the lower density memory requirements evolving for embedded wireless applications. Our most advanced offering, a single die 4 Gigabit (G-bit) at 70-nm chip, is now available in production. NAND Flash is primarily used to store information such as music, still pictures, video, data files in a variety of consumer applications, including mobile phones, MP3 readers, universal serial bust (USB) keys and digital still cameras.

(v) *Smart card IC Division.* Smart cards are card devices containing ICs that store data and provide an array of security capabilities. They are used in a wide and growing variety of applications, including public pay telephone systems, cellular telephone systems and banks, as well as pay television systems and ID/passport cards. Other applications include medical record applications, card-access security systems, toll-payment and secure transactions over the Internet applications. We have a long track record of leadership in Smart card ICs. Our expertise in security is a key in leading the finance and pay-TV segments and developing the IT applications. Our mastering of the nonvolatile memory technologies is instrumental to offer the highest memory sizes (up to 128 KBytes and even 1 MByte), particularly important to address the emerging high end mobile phone market. Our offer in embedded software provides added value to our silicon and contributes to facilitate the Smart card market development. Proton World International is now part of the Smart card IC division.

In 2005, On Track Innovation (OTI) announced that OTI s contactless Smart card, based on the ST19WR02 contactless, secure microcontroller, was the first to be approved by Visa International for use in its contactless program in the United States. We are also working with SmardTech to develop a Smart card solution, based on our ST19W contactless secure microcontrollers, as part of an electronic ticketing system for a German transport application.

(vi) *Incard Division.* The division develops, manufactures and sells plastic cards (both memory- and microprocessors-based) for banking, identification and telecom applications. Incard operates as a stand alone organization and also directly controls the sales force for this product offering.

We have done important work on our cost position of our Memory Product Group Segment, in particular widely developing the two bit per cell architecture, which has generated an operating profit for the Memory Product Group in the fourth quarter of 2005. We will continue to seek to enhance our competitive position on all fronts of the memory market we serve both by adding new products and improving manufacturing costs. However, in the memory business the dimension of scale remains a critical element and therefore we continue to be active in strategic discussions with the aim of addressing that issue and generating more value for our shareholders.

Micro, Linear and Discrete Product Group Segment

The Micro, Linear and Discrete Product Group segment is responsible for the design, development and manufacture of discrete power devices, (power transistors and other discrete power devices), standard linear and logic ICs, and radio frequency products. As of January 1, 2006, we renamed this segment the Micro, Power and Analog Group to better reflect our efforts of developing high-end analog products and of consolidating our world leadership position in power applications, with full solutions centered around micro applications.

(i) Power MOSFET Division. We design, manufacture and sell Power Mosfet (Metal-Oxide-Silicon Field Effect) transistors ranging from 20 to 1000 volts for most of the switching applications on the market today. Our products are particularly well suited for high voltage switch mode power supplies and in lighting applications, where we hold a leadership position in high current and high voltage devices for a variety of switching and pulse-mode applications.

(ii) Power Bipolar, IGBT and RF Division. Our bipolar power transistors are used in a variety of voltage applications, including television/monitor horizontal deflection circuits, lighting systems and high power supplies. Our family of ESBT (Emitter Switch Bipolar Transistor) is suitable for very high current very high voltage applications, such as welding machines and PFC (Power Factor Corrector) devices. The IGBT transistors

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are well suited for Automotive applications, such as motor control and high voltage electronic ignition actuators. Within this Division we also supply RF transistors used in television broadcasting transmission systems, radars, telecommunications systems and avionic equipment.

(iii) ASD and IPAD Division. This division offers a full range of rectifiers, protection thyristors (silicon controlled rectifiers or SCRs and three-terminal semiconductors for controlling current in either direction or Triacs) and protection devices. These components are used in various applications, including telecommunications systems (telephone sets, modems and line cards), household appliances and industrial systems (motor control and power control devices). More specifically, rectifiers are used in voltage converters and regulators, protection devices, while thyristors vary current flows through a variety of electrical devices, including lamps and household appliances. We are leaders in a highly successful range of new products built with our proprietary Application Specific Discrete (ASD™) technology, which allows a variety of discrete components (diodes, rectifiers, thyristors) to be merged into a single device optimized for specific applications such as electromagnetic interference filtering for cellular phones. Additionally, we are leaders in electronic devices integrating both passive and active components on the same chip, also known as Integrated Passive and Active Devices (IPAD), which are widely used in the wireless handset market.

(iv) Linear and Interface Division. We offer a broad product portfolio of linear and switching regulators along with operational amplifiers, comparators, serial and parallel interfaces covering a variety of applications like decoders, DC-DC converters and mobile phones.

(v) Microcontroller Division. We focus on high-volume 8, 16 and 32 bit microcontrollers in this division. These products have been developed with a wide technology portfolio and processes capable of embedding EPROM, EEPROM and Flash non volatile memories as appropriate. In 2003, we introduced new products for the ST7Lite series of integrated 8-bit Flash microcontrollers. The ST7FLite1 and ST7Flite2 are suited for a wide range of high volume applications including appliances, alarms, sensors, battery-powered products, industrial controls and many other portable and low cost systems. In 2005, we introduced a line of 32-bit ARM7-based microcontrollers optimized for multiple industrial applications, including factory automation, appliances and security systems. We also updated our STR7 Software Library supporting our 32-bit ARM7-based microcontrollers. Additionally, we gained design wins for our ST7MC microcontroller in a new generation of brushless electric motors for refrigerators with China s leading home-appliance maker and with one of the world s top five refrigeration compressor manufacturers.

(vi) Industrial and Power Conversion Division. We design and manufacture products for industrial automation systems, lighting applications (lamp ballast), battery chargers and SMPS. Our key products are power ICs for motor controllers and read/write amplifiers, intelligent power ICs for spindle motor control and head positioning in computer disk drives and battery chargers for portable electronic systems, including mobile telephone sets. In 2005, we introduced an innovative and patented DC/ DC converter chip that for the first time, allows two different output voltages to be generated using a single external coil. The STw4141 is specifically designed to efficiently supply power to digital baseband and multimedia processors in portable applications. We also introduced the PM6685 mobile PC power management IC, a dual step-down controller that provides the four output voltages necessary for notebook system power. Also in this area, we introduced our L6668 current-mode primary-controller IC for single-ended switching power converters to be used in high-end AC/ DC adapters and chargers for notebook or laptop PCs. Our family of Viper products and Omnifets exhibit the operating characteristics of power transistors while incorporating full thermal, short-circuit and over-current protection and allowing logic-level input typical of ICs. They are primarily used in low power switch mode power supplies where protection against overvoltage and or overtemperature is needed.

(vii) Advanced Analog and Logic Division. We develop innovative, differentiated and value-added analog products for a number of markets and applications such as point of sales terminals, power meters and white goods. In 2005, we introduced our NEATSwitch™ portfolio of application-specific analog, digital, and power switches and extended our supervisor and reset IC family with the STM1061 low-power precision voltage detectors for applications in systems where signal levels need to be monitored. Also in this area, we gained a design win for a multiple-voltage microprocessor reset IC with a major Set Top Box manufacturer. In addition, we introduced the STM1404, the world s first FIPS (Federal Information Processing Standard) level 4 security supervisor for point-of-sale equipment. We also produce a variety of HCMOS logic device families, which include clocks, registers, gates, latches and buffers. Such

devices are used in a variety of applications, including portable computers, computer networks and telecommunications systems.

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Strategic Alliances with Customers and Industry Partnerships

We believe that strategic alliances with customers and industry partnerships are critical to success in the semiconductor industry. We have entered into several strategic customer alliances, including alliances with Alcatel, Bosch, Hewlett-Packard, Marelli, Nokia, Nortel, Pioneer, Seagate, Siemens VDO, Thomson and Western Digital, among others. Customer alliances provide us with valuable systems and application know-how and access to markets for key products, while allowing our customers to share some of the risks of product development with us and to gain access to our process technologies and manufacturing infrastructure. We are actively working to expand the number of our customer alliances, targeting OEMs in the United States, Europe and in Asia.

Partnerships with other semiconductor industry manufacturers permit costly research and development and manufacturing resources to be shared to mutual advantage for joint technology development. We have been collaborating with Philips for the joint development of CMOS process technologies in Crolles, France, since 1992. In 2003, we began cooperating with Freescale and Philips for the joint research and development of CMOS process technology to provide 90-nm to 32-nm chip technologies on 300-mm wafers, as well as for the operations of a 300-mm wafer pilot line fab which has been built in Crolles2 with the stated goal of accelerating the development of future technologies and their proliferation throughout the semiconductor industry. We have extended this agreement to cover the development and licensing of core libraries.

We began working with Texas Instruments in 2002 to jointly define and promote an open standard for wireless application processor interfaces. This initiative has now broadened and is known as the MIPI Alliance. It now includes over 92 members that collaborate as mobile industry leaders with the objective of defining and promoting open standards for interfaces to mobile application processors. Through these open standards, the MIPI Alliance intends to speed deployment of new services to mobile users by establishing specifications for standard hardware and software interfaces to mobile application processors and encouraging the adoption of those standards throughout the industry. We are members of the MIPI alliance.

We have also established joint development programs with leading suppliers such as Air Liquide, Applied Materials, ASM Lithography, Axalto, Canon, Hewlett-Packard, KLA-Tencor, LAM Research, MEMC, Teradyne and Wacker and with computer-aided design (CAD) tool producers, including Cadence, Co Ware and Synopsys. We also participate in joint European research programs, such as the MEDEA+ and ITEA programs, and cooperate with major research institutions and universities.

In 2004, we signed and announced a joint venture agreement with Hynix to build a front-end memory-manufacturing facility in Wuxi City, China. The joint venture is an extension of the NAND Flash Process/product joint development relationship. Construction of the facility began in 2005. When complete, the fab will employ approximately 1,500 people and will feature a 200-mm wafer production line planned to begin production at the end of 2006 and a 300-mm wafer production line planned to begin production in 2007. The total investment planned for the project is $2 billion. We will be contributing 33% of the equity financing, equivalent to $250 million, while Hynix will contribute 67%. We will also contribute $250 million as long-term debt to the joint venture, guaranteed by subordinated collateral on the joint venture s assets. The financing will also include funding from local Chinese institutions including long-term leasehold and local debt financing which remains to be implemented. In 2005, our contributions to the equity investment reached approximately $38 million. We plan to subscribe the additional capital of $212 million in 2006 concurrently with Hynix and once the financing from local financing institutions is in place.

Customers and Applications

We design, develop, manufacture and market thousands of products that we sell to approximately 1,300 direct customers. Major customers include Axalto, Alcatel, Bosch, Delphi, Delta, Ericsson, Hewlett-Packard, LG Electronics, Marelli, Maxtor, Motorola, Nokia, Philips, Pioneer, Samsung, Scientific Atlanta, Seagate, Siemens, Thomson, Vestel, Visteon and Western Digital. To many of our key customers we provide a wide range of products, including dedicated products, discrete devices, memory products and programmable products. Our position as a strategic supplier of application-specific products to certain customers fosters close relationships that provide us with opportunities to supply such customers requirements for other products, including discrete devices, programmable products and memory products. We also sell our products through distributors, including Arrow Electronics, Avnet

Inc., BSI Group, Wintech and Yosun.

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The following table sets forth certain of our significant customers and certain applications for our products:

Telecommunications				
Customers:	2Wire	Finisar	Nokia	Sagem
	Alcatel	Huawei	Nortel Networks	Siemens
	Cellon	LG Electronics	Philips	Sony Ericsson
	Cisco	Motorola	Sanyo	TCL Corporation
Applications:	Camera modules/ mobile imaging		Portable multimedia Telephone terminals (wireline and wireless)	y (Bluetooth, ure
	Central office switching systems		Wireless connectivit	
	Data transport (routing, switching for electronic and optical networks)		WLAN, FM radio)	
	Digital cellular telephones		Wireless infrastruct	
	Internet access (XDSL)			
Computer Peripherals				
Customers:	Agilent	Delta	Lexmark	Samsung
	BenQ	Hewlett-Packard	Logitech	Seagate
	Creative Technology	Intel	Maxtor	Western Digital
	Dell	Lenovo-IBM	Microsoft	Xerox
Applications:	Data storage		Power management	
	Monitors and displays		Printers	
			Webcams	
Automotive				
Customers:	Alpine	Denso	Marelli	Sirius
	Bosch	Harman	Motorola	Valeo
	Conti	Hella	Pioneer	Visteon
	Delphi	Lear	Siemens	XM Satellite
Applications:	Airbags		Global positioning systems	
	Anti-lock braking systems		Multimedia	
	Body and chassis electronics		Radio/ satellite radio	
	Engine management systems (ignition and injection)		Telematics	
			Vehicle stability control	
Consumer				
Customers:	Bose Corporation	LG Electronics	Pace	Skardin
	Echostar	Matsushita	Philips	Sony
	Humax	Microsoft	Samsung	Thomson
	Kenwood	Motorola	Scientific Atlanta	Tomen
				Vestel
Applications:	Audio processing (CD, DVD, Hi-Fi)		DVDs	
	Analog/ digital TVs		Imaging	
	Digital cameras		Set-top boxes	
	Digital music players		VCRs	
Industrial/ Other Applications				
Customers:	American Power Conversion	Delta	Gillette	Philips
	Astec	Echelon	Hewlett-Packard	Siemens
	Autostrade	Enel	Nagra	Toppan

	Axalto	Gemplus	Oberthur	Taiwan Liton
Applications:	Battery chargers		Lighting systems (lamp ballasts)	
	Smart card ICs		Motor controllers	
	Industrial automation/ control systems		Power supplies	
	Intelligent power switches		Switch mode power supplies	

In 2005, our largest customer, Nokia, represented 22.4% of our net revenues, compared to 17.1% in 2004 and 17.9% in 2003. No other single customer accounted for more than 10% of our net revenues. Sales to our OEM customers accounted for approximately 82% of our net revenues in 2005, from approximately 79% of our net revenues in 2004 and 82% in 2003. Sales to our top ten OEM customers were approximately 50% of total revenues in 2005, 44% in 2004 and 46% in 2003. We have several large customers, certain of whom have entered into strategic alliances with us. Many of our key customers operate in cyclical businesses and have in the past, and may in the future, vary order levels significantly from period to period. In addition, approximately 18% of our net revenues in 2005 were sold through distributors, compared to 21% in 2004 and 18% in 2003. There can

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be no assurance that such customers or distributors, or any other customers, will continue to place orders with us in the future at the same levels as in prior periods. See Item 3. Key Information Risk Factors Risks Related to Our Operations Disruptions in our relationships with any one of our key customers could adversely affect our results of operations .

Sales, Marketing and Distribution

We operate regional sales organizations in Europe, North America, Asia Pacific, Japan and Emerging Markets, which include Latin America, the Middle East and Africa, Europe (non-EU and non-EFTA), Russia and India. For a breakdown of net revenues by product segment and geographic region for each of the three years ended December 31, 2005, see Item 5. Operating and Financial Review and Prospects Results of Operations Segment Information .

The European region is divided into five business units: automotive, consumer and computers, Smart card, telecom, EMS and distribution. Additionally, for all products, including commodities and Dedicated ICs, we actively promote and support the sales of these products through sales force, field application engineers, supply-chain management and customer-service, and a technical competence center for system-solutions, with support functions provided locally.

In the North America region, the sales and marketing team is organized into seven business units. They are located near major centers of activity for either a particular application or geographic region: automotive (Detroit, Michigan), industrial (Boston, Massachusetts), consumer (Chicago, Illinois), computer and peripheral equipment (San Jose, California and Longmont, Colorado), RFID and Smart card (Longmont, Colorado), communications (Dallas, Texas) and distribution (Boston, Massachusetts). Each regional business unit has a sales force that specializes in the relevant business sector, providing local customer service, market development and specialized application support for differentiated system-oriented products. This structure allows us to monitor emerging applications, to provide local design support, and to identify new products for development in conjunction with the various product divisions as well as to develop new markets and applications with our current product portfolio. A central product marketing operation in Boston provides product support and training for standard products for the North American region, while a logistics center in Phoenix, Arizona supports just-in-time delivery throughout North America. In addition, a comprehensive distribution business unit provides product and sales support for the regional distribution network.

In the Asia Pacific region during 2005, sales and marketing segments was managed from our regional sales headquarters in Singapore and organized into nine segments (computer and peripheral, automotive, industrial/computer/ MLD, home entertainment, communications and mobile multimedia, display, Smart card and security, distribution and EMS) with three transversal support organizations (business management, field quality and communications). We have sales offices in Taiwan, Korea, China, Hong Kong, Malaysia, Thailand and Australia. The Singapore sales organization provides central marketing, customer service, technical support, logistics, application laboratory and design services for the entire region. In addition, there are design centers in Korea and China.

On January 1, 2006, we created a new sales region, Greater China , which encompasses China, Taiwan and Hong Kong. This new sales region will be dedicated to sales, design and support resources and is aimed at expanding on our many years of successful participation in this quickly growing market. This market is also expected to grow significantly in the next few years according to industry analysts. In 2004, industry analysts estimated that we were one of the top five semiconductor suppliers in China. Our intent is to meet the needs of our transnational customers there, as well as to build new relationship with the evolving local market.

In Japan, the large majority of our sales are made through distributors, as is typical for foreign suppliers to the Japanese market. However, our sales and marketing engineers in Japan work directly with customers as well as with the distributors to meet customers needs. We provide marketing and technical support services to customers through sales offices in Tokyo and Osaka. In addition, we have established a design center and application laboratory in Tokyo. The design center designs custom ICs for Japanese clients, while the application laboratory allows Japanese customers to test our products in specific applications. We have recently announced changes in our organization for Japan and have targeted to increase our presence in this significant market, by expanding our sales design and support resources.

Our Emerging Markets organization includes Latin America, the Middle East and Africa, Europe (non-EU and non-EFTA) and Russia as well as our design and software development centers in India, which employed

approximately 1,500 people.

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The sales and marketing activities carried out by our regional sales organizations are supported by the product marketing that is carried out by each product division, which also include product development functions. This matrix system reinforces our sales and marketing activities and our broader strategic objectives. We have initiated a program to expand our customer base. This program s key elements include adding sales representatives, adding regional competence centers and new generations of electronic tools for customer support.

Except for Emerging Markets, each of our regional sales organizations operates dedicated distribution organizations. To support the distribution network, we operate logistic centers in Saint Genis, France, Phoenix, Arizona and Singapore.

We also use distributors and representatives to distribute our products around the world. Typically, distributors handle a wide variety of products, including products that compete with our products, and fill orders for many customers. Most of our sales to distributors are made under agreements allowing for price protection and/or the right of return on unsold merchandise. We generally recognize revenues upon transfer of ownership of the goods at shipment. Sales representatives generally do not offer products that compete directly with our products, but may carry complementary items manufactured by others. Representatives do not maintain a product inventory; instead, their customers place large quantity orders directly with us and are referred to distributors for smaller orders.

At the request of certain of our customers, we are also selling and delivering our products to EMS, which, on a contractual basis with our customers, incorporates our products into the dedicated products which they manufacture for our customers. Certain customers require us to hold inventory on consignment in their hubs and only purchase inventory when they require it for their own production. This may lead to delays in recognizing revenues as such customers may choose within a specific period of time the moment when they accept delivery of our products.

Research and Development

We believe that research and development is critical to our success, and we are committed to increasing research and development expenditures in the future. The main research and development (R&D) challenge we face is to continually increase the functionality, speed and cost-effectiveness of our semiconductor devices, while ensuring that technological developments translate into profitable commercial products as quickly as possible.

Our policy in the field of research and development is market driven and is focused on leading-edge products and technologies in close collaboration with strategic alliance partners, leading universities and research institutes, key customers and global equipment manufacturers working at the cutting edge of their own markets. On January 1, 2005, we created a new Front-End Technology and Manufacturing organization (FTM) encompassing the present front-end manufacturing and central research and development functions in order to improve our technology research and development effectiveness and our manufacturing competitiveness and efficiency. The research and development activities relating to new products are managed by the Product Segments and consist mainly of design activities while the technologies research and development activities are managed by our new FTM organization.

In 2005, we reallocated 10% of our research and development resources in favor of higher priority projects for both process technology development and product design with the aim to increase the efficiency of our research and development activity and accelerate product innovation. We selected 20 key technology and product programs that set a clear roadmap with defined milestones and that are reviewed on a monthly basis by our Executive Committee.

We invest in a variety of research and development projects ranging from long-term advanced research for the acceleration, in line with industry requirements and roadmaps such as the International Technology Roadmap for Semiconductors (ITRS), of our broad range of process technologies including BiCMOS; bipolar, CMOS and DMOS (BCD); High Performance Logic; and stand-alone and embedded Flash and other nonvolatile memories; to the continued expansion of our system level design expertise and IP creation for advanced architecture for SoC integration, as well as new products for many key applications in the field of digital consumer wireless communications and networking, computer peripherals, Smart cards and car multimedia among others.

We continue to make significant investments in research and development, while reducing our other general expenses. In 2005, we spent $1,630 million on research and development, which represented approximately a 6% increase from $1,532 million in 2004, while 2004 spending represented a 24% increase from $1,238 million in 2003. The table below sets forth information with respect to our research and development spending since 2003. Our reported research and development expenses are mainly in the areas of product design, technology and

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development and do not include marketing design center costs which are accounted for as selling expenses, or process engineering, pre-production and process-transfer costs, which are accounted for as cost of sales:

	Year Ended December 31,		
	2005	2004	2003
	(In millions, except percentages)		
Expenditures	$ 1,630	$ 1,532	$ 1,238
As a percentage of net revenues	18.3%	17.5%	17.1%

Approximately 88% of our research and development expenses in 2005 were incurred in Europe, primarily in France and Italy. See Public Funding below. As of December 31, 2005, approximately 9,700 employees were employed in research and development activities worldwide.

We devote significant effort to R&D because semiconductor manufacturers face immense pressure to be the first to make breakthroughs that can be leveraged into competitive advantages; new developments in semiconductor technology can make end products significantly cheaper, faster or more reliable than their predecessors and enable, through their timely appearance on the market, significant value creation opportunities.

To ensure that new technologies can be exploited in commercial products as quickly as possible an integral part of our R&D philosophy is concurrent engineering, meaning that new fabrication processes and the tools needed to exploit them are developed simultaneously. Typically, these include not only CAD software, but also cell libraries that allow access to our rich IP portfolio and a demonstrator product suitable for subsequent commercialization. In this way, when a new process is delivered to our product segments or made available to external customers, they are more able develop commercial products immediately.

Our R&D activities are conducted on a worldwide scale and focus on the very large scale integration (VLSI) technology. Our major centers for VLSI technology development are located in Crolles (France) and Agrate Brianza (Italy). Other advanced R&D centers are strategically located around the world: in Italy (Castelletto and Catania), France (Grenoble, Tours and Rousset), USA (Phoenix, Carrollton, and San Diego), Canada (Ottawa), UK (Bristol and Edinburgh), Switzerland (Geneva and Lugano), India (Noida and Bangalore), China (Beijing, Shenzhen and Shanghai) and Singapore.

In Crolles we cooperate with Philips and Freescale as part of the Crolles2 alliance to jointly develop sub-micron CMOS logic processes to provide 90-nm to 32-nm chip technologies on 300-mm wafers and to build and operate an advanced 300-mm wafer pilot line in Crolles, France. The pilot line was officially inaugurated on February 27, 2003, and the first silicon rolled off the line during the first quarter of 2003 with the stated goal of accelerating the development of future technologies and their proliferation throughout the semiconductor industry. On January 31, 2005, the Crolles2 alliance extended the scope of the joint semiconductor research and development activities to include research and development related to wafer testing and packaging. The agreement reflects the special needs of wafer testing and packaging for devices produced on 300-mm wafers in 90-nm and beyond. In September 2005, we extended this agreement to cover the development and licensing of core libraries. The initial five-year term of our Crolles2 agreement has been set through December 31, 2007 and will be automatically extended until December 31, 2010, unless either Freescale, Philips or we serve a written notice of termination prior to December 31, 2006. There is no assurance, however, that we will be able to extend this agreement beyond its initial five year term or that it will not terminate in the event a change of control occurs in one of the parties. The non-renewal or termination of our Crolles2 alliance could have a material adverse effect on our business. In such an event, we may incur additional unforeseen costs, and our business, results of operation and prospects may be substantially affected.

In addition, our manufacturing facility in Crolles, France houses a research and development center that is operated in the legal form of a French Groupement d intérêt économique (GIE) named Centre Commun de Microelectronique de Crolles . Laboratoire d Electronique de Technologie d Instrumentation (LETI), a research laboratory of Commissariat de l Energie Atomique (CEA), an affiliate of Areva Group (one of our indirect

shareholders), is our partner.

There can be no assurance that we will be able to develop future technologies and proliferate them on satisfactory terms, that the alliance will be successful or will enable us to effectively meet customer demands or that its operations will not be adversely affected by unforeseen events and the sizeable risks related to such development of new technologies, which could materially adversely affect our business, results of operations and prospects. See Item 3. Key Information Risk Factors Risks Related to Our Operations Our research and development efforts are increasingly expensive and dependent on alliances, and our business, results of operations and prospects could be materially adversely affected by the failure or termination of such alliances in developing new process technologies in line with market requirements .

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Our 200-mm central R&D facility in Agrate (Italy) (R2) is focused on the development of new generation Flash memories from which other non-volatile memory products are derived: EEPROM, EPROM/ OTP, Smart Cards and memory embedded ASIC. We are currently developing new products for both NOR and NAND in advanced technologies, with a strong focus on 2bit per cell.

The Agrate R2 activity encompasses prototyping, pilot and volume production of the newly developed technologies with the objective to accelerate process industrialization and time to market.

Our center in Phoenix works on technologies for digital integrated circuits. These are also areas of great strategic importance and the advances made in recent years have placed us among the world leaders in logic technology. In addition, our contacts with universities, such as the University of California at Berkeley and Carnegie Mellon in the United States, have made innovative product development possible.

Our intellectual property design center in Noida, India supports all of our major design activities worldwide and hosts a major central R&D activity focused on software and core libraries development, with a strong emphasis on system solutions. Our corporate technology R&D teams work in a wide variety of areas that offer opportunities to harness our deep understanding of microelectronics and our ability to synthesize knowledge from around the world. These include:

Soft Computing, in which a variety of problem-solving techniques such as fuzzy logic, neural networks and genetic algorithms are applied to situations where the knowledge is inexact or the computational resources required to obtain a complete solution would be excessive using traditional computing architectures. Potential applications include more effective automotive engine control, emerging fuel cell technology and future quantum computing techniques that will offer much greater computational speeds than are currently achievable;

Nano-Organics, which encompasses a variety of emerging technologies that deal with structures smaller than the deep sub-micron scale containing as little as a few hundred or thousand atoms. Examples include carbon nanotubes, which have potential applications in displays and memories, and all applications that involve electronic properties of large molecules such as proteins; and

Micro-Machining, in which the ability to precisely control the mechanical attributes of silicon structures is exploited. There are many potential applications, including highly sensitive pressure and acceleration sensors, miniature microphones, microfluidic devices and optical devices. In addition, along with its optical properties, the mechanical properties of silicon represent one of the most important links between conventional SoC technology and all the emerging technologies such as bioelectronics that can benefit our semiconductor expertise.

The fundamental mission of our Advanced System Technology (AST) organization is to create system knowledge that supports our system-on-chip (SoC) development. AST s objective is to develop the advanced architectures that will drive key strategic applications, including digital consumer, wireless communications, computer peripherals and smart cards, as well as the broad range of emerging automotive applications such as car multimedia. The group has played a key role in establishing our pre-eminence in mobility, connectivity, multimedia, storage and security, the core competences required to drive today s convergence markets.

AST s challenge is to combine the expertise and expectations of our customers, industrial and academic partners, our central R&D teams and product segments to create a cohesive, practical vision that defines the hardware, software and system integration knowledge that we will need in the next three to five years and the strategies required to master them.

In addition, AST includes a team dedicated to longer term system research, which works in synergy with university research teams, allowing a continuous flow of ideas from top class research centers. AST has eight large laboratories around the world, plus a number of smaller locations located near universities and research partners. Its major laboratories are located in: Agrate Brianza; Catania; Castelletto; Geneva; Grenoble; Lecce; Noida; Portland, Oregon; Rousset; and San Diego, California.

We also have divisional R&D centers such as those in Castelletto, Catania and Tours that carry out more specialized work that benefits from their close relationship to their markets. For example, Castelletto pioneered the

BCD process that created the world smart-power market and has developed advanced MEMS (Micro-Electronic-Mechanical Systems) technologies used to build products such as inkjet printheads, accelerometers and the world s first single chip for DNA amplification and detection.

The Application Specific Discretes (ASD) technology developed at Tours has allowed ST to bring to the market numerous products that can handle high bi-directional currents, sustain high voltages or integrate various

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discrete elements in a single chip, like the Integrated Passive and Active Devices (IPADs). ASD technology has proved increasingly successful in a variety of telecom, computer and industrial applications: ESD protection and AC switching are key areas together with RF filter devices.

The Catania facility hosts a wide range of R&D activities and its major divisional R&D achievements in recent years include the development of our revolutionary PowerMESHTM and STripFET TM MOSFET families.

Our other specialized divisional R&D centers are located in Grenoble (packaging R&D, IP center), and Rousset (smart card and microcontroller development), in addition to a host of centers focusing on providing a complete system approach in digital consumer applications, such as TVs, DVD players, set-top boxes and cameras. These centers are located in various locations including: Beijing; Bristol; Carrollton, Texas; Edinburgh; Grenoble; Noida; Rousset; and Singapore. For Smart card SoC, we have centers in Prague and Shanghai.

All of these worldwide activities create new ideas and innovations that enrich our portfolio of intellectual property and enhance our ability to provide our customers with winning solutions.

Furthermore, an array of important strategic customer alliances ensures that our R&D activities closely track the changing needs of the industry, while a network of partnerships with universities and research institutes around the world ensures that we have access to leading-edge knowledge from all corners of the world. We also play leadership roles in numerous projects running under the European Union s IST (Information Society Technologies) programs. We actively participate in these programs and continue collaborative R&D efforts within the MEDEA+ research program.

Finally, we believe that platforms are the answer to the growing need for full system integration, as customers require from their silicon suppliers not just chips, but an optimized combination of hardware and software. More than 1,500 engineers and designers are currently developing the five platforms we selected to spearhead our future growth in some of the fastest developing markets of the microelectronics industry. The five platforms include:

- Two in the area of consumer: set-top boxes, ranging from digital terrestrial, to cable, and satellite to Internet Protocol based devices, and Integrated Digital TV, which will include the expected promising new wave of High-Definition sets;

- One in the area of computer peripherals: the SPEAr family of re-configurable SoC ICs for printers and related applications; and

- Two in the area of wireless: Application Processors, namely our Nomadik platform that is bringing multimedia to the next-generation mobile devices and Wireless Infrastructure for 3-G base-stations.

Property, Plants and Equipment

We currently operate 16 (as per table below) main manufacturing sites around the world. The table below sets forth certain information with respect to our current manufacturing facilities, products and technologies. Front-end manufacturing facilities are wafer fabrication plants, known as fabs, and back-end facilities are assembly, packaging and final testing plants.

Location	Products	Technologies
Front-end facilities		
Crolles1, France	Application specific products	Fab: 200-mm CMOS and BiCMOS, research and development on VLSI sub-micron technologies
Crolles2, France(1)	Dedicated products and leading edge logic products	Fab: 300-mm research and development on deep sub-micron (90-nm and below) CMOS and system-on-chip (SoC) technology development
Phoenix, Arizona		

Dedicated products and microcontrollers	Fab: 200-mm CMOS, BiCMOS, BCD

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Location	Products	Technologies
Agrate, Italy	Nonvolatile memories, microcontrollers and dedicated products	Fab 1: 150-mm BCD, nonvolatile memories, MEMS. (converting to 200-mm) Fab 2: 200-mm Flash, embedded Flash, research and development on nonvolatile memories and BCD technologies
Rousset, France	Microcontrollers, nonvolatile memories and Smart card ICs and dedicated products	Fab 1: 150-mm CMOS, Smart card (phase-out planned in 2006) Fab 2: 200-mm CMOS, Smart card, embedded Flash
Catania, Italy	Power transistors, Smart Power ICs and nonvolatile memories	Fabs 1/2: 150-mm Power metal-on silicon oxide semiconductor process technology (MOS), VIPpower, MO-3 and Pilot Line RF Fab 3: 200-mm Flash, Smart card, EEPROM 300-mm building constructed but not fully facilitized and equipped.
Castelletto, Italy	Smart power BCD	Fab: 150-mm BCD and MEMS pilot line (closure planned for the end of Q2 2006)
Tours, France	Protection thyristors, diodes and application-specific discrete-power transistors	Fab: 125-mm,150-mm and 200-mm pilot line discrete
Ang Mo Kio, Singapore	Dedicated products, microcontrollers, power transistors, commodity products, nonvolatile memories, and dedicated products	Fab 1: 125-mm, power MOS, bipolar transistor, bipolar ICs, standard linear Fab 2: 150-mm bipolar, power MOS and BCD, EEPROM, Smart card, Micros Fab 3: 200-mm BiCMOS, Flash Memories
Carrollton, Texas	Memories and Application specific products	Fab: 150-mm BiCMOS, BCD and CMOS
Back-end facilities		
Muar, Malaysia	Dedicated and standard products, microcontrollers	
Kirkop, Malta	Application specific products	
Toa Payoh, Singapore	Nonvolatile memories and power ICs	
Ain Sebaa, Morocco	Discrete and standard products	
Bouskoura, Morocco	Nonvolatile memories, discrete and standard products, micromodules, RF and subsystems	
Shenzhen, China(2)	Nonvolatile memories, discrete and standard products	

(1) Operated jointly with Philips and Freescale.

(2) Jointly operated with SHIC, a subsidiary of Shenzhen Electronics Group.

As of December 31, 2005, we had a total of approximately 610,000 square meters of front-end facilities, comprised of approximately 370,000 square meters in Europe, approximately 90,000 square meters in the United States and approximately 150,000 square meters in Asia (these numbers exclude Crolles2 and M6). We also had a total of approximately 240,000 square meters of back-end facilities.

At the end of 2005, our front-end facilities had total capacity of approximately 230,000 150-mm equivalent wafer starts per week. The number of wafer starts per week varies from facility to facility and from period to period as a result of changes in product mix. We have six 200-mm wafer production facilities currently in operation. Of these, four (at Crolles, France; Agrate, Italy; Catania, Italy; and Phoenix, Arizona) have full design capacity installed as of December 31, 2005; as of the same date, fabs (in Rousset, France and in Singapore) have approximately two-thirds of the ultimate capacity installed.

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We, along with our partners Philips and Freescale, began volume production in our advanced 300-mm wafer pilot-line fabrication facility in Crolles, France in the first half of 2004. By the end of 2005, the pilot line, initially designed to produce up to 1,000 wafers per week, produced approximately 1,500 wafers per week.

The building shell for our future 300-mm wafer volume manufacturing fabrication facility in Catania, Italy is completed and in 2005 the first phase of facilitization was also completed. Because of the location of this facility in southern Italy (Catania, Sicily), we face the risk that an earthquake could damage this facility. Any disruption in our product development capability or our manufacturing capability arising from earthquakes could cause significant delays in the production or shipment of our products until we are able to shift development or production to different facilities or arrange for third parties to manufacture our products. Such risks, like other risks, may not be fully or adequately covered under our corporate insurance policies. See Item 8. Financial Information Risk Management and Insurance .

We own all of our manufacturing facilities, except Crolles2, France, which is the subject of a capital lease.

We have historically subcontracted approximately up to 20% of total volumes for back-end operations to external suppliers. In periods of high demand, we intend to outsource up to 20% of our front-end production requirements to external foundries, reducing outsourcing as needed to meet market conditions, when, due to reduced customer demand, the average level of front-end subcontracting was significantly lower.

During the most recent downturns in the industry, we limited our capital investment, allocating it to strategic projects such as the evolution of the production capability to lower geometries in the 200-mm facilities; the development of advanced manufacturing processes (90-nm and 65-nm); the improvement in the quality of our operations; the ramp-up of the new 200-mm production facility in Singapore; the continuation of the two 300-mm projects (Crolles, France, for pilot-line; Catania, Italy, for volume manufacturing); the ramp-up to volume manufacturing of the new Bouskoura, Morocco back-end facility; and the completion of the extension of the back-end Shenzhen, China facility. We have also increased overall installed front-end capacity.

As of December 31, 2005, we had $576 million in outstanding commitments for purchases of equipment for delivery in 2006. The most significant of our 2006 capital expenditure projects are expected to be (i) the expansion of the 300-mm front-end joint project with Philips and Freescale in Crolles2, France, (ii) the preliminary equipment installation in our 300-mm front-end plant in Catania (Italy), (iii) the upgrading to finer geometries of our 200-mm fab in Rousset (France), (iv) the upgrading of our 200-mm facility in Ang Mo Kio (Singapore), (v) the upgrading of our 200-mm front-end facility and pilot line in Agrate (Italy) and (vi) the capacity expansion of our back-end plants in Shenzhen (China), Muar (Malaysia), and Bouskoura (Morocco). We will continue to monitor our level of capital spending, however, taking into consideration factors such as trends in the semiconductor industry, capacity utilization and announced additions. We plan 2006 capital expenditures to be approximately $1.8 billion, although we have the flexibility to modulate our investments to changes in market conditions. The major part of this amount will be allocated to leading-edge technologies and research and development programs.

Although each fabrication plant is dedicated to specific processes, our strategy is to develop local presence to better serve customers and mitigate manufacturing risks by having key processes operated in different manufacturing plants. In certain countries, we have been granted tax incentives by local authorities in line with local regulations, being recognized as an important contributor to the economies where our plants are located. In periods of industry capacity limitations we have sought to minimize our capital expenditure needs, by purchasing from subcontractors both wafer foundry and back-end services. In difficult market conditions, we may face overcapacity issues, particularly in our older fabrication facilities that use mature process technologies. Like other semiconductor manufacturers, we could have mature fabrication facility capacity being only partially used, which may affect our cost of operations. Such overcapacity has led us, in recent years, to close manufacturing facilities using more mature process technologies and restructure our 150-mm manufacturing. In 2002, we completed the closure of our 150-mm wafer manufacturing facility in Rancho Bernardo, California. Pursuant to such closure in 2002, we recorded impairment, restructuring charges and related closure costs of $34 million. In 2003, we recorded impairment, restructuring charges and other related closure costs of $205 million pursuant to a plan announced in October 2003 to increase our cost competitiveness by restructuring our 150-mm fab operations and part of our back-end operations. In 2004, our 150-mm wafer manufacturing facility in Rennes, France and our back-end facility in Tuas, Singapore were

closed pursuant to this restructuring initiative and the total amount of impairment, restructuring charges and other related closure pre-tax costs amounted to $76 million. In 2005, the amount of impairment, restructuring charges and other related closure pre-tax costs amounted to $128 million. See Item 5. Operating and Financial Review and Prospects and Note 18 to the Consolidated Financial Statements.

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Through the period ended December 31, 2005, we have incurred $294 million of the announced approximate $350 million in pre-tax charges associated with the restructuring plan that was defined on October 22, 2003, and which is now expected to be substantially completed in the second half of 2006.

Our manufacturing processes are highly complex, require advanced and costly equipment and are continuously being modified in an effort to improve yields and product performance. Impurities or other difficulties in the manufacturing process can lower yields, interrupt production or result in losses of products in process. As system complexity has increased and sub-micron technology has become more advanced, manufacturing tolerances have been reduced and requirements for precision and excellence have become even more demanding. Although our increased manufacturing efficiency has been an important factor in our improved results of operations, we have from time to time experienced production difficulties that have caused delivery delays and quality control problems, as is common in the semiconductor industry.

No assurance can be given that we will be able to increase manufacturing efficiency in the future to the same extent as in the past or that we will not experience production difficulties in the future.

As is common in the semiconductor industry, we have from time to time experienced difficulty in ramping up production at new facilities or effecting transitions to new manufacturing processes and, consequently, have suffered delays in product deliveries or reduced yields. There can be no assurance that we will not experience manufacturing problems in achieving acceptable yields, product delivery delays or interruptions in production in the future as a result of, among other things, capacity constraints, production bottlenecks, construction delays, equipment failure or maintenance, ramping up production at new facilities, upgrading or expanding existing facilities, changing our process technologies, or contamination or fires, storms, earthquakes or other acts of nature, any of which could result in a loss of future revenues. In addition, the development of larger fabrication facilities that require state-of-the-art sub-micron technology and larger-sized wafers has increased the potential for losses associated with production difficulties, imperfections or other causes of defects. In the event of an incident leading to an interruption of production at a fab, we may not be able to shift production to other facilities on a timely basis, or our customers may decide to purchase products from other suppliers, and, in either case, the loss of revenues and the impact on our relationship with our customers could be significant. Our operating results could also be adversely affected by the increase in our fixed costs and operating expenses related to increases in production capacity if revenues do not increase commensurately. Finally, in periods of high demand, we increase our reliance on external contractors for foundry and back-end service. Any failure to perform by such subcontractors could impact our relationship with our customers and could materially affect our results of operations.

Intellectual Property

Intellectual property rights that apply to our various products include patents, copyrights, trade secrets, trademarks and mask work rights. A mask work is the two or three-dimensional layout of an integrated circuit. We own more than 19,000 patents or pending patent applications which have been registered in several countries around the world and correspond to more than 8,000 patent families (each patent family containing all patents originating from the same invention). We filed 720 new patent applications around the world in 2005.

Our success depends in part on our ability to obtain patents, licenses and other intellectual property rights covering our products and their design and manufacturing processes. To that end, we intend to continue to seek patents on our circuit designs, manufacturing processes, packaging technology and other inventions. The process of seeking patent protection can be long and expensive, and there can be no assurance that patents will issue from currently pending or future applications or that, if patents are issued, they will be of sufficient scope or strength to provide meaningful protection or any commercial advantage to us. In addition, effective copyright and trade secret protection may be unavailable or limited in certain countries. Competitors may also develop technologies that are protected by patents and other intellectual property rights and therefore such technologies may be unavailable to us or available to us subject to adverse terms and conditions. Management believes that our intellectual property represents valuable property and intends to protect our investment in technology by enforcing all of our intellectual property rights. We have used our patent portfolio to enter into several broad patent cross-licenses with several major semiconductor companies enabling us to design, manufacture and sell semiconductor products without fear of infringing patents held by such companies, and intend to continue to use our patent portfolio to enter into such patent cross-licensing

agreements with industry participants on favorable terms and conditions. As our sales increase compared to those of our competitors, the strength of our patent portfolio may not be sufficient to guarantee the conclusion or renewal of broad patent cross-licenses on terms which do not affect our results of operations. Furthermore, as a result of litigation, or to address our business needs, we may be required to take a license to third-party intellectual property rights upon economically

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unfavorable terms and conditions, and possibly pay damages for prior use, and/or face an injunction, all of which could have a material adverse effect on our results of operations and ability to compete.

From time to time, we are involved in intellectual property litigation and infringement claims. See Item 8. Financial Information Legal Proceedings . In the event a third-party intellectual property claim were to prevail, our operations may be interrupted and we may incur costs and damages, which could have a material adverse effect on our results of operations, cash flow and financial condition.

Finally, we have received from time to time, and may in the future receive communications alleging infringement of certain patents and other intellectual property rights of others, which has been and may in the future be followed by litigation. Regardless of the validity or the successful assertion of such claims, we may incur significant costs with respect to the defense thereof, which could have a material adverse effect on our results of operations, cash flow or financial condition. See Item 3. Key Information Risk Factors Risks Related to Our Operations We depend on patents to protect our rights to our technology .

Backlog

Our sales are made primarily pursuant to standard purchase orders that are generally booked from one to twelve months in advance of delivery. Quantities actually purchased by customers, as well as prices, are subject to variations between booking and delivery and, in some cases, to cancellation due to changes in customer needs or industry conditions. During periods of economic slowdown and/or industry overcapacity and/or declining selling prices, customer orders are not generally made far in advance of the scheduled shipment date. Such reduced lead time can reduce management s ability to forecast production levels and revenues. When the economy rebounds, our customers may strongly increase their demands, which can result in capacity constraints due to our inability to match manufacturing capacity with such demand.

In addition, our sales are affected by seasonality, with the first quarter generally showing lowest revenue levels in the year, and the fourth quarter generating the highest amount of revenues due to electronic products purchased from many of our targeted market segments during the holiday period.

We also sell certain products to key customers pursuant to frame contracts. Frame contracts are annual contracts with customers setting forth quantities and prices on specific products that may be ordered in the future. These contracts allow us to schedule production capacity in advance and allow customers to manage their inventory levels consistent with just-in-time principles while shortening the cycle times required to produce ordered products. Orders under frame contracts are also subject to a high degree of volatility, because they reflect expected market conditions which may or may not materialize. Thus, they are subject to risks of price reduction, order cancellation and modifications as to quantities actually ordered resulting in inventory build-ups.

Furthermore, developing industry trends, including customers use of outsourcing and their deployment of new and revised supply chain models, may reduce our ability to forecast changes in customer demand and may increase our financial requirements in terms of capital expenditures and inventory levels.

Our backlog (defined here to include frame orders) decreased significantly in 2001 from the levels of 2000, reflecting the most severe downturn in the semiconductor industry. Starting in 2002 we steadily registered an increase in the backlog compared to 2001, which continued in 2003 compared to 2002. We entered 2004 with a backlog approximately 30% higher than we had entering 2003. Following the industry-wide over-inventory situation and the declining level of order booking in the second half of 2004, we entered 2005 with an order backlog that was approximately 9% lower than we had entering 2004. During 2005, our backlog registered a solid increase and we are entering 2006 with an order backlog that is significantly higher than what we had entering 2005.

Competition

Markets for our products are intensely competitive. While only a few companies compete with us in all of our product lines, we face significant competition in each of our product lines. We compete with major international semiconductor companies, some of which may have substantially greater financial and other more focused resources than we do with which to pursue engineering, manufacturing, marketing and distribution of their products. Smaller niche companies are also increasing their participation in the semiconductor market, and semiconductor foundry companies have expanded significantly, particularly in Asia. Competitors include manufacturers of standard semiconductors, ASICs and fully customized ICs, including both chip and board-level products, as well as customers

who develop their own IC products and foundry operations. Some of our competitors are also our customers.

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The primary international semiconductor companies that compete with us include Advanced Micro Devices, Agere Systems, Analog Devices, Broadcom, IBM, Infineon Technologies, Intel, International Rectifier, Freescale Semiconductor, Marvell Technology Group, National Semiconductor, Nippon Electric Company, ON Semiconductor, Philips Semiconductors, Qualcomm, Renesas, Samsung, Spansion, Texas Instruments and Toshiba.

We compete in different product lines to various degrees on the basis of price, technical performance, product features, product system compatibility, customized design, availability, quality and sales and technical support. In particular, standard products may involve greater risk of competitive pricing, inventory imbalances and severe market fluctuations than differentiated products. Our ability to compete successfully depends on elements both within and outside of our control, including successful and timely development of new products and manufacturing processes, product performance and quality, manufacturing yields and product availability, customer service, pricing, industry trends and general economic trends.

Organizational Structure and History

We are a multinational group of companies that designs, develops, manufactures and markets a broad range of products used in a wide variety of microelectronic applications, including telecommunications systems, computer systems, consumer goods, automotive products and industrial automation and control systems. We are organized in a matrix structure with geographical regions interacting with product divisions, both being supported by central functions, bringing all levels of management closer to the customer and facilitating communication among research and development, production, marketing and sales organizations.

While STMicroelectronics N.V. is the parent company, we also conduct our operations through our consolidated subsidiaries. Except for our subsidiaries in Shenzhen, China, in which we own 60% of the shares and voting rights, Accent S.r.L. (Italy), in which we own 51% of the shares and voting rights, Hynix, ST (China) joint venture company, in which we own a 33% equity participation, Shanghai Blue Media Co. Ltd (China), in which we own 65%, and Incard do Brazil, in which we own 50% of the shares and voting rights, STMicroelectronics N.V. owns directly or indirectly 100% of all of our significant operating subsidiaries shares and voting rights, which have their own organization and management bodies, and are operated independently in compliance with the laws of their country of incorporation. We provide certain administrative, human resources, legal, treasury, strategy, manufacturing, marketing and other overhead services to our consolidated subsidiaries pursuant to service agreements for which we receive compensation.

The simplified organigram below shows the principal industrial subsidiaries of ST:

Public Funding

We participate in certain programs established by the EU, individual countries and local authorities in Europe (principally France and Italy). Such funding is generally provided to encourage research and development activities, industrialization and the economic development of underdeveloped regions. These programs are characterized by direct partial support to research and development expenses or capital investment or by low-interest financing.

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Public funding in France, Italy and Europe generally is open to all companies, regardless of their ownership or country of incorporation, for research and development and for capital investment and low-interest-financing related to incentive programs for the economic development of under-developed regions. The EU has developed model contracts for research and development funding that require beneficiaries to disclose the results to third parties on reasonable terms. As disclosed, the conditions for receipt of government funding may include eligibility restrictions, approval by EU authorities, annual budget appropriations, compliance with European Commission regulations, as well as specifications regarding objectives and results.

In the research and development context, some of our government funding contracts involving advance payments requires us to justify our expenses after receipt of funds. Certain specific contracts (Crolles2, Rousset, France and Catania, Italy) contain obligations to maintain a minimum level of employment and investment during a certain amount of time. There could be penalties (partial refund) if these objectives are not fulfilled. Other contracts contain penalties for late deliveries or for breach of contract, which may result in repayment obligations. However, the obligation to repay such funding is never automatic.

The main programs for research and development in which we are involved include: (i) the Micro-Electronics Development for European Application (MEDEA+) cooperative research and development program; (ii) EU research and development projects with FP6 (Sixth Frame Program) for Information Technology; and (iii) national or regional programs for research and development and for industrialization in the electronics industries involving many companies and laboratories. The pan-European programs cover a period of several years, while national programs in France and Italy are subject mostly to annual budget appropriation.

The MEDEA+ cooperative research and development program was launched in June 2000 by the Eureka Conference and is designed to bring together many of Europe s top researchers in a 12,000 man-year program that covers the period 2000-2008. The MEDEA+ program replaced the joint European research program called MEDEA, which was a European cooperative project in microelectronics among several countries that covered the period 1996 through 2000 and involved more than 80 companies. In Italy, there are some national funding programs established to support the FIRB (*Fondo per gli Investimenti della Ricerca di Base*, aimed to fund fundamental research), the FAR (*Fondo per le Agevolazioni alla Ricerca*, to fund industrial research), and the FIT (*Fondo per l Innovazione Tecnologica,* to fund precompetitive development). These programs are not limited to microelectronics. Italian programs often cover several years, but funding from each of FIRB, FAR and FIT is subject to annual budget appropriations. During 2004, the FAR and FIT suspended funding of new projects, including the MEDEA+ projects whose Italian activities are subject to FAR rules and availability. In September 2005, however, the Italian Government began considering funding new projects, and in doing so called for limited Strategic programmes on areas selected by the Government. One of these areas was semiconductors where we have submitted several proposals, which are presently under review. Furthermore, there are some regional funding tools that can be addressed by local initiatives, primarily the regions Puglia and Val D Aosta, provided that a reasonable regional socio-economic impact could be recognized in terms of industrial exploitation, new professional hiring and/or cooperation with local academia and public laboratories.

In France, support for microelectronics is provided to over 30 companies manufacturing or using semiconductors. The amount of support under French programs is decided annually and subject to budget appropriation.

In accordance with SEC Statement Accounting Bulletin No. 104 *Revenue Recognition* (SAB 104) and our revenue recognition policy, funding related to these contracts is booked when the conditions required by the contracts are met. Our funding programs are classified in three general categories for accounting purposes: funding for research and development activities, funding for research and development capital investments, and loans.

Funding for research and development activities is the most common form of funding that we receive. Public funding for research and development is recorded as Other Income and Expenses, net in our consolidated statements of income. Public funding for research and development is booked pro rata in relation to the relevant cost once the agreement with the applicable government agency has been signed and as any applicable conditions are met. See Note 17 to our Consolidated Financial Statements. Such funding has totaled $76 million, $84 million and $76 million in the years 2005, 2004 and 2003, respectively.

Government support for capital expenditures funding has totaled $38 million, $46 million and $62 million in the years 2005, 2004 and 2003, respectively. Such funding has been used to support our capital investment. Although receipt of these funds is not directly reflected in our results of operations, the resulting lower amounts recorded in property, plant and equipment costs reduce the level of depreciation recognized by us. Public funding reduced depreciation charges by $66 million, $74 million and $80 million in 2005, 2004 and 2003, respectively.

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As a third category of government funding, the Company receives some loans, mainly related to large capital investment projects, at preferential interest rates. The Company recognizes these loans as debt on its balance sheet in accordance with paragraph 35 of Statements of Financial Accounting Concepts No. 6, *Elements of Financial Statements* (CON 6). Low interest financing has been made available (principally in Italy) under programs such as the Italian Republic s Fund for Applied Research, established in 1988 for the purpose of supporting Italian research projects meeting specified program criteria. At year-end 2005, 2004 and 2003, we had $120 million, $156 million and $84 million, respectively, of indebtedness outstanding under state-assisted financing programs at an average interest cost of 1.0%, 1.0% and 1.1%, respectively.

Funding of programs in France and Italy is subject to annual appropriation, and if such governments or local authorities were unable to provide anticipated funding on a timely basis or if existing government- or local authority-funded programs were curtailed or discontinued, or if we were unable to fulfill our eligibility requirements, such an occurrence could have a material adverse effect on our business, operating results and financial condition. Furthermore, we may need to rely on public funding as we transition to 300-mm manufacturing technology. We are dependent on public funding for equipping the 300-mm wafers production facility in Catania (Italy). If such planned funding does not materialize, we may lack financial resources to continue with our investment plan for this facility, which in turn could lead us to discontinue our investment in such facility and consequentially incur significant impairments. From time to time, we have experienced delays in the receipt of funding under these programs. As the availability and timing of such funding are substantially outside our control, there can be no assurance that we will continue to benefit from such government support, that funding will not be delayed from time to time, that sufficient alternative funding would be available if necessary or that any such alternative funding would be provided on terms as favorable to us as those previously committed.

Due to changes in legislation and/or review by the competent administrative or judicial bodies, there can be no assurance that government funding granted to us may not be revoked or challenged or discontinued in whole or in part, by any competent state or European authority, until the legal time period for challenging or revoking such funding has fully lapsed. See Item 3. Key Information Risk Factors Risks Related to Our Operations Reduction in the amount of state funding available to us or demands for repayment may increase our costs and impact our results of operations .

Suppliers

We use three main critical types of suppliers in our business: equipment suppliers, raw material suppliers and external subcontractors.

In the front-end process, we use steppers, scanners, track equipment, strippers, chemo-mechanical polishing equipment, cleaners, inspection equipment, etchers, physical and chemical vapor-deposition equipment, implanters, furnaces, testers, probers and other specialized equipment. The manufacturing tools that we use in the back-end process include bonders, burn-in ovens, testers and other specialized equipment. The quality and technology of equipment used in the IC manufacturing process defines the limits of our technology. Demand for increasingly smaller chip structures means that semiconductor producers must quickly incorporate the latest advances in process technology to remain competitive. Advances in process technology cannot be brought about without commensurate advances in equipment technology, and equipment costs tend to increase as the equipment becomes more sophisticated.

Our manufacturing processes use many raw materials, including silicon wafers, lead frame, mold compound, ceramic packages and chemicals and gases. The prices of many of these raw materials are volatile. We obtain our raw materials and supplies from diverse sources on a just-in-time basis. Although supplies for the raw materials used by us are currently adequate, shortages could occur in various essential materials due to interruption of supply or increased demand in the industry. See Item 3. Key Information Risk Factors Risks Related to Our Operations Because we depend on a limited number of suppliers for raw materials and certain equipment, we may experience supply disruptions if suppliers interrupt supply or increase prices .

Finally, we also use external subcontractors to outsource wafer manufacturing and assembly and testing of finished products. See Property, Plants and Equipment above. We also have an agreement with Hynix for the co-development and manufacturing of NAND products pursuant to which Hynix from Korea is supplying the

co-developed NAND products to us, in part using equipment that we have provided on consignment for capacity dedicated to us. We have also set up a joint venture in China to build a memory manufacturing facility in Wuxi City, China.

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Environmental Matters

Our manufacturing operations use many chemicals, gases and other hazardous substances, and we are subject to a variety of evolving environmental and health and safety regulations related, among other things, to the use, storage, discharge and disposal of such chemicals and gases and other hazardous substances, emissions and wastes, as well as the investigation and remediation of soil and ground water contamination. In most jurisdictions in which we operate, our manufacturing activities are subject to obtaining permits, licences or other authorizations, or to prior notification. Because a large portion of our manufacturing activities are located in the EU, we are subject to European Commission regulation on environmental protection, as well as regulations of the other jurisdictions where we have operations.

Consistent with our Total Quality Environmental Management (TQEM) principles, we have established proactive environmental policies with respect to the handling of chemicals, gases, emissions and waste disposals from our manufacturing operations, and we have not suffered material environmental claims in the past. We believe that our activities comply with presently applicable environmental regulations in all material respects. We have engaged outside consultants to audit all of our environmental activities and created environmental management teams, information systems and training. We have also instituted environmental control procedures for new processes used by us as well as our suppliers. All of our 16 manufacturing facilities have been certified to conform to International Organization for Standardization (ISO) international quality standards and Eco Management and Audit Scheme (EMAS).

We have participated in various working groups set up by the European Commission for the adoption of two directives on January 27, 2003: Directive 2002/95/ EC on the restriction of the use of certain hazardous substances in electrical and electronic equipment (ROHS Directive, as amended by Commission Decision 2005/618/ EC of August 18, 2005) and Directive 2002/96/ EC on waste electrical and electronic equipment (WEEE Directive, as modified by Directive 2003/108/ EC of December 8, 2003). Directive 2002/95/ EC aims at banning the use of lead and other flame-retardant substances in manufacturing electronic components by July 1, 2006. Directive 2002/96/ EC promotes the recovery and recycling of electrical and electronic waste. Both directives had to be transposed by the EU Member States into national legislation by August 13, 2004. In France, a decree partially implementing the Directives 2002/95/ EC and 2002/96/ EC was adopted on July 27, 2005.

Our activities in the EU are also subject to the European Directive 2003/87/ EC establishing a scheme for greenhouse gas allowance trading (as modified by Directive 2004/101/ EC), and the applicable national legislation. In particular, in France, one of our manufacturing sites has been allocated a quota of greenhouse gas for the period 2005-2007. Failure to comply with this quota would force us to acquire potentially expensive additional emission allowance from third parties and to pay a fee for each extra ton of gas emitted. We do not know what our obligations with regard to greenhouse gas reductions will be in the future, in particular for the period 2008-2012 for which the regulations should be adopted before December 31, 2006, but we intend to proactively comply with these regulations. In the United States, we are part of the Chicago Climate Exchange program, a voluntary greenhouse gas trading program whose members commit to reduce emissions for the period 2003-2006. We have also implemented voluntary reforestation projects in several countries in order to sequester additional carbon dioxide (CO_2) emissions.

Furthermore, new legislative proposals by the European Commission deal with the registration, evaluation and authorization of chemicals (REACH), a draft of which has been adopted on first reading by the European Parliament on November 17, 2005. We intend to proactively implement such new legislation when enacted, in line with our commitment toward environmental protection.

The implementation of any such legislation could adversely affect our manufacturing costs or product sales by requiring us to acquire costly equipment or materials, or to incur other significant expenses in adapting our manufacturing processes or waste and emission disposal processes. However, we are currently unable to evaluate such specific expenses and therefore have no specific reserves for environmental risks. Furthermore, environmental claims or our failure to comply with present or future regulations could result in the assessment of damages or imposition of fines against us, suspension of production or a cessation of operations and, as with other companies engaged in similar activities, any failure by us to control the use of, or adequately restrict the discharge of hazardous substances could subject us to future liabilities. See Item 3. Key Information Risk Factors Risks Related to Our Operations Some of our production processes and materials are environmentally sensitive, which could lead to increased costs due to

environmental regulations or to damage to the environment . Any specific liabilities that we identify will be reflected on our balance sheet. To date we have not identified any such specific liabilities.

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Industry Background

The Semiconductor Market

Semiconductors are the basic building blocks used to create an increasing variety of electronic products and systems. Since the invention of the transistor in 1948, continuous improvements in semiconductor process and design technologies have led to smaller, more complex and more reliable devices at a lower cost per function. As performance has increased and size and cost have decreased, semiconductors have expanded beyond their original primary applications (military applications and computer systems) to applications such as telecommunications systems, consumer goods, automotive products and industrial automation and control systems. In addition, system users and designers have demanded systems with more functionality, higher levels of performance, greater reliability and shorter design cycle times, all in smaller packages at lower costs. These demands have resulted in increased semiconductor content as a percentage of system cost. Calculated on the basis of the total available market (the TAM), which includes all semiconductor products, as a percentage of worldwide revenues from production of electronic equipment according to published industry data, semiconductor content has increased from approximately 12% in 1992 to approximately 21% in 2005.

Semiconductor sales have increased significantly over the long term but have experienced significant cyclical variations in growth rates. According to trade association data, the TAM increased from $32.5 billion in 1987 to $227.5 billion in 2005 (growing at a compound annual growth rate of approximately 11%). In 2004, the TAM increased by approximately 28% and in 2005 by approximately 7%. On a sequential, quarter-by-quarter basis in 2005 (including actuators), the TAM was virtually flat in the first quarter over the fourth quarter 2004, while in the second quarter it decreased by 2.2% over the first quarter, it increased 8.9% in the third quarter over the second quarter, and increased by 2.0% in the fourth quarter over the third quarter. To better reflect our corporate strategy and our current product offering, we measure our performance against our serviceable available market (SAM), redefined as the TAM without DRAMs, microprocessors and optoelectronic products. The SAM increased from approximately $27.8 billion in 1987 to $152 billion in 2005, growing at a compound annual rate of approximately 10%. The SAM increased by approximately 7% in 2005 compared to 2004. In 2005, approximately 18% of all semiconductors were shipped to the Americas, 17% to Europe, 19% to Japan, and 46% to the Asia Pacific region.

The following table sets forth information with respect to worldwide semiconductor sales by type of semiconductor and geographic region:

	Worldwide Semiconductor Sales(1)						Compound Annual Growth Rates(2)					
	2005	2004	2003	2002	1997	1987	04-05	03-04	02-03	87-05	87-97	97-02
	(In billions)						(Expressed as percentages)					
Integrated Circuits and Sensors	$ 197.3	$ 183.5	$ 143.5	$ 121.6	$ 119.5	$ 25.4	7.5%	27.9%	18.1%	12.1%	16.8%	0.3%
Analog, Sensors and Actuators	36.5	36.1	30.4	25.0	20.0	6.0	0.9	19.0	21.6	10.5	12.8	4.6
Digital Logic	112.4	100.3	80.7	69.6	70.2	14.0	12.1	24.3	15.9	12.3	17.5	0.2
Memory:												
DRAM	25.6	26.8	16.7	15.3	19.8	2.4	(4.7)	60.9	9.4	14.1	23.5	(5.1)
Others	22.9	20.3	15.8	11.8	9.5	3.0	13.0	28.3	34.2	12.0	12.2	4.4

Total Memory	48.5	47.1	32.5	27.0	29.3	5.4	2.9	45.0	20.2	13.0	18.4	(1.6)
Total Digital	160.9	147.4	113.2	96.6	99.6	19.4	9.1	30.3	17.1	12.5	17.8	(0.6)
Discrete	15.2	15.8	13.3	12.3	13.2	5.8	(3.3)	18.1	8.1	5.5	8.5	0.3
Optoelectronics	14.9	13.7	9.5	6.8	4.5	1.3	8.6	43.8	40.6	14.5	13.2	8.5
TAM	$ 227.5	$ 213.0	$ 166.4	$ 140.7	$ 137.2	$ 32.5	6.8%	28.0%	18.3%(3)	11.4%	15.5%	0.5%
Europe	39.3	39.4	32.3	27.8	29.1	6.2	(0.4)	22.0	16.3	10.8	16.7	(0.9)
Americas	40.7	39.1	32.3	31.3	45.8	10.3	4.3	20.8	3.4	7.9	16.1	(7.4)
Asia Pacific	103.4	88.8	62.8	51.2	30.2	3.3	16.5	41.3	22.8	21.1	24.8	11.1
Japan	44.1	45.8	38.9	30.5	32.1	12.7	(3.7)	17.5	27.7	7.2	9.7	(1.0)
TAM	$ 227.5	$ 213.0	$ 166.4	$ 140.7	$ 137.2	$ 32.5	6.8%	28.0%	18.3%(3)	11.4%	15.5%	0.5%

(1) Source: WSTS.

(2) Calculated using end points of the periods specified.

(3) Calculated on a comparable basis, that is, without information with respect to actuators, which was not included in the indicator before 2003, the TAM increased 16.8%.

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Although cyclical changes in production capacity in the semiconductor industry and demand for electronic systems have resulted in pronounced cyclical changes in the level of semiconductor sales and fluctuations in prices and margins for semiconductor products from time to time, the semiconductor industry has experienced substantial growth over the long term. Factors that are contributing to long-term growth include the development of new semiconductor applications, increased semiconductor content as a percentage of total system cost, emerging strategic partnerships and growth in the electronic systems industry in the Asia Pacific region.

Semiconductor Classifications

The process technologies, levels of integration, design specificity, functional technologies and applications for different semiconductor products vary significantly. As differences in these characteristics have increased, the semiconductor market has become highly diversified as well as subject to constant and rapid change. Semiconductor product markets may be classified according to each of these characteristics.

Semiconductors can be manufactured using different process technologies, each of which is particularly suited to different applications. Since the mid-1970s, the two dominant processes have been bipolar (the original technology used to produce ICs) and CMOS. Bipolar devices typically operate at higher speeds than CMOS devices, but CMOS devices consume less power and permit more transistors to be integrated on a single IC. CMOS has become the prevalent technology, particularly for devices used in personal computers and consumer applications. Advanced technologies have been developed during the last decade that are particularly suited to more systems-oriented semiconductor applications. BiCMOS technologies have been developed to combine the high-speed and high-voltage characteristics of bipolar technologies with the low power consumption and high integration of CMOS technologies. BCD technologies have been developed that combine bipolar, CMOS and DMOS technologies. Such systems-oriented technologies require more process steps and mask levels, and are more complex than the basic function-oriented technologies.

Semiconductors are often classified as either discrete devices (such as individual diodes, thyristors and transistors, as well as optoelectronic products) or ICs (in which thousands of functions are combined on a single chip of silicon to form a more complex circuit). Compared to the market for ICs, there is typically less differentiation among discrete products supplied by different semiconductor manufacturers. Also, discrete markets have generally grown at slower, but more stable, rates than IC markets.

Semiconductors may also be classified as either standard components, ASSPs or ASICs. Standard components are used for a broad range of applications, while ASSPs and ASICs are designed to perform specific functions in specific applications.

The two basic functional technologies for semiconductor products are analog and digital. Mixed-signal products combine both analog and digital functionality. Analog devices monitor, condition, amplify or transform analog signals, which are signals that vary continuously over a wide range of values.

Analog/digital (or mixed-signal) ICs combine analog and digital devices on a single chip to process both analog signals and digital data. System designers are increasingly demanding system-level integration in which complete electronic systems containing both analog and digital functions are integrated on a single IC.

Digital devices are divided into two major types: memory products and logic devices. Memory products, which are used in electronic systems to store data and program instructions, are classified as either volatile memories (which lose their data content when power supplies are switched off) or nonvolatile memories (which retain their data content without the need for constant power supply).

The primary volatile memory devices are DRAMs, which accounted for approximately 53% of semiconductor memory sales in 2005, and static RAMs (SRAMs), which accounted for approximately 11% of semiconductor memory sales in 2005. SRAMs are roughly four times as complex as DRAMs. DRAMs are used in a computer s main memory. SRAMs are principally used as caches and buffers between a computer s microprocessor and its DRAM-based main memory and in other applications such as mobile handsets.

Nonvolatile memories are used to store program instructions. Among such nonvolatile memories, read-only memories (ROMs) are permanently programmed when they are manufactured while programmable ROMs (PROMs) can be programmed by system designers or end-users after they are manufactured. Erasable PROMs (EPROMs) may

be erased after exposure to ultraviolet light and reprogrammed several times using an external power supply. Electrically erasable PROMs (EEPROMs) can be erased byte by byte and reprogrammed in-system without the need for removal.

Flash memories are products that represent an intermediate solution between EPROMs and EEPROMs based on their cost and functionality. Because Flash memories can be erased and reprogrammed electrically and

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in-system, they are more flexible than EPROMs and, therefore, are progressively replacing EPROMs in many of their current applications. Flash memories are typically used in high volume in digital mobile phones and digital consumer applications (set-top boxes, DVDs, digital cameras, MP3 digital music players) and are also suitable for solid-state mass storage of data and emerging high-volume applications.

Logic devices process digital data to control the operation of electronic systems. The largest segment of the logic market includes microprocessors, microcontrollers and DSPs. Microprocessors are the central processing units of computer systems. Microcontrollers are complete computer systems contained on single ICs that are programmed to specific customer requirements. Microcontrollers control the operation of electronic and electromechanical systems by processing input data from electronic sensors and generating electronic control signals and are used in a wide variety of consumer, communications, automotive, industrial and computer products. DSPs are parallel processors used for high complexity, high-speed real-time computations in a wide variety of applications.

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Item 5. Operating and Financial Review and Prospects

Overview

The following discussion should be read in conjunction with our Consolidated Financial Statements and Notes thereto included elsewhere in this Form 20-F. The following discussion contains statements of future expectations and other forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, or Section 21E of the Securities Exchange Act of 1934, each as amended, particularly in the sections Critical Accounting Policies Using Significant Estimates , Business Outlook and Liquidity and Capital Resources Financial Outlook . Our actu results may differ significantly from those projected in the forward-looking statements. For a discussion of factors that might cause future actual results to differ materially from our recent results or those projected in the forward-looking statements in addition to the factors set forth below, see Cautionary Note Regarding Forward-Looking Statements and Item 3. Key Information Risk Factors . We assume no obligation to update the forward-looking statements or such risk factors.

Critical Accounting Policies Using Significant Estimates

The preparation of our Consolidated Financial Statements in accordance with U.S. GAAP requires us to make estimates and assumptions that have a significant impact on the results we report in our Consolidated Financial Statements, which we discuss under the section Results of Operations below. Some of our accounting policies require us to make difficult and subjective judgments that can affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of net revenue and expenses during the reporting period. The primary areas that require significant estimates and judgments by management include, but are not limited to; sales returns and allowances; reserves for price protection to certain distributor customers; allowances for doubtful accounts; inventory reserves and normal manufacturing capacity thresholds to determine costs to be capitalized in inventory; accruals for warranty costs; litigation and claims; valuation of acquired intangibles; goodwill; investments and tangible assets as well as the impairment of their related carrying values; restructuring charges; assumptions used in calculating pension obligations and share-based compensation; assessment of hedge effectiveness of derivative instruments; deferred income tax assets, including required valuation allowances and liabilities; and provisions for specifically identified income tax exposures. We base our estimates and assumptions on historical experience and on various other factors such as market trends and business plans that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. While we regularly evaluate our estimates and assumptions, our actual results may differ materially and adversely from our estimates. To the extent there are material differences between the actual results and these estimates, our future results of operations could be significantly affected.

We believe the following critical accounting policies require us to make significant judgments and estimates in the preparation of our Consolidated Financial Statements.

Revenue recognition. Our policy is to recognize revenues from sales of products to our customers when all of the following conditions have been met: (a) persuasive evidence of an arrangement exists; (b) delivery has occurred; (c) the selling price is fixed or determinable; and (d) collectibility is reasonably assured. This usually occurs at the time of shipment.

Consistent with standard business practice in the semiconductor industry, price protection is granted to distribution customers on their existing inventory of our products to compensate them for declines in market prices. The ultimate decision to authorize a distributor refund remains fully within our control. We accrue a provision for price protection based on a rolling historical price trend computed on a monthly basis as a percentage of gross distributor sales. This historical price trend represents differences in recent months between the invoiced price and the final price to the distributor, adjusted if required, to accommodate a significant move in the current market price. The short outstanding inventory time period, visibility into the standard inventory product pricing (as opposed to certain customized products) and long distributor pricing history have enabled us to reliably estimate price protection provisions at period-end. We record the accrued amounts as a deduction of revenue at the time of the sale. If market conditions differ from our assumptions, this could have an impact on future periods; in particular, if market conditions were to deteriorate, net revenues could be reduced due to

higher product returns and price reductions at the time these adjustments occur.

Our customers occasionally return our products from time to time for technical reasons. Our standard terms and conditions of sale provide that if we determine that products are non-conforming, we will repair or replace the non-conforming products, or issue a credit or rebate of the purchase price. Quality returns

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are not related to any technological obsolescence issues and are identified shortly after sale in customer quality control testing. Quality returns are always associated with end-user customers, not with distribution channels. We provide for such returns when they are considered as probable and can be reasonably estimated. We record the accrued amounts as a reduction of revenue.

Our insurance policies relating to product liability only cover physical and other direct damages caused by defective products. We do not carry insurance against immaterial, non-consequential damages. We record a provision for warranty costs as a charge against cost of sales based on historical trends of warranty costs incurred as a percentage of sales which we have determined to be a reasonable estimate of the probable losses to be incurred for warranty claims in a period. Any potential warranty claims are subject to our determination that we are at fault and liable for damages, and such claims usually must be submitted within a short period following the date of sale. This warranty is given in lieu of all other warranties, conditions or terms expressed or implied by statute or common law. Our contractual terms and conditions limit our liability to the sales value of the products, which gave rise to the claims.

We maintain an allowance for doubtful accounts for potential estimated losses resulting from our customers inability to make required payments. We base our estimates on historical collection trends and record a provision accordingly. Furthermore, we are required to evaluate our customers credit ratings from time to time and take an additional provision for any specific account that we estimate as doubtful. In 2005, we recorded specific provisions of $7 million related to bankrupt customers, in addition to our standard provision of 1% of total receivables based on the estimated historical collection trends. Although we have determined that our most significant customers are creditworthy, if the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances could be required.

Goodwill and purchased intangible assets. The purchase method of accounting for acquisitions requires extensive use of estimates and judgments to allocate the purchase price to the fair value of the net tangible and intangible assets acquired, including in-process research and development, which is expensed immediately. Goodwill and intangible assets deemed to have indefinite lives are not amortized but are instead subject to annual impairment tests. The amounts and useful lives assigned to other intangible assets impact future amortization. If the assumptions and estimates used to allocate the purchase price are not correct or if business conditions change, purchase price adjustments or future asset impairment charges could be required. At December 31, 2005, the value of goodwill amounted to $221 million.

Impairment of goodwill. Goodwill recognized in business combinations is not amortized and is instead subject to an impairment test to be performed on an annual basis, or more frequently if indicators of impairment exist, in order to assess the recoverability of its carrying value. Goodwill subject to potential impairment is tested at a reporting unit level, which represents a component of an operating segment for which discrete financial information is available and is subject to regular review by segment management. This impairment test determines whether the fair value of each reporting unit for which goodwill is allocated is lower than the total carrying amount of relevant net assets allocated to such reporting unit, including its allocated goodwill. If lower, the implied fair value of the reporting unit goodwill is then compared to the carrying value of the goodwill and an impairment charge is recognized for any excess. In determining the fair value of a reporting unit, we usually estimate the expected discounted future cash flows associated with the reporting unit. Significant management judgments and estimates are used in forecasting the future discounted cash flows including: the applicable industry s sales volume forecast and selling price evolution; the reporting unit s market penetration; the market acceptance of certain new technologies; and relevant cost structure, the discount rates applied using a weighted average cost of capital and the perpetuity rates used in calculating cash flow terminal values. Our evaluations are based on financial plans updated with the latest available projections of the semiconductor market evolution, our sales expectations and our costs evaluation and are consistent with the plans and estimates that we use to manage our business. It is possible, however, that the plans and estimates used may be incorrect, and future adverse

changes in market conditions or operating results of acquired businesses not in line with our estimates may require impairment of certain goodwill. In 2005, we had an impairment of goodwill of $39 million related to the elimination of the Customer Premises Equipment (CPE) product lines.

Intangible assets subject to amortization. Intangible assets subject to amortization include the cost of technologies and licenses purchased from third parties, internally developed software which is capitalized and purchased software. Intangible assets subject to amortization are reflected net of any impairment losses. These are amortized over a period ranging from three to seven years. The carrying value of intangible assets subject to amortization is evaluated whenever changes in circumstances indicate that the

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carrying amount may not be recoverable. In determining recoverability, we initially assess whether the carrying value exceeds the undiscounted cash flows associated with the intangible assets. If exceeded, we then evaluate whether an impairment charge is required by determining if the asset s carrying value also exceeds its fair value. An impairment loss is recognized for the excess of the carrying amount over the fair value. We normally estimate the fair value based on the projected discounted future cash flows associated with the intangible assets. Significant management judgments and estimates are required and used in the forecasts of future operating results that are used in the discounted cash flow method of valuation, including: the applicable industry s sales volume forecast and selling price evolution; our market penetration; the market acceptance of certain new technologies; and costs evaluation. Our evaluations are based on financial plans updated with the latest available projections of the semiconductor market evolution and our sales expectations and are consistent with the plans and estimates that we use to manage our business. It is possible, however, that the plans and estimates used may be incorrect and that future adverse changes in market conditions or operating results of businesses acquired may not be in line with our estimates and may therefore require impairment of certain intangible assets. In 2005, we registered an impairment charge of $25 million. At December 31, 2005, the value of intangible assets subject to amortization amounted to $224 million.

Property, plant and equipment. Our business requires substantial investments in technologically advanced manufacturing facilities, which may become significantly underutilized or obsolete as a result of rapid changes in demand and ongoing technological evolution. We estimate the useful life for the majority of our manufacturing equipment, which is the largest component of our long-lived assets, to be six years. This estimate is based on our experience with using equipment over time. Depreciation expense is a major element of our manufacturing cost structure. We begin to depreciate new equipment when it is put into use.

We evaluate each period whether there is reason to suspect that tangible assets or groups of assets might not be recoverable. Factors we consider important which could trigger an impairment review include: significant negative industry trends, significant underutilization of the assets or available evidence of obsolescence of an asset and strategic management decisions impacting production or an indication that its economic performance is, or will be, worse than expected. Since a significant portion of our tangible assets are carried by our European affiliates and their cost of operations are mainly denominated in euros, while revenues primarily are denominated in U.S. dollars, the exchange rate dynamic may trigger impairment charges. In determining the recoverability of assets to be held and used, we initially assess whether the carrying value exceeds the undiscounted cash flows associated with the tangible assets or group of assets. If exceeded, we then evaluate whether an impairment charge is required by determining if the asset s carrying value also exceeds its fair value. We normally estimate this fair value based on independent market appraisals or the sum of discounted future cash flows, using market assumptions such as the utilization of our fabrication facilities and the ability to upgrade such facilities, change in the selling price and the adoption of new technologies. We also evaluate the continued validity of an asset s useful life when impairment indicators are identified. Assets classified as held for disposal are reflected at the lower of their carrying amount or fair value less selling costs and are not depreciated during the selling period. Selling costs include incremental direct costs to transact the sale that we would not have incurred except for the decision to sell.

Our evaluations are based on financial plans updated with the latest projections of the semiconductor market and of our sales expectations, from which we derive the future production needs and loading of our manufacturing facilities, and which are consistent with the plans and estimates that we use to manage our business. These plans are highly variable due to the high volatility of the semiconductor business and therefore are subject to continuous modifications. If the future evolution differs from the basis of our plans, both in terms of market evolution and production allocation to our manufacturing plants, this could require a further review of the carrying amount of our tangible assets resulting in a potential impairment loss. In 2005, we registered an impairment charge of $3 million related to the optimization of our Electrical Wafer Sorting (EWS) activities (wafer test).

Inventory. Inventory is stated at the lower of cost or net realizable value. Cost is based on the weighted average cost by adjusting standard cost to approximate actual manufacturing costs on a quarterly basis; the cost is therefore dependent on our manufacturing performance. In the case of underutilization of our manufacturing facilities, we estimate the costs associated with the excess capacity; these costs are not included in the valuation of inventories but are charged directly to cost of sales. Net realizable value is the estimated selling price in the ordinary course of business less applicable variable selling expenses.

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The valuation of inventory requires us to estimate obsolete or excess inventory as well as inventory that is not of saleable quality. Provisions for obsolescence are estimated for excess uncommitted inventories based on the previous quarter sales, order backlog and production plans. To the extent that future negative market conditions generate order backlog cancellations and declining sales, or if future conditions are less favorable than the projected revenue assumptions, we could be required to record additional inventory provisions, which would have a negative impact on our gross margin.

Share-based compensation. We have in the past accounted for share-based compensation to employees in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and as such generally recognized no compensation cost for employee stock options. In December 2004, the FASB issued revised FAS No. 123, *Share-Based Payment,* or FAS 123R, which requires companies to expense employee share- based compensation for financial reporting purposes. Pro forma disclosure of the income statement effects of share-based compensation is no longer an alternative. We adopted FAS 123R early in the fourth quarter of 2005 to account for charges related to non-vested stock awards distributed to our employees. As a result, we are now required to value the current and any future employee share-based compensation pursuant to an option pricing model, and then amortize that value against our reported earnings over the vesting period in effect for those awards. Due to this change in accounting treatment of employee stock and other forms of share-based compensation, the share-based compensation expense is charged directly against our earnings. In order to assess the fair value of this share-based compensation through a financial evaluation model, we are required to make significant estimates since, pursuant to our plan, awarding shares is contingent on the achievement of certain financial objectives, including market performance and financial results. We are required to estimate certain items, including the probability of meeting the market performance, the forfeitures and the service period of our employees. As a result, we recorded in the fourth quarter of 2005 a total charge of $9 million and we are expecting to incur additional charges related to this plan during 2006. The impact is further detailed in Note 15.6 to our Consolidated Financial Statements Non-vested share awards .

Restructuring charges. We have undertaken, and we may continue to undertake, significant restructuring initiatives, which have required us, or may require us in the future, to develop formalized plans for our existing activities or to dispose of our activities. We recognize the fair value of a liability for costs associated with an exit or disposal activity when a probable liability exists and it can be reasonably estimated. We record estimated charges for non-voluntary termination benefit arrangements such as severance and outplacement costs meeting the criteria for a liability as described above. Given the significance of and the timing of the execution of such activities, the process is complex and involves periodic reviews of estimates made at the time the original decisions were taken. As we operate in a highly cyclical industry, we continue to evaluate business conditions. If broader or new initiatives, which could include production curtailment or closure of other manufacturing facilities, were to be taken, we may be required to incur additional charges as well as to change estimates of amounts previously recorded. The potential impact of these changes could be material and have a material adverse effect on our results of operations or financial condition. In 2005, the amount of restructuring charges and other related closure costs amounted to $61 million before taxes. See Note 18 to our Consolidated Financial Statements.

Income taxes. We are required to make estimates and judgments in determining income tax expense for financial statement purposes. These estimates and judgments also occur in the calculation of certain tax assets and liabilities and provisions.

We are required to assess the likelihood of recovery of our deferred tax assets. If recovery is not likely, we are required to record a valuation allowance against the deferred tax assets that we estimate will not ultimately be recoverable, which would increase our provision for income taxes. As of December 31, 2005, we believed that all of the deferred tax assets, net of valuation allowances, as recorded on our balance sheet, would ultimately be recovered. However, should there be a change in our ability to recover our deferred tax assets or in our estimates of the valuation allowance, or in the tax rates applicable in the various jurisdictions, this could

have an impact on our future tax provision in the periods in which these changes could occur.

In addition, the calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations. We record provisions for anticipated tax audit issues based on our estimate that probable additional taxes will be due. We reverse provisions and recognize a tax benefit during the period if we ultimately determine that the liability is no longer necessary. We record an additional charge

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in our provision for taxes in the period in which we determine that the recorded provision is less than we expect the ultimate assessment to be.

Patent and other intellectual property litigation or claims. As is the case with many companies in the semiconductor industry, we have from time to time received, and may in the future receive, communications alleging possible infringement of patents and other intellectual property rights of others. Furthermore, we may become involved in costly litigation brought against us regarding patents, mask works, copyrights, trademarks or trade secrets. In the event that the outcome of any litigation would be unfavorable to us, we may be required to take a license to the underlying intellectual property right upon economically unfavorable terms and conditions, and possibly pay damages for prior use, and/or face an injunction, all of which singly or in the aggregate could have a material adverse effect on our results of operations and ability to compete. See Item 3. Key Information Risk Factors Risks Related to Our Operations We depend on patents to protect our rights to our technology .

We record a provision when it is probable that a liability has been incurred and when the amount of the loss can be reasonably estimated. We regularly evaluate losses and claims with the support of our outside attorneys to determine whether they need to be adjusted based on the current information available to us. Legal costs associated with claims are expensed as incurred. We are in discussion with several parties with respect to claims against us relating to possible infringements of patents and similar intellectual property rights of others.

We are currently a party to several legal proceedings including legal proceedings with SanDisk Corporation (SanDisk) and Tessera, Inc. See Item 8. Financial Information Legal Proceedings . As of the end of 2005, based on our assessment there was no impact on our financial statements relating to the SanDisk litigation. However, if we are unsuccessful in resolving these proceedings, or if the outcome of any other litigation or claim were to be unfavorable to us, we may incur monetary damages, or an injunction or exclusion order.

Pension and Post Retirement Benefits. Our results of operations and our balance sheet include the impact of pension and post retirement benefits that are measured using actuarial valuations. These valuations are based on key assumptions, including discount rates, expected long-term rates of return on funds and salary increase rates. These assumptions are updated on an annual basis at the beginning of each fiscal year or more frequently upon the occurrence of significant events. Any changes in the above assumptions can have an impact on our valuations. As of December 31, 2005, we have a total benefit obligation estimated at $323 million, and total plan assets estimated at $194 million resulting in an unfunded status of $129 million, of which $56 million was registered in our balance sheet at December 31, 2005.

Other claims. We are subject to the possibility of loss contingencies arising in the ordinary course of business. These include, but are not limited to: warranty costs on our products not covered by insurance, breach of contract claims, tax claims and provisions for specifically identified income tax exposures as well as claims for environmental damages. In determining loss contingencies, we consider the likelihood of a loss of an asset or the incurrence of a liability, as well as our ability to reasonably estimate the amount of such loss or liability. An estimated loss is recorded when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. We regularly reevaluate any losses and claims and determine whether they need to be readjusted based on the current information available to us. In the event of litigation that is adversely determined with respect to our interests, or in the event we need to change our evaluation of a potential third-party claim based on new evidence or communications, this could have a material adverse effect on our results of operations or financial condition at the time it were to materialize.

Fiscal Year 2005

Under Article 35 of our Articles of Association, our financial year extends from January 1 to December 31, which is the period end of each fiscal year. Our fiscal year starts at January 1 and the first quarter of 2005 ended on April 2, 2005. The second quarter of 2005 ended on July 2, 2005, and the third quarter of 2005 ended on October 1, 2005. The fourth quarter ended on December 31, 2005. Based on our fiscal calendar, the distribution of our revenues and expenses by quarter may be unbalanced due to a different number of days in the various quarters of the fiscal year.

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2005 Business Overview

In 2005, the semiconductor market experienced a moderate increase in total sales after the strong growth recorded in 2004. Semiconductor industry data for 2005 indicates that revenues improved supported by a solid economic environment in the major world economies.

The total available market is defined as the TAM , while the serviceable available market, the SAM , is defined as the market for products produced by us (which consists of the TAM and excludes PC motherboard major devices such as microprocessors (MPU), dynamic random access memories (DRAMs), and optoelectronics devices).

Based upon recently published data, semiconductor industry revenues increased year-over-year by approximately 7% both for the TAM and the SAM in 2005, to reach $227.5 billion and approximately $152 billion, respectively. This increase was driven by unit demand while average selling prices remained basically flat. In the fourth quarter of 2005, the TAM and the SAM increased approximately 9% and 13% year-over-year, respectively, and increased by approximately 2% and 3% sequentially, respectively.

Effective January 1, 2005, we realigned our product groups to increase market focus and realize the full potential of our products, technologies and sales and marketing channels. Since such date we report our sales and operating income in three product segments:

the Application Specific Product Groups (ASG) segment, comprised of three product lines our Home, Personal and Communication Products (HPC), our Computer Peripherals Products (CPG) and our Automotive Products (APG). Our new HPC Sector is comprised of the telecommunications, audio and digital consumer groups. Our CPG products cover computer peripherals products, specifically disk drives and printers, and our APG products now comprise all of our major complex products related to automotive applications.

the Memory Product Group (MPG) segment, comprised of our memories and Smart card businesses; and

the Micro, Linear and Discrete Product Group (MLD) segment, comprised of discrete and standard products plus standard microcontroller and industrial devices (including the programmable systems memories (PSM) division).

Our principal investment and resource allocation decisions in the semiconductor business area are for expenditures on research and development and capital investments in front-end and back-end manufacturing facilities. These decisions are not made by product segments, but on the basis of the semiconductor business area. All these product segments share common research and development for process technology and manufacturing capacity for most of their products.

Our 2005 revenues were characterized by significant high volume demand and improved product mix, which did not translate into an equivalent revenue performance due to persisting negative impact of price pressure in the market we serve. As a result, our revenues increased by approximately 1% to $8,882 million compared to $8,760 million in 2004. Our sales growth was driven primarily by Computer Peripherals, Telecom and Automotive market segments while both Consumer and Industrial and Other declined. Our sales trend, however, was below the TAM and the SAM growth rates.

With reference to the quarterly results, our fourth quarter 2005 revenues performance was below the TAM and the SAM on a year-over-year basis but stronger on a sequential basis.

On a year-over-year basis, our fourth quarter 2005 revenues increased by approximately 3% to $2,389 million compared to $2,328 million in the fourth quarter of 2004. Our sales growth was driven primarily by Telecom and Computer Peripherals while we registered declines in Consumer applications and Industrial and Other. On a year-over-year basis, the TAM and the SAM registered increases of approximately 9% and 13% respectively.

On a sequential basis, in the fourth quarter 2005, revenues increased approximately 6% driven by stronger demand in Telecom, Consumer and Industrial and Other and Automotive. In particular, sequential revenues were driven by the strong growth in wireless. Our net revenues performance was firmly within our guidance, which indicated a sequential growth of between 3% and 9%. Finally, our sales trend was above both the TAM and the SAM, which registered an increase of approximately 2% and 3%, respectively.

In 2005, the effective average U.S. dollar exchange rate was $1.28 for 1.00, which reflects current exchange rate levels and the impact of certain hedging contracts, compared to a 2004 effective exchange rate of $1.23 for

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1.00. For a more detailed discussion of our hedging arrangements and the impact of fluctuations in exchange rates, see Impact of Changes in Exchange Rates below.

Our gross margin dropped from 36.8% in 2004 to 34.2% in 2005 due to the negative impact of the declining sales price and of the effective U.S. dollar exchange rate, which was partially balanced by manufacturing and product mix improvements as well as by the increased sales volume. Our fourth quarter gross margin was well within our guidance that indicated a gross margin of approximately 36% plus or minus one percentage point.

On a sequential basis, our gross margin increased from 34.1% to 36.5% in the fourth quarter 2005. Volume, enhanced product mix, manufacturing performance and currency drove the improvements in gross profit and gross margin.

Our operating expenses including selling, general and administrative expenses and research and development were higher in 2005 compared to 2004 due to higher spending in research and development, the negative impact of the effective U.S. dollar exchange rate, the one-time compensation charges related to our former CEO and other retired senior executives, the new pension scheme for executive management and the 2005 share-based compensation for our employees and members and professionals of the Supervisory Board.

Our total impairment and restructuring charges for 2005 were significantly higher compared to 2004, given that in addition to the ongoing 150-mm restructuring plan launched in 2003, we have incurred charges related to the new 2005 restructuring and reorganization plans. Our manufacturing initiatives are moving forward and are becoming drivers of margin improvements as we complete these programs and realize the associated benefits during the fourth quarter of 2005 and through 2006.

The combined effect of the above mentioned factors and the other operating items resulted in a net negative impact on our operating income for 2005 compared to 2004; our operating income decreased significantly from $683 million in 2004 to $244 million in 2005. In the fourth quarter of 2005, however, our operating income significantly improved compared to the third quarter of 2005. This improvement was driven by higher sales volume, an improved gross margin and lower expenses to sales ratio due to a combination of higher sales and expense control, combined with a more favorable effective average U.S. dollar exchange rate.

Our interest income significantly improved in 2005 mainly as the result of rising interest rates on our available cash. In 2005, our income tax resulted in an expense of $8 million, also positively affected by restructuring charges occurring under higher tax rate jurisdictions and the reversal of some tax provisions.

In summary, our financial results for 2005 compared to the results of 2004 were favorably impacted by the following factors:

- higher sales volume and a more favorable product mix in our revenues, which contributed to an increase in our net revenues over 2004;
- continuous improvement of our manufacturing performances;
- net interest income; and
- lower income tax expense.

Our financial results in 2005 were negatively affected by the following factors:

- negative pricing trends due to a persisting overcapacity in the industry, which translated into our average selling prices declining by approximately 8%, as a pure pricing effect;
- the impact of the effective U.S. dollar exchange rate against the euro and other currencies, which translated into an increase of our cost of sales and in our operating expenses being significantly higher than the favorable impact on our revenues;
- higher impairment, restructuring charges and other related closure costs due to the new restructuring and reorganization activities initiated in 2005; and

the one-time compensation packages and special bonuses to our former CEO and to a limited number of retired senior executives, the new pension scheme charges for executive management and the share-based compensation charges for non-vested shares granted to employees and members and professionals of our Supervisory Board for a total of $37 million.

In 2005, we continued to invest in upgrading and expanding our manufacturing capacity. Total capital expenditures in 2005 were $1,441 million, which were financed entirely by net cash generated from operating

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activities. At December 31, 2005, we had cash and cash equivalents of $2,027 million. Total debt and bank overdrafts were $1,802 million, of which $269 million were long-term debt.

In the fourth quarter of 2005, we continued to make steady progress in improving our financial performance, with both revenue and gross margin results in line with our objectives. Sequential revenue growth was driven by strong performance in wireless, where our product offerings provide important functionality to a wide range of handset requirements. Sequential improvement in our gross margin reflected, in addition to currency, the impact of previously announced actions and programs. Through a sharper focus in both research and development and marketing and sales, operating expenses met our targeted objectives. Additionally, cash generation in the quarter was strong and at the year end our financial position improved to a net cash balance of over $200 million. In summary, in the fourth quarter of 2005, we saw progress across our most important financial metrics.

The year 2005 has been devoted to strengthening and reshaping our company into a stronger and more competitive leader. Key competitive changes have been implemented. The cost savings actions we announced at the beginning of the year delivered the expected benefits of 2005, and we are on track to deliver additional results in the coming year. New product designs have accelerated. Customer base expansion efforts have been developed and are being carried out. Therefore, as we move into 2006, we are confident that we will continue to strengthen our financial performance and product leadership based upon the execution of our corporate performance roadmap.

Business Outlook

We believe that moderate industry growth will continue into 2006. Within these dynamics, we expect to continue to make solid progress in improving our performance thanks to our ongoing plans and initiatives. As it is typical for the first quarter seasonality, we expect our revenues for the first quarter of 2006 to decline from 2005 fourth quarter levels, but to be significantly higher than our first quarter 2005 results. Specifically, we expect sales to decrease between 1% and 7% sequentially. Given the seasonal mix and volume impacts we expect the gross margin to be about 35%, plus or minus 1 percentage point.

Our capital expenditures are targeted to be $1.8 billion for 2006, with flexibility to modulate to market conditions.

This guidance is based on an effective currency exchange rate of approximately $1.205 for 1.00, which reflects current exchange rate levels combined with the impact of existing hedging contracts.

These are forward-looking statements that are subject to known and unknown risks and uncertainties that could cause actual results to differ materially; in particular, refer to those known risks and uncertainties described in Cautionary Note Regarding Forward-Looking Statements and Item 3. Key Information Risk Factors in this Form 20-F.

Other Developments in 2005

In January 2005, we decided to reduce our Access technology products for CPE modem products. This decision was intended to eliminate certain low-volume, non-strategic product families whose return in the current environment did not meet internal targets. This decision resulted in a total impairment charge of approximately $67 million in 2005, out of which $61 million related to impairment of intangible assets and goodwill related to the CPE product lines.

On February 28, 2005, we signed an advanced pricing agreement for the period 2001 through 2007 with the United States Internal Revenue Service resulting in a net one-time tax benefit of approximately $10 million in 2005. In the second quarter of 2005, we benefited from a tax credit of $18 million in relation to the application of the ETI (Extraterritorial Income Exclusion) rules in the United States after notification in writing by the local authorities.

At our annual general meeting of shareholders held on March 18, 2005, our shareholders approved the appointment of Mr. Carlo Bozotti as our President and Chief Executive Officer replacing Mr. Pasquale Pistorio who retired. Our shareholders also approved the distribution of a cash dividend of $0.12 per common share in respect to the 2004 financial year, equivalent to the prior year s cash dividend payment, for a total of approximately $107 million that was paid in the second quarter of 2005. In addition, the shareholders appointed our Supervisory Board and Managing Board members, approved amendments to our Articles of Association and to our 2001 Employee Stock Option Plan, as well as approving a new 2005 share-based compensation for Supervisory Board members and professionals, among other resolutions. Our Supervisory Board is composed of Messrs. Gérald Arbola, Matteo del

Fante, Tom de Waard, Didier Lombard, Bruno Steve and Antonino Turicchi,

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who were each appointed for a three-year term (to expire at our 2008 AGM), as well as Messrs. Doug Dunn, Francis Gavois and Robert White, who were each appointed for a one-year term (to expire at our 2006 AGM). Our Managing Board is composed of Mr. Carlo Bozotti, our President and Chief Executive Officer, who was appointed for a three-year term (to expire at our 2008 AGM).

On May 16, 2005, we announced a head count restructuring plan that, combined with other already announced initiatives, will aim to reduce our workforce by 3,000 outside Asia by the second half of 2006. From these new measures estimated to cost between $100 to $130 million, we anticipate additional savings of $90 million per year, at completion of the plan. On June 8, 2005, we specified our restructuring efforts by announcing the following: our workforce gross reduction in Europe will represent about 2,300 jobs of the 3,000 already announced; we will pursue the conversion of 150-mm and 200-mm production tools; we will optimize on a global scale our Electrical Wafer Sorting (EWS) activities; we will harmonize and rationalize our support functions and we will disengage from certain activities.

Pursuant to the joint venture agreement that we signed in 2004 with Hynix Semiconductor Inc., to build a front-end memory-manufacturing facility in Wuxi City, Jiangsu Province, China, we made during 2005 capital contributions to the joint venture totaling $38 million, of which $13 million were paid in the fourth quarter of 2005. Under the agreement, Hynix Semiconductor Inc., will contribute $500 million for a 67% equity interest and we will contribute $250 million for a 33% equity interest. In addition, we have committed to grant $250 million in long-term financing for the joint venture guaranteed by the subordinated collateral of the joint venture s assets.

On June 30, 2005, we sold our interest in UPEK Inc. (a spin-off of our former TouchChip business) for $13 million and recorded in the second quarter of 2005 a gain amounting to $6 million. Additionally, on June 30, 2005, we were granted warrants for 2 million shares of UPEK Inc., at an exercise price of $0.01 per share. The warrants are not limited in time but can only be exercised in the event of a change of control or an initial public offering of UPEK Inc., above a predetermined value.

On August 6, 2005, the 442 million aggregate principal amount of 3¼% mandatory exchangeable notes, initially issued by France Telecom in 2002 and exchangeable into our common shares, reached maturity. We were informed that the exchange ratio was 1.25 of our common shares per each 20.92 principal amount of notes, which resulted in the disposal by France Telecom of approximately 26.4 million of our currently existing common shares, representing the totality of the shares entirely held by France Telecom in our company.

On September 6, 2005, we announced the appointment of two new Corporate Vice Presidents: Mr. Reza Kazerounian was promoted to the position of Corporate Vice President for the North America region and Mr. Marco Luciano Cassis was appointed to the position of Corporate Vice President of STMicroelectronics Japan.

On October 17, 2005, we announced the creation of our new Greater China region to focus exclusively on our operations in China, Hong Kong and Taiwan and appointed Mr. Robert Krysiak as Corporate Vice President and General Manager of Greater China.

On October 25, 2005, upon the recommendation of its Compensation Committee, our Supervisory Board approved the conditions for the Executive-Vice Presidents and Corporate Vice Presidents to become eligible for the Company s Executive Pension Plan Scheme, as follows: eight years of seniority as Executive Vice President or Corporate Vice President, the Managing Board s decision to be elected into the plan and variable pension amount according to the years of services with the maximum pension after 13 years of service in these positions. In 2005, a provision has been recorded totaling $11 million.

In December 2005, Mr. Piero Mosconi retired, leaving his role of Corporate Vice President and Treasurer, a position he occupied since 1987. Treasury moved under the responsibility of our Chief Financial Officer, Mr. Carlo Ferro. Mr. Giuseppe Notarnicola joined our Company and was appointed Group Vice President, Corporate Treasurer.

Mr. Giordano Seragnoli, Corporate Vice President and General Manager of our worldwide back-end manufacturing operations, is also retiring at the end of the second quarter of 2006. Effective April 3, 2006, Jeffrey See, who is currently General Manager of our manufacturing complex in Ang Mo Kio (Singapore) will take over his responsibilities. Mr. See will continue to be based in Singapore, close to where the largest part of our assembly and test production is located.

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Recent Developments

Upon the proposal of our Managing Board, our Supervisory Board decided in January 2006 to recommend for the 2006 AGM, scheduled in Amsterdam on April 27, 2006, the distribution of a cash dividend of $0.12 per share, maintaining the same cash dividend level as in the prior year.

Results of Operations

Segment Information

We operate in two business areas: Semiconductors and Subsystems.

In the Semiconductors business area, we design, develop, manufacture and market a broad range of products, including discrete, memories and standard commodity components, application-specific integrated circuits (ASICs), full custom devices and semi-custom devices and application-specific standard products (ASSPs) for analog, digital and mixed-signal applications. In addition, we further participate in the manufacturing value chain of Smart card products through our Incard division, which includes the production and sale of both silicon chips and Smart cards.

In the Semiconductors business area, effective January 1, 2005, we realigned our product groups to increase market focus and realize the full potential of our products, technologies and sales and marketing channels. Since such date we report our semiconductor sales and operating income in three product segments:

Application Specific Product Groups (ASG) segment, comprised of three product lines Home, Personal and Communication Products (HPC), Computer Peripherals Products (CPG) and new Automotive Products (APG);

Memory Product Group (MPG) segment; and

Micro, Linear and Discrete Product Group (MLD) segment.

Our principal investment and resource allocation decisions in the Semiconductor business area are for expenditures on research and development and capital investments in front-end and back-end manufacturing facilities. These decisions are not made by product segments, but on the basis of the semiconductor business area. All these product segments share common research and development for process technology and manufacturing capacity for most of their products. Please see Item 4. Information on the Company Business Overview .

We have restated our results in prior periods for illustrative comparisons of our performance by product segment and by period. The segment information of 2003 and 2004 has been restated using the same principles applied to the current 2005 year. The preparation of segment information according to the new segment structure requires management to make significant estimates, assumptions and judgments in determining the operating income of the new segments for the prior years. However, we believe that the prior years presentation is representative of 2005 and we are using these comparatives when managing our business.

In the Subsystems business area, we design, develop, manufacture and market subsystems and modules for the telecommunications, automotive and industrial markets including mobile phone accessories, battery chargers, ISDN power supplies and in-vehicle equipment for electronic toll payment. Based on its immateriality to our business as a whole, the Subsystems segment does not meet the requirements for a reportable segment as defined in Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information* (FAS 131).

The following tables present our consolidated net revenues and consolidated operating income by semiconductor product segment. For the computation of the segments internal financial measurements, we use certain internal rules of allocation for the costs not directly chargeable to the segments, including cost of sales, selling, general and administrative expenses and a significant part of research and development expenses. Additionally, in compliance with our internal policies, certain cost items are not charged to the segments, including impairment, restructuring charges and other related closure costs, start-up costs of new manufacturing facilities, some strategic and special research and development programs or other corporate-sponsored initiatives, including certain corporate level operating expenses and certain other miscellaneous charges. Starting in the first

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quarter of 2005, we allocated the start-up costs to expand our marketing and design presence in new developing areas to each segment, and we restated prior year s results accordingly.

	Year Ended December 31,		
	2005	2004	2003
	(In millions)		
Net revenues by product segment:			
Application Specific Product Group Segment (ASG)	$ 4,991	$ 4,902	$ 4,405
Memory Product Group Segment (MPG)	1,948	1,887	1,294
Micro, Linear and Discrete Product Group Segment (MLD)	1,882	1,902	1,469
Others(1)	61	69	70
Total consolidated net revenues	$ 8,882	$ 8,760	$ 7,238

(1) Includes revenues from sales of subsystems mainly and other products not allocated to product segments.

	Year Ended December 31,		
	2005	2004	2003
	(In millions)		
Operating income (loss) by product segment:			
Application Specific Product Group Segment (ASG)	$ 355	$ 530	$ 582
Memory Product Group Segment (MPG)	(118)	42	(65)
Micro, Linear and Discrete Product Group Segment (MLD)	271	413	192
Total operating income of product segments	508	985	709
Others(1)	(264)	(302)	(375)
Total consolidated operating income	$ 244	$ 683	$ 334

(1) Operating income (loss) of Others includes items or parts of them, which are not allocated to product segments such as impairment, restructuring charges and other related closure costs, start-up costs, and other unallocated expenses, such as: strategic or special research and development programs, certain corporate-level operating expenses, certain patent claims and litigations, and other costs that are not allocated to the product segments, as well as operating earnings or losses of the Subsystems and Other Products segment. Certain costs, mainly R&D, formerly in the Others category, are now being allocated to the segments; comparable amounts reported in this category have been reclassified accordingly in the above table.

	Year Ended December 31,

	2005	2004	2003
	(As a percentage of total net revenues)		
Operating income (loss) by product segment:			
Application Specific Product Group Segment (ASG)(1)	7.1%	10.8%	13.2%
Memory Product Group Segment (MPG)(1)	(6.1)	2.2	(5.0)
Micro, Linear and Discrete Product Group Segment (MLD)(1)	14.4	21.7	13.1
Others(2)	(3.0)	(3.5)	(5.2)
Total consolidated operating income(3)	2.7%	7.8%	4.6%

(1) As a percentage of net revenues per product segment.

(2) As a percentage of total net revenues. Operating income (loss) of Others includes items or parts of them, which are not allocated to product segments such as impairment, restructuring charges and other related closure costs, start-up costs, and other unallocated expenses, such as: strategic or special research and development programs, certain corporate-level operating expenses, certain patent claims and litigations, and other costs that are not allocated to the product segments, as well as operating earnings or losses of the Subsystems and Other Products segment. Certain costs, mainly R&D, formerly in the Others category, are now being allocated to the product segments; comparable amounts reported in this category have been reclassified accordingly in the above table.

(3) As a percentage of total net revenues.

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	Year Ended December 31,		
	2005	2004	2003
	(In millions)		
Reconciliation to consolidated operating income:			
Total operating income of product segments	$ 508	$ 985	$ 709
Operating Income of others(1)			
Strategic and other research and development programs	(49)	(91)	(52)
Start-up costs	(56)	(63)	(54)
Impairment, restructuring charges and other related closure costs	(128)	(76)	(205)
Subsystems	1	(1)	2
One-time compensation and special contributions(2)	(22)		
Patent claim costs		(4)	(10)
Other non-allocated provisions(3)	(10)	(67)	(56)
Total operating income (loss) of others	(264)	(302)	(375)
Total consolidated operating income	$ 244	$ 683	$ 334

(1) Operating income (loss) of Others includes items or parts of them, which are not allocated to product segments such as impairment, restructuring charges and other related closure costs, start-up costs, and other unallocated expenses, such as: strategic or special research and development programs, certain corporate-level operating expenses, certain patent claims and litigations, and other costs that are not allocated to the product segments, as well as operating earnings or losses of the Subsystems and Other Products segment. Certain costs, mainly R&D, formerly in the Others category, are now being allocated to the segments; comparable amounts reported in this category have been reclassified accordingly in the above table.

(2) One-time compensation and special contributions to our former CEO and other executives not allocated to product segments.

(3) Includes unallocated expenses such as certain corporate level operating expenses and other costs.

Net Revenues by Location of Order Shipment and by Market Segment

The table below sets forth information on our consolidated net revenues by location of order shipment and as a percentage of net revenues:

	Year Ended December 31,		
	2005	2004	2003
	(In millions)		
Net Revenues by Location of Order Shipment:(1)			
Europe(2)	$ 2,789	$ 2,827	$ 2,306
North America	1,141	1,211	985
Asia/ Pacific	4,063	3,711	3,190
Japan	307	403	337

Emerging Markets(2)(3)	582	608	420
Total	$ 8,882	$ 8,760	$ 7,238
Net Revenues by Location of Order Shipment:(1)			
Europe(2)	31.4%	32.3%	31.9%
North America	12.8	13.8	13.6
Asia/Pacific	45.7	42.4	44.1
Japan	3.5	4.6	4.6
Emerging Markets(2)(3)	6.6	6.9	5.8
Total	100.0%	100.0%	100.0%

(1) Net revenues by location of order shipment region are classified by location of customer invoiced. For example, products ordered by U.S.-based companies to be invoiced to Asia/ Pacific affiliates are classified as Asia/ Pacific revenues.

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(2) Since January 1, 2005, the region Europe includes the former East European countries that joined the EU in 2004. These countries were part of the Emerging Markets region in the previous periods. Net revenues for Europe and Emerging Markets for prior periods were restated to include such countries in the Europe region for such periods.

(3) Emerging Markets in 2005 included markets such as India, Latin America, the Middle East and Africa, Europe (non-EU and non-EFTA) and Russia.

The table below estimates, within a variance of 5% to 10% in absolute dollar amounts, the relative weighting of each of the target market segments in percentages of net revenues:

	Year Ended December 31,		
	2005	2004	2003
	(As a percentage of net revenues)		
Net Revenues by Market Segment:			
Automotive	16%	15%	14%
Consumer	18	21	20
Computer	17	16	18
Telecom	35	32	33
Industrial and Other	14	16	15
Total	100%	100%	100%

The following table sets forth certain financial data from our consolidated statements of income since 2003, expressed in each case as a percentage of net revenues:

	Year Ended December 31,		
	2005	2004	2003
	(As a percentage of net revenues)		
Net sales	99.9%	100.0%	99.9%
Other revenues	0.1		0.1
Net revenues	100.0	100.0	100.0
Cost of sales	(65.8)	(63.2)	(64.5)
Gross profit	34.2	36.8	35.5
Selling, general and administrative	(11.6)	(10.8)	(10.9)
Research and development	(18.3)	(17.5)	(17.1)
Other income and expenses, net	(0.1)	0.2	(0.1)
Impairment, restructuring charges and other related closure costs	(1.5)	(0.9)	(2.8)
Total operating expenses	(31.5)	(29.0)	(30.9)
Operating income	2.7	7.8	4.6

Interest income (expense), net	0.4		(0.7)
Loss on equity investment			
Loss on extinguishment of convertible debt		(0.1)	(0.6)
Income before income taxes and minority interests	3.1	7.7	3.3
Income tax benefit (expense)	(0.1)	(0.8)	0.2
Income before minority interests	3.0	6.9	3.5
Minority interests			
Net income	3.0%	6.9%	3.5%

2005 vs. 2004

In 2005, based upon recently published industry data, the semiconductor industry experienced a year-over-year revenue increase of approximately 7% both for the total available market (TAM) and the serviceable available market (SAM).

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Net revenues

	2005	2004	% Variation
		(In millions)	
Net sales	$ 8,876	$ 8,756	1.4%
Other revenues	$ 6	$ 4	
Net revenues	$ 8,882	$ 8,760	1.4%

The increase in our net revenues in 2005 was primarily due to our higher sales volumes and improved product mix, as our average selling prices declined by approximately 8% due to the continuing broad-based pressure in the markets we serve.

With respect to our product segments, ASG net revenues increased 2% over 2004, mainly due to a more favorable product mix, which was, however, largely offset by continuous pricing pressure. This revenue increase was generated by higher sales in Imaging, Cellular Communication, Automotive and Data Storage products, while Consumer registered a decline. MLD net revenues slightly decreased 1% compared to 2004, mainly due to the negative price impact that more than offset the sales volume increase registered by all product segments. In 2005, MPG net revenues increased by 3% compared to 2004; this increase was driven by a large volume demand, particularly in Flash products and mainly within NAND, despite a decline in our average selling prices.

Net revenues by market segment increased in Computer by approximately 11%, Telecom by approximately 10% and Automotive by approximately 7%, while Consumer and Industrial and Other decreased by approximately 15% and 9%, respectively. As a significant portion of our sales are made through distributors, the foregoing are necessarily estimates within a variance of 5% to 10% in absolute dollar amounts of the relative weighting of each of our targeted market segments.

By location of order shipment, net revenues increased in the Asia/ Pacific region by approximately 10%, while Japan, North America, Emerging Markets and Europe net revenues decreased by approximately 24%, 6%, 4% and 1%, respectively.

In 2005, we had several large customers, with the largest one, the Nokia Group of companies, accounting for approximately 22% of our net revenues, increasing from the 17% it accounted for in 2004. Our top ten OEM customers accounted for approximately 50% of our net revenues in 2005, compared to approximately 44% of our net revenues in 2004.

Gross profit

	2005	2004	% Variation
		(In millions)	
Cost of sales	$ (5,845)	$	