Consolidated Financial Forecasts Conference Call (Q&A Session) for Q2 FY2020/12 (Held July 30, 2020) Summary

<Questioner 1>

Q: First of all, Mr. Shinkai explained about the upside in sales. What I don't fully understand is, when you provided the original guidance for the second quarter, you incorporated a downside, but you actually exceeded the guidance. I would like you to explain a little more about your outlook and changes in the actual outcome.

A: As previously explained, when we issued this guidance for the second quarter, we had relatively conservative estimates of risk on both the demand side and the logistics side.

For a more detailed description of the risk, about 40% of the JPY10.2 billion in upside, we had a conservative assumption that there would be pushouts or cancellations in consignment sales and orders received in the distribution channel. But, in fact, they did not materialize.

Another 30% was related to logistics. At the time of guidance, an activity restriction order was put in place in Malaysia, so we anticipated that it would result in a delay in shipments from the back-end process, from the warehouse. But, actually, the impact was not so significant and smooth shipments have led to revenue.

Q: My second question is about inventory. This was also mentioned by Mr. Shinkai in his explanation, but what are your thoughts on the 2Q in-house inventory level at the moment, and what do you envision by the end of September?

Also, I'd like to know about your ideas on how the Automotive channel inventory should look like by the end of September. That's the second question.

A: (Shinkai) First of all, regarding in-house inventory, we expect this to gradually decrease in the third and fourth quarters, to be roughly the same as at the end of the previous year. The impact of this will be reflected in the gross margin impact in the third quarter.

Regarding the channel inventory on the right, we believe that the level at the end of the second quarter is quite excessive, particularly for Automotive, so we expect to decrease it gradually through the third quarter towards an appropriate level.

(Shibata) To add one point, I think other companies in the industry are also doing this, but this time we have begun efforts to adjust order-related lead time to match the industry standard in a sense.

As a result, distributors, especially for sales partners in Japan, we will probably accumulate a little more inventory than in the past. It won't be a very large amount, but we assume that we will operate with about 20% additional inventory compared to before.

We have just begun and there might be some ups and downs along the way, but I appreciate if you understand that there is the possibility of structural changes in the way we hold and view inventory going forward as a result of efforts to match order-related lead times to industry standards.

Q: About that point, for automotive semiconductors, the numbers may not be accurate, but I think there was a movement to change the number of days from about 30 days to 45 days. Are you talking about an additional move to increase the number again?

A: I don't mean to increase it. Again, we have been receiving orders in quite a short lead time so far, especially from Japanese channel partners. We are trying to match the industry's standard lead time this time.

Q: Is it lead time? Excuse me, I misunderstood it as an inventory.

Finally, this is the third question. Regarding the third quarter guidance, the Automotive business is to decline slightly QoQ, while the Industrial/Infrastructure/IoT is to rise slightly. I would like to know about what you see at the moment in terms of when the situation is bottoming out. That is the third question.

A: I understood your question as mainly about the outlook for demand.

It is possible that the situation will change in the future depending on the second and third waves but, as of today, we expect that the second and third quarters for Automotive will decline slightly or be flattish and start up gradually toward the final quarter.

Apart from Automotive, COVID-19 has in fact led to a surge in demand for some applications, and the backlog of these applications is slightly accumulating. So their movement is a little different, where they would keep catching up through the third quarter, and the fourth quarter may show a little decline in reaction.

In general, for the non-Automotive businesses, we expect a curve of stronger results in the third quarter and a return to normal levels in the fourth quarter. For the Automotive business, we expect performance to remain near bottom through the second and third quarters and rise through the fourth quarter.

<Questioner 2>

Q: I have a similar question. With regards to the inventory adjustments going forward, you mentioned that channel inventory will be adjusted toward the end of 3Q. Could you please tell us how long will it take to reach an appropriate level?

In particular, I think BCP inventory is at a higher level than before due to concerns about the second wave of COVID-19 in the entire industry. Therefore, it is a little difficult for us to understand the appropriate inventory level so, from your company's viewpoint, will you tell us first how much it will take for this channel inventory to be adjusted?

A: When we talk about adjusting inventory, it may sound somewhat negative but, as I mentioned earlier, there was one change: demand dropped sharply due to COVID-19, and it suddenly came back again. In addition, the other thing I have just mentioned is that we are adjusting the lead time for orders from this time. We expect this to lead to a small increase in appropriate inventory levels in the channel.

On that front, I think it will be from next year's first quarter to the second quarter that we will reach a normal state. Before that, I think there will be some trials and errors leading to ups and downs, so I think that it will be around first quarter, second quarter of next year that the steady state will be achieved.

I understand that the core of your question is whether there is a sense of surplus, or excess, in terms of the overall level of inventory. This is hard to determine, as it depends on the correlation between the amount of inventory and the sales outlook but, at the moment, I think there is a feeling that inventory is slightly excessive and stagnant in the channel. In a usual state, you can expect a curve that converges to an appropriate level from the third quarter towards the end of the year.

But in addition, sorry to be persistent, but as I mentioned earlier, we are changing the lead time for order placement and receipt, so it is fully possible that inventories in channels will move at a high level, say toward the end of the year; at least until next year's second quarter. We assume that it wouldn’t make much sense to dig too deep into the causes of quarterly changes in inventory, given the situation, so I appreciate your understanding of that sentiment.

Q: Thank you very much.

So in that sense, it will take some time until the first half of next year to adjust or normalize inventories. I think that the run rate in the front-end process is about 65% or 70%, so is it correct to assume that it is quite unlikely that the utilization rate would recover to around 70%?

A: Rather than because of inventory adjustments, I think that factory utilization is more dictated by the demand outlook.

Based on what we see now, I feel that 70% is a bit strong. Many of the products manufactured at our own plants are used for automobiles, and various organizations are publishing reports that often say that it will take about two years for automobile production to return to the level of last year. Therefore, we believe that it will take about as long for plant utilization to go up.

Q: Thank you very much.

Finally, Mr. Shibata said at the beginning that he is feeling more assured about the outlook. Could you tell us a little more about what has changed specifically and how you feel compared to the previous guidance?

A: For the non-Automotive businesses, I remember saying last time that overall performance is fairly solid, although there are differences depending on the content. That hasn't changed as of today, and I think it's just a little more positive. In particular, I personally feel that the outlook toward the end of the year has become slightly more positive than last time.

Our sentiment changed greatly mainly for the Automotive business. When we provided the guidance last time, we had a considerable anxiety about how far this would fall or how long the trough would continue.

Again, this time we have adjusted the lead time for orders, so we now have considerable future visibility. Therefore, one factor is that visibility of orders we receive has improved, making it easier to make a prospect, whether in a good or bad sense.

In addition, I don’t think this is a factor unique to us, but automobile production is recovering quite positively within our assumptions. As repeatedly stated, we operate while assuming a certain range of demand, and it seems that it is now moving closer to the high end of that range. As a result, I’m saying that we have raised comfort levels, particularly for this year's outlook.

<Questioner 3>

Q: I have just one question. You mentioned that improving the product mix has increased profitability, but could you please elaborate on this point in more detail?

I imagine it is for data centers in Industrial/Infrastructure/IoT, but I’d like to know how it will be improved, and whether there is improvement in the Automotive business, and how will it continue in the future?

A: There are two major improvements in the product mix. Looking at the whole company, the volume of business for Automotive is decreasing, while Industrial/Infrastructure/IoT is increasing in comparison. As there are gaps of 20 percentage in the gross margin, this will make a significant positive contribution to the gross margin for the company as a whole, about half the contribution of the product mix.

The other is improving the production mix within the Automotive business. This contributed to the second quarter, as sales of Automotive products with relatively low margins decreased.

In terms of continuity, the former will decrease when the business for automobiles recovers. The latter may be temporary or continuous, and we believe that this will be a part of the improvement in the product mix in the future.

<Questioner 4>

Q: First of all, for your company's non-Automotive business related to data centers, and the network-related robust performance in the first half may partly continue in the second half of the fiscal year. I would like to hear additional comments regarding the soundness of the releases related to infrastructures in 3Q.

A: First, I can try explaining about the outlook for the third quarter, focusing on the data center business.

For data centers, we are looking to a relatively strong performance at the same pace as before. This is a sequential growth of roughly double digits. On a YoY basis, we expect growth to continue at 30 to 40%, and it is an extremely important driver of data center growth.

Next, in Infrastructure as a whole, as I've been mentioning from before, 5G base stations are starting up very strongly. But, in turn, 4G base stations have fallen considerably, so the infrastructure business as a whole has been in a state of muted or sometimes slightly negative growth.

From the second quarter to the third quarter, the base station business inevitably moves in a lumpy way each quarter, so there are some areas that do not necessarily make a clean picture. In general, however, I feel that 5G will decline slightly in a sequential manner.

However, on a YoY basis, the growth rate is close to 100%, and I think the current situation is that the data center and 5G growth stories I have discussed so far have not changed. For data centers in particular, we are seeing slightly stronger growth than I had previously mentioned. I'll stop here for now.

Q: Thank you very much.

Second, JEDEC has decided the new DDR5 standards and final specifications recently, so I would like you to explain in detail how your memory interface-related business will grow from here.

A: Similarly to the base station business, this can also be a little lumpy or choppy. You might remember the inventory adjustments in channels and users, especially last year. As a result of these factors, sales do not necessarily grow in a linear fashion, but DDR5 you have pointed out will certainly be an extremely large growth driver and, as a result, we have very positive expectations for the memory interface business. We are bullish.

Q: I see. Thank you very much.

My last question concerns the outsourcing ratio of foundries. What is the second quarter track record and growth outlook in the third and fourth quarters?

A: The foundries do not go up or down so much on a quarterly basis, but it's about 40% on a value basis. This is about wafer foundries.

In particular, in the Automotive business, 40 nm MCUs, an MCU called RH850 and SoC have been continuously starting up and growing in scale. As all of this is outsourced to foundries, so you can be sure that it will continue to rise constantly in the future.

Q: For SoCs, are you seeing positive growth from this second quarter to the third and fourth quarters?

A: That’s hard to say. SoC has a very long lead time. Combined with the lead time adjustments I mentioned earlier, it will probably look like it has slowed down a bit sequentially in the third quarter.

However, on a half-year or annual basis, it is going up at a considerable pace, and especially now, third generation is finally starting up, now accounting for about 10% of total SoC. As it expands on a major scale, we expect that business will grow considerably over the next year.

<Questioner 5>

Q: First in the Automotive business, NXP, which announced financial results the other day, expects QoQ growth of 20%, which is a considerably stronger recovery outlook compared to your flat projection. In terms of the number of automobiles produced, I assume it will probably return even more between April-June and July-September. Please explain a little about why you expect flat growth, is it because of inventory? This is the first question.

A: In short, we think it's inventory. Looking at our revenue, the customers we sell directly to, mainly non-Japanese companies, tend to move in the same way as other companies in the industry.

On the other hand, there is a channel in between for Japanese customers, which made the decline much more moderate, but we believe the way up will also be moderate.

Q: As a follow-up on this point, is it correct to understand that now recovery is in sight for unit production, which is why the outlook is a little brighter for the automotive business?

A: Yes. That's fine.

Q: I see. Thank you very much.

Second, what do you think is the impact of the temporary demand for work-from-home and stay-home products? I understand you have been saying that products for PCs and others will fall by 4Q, but if you have an idea of scale, I would like to know how much products that are not likely to last long are currently included in this Industrial/Infrastructure/IoT category, such as medical devices and PCs.

A: I don't feel like I can answer with much confidence, but I don't think the impact is that big. Perhaps at most, there might be a temporary demand in the lower billions of yen, which would decline going forward.

The reason I’m saying this is, compared to the last time I talked to you, the demand for PCs and tablets seems to last a little bit longer, doesn't it?

Looking at our orders, demand seems to continue in an unexpected way. In particular, we are seeing constant orders from the education market, so we are a bit surprised. We had expected to see a sudden surge in the first half of this year and a sudden fall in the second half, but that doesn’t seem to be the case anymore.

So, the temporary demand that rises and falls is really about consumers buying PCs or home printers, so the impact of the drop may be much smaller than we initially expected. Sorry, but partly because of that, we haven't been monitoring this area very carefully.

Q: I see. What about medical devices?

A: The monetary amount from medical equipment is originally small, but it is hard to determine, in a good way so to speak. At present, we still have a strong outlook for the rest of the year. But there is no change in what I say or think from last time, and we still think that adjustments might happen somewhere, but I'm not saying this on very solid grounds, just that we'll be happy if it would keep going as strongly as it is. The amount is small.

Q: I see.

Finally, I would like to ask for management's current view on the annual outlook. Is it correct to say that, in your view, the Industrial/Infrastructure/IoT business is solid, supported by anticipated 5G and demand from data centers, and Automotive applications are returning as well, so you are somewhat more optimistic about the outlook, and your strategic focus on recovery and growth of business performance seems to be working?

A: I'm not so confident as to say such a bullish statement, but we do feel much more relaxed compared to the last time we talked.

In the non-Automotive businesses, there is little change, in a good sense. However, although this is not the same as with demand for PCs in the education market I just mentioned, particularly after the acquisition of IDT, sensors and sensor signal conditioners have joined our portfolio, which naturally has grown and inquiries have increased significantly. So I think that this area will generally be a tailwind in the post COVID-19 situation.

Again, the total demand for automotives will sink considerably, so it may take some time before we return to strong growth in our final figures. We will talk about this next week.

Then, because the Automotive has long lead times, a considerable amount of time is needed before the results start appearing in the income statement. This can't be helped.

On the other hand, if we look at the progress we have made with regard to the current design-in and lineup of solutions, we can see a considerable degree of progress along with our strategies. In that sense, I think things are getting better than when we talked about our medium-term strategy in February.

However, in the short term, we expect the overall demand for cars will continue to be tough for the next two years or so, so we have to exert a little more wisdom on how to perform during this period.

I think that the figures have supported the view that, we don't see a need for drastic change because of the current COVID-19 or the slowdown in the economy as a whole, but we should rather think of where to tweak while keeping our direction we have been taking up to the present time.

[END]