Q2 Fiscal 2023 Earnings Call

PREPARED REMARKS | MAY 18, 2023

MICHAEL SULLIVAN | Corporate Vice President, Investor Relations

Good afternoon everyone and thank you for joining Applied's second 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.

UPCOMING EVENT

Before we begin, I have a calendar announcement. On July 11th, Applied plans to host a Semicon West technology breakfast from 7:30 to 9AM, Pacific Time. We plan to announce a major new platform and lead a heterogeneous integration panel featuring executives from AMD, Intel and Qualcomm along with Besi and the EV Group. You can register by visiting the events page of our IR website. There won't be a webcast, so we hope you'll join us in San Francisco!

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.

Applied Materials delivered strong results in our second fiscal quarter, with revenues in the high end of our guidance range. Across the business our teams are executing well, successfully managing a dynamic near-term environment, making progress with our longer-term strategic initiatives, and introducing enabling new products and solutions for our customers.

Despite macro headwinds, our outlook remains favorable, and we expect to outperform our markets in 2023 thanks to our balanced market exposure, our strong position at key technology inflections which is driving demand for our differentiated products, especially in metal deposition, CVD, etch, implant, thermal processing, and ebeam, and our growing service business which is increasingly subscription-based.

In my prepared remarks today, I'll cover our perspective on the market – both the near-term dynamics and our longer term, secular growth thesis, how Applied is positioned to outgrow the industry this year and over the longer-term, and finally, the investments we are making to create more value for our customers and productively scale the company.

MARKET OUTLOOK

In 2023, challenging and evolving macro conditions are impacting the semiconductor industry both negatively and positively. Demand that is directly driven by consumer electronics is clearly weak, while demand driven by inflections in technology and strategic, regional supply-chain investments remains robust. This contrast can be seen in our customers' investment levels. Weakness in PCs and smartphones is a key factor for memory customers who have significantly reduced their investments in 2023. Measured as a percentage of total wafer fab equipment, memory spending is tracking at its lowest level in more than a decade. In leading-edge foundry-logic, we have also seen customers trimming their spending plans for the year. We see these changes as timing adjustments, as these companies remain fully committed to their long-term roadmaps to win the race for technology leadership in this market. Push-outs in leading-edge investments are being offset by increased strength from customers who serve the IoT, Communications, Automotive, Power, and Sensors markets.

Over the past quarter, we've revised our 2023 ICAPS forecast upwards with demand being driven by two interconnected factors. First, ICAPS customers are delivering critically enabling technology for large, global inflections that will play out over the next decade. These include clean energy, electric vehicles, and industrial automation. These inflections are driving significant innovation. At Applied, we have released more than 20 major new ICAPS products, since we formed our ICAPS group four years ago. Second, there is a clear trend towards regionalization of supply chains as countries seek to build resilient local capacity to support industry verticals that are central to their economies. We currently see around $400 billion of government incentives being deployed globally over the next five years, a significant portion of which will be directed towards ICAPS markets. While China currently leads in ICAPS spending, we see other countries increasing their investments at a higher rate. In fact, the fastest growing regions for our ICAPS business in 2023 are the U.S., Europe, and Japan.

LONG-TERM GROWTH THESIS

Looking beyond 2023, our long-term growth thesis for the industry remains unchanged. Semiconductors are the foundation of the digital economy, which is driving demand and puts the industry on a path to become a trillion-dollar market by the end of the decade. At the same time, chip technology complexity is increasing significantly as traditional 2D scaling slows and the industry transitions to a new PPACt playbook to drive improved performance, power, area-cost and time-to-market. Increasing complexity means that wafer fab equipment can grow at a higher rate than semiconductor revenues and then, within equipment spending, major technology inflections are increasingly enabled by materials engineering, expanding the available market for Applied Materials.

APPLIED POSITIONED TO OUTPERFORM

I'll highlight a few examples of how major materials engineering inflections contribute to our growth.

First, Gate All Around (GAA) transistors are a great example of a new 3D device structure that is enabled by materials engineering in areas where Applied has leadership products including epi and selective removal. In addition, we have developed differentiated conductor etch solutions specifically for GAA applications. We expect shipments of our GAA products to begin ramping in 2024 as leading customers move into high volume production. For Applied, this inflection creates an incremental opportunity of around $1 billion for every 100 thousand wafer starts of capacity, and we expect to gain five points of transistor market share in the overall transition from FinFET to GAA.

Second, in wiring, we are seeing significant innovation in new materials. Adoption of new low-resistance metals for contact and interconnect enabled us to grow our PVD revenues at three times the rate of wafer fab equipment in 2022. High-speed data connectivity remains a key focus for all of our customers fueling further growth at future nodes.

Third, Applied technology is providing our customers with new tools to drive their scaling roadmap. Recently we launched Sculpta, a breakthrough pattern-shaping technology which provides a simpler, faster, and a more cost-effective alternative to EUV double patterning. It decreases customers' capital cost by $250 million for each layer of adoption per 100 thousand wafer starts*. We are already shipping repeat systems and expect this business to grow to multiple hundreds of millions of dollars of annual revenue in the next several years.

The final example is advanced packaging – while we are still in the very early phases of industry adoption, this inflection is already a great growth area for us. Our packaging revenue has doubled in the past three years to over $1 billion. We have strong leadership positions in key enabling technologies including Through-Silicon-Via, micro-bumping and hybrid bonding. We believe we can double revenues again in the next few years with further adoption of 3D multi-die packaging.

The increasingly complex solutions our customers are deploying to move from one technology node to the next, are also a key growth driver for our service business. Customers are seeing value in our solutions to support their R&D, rapidly transfer and ramp new technologies, and drive device performance, yield, output and cost in high-volume manufacturing. Our service business is on track to grow in 2023 even with lower utilization rates in certain nodes and after absorbing the impact of U.S. export control rules. 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%.

INVESTING IN GROWTH

Given our confidence in the trajectory of the industry and Applied Materials, we are taking actions and making associated investments to support our growth, accelerate our customers roadmaps and drive productivity and efficiency as the industry scales.

On May 22nd, we will formally announce a major strategic investment in a new high-velocity innovation platform focused on next-generation equipment and process technologies. As innovation in the industry is increasingly driven by new materials, structures and devices, our goal is to change the way we collaborate with customers, universities, suppliers and other partners to bring new manufacturing technologies to market faster and optimize the overall economic returns.

We'll look forward to sharing more details next week.

** Wafer starts = WSPM, wafer starts per month*

SUMMARY

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

While 2023 is a challenging year for the economy and areas of the semiconductor market, Applied's business performance remains resilient thanks to our broad exposure to secular trends, strong product positions at key technology inflections, and our growing service business. Our longer-term outlook is very positive as semiconductors become a larger and more strategically important market globally, and industry trends create outsized opportunities for Applied. To position ourselves for the opportunities ahead, we are making strategic investments in R&D and infrastructure while driving improvements in productivity and speed across the organization.

Now Brice, it's over to you.

BRICE HILL | Senior Vice President, Chief Financial Officer

Thank you, Gary.

On today's call, I'll summarize our Q2 results, provide our guidance for Q3, and discuss the investment we're making in our R&D infrastructure.

Before covering the near term, I'd like to remind you of four key points. First, the semiconductor industry is on track for secular growth, with expectations of a $1 trillion market by 2030. Second, materials engineering is increasingly critical to our customers' roadmaps. Third, Applied's broad and differentiated portfolio, market diversity and growing services business make us more resilient today than in the past and set us up to outperform our markets. And fourth we have an efficient business model that generates strong profitability and free cash flow, which enables us to invest in growth and provide attractive shareholder returns.

In fact, in March, we signaled our confidence in the long-term growth of the semiconductor market, and in our ability to deliver the new materials and manufacturing innovations required to drive the industry. The Board of Directors approved a 23% dividend per share increase which is the largest increase in 5 years and supplemented our share buyback program with a new $10 billion repurchase authorization.

We believe our free cash flow can continue to grow and support increasing the dividend at an accelerated rate over the next several years which would double our previous dividend per share. As our services business grows along with our installed base of equipment, it alone produces more than enough operating profit to pay the company's dividend.

Q2 BUSINESS HIGHLIGHTS

Moving now to Q2 business highlights, our team did a great job navigating supply and schedule challenges during the quarter, enabling us to grow revenue and earnings per share on a year-over-year basis. We mitigated most of the supplier cybersecurity situation we described last quarter, and this helped us deliver higher-than-expected revenue in both Semi Systems and AGS. Most of our businesses caught up to demand, and our lead times and inventory levels declined. Growth in our ICAPS business offset year-over-year declines in memory, just as it did in Q1 and our services business generated record revenue, growing year-over-year and offsetting headwinds created by the trade rules announced last October.

Q2 FINANCIAL RESULTS

Now I'll summarize our Q2 financial results. Company revenue in Q2 was $6.63 billion, up 6% year over year and non-GAAP EPS was $2.00, up 8% year over year. These results were in the upper end of our guidance range and only slightly below last quarter's near-record results. Non-GAAP gross margin was flat sequentially at 46.8%, remaining resilient as we offset headwinds related to trade restrictions, inflation, supply chain and logistics. Non-GAAP opex rose slightly quarter over quarter to $1.17 billion.

Turning to the segments, Semi Systems revenue grew 12% year over year to $4.98 billion. Segment non-GAAP operating margin was 35.6%.

AGS revenue grew 3% year over year to nearly $1.43 billion. In fact, this was AGS's 15th consecutive quarter of year-over-year growth. Segment non-GAAP operating margin increased sequentially to 29%.

In Display, revenue was approximately flat sequentially at $168 million and segment non-GAAP operating margin increased sequentially to 12.5%.

Turning to cash flows, we generated $2.3 billion in operating cash flow during the quarter, which was nearly 35% of revenue. We produced over $2 billion in free cash flow which was nearly 31% of revenue which demonstrates the efficiency of our business model. Shareholder returns in the quarter were over $1 billion, including $219 million in dividends and $800 million in share buybacks.

Q3 GUIDANCE

Now, I'll share our guidance for Q3.

We expect company revenue to be $6.15 billion, plus or minus $400 million. We expect non-GAAP EPS of $1.74, plus or minus $0.18. Within this guidance, we expect Semi Systems revenue to be around $4.5 billion, which is down nearly 5% year over year. We expect AGS revenue to be about $1.43 billion, which is up 1% year-over-year. Display revenue should be around $170 million. We expect Applied's non-GAAP gross margin to be about 46.3% and we expect non-GAAP operating expenses to be approximately flat sequentially at $1.17 billion. We are modeling a tax rate of 12.3%.

R&D INFRASTRUCTURE INVESTMENT

Finally, I'll comment on the new innovation platform Gary discussed in his remarks. We're planning to make a multibillion-dollar investment in new 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. We'll provide more details about the amount and timing next week. What I'd like you to know today is that the investment is consistent with our company's existing long-term strategic plans. Also, the scale will depend on our ability to secure government support. While we expect our capital expenditures to be higher over the next several years, there is no change to our longer-term financial model and our strong commitment to shareholder returns.

SUMMARY

In summary, Applied Materials is executing well and demonstrating the advantages of our broad and diverse portfolio, markets and customer base. This year demonstrates how our business has become less volatile and more resilient. We are growing year-over-year in semiconductor systems and services and generating healthy profitability. 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.