

Q2 Fiscal 2021 Earnings Call

PREPARED REMARKS | MAY 20, 2021



MICHAEL SULLIVAN | Corporate Vice President, Investor Relations

Good afternoon everyone.

And thank you for joining Applied's second quarter of fiscal 2021 earnings call. Joining me are Gary Dickerson, our President and CEO, and Dan Durn, 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. We plan to host another Master Class, this time on Logic technology, on the 16th of June at 9AM Pacific Time. We hope you'll join us!

And now, I'd like to turn the call over to Gary Dickerson.

GARY DICKERSON | President and Chief Executive Officer

INTRODUCTION

Thank you, Mike.

I am pleased to report another record quarter for Applied Materials, underpinned by strong and broad-based demand across our semiconductor businesses as large secular trends fuel increasing consumption of silicon. I'd like to thank our passionate and hard-working team for delivering these great results and in particular, I want to acknowledge our operations group and suppliers for successfully overcoming logistics and supply chain challenges in the quarter.

At our recent Investor Meeting, we described our thesis for the industry, laid out our growth strategy, and provided our new financial and capital allocation models. Therefore, in today's call I will focus my comments on three main topics: how we see the current market environment, how Applied is outperforming our markets today, and how we are positioned to grow faster than our markets over the longer-term

Later in the call, Dan will talk about our subscription revenues, the strength in our service business, and provide more color on our financial performance and outlook.

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NEAR-TERM MARKET DYNAMICS

I'll begin with the industry environment. As the world starts to transition to the post-pandemic economy, demand for semiconductors continues to grow. The pandemic accelerated key technology trends that make semiconductors more pervasive and indispensable in people's lives. Current capacity shortfalls in some areas of the market show the highly efficient, 'just-in-time' supply chains that have served the semiconductor industry well for the past two decades, may not be the most effective strategy going forward. There is a clear desire for the chip industry to build more resilient and flexible supply, including more regionally distributed capacity as the strategic importance of the semiconductor supply chain is increasingly acknowledged at a national level.

It is also important to recognize that we are still in the early innings of major secular trends that will play out over the next decade and drive the semiconductor and semi equipment markets structurally higher. At the Investor Meeting, we described five overlapping inflections:

- First, at a macro level, digital transformation of the economy is rapidly advancing. For individuals, companies and nations, embracing digital transformation is non-discretionary because it changes the basis of competition. Those who quickly and effectively embrace these new ways of working will emerge as winners, and those who don't or can't adapt, will not keep up.
- Digital transformation is driving exponential growth in data generation which leads to the second major inflection – AI computing. New computing approaches are needed to create value from these massive volumes of data. AI computing works best with workload-specific software and hardware built from customized and entirely new types of silicon.
- Third, the benefits of traditional Moore's Law 2D scaling are slowing down and the semiconductor industry is transitioning to a new playbook to drive Power, Performance, Area-Cost and time to market. As the PPACt playbook is adopted it is driving a step-up in investments across the ecosystem.
- Fourth, there is an increased focus on ensuring that growth is sustainable and responsible as the industry scales and advancing energy-efficient computing is critical.
- And fifth, there is a business model inflection as companies migrate away from products and transactions to outcomes and deeper collaborations focused on speed and time to market.

These five factors add up to strong and strengthening demand for wafer fab equipment and advanced services that we believe is sustainable well beyond 2021.

For the first time, customers are providing capital spending guidance for multiple years into the future which is a new leading indicator for demand sustainability. In 2021, we expect foundry-logic to be the fastest growing wafer fab equipment market with strong investments in both leading-edge and specialty devices. DRAM is the next fastest growing market with all major DRAM manufacturers investing in new technology and capacity. Finally, we see NAND growing at a more modest rate this year, on the back of about 30% growth in calendar 2020.

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APPLIED'S OUTPERFORMANCE IN 2021

More importantly, Applied is outperforming the overall market. Recent VLSI market data confirmed that our semi equipment business grew 23% in 2020 versus market growth of less than 19%. We outperformed even though the device mix would not typically be considered favorable for Applied.

There are several reasons why I'm confident 2021 will be another strong year of outperformance. To start with, our leadership areas are in the fastest growing parts of the market. We expect CMP, Epi, Thermal, and Implant to all grow more than 50% this year. Next, we are very well positioned to serve the fast-growing specialty markets. We anticipated this market growth several years ago and formed a new group inside the company called ICAPS to focus on IoT, Communications, Automotive, Power and Sensor applications.

In addition, we have strong traction with new products especially in areas where we have space to grow share. In 2020, we gained 240 basis points of market share in conductor etch and 220 basis points in CVD thanks to the momentum we have in patterning applications for DRAM and foundry-logic. This year, our etch and CVD businesses combined will generate more than \$7.5B of revenue. In Process Diagnostics and Control we expect to grow around 50% in 2021 and generate more than \$900M of revenue from our eBeam products. Extending our leadership in eBeam has been a major focus as it is a highly strategic capability that accelerates adoption of our differentiated semi products and Integrated Materials Solutions, as well as being a key component of our Actionable Insight Accelerator.

Finally, we are seeing increasing adoption of our integrated solutions, where we are bringing together unique combinations of technologies and capabilities. In 2021, we expect to generate more than \$400M of revenue from our first integrated materials solutions. In addition, revenues from our advanced packaging product portfolio are on track to exceed \$800M – almost doubling since 2019.

FACTORS DRIVING LONGER-TERM OUTPERFORMANCE

Looking beyond the strength in our business today, we believe we're in a great position to deliver sustainable outperformance over multiple years. As the industry roadmap transitions from traditional 2D Moore's Law scaling to the new PPACt playbook, materials engineering becomes critically enabling. This is because significant PPACt innovations in transistor and interconnect structures and materials are taking place and these innovations are enabled by Applied's leadership technologies. We'll cover this topic in more detail at our upcoming logic masterclass.

As we described at our Investor Meeting, to serve our customers' evolving needs and maximize our growth opportunities, we've built a comprehensive strategy to position Applied as the PPACt enablement company, shift more of our business to subscription revenue, and optimize our investments in synergistic adjacent markets to drive profitable growth and higher free cash flows

Our PPACt enablement strategy has three differentiated pillars:

- First, Applied has the broadest and most enabling portfolio of technologies spanning materials creation, modification, removal and analysis. At our recent memory masterclass, we talked about how we are taking unique Applied technologies that were originally developed for logic – including

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Black Diamond low-k materials and High-k metal gate transistors – into the DRAM market, opening up new billion-dollar opportunities.

- Second, we can combine our technology portfolio in unique and highly enabling ways that no one else can do. A great example is our Draco hard mask material for capacitor scaling in DRAM. Draco has been co-optimized to work with Applied's etch system in a process development that we accelerated with our eBeam technology. Today, we offer a spectrum of solutions from co-optimization of processes and tools – like Draco – all the way to fully integrated materials solutions that combine multiple processes and customized metrology and sensors within a single platform.
- The third pillar is time to market acceleration. We have developed a proprietary suite of solutions to accelerate every stage of the product lifecycle, from R&D, to technology transfer, and High Volume Manufacturing. We call this the Actionable Insight Accelerator or AI^x platform and it brings together process tools, sensors, metrology, and analytics and machine learning capabilities. There is tremendous pull from customers and we already have AI^x engagements with all major memory manufacturers.

One example of how we're applying machine learning in real world applications is ExtractAI that allows us to combine the most powerful attributes of optical and eBeam inspection and provide a solution that's many times faster than traditional approaches. In simple terms, optical inspection is fast and can find critical defects, while eBeam is slower, but has higher resolution to accurately classify those defects. So, we use our eBeam system to train the ExtractAI engine for defect and noise classification. As Applied's eBeam technology has best-in-class resolution and imaging we get the most accurate classification to train our AI models. We then use inferencing to turn an unclassified map of millions of potential defects into an actionable map of thousands of yield-impacting defects.

SUMMARY

Before I hand the call over to Dan, let me quickly summarize:

We see strong and sustainable demand in our semiconductor business underpinned by a wide range of macro and technology drivers. We believe that we're in a great position to outperform our markets again this year thanks to our broad exposure to the major industry inflections, our strong portfolio of differentiated unit process products and accelerating adoption of our integrated materials solutions and advanced packaging products.

We feel very positive about the longer-term secular trends that are driving semiconductor and wafer fab equipment structurally higher, and we're confident that we have the right strategy to accelerate PPACT and grow significantly faster than our markets.

Dan, over to you.

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DAN DURN | Senior Vice President, Chief Financial Officer

Thanks Gary.

Today, I'll begin by summarizing Applied's performance in Q2. Then, I'll recap the latest third-party data on the semiconductor equipment and services markets. I'll build on Gary's comments about the equipment demand environment and then I'll give you an update on our plans to grow our subscription business and generate incremental free cash flow in synergistic adjacent markets. I'll finish with our guidance for Q3.

Q2 PERFORMANCE

Beginning with our Q2 performance, Applied delivered record revenue that was up 41% year-over-year and near the top of our guidance range. Our teams executed well, delivering strong gross margins in a challenging operational environment and this led to record non-GAAP earnings that exceeded our guidance range.

All three of our operating segments exceeded their revenue guidance and we continue to expect each to post higher revenue in the second half of our fiscal year. The Semiconductor Systems team also delivered the highest non-GAAP operating margins in nearly 14 years while AGS delivered the highest margins in nearly 15 years. These accomplishments helped us generate record non-GAAP operating profit and increase non-GAAP operating margin by 700 basis points year over year. We increased operating cash flow by 87% year over year, delivering over a billion dollars for the third quarter in a row.

We're pleased that Moody's recently upgraded Applied's credit rating by a notch to A2.

We also resumed the buyback program in Q2 deploying \$750M in the limited window available to us and we expect to be more active in the current quarter. Also during the quarter, the board approved a new \$7.5B stock buyback authorization along with a 9% dividend increase and we announced our commitment to return 80 to 100% of free cash flow to shareholders.

MARKET DATA

Next, since our last earnings call, VLSI Research published its market sizing report for calendar 2020, which is important for two reasons. One, it distinguishes front-end equipment spending from back-end assembly and test. Two, it includes company services and spares revenue in addition to equipment revenue allowing observers to distinguish between recurring revenue and WFE. Applied Materials was number one in both equipment and services for 2020.

The equipment market was \$61.2B, up nearly 19% year on year. We significantly outgrew the market, gaining 60 basis points of industry market share, with gains in deposition, removal and process control. As Gary described, major inflections are increasing the demand for materials engineering, and we're on track to significantly outperform once again in 2021.

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BUSINESS ENVIRONMENT

Next, I'll discuss the demand environment. Last quarter, we indicated the equipment market would be in the low \$70B in 2021, which was above the consensus at the time. Demand has strengthened further, and we now expect equipment spending to be in the high \$70B for the year. At the investor meeting, I showed you a chart with the rolling two-year sum of equipment spending for each period since 2012 plus 2013. Each successive two-year period has been higher and I now believe that spending in 2021 plus 2022 will be greater than \$160B.

DEMAND THESIS

Our demand thesis for the past several years is that data generation is growing exponentially while 2D scaling is slowing which means more process equipment will be needed. Over the long history of the industry, equipment capital intensity has been close to 12% on average. But because of the higher technical complexity and the slowing of 2D scaling, capital intensity is closer to 14% today.

Multiple industry forecasts call for semiconductor industry revenue to reach \$1T by 2030. If capital intensity stays flat from here, then WFE spending could be over \$140B in the same timeframe.

I realize there are questions about whether the unprecedented demand we are seeing today is secular or cyclical. When I listen to what our customers say, I hear a firm belief that the data economy is real and driving secular growth well into the future. This perspective is being reinforced by plans for substantial multiyear capital investments which are needed to support demand and fuel profitable growth. Against this backdrop we've never felt better about our opportunity to enable our customers generate free cash flow and return cash to shareholders.

SUBSCRIPTIONS

Next, as we discussed at the investor meeting, we're also focused on growing beyond equipment sales. The more we deliver solutions and outcomes for our customers, the more we can increase our subscription revenues which grow and generate free cash flow every year.

The report I mentioned earlier shows that over 90% of Applied's reported services business is composed of recurring services and parts revenue which is the highest amongst our peers. We generated \$3.7B of this true services revenue in 2020, with 60% in long-term agreements and renewal rates of around 90%. In Q2, the trend toward long-term subscriptions was even stronger. Nearly 70% of our services and parts bookings were subscriptions and 50% had terms of at least 3 years.

Our strategy in AGS and as a company is to combine our technologies in unique ways to create higher-value solutions and outcomes for our customers which are best delivered under the subscription model.

SYNERGISTIC MARKETS

We also discussed our strategy to redeploy our technology in synergistic adjacent markets where modest investments can generate attractive supplemental free cash flow. Today, the largest example of

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this strategy is our Display business where our CVD, PVD and eBeam technologies have been adapted to glass substrates. Over the past couple years, we've strengthened our products for the next wave of OLED investments targeting foldable smartphones, notebooks, tablets and TVs. With these investments completed, our focus is on increasing free cash flow. We're committed to increasing non-GAAP operating margins from the high teens level today to over 20% in the coming quarters and then between 25 and 30% over the target model horizon.

Q3 GUIDANCE

Now I'll share our Q3 business outlook.

We expect to increase company revenue to approximately \$5.92B, plus or minus \$200M. The midpoint would be up about 35% year-over-year. We expect non-GAAP EPS to be about \$1.76 plus or minus \$0.06, or up about 66% year-over-year.

Within this outlook, we project Semiconductor Systems revenue of \$4.25B, up around 46% year-over-year and AGS revenue of about \$1.23B, up around 19% year-over-year. We expect Display revenue of around \$415M.

Applied's non-GAAP gross margin should be roughly flat sequentially at 47.7%, or up around 270 basis points year over year. We plan to increase non-GAAP Opex to \$930M, and as a percent of revenue non-GAAP Opex should decline by 290 basis points, with nearly 70% of the spending earmarked for R&D. Our guidance assumes a non-GAAP tax rate of around 12%.

SUMMARY

In summary, I'm pleased that Applied delivered another record quarter of performance in Q2, with strong year-over-year growth in revenue and profitability and I'd like to join Gary in thanking our employees and supply chain partners for supporting our customers.

Now Mike, let's begin the Q&A.