Q3 Fiscal 2021 Earnings Call

PREPARED REMARKS | AUGUST 19, 2021

MICHAEL SULLIVAN | Corporate Vice President, Investor Relations

Good afternoon everyone and thank you for joining Applied's third 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 some calendar announcements. On September 8 at 9 a.m. Pacific Time, we plan to host the third event in our Master Class series, this time focusing on the ICAPS markets, and also on heterogeneous design and advanced packaging. Then, on October 18, also at 9 a.m. Pacific Time, we plan to hold our fourth master class. We'll focus on process control and process optimization, including AI^x platform technologies like eBeam and AI. 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.

In our third quarter of 2021, Applied Materials again delivered record performance capitalizing on strong, broad-based demand for our semiconductor products and services, while navigating a challenging supply environment. Over the past 18 months, the pandemic has accelerated the digital transformation of the economy and adoption of advanced technology creating a permanent, structural shift for the industry. At the same time, COVID-19 has disrupted global supply chains and logistics – a transitory challenge we'll continue navigating over the coming quarters. Across the company, I want to thank our teams for doing an incredible job to successfully overcome these near-term disruptions, provide outstanding support to customers, and keep our R&D roadmap on track.

In today's call, I'll focus on three main topics:

- First, I'll provide our perspective on the market – starting with our near-term outlook and then recapping our longer-term thesis.
- Second, I'll summarize the three pillars of Applied's growth strategy.
- And third, I'll explain how Applied is outperforming our markets today and is well positioned to play an even bigger, broader and more valuable role in the future.

NEAR-TERM OUTLOOK

I'll begin with our near-term outlook. Overall, there are no significant changes to our view of the market. Demand is strong and sustainable, with customers making strategic investments to address long-term secular trends.

In 2021, Foundry-logic is the fastest growing wafer fab equipment market and we believe it will represent more than 55% of total customer investment for the year. This spending is split relatively evenly between leading edge – the three most advanced nodes in foundry and logic – and technologies for IoT, Communications, Automotive, Power electronics and Sensors applications, or what we call ICAPS.

We expect DRAM spending to be the second fastest growing WFE market this year and we see a positive set-up for sustained investment in capacity and new technology. Supply-side inventories remain below normal levels and long-term demand drivers are strong, fueled by memory-intensive AI computing.

On an absolute basis, we expect NAND investments to be similar to DRAM for the year. We believe NAND inventories are at normal levels both on the supply-side and demand-side.

LONG-TERM SUSTAINABILITY

Looking further ahead, I strongly believe there has never been a more exciting time for semiconductor companies. We are only at the beginning of decade-long trends that will underpin secular industry growth. As I've said before, digital transformation is built on silicon and broadens the drivers for semiconductor innovation. Demand for semiconductors is no longer about one or two 'killer applications', but rather an expansive, structural shift in the economy towards digitization and automation.

Smart and connected devices at the edge not only consume more silicon, they are driving exponential growth in machine-generated data. To make sense and create value from the vast volumes of data available, new AI computing approaches are needed fueling further demand for current and next generation semiconductors.

While global consumption of silicon is accelerating, adoption rates of new technology vary considerably by region. As we showed at our investor meeting, we estimate that by 2025, China will have only reached the same levels of silicon spend per capita the US saw in 2015. And India trails China by another eight to 10 years.

Since the impact of digital transformation is so wide-reaching, national governments are increasingly recognizing the strategic importance of semiconductors. As government incentives become available in the U.S., Asia and Europe, they can provide multi-year support as the industry moves from 'lean' and 'just-in-time' supply chains to more resilient, flexible and secure approaches, including regionally distributed capacity.

However, putting the right manufacturing infrastructure in place is only one piece of the puzzle. Investment in innovation infrastructure – to lead in the development and commercialization of next generation technologies – is even more critical to winning the future. Early access to superior semiconductor technologies – or what I refer to as 'winning the PPACt race' – will determine the countries and companies that thrive and those that won't.

GROWTH STRATEGY

At Applied, we have a strong point of view that the industry's future will not be like the past, and we have aligned our strategy and investments accordingly.

Our strategy has three pillars:

- First and foremost, we are focused on being the PPACt enablement company to provide the foundation for customers' Power, Performance, Area, Cost and Time-to-Market roadmaps. We have the broadest and most enabling portfolio of process technologies that we can co-optimize and combine in unique and highly enabling ways.
- Second, we are shifting more of our business to subscriptions as we believe this model provides significant benefits to customers and for us. We have already converted a meaningful portion of our installed base business to recurring revenues and we are starting to monetize new products and services using subscription approaches.
- And, third, we continue to optimize our portfolio of businesses that serve adjacent markets – including Display – to drive profitable growth and higher free cash flows.

OUTPERFORMANCE IN 2021

This strategy is yielding results and 2021 is shaping up to be a strong year of outperformance for Applied.

Starting with our unit process tools, we are seeing very strong demand for our leadership products. For example, taking the midpoint of our fourth quarter guidance, both our epi and thermal businesses are on track to grow more than 70% this fiscal year – while CMP will grow more than 60% and implant more than 50%. We are also seeing outperformance in our growth areas, especially Process Diagnostics and Control, where we expect to grow more than 60% in calendar 2021.

On top of this, we have strong momentum with our co-optimized and integrated solutions. By revenue, about 70% of the semiconductor products we sell today have already been co-optimized at some level. Co-optimization allows us to see and solve higher value problems for customers, speed up technology transition to high-volume manufacturing, and make our solutions stickier. Beyond co-optimization, our integrated materials solutions – called IMS – combine multiple processes with customized metrology and sensors in a single system typically under vacuum. Our latest IMS product, that lowers interconnect resistance by 50% in advanced foundry-logic, directly addresses a multi-billion-dollar opportunity over the next five years. With IMS, we can target the most complex and valuable challenges in the new PPACt playbook, and we have an exciting pipeline of new solutions for both foundry-logic and memory.

Another area where we're seeing strong and sustainable growth is our ICAPS business that serves a broad spectrum of customers and applications in IoT, Communications, Automotive, Power and Sensors. Within ICAPS, demand for 28-nanometer and larger nodes is especially robust. Revenue from products serving these applications is expected to double this year. By acting early and forming a dedicated ICAPS team in 2019, we've been able to increase our focus on these customers and accelerate our share of this market. We are developing new products specifically designed for ICAPS markets including integrated and co-optimized solutions. As a result, we are deepening our partnerships and collaborations with these customers. For example, we have recently signed a five-year contract with a leading ICAPS customer, designed to provide more assured supply for them and more predictable revenues for Applied.

POSITIONED FOR LONG-TERM OUTPERFORMANCE

Today, we are demonstrating strong momentum in our leadership and growth businesses, IMS and ICAPS, and as I look ahead, I'm confident our opportunities are even better.

It is clear that advances in materials engineering are foundational to the industry's PPACt roadmap. The PPACt playbook has five key elements:

- New architectures – including workload-specific ASICs and new memories
- 3D structures – including Gate All Around transistors, Buried Power Rail and 3D DRAM
- New materials for gate, contact and interconnects
- New geometric shrink
- And advanced packaging.

We believe that the relative contribution of these five elements to PPACt at future nodes is evolving in ways that create opportunities for Applied to play an even larger and more valuable role. Let's take advanced packaging as an example:

- We identified this inflection early and began investing in differentiated technology years ago.
- Today, we enjoy a clear leadership position in advanced packaging equipment with more than 60% share of our served market.
- We will generate more than $800M of revenue from our equipment business this year, and through a combination of organic R&D and strategic partnerships, we are also developing highly enabling future technologies.
- We are very excited about our opportunities and pipeline and will share more details with you at our upcoming Packaging Master Class.

Finally, when we talk to customers about PPACt, they consistently highlight the importance of t – time-to-market. Time-to-market acceleration is a critical component of our PPACt enablement strategy. 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. Our Actionable Insight Accelerator or AI^x platform, that we officially launched in May, brings together process tools, sensors, metrology, data analytics and machine learning. We have strong momentum and are adding new installations at multiple leading customers. For example, AppliedPRO is our Process Recipe Optimizer within AI^x and used to accelerate R&D qualification of individual chambers and tools, as well as enable larger process windows and higher chip yields. Over the next 12 months, we expect to double the number of AppliedPRO customer engagements from around 25 this year to more than 50.

SUMMARY

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

We see strong and sustainable demand in our semiconductor business, underpinned by a wide range of positive macro and technology drivers. While COVID-related supply chain disruptions persist, our teams are doing a great job working through these challenges. We believe Applied Materials will outperform our markets again this year thanks to our strong portfolio of differentiated unit process tools for both leading edge and ICAPS markets, combined with accelerating adoption of our IMS and advanced packaging products. As we look ahead, we are confident that the strength of longer-term secular trends will drive semiconductor and wafer fab equipment markets structurally higher, and we believe Applied is in the best position to accelerate our customers' PPACt roadmaps and grow significantly faster than our markets.

Dan, over to you.

DAN DURN | Senior Vice President, Chief Financial Officer

Thanks Gary.

Today, I'll begin by summarizing Applied's overall performance in Q3. Then, I'll discuss our Semi Systems results – including new details about our foundry-logic business. I'll also give you a number of metrics surrounding the large, recurring revenue portion of Applied's Global Services segment.
Then, I'll add my perspective on the demand trends in our markets and provide our guidance for Q4.

Q3 PERFORMANCE

Beginning with our Q3 performance, Applied generated the strongest revenue in company history, with each of the segments exceeding guidance. We increased gross margin to 48%, which is the highest in 14 years despite the ongoing cost headwinds related to COVID. We also delivered the company's highest-ever operating profit, operating margin, and earnings per share. Our results included record operating cash flow and record free cash flow of $1.5 billion. In fact, we've generated nearly $5 billion in cumulative free cash flow over the past four quarters.

At the investor meeting in April, we made a long-term commitment to return 80 to 100% of free cash flow to shareholders and in Q3, the buyback window was available to us for the full quarter. We repurchased $1.5 billion of Applied's stock during the quarter and returned 111% of free cash flow to shareholders including dividends. We ended the quarter with around $6.5 billion remaining in our share buyback authorization. Given the secular growth trends in our end markets, and our view of the intrinsic value of the company, we expect to continue to be active in the market for our shares.

Finally, last quarter, I mentioned that Moody's upgraded Applied's credit rating to A2. I'm pleased that earlier this month, Standard and Poor's also upgraded our rating from A- to A.

SEMI SYSTEMS

Now, I'll provide some insights into the strong performance of our Semi Systems business which generated its highest-ever revenue in Q3. Our demand is broad based across foundry-logic and memory and within foundry-logic, across a wide variety of nodes. We're increasing our technology leadership in many areas, and that's being reflected in our operating margin, which crossed 40% for the first time.

About half of our foundry-logic revenue is being generated by our ICAPS business, which focuses on all but the three most leading nodes. Our ICAPS business has a large, global presence and serves a very large number of customers throughout North America, Europe and Asia. Many of the ICAPS applications have long product cycles, which generate lasting opportunities for us both in equipment and services. We have high share, and the margins are accretive to the company. We look forward to giving you more insights into the ICAPS markets and our strategies at the Master Class next month.

APPLIED GLOBAL SERVICES

Turning to Applied Global Services, we're building a solutions-based, recurring revenue business that delivers predictable free cash flow across market cycles. Our segment reporting gives you good insights into the business and I'll continue to help you with key performance indicators that demonstrate the unique qualities of Applied's services business and the progress of our strategies. From our segment reporting you know that AGS delivered record revenue of $1.29 billion in Q3, up 24% year over year.

87% of AGS revenue was recurring services, parts and software. The remaining amount was primarily legacy 200mm equipment, so Applied generated $1.1 billion in recurring revenue this quarter. This is by far the highest among our process peers and demonstrates our progress in generating lifetime value from the industry's largest installed base.

Today, our semi installed base is just over 40,000 systems, and we have over 160,000 chambers in the field. At our Investor Meeting, we shared our goal to increase revenue per system by 20% between 2020 and 2024. As of Q3, we're already halfway to achieving our goal.

Now I'll put some metrics to our strategies for adding customer value to further grow our recurring revenue. Connecting the installed base to our AI^x servers enables us to perform data-enabled services for our customers. Today, we have just over 4,300 connected tools, which is up over 30% from our 2020 baseline. We're also growing the number of secure remote connections, which allow us to connect our best experts to the installed base to perform remote analytics, diagnostics and optimization, from anywhere in the world. The number of remote connected tools now exceeds 3,200, which is up over 36% from our 2020 baseline.

Another key focus is transitioning our recurring revenue to subscriptions in the form of long-term service agreements. Today, we're generating 60% of our recurring revenue from subscriptions, and our goal is to reach around 70% by 2024. We also have a subscription renewal rate of around 90%.

Another sign of customer value is the tenure of the agreements. Across the entire base of subscription agreements, we've increased the tenure from 1.9 years at the end of 2020 to 2.2 years today. In fact, of our subscriptions booked in Q3, 77% were multiyear agreements. We track all of these KPIs very closely. I hope they give you a good sense of the size and growth of our recurring revenue and the strong customer pull we're generating by focusing on customer time-to-market as well as cost, output and yield.

Finally, another key metric we disclose is AGS segment operating margin, which provides a good indicator of the value our services bring to customers. In Q3, it crossed 30% for the first time in 15 years.

DEMAND OUTLOOK

Next, I'll add my perspective on the demand environment. While Q3 was a record quarter, we see further growth ahead. In fact, our overall backlog is close to $10 billion, with record levels in both semi systems and AGS, and strength across all of our geographies. I still expect equipment spending to be higher in the second half of calendar 2021 for both foundry-logic and DRAM. I expect WFE to be up in 2022 and I expect all of our reporting segments to be higher.

Q4 GUIDANCE

Now I'll share our Q4 business outlook.

We expect to increase company revenue to approximately $6.325 billion, plus or minus $250 million or up around 35% year-on-year. We've widened the revenue range this quarter because of near-term risks within our supply chain. We expect non-GAAP EPS to be around $1.94, plus or minus $0.07 or up around 55% year-on-year.

Within this outlook, we project Semiconductor Systems revenue of $4.60 billion, up around 50% year over year and AGS revenue of about $1.30 billion, up nearly 18% year over year. We expect Display revenue to be around $400 million.

Applied's non-GAAP gross margin should be flat sequentially at 48%, or up around 230 basis points year over year. We plan to increase non-GAAP Opex to $960 million which is around 15.2% of revenue and below our longer-term target of 16%. Our guidance assumes a slightly higher non-GAAP tax rate of around 12.5%.

SUMMARY

In summary, I‘m pleased that Applied delivered another record quarter of financial performance in Q3, with strong margins and free cash flow. The demand environment continues to be strong and I’d like to join Gary in thanking all of our teams and partners for their hard work in a robust but challenging environment.

Now Mike, let’s begin the Q&A.