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## Freescale Could Feel the Heat as Motorola Seeks Second Chip Supplier

By Mark Veverka  
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IT IS INCREASINGLY likely that **Motorola** (MOT<sup>1</sup>) will use a second chip supplier for its next-generation (3G) phones and handheld devices, which could spell trouble for **Freescale**

**Semiconductor** (FSL<sup>2</sup>). Motorola spun off Freescale to shareholders in 2004. Chips for wireless devices contribute about half of Freescale's revenue, and Motorola accounts for about 70% of that business.

Motorola wireless chief Ron Garriques publicly has defended Freescale, while simultaneously allowing his troops to explore the possibility of adding another chip supplier, now thought to be **Qualcomm** (QCOM<sup>3</sup>). A Motorola spokeswoman wouldn't comment on potential vendor changes, citing corporate policy.

Speculation that Motorola is seeking a second source of base-band chipsets has intensified this year (see "Plugged In," Feb. 20), and was all but confirmed by Freescale Senior Vice President Franz Fink, the company's top mobile-wireless executive, in a March 15 conference call with Deutsche Bank analyst Ross Seymore.

Publicly, at least, Fink applauded the notion of a second chip supplier. In response to a query from Seymore about the "dual-sourcing" rumors, he said he expects that "as volume grows," big customers such as Motorola will have "not just one supplier but at least two." According to a transcript of the call provided by Deutsche Bank, he added that the "two-chip business model [is] prudent."

Fink also insisted that such a decision on Motorola's part would result in a "complementary" relationship, as opposed to a "substitution" of Freescale chips with those of another supplier. "I truly believe the partnership is stronger than ever, and that will show in product shipping later this year and into 2007," he said.

Contacted subsequently, a Freescale spokesman said, "We have nothing to add. We have covered this ground several times with analysts."

Just how would a two-chip situation work, especially with regard to Motorola's high-end W-CDMA (3G) supply chain? In a March 20 research note, Citigroup telecom analyst Daryl Armstrong provided some clues. Based on conversations with Motorola's integrated-supply-chain guru, Stu Reed, formerly of IBM, Armstrong noted that Motorola likely would separate its mobile-wireless portfolio into two pieces, splitting W-CDMA devices from lower-end devices. He surmises Freescale would get the lower-margin business, while another vendor, probably Qualcomm, would get the higher-margin slice.

"Qualcomm is best positioned to compete for this other vendor position," based on its leading-edge technology and better pricing strategy, he wrote. "It could help Motorola create thinner, more attractive devices," the report stated.

That last thought is a killer, because Motorola's 3G RAZRs have been criticized for not being as thin as its popular RAZR 2G models, or some super-thin G models made by competitors. Some critics have blamed Freescale chips for causing the heft. (The "fault" lies not with the thickness of the chips, but with design issues related to battery power and other functions.)

Motorola's apparent move to wean itself from dependence on Freescale might not be a surprise to savvy observers. In 2005, Motorola's handset revenues grew by 26%, while Freescale's wireless-chip sales rose only 6%, a disparity suggesting all wasn't well with the relationship. Indeed, Motorola has diverted some of its 2G-phone business from Freescale; its contract manufacturer elected to use chips from **Texas Instruments** (TXN<sup>4</sup>) instead of Freescale on certain 2G phones.

To Freescale shareholders, however, news of any discord between the company and Motorola could come as a shock. Freescale's shares have nearly doubled, to 27.61, since the stock began trading in July 2004. Freescale boasts a market value of more than \$11 billion, and changes hands for 16.3 times the \$1.69 a share analysts expect it to earn this year.

Switching chip vendors is a lot more complex than, say, switching batteries, and shouldn't be taken lightly. A phone's architecture and software are meticulously designed to integrate with specific chips, and implementing a change in platforms could take longer than a year. That Motorola would be willing to undertake such a disruptive move is indicative of the company's dissatisfaction with Freescale, and an indictment of the chip supplier, says a hedge-fund manager who is short Freescale's shares.

A dual-chip model could be the best solution for Motorola in ensuring an orderly platform transition. But it is anything other than good news for Freescale, which was supposed to build on its former parent's business — not lose it.

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