Magnachip Semiconductor
Prepared Remarks for Q3 2022 Investor Conference Call
November 2, 2022

Yujia Zhai

Thank you for joining us to discuss Magnachip's financial results for the third quarter ended September 30, 2022. The third 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.

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 fourth 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 third 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 Q3 earnings call.

First, before I begin, let me say that our hearts and prayers are with the families affected by Halloween incident over the weekend in Seoul and we wish a quick recovery for all those who were injured.

Moving on to our results, we closed Q3 revenue at $71.2 million, which was within the guidance range that we provided but represented a disappointing 43.9% decrease year-over-year and 29.8% decrease sequentially. This result is obviously not satisfactory. As we indicated last quarter, our second half is being severely impacted by several macro challenges that I will detail as I discuss each of our two main businesses.

Beginning with our Display business, Q3 revenue was $6.4 million, down 89.1% YoY, and 77.6% sequentially. These results were primarily due to the supply shortages of 28nm 12-inch OLED wafers in the 2nd half of this year that impacted design-in projects from our large panel customer in Korea, which are typically awarded in advance based on future wafer supply allocation. In addition, China covid lockdowns and the dramatic slowdown in consumer spending as a result of global inflationary pressures reduced demand for smartphones, particularly in China, and resulted in an oversupply of channel inventories. This caused our large customer in Korea to significantly reduce orders to normalize inventory levels. Unfortunately, we believe these poor dynamics will continue in the near future but we expect inventory levels will normalize by the middle of next year. As the global geopolitical situation and economy remains very uncertain, we are focusing on executing the initiatives that are in our control and delivering a strong recovery of our Display business in 2023. During Q3, we made progress in these following areas:

1. First, regarding our new top-tier panel customer, last quarter, we disclosed that the timing of our mass production ramp was delayed due to the customer requesting a feature change so we had to make modifications to our product. In the beginning of October, we successfully released the new modified OLED DDIC to this customer and is now undergoing customer qualification. We anticipate this customer to complete qualification by the end of this year. However, due to the continued weak consumer demand and channel inventory oversupply in China, we expect the production to commence towards end of Q1 2023. While this is unfortunate, the good news is that we received a second design-in project with this large customer. We are extremely excited about this new award as it presents greater volume potential than the first project and also demonstrates our committed partnership. We expect to begin taping out this new part in November this year and begin mass production in late 2023. Over the next few years, OLED production in this region of the world is expected to more than double so we are obviously excited about our growing relationship with this customer.

2. Second, in September, we met several leading OLED manufacturers in this region and their interests in our products are very high due to our product competitiveness and differentiated capabilities. We're continuously discussing with them for our future product business opportunities.

3. Third, regarding our large panel customer in Korea, last quarter, we announced we kicked off the development of two new OLED driver IC

projects with them. We expect to tape out one of the new projects this month and anticipate mass production by 2nd half of next year.

4. Finally, regarding OLED wafer capacity, with the global economic slowdown, we are seeing more wafer availability at most foundries. As a result, we are now in discussions with multiple foundries for 2023 wafer capacity as well as locking in agreements for longer term supply. We believe our 2023 wafer supply will be more than two times higher than 2022.

In summary, our near-term OLED results are very disappointing, and we expect demand weakness to continue in the near future. However, looking forward to 2023, we remain focused on executing towards a strong recovery of our OLED business driven by a significant improvement in both wafer supply and organic demand from our top-tier customers and new design wins.

Now, let's turn to the Power Solutions Business.
Q3 revenue was $56.4 million, down 4.2% year-over-year and 10.4% sequentially, in-line with the broader slowdown we're seeing in global economy, particularly in consumer end markets. For example, our third quarter revenue was affected by lower demand for TVs, e-bikes, smartphones and computing applications. Similar to our Display business, we expect this soft demand environment to continue in the near term as the economy further slows due inflationary pressures and consumers work through the excess inventories that have built up in the channel.

On a positive note, our higher margin Premium Tier Power products remained resilient in Q3 and grew 5.8% year-over-year and 2.3% sequentially driven by record demand for our IGBT product for Industrial Solar applications, which was up 80.4% year-over-year and 24.3% sequentially. We are extremely excited about this trend as the solar industry is benefiting from strong tailwinds such as rising energy prices and favorable regulatory conditions globally as the world accelerates its clean energy initiatives.

In our SJ MOSFET product line, we continue to see resilient demand as revenue only decreased 0.7% sequentially despite slowdown from TVs that was mostly offset from strength in industrial applications like LED Lighting due to higher energy efficiency requirements. During the quarter, we were also awarded several new design-wins with our 600 and 650V SJ MOSFETs with a leading TV manufacturer and an adaptor OEM.

In Q3, we continued to develop new Power products. In September, we introduced a new 200V Medium Voltage MOSFET that incorporates a third-generation trench technology that reduces capacitance by 50% vs the prior generation and significantly improves energy efficiency as a result of faster switching and higher power density. This product is able to operate in temperatures between negative 55 Celsius and 175 Celsius and is perfect for Light EV Motor controllers and industrial power supplies requiring high efficiency and stable power supply in various rugged conditions.

To summarize, our Power solutions business is not immune to slowdowns in the broader economy but we are confident our technology, diversified product portfolio and product roadmap will help us remain resilient and recover with the market. With that said, we are cautious of the semi cycle we're entering and are planning to reduce our 2023 capex spending by nearly 60% from 2022 levels. Shinyoung will provide more details in her section.

In closing, unfortunately, everyone is already too familiar with the inflationary environment that's pressuring consumer spending, not to mention the other challenges like Ukraine, trade tensions between U.S. and China, and the energy crisis in Europe. However, we have a strong balance sheet to weather this down cycle and we continue to remain focused on executing our 2023 recovery plan. We are making progress by winning new designs with our panel customers and expanding customers as well as re-vitalizing new products in both of our businesses. In addition, our OLED wafer capacity challenges will be resolved next year and we are looking forward to a return to growth.

Before I turn the call over the Shinyoung, I do want to address the U.S. CHIPS Act that was enacted in October. At this moment, we do not expect any direct impact on our business in connection with its policies as our products utilize legacy technologies.

Now, I will turn the call over to Shinyoung to go over Q3 results and give our Q4 guidance. Shinyoung?

Shinyoung Park:

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

Total revenue in Q3 was $71.2 million, down 29.8% sequentially and down 43.9% YoY. Revenue from the standard products business was $62.8 million, down 31.2% from Q2 and down 46.5% YoY. As YJ already mentioned, both the sequential and YoY decrease were mainly attributable to the supply constraints for wafers in our OLED business and slow demand for Chinese and Korean smartphone models as a result of the global downturn in the smartphone market. Revenue from our Power solutions business was $56.4 million, down 10.4% sequentially and down 4.2% YoY. The sequential decline was due to a slowdown in TV, e-bike and computing applications affected by COVID lockdowns in China but was partially offset by higher demand in solar and industrials.

Gross profit margin in Q3 was 24.2%, below the low end of our guidance range as we recorded a $3.3 million charge to scrap 12-inch wafers as a result slowing demand caused by elevated smartphone inventories in China. Excluding this charge, our gross profit margin would have been 28.8%, slightly above the high-end of our guidance range. In addition to the scrap cost, our lower gross profit margin YoY was driven by a lower utilization rate at our Fab 3, higher 3rd party foundry costs and unfavorable product mix.

Turning now to Operating Expenses. Q3 SG&A was $11.4 million, as compared to $12.7 million in Q2 2022 and $12.6 million in Q3 last year. Q3 R&D was $13.3 million, as compared to $13.4 million in Q2 2022 and $12.3 million in Q3 last year. Stock compensation charges included in operating expenses were $0.9 million in Q3 compared to $2.0 million in Q2 and $2.0 million in Q3 2021.

In Q3, our operating loss was $10.0 million, compared to operating income of $2.0 million in Q2 and $20.0 million in Q3 2021. Adjusted Operating Loss in Q3 was $6.6 million, compared to Adjusted Operating Income of $4.8 million in Q2 and $22.7 million in Q3 a year ago. Adjusted EBITDA in Q3 was negative $3.0 million, compared to $8.5 million in Q2 and $26.4 million in Q3 a year ago.

We recognized a tax benefit of $3.9 million in Q3 due primarily to pre-tax book loss of our operating entity in Korea mainly driven by non-cash foreign currency translation losses in connection with its intercompany loans.

For the full year 2022, we expect GAAP tax to fall in the range of a benefit of $2 million to an expense of $4 million, excluding the impact of any further FX volatility. This wide range is due to multiple tax items in multiple jurisdictions such as realized foreign currency gains at our operating entity in Korea, expected US taxes from the application of Section 174 of the U.S. Tax code, and other book and cash tax timing differences.

Net loss in Q3 was 17.2 million as compared with $3.3 million in Q2 and a net income of $10.8 million in Q3 a year ago.

Our GAAP diluted loss per share in Q3 was 38 cents, as compared with a loss per share of 7 cents in Q2 and an earnings per share of 23 cents in Q3 last year.

Our non-GAAP diluted earnings per share in Q3 was 2 cents, down from 23 cents in Q2 and down from 42 cents in Q3 last year.

Our diluted shares outstanding for the quarter were about 45.7 million shares, which reflects shares repurchased as part of our expanded share repurchase program that we announced in mid-September, and we continue to exercise the buyback that was authorized by the Board.

Moving to the balance sheet:

Our cash balance at the end of Q3 was $250.8 million. This compares to $273.8 million at the end of Q2.

Accounts receivable, net totaled $36.8 million, decreased 38.5% from Q2. Our days sales outstanding for Q3 was 47 days and 54 days in Q2. The decrease in accounts receivable, net in Q3 was attributable to the decrease in quarterly revenue along with the timing of related payments from certain customers.

Inventories, net totaled $37.3 million compared to $36.2 million in Q2. Our average days in inventory for Q3 was 64 days and 45 days for Q2.

Regarding our CAPEX plan, Q3 CAPEX was $10.3 million and we now anticipate total 2022 capital expenditures to be approximately $23.5 million, which is lower than our prior plan of $28 million including about $8 million special CAPEX for Fab 3 capacity upgrade. This reduction is a result of negotiating better pricing terms and delaying the deployment of certain capital equipment. For 2023, we now anticipate CAPEX to be approximately $10 million, which is nearly 60% lower from the 2022 level.

Before turning to our guidance, I want to provide some clarity on our year-to-date and Q3 cash flows that you see in our financial statements. As a result of this year's Korean Won volatility against the USD, our reporting translation from functional currency Korean Won to USD may provide a confusing operating cash flow picture. On a pro forma basis, excluding the impact of FX translation, our operating cash flow for the quarter was about negative $450 thousand.

From a commercial standpoint, the majority of our sales are contractually in US dollars but about half of our spending are denominated in Korean Won. Our cash balance is also predominantly in US dollars. Therefore, our policy is to hedge the risk of US dollars being weaker than our expectation by entering into certain hedging instruments, whose impacts turned out to be negative to our revenue in the recent quarters due to the current Korean Won volatility against the US dollars.

Now moving to our Fourth quarter guidance:

While actual results may vary, for Q4, Magnachip currently expects:

- Revenue to be in the range of $57 million to $62 million, including about $7 million of Transitional Fab 3 Foundry Services. Our Q4 guidance includes an estimated $5 million revenue loss from foreign exchange hedging instruments.

- Gross profit margin to be in the range of 26% to 28%.

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

Yujia Zhai

Thanks Shinyoung. So that concludes the prepared remarks section of this earnings call. Operator, please begin the Q&A session.

Yujia Zhai – Closing Remarks

Thank you! This concludes our Q3 earnings conference call. Please look for details of our future events on Magnachip's Investor Relations website.

Thank you and take care.
