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Seagate Technology Plc (STX)

Q3 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Seagate Technology Fiscal Third Quarter 2019 Financial Results Conference Call. My name is Amanda, and I will be your coordinator for today. At this time, all participants are in a listen-only mode. Following the prepared remarks, there will be a question-and-answer session. As a reminder, this conference is being recorded for replay purposes.

At this time, I would like to turn the call over to Shanye Hudson, Vice President, Investor Relations. Please proceed, Shanye.

Shanye Hudson
Vice President Investor Relations, Seagate Technology Plc

Thank you. Good afternoon, everyone, and welcome to today's call. Joining me today are Dave Mosley, Seagate's Chief Executive Officer; and Gianluca Romano, our Chief Financial Officer. We've posted our earnings press release and detailed supplemental information for our March 2019 quarter on the Investors section of our website.

We will refer to GAAP and non-GAAP measures. Non-GAAP figures are reconciled to GAAP figures in our earnings release for our March 2019 quarter, which is posted on our website and has been furnished on a Form 8-K that was filed with the SEC.

As a reminder, this call contains forward-looking statements, including our June quarter financial outlook and expectations about our financial performance, market demand, industry growth trends, planned product introductions, ability to ramp production, future growth opportunities, and general market conditions. These statements are based on management's current views and assumptions, and should not be relied upon as of any subsequent date. Actual results may vary materially from today's statements.

Information concerning our risks, uncertainties, and other factors that could cause results to differ from these forward-looking statements are contained in our most recent Form 10-K filed with the SEC and the supplemental information posted on the Investors section of our website.

Today's call is expected to be approximately 30 minutes in length. And we'll do our best to accommodate your questions following our prepared remarks as time permits. Starting next quarter, we plan to extend our call to 60 minutes in duration.

And with that, I'll turn the call over to you, Dave.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

Thanks, Shanye. Good morning, everyone, and welcome to our quarterly earnings call, which we are joining from Dublin, Ireland. During today's call, I will cover the key highlights from the March quarter, share some perspectives on the market, and outline our progress on advancing our technology road map. Gianluca will then discuss details of our March quarter financial results and provide our outlook for the June quarter. Following our prepared remarks, we will open the call for questions.

Seagate executed well in the March quarter, navigating challenging business conditions to deliver financial results that met or exceeded our expectations across every financial metric.

We recorded revenue of $2.31 billion and achieved non-GAAP earnings per share of $0.83, nearly $0.10 above the high end of our guidance range. Free cash flow increased to $291 million, up 81% quarter over quarter. And we returned over $0.5 billion to shareholders through dividends and buybacks, demonstrating our long-standing commitment to capital returns.

We achieved these results through our focused efforts to drive operational efficiencies, controlled expenses and optimize cash flow generation, proactively managing the business in the face of multiple revenue headwinds.

In the edge compute market, revenue was impacted by the expected transition to SSDs, ongoing CPU shortages and seasonal demand slowdown for notebooks and desktop PCs.

In the surveillance market, revenue remained suppressed by economic and geopolitical uncertainties. However, over the long term we expect the market to grow, as camera resolution improves to 8 megapixels and drives the average capacity per drive above current levels of 3 terabytes to 4 terabytes.

In the enterprise market, both seasonal and macroeconomic challenges weighed on revenue for our nearline drives. Revenue from a few hyperscale customers improved slightly quarter-over-quarter. However, that revenue did not fully offset the slower demand from OEM and other global cloud customers.

As a reminder, demand for our nearline drives began to slow in the December quarter, as cloud service providers worked through the inventory built-up during calendar 2018.

However, we anticipate this pause to be short-lived. The demand improvement I just mentioned among select hyperscale customers is an indication that we are approaching the end of this inventory digestion phase. And we expect broader demand recovery starting in the second half of the calendar year.

We also believe some of the slowdown we are experiencing in our nearline product demand is attributed to cloud customers anticipating the transition to our next-generation high-capacity drives.

We are very pleased to announce that we began shipping our 16 terabyte drives in late March as planned. We are delivering the industry's highest capacity disk drives to enable improved performance at the lowest total cost of ownership for our customers.

Qualifications are underway at many major cloud and enterprise customers. We expect to begin ramping to high volume later in calendar 2019 and expect 16 terabyte drives will be our highest revenue SKU by this time next year.

For Seagate, fiscal 2019 is a year of focused execution and technology advancement. And we continue to successfully deliver on our plans. We expect to introduce drives with over 20 terabytes of capacity in calendar year 2020, based on our innovative HAMR recording technology.

These technology breakthroughs are significant enablers, providing a path to 40 terabytes and higher capacities. That's more than double the capacities available today, while at the same time making the transition to this new technology seamless for our customers. Perhaps best stated by one of our large hyperscale customers working to qualify HAMR: It just works.

We also have made strides on our Multi Actuator technology. During the recent Open Compute Project Summit, we set a new speed record for video streaming data rates from a hard drive. With our MACH.2 dual actuator, we demonstrated twice the bandwidth compared to a single actuator drive, the fastest ever sustained transfer rates from a hard drive. We believe HAMR high-density drives combined with our Multi Actuator technology will not only address the heavy workloads and high utilization rates required by large cloud data centers, but also new use cases that are emerging at the edge.

The Global Datasphere is expected to double once every three years to reach a staggering 175 zettabytes by 2025. This rapid growth in data creation is giving rise to new applications including SmartCities, SmartFactories, genomics, autonomous vehicles and other IoT applications, all of which employ AI and machine learning to derive value from big data. To inform real-time decision making, we believe more data processing and machine learning will need to occur closer to the source of data creation. Seagate has referred to this transition as the IT 4.0 Era or the rise in Edge computing. We are starting to see a buildup in private and Edge cloud environments to enable fast, secure access to data 24/7.

With this transition to IT 4.0 and associated growth in data at the Edge, exabyte demand for nearline drives may exceed our prior growth estimates of between 35% and 40% over the long-term. Importantly, Seagate's innovative technology portfolio positions us well to capture and monetize these opportunities.

Now I'll turn the call over to Gianluca to go into more depth on our third quarter results and share our outlook for the fourth quarter.

Gianluca Romano

Chief Financial Officer & Executive Vice President, Seagate Technology Plc

Thank you, Dave. In the March quarter, we delivered strong earnings and free cash flow underscored by our solid operational execution and focus on profitability in the face of a challenging business environment. Consistent with our expectations, March quarter revenue was $2.31 billion, down 15% sequentially with total shipment of 77 exabyte, down 12% quarter-over-quarter.

Our results reflect the impact of softer demand from cloud service provider in advance of our transition to 16 terabyte nearline drives as well as the ongoing global macro concern and typical seasonality as Dave discussed earlier. Revenue for the enterprise market, which includes nearline and mission-critical hard disk drives, represented 39% of March quarter revenue, flat as a percent of revenue from the December quarter.

We shipped approximately 33 exabytes into the enterprise market, down 10% quarter-over-quarter. The vast majority of the exabyte shipment were into the nearline market. Exabyte shipment for cloud customers were up quarter-over-quarter, which partially offset the decline in shipments to OEMs. The average capacity for nearline drive hit a new record of 7.2 terabytes, up 11% over the prior quarter.

Our 12 terabyte nearline drive remained the highest selling enterprise product in the March quarter. As Dave indicated earlier, we have started to ship the industry's highest capacity 16 terabyte drives in the current quarter and expect to ramp production as customers complete their qualification over the next few quarters.

Given the total cost of ownership benefits for customers and expected high reliability of these drives, we believe we are well-positioned to capture market opportunities in the coming quarters. We also continue to leverage our existing product portfolio to harvest customer demand for mission-critical drives which positively contributes to our margin and cash flow.

Revenue for the edge non-compute market contributed 32% of the total March quarter revenue compared to 31% in the prior quarter and includes sales for surveillance, gaming, NAS, DVRs and consumer application. Sales for data-rich application including gaming, NAS and DVRs grew sequentially which partially offset the macro headwind and seasonal trend impacting the surveillance and consumer market, respectively.

Exabyte shipments for edge non-compute platforms were 29 exabyte and down 10% quarter-over-quarter, while average capacity per drive remain approximately flat at 2.4 terabyte. Revenue from the edge compute market, including desktop and notebook hard disk drives represented 20% of total revenue compared to 21% in the December quarter. Our results reflect typical seasonality combined with ongoing CPU shortages. Exabyte shipments for edge compute platforms were nearly 15 exabyte, down 21% quarter-over-quarter with steeper than seasonal decline of notebooks and desktop PCs.

Our non-hard disk drive business including SSD and cloud system solution made up the remaining 8% of March quarter revenue, flat as a percent of revenue from the December quarter.

As we have shared over the past couple of quarters, we are focused on portfolio management to capture opportunities that deliver the highest value to our customers. We continue to make good progress although it will take time to fully make this transition. Cloud systems revenue has remained relatively stable over the past several quarters. SSD revenues declined sequentially ahead of planned product transition which are expected to occur over the next couple of quarters.

Non-GAAP gross margin for the March quarter was above our expectation at 26.6% compared to 29.7% in the December quarter. About half of the sequential margin decline was associated with manufacturing underutilization costs as we effectively managed our production to more closely align with industry condition.

Capacity utilization is directly correlated to portfolio mix. Higher capacity drives such as nearline and surveillance utilize more head and disk and takes longer to test compared to lower capacity HDDs. Accordingly, we expect capacity and our utilization cost to decline and gross margin to improve when demand resumes on higher capacity drives.

Non-GAAP operating expenses came in better than our expectation at $349 million, down 9% year-over-year and 4% sequentially. The decline in spending reflects ongoing expense discipline and lower variable compensation expense.

We continue to focus on managing expenses and utilizing capital for R&D investment to advance our future technology, products and solutions. Through operational efficiency and expense discipline, we deliver non-GAAP EPS of $0.83 in the March quarter, well above the high end of our guidance range.

Our operational focus has also led to solid return on invested capital. On a rolling four-quarter basis, ROIC expanded to nearly 27% in the March quarter compared to 25% in the prior year period.

We generated $438 million in cash from operations, up 52% sequentially, as we improve working capital, including a 9% decline in total inventory value quarter-over-quarter.

Capital expenditure were $147 million during the March quarter, at the lower end of our long-term target range of between 6% and 8% of revenue. Our resulting free cash flow was $291 million, up 81% from the prior quarter.

We utilized $327 million to repurchase 7.2 million ordinary shares and we exited the quarter with 277 million ordinary shares outstanding. Fiscal year-to-date, we have repurchased 13.4 million ordinary shares, and reduced our share count by 4%.

Cash and cash equivalents were $1.4 billion at the end of the quarter. And our board has approved a quarterly dividend payment of $0.63 per share which will be payable on July 3, 2019.

During the March quarter, we entered a new $1.3 billion revolving credit facility. The company debt balance as of March quarter was $4.5 billion, including $200 million drawn from the revolver. Our gross debt to last 12 months non-GAAP EBITDA ratio is 1.9 times as of the March quarter.

Turning to our outlook for the June quarter. We anticipate a relatively flat business environment in the June quarter with similar demand conditions across all of our end markets. In this environment, we expect total revenue to be in the range of $2.32 billion, plus or minus 5%; non-GAAP gross margin to be at least 26.5%; and non-GAAP EPS of $0.83, plus or minus 5%.

During this period, Seagate will continue to drive operational efficiencies to optimize our profitability and free cash flow. While business conditions remain somewhat challenging in the June quarter, based on our interaction with customers, we expect demand to recover, starting in the second half of the calendar year.

I will now turn the call back to Dave for final comments.

William David Mosley

Chief Executive Officer & Director, Seagate Technology Plc

Thanks, Gianluca. In summary, Seagate is executing well on multiple levels. We are driving operational efficiencies by managing our costs and capital investments to align with near-term industry conditions and optimize profitability and free cash flow.

We are harvesting HDD opportunities in markets with low exabyte growth, such as mission-critical drives, which contribute nicely to our bottom line, particularly during these slower demand periods, while requiring no R&D investment.

We are executing our technology roadmap and leveraging our 40-plus year heritage of innovation and expertise in precision engineered data solutions, to introduce new products with the highest areal density, quality and reliability, to address our customers' future mass storage requirements.

We believe the near-term industry headwinds we are experiencing will abate in the coming quarters and the long-term growth trajectory of mass storage demand provides a rich set of opportunities for Seagate.

Data-hungry applications are fueling demand for high capacity storage in both public and private clouds. Looking ahead to fiscal 2020, we expect the exabyte TAM for nearline drives to be well above the long-term CAGR of 35% to 40%. Importantly, Seagate's strong technology portfolio and customer relationships make us well-positioned to capitalize on this growth.

Before opening the call for questions, I'd like to thank our customers, suppliers, business partners and employees for their ongoing support and contributions to the success of our business.

Gianluca and I will now open up for your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from the line of Katy Huberty of Morgan Stanley. And your line is open.

Katy L. Huberty
Managing Director-Research, Morgan Stanley

Q

Thank you. Good morning. How do you think about the gross margin trajectory as demand comes back? If we see stronger cloud and surveillance demand in the September quarter, would you expect gross margins to be in the 29% to 33% long-term range? Or does it take a couple of quarters to expand back to the target model?

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

Hi, Katy. I'll pass it over to Gianluca in just a second. But what I would say, what I talked about last quarter was if gross margins, as we went through these digestion phases, if we got out of the period of factory underutilization faster, then we might see expansion.

I think what we're seeing right now is rather a bit of a build ahead for the fall. And we've got these product transitions going on, which I think is weighing us down just a little bit, otherwise we would have snapped back a little bit faster.

Sure, if the cloud comes back faster than we're anticipating right now, which we're starting to see signs of in the back half, then I think we should be able to get back into the range.

And I think I've said this before that our solve is not gross margin percentage either. In the January timeframe when we last spoke to everyone, we were really focused on free cash flow, just making sure we watched our cash very carefully, make sure we weren't building too much inventory and things like that.

So that may have actually hindered our ability to move a little bit extra product in this last few months. Again, I'd say that's towards the conservative side on my part. But that's how I think about the gross margin. Go ahead, Gianluca.

Gianluca Romano
Chief Financial Officer & Executive Vice President, Seagate Technology Plc

A

Yes. Last earnings release we said that we were expecting about half of the gross margin decline quarter-over-quarter to be related to lower volume produced and we still expect more or less the same impact in F Q4. Our volume in F Q4 will be a little bit higher, but at the same time we are building more capacity in our factory in order to take advantage of the second part of the calendar year where we expect more demand to come in. So, the impact of underutilization charges will be more or less the same in Q3 and Q4.

Katy L. Huberty
Managing Director-Research, Morgan Stanley

Q

Thank you.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

Thanks.

Operator: Thank you. Our next question is from the line of Mitch Steves with RBC Capital Markets. Your line is open.

Mitch Steves
Analyst, RBC Capital Markets LLC

Q

Hey, guys, thanks for taking my questions. Just had a question more on the PC side of the business. Sounds like you guys are seeing some weakness due to CPU constraints. Is there any way to help us quantify what that impact is?

And secondly, when you think that'll abate, since it probably impacts the results in the hard disk drive side?

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

Yeah. Mitch, I would say, it's against the backdrop like we talked about in the script of all the SSD incursions, natural transition, especially for the lower capacity stuff. So on what we call the enterprise – or sorry, the edge compute markets, you're seeing some low capacities, 500 gigabytes and 1 terabyte, and then you're seeing some high-capacity, some bifurcation, if you will, to 2s and 4 terabytes.

Where the CPU constraints are a problem usually are of smaller players, so the long-tail if you will distribution channel I think would be a good way to think about it. In the distribution channel, there are some people still making the lower capacity disk drive products, but very few, I think. They tend to be much more entrepreneurial. I talked about this a little bit last quarter.

We still haven't seen the healthy channels just yet, so while weeks on hand are fairly healthy on a relative basis, I look at the absolute value in the channel. And it's not as strong nearly as it was just a couple quarters ago. And that includes the higher capacity stuff, which should be some of those new markets and creative new markets.

So my perspective is this will start to come online as well through – in the back half of the year, but it really hasn't built up as much momentum as I expected in the January timeframe.

Mitch Steves
Analyst, RBC Capital Markets LLC
Q

Got it. And just to clarify, is that impacting the margin line, the gross margin line as well given that [ph] product under shipping (00:24:01) demand a bit.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc
A

To the extent that we'd have more products to be absorbing in our factories, the answer is yes. And the distribution channels, some of them tended to, over time, provide some nice outlets, low capacities and high capacities. So it would be nice to get some of the high capacity stuff moving again.

Mitch Steves
Analyst, RBC Capital Markets LLC
Q

Got it. Thank you.

Operator: Thank you. And our next question comes from the line of Ananda Baruah of Loop Capital. Your line is open.

Ananda Baruah
Analyst, Loop Capital Markets LLC
Q

Hi. Good morning, you guys. I guess good afternoon for you guys. Dave, Gianluca, thanks for taking the question. I guess just real quick, a couple from me.

So, Dave, is it safe to say that since we're in sort of 90 days further through the calendar that you feel that much more confident about the hyperscale picking back up as we get into the second half of the year?

I guess and just a quick second part to that, with regards to your comment about fiscal 2020 demand, how long do you see – I guess this is all kind of just gut at this point. But how long do you see – how long are you hopeful that this next cycle can last once you get started? Thanks.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc
A

It's interesting. So a couple points, so I think on the February call, we were just coming off of a fairly disturbed pull dynamics that were going on all the way through December. And the cloud was one aspect of it, not the only one obviously. It was fairly global, it's also got a long tail, it's not just one CSP or three CSPs or something, but it's also the smaller build-out.

The reason we have confidence in the back half of the year now is we're starting to see some of the data center build-out that was anticipated, say, six months or nine months ago to be discussed again, the exact same data centers again, especially globally.

And then, we also think that there has been some inventory readjustments that have gone on for the last six months. There will be an anticipation of moving to higher and higher capacity drivers with better total cost of ownership propositions out the back half of the year. So we're feeling a lot more confident that we were there talking to you in February for sure.

As far as the next cycle, this one's been a little bit more pronounced than the last one, it feels that way. And it's been more global and it's been touching, as we reach out, through OEMs and ODMs who are helping do the builds. It's been much more broad-based than the last one.

The last one came back pretty quickly, because of the world turning on at the same time. We're hearing rumors of all this, but I still wouldn't say strong. So it feels like this one may be a bigger peak in exabytes but much wider, I would say that might be just because there will be a little bit of trepidation.

Ananda Baruah
Analyst, Loop Capital Markets LLC
Q

That's helpful. I'll stop there and cede the floor. Thanks so much.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc
A

Thanks, Ananda.

Operator: Your next question is from the line of Kevin Cassidy of Stifel. Your line is open.

Kevin Edward Cassidy
Analyst, Stifel, Nicolaus & Co., Inc.
Q

Thanks for taking my question. On the 16 terabyte drives, what the unit volumes – how does that compared to last year and any other new product ramp?

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc
A

Thanks, Kevin. We like this platform quite a bit. We've been through a lot of transitions, to your point. Different drives going from 6 to 8 to 10 to 12 to 14 we've had different drive platforms. This particular platform for us will take us 16 and 18 with SMR and other variants. It will take us beyond 18 terabytes and probably into the HAMR families as well because HAMR is basically drop into this when we're ready.

So, we feel very comfortable with our ability to yield and ramp this product. It's gone through all its interim qualification testing really well and so that's why we're fairly aggressive about it. I think it's going to be a pretty steep ramp as well. So, in the last couple of months just given the lead times for largely the head wafers that are required for that, that's where we focused a lot of our efforts internally.

My sense is as well that given some of the pause that's gone on in hyperscale and other places around the world that the value proposition of 16 terabytes versus maybe 12 terabytes that was thought of six months ago when the pause started, it's pretty substantial. And I think we'll start to see those revenue ramps in early fiscal year 2020.

Kevin Edward Cassidy
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay, great. Thank you.

Operator: Thank you. Our next question is coming from the line of Aaron Rakers of Wells Fargo. Your line is open.

Aaron Rakers
Analyst, Wells Fargo Securities LLC

Q

Yeah. Thank you for taking the question. Kind of building on the high-capacity nearline drives. One of your competitor kind of notes as far as in the context of visibility, kind of stocking relationships and visibility from an inventory, even getting paid the wholesome inventory for some of the hyperscale customers. So, I'm curious how do you characterize your visibility? Do you have similar relationships as that? And then also, how would you compare 16 terabytes competitively versus the competitors that you see and when they might come to market? Thank you.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

Aaron, I'd answer the second question first. I don't really – we believe we're in the lead on 16 terabytes and the families that go on along with it with different SMR variants and things like that, [ph] like 18s (00:29:57), I don't have very good visibility beyond there as far as when people are going to be able to ramp. All I know is we're ready to ramp.

Relative to stocking, I do think there are a few customers that have such huge scale that they start talking like that, because other customers are much more opportunistic and it's been a buyers' market recently. So, we were, like I said earlier, we were, 90 days ago we were really watching our cash and controlling our builds very, very carefully to make sure we didn't carry too much inventory.

If we had pushed out more of the lower capacity drives in anticipation of the higher capacity, I don't know that, that always serves us right either. So, that's the way we're thinking about it, if that helps.

Aaron Rakers
Analyst, Wells Fargo Securities LLC

Q

Okay. Thank you.

Operator: Thank you. Our next question comes from the line of Jim Suva of Citi. Your line is open.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you. In your prepared comments, you mentioned an improving demand environment in the second half or as the year progresses. Is that based upon order trends that you're seeing or more anecdotal of customers sweating or using their assets a little bit longer, just trying to help figure out the conviction level of that rebound in demand?

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

A

Jim, it's interesting because I think there's a little bit of both of what you said. The first is people know that they're going to be making the investment for five or six or seven years when they buy the next product, so they'll wait to get the right TCO proposition that's – these are more hyperscale and global hyperscale comments.

I think relative to my earlier comments about some of the channels that have been disrupted, there were lots of liquidity issues especially amongst smaller players, more entrepreneurial people who were trying to do edge build-out, very application-specific items. And because of that, I think the market has been pretty choppy.

We're starting to see our way through that. People are coming back to those plans again. As we all know, data will grow and some of these new applications will take off. But I think given some of the issues the world was having back in the December timeframe we just didn't have very good visibility into them. So we're still expressing confidence against this next cycle.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you so much.

Operator: Thank you. And that does conclude our question-and-answer session. I'd like to turn the call back over to management.

William David Mosley
Chief Executive Officer & Director, Seagate Technology Plc

Thanks, Amanda. I want to once again thank all of our employees, customers, suppliers and business partners for their contributions to our third quarter performance. And thanks to our shareholders for their ongoing support. We'll talk to you next quarter. Thank you.

Operator: Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program. You may now disconnect. Everyone, have a great day.