Magnachip Semiconductor

Prepared Remarks for Q2 2022 Investor Conference Call

August 8, 2022

Yujia Zhai

Thank you for joining us to discuss Magnachip's financial results for the second quarter ended June 30, 2022. The second quarter earnings release that was issued today after the stock market closed can be found on the Company's investor relations website. The webcast replay of today's call will be archived on our website shortly afterwards. Access information is provided in the earnings press release.

Joining me today are YJ Kim, Magnachip's chief executive officer, and Shinyoung Park, our chief financial officer. YJ will discuss the Company's recent operating performance and business overview, and Shinyoung will review financial results for the quarter and provide guidance for the third quarter of 2022. 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 statement 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 second quarter earnings release available on our website under the investors section at www.magnachip.com. I now will turn the call over to YJ Kim. YJ?

YJ Kim
Hello everyone, thank you for joining us today and welcome to Magnachip's Q2 earnings call.

I'd like to start today by quickly touching on our Q2 consolidated financial results and then give an update on some of the near-term challenges we are facing in the 2^{nd} half of 2022. After that, I will give an update on our capital allocation plan before wrapping it up with a detailed review of our business segments.

In Q2, revenue was $101.4 million and was within our guidance range. Similar to Q1, our OLED revenue continued to be impacted by severe supply shortages for 28nm 12-inch wafers and our Power solutions business continued its positive momentum of double-digit year-over-year growth.

Looking forward into the remainder of the year, our 2^{nd} half faces a few challenges, particularly in our OLED business that will continue to impact our near-term results before recovery in 2023.

First, in the 2^{nd} half, we are facing further supply constraints of 28nm 12-inch wafers. Lower wafer allocation from our foundries impacted our new design-in assignments for 2^{nd} half of 2022 from our large panel customer in Korea. Typically, these design-in assignments are awarded 9 to 12 months in advance, based on future wafer supply.

Second, in June, we successfully sampled our fully functional next generation OLED DDIC to our new top-tier panel customer using our newly qualified foundry partner, and customer qualification is proceeding. However, in mid-June, there were additional feature changes to the OLED DDIC product just sampled to meet current market changes. Therefore, we modified the product design and completed the new tape-out in July.

We anticipate the timing of our initial mass production to be around the end of the year compared to our previous expectation of the end of Q3. With that said, our customer is going through full evaluation of the current version of the chip. This should significantly speed up the evaluation time-line of the new chip once it is sampled at the end of Q3. As such, we remain confident that our production ramp with this new customer remains on track as we enter 2023, and we expect them to contribute meaningfully to next year's growth.

While these first two events are not related to customer demand, we are also seeing a slowdown in our key consumer end markets such as smartphones and TVs due to continued stresses in the global economy, such as the Ukraine conflict, the China Covid-lockdowns of major cities, and global inflation. These macro factors are driving an end-customer product inventory build in distributor and retail channels, which has caused temporary order cuts at our large Korean customer.

The consumer market slowdown is showing temporary additional capacity becoming available in the near term. We are in active negotiations with our foundry partners and seeing signs of better wafer allocations in 2023. Given these industry market dynamics, we believe it is mutually prudent to pursue shorter term supply agreements for the next few years.

With this decision, our Board of Directors has reaffirmed the remaining $37.5 million stock repurchase program that was announced previously. We believe that with this stock repurchase program and continuing to drive our OLED business recovery plan, combined with the continued momentum of our Power solutions business, we are well positioned to drive significant accretion and value for shareholders over the coming years.

Finally, in order to improve its internal processes, the Company's Board of Directors has activated a Strategic Review Committee to assist the Board in reviewing, considering, exploring and evaluating strategic alternatives that may be available to the Company to maximize shareholder value. The committee's mandate is to review the Company's capital allocation plans and actively explore potential strategic and transactional opportunities, including, but not limited to, joint ventures, strategic partnerships and M&A possibilities that may arise in the future, and make recommendations to the Board regarding those matters, as appropriate.

I'd like to now move to a detailed review of our Q2 results starting with OLED:

Our OLED revenue in Q2 was $24.6 million, down 44.3% YoY, and 5.7% sequentially. The year-over-year decline was due to continued severe supply shortage for 28nm 12-inch OLED wafers which began at end of 2020 and worsened this year. Sequentially, OLED revenue decreased due to lower demand for China smartphones and the Korean flagship smartphone, partially offset by higher demand for the latest generation Korean flagship model that launched in Q2.

During Q2, we made progress in these following areas:

1. First, as I already mentioned, in Q2, we successfully developed and released our first OLED DDIC sample to our new top-tier panel maker outside of Korea. Over the next few years, OLED production in this region of the world is expected to more than double and we are excited about our growing relationship with this customer.

2. Second, during the quarter, we kicked off development of two new OLED Driver IC projects with the top-tier panel maker in Korea. We are targeting to begin mass production in the second half of next year.

3. Third, in our new business areas, we continued to ramp our other OLED products such as OLED TV and Automotive. To date, we have three automotive customers with European Automakers and initial mass production remains on track for the 1st half of 2023.

4. Finally, our additional 28nm manufacturing capacity in Asia remains on track to come online in the later part of this year and we continued to engage in active discussions with multiple foundry partners for additional capacity for Mobile and TV products.

In summary, we continue to face challenges in our OLED business. However, we believe the strategic actions that we are taking to secure additional wafer capacity, together with the recent new panel maker customer and project wins, will set us up to have a strong recovery in 2023.

Now, let's turn to the Power Solutions Business.
It was another solid quarter for our Power solutions business driven by strong demand for our premium power products, as well as BatteryFET products. Our Power solutions business revenue in Q2 was $63.0 million, up 11.1% YoY and down 2.9% sequentially.

The year-over-year growth was driven by continued strong demand across the board for almost all of our products but particularly for our premium products such as our SJ MOSFET, Power IC and IGBT in key end markets like communication, consumer, industrial and computing all driven by the trend in electrification of everything.

Sequentially, SJ MOSFET, BatteryFET and Power IC product revenue decreased slightly in line with the slowdown in smartphone, TV and computing applications but was partially offset by growth in MV MOSFET and IGBT due to the growing demand for E-bikes and solar inverters.

In our SJ MOSFET product line, we continue to see robust demand from TV, PC Power and Lighting applications due to increasing energy efficiency requirements. During the quarter, we were also awarded a new design for Telecom Power and we're expanding the line-up for server and premium computing markets.

For Power IC, we were awarded 5 new designs for premium display panels from a large Korean display customer and continued ramping shipments of our boost ICs for SSDs for servers and data centers.

In our IGBT product line, revenue grew 36% YoY. This was driven by accelerating demand and new design wins from the renewable energy markets, particularly solar inverter applications.

Our MV MOSFET product line achieved record revenue during the quarter due to strong demand and multiple design-wins, particularly in power tool motors and e-bikes. Our latest generation 200V MV MOSFET with our advanced trench technology demonstrates much lower on-resistance and fast switching performance with higher cell density than prior generations. Further, our 40V MV MOSFET for Electric Water Pump in EVs started mass production during the quarter and we are working on expanding the product portfolio to 60V for electric oil pumps, power doors, seats and windshield wipers.

During the quarter, we continued to develop and introduce new Power products. The new 650V IGBT provides 30% better current density compared to the prior generation. We are excited about this new product as we continue to see growing demand for solar based applications because of accelerating global adoption of solar power to reduce carbon emissions.

In summary, we will continue to execute the growth plan of our Power solutions business by strengthening Fab 3 productivity and introducing new products with superior performance and improved cost for new markets, such as renewable energy market. For Q3, we expect our Power solutions business revenue to be down due to some softness in consumer, smartphone and computing end markets, which will be offset in part by a strong IGBT demand for solar applications.

Before I conclude my business summary, I want to say that we feel comfortable about our long-term growth prospects. Both of our businesses have leading technology and are at the intersection of two major trends. We are continuing to focus on executing our OLED recovery plan in 2023 and continuing our success in Power solutions business.

Now, I will turn the call over to Shinyoung and come back for closing remarks and Q3 guidance.

Shinyoung Park:

Thank you, YJ, and welcome to everyone on the call. Let's start with key financial metrics for Q2.

Total revenue in Q2 was $101.4 million, down 2.6% sequentially and down 11.0% YoY. Revenue from the standard products business was $91.3 million, down 2.9% from Q1 and down 11.6% YoY. As YJ already mentioned, both the sequential and YoY decrease was mainly attributable to severe supply shortages in 12-inch 28 nm wafers in our OLED business. Our Power solutions business in Q2 maintained its solid momentum as revenue of $63.0 million represented growth of 11.1% YoY. Sequentially revenue declined 2.9% due to slow down in TV and computing applications but was partially offset by higher demand in solar and industrials.

Gross profit margin in Q2 was 28.6%, below the low end of our guidance range. This represented a 120 basis point decline year-over-year and 890 basis points sequentially. The sequential decrease was primarily the result of a couple of factors: As a reminder, our Q1 gross profit margin benefited 200 basis points from a one-time timing mismatch of lower cost 12" wafers that was purchased in Q4 last year and sold in Q1. During Q2, our large Korea panel customer decommitted on their volume agreement due to lower demand for China smartphones. This resulted in an inventory reserve of approximately $4.7 million related to 12" display products. We also experienced higher foundry cost relating to 12" wafers and unfavorable product mix in Q2. Had we not recorded the material 12" inventory reserve of approximately $4.7 million, our Q2 gross profit margin would have been 33.2%.

Turning now to Operating Expenses. Q2 SG&A was $12.7 million, as compared to $14.2 million in Q1 2022 and $14.0 million in Q2 last year. Q2

R&D was $13.4 million, as compared to $12.0 million in Q1 2022 and $13.3 million in Q2 last year. Stock compensation charges included in operating expenses were $2.0 million in Q2 compared to $1.6 million in Q1 and $2.4 million in Q2 2021.

In Q2, our operating income was $2.0 million, compared to $12.9 million in Q1 and $1.6 million in Q2 2021. Adjusted Operating Income in Q2 was $4.8 million, compared to $14.5 million in Q1 and $9.1 million in Q2 a year ago. Adjusted EBITDA in Q2 was $8.5 million, compared to $18.8 million in Q1 and $12.7 million in Q2 a year ago.

Our tax expense for the first six months of the year was $2.6 million. The income tax expense for the first half of 2022 primarily resulted from a higher-than-expected income tax rate as a result of a combination of the change in Section 174 of the U.S. Tax Code, which requires R&D expenses to be capitalized and amortized over 15 years and lower projected Korea full year taxable income. We believe that there is a possibility that the referred Section 174 legislation could be reversed, and if such action were to be successful, our 2022 annual effective income tax rate would be significantly reduced.

Net loss in Q2 was $3.3 million as compared with a net income of $9.5 million in Q1 and a net loss of $0.2 million in Q2 a year ago.

Our GAAP diluted loss per share in Q2 was 7 cents, as compared with an earnings per share of 20 cents in Q1 and zero in Q2 last year.

Our non-GAAP diluted earnings per share in Q2 was 23 cents, down from 28 cents in Q1 but up from 15 cents in Q2 last year.

There were about 46 million shares outstanding in Q2, calculated on a diluted weighted average basis.

Now moving to the balance sheet:

Our cash balance at the end of Q2 was $273.8 million. This compares to $284.9 million at the end of Q1.

Accounts receivable, net totaled $59.8 million, an increase of 16.8% from Q1. Our days sales outstanding for Q2 was 54 days and 44 days in Q1. The increase in accounts receivable, net in Q2 was attributable to the timing of monthly sales and related payments from certain customers.

Inventories, net totaled $36.2 million, a decrease of 2.1% from Q1. Our average days in inventory for Q2 was 45 days and 51 days for Q1.

In terms of our capital allocation plan, Q2 capex was $0.6 million. For the remainder of 2022 and first half 2023, we are expecting previously planned capex related to our Fab 3 upgrades and normal capex as well as large foundry wafer prepayments to secure capacity and certain employee costs, including an annual contribution of statutory severance to certain external deposit accounts. Our current estimate for these major items approximate between $80 million to $90 million.

Now, I will turn the call back over to YJ for Q3 guidance as well as closing remarks. YJ?

YJ Kim:

Thank you Shinyoung.

Let me summarize my earlier remarks and then I'll move on to the third quarter guidance.

The current environment for OLED is very challenging, starting with wafer supply shortages, followed by delays in new customer ramp due to spec changes and a slowdown in the China smartphone market due to extended Covid city-wide lockdowns and a slowing global economy.

However, let me highlight 3 factors that give us confidence about our business's long-term growth prospects and recovery in 2023.

First, we have successfully sampled the OLED chip to our new panel customer and have begun qualification, and we expect to go to production by the end of the year.

Second, we started 2 new product designs for our Korean panel customer and expect to go into production by the 2nd half of next year.

Third, we are also making good progress with getting more wafer capacity for our Display business next year.

As a result, our Board of Directors has reaffirmed its intentions toward the remaining $37.5 million stock repurchase program. We believe the recovery of our OLED business and the continued momentum of our Power solutions business position us well to drive significant accretion and value for shareholders over the coming years.

Finally, the newly activated Strategic Review Committee will evaluate all strategic alternatives to maximize shareholder value.

I look forward to updating all of you on the progress of our recovery of business during the coming quarters.

Now moving to our third quarter guidance, our results will be challenged by some of the things I just mentioned and further OLED wafer shortages as well as cost challenges, including labor, due to inflationary pressures.

While actual results may vary, for Q3, Magnachip currently expects:

- Revenue to be in the range of $70 million to $75 million, including about $9 million of Transitional Fab 3 Foundry Services.

- Gross profit margin to be in the range of 26.5% to 28.5%.

Thank you and now I will turn the call back over to Yujia.

Yujia Zhai

Thank you YJ. That concludes the prepared remarks section of this earnings call. Operator, you may now begin the Q&A session.

Yujia Zhai – Closing Remarks

Thank you! This concludes our second quarter 2022 earnings conference call. Please look for details of our future events on Magnachip's Investor Relations website.

Thank you and take care.
