

Q3 Fiscal 2023 Earnings Call

PREPARED REMARKS | AUGUST 17, 2023



MICHAEL SULLIVAN | Corporate Vice President, Investor Relations

Good afternoon everyone and thank you for joining Applied's third quarter of fiscal 2023 earnings call. Joining me are Gary Dickerson, our President and CEO, and Brice Hill, our Chief Financial Officer.

Before we begin, I'd like to remind you that today's call contains forward-looking statements which are subject to risks and uncertainties that could cause our actual results to differ. Information concerning the risks and uncertainties is contained in Applied's most recent Form 10-Q filing with the SEC. Today's call also includes non-GAAP financial measures. Reconciliations to GAAP measures are found in today's earnings press release and in our quarterly earnings materials, which are available on the IR page of our website at appliedmaterials.com.

And with that introduction, I'd like to turn the call over to Gary Dickerson.

GARY DICKERSON | President and Chief Executive Officer

INTRODUCTION

Thank you, Mike.

In our third fiscal quarter, Applied Materials delivered results at the high-end of our guidance range. Across the business, our teams are executing well. We are making incremental improvements in our operations as we productively scale the company, and we're driving our technology roadmap, introducing enabling new products and solutions for our customers.

In my prepared remarks today, I will start with our big picture view of the IoT-AI era and how this is driving growth and innovation across the industry. I'll then summarize Applied's strategy and how this is enabling us to outgrow the industry this year while also positioning us for sustained outperformance over the longer-term. And finally, I'll cover our near-term performance and outlook, including some recent business highlights.

IoT-AI ERA

In the summer of 2018, at our AI Design Forum, Applied laid out a thesis explaining how we expected IoT and AI to drive a new wave of semiconductor growth and innovation. Five years later, IoT and AI inflections are having a profound impact across many sectors of the economy, as well as within the semiconductor industry.

We view IoT and AI computing as two sides of the same coin. At the edge, consumer devices, vehicles, buildings, factories, and infrastructure are all getting smarter and more capable. Our customers that serve these IoT, Communications, Auto, Power and Sensors markets—or ICAPS—are growing, and represent the largest portion of wafer fab equipment sales in 2023.

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Increasingly intelligent edge devices are fueling an explosion of data generation that can then be transmitted and combined to create very large datasets for training AI models. High performance AI computing is primarily enabled by hardware innovations. As a result, AI is becoming the key driver of the leading-edge logic and DRAM roadmaps, as well as heterogeneous integration, which creates exciting new innovation opportunities for device designers.

NEW PLAYBOOK AND REGIONALIZATION

In summary, the first part of our thesis is that the combination of IoT and AI drives demand for significantly more chips as well as next-generation silicon technologies. The second part of our thesis relates to how those chips and new technology innovations will be supplied.

In terms of technology, as the benefits of traditional Moore's Law 2D scaling slow down, the industry is moving to a new playbook to drive improvements in Power, Performance, Area-Cost and time-to-market. The PPACT playbook has five key elements—new system and device architectures, new 3D structures, new materials, new ways to shrink, and heterogenous integration.

The transition to the new playbook is positive for Applied in two key ways: First, as the roadmap evolves, it is increasingly enabled by advances in materials engineering where Applied has differentiated capabilities. Key examples of this include the move to Gate-All-Around transistors and Backside Power Distribution in advanced logic. Second, the PPACT playbook is inherently more complex, and we can help customers manage this complexity by providing more comprehensive solutions which include integrated products and advanced services to accelerate R&D, technology transfer, ramp, as well as yield and cost in volume production.

In parallel to the new PPACT playbook being implemented, we are also seeing regionalization of semiconductor supply chains, as countries seek to build resilient local capacity to support industry verticals that are essential to their economies. As a result, hundreds of billions of dollars of government incentives will be deployed globally over the next five years.

APPLIED'S STRATEGY

At Applied, we recognized these trends early and made important changes to our strategy, organization, and investment profile. In the past five years, we created a dedicated organization to focus on the ICAPS market and released more than 20 new products for ICAPS applications, we also formed a team focused on co-optimized and integrated products to accelerate solutions for leading-edge logic and memory. This has resulted in much deeper strategic relationships with our customers, new highly differentiated products, and increasing market share. We developed a very strong portfolio of products to enable multiple generations of DRAM technology that is fueling share gains in this market segment and contributing to our outperformance and, we established a clear leadership position in heterogenous integration and advanced packaging. In fact, we just announced five new heterogenous integration products at SEMICON West in July.

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2023 OUTPERFORMANCE AND POSITIONED TO GROW

This strategy and increased focus on IoT and AI-driven inflections has enabled us to deliver more value to customers and strong performance in 2023, even during a period of very low investment by memory makers. It also positions us for on-going outperformance in 2024 and beyond. Let me highlight a few key areas:

In DRAM, our revenues in the first half of 2023 were higher than our two closest process equipment peers combined. Our strength in DRAM is underpinned by multiple factors. We have gained significant share in DRAM patterning—both for EUV-based- and multi-patterning. We have developed unique, co-optimized hardmask solutions, which are a key enabler for capacitor scaling. We have successfully ported key technologies developed for logic to DRAM, where they are used in the peripheral circuitry to significantly increase I/O speed. And, we are the largest supplier of advanced packaging solutions with leadership positions in micro-bump and Through Silicon Via that enable multiple generations of high-bandwidth memory.

As DRAM investments increase, we feel very positive about our opportunities, especially in high-performance DRAM for the datacenter. High-Bandwidth Memory (HBM) is less than 5% of DRAM capacity today, but it is expected to grow at a 30% compound annual growth rate over the coming years. If you look at a HBM2 die compared to DDR5, it is about 25% larger because of additional I/O routing and the area needed for the TSVs. On top of this, the extra processing steps needed for die-stacking further increase our total available market by approximately 5%.

Another key growth driver is our ICAPS business. We see ICAPS demand as sustainable as these customers are delivering enabling technology for large, global inflections that will play out over the next decade. These include industrial automation, electric vehicles, and vehicles with Advanced Driver-Assistance Systems, solar and wind energy—where each megawatt generated requires \$3,000-4,000 of power chips—and the smart grid, which could drive \$50 billion of annual silicon demand by the end of the decade. ICAPS investments are also expected to be underpinned by government support around the world, and we expect these markets to be a significant beneficiary of regional incentives.

The increasing complexity needed to enable the PPACt playbook combined with a broadening of the industry's geographic footprint, are both key growth drivers for our service business. AGS delivered record revenue this quarter and is on track to grow in 2023 even with this year's low fab utilization rates and after absorbing the impact of new U.S. trade rules. This year, more than 60% of our service revenue is generated from subscriptions in the form of long-term agreements. These agreements are growing at a faster rate than the installed base and have a high renewal rate of more than 90%. With strong customer pull for our services and a robust pipeline of new capabilities, we believe we're on-track to achieve low double-digit AGS growth in the coming years.

SUMMARY

While I am excited about the opportunities ahead, it is important to recognize that to deliver this future, the industry must also overcome significant challenges relating to complexity, cost and our combined carbon footprint. At Applied, we believe the way to do this is through closer

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collaboration and higher velocity innovation and commercialization of next-generation technology for energy efficient computing.

In the past quarter, we announced two major initiatives: Our EPIC platform in the United States and a Collaborative Engineering Center in India. These investments will support even faster and better relationships with customers, universities, suppliers and government partners to accelerate time-to-innovation and time-to-commercialization while increasing our combined R&D productivity. In addition, we are also driving a collaborative approach to reduce carbon emissions as the industry grows.

In July, we rolled out our collaborative Net Zero playbook and we announced two major new products that help customers with carbon reductions: Our Vistara platform, which lowers platform energy consumption by up to 35% and increases throughput density by as much as 30%, and EcoTwin, that enables customers to monitor, model and optimize chemical and energy consumption by tool and by recipe.

Before I hand the call over to Brice, let me quickly summarize.

Advanced chips are at the foundation of major global inflections and, as the IoT-AI era takes shape, it is driving a new wave of growth and innovation for the semiconductor industry. At Applied, we have focused our strategy and investments to deliver high-value technologies that enable key IoT and AI-driven inflections. We have strong leadership positions in ICAPS, leading-edge foundry-logic, DRAM, and heterogenous integration using advanced packaging. This strategy is enabling us to consistently deliver strong results in 2023, despite lower overall wafer fab equipment spending, and positions us for sustainable outperformance over the coming years.

Now Brice, it's over to you.

BRICE HILL | Senior Vice President, Chief Financial Officer

Thank you, Gary.

On today's call, I'll discuss the business environment, summarize our Q3 results, provide our guidance for Q4, and frame the investments we're making in our R&D infrastructure.

Before covering the near term, I'll remind you of our longer-term thesis. First, we believe the semiconductor industry is on track to grow faster than the overall economy over time and reach \$1 trillion in sales by 2030. Second, Applied's leadership in materials engineering is increasingly critical to our customers' roadmaps. Third, Applied's broad portfolio of differentiated products, balanced market exposure, and growing services business make us less volatile today than in the past and more likely to grow faster than our markets. And fourth, our efficient business model generates strong profitability and free cash flow, which enables us to both invest in profitable growth and deliver attractive shareholder returns.

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Q3 BUSINESS ENVIRONMENT

Moving now to the Q3 business environment, we continued to see strength in ICAPS which largely offset weakness in leading-edge foundry-logic and NAND. ICAPS demand was broad-based, generating record revenue in 200mm systems and record revenue in Europe. In fact, the United States, Japan and Europe are the fastest growing ICAPS regions this year. Around the world, customers and governments are making long-term investments to ensure future supply of a wide range of semiconductors needed to support growing demand in key industries such as automotive, medical equipment and renewable energy, to name a few.

Q3 OPERATIONAL PERFORMANCE

Turning to our operational performance in Q3, our teams delivered strong results. We exceeded our revenue guidance across Semiconductor Systems, Services and Display. We improved our delivery performance in systems and services, and made further progress reducing inventory. Cash from operations and free cash flow were both the second highest in our history.

Q3 FINANCIALS

Now I'll summarize our Q3 financial results.

Company revenue was nearly \$6.43 billion, down 1% year-over-year and in the upper end of the guidance range. Non-GAAP gross margin was slightly above our guidance, and operating expenses were slightly below. Non-GAAP EPS was \$1.90, down 2% year-over-year, and near the high end of guidance.

Turning to the segments, Semi Systems revenue of \$4.68 billion was down 1% year-over-year. Segment non-GAAP operating margin was 34.8%.

Applied Global Services generated record revenue of over \$1.46 billion and non-GAAP operating margin of 29.3%. This was AGS's 16th consecutive quarter of year-over-year revenue growth. While 200mm system sales contributed to the growth, the team also made strong progress driving the leading indicators of our subscription business. For example, tools under service agreement are up 5% year-over-year to over 16,000 systems, and tools under comprehensive service agreement, which have the highest revenue per tool, are up 7% year-over-year, reaching 12,000 systems.

In Display, revenue grew sequentially to \$235 million, and segment non-GAAP operating margin was 15.7%.

Turning to cash flows, we generated \$2.58 billion in operating cash flow during the quarter, which was 40% of revenue. We produced over \$2.3 billion in free cash flow which was 36% of revenue. We distributed \$707 million to shareholders through quarterly dividends and share buybacks. We paid \$268 million in dividends and the dividend-per-share was \$0.32, reflecting the 23% increase announced in March. We used \$439 million to repurchase nearly 3.4 million shares at an average price below \$130.

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Q4 GUIDANCE

Now, I'll share our guidance for Q4.

We expect Q4 company revenue to be \$6.51 billion, plus or minus \$400 million. We expect non-GAAP EPS of \$2, plus or minus \$0.18. Within the guidance, we expect Semi Systems revenue to be around \$4.75 billion. We expect DRAM revenue to be up by around \$500 million quarter over quarter – primarily driven by trailing-edge shipments. We expect AGS revenue to be about \$1.42 billion and Display revenue should be around \$290 million.

We expect Applied's non-GAAP gross margin to be about 47% and we expect non-GAAP operating expenses to be around \$1.17 billion. We continue to model a tax rate of 12.3%.

R&D INFRASTRUCTURE INVESTMENT

Finally, as we said last quarter, we plan to make a multibillion-dollar investment in new R&D infrastructure over the next several years to significantly expand our capacity to collaborate more closely and productively with our customers as we develop next-generation materials, process technologies and equipment. The scale of the investment will depend on our ability to secure government support.

The EPIC Center is expected to come online in fiscal 2026, and while we expect our capital expenditures to be higher over the next several years, there is no change to our strong commitment to shareholder returns.

SUMMARY

In summary, Applied Materials continues to execute well. We are making good progress against our internal goals and outperforming our markets. While wafer fab equipment spending is lower in calendar 2023, our semi systems revenue in the first three calendar quarters is trending slightly up year-over-year and our services business remains on track for year-over-year growth. We've aligned our business with the fastest-growing end markets and are winning key decisions across leading-edge foundry-logic, DRAM, ICAPS and advanced packaging. We are in a great position to invest for technology leadership and growth, generate strong free cash flow, and increase shareholder returns.

Mike, please begin the Q&A.