STMICROELECTRONICS NV
Form 20-F
March 14, 2007

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As filed with the Securities and Exchange Commission on March 14, 2007

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, 2006

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:

897,395,042 common shares at December 31, 2006

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 þ Accelerated filer o Non-accelerated filer o

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 , us and Company are to STMicroelectroni N.V. together with its consolidated subsidiaries, references to EU are to the European Union, references to and the euro are 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 2006 revenues according to provisional industry data published by iSuppli and 2005 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). We also report certain non-U.S. GAAP financial measures (net operating cash flow and net financial position), which are derived from amounts presented in the financial statements prepared under U.S. GAAP. Furthermore, since 2005, we have been required by Dutch law to report our statutory and consolidated financial statements, previously reported using generally accepted accounting principles in the Netherlands, in accordance with 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 all of which are highly variable and difficult to predict;
- the financial impact of obsolete 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 manage in an intensely competitive and cyclical industry where a high percentage of our costs are fixed and difficult to reduce in the short term, including our ability to adequately utilize and operate our manufacturing facilities at sufficient levels to cover fixed operating costs;
- our ability to perform the announced strategic repositioning of our Flash memories business in line with the requirements of our customers and without adverse effect on existing alliances or other agreements relating to

this business;

our ability in an intensely competitive environment to secure customer acceptance and to achieve our pricing expectations for high volume supplies of new products in whose development we have or are currently investing;

the anticipated benefits of research and development alliances and cooperative activities, as well as the uncertainties concerning the modalities, conditions and financial impact beyond 2007 of the R&D and manufacturing activities in Crolles, following the termination of our current agreement with NXP Semiconductors and Freescale Semiconductor;

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the ability of our suppliers to meet our demands for supplies and materials and to offer competitive pricing;

significant variations in our gross margin compared to expectations could be the result of changes in revenue levels, product mix and pricing, capacity utilization, variations in inventory valuation, excess or obsolete inventory, manufacturing yields, changes in unit costs, impairments of long-lived assets, including manufacturing, assembly/test and intangible assets, and the timing and execution of the manufacturing ramp and associated costs, including start-up costs;

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

changes in our overall tax position as a result of changes in tax laws or the outcome of tax audits, and our ability to accurately estimate tax credits, benefits, deductions and provisions and to realize deferred tax assets;

our ability to obtain required licenses on third-party intellectual property on reasonable terms and conditions, the impact of potential claims by third parties involving intellectual property rights relating to our business, and the outcome of litigation; and

the results of actions by our competitors, including new product offerings and our ability to react thereto.

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, 2006. 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, 2006, 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 Information Financial Statements in this Form 20-F.

	Year Ended December 31,				
	2006	2005	2004	2003	2002
	(In millions except per share and ratio data)				
Consolidated Statement of Income Data:					
Net sales	$ 9,838	$ 8,876	$ 8,756	$ 7,234	$ 6,270
Other revenues	16	6	4	4	48
Net revenues	9,854	8,882	8,760	7,238	6,318
Cost of sales	(6,331)	(5,845)	(5,532)	(4,672)	(4,020)
Gross profit	3,523	3,037	3,228	2,566	2,298
Operating expenses:					
Selling, general and administrative	(1,067)	(1,026)	(947)	(785)	(648)
Research and development(1)	(1,667)	(1,630)	(1,532)	(1,238)	(1,022)
Other income and expenses, net(1)	(35)	(9)	10	(4)	7
Impairment, restructuring charges and other related closure costs	(77)	(128)	(76)	(205)	(34)
Total operating expenses	(2,846)	(2,793)	(2,545)	(2,232)	(1,697)
Operating income	677	244	683	334	601
Interest income (expense), net	93	34	(3)	(52)	(68)
Loss on equity investments	(6)	(3)	(4)	(1)	(11)
Loss on extinguishment of convertible debt			(4)	(39)	
Income before income taxes and minority interests	764	275	672	242	522
Income tax benefit (expense)	20	(8)	(68)	14	(89)
Income before minority interests	784	267	604	256	433
Minority interests	(2)	(1)	(3)	(3)	(4)
Net income	$ 782	$ 266	$ 601	$ 253	$ 429

Earnings per share (basic)	$ 0.87	$ 0.30	$ 0.67	$ 0.29	$ 0.48
Earnings per share (diluted)	$ 0.83	$ 0.29	$ 0.65	$ 0.27	$ 0.48
Number of shares used in calculating earnings per share (basic)	896.1	892.8	891.2	888.2	887.6
Number of shares used in calculating earnings per share (diluted)	958.5	935.6	935.1	937.1	893.0

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	Year Ended December 31,				
	2006	2005	2004	2003	2002
	(In millions except per share and ratio data)				
Consolidated Balance Sheet Data (end of period):					
Cash and cash equivalents(2)	$ 1,963	$ 2,027	$ 1,950	$ 2,998	$ 2,564
Marketable securities	460				
Short-term deposits	250				
Restricted cash for equity investments	218				
Total assets	14,198	12,439	13,800	13,477	12,004
Short-term debt (including current portion of long-term debt)	136	1,533	191	151	165
Long-term debt (excluding current portion)(2)	1,994	269	1,767	2,944	2,797
Shareholders equity(2)	9,747	8,480	9,110	8,100	6,994
Capital stock(3)	3,177	3,120	3,074	3,051	3,008
Other Data:					
Dividends per share	$ 0.12	$ 0.12	$ 0.12	$ 0.08	$ 0.04
Capital expenditures(4)	1,533	1,441	2,050	1,221	995
Net cash provided by operating activities	2,491	1,798	2,342	1,920	1,713
Depreciation and amortization(4)	1,766	1,944	1,837	1,608	1,382
Net debt (cash) to total shareholders equity ratio(5)	(0.078)	(0.026)	0.001	0.012	0.057

(1) 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 and non-current assets and the costs of certain activities relating to intellectual property. 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.

(2) 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 2006, 637,109 shares were transferred to employees upon vesting of stock awards. In August 2003, we issued $1,332 million principal amount at maturity of our convertible bonds due 2013 (our 2013 Convertible 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. In February 2006, we issued Zero Coupon Senior

Convertible Bonds due 2016 (our 2016 Convertible Bonds) representing total gross proceeds of $974 million. In March 2006, we issued 500 million Floating Rate Senior Bonds due 2013 (our 2013 Senior Bonds). In August 2006, as a result of almost all of the holders of our 2013 Convertible Bonds exercising their August 4, 2006 put option, we repurchased $1,397 million aggregate principal amount of the outstanding convertible bonds at a conversion ratio of $985.09 per $1,000 aggregate principal amount at issuance resulting in a cash disbursement of $1,377 million.

(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, the Debt-to-Equity 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, marketable securities, short-term deposits and restricted cash) 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 cyclical and downturns in the semiconductor industry can negatively affect our results of operations and financial condition.

The semiconductor industry is cyclical and has been subject to significant economic downturns at various times. Downturns are typically characterized by diminished demand giving rise to production overcapacity, accelerated erosion of average selling prices, high inventory levels 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. 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. The negative effects on our business from industry downturns may also be increased to the extent that such downturns are concurrent with the timing of new increases in production capacity in our industry.

We have experienced revenue volatility and market downturns in the past and expect to experience downturns them in the future, which could have a material adverse impact on our results of operations and financial condition.

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 semiconductor products 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, $46.1 billion in 2005 and an estimated $55 billion in 2006, or approximately 27%, 19%, 18%, 22%, 20% and 23%, 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, may exceed demand requirements, leading to overcapacity and price erosion.

Overcapacity and cost optimization have led us, in recent years, to close manufacturing facilities that used more mature process technologies and, as a result, to incur significant impairment, restructuring charges and related closure costs. In 2006, we recorded impairment, restructuring charges and related closure costs of $77 million. See Item 5. Operating and Financial Review and Prospects Impairment, Restructuring Charges and Other Related Closure Costs .

As of December 31, 2006, the 2005 restructuring plan was substantially completed and had resulted in total charges of approximately $73 million for intangible assets and goodwill mainly related to the CPE product lines and $86 million for headcount restructuring charges, out of an estimated $175 million. Through the period ended December 31, 2006, we have incurred $316 million of the total expected of approximately $330 million in pre-tax charges associated with the 150-mm restructuring plan, slightly down from the original estimate of $350 million that was defined on October 22, 2003, and which was substantially completed by the end of 2006.

There can be no assurance that future changes in the market demand for our products, overcapacity, obsolescence in our manufacturing facilities and market downturns may not require us to lower the prices we charge for our products as well as incur 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;

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manufacturing yields; and

sales and technical support.

We face significant competition in each of our product lines. Like us, many of our competitors also 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 that compete with ours, we may not be able to compete successfully. Any consolidation among our competitors could also enhance their product offerings, manufacturing efficiency and financial resources, further strengthening their competitive position.

Given the intense competition in the semiconductor industry, if our products are not selected based on any of the above factors, our business, financial condition and results of operations could be materially adversely affected.

In many of the market segments in which we compete for business, competition for the selection of suppliers to design products for use in our customers equipment and products is very intense, 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 its product plans, which could cause us to generate no sales from a product, resulting in a materially adverse affect on our results of operations and financial condition.

We regularly devote substantial resources to 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 can 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.

Even after obtaining a product design win from one of our customers, we may still experience delays in generating revenue from our products as a result of the customer s or our 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 at the time of such delay or cancellation. 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 that we design and manufacture are characterized by rapidly changing technology and new product introductions, and our success depends on our ability to develop and manufacture complex products cost- effectively and to scale.

Semiconductor design and process technologies are subject to constant technological improvements and require large expenditures for capital investments, advanced research and technology development. Many of the resulting products that we market, in turn, have short life cycles, with some being less than one year.

If we experience substantial delays or are unable to develop new design or process technologies, our results of operations or financial condition could be adversely affected.

We also regularly incur costs to acquire technology from third parties without any guarantee of realizing the anticipated value of such expenditures due to changes in other available technologies or market demand. For example, we charged $52 million as annual amortization expense on our consolidated statement of income in 2006 related to technologies and licenses acquired from third parties through the end of 2006. As of December 31, 2006, the residual value, net of amortization, registered in our consolidated balance sheet for these technologies and licenses was $95 million. In addition to amortization expenses, the value of these assets may be subject to impairment with associated charges being made to our consolidated financial statements.

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

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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. For the years 2003 through 2005, our sales increased at a slower pace than the semiconductor industry as a whole and our market share declined, although we recovered in 2006 with an increase in our sales of 11% compared to an increase of 9% for the industry overall. There is no assurance that we will continue to grow our market share, if we are not able to accelerate product innovation, extend our customer base, realize manufacturing improvements and/or otherwise control our costs. In addition, in recent years the semiconductor industry has continued to increase manufacturing capacity in Asia in order to access lower-cost production and to benefit from higher overall efficiency, which has led to a stronger competitive environment. 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, such as increasing our production capacity in Asia or a discontinuation of certain product families or additional restructurings, which in turn may result in loss of revenues, asset impairments and/or capital losses.

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, or failure to find new partners in such alliances, in developing new process technologies in line with market requirements.

We are dependent on alliances to develop or access new technologies and there can be no assurance that these alliances will be successful or that our partners will continue to participate in the alliances. For example, we are currently cooperating with Freescale Semiconductor, Inc. (formerly a division of Motorola Inc.) (Freescale Semiconductor) and NXP Semiconductors B.V. (formerly Philips Semiconductor International B.V.) (NXP Semiconductors) 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 Crolles, France (Crolles2). We initially formed the Crolles2 alliance with NXP Semiconductors in 2000 and renewed the partnership in 2002 when Freescale Semiconductor joined the alliance. The Crolles2 alliance was also extended in 2002 through a joint development program with TSMC for process technology alignment, in 2004 by the Nanotec-300 research program with CEA-LETI for the development of the 45-nm and 32-nm process technology nodes, and again in 2005 by including 300-mm wafer testing and packaging, as well as the development and licensing of core libraries and IP.

In January 2007, NXP Semiconductors announced that it will withdraw from the alliance at the end of 2007 and therefore our Crolles2 alliance will expire on December 31, 2007. Freescale Semiconductor has also notified us that the Crolles2 alliance will terminate as of such date. There can be no assurance that we will be successful in finding new partners to pursue joint R&D work and/or joint manufacturing production at Crolles2 beyond 2007. In addition, the termination of our R&D alliance in Crolles2 with Freescale Semiconductor and NXP Semiconductors may significantly increase our future cost and capital requirements to access advanced CMOS process technologies and proprietary state-of-the-art derivative CMOS technologies, and the operation of our Crolles2 manufacturing facility.

We continue to believe that the shared R&D business model contributes to the fast acceleration of semiconductor process technology development while allowing us to lower our development and manufacturing costs. However, there can be no assurance that alliances will be successful or that new alliances will be concluded to allow 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 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 we are unable to develop or otherwise access 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.

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 37.9% in the third quarter of 2004 to a low of 32.9% in the first quarter of 2005. We cannot guarantee that

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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.

The competitive environment of the semiconductor industry has led to industry consolidation and we may face even more intense competition from newly merged competitors or we may seek to acquire a competitor or become an acquisition target.

The intensely competitive environment of the semiconductor industry and the high costs associated with developing marketable products and manufacturing technologies may lead to further consolidation in the industry. Such consolidation can allow a company to further benefit from economies of scale, provide improved or more diverse product portfolios and increase the size of its serviceable market. Consequently, we may seek to acquire a competitor to improve our market position and the applications and products we can market. 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 may not be predictable and which can have a materially adverse effect on our results of operations and financial condition.

Future acquisitions or divestitures may adversely affect our business.

Our strategies to improve our results of operations and financial condition may lead us to make significant acquisitions of businesses that we believe to be complementary to our own, or to divest ourselves of activities that we believe do not serve our longer term business plans. In addition, certain regulatory approvals for potential acquisitions may require the divestiture of business activities.

Our potential acquisition strategies depend in part on our ability to identify suitable acquisition targets, finance their acquisition and obtain required regulatory and other approvals. Our potential divestiture strategies depend in part on our ability to define the activities in which we should no longer engage, and then determine and execute appropriate methods to divest of them.

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

- diversion of management s attention;
- difficult integration of acquired company operations and personnel;
- loss of activities and technologies that may have complemented our remaining businesses;
- assumption of potential liabilities, disclosed or undisclosed, associated with the business acquired, which liabilities may exceed the amount of indemnification available from the seller;
- potential inaccuracies in the financial and accounting systems utilized by the business acquired;
- 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;
- loss of important services provided by key employees that are assigned to divested activities;
- whether we are able to retain customers of the acquired entity; and
- goodwill and other intangible asset impairment, due to the inability of the business to meet management s expectations at the time of the acquisition.

These and other factors may cause a materially adverse effect on our results of operations and financial condition.

The strategic repositioning of our memory business may fail to produce the operational and strategic benefits which we envisioned.

As a result of a strategic review of our product portfolio, we decided to actively pursue solutions aimed at strengthening the competitive position of our memory business by deconsolidating that segment from our financial results, and, if possible, participate in industry consolidation. Consequently, on December 13, 2006, we announced plans to create a stand-alone Flash Memories Group. The Flash Memories Group incorporates all Flash memory operations, including research and development and product-related activities, front- and back-end manufacturing, marketing and sales. Our initiative is intended to result in a number of strategic benefits, including the ability to benefit from increased scale and employee incentives more directly tied to our financial performance. This initiative may not produce the anticipated benefits, which could adversely affect the results of our operations and future capital requirements. It may also lead to disadvantages, including but not limited to a

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loss of synergies, economies of scale and one-time or ongoing losses that are not fully offset by any expected benefits.

Furthermore, we have a joint development agreement with Hynix Semiconductor Inc. (Hynix Semiconductor) for the development of NAND Flash memories and a joint venture agreement with Hynix Semiconductor for the building and operation of a front-end memory manufacturing facility in Wuxi City, China.

In addition, we are building a new facility in Catania M6, where facilitization is nearly completed and where we carry approximately $400 million in assets, but which remains to be equipped. Realization of the anticipated benefits depend on the development of future partnerships in the Flash memories business. Future capital investments for this facility should benefit from certain public funding, which has been recently approved by the requisite European Union and Italian authorities. In case the repositioning of our memory business results in a change of control, such business would cease to benefit from those of our agreements which apply only to the subsidiaries in which we have a minimum 50% controlling interest, and our assets value and results of operations may suffer a material adverse effect pursuant to such change of control.

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 2006 include income and expense items translated at the average rate for the period. In 2006, our effective average U.S. dollar exchange rate, which reflects the current exchange rate levels and the impact of our hedging contracts, was 1.00 for $1.24, compared to our effective average exchange rate of 1.00 for $1.28 in 2005.

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 and we spent $1.5 billion in 2006. See Item 5. Operating and Financial Review and Prospects Liquidity and Capital Resources . We have evolved our strategy towards a less capital intensive structure and as such we expect our capital expenditures to be $1.2 billion in 2007. Our costs may also increase 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.

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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 and we are running a 300-mm pilot line at Crolles2, with our partners NXP Semiconductors and Freescale Semiconductor. This relationship will expire at December 31, 2007. There is no assurance that we will be successful in finding alternative partnership opportunities to replace the loading currently supported by NXP Semiconductors and Freescale Semiconductor in Crolles2, which in turn may lead to increased capital commitments and manufacturing costs. We have also constructed a building in Catania (Italy), which is not yet equipped, for the volume production of 300-mm wafers, which has been allocated to our new Flash Memories Group. In addition, we have a 33% equity interest in a joint venture company with Hynix Semiconductor, which has built a new 300-mm fab for the production of NAND memory products in Wuxi, China. Since the joint venture is planning to expand its activity, we may be required to make an additional capital investment to keep this level of equity interest in the joint venture.

The construction, facilitization or equipment of state-of-the-art manufacturing facilities 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 the market price of our common shares.

We may also need additional funding in the coming years to finance our investments or to 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 in 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 wafer production facility in Catania (Italy) and there can be no assurance that we will obtain this public funding, as planned, or that we will be in a position to utilize the funding within the planned time frame. 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 consequently 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 22 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;

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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.

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 fluctuated, 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 guarantee 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 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.

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, 2006, our largest customer was Nokia, which accounted for 21.8% of our 2006 net revenues, compared to 22.4% in 2005 and 17.1% in 2004. In 2006, our top ten OEM customers accounted for approximately 51% of our net revenues, compared to approximately 50% of our 2005 net revenues and

44% of our 2004 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 19% of our net revenues were made through distributors in 2006, compared to approximately 18% in 2005 and approximately 21% in 2004. 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,

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seek alternate suppliers, increase its product returns or fail to meet its payment obligations, our business financial condition and results of operations 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.

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, 2006, the value registered on our audited consolidated balance sheet for goodwill was $223 million and the value for technologies and licenses acquired from third parties was $95 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.

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, as well as other materials such as copper and gold whose prices on the world markets have fluctuated significantly during recent periods. 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. In addition, the costs of certain materials, such as copper and gold, may increase due to market pressures and we may not be able to pass on such cost increases to the prices we charge to our customers. 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

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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 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 or other indemnification to maintain good customer relationships. Furthermore, we could incur significant costs and liabilities if litigation occurs to defend against such claims and if damages are awarded against us. 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 operations. There is no guarantee that our insurance policies will be available or adequate to protect against all such claims.

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.

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We have from time to time received, and may in the future receive, communications alleging possible infringement of patents and other intellectual property rights. Furthermore, we may become involved in costly litigation brought against us regarding patents, mask works, copyrights, trademarks or trade secrets. We are currently involved in patent litigation with SanDisk Corporation with respect to our Flash memory products and in litigation with Tessera, Inc. regarding packaging technologies. 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 rights 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) banned the use of lead and some flame retardants in electronic components as of 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, Regulation 1907/2006 of December 18, 2006 will require registration, evaluation, authorization and restriction of a large number of chemicals (REACH) starting June 1, 2007. The implementation of any such legislation could adversely affect our manufacturing costs or product sales by requiring us to acquire costly equipment, materials or greenhouse 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. 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 .

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.

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 2006, we had an income tax benefit of $20 million, as compared to an income tax expense of $8 million in 2005. In 2006, we benefited from a favorable assessment of our tax assets and liabilities mainly due to a favorable outcome of a tax litigation in one of our jurisdictions. 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

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such tax claims. Our failure to do so and/or the need to increase our provisions for such claims could have a material adverse effect on our financial position.

We have been 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 2006 accounts or as 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 requires 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 increase the complexity 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. 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.

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 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 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, beginning in the fourth quarter of 2005, is now charged directly against our earnings. This change could have an effect on our earnings per share, which could negatively impact our future stock price.

In addition, through the first half of 2005, we 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 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.

If our internal control over financial reporting fail to meet the requirements of Section 404 of the Sarbanes-Oxley Act, it may have a materially adverse effect on our stock price.

The SEC, as required by Section 404 of the Sarbanes-Oxley Act of 2002, adopted rules that require us to include a management report assessing the effectiveness of our internal control over financial reporting in our annual report on Form 20-F. In addition, we must also include an attestation by our independent registered public accounting firm regarding the adequacy of management s assessment and the effectiveness of our internal control over financial

reporting. We have successfully completed our Section 404 assessment and received the auditors attestation as of December 31, 2006. However, in the future, if we fail to complete a favorable assessment from our management or to obtain our auditors attestation, we may be subject to regulatory sanctions or may suffer a loss of investor confidence in the reliability of our financial statements, which could lead to an adverse effect on our stock price.

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Reduction in the amount of public funding available to us, changes in existing public funding programs 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 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.

On April 9, 2002, the EU approved a grant to us by the Italian Government of 542.3 million (Decision N844/2001), representing approximately 26.25% of the total cost (estimated at 2,066 million) (the M6 Grant) for the building, facilitization and equipment of a new 300-mm manufacturing facility in Catania M6 capable of producing approximately 5,000 wafers per week in 2006 for NOR and other nonvolatile memory products (the M6 Plant). The construction of the M6 Plant has not proceeded as planned. In 2006, the Italian Government informed the EU Commission about a proposed modification to the conditions for the M6 Grant, as authorized on April 9, 2002. In a decision on December 6, 2006 sent to the Italian Foreign Minister, the EU Commission, according to the proposal made by the Italian government, accepted to modify the conditions for the M6 Grant.

In particular, the EU Commission accepted the proposal of the Italian government to provide for an extension of the authorized time period for the completion of the planned investment and to allocate, out of the 542.3 million grants originally authorized, 446 million for the completion of the M6 Plant if we made a further investment of 1,700 million between January 1, 2006 through the end of 2009. The 446 million M6 Grant is conditional upon the conclusion of a Contratto di Programma providing, *inter alia,* for (i) the creation of a minimum number of new jobs, (ii) the fixed assets remaining at least five years after the completion of the M6 Plant, (iii) at least 31.25% of the total of 1,700 million investment for the M6 Plant being either in the form of equity or loan, (iv) an annual report on work progress being submitted to the Italian authorities and the EU Commission, and (v) a general verification of the consistency of the project. For the period prior to December 31, 2006, the Commission, upon the proposal of the Italian government, considered that we would have been entitled to the remaining 96 million grant (out of the total 542.3 million originally granted) in the form of a tax credit if we had made a total cumulated investment of 366 million as of such date. As of December 31, 2006, we have invested a cumulative amount of 298 million instead of 366 million and recorded a cumulative amount of tax credit of 78 million out of the 96 million to which we could have been entitled.

There is no assurance that the *Contratto di Programma* will be concluded at acceptable conditions to both the Italian authorities and us, and that, if concluded, such contract will be approved by the EU Commission if the stated

conditions are not consistent with prior decisions by the EU Commission concerning such grants. Failure to receive the grants as anticipated may adversely impair our expected results of operations linked to the equipment and operation of the M6 Plant.

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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, 2006, 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 27.5%, 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 November 27, 2006, our Supervisory Board decided to authorize us to enter into an option agreement with an independent foundation, Stichting Continuïteit ST (the Stichting), and to terminate a substantially similar option agreement dated May 31, 1999, as amended, between us and ST Holding II. Our Managing Board and our Supervisory Board, along with the board of the Stichting, have declared that they are jointly of the opinion that the Stichting is independent of our Company and our major shareholders. Our Supervisory Board approved the new option agreement to reflect changes in Dutch legal requirements, not in response to any hostile takeover attempt. On February 7, 2007, the May 31, 1999 option agreement, as amended, was terminated by mutual consent by ST Holding II and us and the new option agreement we concluded with the Stichting became effective on the same date. The new option agreement provides for the issuance of up to a maximum of 540,000,000 preference shares, the same number as the May 31, 1999 option agreement, as amended. The Stichting would have the option, which it shall exercise in its sole discretion, to take up the preference shares. The preference shares would be issuable in the event of actions considered hostile by our Managing Board and Supervisory Board, such as a creeping acquisition or an unsolicited offer for our common shares, which are unsupported by our Managing Board and Supervisory Board and which the board of the Stichting determines would be contrary to the interests of our Company, our shareholders and our other stakeholders. If the Stichting exercises its call option and acquires preference shares, it must pay at least 25% of the par value of such preference shares. The preference shares may remain outstanding for no longer then two years.

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 or otherwise taking actions considered hostile by our Managing Board and Supervisory Board. In addition, any issuance of additional capital within the limits of our authorized share capital, as approved by our shareholders, is subject to the requirements of our Articles of Association, see Item 10. Additional Information Memorandum and Articles of Association Share Capital as of December 31, 2006 Issuance of Shares, Preemption Rights and Preference Shares (Article 4) .

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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 13, 2007, 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 (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 +31-20-654-3210. 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 N.V.

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 2006 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 2006 results published by iSuppli, we believe we were number one in industrial products, number two in analog products and number three in wireless, automotive electronics and NOR Flash. Based on industry results, we also believe we ranked as a leading supplier of semiconductors in 2006 for set-top boxes, Smartcards 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. Our major customers include Alcatel-Lucent, Bosch, Cisco, Conti, Delphi, Delta, Denso, Ericsson, Hewlett-Packard, LG Electronics, Marelli, Maxtor, Motorola, Nokia, Philips, Pioneer, Samsung, 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 2006, our revenues grew at a compounded annual growth rate of 11.6% compared to 7.7% for the industry as a whole.

We offer a broad and 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 nonvolatile memory and Smartcards. Application Specific Products, which are generally less vulnerable to market cycles than standard commodity products, accounted for approximately 55% of our net revenues in 2006. Memory Product sales accounted for approximately 22% of our net revenues in 2006, while sales of Micro, Power and Analog products accounted for approximately 23% of our net revenues in 2006.

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

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 (BiCMOS) for mixed-signal applications, and diffused metal oxide semiconductor (DMOS) technology and Bipolar, CMOS and DMOS (BCD technologies) for intelligent power applications and embedded memory

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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 this date and until the end of 2006, we report our sales and operating income in three product group 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 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 comprised of all of our major complex products related to automotive applications;

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

- the Micro, Power, Analog Product Group (MPA) segment, comprised of discrete and standard products plus standard microcontroller and industrial devices (including the programmable systems memories (PSM) division); this segment was previously known as Micro, Linear and Discrete Product Group, but no change has occurred in the segment s perimeter or organization.

Effective January 1, 2007, to meet the evolving requirements of the market together with the pursuit of a strategic repositioning in Flash memory, we have reorganized our product segment groups into the Application Specific Product Groups, the Industrial and Multisegment Sector and the Flash Memories Group. We will begin reporting sales and segment financial information using this alignment beginning in the first quarter of 2007.

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. All our product segments share common research and development for process technology and manufacturing capacity for most of their products. However, beginning January 1, 2007, the stand-alone Flash Memories Group (FMG), incorporates all the Flash memory operations (both NOR and NAND), including Technology R&D, all product related activities, front-end and back-end manufacturing, marketing and sales worldwide. Keeping the same overall perimeter, our Application Specific Groups (ASG) will now be comprised of the newly created Mobile, Multimedia & Communications Group (MMC) and the Home Entertainment & Displays Group (HED) as well as the existing Automotive Product Group (APG) and Computer Peripherals Group (CPG). The former MPA segment plus non-Flash memory products (formerly under MPG) and Micro-Electro-Mechanical Systems (MEMS) activity have been combined to form a new sector, Industrial and Multisegment Sector (IMS).

In the past two years, we have 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 focusing on our 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 applications and new major key accounts with a special focus on the Chinese and Japanese markets with a view to increased overall efficiencies, (iv) improving our manufacturing competitiveness through the restructuring of our 150-mm wafer production capacity, (v) launching and implementing various cost-reduction initiatives through procurement savings, improved asset management, general and administration centralization and headcount restructuring, and (vi) establishing a less capital-intensive business model.

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Results of Operations

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

	Year Ended December 31,		
	2006	2005	2004
	(In millions, except percentages)		
Net Revenues by Product Segment			
Application Specific Product Group Segment (ASG)	$ 5,396	$ 4,991	$ 4,902
Memory Products Group Segment (MPG)	2,137	1,948	1,887
Micro, Power, Analog Product Group Segment (MPA)	2,243	1,882	1,902
Others(1)	78	61	69
Total	$ 9,854	$ 8,882	$ 8,760
Net Revenues by Location of Order Shipment(2)			
Europe(3)	$ 3,073	$ 2,789	$ 2,827
North America(6)	1,232	1,281	1,360
Asia Pacific(4)	2,084	1,860	1,852
Greater China(4)	2,552	2,203	1,859
Japan	400	307	403
Emerging Markets(3)(5)(6)	513	442	459
Total	$ 9,854	$ 8,882	$ 8,760
Net Revenues by Product Segment			
Application Specific Product Group Segment (ASG)	54.7%	56.2%	56.0%
Memory Products Group Segment (MPG)	21.7	21.9	21.5
Micro, Power, Analog Product Group Segment (MPA)	22.8	21.2	21.7
Others(1)	0.8	0.7	0.8
Total	100.0%	100.0%	100.0%
Net Revenues by Location of Order Shipment(2)			
Europe(3)	31.2%	31.4%	32.3%
North America(6)	12.5	14.4	15.5
Asia Pacific(4)	21.1	20.9	21.2
Greater China(4)	25.9	24.8	21.2
Japan	4.1	3.5	4.6
Emerging Markets(3)(5)(6)	5.2	5.0	5.2
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) As of January 1, 2006, we created a new region, Greater China to focus exclusively on our operations in China, Hong Kong and Taiwan. Net revenues for Asia Pacific for prior periods were restated according to the new perimeter.

(5) Emerging Markets in 2005 and 2006 included markets such as India, Latin America (excluding Mexico), the Middle East and Africa, Europe (non-EU and non-EFTA) and Russia.

(6) As of July 2, 2006, the region North America includes Mexico which was part of Emerging Markets in prior periods. Amounts have been reclassified to reflect this change.

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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, which has moved from double-digit growth to single-digit average growth over the last several years;
- the strong development of new emerging applications in areas such as wireless communications, solid-state storage, digital TV and video products and games;
- 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 to seek new system-level, turnkey solutions from semiconductor suppliers;
- 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);
- the expansion of available manufacturing capacity through third-party providers; and
- the increased participation in the semiconductor industry of private equity firms, exemplified by the takeovers in 2006 of two of the top ten semiconductor companies, which may lead to strategic repositionings of those companies and reorganization amongst industry players.

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 using a variety of technologies, 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 mice; (iii) digital consumer, including set-top boxes, DVDs, digital TVs, digital cameras and digital audio; (iv) automotive, including engine, body and safety, car radio, car multimedia and telematics; and (v) industrial and multisegment products, including power supplies, and motor-control, lighting, metering, banking and Smartcard.

Product strategy and innovation. We aim to be leaders in multimedia convergence and power applications. In order to serve these segments, our plan is to maintain and further establish existing leadership positions for (i) platforms and chipset solutions for digital consumer, cellular phone and car navigation; and (ii) power applications, which are driving system solutions for a wide consumer base in the field of industrial applications, motor control, factory automation, lighting, power supply and automotive, in particular, and which require less research and development effort and manufacturing capital intensity than more advanced and complex application-specific devices.

We also dedicate significant resources to product innovation. We have identified our key product offerings in each of the targeted market segments and have concentrated our R&D resources to develop leading-edge products for each. Examples include: digital-base band and multi-media solutions for wireless, digital consumer products focused on set-top boxes, SoC offerings in data storage and system-oriented products for the multisegment sector. We are also targeting new end markets, such as medical applications.

Finally, we have decided to strategically reposition our participation in the Flash memory business in order to limit our exposure to the capital intensity of the industry as well as to achieve the appropriate economies of scale which are demanded in this competitive segment.

Customer-based initiatives. There are three tenets to our sales strategy. First, we work with our key customers to identify evolving needs and new applications and to develop innovative products and product features. 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 which give our customers access to our process technologies and manufacturing infrastructure. We have formed alliances with customers including Alcatel-Lucent, Bosch, Hewlett-Packard, Marelli, Nokia, Nortel, Pioneer, Seagate, Siemens VDO, Thomson and Western Digital. Our strategic alliances have been historically a major growth driver for us. In 2004, 2005 and 2006, revenues from strategic customer alliances accounted for approximately 39%, 44% and 41% respectively of our net revenues. Secondly, we are targeting new major key accounts, where we can leverage our position as a supplier of application-specific products with a broad range product portfolio to better address the requirements of large users of semiconductor products with whom our penetration has historically been quite low. Finally, we

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have targeted the mass market, or those customers outside of our traditional top 50 customers, who require system-level solutions for multiple market segments. In addition, we have focused on two regions as key ingredients in future sales growth, Greater China and Japan, where we have reorganized regional management.

Global integrated manufacturing infrastructure. We have a diversified, leading-edge manufacturing infrastructure, comprising front-end and back-end facilities, capable of producing silicon wafers using our broad process technology portfolio, including our CMOS and BiCMOS technologies as well as our memories and discretes technologies. 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. In 2006, while confirming our mission to remain an integrated device manufacturing company, we decided to reduce our capital intensity in order to optimize opportunities between internal and external front-end production, reduce our dependence on market cycles that impact the loading of our fabs, and decrease the burden of depreciation on our financial performance.

Research and development partnerships. The semiconductor industry is increasingly characterized by higher costs and technological risks involved in the research and development of state-of-the-art processes. These higher costs and technological risks have driven us to enter into cooperative partnerships. From 2000 until now, we have been jointly developing advanced CMOS technologies in Crolles (France) with Freescale Semiconductor and NXP Semiconductors. At the end of 2006, one of our partners notified us of their intention to continue their participation in the Crolles2 alliance only through the end of 2007. We remain convinced that the shared R&D business model contributes to the fast acceleration of semiconductor process technology development, and we therefore remain committed to our strategy of alliances to reinforce cooperation in the area of technology development.

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 economic zones that we target: Europe, Asia, China and America. 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 also have design and marketing capabilities in our Japan and Emerging Markets regions. We have front-end manufacturing facilities in Europe, in the United States and in Asia. 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.

Product quality excellence. We aim to develop the quality excellence of our products and in the various applications we serve and we have launched 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.

Return on capital employed. We remain focused on providing our shareholders with value creation, measured in particular in terms of return on net assets compared to the weighted average cost of capital.

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 discretes, 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 Smartcards. 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.

In 2006, we ran our business along product lines and managed our revenues and internal operating income performance based on the following product segments:

Application Specific Product Group segment;

Memory Products Group segment; and

Micro, Power and Analog Product Group segment.

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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, as well as mixed analog/digital semicustom-devices, using advanced bipolar, CMOS, BiCMOS mixed-signal and power technologies. 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 certain 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 the 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 functions (CODEC) and radio frequency ICs. We estimate that we ship over 30%, by volume, of the mobile-phone industry s primary energy-management devices and audio ICs. We are transitioning from ICs to modular solutions in the field of radio frequency and energy management for 3G handsets. In December 2006, we announced a major design win for an ASIC solution for use in 3G/3.5G digital basebands at Ericsson Mobile Platforms. This award represents a significant new product category for us.

(b) *Application Processor Division.* We offer a family of products, known as the Nomadik family, addressing the market for multimedia application processor chips. 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 smart and feature phones for three tier-one customers, Nokia, Samsung and LG.

(c) *Imaging Division.* We focus on the wireless handset image-sensor market. We are in production of CMOS-based camera modules and processors for low-and-high density pixel resolutions, which also meet the auto focus, advanced fixed focus and miniaturization requirements of this market. We have cumulatively shipped approximately 200 million CMOS camera-phone solutions since entering this market in 2003. According to Prismark, we were tied for the number one position in camera module manufacturing in 2006.

(d) *Connectivity Division.* To respond to the market need for increased functionality of handsets, we created the Connectivity Division to address wireless LAN (WLAN), Bluetooth and connectivity requirements. Our product offerings include WLAN and Bluetooth and Bluetooth FM radio combination chips designed for low power consumption and a small form factor. We have multiple design wins and are in volume production for several customers in Asia and Europe for our products. In particular, we are manufacturing in volume our single-chip WLAN, Bluetooth and combination ICs for several customers, including a tier-one cellphone manufacturer. Our next generation of ICs increase combination options, with our third-generation chips offering

single-die multi-function capability in 65-nm.

(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 focuses on products for digital retail, satellite, cable and IPTV set-top box products and digital television offerings. We continue 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. In 2006, we reinforced the market leadership of our

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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 90-nm 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.

Our latest product, the STi7109, is our second-generation H.264 high-definition TV (HDTV) AVC and VC-1 decoder. Building on the success of the STi710x, the world s first single-chip AVC and MPEG-2 decoder, the STi7109 adds VC-1 decoding, improved security, connectivity features, and support for emerging DVD formats and security standards.

The STi7100-based set-top boxes are being rolled out for satellite, IPTV, and terrestrial broadcast by several operators, including Canal+, France Telecom and Telecom Italia. The successor product, the STi7200, a single-chip dual-decode device in 65-nm technology, is now being sampled by customers.

We address the digital television markets with a wide range of highly integrated ASSPs and application-specific microcontrollers. Significant numbers of televisions integrating digital terrestrial capability using the STi55xx family as digital plug-in solutions have been sold, primarily in Europe. 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 we have also introduced our STD1000 device which offers both an improved feature set and competitiveness for this growing market.

(b) *Interactive System Solutions Division.* We offer customers and partners the capability to jointly develop highly integrated solutions for their consumer products. We utilize a broad and proven base of expertise, advanced technologies and hardware/software intellectual property to provide best-in-class differentiated products for a select base of customers and markets.

(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 aimed primarily at home, desktop and mobile applications with digital-to-digital complete system solution capability that improve sound quality while reducing power consumption, size and cost.

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

(a) *Wireless Infrastructure Division.* We formed the Wireless Infrastructure division to develop dedicated infrastructure chip solutions that will be focused on third-generation telecom standards, while 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.

Our Greenside family of products combine the market s first SoC baseband processor for wireless infrastructure applications with multi-standard software libraries, optimized for GSM, EDGE, W-CDMA, and WiMAX networks. This family of products is geared toward addressing the needs of both Macro and Femto basestation markets.

(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.

(c) *Display Division.* Our products cover driver chips for the flat-panel industry and CRT applications. Our product development is focused mainly on driver chips for various kinds of flat-panel display technologies such as small and large LCDs, Plasma, OLED (Organic Light Emitting Diode) and E-Paper. These products use proprietary technologies fitting the various electrical parameters required by those market segments, ranging from low to very high voltages and currents and from junction to oxide isolation (SOI).

Computer Peripherals Products

(i) *Data Storage Division.* We produce SoCs and analog ASICs for several data storage applications, specializing in disk drives with advanced solutions for read-and write-channels, disk controllers, host interfaces,

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digital power processing, motor controllers and micromachinery. We believe that based on sales, we are, and have been for many years, one of the largest semiconductor companies supplying the hard disk drive market.

Complementing our strong position in SoCs, we believe we are the market leader in motor controllers and we are providing solutions for all market segments, including enterprise, desktop and mobile applications. We are currently providing SoC solutions based on proprietary IP in production at 130-nm 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. A market leader in the data storage market selected our latest 90-nm SoC for its next generation of desktop and mobile drives, which we expect to begin shipping in volume in the second half of 2007. This SoC includes a rich variety of our own IP including our proprietary read/write channel, Serial ATA controller and microcomputer core.

(ii) *Printer Division.* We are focusing on inkjet and multifunction printer components and are an important supplier of pen chips, motor drivers, and 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 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 Avian Flu.

Automotive Products

Our automotive products include alternator regulators, airbag controls, anti-skid braking systems, vehicle stability control, ignition circuits, injection circuits, multiplex wiring kits and products for body and chassis electronics, engine management, instrumentation systems, car radio and multimedia, as well as car satellite and navigation systems. We hold a leading position in the IC market for automotive products. We have developed a joint initiative with Freescale Semiconductor for the development of 90-nm embedded Flash technology and common products based on cost-effective 32-bit microcontrollers for use in all automotive applications.

(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.

(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 tolling, navigation and other telematic applications. 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.

(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.

Memory Products Group Segment

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

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In December 2006, we announced our decision to establish a stand-alone Flash Memories Group in 2007. This group will consolidate all the Flash memory operations including NAND and NOR Flash memories technology R&D, all product related activities, front-end manufacturing, marketing and sales worldwide. This strategic repositioning of Flash memories is designed to facilitate the acquisition of dimension of scale which we view as a necessity to compete successfully in this business.

Prior to our December 2006 announcement, our memory business was comprised as follows:

(i) *Wireless Flash Memories Division.* Wireless applications have very specific requirements in power consumption, packaging and memory addressing. We offer a very wide portfolio of wireless NOR Flash memories from single-die low-density products through high-density 1-Gbit solutions, as well as multiple chip packages containing several memory technology components.

(ii) *Standard Nonvolatile Memories Division.* We produce a broad range of industry-standard, general-purpose Flash memories from 1 to 64 Mbit and we are in the process of producing Flash memories that will go up to 128 Mbit. We also produce the more mature erasable programmable read-only memory (EPROM), from 64 Kilobit (Kbit) to 32 Mbit. Efficient manufacturing, together with our sales and distribution channels, has contributed to the exploitation of our technological advantage in Flash and 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 Kbit, 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 Mbit and 128 Mbit 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 Semiconductor. Our efforts are targeted at the lower density memory requirements evolving for embedded wireless applications. Our most advanced offering, a single die 8 Gigabit (Gbit) NAND Flash manufactured in 60-nm technology, is now available in production. NAND Flash is primarily used to store information such as music, still pictures, video and data files in a variety of consumer applications, including mobile phones, MP3 readers, universal serial bus (USB) keys and digital still cameras.

(v) *Smartcard IC Division.* Smartcards 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 Smartcard ICs. Our expertise in security is a key to our leadership in the finance and pay-TV segments and development of IT applications. If addition, our mastering of the nonvolatile memory technologies is instrumental to offering the highest memory sizes (up to 128 KBytes and even 1 MByte), particularly important to address the emerging high-end mobile phone market.

(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 standalone organization and also directly controls the sales force for this product offering.

We have made significant progress on improving the cost position of our Memory Product Group Segment, in particular widely developing the two-bit-per-cell architecture and transitioning to more advanced technologies, and 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. The announced creation of our new Flash Memories Group is designed to facilitate the acquisition of the dimension of scale, which remains a critical element for future success and therefore we plan to strategically reposition our presence in this market.

Micro, Power and Analog Product Group Segment

The Micro, Power and Analog Product Group segment (formerly known as 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. In addition, this segment spearheads our ongoing efforts to maintain and develop high-end analog products and of consolidating our world leadership position in power applications, with full solutions centered around microcontroller applications. Due to the high degree of customer fragmentation and the need for product diversity to meet these numerous requirements, MPA designs and releases approximately four new products each business day.

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(i) *Power MOSFET Division.* We design, manufacture and sell Power MOSFETs (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 lighting applications, where we hold a leadership position from low-power, high-volume consumer to high-power industrial 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 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 or Triacs for controlling current in either direction) and other 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 and 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, and 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 using a wide technology portfolio and are manufactured in processes capable of embedding EPROM, EEPROM and Flash non volatile memories as appropriate. We have improved our product offering in this division, and now offer a new family of 8-bit microcontrollers in addition to our line of 32-bit ARM7-based microcontrollers optimized for multiple industrial applications, including factory automation, appliances and security systems. We have also updated our STR7 Software Library supporting our 32-bit ARM7-based microcontrollers.

(vi) *Industrial and Power Conversion Division.* We design and manufacture products for industrial automation systems, lighting applications (lamp ballast), battery chargers and Switched Mode Power Supplies (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.

(vii) *Advanced Analog and Logic Division.* We develop innovative, differentiated and value-added analog products for a number of markets and applications including point-of-sales terminals, power meters and white goods. We recently introduced our NEATSwitch portfolio of application-specific analog, digital, and power switches and extended our supervisor and reset-IC family. 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.

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-Lucent, 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.

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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 NXP Semiconductors (formerly known as Philips Semiconductors) for the joint development of advanced CMOS process technologies in Crolles, France, since 1992. In 2003, we signed a new joint technology cooperation agreement with Freescale Semiconductor and NXP Semiconductors for the joint research and development of advanced CMOS process technology 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. This agreement had also been extended to include research and development related to wafer testing and packaging and to cover the development and licensing of core libraries. In January 2007, NXP Semiconductors announced that it will withdraw from the alliance at the end of 2007. Freescale Semiconductor has also notified us that the Crolles2 alliance will terminate as of such date. We remain convinced that the shared R&D business model contributes to the fast acceleration of semiconductor process technology development and we will continue to actively pursue an expansion of our portfolio of alliances to reinforce cooperation in the area of technology development in Crolles2.

We have also established joint development programs with leading suppliers such as Air Liquide, Applied Materials, ASM Lithography, Canon, Gemalto, Hewlett-Packard, KLA-Tencor, LAM Research, MEMC, Teradyne and Wacker and with electronic design automation (EDA) 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 on a global basis with major research institutions and universities.

In 2004, we signed and announced a joint venture agreement with Hynix Semiconductor to build a front-end memory-manufacturing facility in Wuxi City, China. The joint venture is an extension of a NAND Flash Process/product joint development relationship. The facility was inaugurated in October 2006. The fab employs approximately 2,700 people and features a 200-mm wafer production line that began production of DRAM in June 2006 and a 300-mm wafer production line, which began NAND production in October 2006. The total investment in the project is approximately $2 billion. We contributed 33% of the equity financing, equivalent to $250 million, while Hynix Semiconductor contributed 67%. In addition, we have provided $218 million out of our total $250 million commitment as debt financing to the joint venture by way of a guarantee. The financing of the joint venture also includes funding from local Chinese institutions, including long-term leasehold and local debt financing.

Customers and Applications

We design, develop, manufacture and market thousands of products that we sell to approximately 1,300 direct customers. Our major customers include Alcatel-Lucent, Bosch, Cisco, Conti, Delphi, Delta, Denso, Ericsson, Hewlett-Packard, LG Electronics, Marelli, Maxtor, Motorola, Nokia, Philips, Pioneer, Samsung, Seagate, Siemens, Thomson, Vestel, Visteon and Western Digital. To many of our key customers we provide a wide range of products, including application-specific 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 and retailers, including Arrow Electronics, Avnet, BSI Group, Wintech and Yosun.

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

Telecommunications				
Customers:	2Wire	Finisar	Nokia	BG/Tech
	Alcatel-Lucent	Huawei	Nortel Networks	Siemens
	BenQ	LG Electronics	Philips	Sony Ericsson
	Cisco	Motorola	Samsung	TCL Corporation
Applications:	Camera modules/ mobile imaging		Portable multimedia	
	Central office switching systems		Telephone terminals	
	Data transport (routing, switching for		(wireline and wireless)	

electronic and optical networks)	Wireless connectivity
Digital cellular telephones	(Bluetooth, WLAN,
Internet access (XDSL)	FM radio)
	Wireless infrastructure

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Computer Peripherals				
Customers:	Agilent	Delta	Lexmark	Samsung
	Apple	Hewlett-Packard	Taiwan-Liton	Seagate
	Xilinx	Intel	Maxtor	Western Digital
	Dell	Lenovo-IBM	Microsoft	Wintech
Applications:	Data storage		Power management	
	Monitors and displays		Printers	
			Webcams	
Automotive				
Customers:	Bosch	Harman	Hitachi	TRW
	Conti	Hella	Marelli	Valeo
	Delphi	Kostal	Pioneer	Visteon
	Denso	Lear	Siemens VDO	Oasis
			Sirius	XM Satellite
Applications:	Airbags		Global positioning systems Multimedia	
	Anti-lock braking systems		Radio/ satellite radio	
	Body and chassis electronics		Telematics	
	Engine management systems (ignition and injection)		Vehicle stability control	
Consumer				
Customers:	ADB	LG Electronics	Pace	AOC
	Bose Corporation	Nintendo	Philips	Sony
	Echostar	Skyworth	Samsung	Thomson
	Humax	Safran	Scientific Atlanta	TTE WW
			Matsushita	Vestel
Applications:	Audio processing (CD, DVD, Hi-Fi)		DVDs	
			Imaging	
	Analog/ digital TVs		Set-top boxes	
	Digital cameras		VCRs	
	Digital music players		Displays	
Industrial/ Other Applications				
Customers:	American Power Conversion	Delta	General Electric	Philips
	Artesyn	Gemalto	Vodafone	Siemens
	Astec	Universal Lighting	Nagra	TIM
	Autostrade		Giesecke & Devrient	Mikron JSC
Applications:	Battery chargers		MEMS	
	Smartcard ICs		Motor controllers	
	Intelligent power switches		Power supplies	
	Industrial automation/ control systems		Switch mode power supplies	
	Lighting systems (lamp ballasts)			

In 2006, our largest customer, Nokia, represented 21.8% of our net revenues, compared to 22.4% in 2005 and 17.1% in 2004. No other single customer accounted for more than 10% of our net revenues. Sales to our OEM

customers accounted for approximately 81% of our net revenues in 2006, from approximately 82% of our net revenues in 2005 and 79% in 2004. Sales to our top ten OEM customers were approximately 51% of total revenues in 2006, 50% in 2005 and 44% in 2004. 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 19% of our net revenues in 2006 were sold through distributors, compared to 18% in 2005 and 21% in 2004. There can 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, Greater China, Japan, and Emerging Markets, which include Latin America, the Middle East and Africa, Europe (non-EU and non-EFTA),

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Russia and India. For a breakdown of net revenues by product segment and geographic region for each of the three years ended December 31, 2006, see Item 5. Operating and Financial Review and Prospects Results of Operations Segment Information .

The European region is divided into seven business units: automotive, consumer and computers, Smartcard, telecom, EMS, industrial, 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 Smartcard (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 2006, sales and marketing segments were managed from our regional sales headquarters in Singapore and organized into nine segments (computer and peripheral, automotive, industrial/computer/ MPA, home entertainment, communications and mobile multimedia, display, Smartcard and security, distribution and EMS) with three transversal support organizations (business management, field quality and communications). We have sales offices in Korea, Malaysia, Thailand and Australia. The Singapore sales organization provides central marketing, customer service, technical support, logistics, an application laboratory and design services for the entire region. In addition, there is a design center in Korea.

On January 1, 2006, we created a new sales region, Greater China , which encompasses China, Taiwan and Hong Kong. This new sales region is dedicated to sales, design and support resources and is aimed at expanding on our many years of successful participation in this quickly growing market, not only with transnational customers that have transferred their manufacturing to China, but also with domestic customers. This market is expected to grow significantly in the next few years according to industry analysts. In 2006, we grew our sales in Greater China by 16% and industry analysts estimated that we were one of the top five semiconductor suppliers in China.

In Japan, the large majority of our sales have historically been made through distributors, as is typical for foreign suppliers to the Japanese market. However, we are now seeking to work more directly with our major customers to address their requirements. 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. In 2006, we implemented changes in our organization for Japan and are targeting, by expanding our sales design and support resources, to improve our coverage of this significant market for the products we serve. In 2006, our sales grew by more than 30% in Japan, while the Japanese market grew only 5%.

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.

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

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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, incorporate our products into the application-specific 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.

We are market driven in our research and development and focused on leading-edge products and technologies developed 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 process technologies research and development activities are managed by our new FTM organization.

In 2005, we reallocated approximately 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. In addition, we focus on our key technology and product programs that set a clear roadmap with defined milestones and that are reviewed at least once every quarter by our Executive Committee.

We invest in a variety of research and development projects ranging from long-term advanced research 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 digital consumer, wireless communications and networking, computer peripherals, Smartcards and car multimedia, among others.

We continue to make significant investments in research and development, while reducing these investments as a percentage of revenues. In 2006, we spent $1,667 million on research and development, which represented approximately a 2% increase from $1,630 million in 2005, while 2005 spending represented a 6% increase from $1,532 million in 2004. The table below sets forth information with respect to our research and development spending since 2004. Our reported research and development expenses are mainly in product design, technology and development and do not include marketing and 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,		
	2006	2005	2004
	(In millions, except percentages)		
Expenditures	$ 1,667	$ 1,630	$ 1,532

As a percentage of net revenues	16.9%	18.3%	17.5%

Approximately 86% of our research and development expenses in 2006 were incurred in Europe, primarily in France and Italy. See Public Funding below. As of December 31, 2006, we employed approximately 10,300 employees in research and development activities worldwide.

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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, smaller, 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 EAD 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 to develop commercial products immediately.

Our R&D activities are conducted on a worldwide scale and focus on 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 (Catania), France (Grenoble, Tours and Rousset), the United States (Phoenix, Carrollton, and San Diego), Canada (Ottawa), the United Kingdom (Bristol and Edinburgh), Switzerland (Geneva), India (Noida and Bangalore), China (Beijing, Shenzhen and Shanghai) and Singapore.

In Crolles we are cooperating through 2007 with NXP Semiconductors and Freescale Semiconductor as part of the Crolles2 alliance to jointly develop sub-micron CMOS logic processes 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 smaller technologies. 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 had been set through December 31, 2007 and on January 12, 2007 NXP Semiconductors informed us that they would cease participation in the alliance at year end. Freescale Semiconductor has also notified us that the Crolles2 alliance will terminate as of such date. For our own core process technology development below 45-nm, we intend to work with an industry leader, and are currently in negotiations with potential partners. We intend, however, to continue to develop state-of-the-art derivative technologies (defined as RF CMOS, Power CMOS and CMOS Imaging) at Crolles2.

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 commercially implement them on satisfactory terms, or that we will be able to successfully enter into new alliances for the development of core CMOS technologies on satisfactory terms beyond 2007, or that we will be able to find new partners to pursue advanced technology developments in Crolles2, upon the termination of our Crolles2 Agreement. 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, or failure to find new partners in such alliances, in developing new process technologies in line with market requirements .

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

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. As part of the recently announced plans to separate the activities of our Flash Memories Group, the activities in Agrate will be split between those which will remain with us and those attributed to the Flash Memories Group. There is no assurance that we will be successful in implementing such reorganization or enjoy the expected benefits.

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

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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 from 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 Smartcards, 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 world-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 microarray for DNA amplification and detection.

The Application Specific Discretes (ASD^{tm}) 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 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 PowerMESH™ and STripFET™ MOSFET families.

Our other specialized divisional R&D centers are located in Grenoble (packaging R&D, IP center), and Rousset (Smartcard 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 Smartcard SoC, we have centers in Prague and Shanghai.

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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 reconfigurable 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 3G base-stations.

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Property, Plants and Equipment

We currently operate 15 (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)	Application-specific 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	Application-specific products and microcontrollers	Fab: 200-mm CMOS, BiCMOS, BCD
Agrate, Italy	Nonvolatile memories, microcontrollers and application-specific products	Fab 1: 200-mm BCD, nonvolatile memories, MEMS Fab 2: 200-mm Flash, embedded Flash, research and development on nonvolatile memories and BCD technologies
Rousset, France	Microcontrollers, nonvolatile memories and Smartcard ICs and application-specific products	Fab 1: 150-mm CMOS, Smartcard (phase-out to be completed in early 2007) Fab 2: 200-mm CMOS, Smartcard, 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, Smartcard, EEPROM 300-mm building constructed but not fully facilitized and equipped
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	Microcontrollers, power transistors, commodity products, nonvolatile memories, and application-specific products	Fab 1: 125-mm, power MOS, bipolar transistor, bipolar ICs, standard linear Fab 2: 150-mm bipolar, power MOS and BCD, EEPROM, Smartcard, 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	Application-specific 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	

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(1) Operated jointly with NXP Semiconductors and Freescale Semiconductor. The agreement will terminate at the end of 2007.

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

As of December 31, 2006, 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 280,000 square meters of back-end facilities.

At the end of 2006, our front-end facilities had total capacity of approximately 125,000 200-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 seven 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, 2006; as of the same date, fabs (in Rousset, France and in Singapore) have approximately two-thirds of the ultimate capacity installed. Our latest 200-mm line in Agrate, Italy primarily planned for MEMS products was still in the start-up phase on December 31, 2006.

We, along with our partners NXP Semiconductors and Freescale Semiconductor, 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 2006, the pilot line produced approximately 2,500 wafers per week.

At the end of 2006, the building shell for our future 300-mm wafer volume manufacturing fabrication facility in Catania, Italy and the first phase of facilitization were completed. In December 2006, we received confirmation from the Italian Government that the conditions concerning investment and employment linked to the grant of subsidies for the construction, facilitization and equipment of our new M6 facility could be met during the period 2006 to 2009, instead of the original period expiring in 2006. Because of the location of this new 300-mm facility as well as other 200-mm and 150-mm facilities in southern Italy (Catania, Sicily), we face the risk that an earthquake could damage such facilities. 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 a portion of total manufacturing volumes to external suppliers. We have recently announced that our goal is to reduce our capital investment spending to sales ratio from above 20% in the past several years to a target of 12%, due to the change in the structural growth of the semiconductor market which has moved from double to single digit over the last ten years. The reduction in our capital investments is also designed to reduce our dependence on economic cycles which affects the loading of our fabs and to decrease the burden of depreciation on our financial performance while optimizing opportunities between internal and external front-end production.

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 finer 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, 2006, we had $467 million in outstanding commitments for purchases of equipment for delivery in 2007. The most significant of our 2007 capital expenditure projects are expected to be: for the front-end facilities, (i) in Agrate (Italy), related to the upgrading of our 200-mm pilot line, the ramp-up of the 200-mm line for

MEMS and the expansion of capacity to our 200-mm fab; (ii) the upgrading to finer geometry technologies for our 200-mm plant in Rousset (France); (iii) the upgrading of our 200-mm plant in Singapore; and (iv) for the back-end facilities, the capital expenditures will be mainly dedicated to the capacity expansion in our plants in Shenzhen (China) and Muar (Malaysia) and capacity upgrade in Malta and Toa Payoh (Singapore). 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 2007 capital expenditures to be approximately $1.2 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.

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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 19 to the Consolidated Financial Statements. In 2006, we were still incurring charges for impairment, restructuring and other closure costs related to the ongoing plans, which included the closing of the Casteletto, Italy production facility and concentrating EWS activities in Singapore. These actions were largely completed at December 31, 2006; the total amount of these charges in 2006 was $77 million.

Through the period ended December 31, 2006, we have incurred $316 million of the total expected of approximately $330 million in pre-tax charges associated with the 150-mm restructuring plan, slightly down from the original estimate of $350 million that was defined on October 22, 2003, and which was 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.

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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 close to 9,000 patent families (each patent family containing all patents originating from the same invention). We filed 609 new patent applications around the world in 2006.

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 assets 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 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 from competitors or other parties 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 third or fourth quarter generating the highest amount of revenues due to electronic products purchased from many of our targeted market segments for 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.

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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 lower than we had entering 2004. During 2005, our backlog registered a solid increase. We entered 2006, with a backlog higher than we had entering 2005, while, due to a more difficult industry environment, we are entering 2007 with an order backlog that is lower than what we had entering 2006.

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.

The primary international semiconductor companies that compete with us include Analog Devices, Broadcom, IBM, Infineon Technologies, Intel, International Rectifier, Fairchild Semiconductor, Freescale Semiconductor, Linear Technology, LSI Logic, Marvell Technology Group, Maxim Integrated Products, Microchip Technology, National Semiconductor, Nippon Electric Company, ON Semiconductor, NXP 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 subsidiaries. With the exception of our subsidiaries in Shenzhen, China, in which we own 60% of the shares and voting rights; Hynix, ST (China), a 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.

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The following list includes our principal subsidiaries and equity investments and the percentage of ownership we held as of December 31, 2006:

Legal Seat	Name	Percentage Ownership (Direct or Indirect)
Australia Sydney	STMicroelectronics PTY Ltd	100
Belgium Zaventem	STMicroelectronics Belgium N.V.	100
Belgium Zaventem	Proton World International N.V.	100
Brazil Sao Paolo	STMicroelectronics Ltda	100
Brazil Sao Paulo	Incard do Brazil Ltda	50
Canada Ottawa	STMicroelectronics (Canada), Inc.	100
China Shenzhen	Shenzhen STS Microelectronics Co. Ltd	60
China Shenzhen	STMicroelectronics (Shenzhen) Co. Ltd	100
China Shenzhen	STMicroelectronics (Shenzhen) Manufacturing Co. Ltd	100
China Shenzhen	STMicroelectronics (Shenzhen) R&D Co. Ltd	100
China Shanghai	STMicroelectronics (Shanghai) Co. Ltd	100
China Shanghai	STMicroelectronics (Shanghai) R&D Co. Ltd	100
China Shanghai	Shanghai Blue Media Co. Ltd	65
China Shanghai	STMicroelectronics (China) Investment Co. Ltd	100
China Jiangsu(1)	Hynix-ST Semiconductor Ltd	33
China Beijing	STMicroelectronics (Beijing) R&D Co. Ltd	100
Czech Republic Prague	STMicroelectronics Design and Application s.r.o.	100
Finland Lohja	STMicroelectronics OY	100
France Crolles	STMicroelectronics (Crolles 2) SAS	100
France Montrouge	STMicroelectronics S.A.	100
France Rousset	STMicroelectronics (Rousset) SAS	100
France Tours	STMicroelectronics (Tours) SAS	100
France Grenoble	STMicroelectronics (Grenoble) SAS	100
Germany Grasbrunn	STMicroelectronics GmbH	100
Germany Grasbrunn	STMicroelectronics Design and Application GmbH	100
Holland Amsterdam	STMicroelectronics Finance B.V.	100
Hong Kong Hong Kong	STMicroelectronics LTD	100
India Noida	STMicroelectronics Pvt Ltd	100
Israel Netanya	STMicroelectronics Ltd	100
Italy Catania	CO.RI.M.ME.	100
Italy Aosta	DORA S.p.a.	100
Italy Agrate Brianza	ST Incard S.r.l.	100
Italy Naples	STMicroelectronics Services S.r.l.	100
Italy Agrate Brianza	STMicroelectronics S.r.l.	100
Italy Caivano(1)	INGAM Srl	20
Japan Tokyo	STMicroelectronics KK	100
Malaysia Kuala Lumpur	STMicroelectronics Marketing SDN BHD	100
Malaysia Muar	STMicroelectronics SDN BHD	100
Malta Kirkop	STMicroelectronics Ltd	100
Mexico Guadalajara	STMicroelectronics Marketing, S. de R.L. de C.V.	100
Mexico Guadalajara		100

		STMicroelectronics Design and Applications, S. de R.L. de C.V.	
Morocco	Rabat	Electronic Holding S.A.	100
Morocco	Casablanca	STMicroelectronics S.A.	100
Singapore	Ang Mo Kio	STMicroelectronics ASIA PACIFIC Pte Ltd	100
Singapore	Ang Mo Kio	STMicroelectronics Pte Ltd	100
Spain	Madrid	STMicroelectronics S.A.	100
Sweden	Kista	STMicroelectronics A.B.	100
Switzerland	Geneva	STMicroelectronics S.A.	100
Switzerland	Geneva	INCARD SA	100
Switzerland	Geneva	INCARD Sales and Marketing SA	100
Turkey	Istanbul	STMicroelectronics Elektronik Arastirma ve Gelistirme Anonim Sirketi	100
United Kingdom	Marlow	STMicroelecrtonics Limited	100
United Kingdom	Marlow	STMicroelectronics (Research & Development) Limited	100
United Kingdom	Bristol	Inmos Limited	100
United Kingdom	Reading	Synad Technologies Limited	100
United States	Carrollton	STMicroelectronics Inc.	100
United States	Wilmington	STMicroelectronics (North America) Holding, Inc.	100
United States	Wilsonville	The Portland Group, Inc.	100

(1) Equity Investments

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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.

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.

Some of our government funding contracts for research and development involve advance payments that 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.

On April 9, 2002, the EU approved a grant to us by the Italian Government of 542.3 million (Decision N844/2001), representing approximately 26.25% of the total cost (estimated at 2,066 million) (the M6 Grant) for the building, facilitization and equipment of a new 300-mm manufacturing facility in Catania M6 capable of producing approximately 5,000 wafers per week in 2006 for NOR and other nonvolatile memory products (the M6 Plant). The construction of the M6 Plant has not proceeded as planned. In 2006, the Italian Government informed the EU Commission about a proposed modification to the conditions for the M6 Grant, as authorized on April 9, 2002. In a decision on December 6, 2006 sent to the Italian Foreign Minister, the EU Commission, according to the proposal made by the Italian government, accepted to modify the conditions for the M6 Grant.

In particular, the EU Commission accepted the proposal of the Italian government to provide for an extension of the authorized time period for the completion of the planned investment and to allocate, out of the 542.3 million grants originally authorized, 446 million for the completion of the M6 Plant if we made a further investment of 1,700 million between January 1, 2006 through the end of 2009. The 446 million M6 Grant is conditional upon the conclusion of a Contratto di Programma providing, *inter alia*, for (i) the creation of a minimum number of new jobs, (ii) the fixed assets remaining at least five years after the completion of the

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M6 Plant, (iii) at least 31.25% of the total of 1,700 million investment for the M6 Plant being either in the form of equity or loan, (iv) an annual report on work progress being submitted to the Italian authorities and the EU Commission, and (v) a general verification of the consistency of the project. For the period prior to December 31, 2006, the Commission, upon the proposal of the Italian government, considered that we would have been entitled to the remaining 96 million grant (out of the total 542.3 million originally granted) in the form of a tax credit if we had made a total cumulated investment of 366 million as of such date. As of December 31, 2006, we have invested a cumulative amount of 298 million instead of 366 million and recorded a cumulative amount of tax credit of 78 million out of the 96 million to which we could have been entitled.

There is no assurance that the *Contratto di Programma* will be concluded at acceptable conditions to both the Italian authorities and us, and that, if concluded, such contract will be approved by the EU Commission if the stated conditions are not consistent with prior decisions by the EU Commission concerning such grants. Failure to receive the grants as anticipated may adversely impair our expected results of operations linked to the equipment and operation of the M6 Plant.

In France, support for microelectronics is provided to over 30 companies with activities in the semiconductor industry. 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 18 to our Consolidated Financial Statements. Such funding has totaled $54 million, $76 million and $84 million in the years 2006, 2005 and 2004, respectively.

Government support for capital expenditures funding has totaled $15 million, $38 million and $46 million in the years 2006, 2005 and 2004, 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 $54 million, $66 million and $74 million in 2006, 2005 and 2004, respectively.

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 2006, 2005 and 2004, we had approximately $125 million, $120 million and $156 million, respectively, of indebtedness outstanding under state-assisted financing programs at an average interest cost of 0.9%, 1.0% and 1.0%, 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

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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, tracking 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 frames, 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 Semiconductor for the co-development and manufacturing of NAND products pursuant to which Hynix Semiconductor from Korea is supplying the co-developed NAND products to us. We have also set up a joint venture in China which has built and operates a memory manufacturing facility in Wuxi City, China and expect to receive an amount of wafers produced at this facility at competitive conditions and commensurate with our 33% equity interest in the joint venture.

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. As a company, we have been certified to be in compliance with the quality standard ISO9001:2000 and with the technical specification ISO/TS16949:2002. In addition, all 15 of our manufacturing facilities have been certified to conform to the environmental standard ISO14001, to the Eco Management and Audit Scheme (EMAS) and to the Health and Safety standard OHSAS18001.

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

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transposed by the EU Member States into national legislation by August 13, 2004. In France, Directives 2002/95/EC and 2002/96/ EC have been implemented by a decree dated July 20, 2005 and five ministerial orders published in November 2005, December 2005 and March 2006. The French scheme for the recovery and recycling of WEEE was officially launched on November 15, 2006.

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 quotes are still being discussed between the French government and the European Commission, but we intend to proactively comply with these regulations. In the United States, we participated in the first phase of the Chicago Climate Exchange program, a voluntary greenhouse gas trading program whose members commit to reduce emissions, for the period 2003-2006 and we intend to continue our participation in the second phase for the period 2007-2010. We have also implemented voluntary reforestation projects in several countries in order to sequester additional carbon dioxide (CO(2)) emissions.

Furthermore, Regulation 1907/2006 of December 18, 2006 concerning the registration, evaluation, authorization and restriction of chemicals (REACH) has been adopted and will enter into force on June 1, 2007. We intend to proactively implement such new legislation, 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.

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 22% in 2006.

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 $45 billion in 1988 to $247.7 billion in 2006 (growing at a compound annual growth rate of approximately 9.9%). In 2005, the TAM increased by approximately 7% and in 2006 by approximately 9%. On a sequential, quarter-by-quarter basis in 2006

(including actuators), the TAM decreased by 1.3% in the first quarter over the fourth quarter 2005, while in the second quarter it increased by 0.4% over the first quarter, it increased by 7.9% in the third quarter over the second quarter, and increased by 1.9% 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 $35 billion in 1988 to $164.5 billion in 2006, growing at a

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compound annual rate of approximately 9%. The SAM increased by approximately 8% in 2006 compared to 2005. In 2006, approximately 18% of all semiconductors were shipped to the Americas, 16% to Europe, 19% to Japan, and 47% 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)					
	2006	2005	2004	2003	1998	1988	05-06	04-05	03-04	88-06	88-98	98-03
	(In billions)						(Expressed as percentages)					
Integrated Circuits and Sensors	$ 214.8	$ 197.3	$ 183.5	$ 143.5	$ 109.1	$ 35.9	8.9%	7.5%	27.9%	10.5%	11.8%	5.6%
Analog, Sensors and Actuators	42.3	36.5	36.1	30.4	19.1	7.2	16.0	0.9	19.0	10.3	10.2	9.7
Digital Logic	114.1	112.4	100.3	80.7	67.0	17.8	1.5	12.1	24.3	10.9	14.2	3.8
Memory:												
DRAM	33.8	25.6	26.8	16.7	14.0	6.3	32.0	(4.7)	60.9	9.8	8.3	3.6
Others	24.7	22.9	20.3	15.8	9.0	4.6	7.7	13.0	28.3	9.8	6.9	12.0
Total Memory	58.5	48.5	47.1	32.5	23.0	10.9	20.5	2.9	45.0	9.8	7.7	7.2
Total Digital	172.6	160.9	147.4	113.2	90.0	28.7	7.3	9.1	30.3	10.5	12.1	4.7
Discrete	16.6	15.2	15.8	13.3	11.9	7.0	8.8	(3.3)	18.1	4.9	5.5	2.3
Optoelectronics	16.3	14.9	13.7	9.5	4.6	2.1	9.3	8.6	43.8	12.0	8.1	15.6
TAM	$ 247.7	$ 227.5	$ 213.0	$ 166.4	$ 125.6	$ 45.0	8.9%	6.8%	28.0%	9.9%(3)	10.8%	5.8%(3)
Europe	39.9	39.3	39.4	32.3	29.4	8.1	1.6	(0.4)	22.0	9.3	13.8	1.9
Americas	44.9	40.7	39.1	32.3	41.4	13.4	10.3	4.3	20.8	6.9	11.9	(4.8)
Asia Pacific	116.5	103.4	88.8	62.8	28.9	5.4	12.7	16.5	41.3	18.6	18.3	16.8
Japan	46.4	44.1	45.8	38.9	25.9	18.1	5.3	(3.7)	17.5	5.4	3.7	8.5
TAM	$ 247.7	$ 227.5	$ 213.0	$ 166.4	$ 125.6	$ 45.0	8.9%	6.8%	28.0%	9.9%(3)	10.8%	5.8%(3)

(1) Source: WSTS.

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

(3) Calculated on a comparable basis, without information with respect to actuators as they were not included in the indicator before 2003.

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

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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 to the device is switched off) or nonvolatile memories (which retain their data content without the need for continuous power).

The primary volatile memory devices are DRAMs, which accounted for approximately 58% of semiconductor memory sales in 2006, and static RAMs (SRAMs), which accounted for approximately 5% of semiconductor memory sales in 2006. 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 programming by exposure to ultraviolet light and can be 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 in-system, they are more flexible than EPROMs and are therefore progressively replacing EPROMs in many 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, because of their ability to store large amounts of information, 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. They 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 loading 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; other non-recurring special charges and stock-based compensation 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; provisions for specifically identified income tax exposures; and evaluation of tax provisions. 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 are not related to any technological obsolescence issues and are identified shortly after sale in customer

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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 typically 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 2006, we recorded specific provisions amounting to $4 million related to the expected inability to fully collect a certain customer s receivables, in addition to our standard provision of 1% of total receivables based on the estimated historical collection trends. If we receive information that the financial condition of our customers has deteriorated, resulting in an impairment of their ability to make payments, additional allowances could be required.

While the majority of our sales agreements contain standard terms and conditions, we may, from time to time, enter into agreements that contain multiple elements or non-standard terms and conditions, which require revenue recognition judgments. Where multiple elements exist in an arrangement, the arrangement is allocated to the different elements based upon verifiable objective evidence of the fair value of the elements, as governed under Emerging Issues Task Force Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables* (EITF 00-21). In 2006, we signed a $17 million licensing agreement which included $10 million of upfront revenue recognition related to the perpetual license granted and separate training and consulting units that will be recognized as revenue as services are provided.

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, 2006, the value of goodwill in our Consolidated Financial Statements amounted to $223 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

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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 2006, we recorded a goodwill impairment charge of $6 million due to our decision to discontinue developing products from our Tioga Technologies Ltd. (Tioga) business acquisition. See Note 7 to our Consolidated Financial Statements.

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 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 2006, we recorded an impairment charge of $4 million due to the discontinuance of product development related to our Tioga business acquisition, which was determined to be without any alternative use. See Note 8 to our Consolidated Financial Statements. At December 31, 2006, the value of intangible assets in our Consolidated Financial Statements subject to amortization amounted to $211 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 the carrying value of 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. 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

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loss. In 2006, we recorded an impairment charge of $7 million related to optimizing 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.

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.

Asset disposal. At December 31, 2006, we were required to evaluate the likelihood of the announced deconsolidation of our Flash memory business under Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (FAS 144). Given the status of the project at the closure date, we determined that the deconsolidation was more likely than not to occur for accounting purposes, thus triggering an impairment review for Flash memory activity. The outcome of this test determined that no impairment was required at December 31, 2006.

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 exiting any of our existing activities. We recognize the fair value of a liability for costs associated with exiting an 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 monitor and evaluate business conditions on a regular basis. 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 2006, the amount of restructuring charges and other related closure costs amounted to $65 million before taxes. See Note 19 to our Consolidated Financial Statements.

Share-based compensation. In December 2004, the FASB issued revised Statement of Financial Accounting Standards No. 123, *Share-Based Payment* (FAS 123R), which requires companies to expense employee share-based compensation for financial reporting purposes. 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 were required to value our current and anticipated future employee share-based compensation pursuant to a pricing model, and then amortize that value against our reported earnings over the vesting period in effect for those awards. Due to this accounting treatment, 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 were 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 objective, the forfeitures and the service period of our employees. As a result, we recorded in 2006 a total pre-tax charge of $13 million related to the 2005 stock-based compensation plan and are expecting a pre-tax charge of approximately $2 million in each of the first two quarters of 2007 and $1 million in each of the last two quarters

of 2007. The impact is further detailed in Note 16.6 to our Consolidated Financial Statements. Furthermore, on September 29, 2006 our Compensation Committee gave its final approval of the 2006 stock-based compensation plan which is contingent on Company performance criteria. All performance criteria have been met; therefore, we recorded for the 2006 stock-based compensation plan a pre-tax charge of $15 million in 2006, of which $3 million was capitalized in inventory, and are expecting a pre-tax charge of approximately $15 million in the first quarter of 2007, $9 million in the second quarter of 2007 and $6 million in each of the last two quarters of 2007.

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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. On the basis of this assessment, at the end of 2006 we recorded a provision of approximately $15 million in one of our tax jurisdictions. As of December 31, 2006, 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, in our estimates of the valuation allowance, or a change 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 received in the past a tax assessment from the United States tax authorities, and accordingly we took a provision at the moment the assessment was received. In the second quarter of 2006, we received a favorable recommendation from the United States tax authorities Appeals Team Case Leader in relation to this tax assessment. This recommendation was sent to the Joint Committee for Taxation for final ruling. In December 2006, the Joint Committee for Taxation decided that there was no tax liability for us and as a result we reversed the entire $90 million provision we established to cover these claims. See Note 24 to our Consolidated Financial Statements.

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 we believe that 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 December 31, 2006, based on our assessment, we did not record any provisions in our Consolidated Financial Statements relating to those legal proceedings, because we had not identified any risk of probable loss that is likely to arise out of the proceedings. There can be no assurance, however, that we will be successful in resolving these proceedings. If we are unsuccessful, 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 pension schemes or in the above assumptions can have an impact on our valuations. As of December 31, 2006, the Company adopted Statement of Financial Accounting Standards No. 158, *Employer s Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132(R)* (FAS 158), which requires the Company to account for the overfunded and underfunded status of defined benefit and other post retirement plans in its consolidated financial statements. As of

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December 31, 2006, we had a total benefit obligation estimated at $575 million, and total plan assets estimated at $241 million resulting in an underfunded status of $334 million, recorded in our balance sheet at December 31, 2006.

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 we believe that 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 our provisions need to be adjusted 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 that 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 2006

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 2006 ended on April 1, 2006. The second quarter of 2006 ended on July 1, 2006, and the third quarter of 2006 ended on September 30, 2006. The fourth quarter ended on December 31, 2006. 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.

2006 Business Overview

In 2006, the semiconductor market experienced a higher increase in total sales compared to 2005, 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 by the World Semiconductor Trade Statistics (WSTS), semiconductor industry revenues increased year-over-year by approximately 9% for the TAM and 8% for the SAM in 2006 to reach approximately $248 billion and approximately $165 billion, respectively. This increase was driven by unit demand while average selling prices declined compared to 2005. In the fourth quarter of 2006, the TAM and the SAM increased approximately 9% and 4% year-over-year, respectively, while the TAM increased by approximately 2% and the SAM decreased 1% sequentially.

Our 2006 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 11% to $9,854 million compared to $8,882 million in 2005. Strong growth in revenues was driven by double-digit increases in Wireless and Industrial applications with mid-single digit contributions from the Automotive, Consumer and Computer segments. Our 2006 sales performance was above the TAM and the SAM growth rates.

With reference to the quarterly results, our fourth quarter 2006 revenues performance was below the TAM and flat with the SAM, both on a year-over-year basis and on a sequential basis.

On a year-over-year basis, our fourth quarter 2006 revenues increased by approximately 4% to $2,483 million compared to $2,389 million in the fourth quarter of 2005, driven primarily by Digital Consumer and Automotive segment applications while we registered declines in Telecom and Memories. On a year-over-year basis, the TAM and the SAM registered increases of approximately 9% and 4%, respectively.

On a sequential basis, in the fourth quarter 2006, revenues decreased approximately 1% mainly due to the overall weakness in the Telecom sector. Our net revenues performance was at the low end of our guidance, which indicated a sequential growth of between -1% and +5%. Sequentially, the TAM registered an increase of approximately 2% while the SAM registered a decrease of 1%.

In 2006, our effective average U.S. dollar exchange rate was 1.00 for $1.24, which reflects the actual exchange rate levels and the impact of certain hedging contracts, compared to our 2005 effective average

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exchange rate of 1.00 for $1.28. 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.

On a total year basis, our gross margin increased from 34.2% in 2005 to 35.8% in 2006 due to overall improvements in volume, manufacturing performances and product mix, which were partially offset by the declining selling prices.

On a sequential basis, our gross margin increased from 36.0% to 36.3% in the fourth quarter 2006, due to improved manufacturing efficiency and product mix, partially offset by the pricing pressures and the unfavorable U.S. dollar exchange rate impact. Our fourth quarter gross margin was within our guidance that indicated a gross margin of approximately 37% plus or minus one percentage point.

Our operating expenses combining selling, general and administrative expenses and research and development were higher in 2006 compared to 2005 due to higher spending in research and development and the 2006 share-based compensation for our employees and members and professionals of the Supervisory Board.

Our total impairment and restructuring charges for 2006 were significantly lower compared to 2005 as our previously announced restructuring plan costs were largely recognized in prior time periods. Our manufacturing initiatives are now substantially completed and were drivers of margin improvements in 2006.

The combined effect of the above mentioned factors and the other operating items resulted in a quite favorable impact on our operating income, that increased significantly from $244 million in 2005 to $677 million in 2006. The operating margin for 2006 improved over 400 basis points to 6.9%. This improvement was driven by higher sales volume, an improved gross margin and a more favorable effective U.S. dollar exchange rate. In the fourth quarter of 2006, however, our operating income decreased both sequentially and on a year-over-year basis as the result of an unfavorable industry environment.

Our interest income significantly improved in 2006 mainly as the result of rising interest rates on our available cash, which significantly increased after the refinancing transactions in the first quarter of 2006 and due to the continued generation of positive net operating cash flow. Due to some favorable adjustments in our tax position, our income tax for 2006 resulted in a benefit of $20 million.

In summary, our financial results for 2006 compared to the results of 2005 were favorably impacted by the following factors:

- higher sales volume and a more favorable product mix in our revenues, which contributed to a solid increase in our net revenues over 2005;
- continuous strong improvement of our manufacturing performance;
- a more favorable effective exchange rate for the U.S. dollar;
- net interest income;
- lower impairment, restructuring charges and other related closure costs; and
- income tax benefit.

Our financial results in 2006 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;
- stock-based compensation charges related to 2005 and 2006 grants; and
- higher amount of other expenses.

In 2006, we continued to invest in upgrading and expanding our manufacturing capacity. Total capital expenditures in 2006 were $1,533 million, which were financed entirely by net cash generated from operating

activities. In fact, we generated $666 million of net operating cash flow during the year. Net operating cash flow is not a U.S. GAAP measure, as further discussed in section Liquidity and Capital Resources Liquidity Net operating cash flow. At December 31, 2006, we had cash, cash equivalents, marketable securities and short-term deposits of $2,673 million. Total debt and bank overdrafts were $2,130 million, of which $1,994 million were long-term debt.

Looking at the fourth quarter and the near term environment, the current market correction underway in some of the key applications that we serve is more pronounced than forecasted. Our wireless results, in particular, came in well below historical seasonal patterns and were also negatively impacted by product mix shift towards the low end, which put additional pressure on our margins and operating performance in the quarter. However, for the full year, we achieved double digit year-over-year sales growth in a market that appears to be growing in the high single digits. This is a clear signal that the evolution of our product portfolio is delivering results with higher

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revenues, improved profitability, better leverage of our research and development and capital investments, and expansion of our market share.

During 2006, we made significant headway in delivering on our most important business and strategic imperatives. Our product portfolio continues to strengthen. We are driving a significant reduction in our capital intensity. This is visible in our 2006 results, with our capital investments to sales ratio down to 15.6% from over 20% on average for 2004 and 2005. Further, we have initiated a new mid-term target of 12% through a combination of a less capital-intensive product portfolio, increased usage of foundries for non-proprietary technologies and optimization of our manufacturing facilities. As of January 1, 2007, we have organized our NOR and NAND Flash business into a stand-alone segment and are moving ahead on creating a separate legal entity in connection with our strategic repositioning of this business. In summary, we achieved our primary objectives for 2006: gaining market share while simultaneously improving financial performance in terms of return on assets and cash flow.

Business Outlook

Notwithstanding the current tougher environment as the market works through inventory in selected applications in the first half of 2007, we believe we are poised to make further important progress on our ongoing key initiatives for sales expansion, new product introduction and asset leverage, which will strengthen our market opportunities and financial position.

As it is typical for the first quarter seasonality, we expect our revenues for the first quarter of 2007 to decline from 2006 fourth quarter levels. Specifically, we expect sales to decrease between 3% and 11% sequentially. This sales range, coupled with our intention to control the absolute level of inventory, will result in adverse fab loading conditions in the quarter, leading to a gross margin of about 35%, plus or minus 1 percentage point.

Our capital expenditures are currently budgeted to be $1.2 billion for 2007, which is expected to further reduce our capital expenditure to sales ratio from the previous year s level.

This guidance is based on an effective average U.S. dollar exchange rate of approximately 1.00 for $1.29, 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

As of January 1, 2006, we created 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.

As of January 1, 2006, we renamed the Micro, Linear and Discrete Product Group (MLD) segment Micro, Power, Analog Product Group (MPA) segment 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.

On January 26, 2006, we announced the appointment of Mr. Jeffrey See as Corporate Vice President and General Manager of our worldwide back-end operations. Effective April 3, 2006, Mr. See took 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.

On February 20, 2006, we inaugurated our new design and development facility in Greater Noida (India) and we announced our plans to invest $30 million in local operations over the next two years and to recruit 300 new engineers by the end of 2006.

On February 23, 2006, we issued Zero Coupon Senior Convertible Bonds due 2016 (2016 Convertible Bonds) representing total gross proceeds of $974 million. The amount due to bondholders upon redemption or at maturity based on the accreted value of the bonds will produce a yield equivalent to 1.5% per annum on a semi-annual bond equivalent basis. The bonds are convertible into a maximum of approximately 42 million of our underlying ordinary shares. The conversion price at issuing date is $23.19, based on the closing price of ordinary shares on the NYSE on

February 14, 2006, plus a 30% premium.

On March 13, 2006, we issued 500 million Floating Rate Senior Bonds due 2013 in the Euro Debt Capital Market (2013 Senior Bonds). These bonds will pay interest quarterly at a rate equal to three-month Euribor plus 40 basis points.

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On March 29, 2006, we announced our intention to further expand our presence and support for the China market. In addition to our joint venture with Hynix Semiconductor in Wuxi and to supplement our existing plant in Shenzhen, we plan to invest approximately $500 million to build our second back-end plant in China, which is expected to start production in the third quarter of 2008.

Following the decision by the Compensation Committee of our Supervisory Board in April 2006, the number of shares granted under our 2005 stock-based compensation plan will be a maximum of approximately 2.7 million shares out of the maximum of 4.1 million non-vested shares granted to our employees and CEO in 2005. In April 2006, the Compensation Committee of our Supervisory Board determined that two out of the three predetermined criteria linked to company performance had been met.

At our annual general meeting of shareholders held in Amsterdam on April 27, 2006, our shareholders approved the following proposals of our Managing Board upon the recommendation of our Supervisory Board:

the Company s accounts, which were for the first time reported in accordance with International Financial Reporting Standards (IFRS);

a cash dividend of $0.12 per share, equal to last year s cash dividend distribution. The cash dividend was distributed in May 2006. On May 22, 2006, our common shares traded ex-dividend on the three stock exchanges on which they are listed;

the reappointment of Mr. Doug Dunn for a new three-year term until the 2009 annual general meeting of shareholders and of Mr. Robert White for an additional one-year-term until the 2007 annual general meeting of shareholders, as well as the three-year term appointment of Mr. Didier Lamouche as a new Supervisory Board member in replacement of Mr. Francis Gavois whose mandate was up at this year s annual shareholders meeting;

the approval of the main principles of the 2006 stock-based compensation plan for our employees and CEO. As part of such plan and specifically as approved by the general meeting of shareholders, our President and CEO will be entitled to receive a maximum of 100,000 common shares;

the adoption of the compensation, including stock-based compensation, for members of our Supervisory Board; and

the delegation of authority to our Supervisory Board for five years to issue new shares, to grant rights, to subscribe for new shares and to limit and/or exclude existing shareholders pre-emptive rights.

On June 20, 2006, we announced the appointment of two new Corporate Vice Presidents. Mr. François Guibert, Corporate Vice President, and formerly General Manager of our Emerging Markets Region, was appointed to the position of General Manager of our Asia Pacific region, effective October 1, 2006. Mr. Guibert replaces Mr. Jean-Claude Marquet, who retired in October. Succeeding Mr. Guibert s position, Mr. Thierry Tingaud, formerly Vice President Sales and Marketing Europe for Telecommunications, was promoted to the position of Corporate Vice President and General Manager of our Emerging Markets Region, effective July 1, 2006.

On June 29, 2006, we sold to Sofinnova Capital V our 51% interest in Accent, one of our subsidiaries based in Italy specialized in hardware and software design and consulting services for integrated circuit design and fabrication. We recorded a net pre tax gain of $6 million relating to this sale. We simultaneously entered into a license agreement with Accent in which we granted them, for a total agreed lump sum amount of $3 million, the right to use certain of our specifically identified intellectual property currently used in its business activities. In connection with this agreement, we were granted warrants for 6,675 new shares of Accent. Such warrants expire after 15 years and can only be exercised in the event of a change of control or an initial public offering of Accent above a predetermined value.

On August 7, 2006, as a result of almost all of the holders of our 2013 Convertible Bonds exercising their August 4, 2006 put option, we repurchased $1,397 million aggregate principal amount of the outstanding convertible

bonds at a conversion ratio of $985.09 per $1,000 aggregate principal amount at issuance resulting in a cash disbursement of $1,377 million.

On October 10, 2006, we, along with Hynix Semiconductor officially inaugurated the new joint front-end memory-manufacturing facility in Wuxi City, China. The facility is currently producing DRAM memories and will begin production of NAND Flash by the middle of 2007.

On November 27, 2006, our Supervisory Board approved entering into an option agreement with an independent foundation, Stichting Continuïteit ST, to replace a substantially similar option agreement dated May 31, 1999, as amended, between us and one of our shareholders, STH II B.V. The new option agreement has

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been entered into to reflect changes in Netherlands legal requirements. It was not adopted in response to any hostile takeover attempt.

Following the discovery in 2006 by our internal audit of a fraud perpetrated by our former head of treasury operations, who retired at the end of 2005, we filed a criminal complaint in September 2006 with the prosecutor in Lugano, Switzerland, that led to the arrest of our former treasurer. The criminal proceeding is ongoing. Our Audit Committee appointed a U.S. law firm last fall to conduct an independent investigation to determine the nature of the fraud and whether the wrongdoing was limited to our former treasurer. To date, based on this investigation, which is substantially complete, and based on our understanding of the available evidence from the criminal proceeding, nothing has been brought to the attention of the Audit Committee or the Company indicating that the fraud was committed with the knowledge or involvement of any of our current or former senior management team, or that such transactions materially affected our financial statements for the current or prior periods.

In an effort to better align our Company to meet the requirements of the market, together with the pursuit of strategic repositioning in Flash Memory, on December 13, 2006, we announced a reorganization of our product segment groups effective as of January 1, 2007: the Application Specific Groups, the Industrial and Multisegment Sector and the Flash Memories Group. The Application Specific Groups include the existing Automotive Products Group and Computer Peripherals Group and the newly created Mobile, Multimedia & Communications Group and Home Entertainment & Displays Group. The Industrial and Multisegment Sector contain the Microcontrollers, Memories & Smartcards Group and the Analog, Power & MEMS Group. The Flash Memories Group incorporates all Flash memory operations, including research and development and product-related activities, front- and back-end manufacturing, marketing and sales. In conjunction with this realignment, we announced a number of new executive and corporate vice presidents. These include Mr. Mario Licciardello as the Corporate Vice President and General Manager of the stand-alone Flash Memories Group; Mr. Carmelo Papa was promoted to Executive Vice President leading the Industrial and Multisegment Sector; Mr. Claude Dardanne as the new Corporate Vice President leading the Microcontrollers, Memories & Smartcards Group; Mr. Tommi Uhari was promoted to Executive Vice President over Mobile, Multimedia & Communications Group; and Mr. Christos Lagomichos promoted to Corporate Vice President for the Home Entertainment & Displays Group.

On January 16, 2007, we confirmed that the technology development at Crolles will continue beyond 2007 despite the announcement that NXP Semiconductors will withdraw from the Crolles2 alliance at the end of 2007 and the joint technology cooperation agreements with NXP Semiconductors and Freescale Semiconductor will expire on December 31, 2007. The Crolles2 alliance, in which we have partnered with NXP Semiconductors and Freescale Semiconductor, will work together to complete the program on 45-nm CMOS and manage the transition throughout 2007.

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 divisions, which include 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 group 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 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 are comprised of all of our major complex products related to automotive applications;

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

the Micro, Power, Analog Product Group (MPA) segment, comprised of discrete and standard products plus standard microcontroller and industrial devices (including the programmable systems memories

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(PSM) division); this segment was previously known as Micro, Linear and Discrete Product Group (MLD), but no change has occurred in the segment s perimeter or organization.

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 group segments, but on the basis of the semiconductor business area. All these product group segments share common research and development for process technology and manufacturing capacity for most of their products.

We have restated our results in prior periods for illustrative comparisons of our performance by product segment and by period. The segment information of 2004 has been restated using the same principles applied to the 2005 and 2006 years. 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 presentation for the 2004 year is representative of 2005 and 2006 years 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 group 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 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,		
	2006	2005	2004
	(In millions)		
Net revenues by product group segment:			
Application Specific Product Group Segment (ASG)	$ 5,396	$ 4,991	$ 4,902
Memory Products Group Segment (MPG)	2,137	1,948	1,887
Micro, Power, Analog Product Group Segment (MPA)	2,243	1,882	1,902
Others(1)	78	61	69
Total consolidated net revenues	$ 9,854	$ 8,882	$ 8,760

(1) Net revenues of Others include revenues from sales of subsystems mainly and other products not allocated to product group segments.

Year Ended December 31,

	2006	2005	2004
		(In millions)	
Operating income (loss) by product group segment:			
Application Specific Product Group Segment (ASG)	$ 439	$ 355	$ 530
Memory Products Group Segment (MPG)	34	(118)	42
Micro, Power, Analog Product Group Segment (MPA)	362	271	413
Total operating income of product group segments	835	508	985
Others(1)	(158)	(264)	(302)
Total consolidated operating income	$ 677	$ 244	$ 683

(1) Operating income (loss) of Others includes items 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

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other costs that are not allocated to the product group segments, as well as operating earnings or losses of the Subsystems and Other Products Group. Certain costs, mainly R&D, formerly in the Others category, have been allocated to the product group segments; comparable amounts reported in this category have been reclassified accordingly in the above table.

	Year Ended December 31,		
	2006	**2005**	**2004**
	(As a percentage of total net revenues)		
Operating income (loss) by product group segment:			
Application Specific Product Group Segment (ASG)(1)	8.1%	7.1%	10.8%
Memory Products Group Segment (MPG)(1)	1.6	(6.1)	2.2
Micro, Power, Analog Product Group Segment (MPA)(1)	16.1	14.4	21.7
Others(2)	(1.6)	(3.0)	(3.5)
Total consolidated operating income(3)	6.9%	2.7%	7.8%

(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 group 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 group 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, have been allocated to the product group segments; comparable amounts reported in this category have been reclassified accordingly in the above table.

(3) As a percentage of total net revenues.

	Year Ended December 31,		
	2006	**2005**	**2004**
	(In millions)		
Reconciliation to consolidated operating income:			
Total operating income of product group segments	$ 835	$ 508	$ 985
Operating Income of others(1)			
Strategic and other research and development programs	(17)	(49)	(91)
Start-up costs	(57)	(56)	(63)
Impairment, restructuring charges and other related closure costs	(77)	(128)	(76)
Subsystems	(1)	1	(1)
One-time compensation and special contributions(2)		(22)	
Patent claim costs			(4)
Other non-allocated provisions(3)	(6)	(10)	(67)
Total operating income (loss) of others	(158)	(264)	(302)

Total consolidated operating income	$ 677	$ 244	$ 683

(1) Operating income (loss) of Others includes items or parts of them, which are not allocated to product group 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 group 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, have been allocated to the product group 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 group segments.

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

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Net Revenues by Location of Order Shipment

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

	Year Ended December 31,		
	2006	2005	2004
		(In millions)	
Net Revenues by Location of Order Shipment:(1)			
Europe(2)	$ 3,073	$ 2,789	$ 2,827
North America(5)	1,232	1,281	1,360
Asia Pacific(3)	2,084	1,860	1,852
Greater China(3)	2,552	2,203	1,859
Japan	400	307	403
Emerging Markets(2)(4)(5)	513	442	459
Total	$ 9,854	$ 8,882	$ 8,760
Net Revenues by Location of Order Shipment:(1)			
Europe(2)	31.2%	31.4%	32.3%
North America(5)	12.5	14.4	15.5
Asia Pacific(3)	21.1	20.9	21.2
Greater China(3)	25.9	24.8	21.2
Japan	4.1	3.5	4.6
Emerging Markets(2)(4)(5)	5.2	5.0	5.2
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.

(2) Since January 1, 2005, the region Europe includes the former East European countries that joined the European Union 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) As of January 1, 2006, we created a new region Greater China to focus exclusively on our operations in China, Hong Kong and Taiwan. Net revenues for Asia Pacific for prior periods were restated according to the new perimeter.

(4) Emerging Markets in 2005 and 2006 included markets such as India, Latin America (excluding Mexico), the Middle East and Africa, Europe (non-EU and non-EFTA) and Russia.

(5) As of July 2, 2006, the region North America includes Mexico which was part of Emerging Markets in prior periods. Amounts have been reclassified to reflect this change.

Net Revenues by Market Segment

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

	Year Ended December 31,		
	2006	**2005**	**2004**
	(As a percentage of net revenues)		
Net Revenues by Market Segment:			
Automotive	15%	16%	15%
Consumer	16	18	21
Computer	17	17	16
Telecom	38	35	32
Industrial and Other	14	14	16
Total	100%	100%	100%

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The following table sets forth certain financial data from our consolidated statements of income since 2004, expressed in each case as a percentage of net revenues:

	Year Ended December 31,		
	2006	2005	2004
	(As a percentage of net revenues)		
Net sales	99.8%	99.9%	100.0%
Other revenues	0.2	0.1	
Net revenues	100.0	100.0	100.0
Cost of sales	(64.2)	(65.8)	(63.2)
Gross profit	35.8	34.2	36.8
Selling, general and administrative	(10.8)	(11.6)	(10.8)
Research and development	(16.9)	(18.3)	(17.5)
Other income and expenses, net	(0.4)	(0.1)	0.2
Impairment, restructuring charges and other related closure costs	(0.8)	(1.5)	(0.9)
Total operating expenses	(28.9)	(31.5)	(29.0)
Operating income	6.9	2.7	7.8
Interest income (expense), net	0.9	0.4	
Loss on equity investment	(0.1)		
Loss on extinguishment of convertible debt			(0.1)
Income before income taxes and minority interests	7.7	3.1	7.7
Income tax benefit (expense)	0.2	(0.1)	(0.8)
Income before minority interests	7.9	3.0	6.9
Minority interests			
Net income	7.9%	3.0%	6.9%

2006 vs. 2005

In 2006, based upon recent industry data, the semiconductor industry experienced a year-over-year revenue increase of approximately 9% for the total available market (TAM) and an increase of approximately 8% for the serviceable available market (SAM), respectively.

Net revenues

	2006	2005	% Variation
	(In millions)		
Net sales	$ 9,838	$ 8,876	10.8%
Other revenues	16	6	192.9%

Net revenues	$ 9,854	$ 8,882	11.0%

The increase in our net revenues in 2006 was primarily due to our higher sales volumes and improved product mix, which exceeded the negative impact of the declining selling prices due to the continuing pricing pressure in the markets we serve. Our average selling prices decreased overall by approximately 8%, which is the result of a tougher pure pricing effect mitigated by a higher selling price from improved product mix.

All product group segments registered a positive revenue performance with a particularly strong result by MPA. ASG net revenues increased 8.1% over 2005, mainly driven by Imaging, Computer Peripherals, Connectivity, Digital Consumer and Automotive products. Cellular Communication slightly increased, while Data Storage product registered a decline. Net revenues for MPA significantly increased by 19.2% compared to 2005, with all of the products lines generating strong revenue growth. MPG net revenues increased 9.7% compared to 2005, supported by NOR Flash for wireless applications and other memory products, while Smartcard sales decreased.

By market segment application, the most important contribution to net revenue growth came from Telecom and Industrial, while Automotive, Consumer and Computer registered approximately mid-single digit growth. Net revenues by market segment increased in Telecom by approximately 19% and Industrial by approximately 10%, while Automotive, Consumer and Computer each increased by approximately 6%. 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.

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By location of order shipment, Japan revenues strongly increased by approximately 31%, all of the other regions registered a solid double-digit growth, with the exception of North America which slightly declined compared to last year.

In 2006, we had several large customers, with the largest one, the Nokia Group of companies, accounting for approximately 22% of our net revenues, which remained flat compared to 2005. Our top ten OEM customers accounted for approximately 51% of our net revenues in 2006, compared to approximately 50% of our net revenues in 2005.

Gross profit

	2006	2005	% Variation
		(In millions)	
Cost of sales	$ (6,331)	$ (5,845)	(8.3)%
Gross profit	$ 3,523	$ 3,037	16.0
Gross margin (as a percentage of net revenues)	35.8%	34.2%	

The cost of sales increased at a lower pace than the net revenues, therefore leveraging a 16% improvement of our gross profit. The increase in gross profit was driven by sales volume, more favorable product mix and improved manufacturing efficiencies, which are the result of lower depreciation charges, the cost savings realized from the 150-mm restructuring plan that has been almost totally completed, and the benefit of solid level of loading in our facilities over the first three quarters of 2006. As a result of these improvements, which were partially offset by the negative impact of severe price pressures, our gross margin increased 160 basis points to 35.8%.

Selling, general and administrative expenses

	2006	2005	% Variation
		(In millions)	
Selling, general and administrative expenses	$ (1,067)	$ (1,026)	(4.0)%
As a percentage of net revenues	(10.8)%	(11.6)%	

The increase in selling, general and administrative expenses was largely due to the higher expenses associated with increased activities and to the charges related to the share-based compensation which amounted to $14 million. However, as a percentage to sales ratio, the selling, general and administrative expenses decreased to 10.8%.

Research and development expenses

	2006	2005	% Variation
		(In millions)	
Research and development expenses	$ (1,667)	$ (1,630)	(2.3)%
As a percentage of net revenues	(16.9)%	(18.3)%	

Research and development expenses increased 2.3% in 2006 resulting from a combination of higher spending in relation to our activities and $8 million in share-based compensation charges. As a percentage of net revenues, research and development expenses decreased significantly by 140 basis points to 16.9%. 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 or process-transfer costs, which are accounted for as cost of sales.

Other income and expenses, net

	2006	2005
	(In millions)	
Research and development funding	$ 54	$ 76
Start-up costs	(57)	(56)
Exchange gain (loss), net	(9)	(16)
Patent litigation costs	(22)	(14)
Patent pre-litigation costs	(7)	(8)
Gain on sale of Accent subsidiary	6	
Gain on sale of non-current assets, net	2	12
Other, net	(2)	(3)
Other income and expenses, net	$ (35)	$ (9)
As a percentage of net revenues	(0.4)%	(0.1)%

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Other income and expenses, net results include miscellaneous items, such as research and development funding, gains on sale of non-current assets, start-up and phase-out costs, net exchange gain or loss and patent claim costs. Research and development funding includes income of some of our research and development projects, which qualify as funding on the basis of contracts with local government agencies in locations where we pursue our activities. The major amounts of research and development funding were received in Italy and France; however, the funding significantly decreased in 2006 due to restricted support in certain jurisdictions. The net gain on sale of non-current assets is mainly related to the sale of a minor investment. Start-up and phase-out costs in 2006 were related to our 150-mm fab expansion in Singapore, the conversion to 200-mm fab in Agrate (Italy) and the build-up of the 300-mm fab in Catania (Italy). The net exchange loss related to transactions not designated as a cash flow hedge denominated in foreign currencies.

Impairment, restructuring charges and other related closure costs

	2006	2005
	(In millions)	
Impairment, restructuring charges and other related closure costs	$ (77)	$ (128)
As a percentage of net revenues	(0.8)%	(1.5)%

In 2006, we recorded impairment, restructuring charges and other related closure costs of $77 million. This expense was mainly composed of:

Our headcount restructuring plan announced in May 2005, which resulted in total charges of $45 million mainly for employee termination benefits; the total cost of this restructuring plan was estimated to be approximately $100 million and was substantially complete at the end of 2006, with total charges of $86 million incurred through December 31, 2006;

An impairment charge of approximately $10 million was recorded pursuant to subsequent decisions to discontinue adoption of Tioga related technologies in certain products, of which $6 million corresponded to the write-off of Tioga goodwill and $4 million to impairment charges on technologies purchased as part of the Tioga business acquisition which were determined to be without any alternative use;

Our ongoing 150-mm restructuring plan and related manufacturing initiatives generated restructuring charges of approximately $22 million. As of December 31, 2006, we have incurred $316 million of the total expected of approximately $330 million in pre-tax charges in connection with this restructuring plan, slightly down from the original estimate of $350 million, which was announced in October 2003.

In 2005, we incurred $128 million of impairment, restructuring charges and other related closure costs mainly related to our 2005 headcount restructuring plan and our 150-mm restructuring plan. See Note 19 to our Consolidated Financial Statements.

Operating income

	2006	2005	% Variation
		(In millions)	
Operating income	$ 677	$ 244	178.0%
As a percentage of net revenues	6.9%	2.7%	

Operating income increased significantly in 2006 as the combined effect of all of the factors presented above.

In 2006, all of our product group segments were profitable. ASG registered an increase in its operating income from $355 million in 2005 to $439 million in 2006, mainly resulting from the contribution of an increase in sales

volume. MPA operating income increased significantly from $271 million in 2005 to $362 million in 2006 driven by the strong revenue leverage. MPG moved from an operating loss of $118 million in 2005 to an operating income of $34 million in 2006, in spite of significant negative price impact on sales. All the product group segments were negatively impacted by declines in pricing.

Interest income (expense), net

	2006	2005
	(In millions)	
Interest income (expense), net	$ 93	$ 34

The interest income, net significantly increased to $93 million in 2006 from $34 million in 2005, reflecting more effective placement of liquidity investments and rising interest rates in the U.S. dollar and the euro on our available cash, and the strong net operating cash flow which further contributed additional cash during the year.

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Loss on equity investments

	2006	2005
	(In millions)	
Loss on equity investments	$ (6)	$ (3)

During 2006, we recorded a loss of $6 million and in 2005 we recorded a loss of $3 million, mainly related to start-up costs due to our investment as a minority shareholder in our joint venture in China with Hynix Semiconductor.

Income tax benefit (expense)

	2006	2005
	(In millions)	
Income tax benefit (expense)	$ 20	$ (8)

In 2006, we had an income tax benefit of $20 million. This is the result of our effective tax rate for the full year 2006 which was approximately 8% and the benefit of certain favorable adjustments in our tax position that occurred during the year. In particular, in 2006, we recorded a reversal of a $90 million provision due to a favorable outcome of a tax litigation in one of our jurisdictions and approximately a $23 million benefit pursuant to the application of certain favorable tax regimes. 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; as such benefits may not be available in the future due to changes within the local jurisdictions, our effective tax rate could increase in the coming years.

Net income

	2006	2005	% Variation
		(In millions)	
Net income	$782	$266	193.9%
As a percentage of net revenues	7.9%	3.0%	

For 2006, we reported a net income of $782 million, a strong increase compared to 2005. Basic and diluted earnings per share for 2006 were $0.87 and $0.83, respectively, compared to basic and diluted earnings of $0.30 and $0.29 per share for 2005.

2005 vs. 2004

In 2005, based upon published industry data by WSTS, 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).

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 group 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. MPA 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 group 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

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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 strongly in Greater China by approximately 18%, while net revenues were flat in the Asia Pacific and declining in Japan, North America, Emerging Markets and Europe 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)	$ (5,532)	(5.7)%
Gross profit	$ 3,037	$ 3,228	(5.9)%
Gross margin (as a percentage of net revenues)	34.2%	36.8%	

The increase in our cost of sales is due to the strong sales volume increase and the negative impact of the effective U.S. dollar exchange rate because a large part of our manufacturing activities is located in the euro zone. The combined effect of price impact on our revenues and of the increase in cost of sales generated a decrease in our gross profit; as a result, our gross margin decreased 260 basis points to 34.2% because the profitable contribution of higher sales volume, improved product mix and manufacturing efficiencies was offset by the negative impacts of the decline in selling prices and of the effective U.S. dollar exchange rate.

Selling, general and administrative expenses

	2005	2004	% Variation
		(In millions)	
Selling, general and administrative expenses	$ (1,026)	$ (947)	(8.4)%
As a percentage of net revenues	(11.6)%	(10.8)%	

The increase in selling, general and administrative expenses was largely due to 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 for $7 million, the new pension scheme for executive management for $11 million, the share-based compensation amounting to $5 million and the overall increase in our expenditures.

Research and development expenses

	2005	2004	% Variation
		(In millions)	
Research and development expenses	$ (1,630)	$ (1,532)	(6.3)%
As a percentage of net revenues	(18.3)%	(17.5)%	

The combined result of the negative impact of the effective U.S. dollar exchange rate, higher spending in our research and development activities, a $6 million one-time termination charge for two former executives and a $3 million share-based compensation charge resulted in an increase of our research and development expenses in 2005. As a percentage of net revenues, research and development expenses grew at a higher rate than our net revenues, thus increasing from 17.5% in 2004 up to 18.3% in 2005. 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 or process-transfer costs, which are accounted for as cost of sales.

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Other income and expenses, net

	2005	2004
	(In millions)	
Research and development funding	$ 76	$ 84
Start-up costs	(56)	(63)
Exchange gain (loss), net	(16)	33
Patent claim costs	(22)	(37)
Gain on sale of non-current assets, net	12	6
Other, net	(3)	(13)
Other income and expenses, net	$ (9)	$ 10
As a percentage of net revenues	(0.1)%	0.2%

Other income and expenses, net results include miscellaneous items, such as research and development funding, gains on sale of non-current assets, start-up costs, net exchange gain or loss and patent claim costs. In 2005, research and development funding included income of some of our research and development projects, which qualify as funding on the basis of contracts with local government agencies in locations where we pursue our activities. The major amounts of research and development funding were received in Italy and France. In 2005, research and development funding slightly decreased, compared to 2004. The net gain on sale of non-current assets of $12 million is the result of the gain of $6 million on the sale of our share in UPEK Inc., the gains on sales of buildings and lands for a total of $8 million and losses of $2 million on the sale of equipment. Start-up costs in 2005 were related to our 150-mm fab expansion in Singapore and the conversion to 200-mm fab in Agrate (Italy) and the build-up of the 300-mm fab in Catania (Italy). The net exchange loss related to transactions not designated as a cash flow hedge denominated in foreign currencies. Patent claim costs included costs associated with several ongoing litigations and claims. These costs are categorized either as patent litigation costs or pre-litigation costs, amounting to $14 million and $8 million, respectively.

Impairment, restructuring charges and other related closure costs

	2005	2004
	(In millions)	
Impairment, restructuring charges and other related closure costs	$ (128)	$ (76)
As a percentage of net revenues	(1.5)%	(0.9)%

In 2005, we recorded impairment, restructuring charges and other related closure costs of $128 million. This expense was mainly composed of:

Our new headcount restructuring plan announced in May 2005, which resulted in total charges of $41 million mainly for employee termination benefits; the total cost of this restructuring plan is estimated to be in a range of between $100 and $130 million and its completion is expected by the second half of 2006;

Our restructuring and reorganization activities initiated in the first quarter of 2005, which generated a total charge of impairment on goodwill and other intangible assets of $63 million and $10 million for restructuring and other related closure costs; this restructuring plan was fully completed in 2005;

Our ongoing 150-mm restructuring plan and related manufacturing initiatives generated restructuring charges of approximately $13 million. As of December 31, 2005, we have incurred $294 million of the total expected of approximately $330 million in pre-tax charges in connection with this restructuring plan, slightly down from the original estimate of $350 million, which was announced in October 2003. We expect to incur the balance in the

coming quarters, which is later than anticipated to accommodate unforeseen qualification requirements of our customers, and to complete the plan in the second half of 2006; and

Our impairment review of goodwill and intangible assets that resulted in a charge of $1 million.

In 2004, we incurred $76 million of impairment, restructuring charges and other related closure costs mainly related to our 150-mm restructuring plan. See Note 18 to our 2005 Consolidated Financial Statements.

Operating income

	2005	2004	% Variation
		(In millions)	
Operating income	$ 244	$ 683	(64.3%)
As a percentage of net revenues	2.7%	7.8%	

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The decrease in operating income was mainly caused by the negative impact of the ongoing pricing pressure on our net revenues, the negative impact of the effective U.S. dollar exchange rate, an increase in our total operating expenses as well as an increase of our impairment, restructuring charges and other related closure costs. These negative factors were partially compensated by overall improved efficiencies in our manufacturing activities and higher volume of sales.

In 2005, our product group segments were profitable with the exception of MPG. ASG registered a decrease of its operating income from $530 million in 2004 to $355 million in 2005, as improved product mix was insufficient to c