Q1 Fiscal 2023 Earnings Call

PREPARED REMARKS | FEBRUARY 16, 2023

APPLIED MATERIALS®

MICHAEL SULLIVAN | Corporate Vice President, Investor Relations

Good afternoon everyone and thank you for joining Applied's first 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-K 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.

Before we begin, I have a calendar announcement. Later this month, Applied Materials is participating in the SPIE Advanced Lithography and Patterning Conference. For those who aren't traveling to San Jose for the conference, we plan to hold a new product launch event on our IR Website on Tuesday, February 28th at 9AM Pacific Time. We hope you'll join us!

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 executed well in our first fiscal quarter, delivering results towards the high end of our guidance range. We also grew our backlog for the ninth consecutive quarter. Going forward, we expect backlog to start declining as we move through 2023. Overall, we are making good progress closing our supply-versus-demand gap. However, very recently, one of our major suppliers encountered a disruption that will impact our second quarter shipments. Brice will provide more details about this when he shares our guidance. In my prepared remarks, I will cover three main topics:

- Our current outlook for 2023.
- Our longer-term growth thesis for the industry, and how Applied is positioned to grow faster than our markets overall.
- And finally, a brief overview of the investments we are making to productively scale the company and accelerate our customers' roadmaps.

MARKET OUTLOOK

Let me begin with our near-term perspective on the market. In this environment of mixed macro-economic signals, our customers are facing a variety of demand dynamics. Consumer-driven markets, including PCs and smartphones are clearly weaker, while inflection-driven markets remain more resilient—especially high-performance computing and AI, automotive, industrial automation, and clean energy. In terms of wafer fab equipment investments, 2023 will be a down year for memory spending as customers rebalance inventories and defer capacity additions in both NAND and DRAM. We expect DRAM to pick up ahead of NAND, potentially beginning to recover later this calendar year. We now see leading-edge foundry-logic spending being slightly down year-on-year. While near-term demand headwinds are causing customers to trim capacity additions, they remain firmly committed to strategic investments in advanced nodes to win the battle for next-generation technology leadership.

Our view of ICAPS—chips for IoT, Communications, Auto, Power and Sensor applications—is incrementally more positive than it was last quarter, and we now see spending being up year-on-year. Leading ICAPS companies are investing in both technology and capacity to serve growing demand across a wide range of verticals. In addition, there is strong government support around the world to build resilient, regionalized ICAPS supply.

Based on what we are seeing in our business and hearing from our customers, we believe Applied Materials is well positioned to outperform the market in 2023. The resilience in our business is driven by several contributing factors:

- First, our balanced market exposure which allows us to perform well in a variety of spending mix environments.
- Second, our position with technology leaders who remain focused on investing in their long-term strategies. We have strong positions at all the key technology inflections in advanced foundry-logic, ICAPS, DRAM, and advanced packaging.
- Third, our record backlog, of which a significant percentage is made up of our most differentiated products including metal deposition that is uniquely enabling for critical next-generation wiring resistance improvements.
- And finally, our service business which is on track to grow in 2023, even after the impact of current U.S. export control regulations. More than 60% of our service revenue is generated from subscriptions in the form of long-term agreements. These agreements have an average tenure of 2.6 years and a high renewal rate of more than 90%.

LONG-TERM GROWTH THESIS

While we are cognizant of near-term volatility in our markets and ready to respond to both upside or downside, our long-term outlook remains highly positive. Semiconductors are the foundation of the digital economy making them more strategically and economically important than ever before. Around the world, governments are incentivizing the industry to build regional manufacturing capacity and accelerate investments in strategic next-generation technologies. The semiconductor industry remains on track to grow from approximately $600 billion in 2022 to a trillion dollars or more by the end of this decade.

Technology complexity of chips is increasing significantly as traditional 2D Moore's Law scaling slows and the industry transitions to a new PPACt playbook to drive improved performance, power, area-cost and time-to-market. In addition, as 2D Moore's Law decelerates, we are seeing average die sizes in advanced foundry-logic grow. This drives the need for additional wafer capacity while also accelerating the transition to chiplets and heterogeneous designs. Beyond advanced packaging, major technology inflections in transistor, wiring, and patterning are also enabled by new materials and materials engineering. These inflections increase the size of Applied's available market.

As we have been investing in these inflections for multiple years, we are now well positioned to capture a larger share of our available market. We have a deep pipeline of solutions to enable new wiring innovations, Gate-All-Around transistors, backside power delivery, heterogeneous integration and hybrid bonding. Our broad portfolio of products enables us to offer customers traditional unit process equipment all the way to integrated materials solutions—or IMS—that combine multiple process technologies with on-board metrology and advanced data analytics in a single platform.

INVESTING IN GROWTH

We are very confident about the growth trajectory of the industry and Applied's outperformance within that environment. To support this growth, we are making strategic investments in new manufacturing, logistics and R&D infrastructure. The scale, speed and location of these investments will be dependent on receiving government support, some of which we have already secured.

Beyond simply expanding capacity, we see these infrastructure investments as a catalyst to change the way we collaborate with customers, suppliers and research partners. For example, in the coming months, we expect to break ground on our next-generation R&D center in Silicon Valley. We believe this new high-velocity platform will increase innovation and commercialization speed while reducing the overall cost of bringing new manufacturing technologies to market.

As the industry and Applied Materials scale, we need to do so productively and efficiently. This is a major strategic theme for us and, across the company, we are focused on driving up productivity and implementing new ways to work that are better and faster.

SUMMARY

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

While the economy and semiconductor industry are facing challenges in 2023, we remain confident that Applied is well positioned to outperform our markets this year. Our resilience is underpinned by our large backlog of differentiated products, growing service business, and strong positions with leading customers at key technology inflections. Our longer-term outlook remains highly positive as secular trends create opportunities for Applied to outgrow the semiconductor and wafer fab equipment markets by enabling the PPACt roadmap with our differentiated portfolio of materials engineering solutions.
In line with this view, 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.

I'd like to start by thanking our team and our supply chain partners for helping us deliver strong revenue in a dynamic environment. On today's call, I'll summarize our Q1 results and provide our guidance for Q2. Before going into the near term, I'd like to discuss the broader context for the industry and the company.

Over the past few cycles, the semiconductor industry has become significantly larger and more diverse. Applied's revenue and earnings have grown and become more resilient over this period. In Semiconductor Systems, more than half our revenue comes from leadership businesses where our market segment share is near or well above 50%. The growth of our services business has added another dimension of stability. These factors strengthen our confidence in our ability to invest, generate high returns, and return capital to shareholders. Our business model is very efficient and generates attractive returns. In fact, from fiscal 2013 through 2022, we have grown Applied's free cash flow at a compound annual rate of 30% and increased our return on invested capital to over 35%.

We have three capital allocation priorities. The first is funding future growth and returns, and the second is maintaining a strong balance sheet so we can fund R&D through market cycles. Accordingly, even though the semiconductor market is weaker this year, we are investing to scale the company to support our customers in what we believe will be a trillion-dollar semiconductor market. We are increasing our manufacturing and logistics capacity, and we are making significant investments in our R&D infrastructure to collaborate more closely and productively with our customers and industry partners to help solve their highest-value problems.

Our third capital allocation priority is returning excess cash to shareholders. We have committed to return 80 to 100% of free cash flow, and actual returns for the past 10 years have been 106%. We have repurchased 40% of shares outstanding at the beginning of this period. As the business has become larger and more diverse, we've also increased the dividend. We've increased our quarterly dividend per share at a 14% CAGR over the past 17 years. In fact, operating income from our services business alone more than covers a growing dividend.

Finally, I want our investors to know that we are increasingly focused on improving our productivity. We increased our full-time employee base by around 20% last year and have restricted hiring to critical positions and slowed our spending growth. R&D is our largest expense, and we are making portfolio decisions to ensure we generate the highest possible returns from our investments. We also see opportunities to make our manufacturing more predictable and efficient, and have formed new teams to drive our operational goals.

Q1 RESULTS

Moving now to our Q1 financials, we delivered net sales of nearly $6.74 billion and non-GAAP EPS of $2.03. These results were in the upper end of our guidance range and nearly identical to last quarter's record results. Non-GAAP gross margin increased 80 basis points sequentially to 46.8%, primarily driven by improved manufacturing and logistics costs along with pricing adjustments. Non-GAAP opex was nearly $1.17 billion, with about two-thirds of the sequential increase from R&D.

Turning to the segments, Semi Systems revenue grew by 13% year-over-year to $5.16 billion. Strength in ICAPS more than offset reductions in memory and advanced foundry-logic. Segment non-GAAP operating margin was 37.3%.

AGS revenue grew nearly 4% year-over-year in Q1 to approximately $1.37 billion. AGS absorbed a full quarter of revenue impact from U.S. trade regulations and performed better than the midpoint of our expectations. Segment non-GAAP operating margin was 28%.

In Display, revenue declined to $167 million, and segment non-GAAP operating margin was 4.8%.

Turning to our cash flows, we generated $2.27 billion in operating cash flow during the quarter, which was 34% of revenue. We returned $470 million to shareholders including $220 million in dividends and $250 million in buybacks.

Q2 GUIDANCE

Now, I'll share our guidance for Q2.

We expect revenue to be nearly $6.4 billion, plus or minus $400 million, or up over 2% year-over-year. We expect non-GAAP EPS of $1.84 plus or minus 18 cents. This guidance includes a negative estimated adjustment of $250 million related to a cybersecurity event that was recently announced by one of our suppliers. Based on our current assessment of the situation, we expect to recover all of this revenue, and the majority of it in Q3. We expect Semi Systems revenue to be about $4.84 billion, which is up over 8% year-over-year. We expect AGS revenue to be about $1.34 billion, which is down around 3% year-over-year including the negative impact of recent U.S. trade regulations. Display revenue should be around $160 million. We expect Applied's non-GAAP gross margin to be approximately 46.5% which is lower quarter-over-quarter primarily driven by lower volumes and higher near-term supply chain logistics costs, and we expect non-GAAP operating expenses to be around $1.16 billion. We are modeling a tax rate of 12.5% and a weighted average share count of 850 million.

SUMMARY

I'll close my remarks today by saying thank you to our long-term investors for your support. We are investing for the future with confidence. Our products and services are being directed to a semiconductor industry that is growing in size and strategic importance to the global economy. Our business model is highly efficient, with low capital intensity and a high return on invested capital, driven primarily by R&D spending deployed in close collaboration with our customers. Our business has become less volatile and more resilient as semiconductor demand has broadened to more markets. Equipment capital intensity has recovered and our services business has grown larger and more subscription-based.

In fact, over the past five fiscal years, we've increased non-GAAP net income by 87%, generated $18.7 billion in free cash flow, and returned 118% of free cash flow to investors. Looking forward, we believe the growing complexity of the semiconductor roadmap and our ability to deliver the innovations required by our customers will enable us to grow faster than the industry. We plan to expand our global R&D and manufacturing infrastructure, including the plans Gary previewed. Finally, we will focus on increasing our productivity and maintaining our efficient spending model.

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