MagnaChip Semiconductor
Prepared Remarks for Q3 2020 Investor Conference Call
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Thank you for joining us to discuss MagnaChip's financial results for the third quarter ended September 30, 2020. The third quarter earnings release that was filed today after the stock market closed can be found on the Company's investor relations website. A telephone replay of today's call will be available shortly after the completion of the call and the webcast will be archived on our website for one year. Access information is provided in the earnings press release.

Joining me today are YJ Kim, MagnaChip's chief executive officer, and Young Woo, our chief financial officer. YJ will discuss the Company's recent operating performance and business overview, and Young will review financial results for the quarter and provide guidance for the fourth quarter. There will be a Q&A session following the prepared remarks. During the course of this conference call, we may make forward-looking statements about MagnaChip's business outlook and expectations. Our forward-looking statements, and all other statements that are not historical facts, reflect our beliefs and predictions as of today and therefore are subject to risks and uncertainties as described in the Safe Harbor discussion found in our SEC filings.

During the call we also will discuss non-GAAP financial measures. The non-GAAP measures are not prepared in accordance with generally accepted accounting principles but are intended to illustrate an alternative measure of MagnaChip's operating performance that may be useful. A reconciliation of the non-GAAP financial measures to the most directly comparable GAAP measures can be found in our third quarter earnings release available on our website under the investor relations at www.magnachip.com. I now will turn the call over to YJ Kim. YJ?

YJ Kim

Hello everyone. Thank you for joining our call today! COVID-19 indeed changed the way we live, work and think… and our team members at MagnaChip have been actively adapting to the new normal by adhering to our multiple safety protocols and business continuity plan. We hope that you and your family are all healthy and well.

We successfully completed the sale of the foundry business and Fab 4 slightly ahead of our internal schedule for a purchase price of about $350.6 million. We used $227.4 million of the proceeds to fully redeem all of the 6.625% Senior Notes due 2021 on October 2, 2020, lowering the future interest expense by approximately $16 million annually. This sets our new chapter as a fab-lite, pure-play standard product company generating substantial and sustainable cash flow.

In Q3, we achieved solid quarterly results with a 5% sequential revenue growth, which came in above the high-end of the guidance range, as well as a healthy bottom line. This was achieved despite the backdrop of market disruptions caused by the global pandemic, the escalated US-China trade tension, and the supply-constrained environment. Gross profit margin was largely impacted by 2 one-time items, including the delayed recovery from the power outage of Fab 3 and the Display's excess inventory charge related to the U.S. Government's export restrictions to Huawei. These 2 one-time items together negatively impacted our gross profit margin by 3-percentage-points. Adjusted for the impact of these one-time factors, we delivered non-GAAP diluted earnings per share of 14 cents.

Now let's take a closer look at our product business… starting with the Display business.

I remind you that we have completely exited the non-auto LCD business in Q2 2020. As a reference point, our Display revenue in Q3 of 2019 was $90.6 million, which included about $10.4 million of non-automotive LCD business. Our Display revenue was $69.6 million for the third quarter, up 0.6% sequentially and down about 14% year-over-year (YoY), adjusting the non-automotive LCD revenue in 2019. Q3 OLED DDIC revenue was $67.6 million, up 0.9% sequentially and down 13.7% YoY.

In September, we recorded a $2.3 million excess inventory charge driven by our Display customers' last-minute business decision based on the U.S. Government's export restrictions on Huawei. Our panel customers have de-risked the Huawei business, and we don't expect further impact from the Huawei ban other than this unusual excess inventory charge. Please note that our Q4 guidance does not include any of Huawei business.

Now, let me highlight 3 key takeaways for our Display business.

First, starting with demand. During our last earnings call, we mentioned an upswing in demand for our OLED product, which was outstripping our supply capability in Q3 due to the recent longer lead times. The strong demand continued throughout the quarter and to date. We are working very closely and diligently with our foundry partners to be able to continue to serve our customers' strong ramp schedules in Q4 and beyond. We remain confident and excited about the long-term growth trajectory of the overall OLED DDIC market and our leading market position as one of the pioneers.

Second, both our revenue and design activities were driven by a major Korean smartphone OEM and Chinese OEMs. One of the notable achievements that we are very excited about is that a major Korean smartphone OEM has launched a new key model with our display driver in early October. This end customer's model is being well adopted in the market as it keeps the flagship features that consumers want while hitting the price point that consumers need, and we expect the momentum to continue in the remaining 2020. In addition, design activities from major Chinese smartphone OEMs have been very strong in Q3, and we expect these design wins to support our revenue growth in Q4 as well as in 2021. MagnaChip's top market position as a non-captive supplier in the OLED DDIC market reflects that our advanced technology and distinctive portfolio resonate with our customers. We continue to focus on empowering our customers through relentless innovation and unparalleled support.

Last but not least, 5G momentum: We are enjoying the booming 5G smartphone industry especially with High Frame Rate (HFR) OLED DDIC. In

Q3, we were awarded 8 new design wins, and 7 of them were 5G and HFR models using 28 nm process. You may recall that our revenue from 5G smartphones counted for about 20% of the total OLED revenue in 1H 2020. In Q3, 5G revenue represented about 40% of the OLED revenue. According to the market data, the global 5G smartphone shipment in 2020 will be about 200 million units, and it will likely to be more than double in 2021. The emerging global 5G trend bodes well with the underlying strength in our product portfolio.

Now, let's turn to the Power business.

The power revenue came in at $46.7 million, up 17.3% sequentially, and down 4.2% YoY. The complete recovery from the power outage took longer than we anticipated, which limited Fab 3 output at full capacity resulting in a lower utilization during Q3. Despite this handicap, we achieved a double-digit sequential growth and managed the production. The market momentum and our product pipeline remain strong.

Now, let me highlight key takeaways for our Power business.

First, starting with demand. As both China and Korea were gradually recovering from the global pandemic, our power revenue in the third quarter was mainly driven by personal transportation and TV applications. The rebound in Chinese and Korean TV markets drove strong demand for our Super Junction MOSFET and Power IC products in Q3, and the trend is continuing in Q4. We expect our Power business in Q4 to grow 15% to 20% YoY.

Driven by the combination of capacity constraint and strong demand, our channel inventory level became below our normal operating range. We are striving to address the continued demand and also to replenish the channel inventory to a more balanced level in the future.

Let me also underline the progress we are making in the China market under our go-to-market strategy with a newly established leadership team. To efficiently target the fast-growing China market, we set up a regional support system with a dedicated sales and marketing function. The team focused our products to be more optimized for the Chinese market demand, and we directly engaged with numerous power customers that resulted in new wins from a wide range of applications including TV, Industrials and mobiles. We are encouraged by the great momentum in China power business.

Looking ahead, I am very excited about our Power business potential. By 2022, we will have introduced a complete set of next generation power discrete product portfolios. These new generation premium product families will carry superior performance with a much-improved cost. The upgrade will take place at our Fab 3, and by that time, our Fab 3 will be up and running with about 40% additional capacity.

Now turning to our long-term plan.

We are repositioning MagnaChip to achieve sustainable and profitable growth. As we closed the divestiture ahead of our original schedule, we decided to accelerate our disclosure of pro-forma financials rather than wait till the future Analyst Day. Let me provide our key goals we are targeting to achieve by 2023. While our quarterly reports are based on the total revenue including the transitional Fab 3 foundry service in accordance with GAAP, we are providing the following metrics based on the Standard Products Business revenue excluding the transitional Fab 3 foundry service as such service is expected to cease after a certain period of time. We plan to:

1. Grow our topline at a double-digit CAGR
2. Consistently achieve above 30% gross profit margin
3. Reduce adjusted OPEX to be below 18% of revenue.
4. Exceed 10% adjusted operating income margin. This will enhance our ability to generate free cash flow.
5. Tax rate to be approximately 14% to 16% in the next 2 to 3 years due to the net operating loss carryforwards available to offset taxable income in part. Our estimated consolidated tax rate is based on our current organizational and business structure, and tax strategies.
6. CAPEX for PP&E: Last quarter, we discussed about the special investment we are making in Fab 3 for 2020 and 2021. From 2022, we expect the Capital spending to return to the moderate level of 3% of revenue or below.
7. By 2023, we will generate free cash flow in excess of 8% of revenue.

These additional financial pro forma metrics will give you a better understanding of our longer-term outlook and value creation. We also would like to further share our capital allocation plan in the near future. Our board and management are actively evaluating all available options to maximize our shareholders value.

Now that we communicated the key pro-forma financial metrics, it seems more prudent that we reschedule our Analyst Day to Q1 2021 due to uncertainties around COVID 19 and related matters. We will then share capital allocation plan and our growth strategic initiatives. We believe this rescheduling will allow for a more comprehensive discussion with investors and analysts. The date will be announced in the near future.

In closing, Q3 represented a pivotal chapter of MagnaChip as we successfully closed the sale of Foundry business and Fab 4 that ultimately resulted in MagnaChip becoming a pure-play Products company with a very healthy balance sheet for the first time. Across the company, we are making well-planned moves to realign our resources, sharpen our R&D focus on key priority areas, and improve our operational efficiency.

More importantly, the upswing in demand which began since July is continuing into the fourth quarter. We are encouraged by the robust growth opportunities ahead of us, which creates a stronger foundation for profitable growth. We continue to push the envelope on enhancing our competitive position through continuous technology advancement, addressable market expansion and strategic customer engagements.

Now I will turn the call over to Dr. Woo and come back for the Q&A.

Young Woo:

Thank you, YJ, and welcome to everyone on the call. Let’s start with key financial metrics for Q3.

Total revenue in Q3 was $124.8 million, up 5% from Q2 and down 16.3% from Q3 a year ago. Revenue from the standard product business was $116.3 million, up 6.7% from Q2 and down 16.5% from the same quarter a year ago. The sequential increase was driven mainly by strong demand in our power products for personal transportation and TV applications. The YoY decline was primarily due to the U.S. Government's export restrictions on Huawei that impacted the shipment of certain OLED Display Driver ICs to our customers. The YoY decline was also attributable to the strategic exit of non-auto LCD business, which accounted for $10.4 million in Q3 2019 and nil in Q3 2020.

Display revenue in Q3 was $69.6 million, up 0.6% quarter-over-quarter and down 23.2% YoY. Adjusting the non-auto LCD business, it was down about 13% YoY. Power revenue in Q3 was $46.7 million, up 17.3% quarter-over-quarter and down 4.2% YoY. The sequential improvement in the Power business was due to a solid rebound in the China market.

Gross profit margin in Q3 was 22.9%, down 4.1 percentage points from Q2 and down 0.7 percentage points or 70 basis points from Q3 a year ago. There were two unusual items as mentioned by YJ earlier that collectively translated into a negative 3% gross profit margin hit in the third quarter.

Turning now to Operating Expenses in Q3. Operating expenses were $25.4 million or 20.3% of total revenue as compared to $23.5 million or 19.8% in Q2 and $20.9 million or 14% for the same quarter a year ago. SG&A in Q3 was $12.9 million as compared to $12.4 million in Q2 and $10.7 million in Q3

2019. R&D in Q3 was $12.5 million as compared to $11.1 million in Q2 and $10.2 million in Q3 last year. Stock compensation charges included in operating expenses were $2 million in Q3, $1.4 million in Q2, and $0.4 million in Q3 of last year.

Adjusted Operating Income in Q3 was $8.8 million, down from $10.1 million in Q2 and down from $14.8 million in Q3 a year ago.

Adjusted EBITDA in Q3 was $11.7 million, down from $12.7 million in Q2 and down from $17.4 million in Q3 a year ago.

Net income in Q3, including income from discontinued operations, net of tax, was $273 million, up from $29.2 million in Q2 and up from negative $1.6 million in Q3 a year ago. This sharp increase was primarily due to the recognition of gain on sale of the Foundry business and Fab 4 of $287.1 million. Q3 net income from continuing operations was $8.5 million, down from $11.8 million in Q2 and up from negative $14.2 million in Q3 2019.

Our earnings per share, including results from discontinued operations, was $7.74 in Q3, up from 84 cents in Q2 and up from negative 5 cents in Q3 a year ago. Our earnings per share from continuing operations was 24 cents in Q3, down from an earnings per share of 34 cents in Q2 and up from a LOSS per share of 41 cents in Q3 2019.

Our non-GAAP diluted earnings per share from continuing operations was 14 cents in Q3, up from 13 cents in Q2 and down from 21 cents in Q3 last year. The difference between our GAAP and non-GAAP EPS was primarily due to the elimination of the non-cash net foreign currency gain of $8.9 million, which was offset in part by the elimination of the two one-time expenses of $3.5 million.

There were 35.3 million basic weighted average number of shares outstanding, and 46.6 million diluted weighted average number of shares outstanding in Q3. The difference between share counts primarily relates to the dilutive effect of including the Company’s exchangeable notes as if they were converted into shares at the beginning of the period.

Now moving to the balance sheet:
Cash was $542.1 million at the end of Q3. This compares to $192.8 million at the end of Q2.

In Q3, we completed the sale of the foundry business and Fab 4 for a purchase price of approximately $350.6 million in cash. We plan to use some of our net operating loss carryforwards to offset capital gain tax on this sales transaction. The capital gain tax, which is currently estimated to be in the range of $14 to $16 million, will be finalized and paid in Q1 2021 as part of our annual 2020 corporate income tax filing.

On October 2nd, we fully redeemed 2021 Senior Notes. As part of this redemption, we paid a withholding tax of $20.5 million as we moved the proceeds from our Korean subsidiary to the ultimate parent company in the U.S., who was the issuer of the Senior Notes.

Accounts receivable was up 19% from Q2. The increase in accounts receivable in Q3 was attributable to the timing of payments from certain customers as the quarter end fell on a holiday in Korea, and the related payments were collected by the following week. Our days sales outstanding for Q3 was 43 days.

Inventories were down 26.1% from Q2, due primarily to the limited ability to manufacture the products in Fab 3 at full capacity, caused by the delayed recovery from the power outage. Our average days in inventory for Q3 was 32 days.

CAPEX was $7.5 million in Q3 as compared to $5.5 million in Q2.

Before moving to the fourth quarter guidance, I would like to note that we commenced a voluntary resignation program, which is available for all employees from October 16th. Due to the voluntary nature of this Program, we are unable to provide an estimated amount of the related severance and other termination benefits for those employees under the Program at this time. Once completed, this will help enhance our profitability.

Now moving to Q4 Guidance

The COVID-19 global pandemic is still evolving and continues to reduce our forward visibility. While actual results may vary, MagnaChip currently anticipates for Q4 2020:

- Revenue to be in the range of $ 128 million to $136 million, which represents approximately 3% to 9% sequential growth, including $10 million to $11 million of the Transitional Fab 3 Foundry Services.

- Gross profit margin to be in the range of 25% to 27%.

With that, I will turn the call over to So-Yeon.

So-Yeon Jeong

Thank you YJ and Young. So, operator, this concludes our prepared remarks, and we will now open the call for questions.

So-Yeon Jeong – Closing Remarks

Thank you! This concludes our third quarter 2020 earnings conference call. Please look for details of our future events on MagnaChip's Investor Relations website. Thank you for joining us today!