Q2 2019 Earnings Call

Company Participants

- Beatrice F. Russotto, Director, Investor Relations
- Hock E. Tan, President and Chief Executive Officer
- Thomas Krause, Chief Financial Officer

Other Participants

- Blayne Curtis, Analyst
- Chris Caso, Analyst
- Chris Stanley, Analyst
- Craig Hettenbach, Analyst
- Harlan Sur, Analyst
- John Pitzer, Analyst
- Matthew D. Ramsay, Analyst
- Ross Seymore, Analyst
- Timothy Arcuri, Analyst
- Toshiya Hari, Analyst
- Vivek Arya, Analyst
- William Stein, Analyst

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Q2 2019 Broadcom Earnings Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions will follow at that time. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to introduce your host for today's call, Ms. Beatrice Russotto, Director, Investor Relations. Ms. Russotto, you may begin.

Beatrice F. Russotto {BIO 20827438 <GO>}

Thank you, operator, and good afternoon, everyone. Joining me today are Hock Tan, President and CEO; and Tom Krause, Chief Financial Officer of Broadcom. After the market closed today, Broadcom distributed a press release and financial tables describing our financial performance for the second quarter of fiscal year 2019. If you did not receive a copy, you may obtain information from the Investors section of Broadcom's website at broadcom.com.

This conference call is being webcast live and the recording will be available via telephone playback for one week. It will also be archived in the Investors section of our website at broadcom.com.

During the prepared comments section of this call, Hock and Tom will be providing details of our second quarter fiscal year 2019 results, guidance for fiscal year 2019 and commentary regarding the business environment. We will take questions after the end of our prepared comments.

Please refer to our press release today and our recent filings with the SEC for information on the specific risk factors that could cause our actual results to differ materially from the forward-looking statements made on this call.

In addition to US GAAP reporting, Broadcom reports certain financial measures on a non-GAAP basis. A reconciliation between GAAP and non-GAAP measures is included in the tables attached to today's press release. Comments made during today's call will primarily refer to our non-GAAP financial results.

So with that, I'll now turn the call over to Hock.

Hock E. Tan {BIO 1460567 <GO>}

Thank you, Bea, and thank you everyone for joining in today.

Let me touch on the second quarter results, after which I will update you on the current environment and our outlook for the second half of the year. Looking at the second quarter just passed, it really went as planned. Networking continued to perform very well and our broadband business started to recover. This was offset by the anticipated sharp decline in wireless, and the ongoing softness in storage.

On the other hand, the infrastructure software business delivered solid top line results, benefiting from the sustained enterprise demand for our mainframe and distributed software, as well as SAN switching products.The integration of CA is progressing well. Just last week, we reached a major milestone with day 2, which is the integration of the CA's business processes onto Broadcom's IT platform. We remain confident that we can meet, if not exceed, the long-term revenue and profitability targets that we laid out for CA to you last year. Renewals in our CA business are strong and the dollar commitments from our core customers continue to grow.

Now let me address the current business environment and our outlook for the remainder of the year. We have, as I indicated, performed very much to plan in the first half of fiscal '19. And in the second half, we had expected a recovery. However, while enterprise and mainframe software demand remained stable, particularly in North America and Europe, with respect to semiconductors, it is clear that the US-China trade conflict including the

Huawei export ban is creating economic and political uncertainty and reducing visibility for global OEM customers. As a result, demand volatility has increased and our customers are actively reducing inventory levels to manage risk. This leads us to believe the second half of 2019 will be more in line with the first half as opposed to the previously expected recovery.

We now anticipate fiscal 2019 Semiconductor Solutions segment revenue of $17.5 billion, which translates into a year-over-year decline in the high-single digits. CA's software continues to perform above our original expectations while SAN switching is slowing down after a very strong first half. As a result, we are maintaining our fiscal 2019 infrastructure software outlook at $5 billion.

While this scenario has been playing out, I should emphasize the fundamentals of our business remains very much intact. We continue to execute on a very rich roadmap for next-generation network switching and routing in the cloud and enterprises, including the leading edge Trident 4 software-defined network switch just recently announced this week.

We have also secured the next two generations of RF front-end at a large North American OEM, which positions us very well for the transition into 5G. We continue to win increasing numbers of compute offload accelerators in the hyper cloud operators across AI, video transcoding, encryption and networking. We are pleased with the ramp of our new generation Wi-Fi 802.11ax, otherwise called Wi-Fi 6 in the enterprise gateways and carrier access points. All these leaves us confident that we will be able to continue to drive sustained long-term revenue growth and increasing free cash flow.

Let me now turn it over to Tom, who will provide you with more color.

Thomas Krause {BIO 17978469 <GO>}

Thank you, Hock.

Consolidated net revenue for the second quarter was $5.5 billion, a 10% increase from year ago, and EPS came in at $5.21, a 7% increase from a year ago off of a 448 million weighted average fully diluted share count. In addition, we had record free cash flow of $2.54 billion or 46% of revenue. Free cash flow grew 20% year-over-year.

The Semiconductor Solutions segment revenue was $4.1 billion and represented 74% of our total revenue this quarter. This was down 10% as expected year-on-year on a comparable basis. Our Infrastructure Software segment revenue was $1.4 billion and represented 26% of revenue.

Let me now provide additional detail on our financial performance. Operating expenses were $1.02 billion. Operating income from continuing operations was $2.95 billion and represented 53.5% of net revenue. Adjusted EBITDA was $3.11 billion and represented 56.4% of net revenue. This figure excludes $142 million of depreciation.

Receivables in the quarter decreased to $193 million and inventory decreased $40 million from the prior quarter. I would also note that we accrued $136 million of restructuring, integration expenses and made $218 million of cash restructuring and integration payments in the quarter. Finally, we spent $125 million on capital expenditures. In the second quarter, we returned $2.4 billion to stockholders consisting of $1.1 billion in the form of cash dividends and $1.3 billion for the repurchase and elimination of 4.7 million of AVGO shares.

We ended the quarter with $5.3 billion of cash, $37.5 billion of total debt, 399 million outstanding shares and 447 million fully diluted shares outstanding. We also refinanced our $18 billion of term loans that we put in place at the beginning of fiscal 2019 to finance the CA acquisition. Via the combination of $11 billion of investment grade bonds and a new term loan, we were able to extend our average debt maturity to approximately five years and substantially reduced the quantum of debt due in any one year. As of today, our average cost of borrowing stands at approximately 3.7%.

Turning to our fiscal year 2019 guidance, as Hock discussed, we are updating our full-year revenue guidance to $22.5 billion, including approximately $17.5 billion from Semiconductor Solutions and approximately $5 billion from Infrastructure Software, IP licensing is not expected to generate a material amount of revenue.

On a non-GAAP basis, operating margins are expected to be approximately 52.5%, an increase of approximately 150 basis points from prior guidance. Net interest expense and others expected to be approximately $1.3 billion. We do not contemplate any debt paydown in fiscal year 2019. The tax rate is forecasted to be approximately 11%, depreciation is expected to be approximately $600 million, CapEx is expected to be approximately $500 million.

As a result, free cash flow is expected to be approximately $9 billion, which takes into account projected restructuring integration charges of approximately $1.1. billion. Stock-based compensation expense is expected to be approximately $2.2 billion. And finally, we expect a weighted average diluted share count to be 444 million for Q3 and 443 million for Q4 and this excludes any impact from share buybacks and eliminations.

Now on the capital allocation. Our capital allocation strategy remains the same. We plan to maintain the current quarterly dividend payout of $2.65 per share throughout the year subject to quarterly Board approval, which means we plan to payout over $4 billion in cash dividends in fiscal 2019. In addition, we remain committed to buying back and eliminating a total of 8 billion of stock in fiscal 2019. In the first half of the fiscal year, we have spent $4.8 billion for the repurchase and elimination of shares.

That concludes my prepared remarks. During the Q&A portion of today's call, please limit yourself to one question each, so we can accommodate as many analysts as possible. Operator, please open up the call for questions.

Questions And Answers

Operator

Thank you. (Operator Instructions) Our first question comes from Vivek Arya with Bank of America.

Q - Vivek Arya {BIO 6781604 <GO>}

Thanks for taking my question. Hock, in the $2 billion or so reduction in the semiconductor outlook for the next two quarters, can you give us some sense, how much of that is Huawei, how much is outside of Huawei, and just any segment level impact so we can calibrate our models? Thank you.

A - Hock E. Tan {BIO 1460567 <GO>}

Well, it's an interesting way to figure that out because in terms of full disclosure, Huawei represented last year about $900 million of revenues for this Company by itself. But the other side of the picture I should add is that guide down that we're providing as you put it of $2 billion obviously extends beyond just one particular customer. We are talking about uncertainty in our marketplace, uncertainty because of that -- of demand in the form of order reduction as the supply chain of that constricts, compress so to speak, and because we do see to some extent end users in the US, particularly in North America and Europe, continuing to be there, but what we do see in between is the uncertainty of the environment has put in place a concern about placing additional orders and actively a reduction of inventory out there. Basically, a compression of supply chain is what's driving this reduction more than anything else and it's broad based.

Operator

Thank you. Our next question comes from Blayne Curtis with Barclays.

Q - Blayne Curtis {BIO 15302785 <GO>}

Hey guys. Thanks for taking my question. Maybe I guess follow-up on Vivek's question. Hock, just kind of curious as you look, I mean I think markets were soft and you saw a lot of revisions last quarter, you guys kind of maintain your forecast. I'm kind of just trying to figure out when you saw the slowdown, if you can give us any idea of that and then is there just any more color you can add per end market? Is there any end markets that you're not seeing this weakness and if you can point to any particular product that would be helpful?

A - Hock E. Tan {BIO 1460567 <GO>}

Well, we started seeing this softness as we -- basically the beginning of this quarter, right, Q3, very much so and dramatic reduction and it particularly accelerated with the de novo order that was impulse on Huawei.

Operator

Thank you. Our next question comes from Harlan Sur with JP Morgan.

Q - Harlan Sur {BIO 6539622 <GO>}

Good afternoon. Thanks for taking my question. On the networking side specifically that's been a strong area for the team growing double digits year-over-year for the past few quarters. And it's been area where you guys actually do have some pretty strong product cycles like Tomahawk 3, Jericho 2, some of your compute offload ASICs [ph]. In your revised outlook ex-Huawei, how is the macro uncertainty impacting this segment in some of these programs and again ex-Huawei, would you expect the networking business to grow second half over first half?

A - Hock E. Tan {BIO 1460567 <GO>}

Harlan, very good question. Our networking business, which I think is what you're referring to continues to be a very strong business. Year-on-year, we expect our networking -- total networking business to grow double-digits year-on-year, it's strong, particularly with new product ramps and new product cycles that we're seeing both in switching, routing related to that, it is the -- it is one of the brightest areas in our portfolio in this environment and continues to be strong, notwithstanding the export ban on Huawei.

Operator

Thank you. Our next question comes from Ross Seymore with Deutsche Bank.

Q - Ross Seymore {BIO 20902787 <GO>}

Hi, Hock. Thanks for letting me ask the question, I wanted to go into the wireless side. I know you just signed a supply agreement with a large North American customer. They typically have positive second half seasonality and most of us believe you actually were regaining some share. So when I put that all into the mix, how are you getting, especially given what you just said networking growing double digits, how are you getting the second half to be relatively flat with the first half? Is there some offsets in other areas or are some of our assumptions in wireless incorrect?

A - Hock E. Tan {BIO 1460567 <GO>}

Well, I don't know what the assumptions are Ross on wireless, but networking is about really do very -- is above the only area of strength in this current environment and that's because it coincides with very strong product cycles we have seen. In just about broadly any other end-market segments, we do not see in terms of year-on-year improvement from 2018.

Operator

Thank you. Our next question comes from Timothy Arcuri with UBS.

Q - Timothy Arcuri {BIO 3824613 <GO>}

Hi Hock. I have just had a question about the competitive environment for your RF front end business, as we kind of move into 5G and particularly around a large motor maker now that's talking about having a complete RF package and sort of being able to sweep that in with their modems. So can you kind of talk about the competitive environment and your position as you kind of get into 5G? Thanks.

A - Hock E. Tan {BIO 1460567 <GO>}

That's a very interesting question. We continue to believe we are very, very strongly positioned and it's many ways validated by the data points I just mentioned. We have by far the best technology and products out there in RF front end components, that's typically the filters and the integrated front-end modules. We re by far the farthest ahead technology-wise and in terms of capabilities and we continue to believe we are still very much in front. And as I say is pretty validated and continues to be validated by the value we give to our very critical customers and fact that they continued through being very supportive of our business.

Operator

Thank you. Our next question comes from Toshiya Hari with Goldman Sachs.

Q - Toshiya Hari {BIO 6770302 <GO>}

Hi, guys. Thanks for taking the question. I had a question on RF as well. Hock, can you remind us what kind of content growth are you expecting or assuming into the back half, both on the RF side, as well as the Wi-Fi side of your business within wireless and then you also talked about 5G or rather how the recent win positioned you well into 5G. As of today, what you know based on what you've heard from our customers, what kind of content growth on the RF side are you expecting as we transition to 5G over the next couple of years? Thank you.

A - Hock E. Tan {BIO 1460567 <GO>}

Thank you. Well, asking year-on-year as you see is very difficult. So I appreciate your asking me what do I see over the next two, three years on content growth, and I mean, the best way to describe content growth in RF and within that we have empirical evidence of that for the last five years, even longer, and not the same every year, is that annually we probably see in the 5% to 10% range content growth and with -- in terms of the products we ship. Now for the entire I guess a bit of -- to serve available market, it's probably a smaller growth percentage.

Operator

Thank you. Our next question comes from John Pitzer with Credit Suisse.

Q - John Pitzer {BIO 1541792 <GO>}

Yeah, good afternoon guys. Hock, I just want to go back to Ross' question about the wireless guide for the balance of the year. I'm just curious, relative to 90 days ago when you guys were kind of guiding the overall semi business well above normal seasonality for the balance of the year and now you're talking about a flat half to half. To what extent did your content expectations come down to the back half of the year versus just this really being a unit issue on the wireless side of the business?

A - Hock E. Tan {BIO 1460567 <GO>}

Well, that's an interesting question that lays out that way. It's -- keep in mind, we're taking a very conservative stance here and very frankly even as we see the ramp-up and we do see the ramp-up, we have also been forecasting a fairly dramatic set of numbers before. And when you -- and that is more than offset by the fact that for the ramps of the broader market, we're just seeing a demand environment that is extremely uncertain.

Operator

Thank you. Our next question comes from Craig Hettenbach with Morgan Stanley.

Q - Craig Hettenbach {BIO 6185428 <GO>}

Yes. Thanks, Hock, just coming back to the compute offload, you talked about it at Hyperscale, I know a little while back you guys talked about some initial traction to ASICs. Just wanted to get an update in terms of the breadth of that particular Hyperscale is and how to extent that you're extending that to multiple customers as we look forward?

A - Hock E. Tan {BIO 1460567 <GO>}

Well, I have mentioned before in previous calls -- earnings calls about our focus and increasing traction in what we call compute offload engines, or I call it compute offload accelerators in multiple areas including AI, of course, virtualization, orchestration from the compute servers, and expanding net amount of video transcoding and encryption. And we continue to see that and it is an emerging space, it's from our perspective, but nonetheless, it's a space that seems to be growing very steadily and continuing to trend up very significantly.

And this is a space we believe at the end of -- in matter of three years to five years, could be a significant percentage of the total compute spend within any large scale datacenter. And we're talking about potentially getting to perhaps even as high as 25% or more of total spend in the computing environment of a large scale cloud datacenter.

Operator

Thank you. Our next question comes from Chris Stanley with Citi.

Q - Chris Stanley {BIO 17975205 <GO>}

Hey. Thanks guys. Just looking at the overall environment, Hock, do you think your guidance incorporates the proposed next round of $300 billion in tariffs, i.e. if that thing does go through, do you still feel good about your guidance or do you think there could be more downside if it does go through?

A - Hock E. Tan {BIO 1460567 <GO>}

I think at this point, we try to capture everything including that proposed next round into the picture. We are of the belief that things are -- environment is very, very nervous. And that's why we see a very, very sharp and rapid contraction of supply chain and orders out there from our customers, especially of global OEM customers. Even as we believe, as I mentioned, in North America and Europe, end demand hasn't reflected there. So we are seeing a very reactive mode here.

And so I got to believe that includes the sense that this $300 billion mix from potential tariffs could be in place. Also keep in mind and something I should add is that, even as we see some -- and on that, two parts of this. One part is what's the impact of the Huawei ban on a company like us selling components and technology? Well, short term, keep in mind, we'll see a very sharp impact, simply because no purchase of a lot. And there is no obvious substitution in place from other OEMs replace picking over end demand, which may exist, which may continue to exist.

Give it a few months, give it six months, if those end demand still remains out there, we'll see other OEMs qualified to take over those the replace Huawei on those demand and other OEMs will come in. And those OEMs will continue to buy our products. And so we have a rebalancing and readjustment in demand from our side. But short term, we do not expect to see that.

Operator

Thank you. Our next question comes from William Stein with SunTrust.

Q - William Stein {BIO 15106707 <GO>}

Great, thanks for taking my question. On a brighter note, I'd like to ask about CA, a little bit. Last quarter, Hock, I think you talked about at least one proof point with regard to sort of a deeper engagements with CIOs around a deal that might involve both sides of the business. Anything similar to that, where you see more proof points -- more proof points around traction and the sort of the strategic approach in that acquisition? Thank you.

A - Hock E. Tan {BIO 1460567 <GO>}

Well, yes, one of the things we are doing is, as we said last time is, as we focus on core accounts as I said, these are the largest enterprises in the world, who buys a lot of software infrastructure and infrastructure software. And given the broad portfolio of products CA has that we bring back between mainframes and these largest companies mostly a lot -- runs a lot of mainframe capacity and distributed software in infrastructure. And our ability to offer this as an enterprise and portfolio-wide transaction, we've been very, very successful in securing such enterprise-wide contracts. with significant uplift in booking dollars on the form of larger amount of renewals, with right now over 20 large accounts in the six months since we've taken over and closed on this transaction. And we foresee that rate being even higher over the next six months. So that's working and that's working very well, which gives -- which allows us to gives you a fairly positive tone to how the CA business has been trending as far as we're concerned, putting in the nutshell, and I said that earlier, the amount of dollar commitments we've been able to achieve, compared to what expires has increased quite significantly.

Operator

Thank you. Our next question comes from Matt Ramsay with Cowen.

Q - Matthew D. Ramsay {BIO 17978411 <GO>}

Thank you very much. Good afternoon. Hock, I wanted to ask a little bit about, obviously, we talked about the demand environment and the trade environment a bit, but I wanted to ask a little bit about the M&A environment as you see it. Obviously, CA scoped the company in a little bit of a different direction, but we've seen some semiconductor mergers announced here very recently and I wonder if you might give us a little bit of a view on the M&A environment as you see it right now on the semiconductor side? Thank you.

A - Hock E. Tan {BIO 1460567 <GO>}

Oh, you're saying M&A environment in the semiconductor space? Yes, I see what you see there which is some level of activity that seems to go on, and it's quite interesting, in a way, quite encouraging for us to see that the direction we've taken a large part of this industry seems to be making sense to a lot of our peers too. And from our point of view, we welcome it.

And as I've indicated before in previous earnings call, for us, it's what's makes sense, what's actionable in terms of our businesses that our franchises that we see as very sustainable and that we are able to acquire. But right now, we see a lot of movements, but we -- and we are very -- we continue to be very interested in opportunities that may present themselves, and we continue to be very active in assessing those opportunities.

Operator

Thank you. And our final question will come from Chris Caso with Raymond James.

Q - Chris Caso {BIO 4815032 <GO>}

Yes, thank you. Hock, I just wanted to return to some of your questions -- some of your comments rather regarding inventory and you talked about the customers reducing inventory. Do you think that the inventory levels at the customers were elevated coming into the quarter? Or is this just a situation where the customers are reducing inventory proactively because of the uncertainty? I guess the question is, how much of the weakness you see here is driven by inventory reductions as opposed to demand?

A - Hock E. Tan {BIO 1460567 <GO>}

I think what we're seeing a lot here because overall demand weakness or uncertainty probably started even before this quarter began. But the sharpness in terms of demand contraction -- demand reduction as you say, is coming from the fact that customers are even more aggressively now trying to reduce inventory out there. And a lot of it is customer inventory that we are talking about directly.

As you noticed in our -- on our balance sheet, our inventory has been very well managed, tightly managed and we continue to be very, very consistent through all this in the range of 60 days, 65 days of inventory. So it's -- this reduction is very much an action of our -- of the supply chain of the end user, which really reflects on our direct customers, where there's a been a sharp reduction of inventory out there. And are we talking significant? Yeah. We believe it is -- what we have seen is very significant and we anticipate that to continue, which reflects in our revised guidance for the rest of this year, which is the next less than six months out there. Beyond that, who knows.

Operator

Thank you. Ladies and gentlemen, thank you for participating in today's Q&A session as well as today's conference call, This concludes the program. You may all disconnect and have a wonderful day.