

Third Quarter of the Year Ending December 31, 2019

Conference Call (Held November 7, 2019) Question & Answer Summary

<Questioner 1>

Q: I have two questions, and the first is in regards to third quarter performance. I do not remember for how long, but I understand that you haven't fallen far short of the guidance you had provided in quarterly results. My first question is which part of revenue or profits deviated from the forecast for the fourth quarter.

A: This is Shibata. What you have pointed out is true, and there has been a variety of factors overlapping. First of all, we regret that we estimated top line too optimistically. In the presentation from Shinkai, there was a graph about backlog coverage. As you can see on page 12, if you follow this, you can see how the mid-point of the previous guidance was slightly lower in terms of coverage than the run rate.

At that time, there was some thought that things may eventually improve, but that did not happen actually, and things just ran their course. So the first point is that the top-line guidance was a bit too optimistic.

And, as mentioned earlier, another factor is that we had estimated OPEX somewhat optimistically, in that we underestimated them. The other factor is rather a mistake related to how to allocate bonuses. When we provided guidance, we intended to adjust the allowance over the entire second half of the fiscal year. However, it was then decided to adjust it just in the third quarter. Based on various considerations, we concluded that we will not correct this on a Non-GAAP basis. As a result, expenses became skewed to the third quarter compared to the fourth quarter.

So it is a combination of the three factors I have just mentioned. We were a bit too optimistic about the top line. It also led to downward movement in the operating margin. In addition, we were a little aggressive about OPEX, which also added downward pressure. There is also a technical factor that drove the figures even further down, and as a result, the operating margin gap appears to have shifted far below normal.

In light of this, we have not made any major changes in the fourth quarter guidance, and we have basically intended to create the guide in the same way as before. I believe that the guidance is made in a way that you may expect is typical of Renesas. That's all.

Q: As a follow-up question, were the strong assumptions about revenue made in the Automotive or Industrial, non-Auto business, or both?

A: Shinkai will answer. In terms of the gap between the guidance and actual results, slightly over 70% are from automotive and slightly less than 30% are from others.

Q: The second question is the outlook for the next year. What do you feel about current orders for Automotive and Industrial, and what is your outlook going forward? It can be a qualitative comment.

A: I fully understand your intention and interest, but in particular about next year, we are really looking at the figures and deliberating. We are looking at the figures while thinking about different possibilities. To put it very roughly, Automotive as a whole are not that strong. The core Automotive business isn't that good, as OEMs have recently shown a more conservative outlook for units.

However, needless to say, there is some improvement in ADAS and EVs, and some of the MCUs in our 40nm are making relatively smooth progress. We don't expect any surprising ups or downs, and the general outlook is about flat to slightly upward from the current level.

On the other hand, in terms of non-Automotive, there are vast differences across applications. Things are especially unclear in the Industrial applications. This is very uncertain, and we have a relatively weak outlook for the time being. We don't currently expect it getting worse and worse from the current situation, but the situation may remain stagnant at a low level. In contrast, data center and 5G deployment are probably the common up-side for all companies. We have a prospect that they will grow relatively steadily through the second half of next year.

Therefore, our assumption is that orders will still rise until around next year's first quarter, and we are considering a fairly soft situation. As for the second half, we currently have the prospect that the application in the growth area I mentioned earlier will be launched to a considerable extent, but I am also talking about the uncertain situation which makes me reluctant to touch on how things will turn out one year from now. That's all.

<Questioner 2>

Q: I have two questions. It may overlap with a previous question, but on a QoQ basis, sales increased in the first and second quarters, but unexpectedly declined in the third quarter. When do you expect the sales to increase again on a QoQ basis? You mentioned earlier that in the second quarter of next year, applications for growth areas will be launched. Could you elaborate on this point?

A: Shinkai will answer your question.

I understood that the question is when the operating profit will actually turn to an increase. This depends significantly on the top line, so based on what Shibata mentioned earlier about the outlook for next year, it's honestly hard to say when the trend will reverse at this point in time.

Q: Secondly, what are the reasons for the decline in the operating margin in the fourth quarter of the current fiscal year?

A: Shinkai will answer your question.

One is that the top line will grow QoQ, but on the other hand, there are some expenses that will be concentrated at the end of the fiscal year. This is the biggest factor behind the decline in operating profit. Therefore, we expect a negative QoQ of 0.7 percentage points.

Q: For confirmation, is the cost incurred at the end of the fiscal year mostly related to R&D?

A: Yes. You're correct. Mainly R&D expenses are expected to be concentrated at the end of the fiscal year.

<Questioner 3>

Q: Please tell us about the adjustments made to expenses that have been incurred in the third quarter. I understand that this will be a factor for increased profits on a QoQ basis, as it is shifted before the fourth quarter. If possible, could you tell us the actual amount?

A: Shinkai will answer your question.

The actual amount is 1.2 billion yen. This is the actual amount of the accounting factor for the third quarter increase over the forecast.

Q: Is it all right to assume that it will just be absent in the fourth quarter?

A: Yes. That's right.

Q: Second, please elaborate on the situation for each segment. As for Automotive, revenue has declined considerably compared to the adjustments in production volume, and there are talks about replenishment of inventories, so I have hoped that they will recover more than the return of production volume. What do you think about this? And skipping Industrial, what are the specific products expected to grow for data centers and 5G? What are your thoughts on these two points?

A: This is Shibata. First, Yamamoto is here for the Automotive Business, so he will explain first. Then I will fill in for the other aspects. Mr. Yamamoto, please.

A: This is Yamamoto.

That's the case with the number of cars, but we have some strengths and weaknesses. Our strength is seen in Japan and the US, while in China we have a slightly weaker proportion. With characteristics of China and other countries, including Japan, Toyota has been well in line with their plan or even exceeded targets up to the third quarter, but other Japanese manufacturers have been struggling slightly. We understand that the portfolio mix has resulted in a slight stagnation in revenue growth.

Q: I think you have also talked about the launch of new products, but it is correct to understand that they are not enough to offset the weak recovery of Japanese OEMs?

A: As mentioned earlier from Shibata, the launch of new products has been relatively smooth for the 40nm MCUs. Other than that, I think this is not the only trend for Renesas, but particularly in the area of SOC, especially for sales secured in 2016 and 2017, projects of OEMs and Tier1 companies in autonomous driving and ADAS have been delayed, on average, by about two years. They are launching only limited products, such as high-end models or premium brands, and we understand that newly anticipated launches tend to be delayed compared to what we previously reported.

Q: What about Infrastructure?

A: We are relatively optimistic about infrastructure. However, one difficulty is that, because both data centers and telecom are based on a small number of fairly large customers, there may be fluctuations based on specific projects of specific clients, so it's quite possible that figures move in a different way to the market when looking at quarterly changes. Looking at the current situation, as I mentioned earlier, we expect a part of the data center business to take off substantially from Q4. We also expect business to be quite robust by the second half of next year, looking across 5G and data center applications.

Q: Is it correct to understand that they are mainly IDT's products?

A: Yes. It's mainly IDT's products, with some products from former Intersil and former Renesas.

<Questioner 4>

Q: I have three questions:

The first is about the order backlog and the revenue guidance for the October to December period. The order backlog figures shown on the bar graph on page 12 appear to be almost unchanged, so if it follows this path, as Mr. Shibata's comments mentioned earlier, it is straightforward to say that the result should be about the same. Please let me know the reason why the QoQ is going to increase a little in October to December.

Second, excluding the effects of the acquisition of IDT, if we roughly calculate revenue, we believe that revenue has declined significantly by around 15% on a conventional basis. It seems like a large decrease this year compared to competitors, so please tell us whether the inventory has been cut too far, or whether we can expect more returning demand toward the next fiscal year in 2020. This is the second question.

Finally, regarding the factors behind the growth of each business in the Mid-Term Plan that Mr. Shibata explained on pages 33, I understood that you will be strengthening what have not been so strong so far. I would like to confirm whether the strategy is to pursue growth in new areas, with little growth in existing areas, since you mentioned DEEPER and BROADER. Simply put, still I do not have a clear understanding of how growth will be generated in in the next three or five years.

A: This is Shibata. Shinkai will answer the first question, and I would like to answer the second and third questions. Mr. Shinkai, please.

A: About the backlog, the Q2 and Q3 figures on the right-hand side look almost flat, but the actual backlog is increased by about 2%. Accordingly, revenue for the following quarter is expected to increase by almost 2% in tandem with this.

A: Regarding the second question, I don't think the run rate is falling so much. I assume you are looking at YoY. It depends on which area we look at, but the Automotive Business overall is almost flat or really just a slight decline.

The top-line decline is large in the non-Automotive businesses, and it's true that we are seeing about a mid-teen drop YoY. As I have mentioned several times, the Industrial sector is very weak. And regarding communication infrastructure, the acceleration of 5G is good but as a result, 4G has fallen quite rapidly, and we are still being impacted by this. That's why there is a large decline in the total figure.

When asked whether this is to recover very strongly, we do not have such a forecast for the time being except for the data centers and 5G, which I mentioned earlier, so we think it will be stable at a low level for the time being. The outlook is for growth to begin toward the second half of next year, and the overall figures are likely to see a slight recovery. Therefore, there should be no misunderstanding that revenues are dropping at double-digit rates for the entire company. In terms of the run rate, it is not falling so drastically, and in comparison to actual results, we expect it's more or less similar. Please tell me if I haven't fully answered your question.

Q: Is it correct to understand that for this part, most of the revenue is from IDTI added on from the Second Quarter, resulting in the figure on the right-hand side of page eight?

A: Page eight, yes.

Q: So it's correct to say both Automotive and the Industrial/Infrastructure/IoT include IDT.

A: By include, you mean that consolidated IDT from a certain point?

Q: Yes.

A: Yes. That's right.

Regarding the third point, there should be no misunderstanding, but there is no reason to renew our focus on the strong points, so we will continue our efforts in our strong areas. As I mentioned earlier, what was lacking is actually expressed in DEEPER and BROADER. BROADER is to expand the customer base, so it is not necessarily directly related to the products themselves. Since we are now in the midst of a major review of our distribution strategy, I believe that will be a major driver.

We have the viewpoint of making it easier for BROADER customers to purchase, and more importantly, from a DEEPER viewpoint to provide more contents to the existing customer base, the key is solution, or reference design. In fact, Renesas has been advocating solutions since 2013, but unfortunately, in reality, we have not been able to move strongly in the direction of solutions.

Now that it's two years since the acquisition of Intersil, and IDT also joined the company, we now have a minimum set of tools for constructing solutions. As a result, we are finally able to provide solutions in the true sense. From this point of view, we are suggesting to re-evaluate the product areas, for example. Our current theme is to tailor them into robust solutions and deliver to a wide range of customers.

Therefore, it's not that there is a change in policy from the past. We have finally established the minimum necessary tools for serious efforts to address areas that have not yet reached a firm footing, despite our past announcements to do so. Therefore, my message is that we will implement these measures properly.

<Questioner 5>

Q: I have three questions. First, I would like to ask about distribution inventory or sales channel inventory. I think aggregate demand continues to be weak, but please confirm whether there is any sense of excess in the new sales channel inventories. It would be helpful if you could tell us about non-Auto and Automotive separately. Thank you very much.

A: This is Shibata. To begin with the conclusion, at present, there is no sense of excess. Even though we have been saying we will increase BCM inventory in the Automotive Business, we haven't been able to increase it. As I mentioned earlier, this is partly due to internal factors, and we are hoping to see a further increase from now on. Or we rather think we should increase it.

In the non-Automotive sector, there was a temporary sense of inventory buildup for data center-related specific customers and specific product-related factors. However, this has been completely eliminated in the quarter, and inventory has been cut down to the point where we can have a little more, just as in the case of Automotive. Because of this situation, while there is a tendency for short turn-around-time orders to come in, in order to avoid the loss of such opportunities, we'd like to have some more inventory in place. My answer has become long, but the current outlook is that we should rather increase sales inventories a little more.

Q: To confirm, I believe there has been a sense of excess inventory in the Industrial sector, but have they also been resolved?

A: Industrial inventory is not at the level of increasing, but it has been decreasing steadily, so the sense of excess is no longer as high as in the past.

Q: Second, what are your thoughts on input in the fourth quarter? Looking at QoQ for revenue, I think it will be nearly flat, but what about input?

A: Shinkai will answer your question. As described on page 11, we currently have a plan to reduce the input by low single-digit percentage points against the third quarter results. This is largely attributable to the operating days of factories around the year-end and New Year.

Q: Is there any noteworthy movement by inches?

A: Yes. The 8-inch lines has more days off, so it will be slightly less on a QoQ basis.

Q: Third, perhaps I should ask this when you update the strategy next year. As for the operation by BU, I think that each BU will probably be managed based on KPIs, such as revenue and operating profit. Considering your factories, I think there is a mixed flow of various products, but I would like you to explain how each BU will be

involved in areas such as factories, production lines, or capacity utilization rates, and what decisions will be made. Thank you very much.

A: I'm sorry, but I didn't understand your question very well.

Q: I'm sorry. I believe you have various lines in the factory, for example, lines for Automotive and Industrial in operation at the Naka Factory. I think that your company's profit and loss will change greatly depending on the utilization rate for each BU, so I would like to know how the relationship between each BU and its production will change.

A: I'm sorry. I'm not confident that I understood your questions correctly, but to put it very roughly, our own fabs will gradually become more focused on Automotive. We have this kind of outlook. Therefore, increasing the loading of our fabs and increasing the operation of our fabs will probably be done primarily in the Automotive field. Needless to say, there are other non-Auto movements like MCUs in the near term, but this will be the case in the mid- to long-term.

The question of how to operate is as I have said. Based on this outlook, we will formulate a cost outlook, which will naturally be reflected in our profit and loss plans. Does this answer your question or not?

Q: Is it correct to understand that, for example, the Naka Factory is not classified under a certain division or anything?

A: That's what you mean. That will not happen very soon, at least. We've been thinking about it for a long time, and one idea is to categorize into Automotive and others, or focus on product areas and say, for example, this plant mainly handles digital, or only handles digital. Alternatively, a plant may have only power or power and analog. It's true that plants of this nature can be easier to operate in various aspects. But it is impossible in the short run to make this change. We intend to take time so the characteristics of each plant, in terms of application and products, will gradually be enhanced, and that's what is actually happening. I do not think this will be a wildcard or a major variable factor for the profit and loss plan for the next five years.

<Comments from CEO Shibata>

As mentioned at the beginning of this call, we take seriously the fact that in contrary to conventional practices, we have fallen considerably short of our guidance. Based on various considerations, we would like to continue providing guidance that is closer to what we've provided before from the fourth quarter onwards.

And, as I've been mentioning, the market is still very uncertain, and we are not yet in a condition to hold an optimistic outlook. On the other hand, in terms of inventory control, both the company and the channels, especially last year, caused anxiety to all of you, but we have already been able to control it as expected from this year. From the standpoint of preventing opportunity losses, which I mentioned earlier, I am thinking of shifting to a more generous inventory operation next year in some cases. We would also like to update our progress in this area in a timely manner.

Thank you again for taking the time in your busy schedule.

[END]

***This transcript was edited from the original recording and transcript provided by SCRIPTS Asia, Inc.**