Q3 Fiscal 2022 Earnings Call

PREPARED REMARKS | AUGUST 18, 2022

MICHAEL SULLIVAN | Corporate Vice President, Investor Relations

Good afternoon everyone and thank you for joining Applied's third quarter of fiscal 2022 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 and 8-K filings 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.

Before we begin, I have a calendar announcement. Applied plans to host our Services Master Class five weeks from today, on Thursday, September 22nd at 9:00 a.m. Pacific Time. We'll describe the market opportunity for our services business, explain why 87% of AGS revenue is truly recurring, and give you the growth formula for the business through our 2024 financial model horizon and beyond. We hope you'll join key members of our global services team for presentations and Q&A.

And now, 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 and record quarterly revenues. The actions we've been taking to mitigate supply chain challenges are beginning to have an impact and we expect steady, incremental improvements from here. Resolving supply issues has required new levels of collaboration between our global teams, suppliers and customers. While all of this hard work is yielding results, global supply chains remain stretched. Demand for Applied's products is still higher than our ability to fulfill it, and our backlog continues to grow. In addition, our relentless focus on meeting customers' needs in this very difficult environment has created margin headwinds that we are working hard to overcome. We are driving actions to reduce costs and improve value capture, including price adjustments.

In my prepared remarks today, I'll cover three key topics: First, our near-term outlook on supply and demand dynamics, second, our longer-term view of the markets and the industry's roadmap and third, Applied Materials' strategy, priorities and progress. After that, Brice will provide more color on our financial performance and key areas of operational focus.

NEAR-TERM OUTLOOK

Let me begin with our near-term perspective on the market. Due to large gaps between demand and supply, as well as equipment companies shipping partially finished systems and merging components in the field, overall 2022 wafer fab equipment spending is difficult to quantify with precision. Our best estimate is that it will land somewhere in the mid-$90 billion range. For Applied, the picture is clearer. If we use the mid-point of our fourth quarter guidance, we expect our wafer fab equipment revenues to be up approximately 15% for our fiscal year.

As we look ahead to 2023, there are three major factors shaping our view of the market. First, memory spending is expected to be lower than in 2022, as macro uncertainty and weakness in consumer electronics and PCs causes these customers to defer some capacity additions. Second, leading-edge foundry-logic looks strong, with customers battling for leadership and racing to be first to implement major technology inflections. Third, ICAPS customers—who serve IoT, Communications, Auto, Power and Sensor markets—are reporting areas of strength and weakness. These customers serve broad and diverse applications. They are seeing softness in consumer-centric markets, which are being impacted by macro-economic factors. Auto and industrial demand continues to be solid because those investments are driven by large inflections such as electric vehicles and industrial automation. In these areas, chip makers are securing long-term capacity agreements that underpin their capital spending plans.

While it is too early to provide a forecast for 2023, we believe our business will be more resilient than in the past if there is demand pull-back in certain areas of the market. We expect Applied to remain supply constrained for the next several quarters, we are working through our very substantial backlog of orders which provides a buffer to in-year demand fluctuations and, in addition, customers are providing us with longer-term visibility and commitments in response to their own customers' actions to lock in the strategic capacity they need. Although we are confident in our ability to perform well in a range of market scenarios, we are mindful of the current macro-economic trends. As result, we are slowing down hiring, while ensuring we fully fund the R&D programs and strategic operational capabilities that support our long-term growth.

Regionalization of supply chains is also something new for the industry. We expect this will provide a small positive tailwind for overall wafer fab equipment spending starting in late 2023. Also, because of the time-bound nature of government incentives in the US, Europe and Asia, we see a higher degree of certainty for these investments. Last week I was in Washington D.C. for the signing of the CHIPS Act and met with government officials and leaders from across the semiconductor and automotive eco-systems. I am happy to see the critical role that semiconductors play in the economy is being recognized and acted upon. The need to build more resilient and flexible supply chains remains a key theme for these leaders, and the CHIPS Act will enable many companies to accelerate their investments in strategic capacity. I am also excited about the potential to create a new high velocity innovation platform in the United States to accelerate the development and commercialization of next-generation technologies.

LONGER-TERM OUTLOOK

As I look further to the future, I feel very positive about the direction of the industry and our long-term opportunities at Applied. Consensus within the industry is that semiconductor revenues can reach a trillion dollars before the end of the decade. That translates to a high single-digit compound annual growth rate from today. In parallel, the technology roadmap is becoming increasingly complex. As a result, we expect equipment intensity—the ratio of wafer fab equipment investment to semi revenues—to remain at today's level or increase over this period.

Then, the major technology roadmap inflections—including Gate All Around transistors, Backside Power Distribution Networks, new materials for interconnect and contact, and Heterogeneous Integration of chips and chiplets—are enabled by materials engineering where Applied Materials is the leader, and this shifts more dollars to our available market over time. We've invested ahead of these inflections to create a portfolio of differentiated solutions that positions us to outperform as these new technologies transition to volume manufacturing.

APPLIED'S STRATEGY, PROGRESS AND PRIORITIES

Applied Materials' strategy is built upon the breath and strength of our technology and capabilities. This provides us with a unique ability to engineer, co-optimize and integrate solutions that address our customers' highest-value technology challenges. Co-optimized solutions—where we optimize adjacent process steps—and Integrated Materials Solutions, or IMS—where we optimize a combination of processes steps in a single system under vacuum—are becoming an increasingly important part of our product portfolio.

In our recent master class, we talked about a break-through IMS approach for tungsten-only contacts that are free of conventional barrier materials. This provides significant improvements in contact resistance and is critically enabling for smaller foundry-logic nodes. The number of process steps are growing as these customers migrate to this 'pure-metal' technology and these low-resistance integrated solutions for contact and wiring represent new multi-billion-dollar revenue opportunities. Over the past two quarters, we have secured multiple tool-of-record positions at all leading customers.

Our ability to co-optimize materials engineering solutions with novel inspection and metrology is also driving record performance in our Process Diagnostics and Control business. We expect PDC revenues to be up almost 40% in fiscal 2022, with broad-based customer adoption of our eBeam metrology and new optical wafer inspection platforms.

In the quarter, we also strengthened our ICAPS portfolio with a tuck-in acquisition. Picosun is a leader in batch ALD technology, and we're delighted to welcome their talented team to the Applied Materials family.

Turning to Service, AGS delivered record quarterly revenues despite headwinds for our transactional spares and 200mm equipment businesses due to supply chain constraints. The subscription portion of AGS continues to demonstrate strength. Installed base tools under long-term service agreements grew 9% over the past 12 months. Our renewal rate for these agreements continues to be strong and is currently running at 93%.

SUMMARY

Before I hand the call over to Brice, I'll quickly summarize:

We are beginning to see gradual improvements in our supply chain which enabled us to deliver record revenue for the quarter. We expect demand to remain higher than supply for the next several quarters, and we are continuing to drive actions to close the gap. The changing macro-economic environment is causing some customers to adjust the timing of their investments. However, we are confident that our business will be more resilient thanks to strong pull for our uniquely enabling technology, our large backlog, longer-term visibility from our customers, and industry-wide investment in strategic regional capacity. Our long-term view of the market remains unchanged as multiple, parallel secular trends drive the semiconductor and wafer fab equipment markets structurally higher. At the same time large technology inflections, that are enabled by our core capabilities in materials engineering, create outsized growth opportunities for Applied Materials.

Now, I'll hand the call over to Brice.

BRICE HILL | Senior Vice President, Chief Financial Officer

Thank you Gary.

I'd like to begin by saying thank you to our teams and our supply chain partners for helping to increase our output despite ongoing constraints and unexpected shortages. Our factory and logistics teams operated with agility, adjusting to almost daily changes in supply schedules. We are still not meeting all of our customers' demand and solving the supply chain shortages to increase our manufacturing output remains our top priority.

Before I summarize our Q3 results, I'd like to emphasize four points:

First, our overall demand remains healthy, specifically, our orders remained strong in Q3, our backlog increased, overall factory utilization remains high, and customers have added four new factory projects to the long-term roadmap. There are pockets of weakness in the semiconductor market and a number of affected customers have asked us to reschedule their capacity additions. At the same time there are areas of strength, and we have broad market exposure and strong customer pull for technology investments.

Second, our supply chain improved incrementally in the quarter as Gary mentioned. We have added significant investments and talent to our supply chain teams to resolve bottlenecks, and to improve our inventory and overall output.

Third, we remain committed to our long-term gross margin targets. Today, we are still experiencing the effects of higher costs and unfavorable mix which are being partially offset by pricing adjustments. We expect to incrementally improve gross margins over the coming quarters, driven by forecasted improvements in manufacturing volumes, product mix, pricing, and logistics costs.

And fourth, we are confident in the industry's underlying growth trajectory and our unique materials engineering capabilities for process innovation. While we are slowing our headcount growth, we have increased our R&D spending by around 10% year to date, and remain fully invested in enabling our customers' roadmaps.

Q3 RESULTS

Turning to our Q3 results, we delivered record revenue of $6.52 billion which was in the high end of our guidance range. Non-GAAP gross margin of 46.2% declined 80 basis points quarter-on-quarter. Non-GAAP operating spending was $1.06 billion, which was right on target and up $39 million quarter-on-quarter as we increased R&D and added supply chain resources. Non-GAAP operating margin declined 60 basis points to 30% driven by the lower gross margin and headcount additions, primarily in engineering. Non-GAAP earnings of $1.94 grew 9¢ quarter-on-quarter and matched our previous record.

SEMICONDUCTOR SYSTEMS

Turning to the segments, the Semi Systems team did a great job maximizing shipments, growing revenue by $276 million, up 6% quarter-on-quarter. Segment non-GAAP operating margin declined 100 basis points sequentially to 36.1% due to higher materials, freight, expedite and labor costs, partially offset by price adjustments.

APPLIED GLOBAL SERVICES

The AGS team delivered record quarterly revenue, growing $37 million or 3% quarter-on-quarter. We continued to deliver healthy year-over-year growth in subscription revenue, while the supply chain shortages constrained our growth in transactional parts and 200mm systems. AGS non-GAAP operating margin was 30.6% and slightly up quarter-on-quarter.

I'll take a minute to share a few observations about AGS. Next month we'll host a Services Master Class, where you'll have an opportunity to learn more about our strategy to increase our recurring revenue. The three key drivers are the growth of our installed base, equipment service intensity, and long-term service agreements. AGS is making excellent progress toward our 2024 financial model. We exited Q3 tracking around $500 million ahead of the base case of our AGS revenue plan and around $250 million ahead of our high case. In addition, the services business is capital-light and produces excellent cash flow.

DISPLAY

Moving on to Display now, the market is weaker due to its high exposure to the consumer portion of the economy. During the quarter, we lowered spending in line with the current market environment. Our Display revenue declined by $48 million or 13% to $333 million. The business contributed $70 million of non-GAAP operating profit, which was down sequentially by $12 million or 15%.

CASH FLOWS

Turning to our cash flows, we generated $1.47 billion of operating cash flow during the quarter, which was 23% of revenue. We returned $1.23 billion or 97% of free cash flow to our shareholders deploying $1 billion to repurchase 9.8 million shares of company stock and paying $225 million in dividends. We also deployed around $440 million for two strategic acquisitions. We expanded our ALD portfolio with the addition of Picosun, and we acquired a talented simulation software team. Year-to-date, we have produced over $4.5 billion in operating cash flow and nearly $4 billion in free cash flow and returned $5.25 billion to our shareholders.

Q4 GUIDANCE

Now, I'll share our guidance for Q4. We expect revenue to increase to $6.65 billion, plus or minus $400 million. We expect non-GAAP EPS to be $2.00 plus or minus 18¢. Within this outlook, we expect Semi Systems revenue to increase to $4.93 billion or up 14% year-over-year. We expect AGS revenue to increase to $1.43 billion or up 4% year-over-year, with continued healthy growth in services and ongoing supply chain limitations in 200mm systems and transactional parts. Display revenue should decline to around $250 million. We expect to incrementally increase our non-GAAP gross margin to 46.4% and we expect non-GAAP operating expenses to increase slightly to $1.08 billion. We are modeling a tax rate of 11.8%.

SUMMARY

Before we begin the Q&A, I'd like to summarize our company's position in the current environment.

We continue to see very strong customer pull for advanced technology in all of our markets, and our backlog continues to grow. We believe some of our customers will moderate their capacity additions in areas that have been impacted by weak consumer spending, however, I expect Applied's business to be more resilient than in past periods for three reasons. One is that we have strong exposure to technology investments, particularly in the foundry-logic market which has grown to become approximately two-thirds of wafer fab equipment spending. Second is that we have multiple quarters of backlog for products that are essential to our customers' technology roadmaps and we expect to continue to increase supply over the next several quarters. Third is that our services business has grown to over $5.5 billion in size and generates 87% of revenue from recurring demand for parts, services and software.

And now, Mike, please begin the Q&A.